Stock Market Integration Between the Hong Kong SAR
and the People's Republic of China -
the Use of a Revised 'H' Share Model
and Enhanced Institutional Support

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ABSTRACT

Stock Market Integration Between the Hong Kong SAR and the People’s Republic of China – the Use of a Revised ‘H’ Share Model and Enhanced Institutional Support

Bilateral, multilateral and regional linkages between stock exchanges generate increased sources of funds, investor return and product choice. Such associations can also lower transaction costs in both initial listing and subsequent trading, increase liquidity more generally in the secondary market and enhance investor protection and confidence in the stability and reputation of the market and the status of companies listed on the market. This thesis argues that the integration of the stock markets between The Special Administrative Region of Hong Kong ("Hong Kong") and the People’s Republic of China ("PRC") is therefore a desirable objective and investigates how a more successful and substantial degree of integration could be achieved in this area.

Integration, in particular, requires harmonization of laws and regulations. In 1993, H shares issued by PRC companies were first allowed to cross-list on the Hong Kong Stock Exchange. This listing was made possible by the introduction of a new set of legal and operational rules promulgated in both the PRC and Hong Kong.

This thesis expounds four models of integration, the H Share Model, the System Harmonization Model, the Mixed Harmonization and Mutual Recognition Model, and the Full Harmonization Model and argues that H share regulations are an effective way to further integration despite problems inherited from the PRC’s ‘pre-open door’ policy.

In considering other potential models, the European Union and the United States capital market are also considered as potential models for further integration of the PRC and Hong Kong stock markets despite the inherent limitations of the latter model.
It is also proposed that enhanced institutional support can be used as an effective means of accelerating the integration process. Investigating both the feasibility and possible implementation of market integration within an appropriate institutional framework ensures an autonomous, legal and independent environment separate from the political realm.
**ABBREVIATIONS**

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<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>ADR</td>
<td>American Depository Receipt</td>
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<td>AFTA</td>
<td>ASEAN Free Trade Area</td>
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<td>AMS/3</td>
<td>Third Generation Automatic Order Matching and Execution System</td>
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<td>APEC</td>
<td>Asia-Pacific Economic Co-operation</td>
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<td>ARF</td>
<td>ASEAN Regional Forum</td>
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<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
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<td>ASEM</td>
<td>Asia Europe Meeting</td>
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<td>BVLP</td>
<td>Bolsa de Valores de Lisboa e Porto, the Portuguese exchange</td>
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<td>CARD</td>
<td>Consolidated Admission and Reporting Directive</td>
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<td>CCASS</td>
<td>Central Clearing and Settlement System</td>
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<td>CDR</td>
<td>China Depository Receipt</td>
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<td>CEPA</td>
<td>Mainland and Hong Kong Closer Economic Partnership Agreement</td>
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<td>CESR</td>
<td>Committee of European Securities Regulators</td>
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<td>CSRC</td>
<td>China Securities Regulatory Commission</td>
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<tr>
<td>EAEC</td>
<td>East Asian Economic Caucus</td>
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<td>ECJ</td>
<td>European Court of Justice</td>
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<td>ECSC</td>
<td>European Coal and Steel Community</td>
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<td>EP</td>
<td>European Parliament</td>
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<tr>
<td>ESC</td>
<td>European Securities Committee</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
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<td>G30</td>
<td>Group of Thirty</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GEM</td>
<td>Growth Enterprise Market of The Stock Market of Hong Kong Limited</td>
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<td>GEM Listing Rules</td>
<td>Rules Governing the Listing of Securities on the Growth Enterprise Market</td>
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<td>HK$</td>
<td>Hong Kong dollar</td>
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<td>HKATS</td>
<td>Hong Kong Futures Automated Trading System</td>
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<td>HKEx</td>
<td>Hong Kong Exchanges and Clearing Limited</td>
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**Abbreviations**

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<tr>
<th>Abbreviation</th>
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<tr>
<td>BKFE</td>
<td>Hong Kong Futures Exchange Limited</td>
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<td>HKFRS</td>
<td>Hong Kong Financial Reporting Standards</td>
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<td>HKMA</td>
<td>Hong Kong Monetary Authority</td>
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<td>HKSCC</td>
<td>Hong Kong Securities Clearing Company Limited</td>
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<tr>
<td>HKSE</td>
<td>The Stock Exchange of Hong Kong Limited</td>
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<td>IFRS</td>
<td>International Financial Reporting Standards</td>
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<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
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<td>IPO</td>
<td>Initial Public Offering</td>
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<tr>
<td>LIFFE</td>
<td>London International Financial Futures and Options Exchange</td>
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<td>Listing Rules</td>
<td>Listing Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Ltd.</td>
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<td>MJDS</td>
<td>Multi-Jurisdictional Disclosure System</td>
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<td>MOF</td>
<td>Ministry of Finance</td>
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<td>MOFCOM</td>
<td>Ministry of Commerce</td>
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<td>MTF</td>
<td>Multilateral Trading Facilities</td>
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<td>NASDAQ</td>
<td>National Association of Security Dealers Automated Quotation Service</td>
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<td>MIFID</td>
<td>New Investment Services Directive</td>
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<td>NPC</td>
<td>National People's Congress of the People's Republic of China</td>
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<td>NSMIA</td>
<td>National Securities Markets Improvement Act</td>
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<td>NYSE</td>
<td>New York Stock Exchange</td>
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<td>OECD</td>
<td>Organization for Economic Co-operation and Development</td>
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<td>PBOC</td>
<td>People's Bank of China</td>
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<tr>
<td>PRC</td>
<td>People's Republic of China, excluding Hong Kong and Macau for the purpose of this thesis</td>
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<td>QDIIs</td>
<td>Qualified Domestic Institutional Investors</td>
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<td>QFIIs</td>
<td>Qualified Foreign Institutional Investors</td>
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<tr>
<td>RMB</td>
<td>Renminbi, the official currency in the People's Republic of China</td>
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<tr>
<td>RTGS</td>
<td>Real Time Gross Settlement</td>
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<tr>
<td>SAFE</td>
<td>State Administration of Foreign Exchange</td>
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<td>SASAC</td>
<td>State-owned Asset Supervision and Administration</td>
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<td>SCMP</td>
<td>South China Morning Post, a reputable English newspaper in Hong Kong</td>
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Abbreviations

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<th>Abbreviation</th>
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<td>SCREC</td>
<td>State Commission for Restructuring the Economic System</td>
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<td>SCSC</td>
<td>State Council Securities Committee</td>
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<td>SEC</td>
<td>Securities Exchange Commission (US)</td>
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<td>SEM</td>
<td>Single European Market</td>
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<td>SFC</td>
<td>Hong Kong Securities and Futures Commission</td>
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<tr>
<td>SFO</td>
<td>Securities and Futures Ordinance (Cap. 571)</td>
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<td>SOEs</td>
<td>state-owned enterprises</td>
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<tr>
<td>SPC</td>
<td>State Planning Commission</td>
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<tr>
<td>SSE</td>
<td>Shanghai Stock Exchange</td>
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<td>SZSE</td>
<td>Shenzhen Stock Exchange</td>
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<td>TraHK</td>
<td>Tracker Fund of Hong Kong</td>
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<td>UCITS</td>
<td>Undertakings for Collective Investment in Transferable Securities</td>
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<td>UK</td>
<td>United Kingdom</td>
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<tr>
<td>US</td>
<td>United States of America</td>
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<td>$</td>
<td>United States dollar</td>
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<td>WTO</td>
<td>World Trade Organization</td>
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To my late Mother, Lau Wai Kin, and

to my Father, Wu Shing Ka,

and Dino Mahoney

for all their love and support
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INTRODUCTION AND METHODOLOGY

A. Introduction

Bilateral, multilateral and regional linkages of stock exchanges generate greater sources of funds, more investor return and greater choice for investors. Such linkages can also lower transaction costs through placement and trading, increase liquidity in the secondary market and potentially enhance investors' confidence and the reputation of the listed companies. There has been a recent global trend to consolidate regional stock exchanges, notably the formation of Euronext N.V. on September 22, 2000 when the exchanges of Amsterdam, Brussels and Paris merged.¹ At the beginning of 2002, the Euronext group further expanded with the acquisition of London International Financial Futures and Options Exchange ("LIFFE") and the merger with the Portuguese exchange BVLP, making it Europe's leading cross-border exchange.² Even more significantly from a legal point of view³, the European Union ("EU") has also issued directives to provide EU-wide passport for prospectuses and minimum standards for proper market conduct.

However, consolidation of stock markets similar to Euronext or harmonization of listing rules along the line of EU directives has not yet occurred in Asia. This thesis explores the possibilities of stock market integration between the People's Republic of China ("PRC") ⁴ and Hong Kong in either form and

² See id.
³ Euronext is subject to Euronext model (i.e. order-driven market with an electronic central order book; execution of different types of orders; automatic order matching and full anonymity for orders and trades) and a set of common trading rules and partially harmonized listing rules. Listing applicants are free to choose their point of entry to the market (Amsterdam, Brussels, Paris or Lisbon) and cross-border transactions can be facilitated through a single trading platform, NSC, and cleared through a single system, Clearing 21®. See Euronext at http://www.euronext.com. (last viewed on Dec. 4, 2005). Euronext is governed by separate national regulators of its members.
⁴ For the purpose of this thesis, the use of the word "China" includes the PRC, Hong Kong Special Administrative Region ("Hong Kong") and Macao Special Administrative Region ("Macao") while the use of the word "People's Republic of China ("PRC")" refers to Mainland China excluding Hong Kong and Macao.
Introduction and Methodology

examine whether the H share experiment has contributed to limited legal harmonization of listing rules between these two jurisdictions and, therefore, is the first step leading to further integration. Hong Kong was handed over by Britain to the PRC on July 1, 1997 and renamed The Special Administrative Region of Hong Kong ("Hong Kong SAR"). This event was unprecedented considering the significant differences between the systems of both places. The PRC is a communist country and Hong Kong is regarded as the freest economy in the world by the Heritage Foundation. In 2001, the GDP per capita in Hong Kong was US$24,850, ranking 15th in the world whereas the GDP per capita in the PRC was US$4,020, ranking 102nd in the world. The challenge facing the integration of Hong Kong into the PRC was how to integrate one of the freest, wealthiest and industrialized economies in the world to the rule of a restrictive, less prosperous and still developing country. Under these circumstances, the principle of "One Country, Two Systems" was created and brought into practice on July 1, 1997, through the Basic Law, the mini-

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5 For the ease of reference, the shortened form "Hong Kong" will be used instead of "Hong Kong SAR" in this thesis.

6 The Heritage Foundation ranked the PRC 111 in its 2006 Index of Economic Freedom. The PRC was graded against ten factors, including trade and tax policies, government consumption of economic output, foreign investment and wage and price controls. See Marc A. Miles et al., The 2006 Index of Economic Freedom: The Countries, in MARC A. MILES et al., 2006 INDEX OF ECONOMIC FREEDOM: THE LINK BETWEEN ECONOMIC OPPORTUNITY AND PROSPERITY 143 (Heritage Foundation & Wall Street Journal 2005).

7 The Heritage Foundation ranked Hong Kong as the world’s freest economy in its 2006 Index of Economic Freedom. Hong Kong was graded against ten factors, including trade and tax policies, government consumption of economic output, foreign investment and wage and price controls. Hong Kong came out top of the list. See Marc A. Miles et al., The 2006 Index of Economic Freedom: The Countries, in MARC A. MILES et al., 2006 INDEX OF ECONOMIC FREEDOM: THE LINK BETWEEN ECONOMIC OPPORTUNITY AND PROSPERITY 211 (Heritage Foundation & Wall Street Journal 2005). Hong Kong has been ranked the world’s freest economy for the last ten years by Heritage Foundation. See Ming Pao, Quan Qiu Jing Ji Gang Zui Zi You Shi Lian Guan (Hong Kong as the Freest Economy for Ten Consecutive Years), Jan. 10, 2004, at B3 (Economic Page).


9 Article 5 of the Basic Law of the Hong Kong Special Administrative Region of the PRC (the "Basic Law") stipulates that the socialist system and policies shall not be practiced in Hong Kong and the previous capitalism system and its way of life shall remain unchanged for 50 years and Article 8 of the Basic Law stipulates that the laws previously in force in Hong Kong, that is, the common law, rules of equity, ordinances, subordinate legislation and customary law shall be maintained, except for any that contravene [the Basic Law], and subject to any
Introduction and Methodology

constitution of Hong Kong, which confers economic autonomy to Hong Kong. As such, the resources of Hong Kong were to be managed separately and independently and Hong Kong’s financial and monetary affairs were to be determined exclusively by Hong Kong laws. However in the context of international finance, it was integration rather than autonomy that both economies aspired to.

This thesis takes a law-based approach in examining the possibility of a merger between the Hong Kong Exchanges and Clearing Limited (“HKEx”) and the two PRC stock markets. Statistics from the World Federation of Exchanges show that in 2004, the market capitalization of the HKEx was

amendment by the legislature of the Hong Kong SAR. The Basic Law was adopted on Apr. 4, 1990 and was effective on July 1, 1997. The creation of the Special Administrative Region is in accordance with Article 31 of the Constitution of the PRC.

Three Articles in the Basic Law define Hong Kong’s future economic autonomy. Article 106 states: “The Hong Kong Special Administrative Region shall have independent finances.” Article 110 states: “The monetary and financial systems of the Hong Kong Special Administrative Region shall be prescribed by law.” Article 115 states: “The Hong Kong Special Administrative Region shall pursue the policy of free trade and safeguard the free movement of goods, intangible assets and capital.”


During the late 1980s and 1990s, regional cooperation has gradually become one of the declared objectives of most East Asian nations and such initiatives occur at different levels (e.g. the sub-regional level of Association of Southeast Asian Nations (“ASEAN”), ASEAN Free Trade Area ("AFTA"), the Growth Triangle and the Greater China; at the inter-regional level of Asia-Pacific Economic Co-operation (“APEC”), ASEAN Regional Forum (“ARF”), Asia Europe Meeting (“ASEM”); or even the East Asian Economic Caucus (“EAEC”), and the latest development of the “ASEAN plus 3” process at the intra-regional level). See Fu-Kuo Liu & Philippe Régnier, Prologue: Whether Regionalism in East Asia?, in REGIONALISM IN EAST ASIA: PARADIGM SHIFTING? xix-xx (Fu-Kuo Liu & Philippe Régnier eds., RoutledgeCurzon, 2003). Regional integration “can refer to the legal and institutional relationship within a region in which economic transactions take place, or it can refer to the market relationship among goods and factors within a region.” See Richard Cooper, Worldwide Regional Integration: Is There an Optimal Size of the Integrated Area?, in ASIA PACIFIC REGIONALISM: READINGS IN INTERNATIONAL ECONOMIC RELATIONS 12 (Garnaut and Drysdale eds., Harper Educational 1994). At the sub-regional level, Greater China is generally used to refer to the integration of Hong Kong, Taiwan and the PRC and such integration is largely economic, driven by the shared culture. The term “China Economic Area” is frequently used by World Bank, IMF and Organization for Economic Co-operation and Development (“OECD”) to avoid the political implications of “Greater China”. See Wei-Wei Zhang, The Concept of ‘Greater China’ and East Asia, in REGIONALISM IN EAST ASIA: PARADIGM SHIFTING? 157, 172 (Fu-Kuo Liu & Philippe Régnier eds., RoutledgeCurzon 2003).

See Methodology below for more details.
US$861.5 billion (ranking the 9th largest in the world) while the combined capitalization of the Shanghai and Shenzhen Stock Exchanges was a short way behind at US$447.7 billion (ranking as the 13th largest stock market in the world). Were the HKEx and the PRC stock markets to integrate the combined stock markets would result in the sixth largest stock market in the world in terms of market capitalization, and the second largest stock market in Asia after the markets in Japan. This would represent a significant advance in the international ranking for both stock markets, increasing its reputation in the primary market and its liquidity in the secondary market.

Despite the potential benefits to both Hong Kong and the PRC from such a merger there are still a number of obstacles to overcome - political, economic and legal. By taking a law-based approach, this thesis concentrates on a discussion of the legal obstacles.

One of the ways to overcome the legal obstacle to the consolidation of stock markets in Hong Kong and the PRC is the creation of H shares. What are H shares and in what ways can H shares help to bring about the integration of Hong Kong and PRC stock markets if such consolidation ever takes place? In 1993, H shares issued by PRC companies were allowed to cross-list on the

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15 See id. The combined capitalization of Hong Kong stock market and the PRC stock markets amounts to US$1309.2 billion in 2005, making them the sixth largest stock market in terms of market capitalization trailing after the stock markets in US (NYSE + Nasdaq), Japan, London, Frankfurt and Deutsche Börse. Japan has a market capitalization of US$2,746 billion as at the end of June 2003.

16 However, political and economic obstacles are referred to in order to give a full picture of the obstacles to integration. Political obstacles refer mainly to the PRC government's desire to maintain social and political stability by gradual reforms with a corresponding reluctance to initiate openly integrative measures. See Chapter I (A(3)(e)). Such a conservative attitude is also behind the PRC government's cautious policy regarding foreign exchange control which poses one of the main obstacles to integration. See Chapter III (C1). Economic obstacles include the different PE ratios of the same companies listed on the Hong Kong and PRC stock markets due to the segregation of the stock markets of these two jurisdictions. There are, however, some signs that such ratios are improving in favour of integration. See Chapter I (Provisional Conclusions) and Chapter V (H). Legal obstacles can be discerned in different areas including: market functions, equity share characteristics, regulatory agencies and securities laws between the Hong Kong and the PRC stock markets. See Chapter I generally.
Introduction and Methodology

Hong Kong Stock Exchange and they were also allowed to cross-list on the Growth Enterprise Market ("GEM") (the second board which was launched on the Hong Kong Stock Exchange in late 1999). The H share listing was made possible by the introduction of a new set of legal and operational rules in the PRC and Hong Kong and it was a first step towards the harmonization of laws and rules between the two jurisdictions.

This thesis provides a legal critique of H shares as a device for integrating the Hong Kong and PRC stock markets, and suggests an institutional approach to create a single capital market in China.

This thesis is divided into five chapters. The first chapter gives a brief introduction of the stock markets in Hong Kong and the PRC and explains why integration of the stock markets in these two places is desirable. The second chapter examines critically the advantages and disadvantages of H shares as an effective integration device. The third chapter analyses the impact of international soft laws and the Mainland-Hong Kong Closer Economic Partnership Arrangement ("CEPA") to effective integration of the Hong Kong and PRC stock markets. The fourth chapter scrutinizes international relations theories, the EU model and the United States ("US") model. The fifth chapter

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17 BAO MING GAO & YAN MEI FU, SECURITIES MARKETS IN CHINA 127 (Henry M.K. Mok et al. eds. 1997).

18 GEM allows companies with potential growth to list on the Hong Kong stock market even though they cannot meet the requirements to be listed on the Main Board. Investors are reminded that investment in companies listed on GEM is riskier than those on the Main Board. The GEM adopts a disclosure-based philosophy rather than a merit-based one. The Exchange will review all listing documents to see if they comply with the Companies Ordinance, the Securities and Futures Ordinance and the GFM Listing Rules but it will not assess the commercial viability of the listing applicants. It works on the principle of caveat emptor or buyers beware. See GEM, Regulatory Philosophy and Major Features of GEM at http://www.hkgem.com/aboutgemi_helpers.htm (GEM: About GEM/Regulatory Philosophy and Major Features of GEM) (last viewed on Mar. 18, 2006).


20 Harmonization of law does not imply uniformity of law. Harmonization of law is further discussed under Chapter III (A) when this thesis argues for a structural legal reform other than the introduction of H share listing rules. Harmonization of law is further defined under Chapter V (G) when this thesis discusses four models on various degrees of harmonization.

21 For this thesis, the use of the word "China" includes the PRC and Hong Kong while the use of the word the "PRC" only refers to Mainland China.
concludes by summarizing the inter-relationship of the main points, proposing four models of integration and an institutional framework for establishing a single capital market in China.

**Scope of the Thesis**

The securities markets broadly include cash and derivative markets. Cash markets can further be broadly categorized into equity and bond markets.

The analysis of this thesis focuses on the equity markets as the lessons learnt from the equity markets can generally be applied to other kinds of securities market. Since the bond issue does not affect the issuer's ownership and the debenture holders take relatively fewer risks than shareholders, bond markets may have fewer obstacles in achieving harmonization of rules and regulations than the equity markets. Corporate governance may have greater importance to shareholders than bondholders but bondholders are also concerned with it. For example, weak minority shareholder rights create uncertainties as to whether or not bondholder rights will be upheld during disputes and bankruptcies. Inadequate market discipline and transparency implies that controlling interests may take unwarranted risks and increase the likelihood of bond default. That means that bondholders will demand a higher premium for holding corporate bonds which in turn will increase the chance of bond default because of the higher costs.

The derivative markets are strictly monitored and therefore rather underdeveloped in the PRC until rather recently with the promulgation of the Revised Securities Law effective on January 1, 2006. Hence the discussion in this thesis is based on the equity markets whenever stock markets and capital markets are referred to.

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22 In general, however, the bondholders are more concerned with bankruptcy rules and such rules have to be clear, legally enforceable and are explicit on the treatment of creditors' rights. See Raul Fabello & Srinivasan Madhur, Bond Market Development in East Asia: Issues and Challenges 11 (Asia Development Bank, ERD Working Paper Series No. 35, 2003).

Introduction and Methodology

B. Methodology

Overview

This thesis examines the possibility of integration of the Hong Kong and the PRC stock markets. The first question posed is the desirability of such integration. Once it is established that such integration is beneficial, the thesis then moves on to examine the legal readiness for such consolidation. The nature of the questions and answers calls for a policy analysis. Policy analysis seeks for the best method or course of action for reaching a target or destination, a means-end way of thinking about government goals and actions.24

Policy analysis tends to be prescriptive rather than explanatory. In the process of decision-making, an important element for the prescriptive approach, one should be aware of the dichotomy of positivist and normative approaches25. This thesis takes a cooperative view of the ontological divide between objectivism and subjectivism.26

This thesis relies heavily on the normative approach in its discussion, an analysis based on observation, experience, argument and logical reasoning. The positive approach requires hypothesis, data collection, calculation and experimental methods and through this scientific process, they claim to be value-neutral and objective. This thesis argues that it is empirically difficult for social scientists to rely on experimental methods to verify its hypothesis


25 Keynes once wrote: “The object of a positive science is the establishment of uniformities, of a normative science the determination of ideals.” See MARK BLAUG, THE METHODOLOGY OF ECONOMICS 122 (2nd. ed. Cambridge University Press 1992) “Positive theories say what is, while normative theories say what ought to be. Positive theories are concerned with facts, while normative theories are concerned with values.” See DANIEL M. HAUSMAN & MICHAEL S. MCPHERSON, ECONOMIC ANALYSIS AND MORAL PHILOSOPHY 223 (Cambridge University Press 1996). For the purpose of this thesis, normative approach is used only to describe a value-laden and judgment methodology.

26 JACKSON & SORENSEN, supra note 24, at 263.
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and most positivist approaches are arguably not as value-neutral as they proclaim to be. Generalized models are, however, useful objective tools for social engineering. The recommendations, therefore, take the form of non-quantitative models to shed light on different degree of integration in the stock market scenario.

To arrive at its conclusion, this thesis also adopts comparative law methodology, an approach which is dominant in Chapters III and IV.

The scope of analysis and recommendations concentrates primarily on legal issues but the complexity of the subject matter requires an understanding of other disciplines including political philosophy, economics and international relations. In particular, the reasons for integration of stock markets are closely related to economic rather than legal issues. This thesis therefore takes on a law-based multi-disciplinary approach.

Policy Analysis

This thesis is set out to explore legal reforms in which law is used as a tool of social engineering. This process of exploration follows similar routes of enquiry that a policy maker would need to take. Policy makers are more normative than positive as they tend to simply consider how reliably the theory produces correct answers to a particular question.

In their analytical process, policy makers have to take into account of all relevant factors. The debate is how "scientific" the policy makers should be to arrive at their decisions. Under a strictly positivist methodology, what cannot be observed or measured cannot form either the subjects or predicates of propositions to make assertions about the world. However law, being broadly a

37 Take for an instance, rationality is the basic principle and assumption of positivist economics but to say that one ought to be rational is normative. See DANIEL M. HAUSMAN and MICHAEL S. MCPHERSON, ECONOMIC ANALYSIS AND MORAL PHILOSOPHY 38-50 (Cambridge University Press 2002) (1996).

social science, must tolerate a greater amount of uncertainty than do the other sciences. The uncertainties arise from the subject matter itself - human beings, with their range of human actions and perceptions. Even though the positivist economists employ measurable surrogates such as units of utility, to objectify and measure subjective behaviour and to predict reaction is, at best, difficult. Estimation and generalization are also inherent in the process of objectification which may oversimplify a problem with questionable premises and assumptions. A classic scholarly approach through identifying and ordering the central questions, clarifying the relevant concepts, drawing appropriate distinctions, investigating the historical evidence, comparing with similar experiences elsewhere, and formulating a coherent argument may be more useful to the policy-makers if the latter wants to make a more morally sound decision. This thesis relies heavily on this classic approach in analysis.

It has been stated that this thesis takes a cooperative view of positivism and normativism. What it means is that this thesis does not ignore data produced by positivists' works. Throughout the thesis, economic data and published economic findings are used to assess the degree of success in the stock markets in these two jurisdictions. Economic theories and concepts are mentioned, if relevant, to shed light on the economists' concern regarding the present topic.

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29 See id. 841.
30 Id.
31 Id. at 847, 851.
32 JACKSON & SORENSEN, supra note 24, 233-238.
33 Simon Caulkin, Business Schools for Scandal: What the Academics Teach Is What Created Errors, THE OBSERVERS, Mar. 28, 2004, at 9 (The author quoted the late Professor Sumantra Ghoshal tracing the modern mismanagement to business studies which tried to look "respectable" by removing the subjectivity of analyzing the company behaviour in terms of human choices and actions, instead looking for explanations in impersonal patterns and laws. The pretension to science excluded moral or ethical dimensions from management since they were about intentions which could not be modeled or quantified. It could only admit strictly economic motivations, precisely because they could be quantified. The author continued to say that trying to make human organizations fit the causal logic of physics was a blatant error as unlike physics, humans and their organizations had intentions and choices and employed strategy. The author said that social scientists carried an even greater social and moral responsibility than their colleagues in the physical sciences. If a physicist was wrong, she was wrong but in the social sciences, a "wrong" theory could become "right" if enough people believed it. For example, governance that assumed managers could not be trusted to maximize shareholder value without hefty incentives, bred managers who required huge stock options.)
Yet in terms of analysis, a normative approach is adopted. Since this thesis primarily explores the different degrees of legal integration of stock markets, no attempt is made to construct any economic model or assess the validity of various economic theories other than a general discussion of its relevance to this thesis.

**Law-based Multi-disciplinary Approach**

This thesis takes a law-based approach but as stated above, it is inevitable that economic and political issues have to be discussed. Despite such discussion, the issues this thesis is concerned with are strictly legal and it is elaborated chapter-by-chapter as follows:

1. Chapter I examines the legal and regulatory frameworks of the Hong Kong and PRC stock markets;

2. Chapter II proceeds to explain the H share legal regulatory framework and its merits and problems;

3. Chapter III takes a detailed look at other legal-related factors that are favourable for the integration of the stock markets in Hong Kong and the PRC including international soft laws and CEPA as law affects institutions and vice versa.

4. Chapter IV explores the legal and regulatory framework of the capital markets in the EU and the US, the former focusing on directives related to the capital markets promulgated by the EU and the latter on the Securities Acts of 1933 and Securities Exchange Acts of 1934;

5. Chapter V lays down models on different degrees of legal integration for the Hong Kong and the PRC stock markets and the necessary institutions to support such legal development.
Introduction and Methodology

Other than this law-based approach, the discussion of integrating the stock markets in Hong Kong and the PRC inevitably involves cross-discipline issues. Stock markets are economic entities and the benefits of stock market integration are mainly economic ones; the act of stock market integration involves political issues; and the fact that it includes both Hong Kong and the PRC involves inter-governmental issues and bilateral talks and negotiations. This thesis therefore draws heavily on well-established disciplines: history, political theories and international relations theories.

Sub-questions Inspired by Development Law

Development law is relevant because the PRC is one of the “Big Five” emerging economies according to the World Bank and an understanding of the development law is essential for its legal development. Although the focus of this thesis is on the integration of the PRC and Hong Kong stock markets and therefore it should explore the common grounds between the two capital market regimes, more often than not, the party that may need to carry out legal reforms rests on the PRC government to catch up with the international standards laid down by their Hong Kong counterpart. It is therefore important to map out the strategies for such legal reforms through an understanding of development law.

For legal practitioners, law is the key to development. Development law as a legal subject is primarily concerned with the promotion of the rule of law and establishing good corporate governance in countries in transition including strengthening judicial and local institutions to promote a viable legal framework for commerce, trade and investment. In terms of emerging capital

34 Milan Braimbhatt et al., Global Economic Prospects and Development Countries (World Bank, 1997). Rumu Sarkar, Development Law and International Finance 222 (note 1) (Kluwer Law International 2d ed. 2002) (1999) (“Further, Jeffrey Garten, the dean of the Yale School of management, declares in his book entitled The Big Ten: The Big Emerging Markets and How They Will Change Our Lives (Basic Books, 1997) that the rising stars are China, Mexico, Brazil, Argentina, India, Indonesia, Poland, South Africa, South Korea, and Turkey.”)
markets, the developing country must meet the expectations of the Western-based and domestic investors whose interests are ultimately very similar\(^{35}\). Legally speaking, the expectations will include a clear, cohesive and enforceable legal framework which is safe from state expropriation and corruption.\(^{36}\)

To understand how such expectations can be realized, one has to understand the relationship between law and the process of development which is highly complex. Development theory was rooted on two fundamental but opposing viewpoints as expressed by the modernization theorists and dependency theorists.\(^{37}\) Modernization theorists or neo-classical theorists assumed that development follows a linear process whereby a free market economy provides for the economic prosperity and liberty of all.\(^{38}\) On institutional level, it translated into an action plan for developing countries which strive to establish a balance-of-payment stability, a well-managed fiscal budget, a market economy with a highly developed private business sector, and a reasonably developed capital market.\(^{39}\) Every society is capable of modernization by replacing traditional values for modern one in the image of Western, democratic, market-based economies.\(^{40}\) Dependency theorists argue that "underdevelopment" is the result of a system of world capitalism that perpetuates extractive and exploitative relations with the developing world.\(^{41}\) Dependency theorists advocate measures like nationalization, import

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\(^{35}\) In the short run, domestic investors may be more tolerant and less sophisticated than their Western counterparts as long as their investments remain profitable.


\(^{38}\) Id. at 28.


\(^{40}\) *Sarkar, supra* note 37, at 28.

\(^{41}\) Id. at 31-32.
substitution, and other forms of protectionism in support of the existing
industries. 42

Seeing the limitations of both theories 43, Rumu Sarkar 44 proposed the value-
neutral Janus Law Principle (the “Principle”) to stress the importance of
looking backward into the past of a developing country as well as ahead into
the future 45, as opposed to the ahistorical approach of modernization theorists 46
and the entrenched protectionist approach of the dependency theorists. The
Principle acknowledges both the time (whether the time is ripe for the reform)
and spatial dimension (the developing countries must assess the domestic and
international implications of legal reform measures) implicit in legal reform. 47
The importance of the Principle is to draw our attention to the time and spatial
dimensions of development. The following five sub-questions regarding the
integration of Hong Kong and the PRC stock markets are discussed later in the
thesis and the questions are based on the Principle, questions 1, 4 and 5 being
the spatial dimension of development and questions 2 and 3 being the temporal
dimension:

1. Driving force: Who will be the principal actors for such integration? Is
it going to be top down or bottom up? Or are we going to abandon the
linear causal relationship and treat each actor as a building block in a
legal and social ecosystem, each affected or being affected by the others
through an input-output system?

2. Timing: Should the integration be accomplished all at once or should it
be a gradual process?

42 Id. at 32.

43 Id. at 29-37 (For a general discussion of the limitation of both modernization and
dependency theories).

44 Id. at 38-43.

45 Janus was a Roman god with two faces – one looking forward, one looking behind.

46 Id. at 38-39.

47 Id. at 40-41.
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3. Sequencing: Should there be political reform first or economic reform first?

4. Institutions: Are supranational organizations required to oversee such integration? If so, what kinds of supranational organization are required?

5. Extent: Should the integration be sectoral/geographical or should it be holistic covering all fields?

Following from the Principle, the first two chapters adopt a historical and chronological approach to look at the background of the Hong Kong and the PRC stock markets and the emergence of the H shares. This historical and chronological approach provides the necessary background for a socio-political understanding of the stock markets in these two places and the culture within which the markets operate and the securities laws, regulations and codes of conduct develop. Such legal reform ensures continuity, easy acceptance by the public, builds on the existing infrastructure and reduces transitional costs.

Comparative Law

This thesis employs comparative law as a problem-solving methodology and hence as a tool of law reform. Comparative law is primarily a method of

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48 This is also embodied in the Janus Principle - looking into the past to find out how a country should develop.


50 But see Alan Watson, Legal Transplants: An Approach to Comparative Law 1-7, 9 (Scottish Academic Press) (1974) (criticizing the description of comparative law as a method and explaining its potentials). See also Imre Zajtay, Aims and Methods of Comparative Law, 7 COMP. & INTL. L. J. 321, 327-30 (1974) (discussing whether comparative law is a science or merely a method. See also Vivian Grosswald Curran, Cultural Immersion, Difference and Categories in U.S. Comparative Law, 46 AM. J. COMP. L. 43, 62-66 (1998) (discussing whether or law is scientific) ("Law resists scientization, however, because, like all the social sciences and humanities, its terms and concepts are inconsistent, fluid and incomplete). Id. at 63.
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legal analysis. It goes beyond studying foreign laws by asking what the law could, and ought to be, by revealing existing diversity, by highlighting alternatives and by alerting us to the ways our legal system is conditioned by social, political, economic and other factors by observing their effects and interplay with an outsider’s perspective in other legal communities.

In terms of policy making, comparing legal systems facilitates prospects of success for legal reforms as the policy makers do not need to base their judgment on uncertain prediction but on other countries’ experience. However it is important to note that a transfer of a legal system cannot occur without a thorough analysis of both legal systems to be compared. An analogy with this can be made with an organ transplant. This transplant has to consider socio-economic, cultural-political, and systematic differences of the respective jurisdictions in the same way that a liver transplant would have to consider with its holistic interplay with other organs and the human body itself. Every reception must be a re-creation that requires courage, intuitive perception, discipline and human imagination. This thesis looks at the US

51 Comparative law is not a body of rules and principles but it is the process of studying the relationships of legal systems and their rules. Kai Schadbach, The Benefit of Comparative Law: A Continental European View, 16 B.U. INT’L L.J. 331, 333 (Fall, 1998).

52 See id, 346-347.

53 See id, 387. See also RENE DAVID & JOHN E.C. BRIERLEY, MAJOR LEGAL SYSTEMS IN THE WORLD TODAY—AN INTRODUCTION TO THE COMPARATIVE STUDY OF LAW 6 (3d ed. 1985); MARY ANN GLENDON et al., COMPARATIVE LEGAL TRADITIONS 10 (2d ed. 1994); Friedrich K. Juenger, American Jurisdiction: A Story of Comparative Neglect, 65 U. COLO. L. REV. 1 (1993) and; George A. Zaphirious, Use of Comparative Law by the Legislature, 50 AM. J. COMP. L. 71 (Supp. 1982).

54 Kai Schadbach, The Benefit of Comparative Law: A Continental European View, 16 B.U. INT’L L.J. 331, 387-390 (Fall, 1998). It is more preferable to borrow from others the end result than to go through expensive and dangerous experiments and experiments that failed in other countries can be avoided. See id. 390. See also Max Rheinstein, Comparative Law—Its Functions, Methods and Usages, 22 ARK. L. REV. 416, 424 (1968).

55 See Schadbach, supra note 54, at 388-389.

56 See id. 422. See also Bernhard Grossfeld, Comparative Law as a Comprehensive Approach: A European Tribute to Professor Jack A. Hiller, 1 RICH. J. GLOBAL L. & BUS. 1, 30-31 (winter/spring, 2000).
and EU experiences (particularly the latter\textsuperscript{57}) to throw light on what can be done regarding the integration of the Hong Kong and the PRC stock markets.

**Methodology Review**

This thesis adopts an essentially prescriptive and comparative as opposed to empirical (quantitative) approach.

This thesis constructs four alternative or complementary models to establish a new framework for securities law harmonization in Hong Kong and the PRC. In so doing, the methodology adopted is partly subjective (being moral or judgment based) and partly objective (through development of the models identified). The assessment as to the most appropriate model is based on both the area of investigation of the advantages and disadvantages of integration between the two markets and the apparent efficiency and effectiveness of each of the four models developed.

The recommended four models of integration at the end of the thesis were based on legal studies of EU and US capital market models using comparative law methodology. Some subsidiary questions were investigated using development law as a tool with which to throw light on the speed and timing of integration and what suitable agents of change should be.

\textsuperscript{57}The difference between the legal systems in Hong Kong and the PRC is more similar to the difference between the European countries than difference between the states in the US. The US has unified national securities laws supplemented by blue sky laws from each state.
CHAPTER I

OVERVIEW OF
THE PRC AND HONG KONG SECURITIES MARKETS

A. Introduction to the PRC Securities Markets

Definition of “Securities” (zhengquan)

The Chinese term for securities is “zhengquan” which literally means any certificate representing proof or evidence of rights and interests. Local government regulations and operational rules of the two PRC stock exchanges have defined the word “securities” but a formal definition of the word from the central government has never been given.

Trading Rules Governing Shanghai and Shenzhen Stock Exchanges only provide that the following securities are allowed to be traded on the exchanges: (1) Ordinary shares (A and B shares); (2) Investment funds; (3) Bonds (including enterprise bonds, corporate bonds, convertible bonds, financial bonds and treasury bonds); (4) bond repurchase agreements and; (5) other securities approved by the China Securities Regulatory Commission (“CSRC”).

The early 1993 draft of the national Securities Law has defined “securities” but the definition of “securities” was omitted in the 1994 draft and has since been 160 of Zonghua Renmin Gongheguo Gongsi Fa [the Company Law of the PRC] and article 5 of Qiye Zhaiquan Guanli Tiaoli [the Regulations on Enterprise Bonds] (the latter being promulgated by the State Council on Aug. 2, 1993) defines corporate bonds as a kind of “youjia zhengquan” which literally means “traded securities” and is similar in meaning to “negotiable instrument”, including bill of lading, bill of exchange, promissory note, cheque, share, bond and debenture. Bill of lading, promissory note and cheque are regulated by 1995 Negotiable Instrument Law of the PRC. See ZHU SAKZHU, SECURITIES REGULATION IN CHINA 25-26 (Transnational Publishers & Simmonds & Hill Publishing, 2001).

1 SHANGHAI-SHENZHEN ZHENGQUAN JIAOTUJUO JIAOJI GUZEE [Trading Rules Governing Shanghai and Shenzhen Stock Exchanges] were approved by the CSRC and promulgated on Aug. 31, 2001, effective three months from the date of promulgation.

2 The 1993 draft Securities Law, art. 6(i). See ZHU, supra note 1, at 31-32.
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not been restored. The 1998 Securities Law does not define "securities" and simply states that the Securities Law of PRC\(^4\) applies to shares, corporate bonds and securities affirmed by the State Council (the executive arm of the Chinese government which also has legislative power delegated by the National People's Congress ("NPC")). The latter, as some pointed out, includes investment in open-ended and close-ended funds.\(^5\)

Treasury bonds are separately administrated by the People's Bank of China ("PBOC") for government budgetary finance.\(^6\)

Commodity and financial futures did not fall within the scope of Securities Law when it was promulgated in 1998 although it was generally regarded as securities.\(^7\) The move showed that the PRC government was deeply suspicious of derivatives and the futures market and the possible destabilizing effect they would have on the society and the Communist Party in case of market failures. Instead of granting official legal recognition for all of these derivatives and the various innovative financial products created by the financial institutions, the PRC government preferred to retain its flexibility to decide whether a financial product was a security on a case-by-case basis. With the affirmation from the State Council, a financial product could then become a security to be regulated under the Securities Law. Unless affirmed by the State Council, the word "securities" mainly referred to corporate bonds and shares. As a result, the word "securities" in the PRC generally referred to shares and bonds. The


\(^6\) Articles 8 and 9 of the Zhonghua Renmin Gongheguo Guokuguan Tiaoli [Treasury Bond Regulations of the PRC] (promulgated by the State Council on, and was effective from Mar. 18, 1992) state that a treasury bond may be pledged and transferred. It is a significant regulation in establishing a government debt securities market as treasury bonds are not tradable before 1988.

\(^7\) The CSRC, the regulatory body of the securities industry, also regulates the futures markets. See the Provisional Administrative Regulation on Futures Trading, art. 5. The Regulation codifies a centralized regulatory regime by empowering the CSRC to approve establishment of any futures exchange and brokerage; supervise market activities, enact regulations; and enforce regulations. See also Zhang Xianchu, The New Futures Regulations, China Law & Practice, August 1999, at 36.
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revised Securities Law took effect on January 1, 2006\(^8\) and under article 2 of the revised Securities Law, derivatives are allowed in accordance with regulations issued by the State Council and derivatives are therefore finally recognized as a security. However as explained earlier, the emphasis of this thesis is on equity shares that are traded on the two stock exchanges in the PRC.

1. Historical Background

a. Securities Markets

A stock exchange is a non-profit making legal person established by the State Council that offers a location for securities price-bidding transactions.\(^9\) Its article of association has to be approved by the CSRC (formerly known as Securities Regulatory Commission).\(^10\) There are two national stock exchanges in the PRC. The Shanghai Stock Exchange ("SSE") was founded on November 26, 1990\(^11\) and its first

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\(^9\) Securities Law, art. 95.

\(^10\) Securities Law, art. 96.

\(^11\) Chinese stock exchanges can be traced back to the Shanghai Standard Stock Exchange in 1882 but it was soon closed down due to a lack of government support and commercial interests as a result of political instability. The promulgation in 1914 of an Exchange Law produced the Shanghai Stock & Bond Trading Association, also known as the Shanghai Stock Markets Association in 1914. In 1917, the Peking Stock Exchange was formed. Due to significant interests, the China Merchants' Stock & Commodity Exchange and the Shanghai Chartered Stock & Produce Exchange were formed some time later. The success of the exchanges created "the Stock Exchange Storm" and by the close of 1921, some 140 were reported. By the spring of 1922, the bubble burst and only 12 of the longer established markets were operating. Since then stock exchanges closed and re-opened and despite wars and high inflation, share trading continued either on the stock exchanges or the 'grey market'. After the Second World War, foreign stockbrokers could not join the Shanghai Securities exchange which was reopened in September 1946 and foreign businesses were not allowed to be listed as the new law required every listed company to do business in China. Faced with such exclusion, foreign companies then turned to the Hong Kong market. A British trade mission to China in 1947 reported that "there is hardly a British firm in Shanghai which has not since the war transferred its principal office in China from Shanghai to Hong Kong." (Catherine R. Schenk, Commercial Rivalry Between Shanghai and Hong Kong During the Collapse of the Nationalist Regime in China, 1945-1949, 20 The International History Review 1, 70-71 (March 1998)). The Shanghai Securities Exchange finally closed down in May 1949 when the People's Liberation Army marched into Shanghai. The Communist administration abolished the entire republican legal system, including the company law and the 11,298 registered companies either ceased to operate or were nationalized. Share trading continued till
trading day started on December 19, 1990. The Shenzhen Stock Exchange ("SZSE") was opened on December 1, 1990 for a trial run and was formally established on July 3, 1991. The business scope of the Shanghai and Shenzhen Stock Exchanges includes provision of premises and facilities for trading and managing the settlement and delivery for all listed shares.

b. Stock Settlement

The China Securities Depository and Clearing Corporation Limited was launched on March 30, 2001 with the approval of the CSRC. The previous two Chinese securities depositories, the Shanghai Securities Central Clearing & Registration Corporation and Shenzhen Securities Clearing Corporation were merged into this new corporation and operated as its subsidiary. The former one is renamed the China Securities Depository and Clearing Corporation Limited, Shanghai Branch, and the latter, the Shenzhen Branch. The corporation was

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17 The Shanghai Securities Central Clearing & Registration Corporation was first established on March 8, 1993. See www.sscrc.com (China Securities Depository and Clearing Corporation Ltd., Shanghai Branch: Introduction to the Corporation).

18 Newsletter, Asia-Pacific Central Securities Depository Group (April, 2001), at 14.
jointly funded by the SSE and the SZSE, with a registered capital of RMB 600 million (approximately US$72.5 million). 19

2. PRC Model: Socialist Market Economy

The ideology behind Chinese economy has a profound effect on its legal development. It is the vision and the direction the whole economy is heading for. Chinese economy is often referred to as socialist market economy or socialist economy with Chinese characteristics. What do they mean? Can socialist ideas and market principles ever reconcile with each other or is it an oxymoron? What is their relative importance? Is socialist market economy equivalent to socialist economy with Chinese characteristics?

Socialist market economy is engraved into the Constitution and is central to Deng Xiaoping’s thought. 20 The first important step to achieve this goal was to reform the ailing state-owned enterprises (“SOEs”) by corporatization through establishment of shareholding companies. Such shareholding system was the prelude to the development of the securities markets. Corporatization (the conversion of SOEs into shareholding companies) and securitization (the sale of shares of such companies in the securities market) were believed to be effective means to save the Chinese economy as they could serve four functions: 21: (1) to relieve the state financial departments and banks from financing the enterprises which required investment funds; (2) to channel saving into “social accumulation capital”; 22; (3) to provide the internal self-regulating mechanism for enterprises to assume its own profits and losses; (4) to separate the government administration from enterprise management.

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20 For the legal and political significance of the PRC constitution, see this chapter A(6). Deng was the first PRC leader to introduce the concept of socialist market economy.


The biggest ideological hurdle to the shareholding system was to reconcile the shareholding system being a prominent feature of capitalism of private ownership with the socialist ideology of public ownership. The combination of the conflicting “market” and “socialist” principles was uneasy at its best. To reconcile the concept of “market” with “socialism”, it was argued that socialist planning at the macro level was to be implemented by market mechanisms at the micro level. In other words, such an economic structure allowed macroeconomic control of the state, while allowing market forces to regulate the allocation of resources in accordance with demand and supply. The Thirteenth Party Congress introduced a new “economic mechanism” concept, under which “the state regulates the market, and the market guides the enterprises”. It was understood to mean that the government, through regulation, ensured that market forces were in play, and that enterprises should then function in such a pure competitive market environment. The importance of upholding the socialist market economy has been reiterated in all the major laws promulgated in the PRC including the Securities Law.

“Socialist market economy” is frequently used interchangeably with the term “socialist economy with Chinese characteristics”. The socialist ideology, the economic reality in the PRC and the Chinese values all play an important role in shaping the intended goals of the Securities Law. After over six years of debate, the Securities Law of the PRC was enacted at the end of December 1998.

23 Such view is supported by Professor Dong Fureng, a prominent Chinese economist. See CHEN, YAO, STOCK MARKET AND FUTURES MARKET IN THE PEOPLE’S REPUBLIC OF CHINA 29 Note 38 (Oxford University Press, 1998).

24 See id.

25 Report of the Thirteenth National Congress of the CCP, March Forward on the Road of Socialism with Chinese Characteristics, delivered by Zhao Ziyang, Secretary General of the Central Committee of the CCP on Oct. 25, 1987, in Documents of the Thirteenth National Congress of the Communist Party of China (Foreign Language Press, 1987), at note 8. The Thirteenth National Congress holds the view that “Regulation by market does not mean practicing capitalism”.

26 Such view is supported by Professor Dong Fureng, a prominent Chinese economist. See YAO, supra note 23, at Note 38.

27 See this chapter (A(6)) for what Chinese characteristics means by reviewing Chinese legal history.
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1998 and came into effect on July 1, 1999. The objectives of the Securities Law parallel to the Company Law and include\(^\text{28}\) (1) standardizing securities issuance and transaction (an act of centralization), (2) protecting the legitimate rights and interests of investors (paternal value of the PRC government), (3) maintaining social economic order and social public interest (preserving the Party leadership), and (4) promoting the development of the socialist market economy (preserving the Party leadership while observing the economic reality).

3. Market Functions

Securities markets\(^\text{29}\) serve many functions in society. How far the securities market has achieved or will achieve depends on how the securities markets are operated, regulated and supervised in different countries and the role of the governments vis-à-vis the securities markets may play a decisive part in the latter's success. The sole purpose of the securities market in many parts of the world is to produce a cost-effective, efficient and reliable mechanism through which securities are bought and sold\(^\text{30}\). The government and the securities markets are to ensure the trading of securities market to be conducted in such a way that it is free of corruption, insiders' dealing, price manipulation and fraud.

However, the securities market in the PRC is set off to serve a rather different function. After many years of communist rule and the Cultural Revolution, nearly all the enterprises in the PRC were state-owned\(^\text{31}\) or collectively-owned. Moral hazard and lack of sanction and supervision mechanism result in heavy

\(^{28}\) Securities Law, art. 1.

\(^{29}\) Securities Law defines a "stock exchange" to be a "non-profit legal person that provides a place for the centralized trading of securities at competing prices." Securities Law, art. 95.


\(^{31}\) Alison W Conner, To Get Rich is Precarious: Regulation of Private Enterprise in the People's Republic of China, 5 Chinese L.J. 1, 3 (1991). Individuals and collectives as a whole own less than 0.2% in both investment in fixed assets and in the gross industrial output value.
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loss to such enterprises\(^{32}\) to the extent that the Government found unable to finance. The Government was faced with two daunting tasks: (1) to find way to raise capital for the ailing state-owned enterprises and (2) to modernize such enterprises so that they can become competitive on their own.\(^{33}\) The securities market was seen to be the appropriate tool to extricate the Government from continuing subsidizing the failing enterprises and the shareholding system a means to revive them and rationalize their allocation of resources.

(a) Fund-raising for State-owned Enterprises ("SOEs")

Historically, SOEs were not mere companies owned by the government. They were self-contained "administrative units" as SOEs served both political and social functions by providing schools, hospitals, leisure centres and shops for the employees and their family members. They also provided pension cover for the retired. To raise funds for SOEs did not only benefit the enterprises concerned, it also benefited the state employees and the whole community they were in. By raising funds through the stock markets, SOEs facilitated income redistribution from investors to ailing enterprises and state workers.

The fact that the purpose of the securities market is to preserve and enhance the socialist order is self-explanatory.\(^{34}\) The securities markets were not set up to facilitate privatization or capitalism in the western sense. Although the mere

\(^{32}\) Joachim Starbatty, Ideological and Historical Background - Functioning of a Socialist System Transition to Market Economies: Case Studies - People's Republic of China, a paper prepared for the University of Washington, Seattle (Spring 2002) available at http://www.uni-tuebingen.de/uni/www/download/seattle/case_studies_china.pdf (last viewed May 6, 2003). It is claimed that about 70% of the SOEs made losses and 20% of the employees were under-employed.

\(^{33}\) Liu Hongru, the former Chairman of the CSRC, stated that the five fundamental goals of the Chinese securities market are to raise funds for domestic economic development, to reform SOEs for a market orientation, to optimize financial resources, to combat inflation, and to promote the function of a socialist economy. See Liu Hongru, Address in New York (Jan. 24, 1994), quoted by Henry M.K. Mok and Zhou Daozhi, Economy and Securities Market in SECURITIES MARKETS IN CHINA (M.K. Mok et al. eds., Chinese University Press, 1997, 29, 30 (in Chinese).

\(^{34}\) See the Company Law, art. 1 and the Securities Law, art 1. The purposes of these laws, among others, are to protect the legitimate rights and interests of the investors, to maintain social economic order, and promote the development of the socialist market economy.
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share listing inevitably facilitated a certain degree of privatization, the emphasis was on corporatization and securitization. The different categories of shares were set up to make sure that the PRC government was always the majority shareholders of the restructured SOEs. State shares are non-transferable without the state approval and legal person shares (the latter being mostly owned by government departments or by companies controlled by such government departments) are only transferable in limited circumstances at designated trading venue. As at 1999, companies which have 60% to 70% of state shares or legal person shares amounted to two-thirds of the listed companies. Besides, one of the grave concerns for B share (the issuance of which was limited to foreign investors before February 19, 2001) or H or N share listing (the listing of PRC companies in Hong Kong and New


36 Legal person shares are divided into state-owned legal person shares, collective enterprise legal person shares (shares that are either owned by local governments, assets derived from the government but deemed not to be owned by the government or individual invested enterprises, which are attached to a supervisory administrative departments for benefits only available to the public enterprises), private enterprise legal person shares, foreign invested enterprise legal person shares and institutional legal person shares. See Minkang Gu and Robert C. Art, Securitization of state ownership – Chinese Securities Law, 18 Mich. J. Int'l L. 115 (Fall, 1996).

37 Both the Securities Trading Automated Quotations (STAQ) System (launched in 1992) and the National Electronic Trading (NET) System (launched in 1993) provide a secondary market for the trading of state-owned legal person shares. The two computer-based markets allowed financially strapped state firms to raise cash by selling shares to other government entities without relinquishing state control. The former operates with the participation of market-makers but the latter operates without them. See Business Asia, China Halts Trade on Institutional Markets, Oct. 25, 1999 at http://www.findarticles.com/cf_dls/m0BJT/20_7/ 57624448/p1/article.html (last viewed at May 6, 2003).


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York respectively) was to avoid the dissipation of state assets. The primary market was established to raise capital without relinquishing state control. As such, any individual is prohibited from owning more than 0.5% of the outstanding shares of the listed company. The corporatization and securitization are to improve the operation of the SOEs and hence their profitability and productivity.

The securities market is also an effective tool to redirect resources from individuals and the non-state sector to the ailing state sector. Since the opening of the PRC, private enterprises, which did not suffer from the moral hazard, have been striving and such entrepreneurs formed an affluent class. In addition, Chinese workers were hard working and frugal. With limited investment channels, most money stayed in the various types of bank account. The A share market, when created, was limited to domestic investors and was targeted at the huge saving of private individuals.

The first objective, namely, to raise capital for the ailing SOEs has been achieved in the early years of securitization. However to continuously tap into the pockets of individual investors and to attract the sophisticated institutional investors, the government has to make sure that the securities market is liquid and growing and the investors’ interests are protected.

40 See Guanyu Jinyibu Jiaqiang Zai Faxing Guptao He Shangshi Guanli [Concerning Further Strengthening the Share Issuance and Listing Management Overseas], generally known as The Red Chip Guideline issued by the State Council on 20th June 1997, preamble.

41 See Guptao Faxing Yu Jiaqyi Guanli Zaoxing Tieli [Provisional Regulations on Administration of the Issuing and Trading of Shares] promulgated by the State Council in 1993, art.46.

42 See Cao, supra note 35, at 43-44. (Over the years, the prosperity of the non-state sector allowed the PRC’s private citizens to save large amount of money. With one of the highest annual savings rates in the world – approximately thirty percent – private surplus capital at one point constituted approximately RMB 1.3 trillion or US$260 billion, although other sources put the amount at US$310 billion, with an estimate US$200 billion idle in the domestic banking system and another US$100 billion concealed outside the system, under mattresses.)
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(b) Modernization

For the purpose here, modernization is defined as the orientation of the companies to adopt any management structures or systems that will enable the companies to stay competitive both domestically and internationally in the market. This objective of the securities market is more difficult to achieve than the first one.

After restructuring and repackaging, the structure of the listed company may be more modernized (shareholders' meeting, board of directors, supervisory board), the accounting standards more updated and the enterprise more market-driven. Yet essentially, the change is more in form than in substance for SOEs. For instance, as a general practice, the loss making liabilities are transferred to the parent company to boost up the profit of the would-be listed company in the pre-IPO restructuring. After a successful IPO, the listed company will continue to fund the parent company through numerous connected transactions. The personnel of the enterprise will remain the same, with the chairman, most directors and managers appointed by the government and the committee of the Communist Party exists side by side with them. As the government is deeply involved with the management of the listed companies, all the problems of the ailing SOEs remain due to moral hazard and lack of incentive. The management is still bureaucratic with rampant corrupt practices.43

(c) Social and Political Stability

The securities markets were necessary to save the economy which was described by some to be “on the brink of disaster”44 in 1978. If the PRC government opens the securities markets but chooses not to intervene, many

43 Gu Xiaorong, ZHENGQUAN FANZHU YU ZHENGQUAN WEIGUI WEIFA [Securities Crimes and Violation] 25 (China Procuratorate Press, 1998) observed that insider trading and manipulation of the market have been carried out almost half-openly in the PRC with the involvement of high ranking officials.

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SOEs will be in demise because of its lack of competitiveness. Others may fall under foreign control and the restructuring may be more ruthless. Subsequent massive unemployment will threaten social stability and ultimately the communist rule. Fear of foreign intervention and dissipation of state assets as the communist leaders learnt from not very distant Chinese history result in the segregation of shares (to avoid full privatization and retain control of the enterprises) and the segmentation of the stock markets (to confine foreign elements to specific markets). The PRC government welcomes foreign investment but at the same time never fails to keep a close eye on it. The ultimate reason behind government intervention in the early phase of securities market development is to keep itself in power and social and political stability are instrumental in achieving this goal.

4. Equity Share Characteristics

In the PRC, shares are compartmentalized on the basis of their ownership rights and they are named under different alphabets, namely A shares, B shares, C shares, H shares and N shares. Other than the ownership rights and the fact that dividends of B and H shares are paid in foreign currency, all the shares enjoy the same rights and obligations and rank pari passu with one another.

“A” shares\(^45\) (also known as domestic shares – neizi gu) are shares that are denominated and traded in RMB and can only be bought and sold by domestic investors before the creation of qualified foreign institutional investors (“QFII")\(^46\). By December 2000, a total of approximately RMB 324 billion had

\(^{45}\) A shares include “internal employee shares” (neibu zhigong gu) which shares issued to employees of the issuing companies and their transferability is limited. See [1 MAIN REPORT - STRATEGIC ISSUES AND OPTIONS] COUNTRY OPERATIONS DIVISIONS, WORLD BANK, CHINA, THE EMERGING CAPITAL MARKET 83 (Report No. 14501-CHA, Nov. 3, 1995). Companies ceased to issue internal employee shares from 1998. See Notice Concerning Forbidding Issuing Internal Employee Shares, promulgated by the CSRC on Nov. 25, 1998 as Zhengjian Fazi No. 297, effective on the same day, paras. 1 and 2.

\(^{46}\) Although foreigners are not allowed to hold A shares, a small proportion of A shares are believed to be in the hand of foreigners, probably Taiwanese, by investing in locally registered companies and it is one of the reasons that prompted the government to allow for the issue of B shares. See COUNTRY OPERATIONS DIVISIONS, WORLD BANK, supra note 45, at 83.
been raised through the issue of A shares.47 "B" shares are shares denominated in RMB and traded in United States dollars in Shanghai Stock Market and Hong Kong dollars in Shenzhen Stock Market. Historically B shares48 could only be bought and sold by foreigners49 but since February 19, 2001, PRC investors were permitted to buy and sell B shares.50 By December 2000, a total of approximately US$ 5 billion had been raised through the issue of B shares.51 "H" shares are PRC companies whose shares are listed on the Hong Kong stock market. It is readily apparent that the issue of A share raises most capital to be followed by H shares52 and then by B shares. B share trading suffers from poor liquidity. One of the reasons is that B-share company is required to disclose adjusted profits in accordance with international accounting standard which significantly reduce its profits and since investors make decisions on the net profit ratios, there is a significant disparity between the market price of A shares and B shares.53

"N" shares are issued by the PRC companies. The actual "N" shares are not traded and they are held by a custodian. With 20 N shares, one American Depository Receipt ("ADR") is issued and the ADR are listed on the New

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48 "B" shares are usually referred to as "domestically listed and foreign invested shares" (jinguo shangsi waizi gu) in Chinese laws and regulations.

49 A Shanghai banker explains: "Controls are very lax. If you go to the B share market you will only see local people. They use the passport of a relative who lives abroad. This also means they can then get their hands on foreign currency. They then trade." However arbitrage the A share and B share markets is not possible as the two markets are kept separate. See Chris Cockerill, The Two Faces of Chinese Capital, Euromoney (Dec. 2000).

50 The aggregate market value of the B share trading market rose from only RMB 50 billion on Feb. 19, 2001 to RMB 150 billion by the end of March 2001. See CHEN & SHIH, supra note 47, at 33.

51 See id. 29 (please note that there is a discrepancy between table 2.3 on p.29 and the description on p.28 regarding the denomination of B share issue).

52 In principle, if a listed company has issued B shares or H shares, it will not be allowed to issue A shares unless there are exceptional circumstances. See Supplementary Notice Concerning Several Questions on Share Issuance promulgated by the CSRC on Mar. 17, 1998 as Zheng Jian [1998] No. 8, para. 1.

53 See id. 33.
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York Stock Exchange ("NYSE"). PRC companies have also shares listed on LSE in the form of global depository receipts. Other countries where PRC companies are listed include Singapore, Tokyo and Toronto.

"C" shares are legal person shares and they refer to shares of a joint stock company or any company or institution with a legal person status and are generally regarded as shares indirectly owned by the state. However a detailed analysis shows that they can be more complicated as they are further subdivided into the following: (a) state-owned legal person shares—shares owned by the state indirectly through economic entities like trust and investment companies or securities companies; (b) collective enterprise legal person shares—there are three types of collective enterprises: i) collective enterprises that are owned by the local government; ii) collective enterprises with state assets but are deemed not to be owned by the state; iii) collective enterprises which are individually owned but are attached to a supervisory administrative department for licensing or tax purposes; (c) private enterprise legal person shares—they are limited liability companies financed by private individuals; (d) foreign invested enterprise legal person shares—they are shares owned by foreign-owned enterprises with legal person status, namely, the sino-foreign equity joint ventures, the sino-foreign contractual joint ventures and the wholly foreign-owned enterprises and (e) institutional legal person shares are shares owned by institutions with legal person status including trade unions, the Communist Youth League and the Women’s Federation. Such shares are not tradable on the securities markets. The transferability of C shares has never been made clear by Chinese legislation. In practice, C shares were traded over the counter on the NETS \(^5^6\) and STAQS \(^5^7\) systems (the NASDAQ-type

\(^5^4\) Under art. 2 of the Provisional Measures on the Regulation of State-owned Share Rights Issued by Companies Limited by Shares jointly promulgated by National Administration of State Assets and the SCREC promulgated on and effective as of Nov. 3, 1994, "state-owned legal person shares" are the shares obtained by a state-owned legal person industrial enterprise or state-owned legal person non-industrial entity in exchange for the capital contribution made by that enterprise or entity to a company limited by shares using the state assets to which the enterprise or entity has a legal right to dispose.

\(^5^5\) See Gu & Art, supra note 36, at 115.

\(^5^6\) NET System went into operation in 1993 and was developed, and is operated and managed by China Securities Trading System Co. Ltd. (CSTS). The CSTS was jointly owned by the
computerized trading systems) by the PRC state and private enterprises with legal person status, both of which were closed in September 1999. \(^{58}\) Since June 1993, new issue of C shares has been banned. \(^{59}\) "C" shares are supposed to be able to be converted into "A" shares or "B" shares although officials are apprehensive about approving such transfer as it may flood the existing securities markets and they tend to be cautious to avoid any dissipation of state assets. \(^{60}\) Consequently, such conversion therefore remains insignificant.

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\(^{57}\) STAQ was launched in 1992 in response to a report by the SCREC entitled "Key Points of Economic Restructuring for 1992" to speed up organization restructuring of the enterprises and the shareholding systems. The market operation of the STAQ System is run by a membership organization, China Stock Exchange Executive Council. By 1993, the STAQ System had a member of 294 financial institutions including nine large government-owned financial institutions. Unlike the two stock exchanges and the NET System, the STAQ System operates in a dealer market environment with the compulsory participation of a maker maker in every trade. See CHENGXI YAO, STOCK MARKET AND FUTURES MARKET IN THE PEOPLE'S REPUBLIC OF CHINA 46, 47 (Oxford University Press, 1998).

\(^{58}\) The rise of share prices of the legal person shares had broken all records in May 1993 and the ferocious speculative trading lasted for half a month before the CSRC promulgated a guideline to slow down the approval for legal person shares to be listed on May 20, 1993. Since then, the trading of legal person shares was thin and in 1997 Net was renamed Central Bond Clearing and Settlement Company Limited and share trading was deleted from its scope of business. On Sept., 9 and Sept. 10, 1999, STAQ and NET respectively claimed that due to technical reasons, all trading activities were suspended and since then they have not reopened for trading. Approved by the CSRC, The Securities Association of China issued the Provisonal Measures Concerning Off Market Securities Transfer Service by Securities Companies on Jun. 12, 2002 to deal with legal person shares originally listed on these two computer-based markets, signifying the demise of STAQ and NET. See The Securities Association of China, Brief Introduction to the Off Market Securities Transfer System at http://www.s-a-c.org.cn/stock/sysintro.htm (The Securities Association of China: Share Transfer/Brief Introduction to the Off Market Securities Transfer System) (in Chinese); see also China Business, "Huo Zhe Chu Ju ? - Qi Nian Fa Ren Gu Xing Shuishu Lu [Coming Out Alive? - The Rise and Fall of Legal Person Shares in Seven Years]", Jan. 18, 2000 (No. 1243) (in Chinese), also available at http://www.cb.com.cn/old/asp/1243/1243f16.htm; also Sohu, "STAQ, NET Xi Tong <Shi Dian Bian Fa> Chu Tai [The Promulgation of Provisional Measures for STAQ and NET Systems], Feb. 25, 2002 at http://business.sohu.com/82/28/article200282885.shtml (last viewed Jan. 27, 2004).

\(^{59}\) THE INTERNATIONAL SECURITIES CONSULTANCY, THE CAPITAL GUIDE TO CHINA'S SECURITIES MARKETS 13(ISI Publication 1994).

\(^{60}\) See id.
State shares or state-owned shares are by far the largest number of shares and as the name suggests, the shares are owned by the states. Under the Provisional Measures on the Regulation of State-owned Share Rights Issued by Companies Limited by Shares jointly promulgated by National Administration of State Assets and the State Commission for Restructuring the Economic System ("SCREC") promulgated in 1994, "state share" are defined as shares obtained by an institution on behalf of the state in exchange for capital contribution made by that institution on behalf of the state to a company limited by shares. Unless the state approves their transference, they are not tradable. State shares are used by the government to maintain the predominance of the socialist public ownership system but the government also hopes that it will be the first step to enhance the operating efficiency of state assets. With the creation of the state shares and state-owned legal shares, the government also calls for a clear delineation and separation of its functions as market regulator and market participants. However the existence of state shares and state-owned legal person shares in particular raise a number of questions which remain unanswered by existing laws and regulations: What are the legal relationship between the state and the entities that hold state shares or state-owned legal person shares? What are the corporate law and securities law characteristics of the state shares and state-owned legal person shares? How can the investment performance of state assets be enhanced when the transfer of state shares and state-owned legal shares in the secondary market is forbidden or strictly restricted in fear of losing the predominant position of state ownership in the national economy? What measures can be taken to ensure the dual functions of the government as market regulator and market participator be separated?

This equity structure reflects that on one hand, the Chinese government was eager to attract foreign investment by allowing foreigners to buy shares from certain PRC companies and on the other hand, the Chinese government sought to protect state-owned assets and retain the dominant control of socialist public ownership through the use of state shares, legal person shares and A share.

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61 Provisional Measures on the Regulation of State-owned Share Rights Issued by Companies Limited by Shares jointly promulgated by National Administration of State Assets and the SCREC promulgated on and effective as of Nov. 3, 1994, art. 2.
offering. However the share structure became a major problem when the PRC government wanted to further develop its stock markets by attracting more potential investors. As a result, the PRC government put forward the state share reform in 2005 which is discussed in the last chapter of this thesis.

5. Regulatory Agencies

a. China Securities Regulatory Commission

In the early stage, the PBOC and its local branches oversaw the securities market. Being the central bank in the PRC, the PBOC was given the power to regulate bonds and shares and, among other things, to approve their issue, to license securities firms and to monitor the securities markets. The power was initially given to the PBOC rather than an independent government body because the central bank can then retain the overall control over investment funds raised by the public issue of the securities. As the national stock exchanges were located in Shanghai and Shenzhen, the respective local governments in these two municipals also participated in the regulation of the stock exchanges in conjunction with the local branches of the PBOC in Shanghai and Shenzhen. To complicate the bureaucratic structure, different aspects of securities activities were also regulated by various government bodies including the State Planning Commission ("SPC"), the SCREC, and the Ministry of Finance ("MOF").

Widespread fraud and government corruption in the stock markets involving the PBOC resulted in a riot in Shenzhen in 1992. The PRC quickly learnt a lesson that poorly managed equity markets might cause social unrest which

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62 ZHU, supra note 1, at 28.

63 ZHU, supra note 1, at 8-14.

64 Tens of thousands of potential investors queued up overnight to obtain the forms necessary to subscribe to a share offering only to discover that the forms had all been distributed internally. Angry investors resulted in major riots and the incident is generally known as the “810 Incident”.

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was most feared by the Chinese government. Other than the power to license securities firms, the regulatory power of the PBOC over the securities market was then taken away. This is the first step towards a more independent securities regulatory body. The mismanagement or the alleged corruption of the PBOC officials is only the immediate cause. The PBOC is responsible for regulating banks and financial institutions which compete with the stock markets for funds and there was an apparent conflict of interest in its role as the securities regulator.

In its place, the State Council Securities Committee ("SCSC") was established as an independent body to coordinate various ministries, formulate polices and draft laws and regulations for the securities market. The SCSC was made up of various government ministries and commissions including the PBOC, the SPC, the SCREC, the MOF, the State Bureau for the Administration of State Assets, the State Administration of Industry and Commerce, the State Tax Bureau, the Supreme Court and the State Administration for Foreign Currency Control. The CSRC was established as the executive arm of the SCSC to implement the administrative measures of the SCSC. The CSRC initially had a professional and international team headed by Liu Hongru with many staff trained in Hong Kong. As CSRC was a quasi-government vice-ministerial body, it could not communicate with ministry-level departments unless through the SCSC. Bearing in mind the composition of SCSC, any action taken by CSRC in the PRC might need the approval and cooperation of a galaxy of bureaucratic ministries. The CSRC therefore devoted most of its time to explore listing PRC companies in Hong Kong. When Chairman Liu was ousted in 1994 and his team disbanded, the CSRC became a more localized government body and

65 Throughout history, Chinese leaders' concern for social stability is reflected and well-documented in writings. Such writings can be found in the centuries even preceding the Han Dynasty: "When the granaries are full, [the people] will know propriety and moderation, when their clothing and food are adequate, they will know [the difference between] honour and shame." See W. Allyn Rickett, *GUANZI: POLITICAL, ECONOMIC, AND PHILOSOPHICAL ESSAYS FROM EARLY CHINA* 52 (Princeton University Press, 1985).

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its power began to increase. In 1998, the SCSC was dissolved and the CSRC was elevated to a ministry level directly under the State Council endorsed by the Securities Law. The CSRC finally won the official turf war and became the all powerful regulatory body of the securities markets. The rivalry between different ministries still exists and it continues to affect the development of the securities market.

The functions and responsibilities of CSRC include promulgating securities-related laws and regulations, supervision of the securities industry, enforcement of securities-related laws and regulations and setting standards for the securities intermediaries.

b. Stock Exchanges in the PRC

Since 1997, the power of overseeing the exchanges was transferred from their respective regional governments and the local provincial branches of the PBOC to the CSRC. The stock exchanges in the PRC have little power to regulate the listing of companies:

i. Reporting System: According to the provisional rules issued by the CSRC, the stock exchanges must follow the reporting system to report various matters to the CSRC. Although stock markets like the NYSE

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67 CARL E. WALTER ET AL, TO GET RICH IS GLORIOUS - CHINA'S STOCK MARKETS IN THE '80S AND '90S 10-11 (Palgrave, 2001).

68 The CSRC is not responsible for the issuing of bonds. However it has regulatory authority over any bonds listed on the PRC exchanges. MOF is responsible for the issue of treasury bonds; People's Bank of China for the examination and approval of financial bonds and provincial and municipal people's government for the examination and approval of regional enterprise bonds or regional investment companies. See ASIA LAW & PRACTICE, CHINA FINANCE MANUAL 54 (Brian W. Semkow ed., Asia Law & Practice, 1995).

69 Securities Law, art. 167 and Revised Securities Law, art. 179.


71 Id.
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also need to report to its regulators\textsuperscript{72}, the CSRC's reporting system cover nearly all decisions of the stock markets, some for approval, some for possible objection and some for information.\textsuperscript{73} The CSRC has an absolute power to intervene nearly every step performed by the stock exchanges. Despite two attempts to relax some administrative approvals\textsuperscript{74}, the CSRC still retains tight control over the stock markets.

Listing Standards: Although the Measures\textsuperscript{75} provide that the stock exchanges should stipulate rules concerning listing\textsuperscript{76}, only government agencies have the real power to decide which company to be listed. There have been many rules regarding listing standards since the securities markets began to develop in the PRC. \textit{Provincial Measures of Shenzhen Municipality for Administration of the Issue and Trading of Shares} was promulgated by the Shenzhen Municipal People's Government.\textsuperscript{77} The State Council issued the \textit{Provisional Provisions on


\textsuperscript{73} Circular Concerning 'Provisional Rules for Reporting System of Stock Exchanges', supra note 70, art. 3.


\textsuperscript{75} Measures for the Administration of Securities Exchanges approved by the State Council on November 30, 1997 and promulgated by the Securities Committee of the State Council on December 10, 1997; re-promulgated by the CSRC on December 12, 2001 according to the Reply of Approval of the State Council Concerning the Amendment of the Measures for the Administration of Securities Exchanges.

\textsuperscript{76} Id. art. 3.

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The Management of the Issuing and Trading of Stocks. The Measures for the Administration of the Listed Company Issuing New Shares was issued by the CSRC. All of the rules regarding listing standards were promulgated by government departments not the stock exchanges.

The stock exchanges did issue their listing rules. According to an official in the Department of Market Supervision at the CSRC, all the articles relating to information disclosure in the listing rules were not drafted by the stock exchanges themselves but by the CSRC.

After the CSRC has granted a company to be listed, the CSRC allocated such a company to one of the two stock exchanges for listing. Although the listing rules provide that “[a] company may apply to list its shares on the Exchange, after the issue is verified by the CSRC, subject to examination and approval by the Exchange,” in fact it is impossible that a stock exchange denies the listing of a company after the CSRC has verified it. It is completely within the CSRC’s power to decide which companies are qualified to be listed.

iii. Suspension and termination: In western countries such as US, normally a stock exchange promulgates and implements rules regarding the standards of suspension or termination of listings. In the PRC, however, it is the CSRC that promulgates such rules. The first circular


79 Order No. 1 of China Securities Regulatory Commission, Measures for the Administration of the Listed Company Issuing New Shares, promulgated and came into effect on Feb 25, 2001

80 A face-to-face interview conducted by Dr. Huaiyu Wang with an official at the Department of Market Supervision at the CSRC. The interview happened from 16:30 to 17:30 on April 20, 2004.


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concerning suspension and termination was issued by the CSRC in February 2001. Soon after, the CSRC issued another circular to revise the first one and abolish the old one. The CSRC made further revision on the rules regarding suspension and termination of listings about a year later.

As it is completely within the CSRC’s power to decide which companies are qualified to be listed, it is also completely within their power to determine which companies’ listing should be terminated or suspended. What the stock exchanges have to do is just to follow the CSRC’s decision as if they were the CSRC’s branch offices.

6. Securities Laws and Regulations of the PRC

Unlike the over 900 year-old common law system in the United Kingdom, the PRC legal system is only about 50 years old. The civil law system in the

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86 The first criminal code in China can be traced as far back as 455 - 395 B.C. During the Warring States period (475 to 221 B.C.), legalism advocated strict rules of law as legalists maintained that human nature was inherently evil and therefore needed the restrictions of law to moderate potential disruptive behaviour. Legalism was most influential during the Qin Dynasty (221 to 207 B.C.). During the Han Dynasty (206 B.C to 220 A.D) Confucius’ more optimistic philosophy modified the harsh Qin laws giving greater decision-making powers to magistrates during trials. During the late Qing Dynasty (1644-1911), attempts were made to implement a modernized Japanese legal system based on German judicial precedents, however these efforts were short-lived. After the overthrow of the Qing Dynasty in 1911, China fragmented into various regions each governed by a warlord; during this period there were no legal reforms or developments. In 1927, Chiang Kai-shek’s Guomindang government suppressed the warlords and attempted to develop Western-style legal and penal systems, however these systems failed to be implemented nationwide. In 1949, the Communist government abolished all Guomindang laws and judicial organs. In 1953, the PRC government set about establishing a new legal framework by first implementing certain criminal laws and in the period 1954 to 1957 continued by drafting criminal and civil codes based on the Soviet model. This process was reversed by the Cultural Revolution (1966-1976) which overturned the legal system in a mass anarchic decentralizing movement. The present PRC legal system was allowed to develop only after the demise of the Cultural Revolution. See Federal Research
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PRC means that case laws are not binding precedents and all sources of law are legislated.

To understand the hierarchy of law in the PRC is the first step of understanding how the legal system works. The constitution has the highest status but it only provides general guidelines. Without implementing legislation, it is not enforceable. However any amendment to the Constitution reveals important ideological changes in the PRC. Communists believe that law is only a superstructure, an instrument used by the ruling class. It is the ideology that moves history. After the founding of the Communist China in 1949, there were a succession of four constitutions in 1954, 1975, 1978 and 1982. The present 1982 constitution was amended in 1988, 1993, 1999 and 2004. In 1988, the Constitution was amended to give private sector certain legal recognition ("...the private sector of the economy is a complement to the socialist public economy...") and allowed for the right to transfer land according to law. In 1993, the Constitution stated for the first time that "the basic task of the nation is, guided by the theory of building the socialism with Chinese characteristics, to concentrate its efforts on the construction of socialist modernization." The changes reaffirmed the socialist market economy and importance of the SOEs and collective economic organizations to be independently operated in accordance with law. The 1999 amendments went one step further by

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87 ALBERT HUNG-YEE CHEN, AN INTRODUCTION TO THE LEGAL SYSTEM OF THE PEOPLE’S REPUBLIC OF CHINA Chapter 6 (Butterworths Asia, 1992).


89 Zhonghua Renmin Gongheguo Xianfa (Constitution of the PRC) (hereinafter "Constitution"), art. 11.

90 Constitution, art. 10.

91 Constitution, seventh paragraph of the preamble.

92 See Constitution, art. 15.

93 See Constitution, arts. 16 and 17.
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affirming Deng Xiaoping's theory i.e. the socialist economy with Chinese characteristics and asserted that non-public ownership economies are important component to the socialist market economy (the previous version is that they were "supplements to the socialist market economy"). The important theory of "Three Represents" expounded by Jiang Zemin was written into the PRC's Constitution, along with the provision that "citizens' lawful private property is inviolable" and "the State protects the lawful rights and interests of the non-public sectors of the economy and encourages, supports and guides the development of the non-public sectors of the economy." The gradual swing from centrally planned economy to the more capitalist economy can be discerned from the various amendments to the Constitution over the years.

The supreme legislative body in the PRC is the NPC and its legislative enactments include laws (fa) and resolutions (jueyi) (the latter being the amendments or supplements of laws) and decision (jueding). The 1982 Constitution gave the NPC plenary meeting the sole authority to enact and amend those "basic laws" (jiben fa) which dealt with "criminal offences, civil affairs, the state organs and other matters". NPC only meets once a year but

94 "Deng Xiaoping's theory" is added to "the guidance of Marxism-Leninism and Mao Zedong Thought". This move aims to parallel Deng's proposals for market reform with the theories of Marxism-Leninism to justify the capitalist reforms in the past two decades. See Constitution, the preamble.

95 Constitution, art. 11 (1999 Amendment).

96 Constitution, art. 13.

97 Constitution, art. 11 (2004 Amendment).


99 See also Zhonghua Renmin Gongheguo Lifa Fa [the Legislative Law of the People's Republic of China] adopted by the Third Session of the Ninth National People's Congress of the People's Republic of China on 15 March 2000 promulgated as Presidential Decree No. 31, effective from July 1, 2000, arts. 7 and 8.
NPC Standing Committee meets six times a year and its power to make laws was affirmed after the promulgation of the 1982 Constitution. Its legislative enactments include laws (fa), regulations (tiaoli) and decisions (jueding). By far, most laws were passed by the State Council and its legislative enactments include regulations, resolutions, decisions, measures (banfa), notices (tongzhii), orders (mingling), directions (zhishi), detailed rules (xize), and detailed implementing rules (shishi xize). Since 1982, the NPC has the additional authorization from the State Council to promulgate temporary legislation (zhanxing tiaoli and zhanxing guiding) on issues of economic reform and restructuring, and opening to the outside. At local level, departments under the State Council, people's governments in provinces, municipalities directly under the central government, special autonomous regions all have law-making power. The 1982 Constitution provides that the laws should not conflict with the Constitution; administrative regulations should not conflict with the Constitution and the laws and local regulations should not conflict with the Constitution, the laws and administrative regulations. The titles of the laws and regulations may also denote their

100 See also the Legislative Law of the PRC, art. 7.

101 When a law is enacted, there usually follows the implementing rules. Laws tend to state the general principle and the implementing rules are more detailed and more practical in their implementation.

102 The Legislative Law of the PRC, art. 56.

103 The word "Regulation" cannot be used in departmental rules and provincial government legislation and the words "rule" and "measure" should be used instead. See the Regulation on Rule-making Procedures promulgated by State Council as No. 322 on Nov. 16, 2001 and effective as of Jan. 1, 2002, art. 6.

104 MURRAY SCOT TANNER, THE POLITICS OF LAWMAKING IN POST-MAO CHINA 45 (Clarendon Press, 1999). See also the Legislative Law of the PRC, art. 9.

105 The Legislative Law of the PRC, art. 63. See the Regulation on Rule-making Procedures, art. 9. For departments under the State Council, approval has to be obtained from State Council and for provinces, municipalities directly under the central government and special autonomous regions, approval has to be obtained from provinces of a higher level.

106 Constitution, art. 5.

107 See id, art. 89(1). See also the Legislative Law of the PRC, art. 78.

108 See id, art. 100. See Chapter 5 of the Legislative Law of the PRC, in particular arts. 78-83.
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territorial application. The word “jingnei” (inside the Chinese territory) refers to laws and regulations that apply to securities activities carried inside the PRC and the word “jingwai” (outside the Chinese territory) refers to laws and regulations that apply to securities activities carried outside the PRC. 110

While conceding that great progress has been made since 1977 in clarifying and codifying Chinese legislative authority and procedures, the key lines of authority and procedures between the major law-making institutions are only vaguely defined. The words “basic law” in the Constitution remains undefined. The Legislative Law of the PRC has significantly clarified the law-making process. However it is still rather arbitrary regarding economic and financial laws and regulations. 111 The result is a system which is not clear even for the officials working within it. Party, NPC and State Council officials must separately negotiate for each law to decide which state organ should promulgate it. They are all anxious to maximize their sphere of influence and jurisdictional disputes are not uncommon. 112

As for the interpretation of laws, the NPC Standing Committee has the power to interpret laws tantamount to legislative amendments. 113 The Supreme People’s Court, the Supreme People’s Procuratorate, and the State Council can suggest interpretation to the NPC Standing Committee. 114 Departments under the State Council or a local government may also interpret local regulations. 115

109 In law, the local regulations will be superseded by national regulations if any inconsistency arises. See also the Legislative Law of the PRC, art. 63. In practice, due to the protectionism of different provinces and the central government being further away, some enterprises may prefer to follow the local regulations to please the local authorities.

110 ZHU, supra note 1, at 40.

111 The Legislative Law of the PRC, arts 8(8) and 9.


113 The Legislative Law of the PRC, art. 42.

114 Id. art. 43.

115 See the NPC Standing Committee’s Resolution on Strengthening the Work of Interpretation of Laws (1981). See also the Regulations on Rule-making Procedures, art. 33.
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As a rule of thumb, for any ambiguity in a departmental rules and measures, interpretation should be sought from the government departments or ministries that promulgated such legislation.

As discussed above, any piece of legislation that uses the word "law" (fa) is an important piece of legislation to be followed by administrative regulations. The major laws in the PRC regarding securities industry are The Securities Law and The Company Law. The Securities Law applies to the issue and trading of shares, corporate bonds and other securities recognized by the State Council and it is the first comprehensive national law on securities matters. The Company Law and other laws and administrative regulations supplement the Securities Law for any issue relating to issuance and transaction of the shares, corporate bonds and other securities affirmed by the State Council if the Securities Law does not provide for it. 116 One of the laws and administrative regulations that deals with the issue and trading of domestic shares is the Provisional Regulations on Administration of the Issuing and Trading of Shares promulgated in 1993 which is the first attempt to unify the regional laws and regulations regarding the issue and trading of shares. 117

At local level, Trading Rules Governing Shanghai and Shenzhen Stock Exchanges were promulgated on August 31, 2001 and effective three months after its promulgation to replace the Shanghai Stock Exchange Trading Rules (revised on June 8, 2001 and amended on February 25, 2002) and Shenzhen Stock Exchange Trading Rules (revised June 7, 2001 and amended February 24, 2002).

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116 See Securities Law, art. 2.

117 Since 1986, many securities-related rules and regulations had been passed before the promulgation of the Provisional Regulations, they include the Provisional Rules Concerning the Management of the Bank of the People's Republic of China (issued Nov. 7, 1986), the Notice Concerning Strengthening Management of Stocks and Bonds (Mar. 1987), the Provisional Measures of Management of Stock Companies (1990), the Provisional Measures Concerning Management of Business of Stock Exchanges (1990) and the Provisional Measures Concerning Management of Stock Exchange Across Provinces (1990). See Gu and Art, supra note 36, at 115.
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B shares are primarily governed by Regulations of the State Council Concerning Foreign Investment Shares Listed in the People's Republic of China of Joint Stock Companies\textsuperscript{118} and its Detailed Implementing Rules\textsuperscript{119} both promulgated on and effective from December 25, 1995. H shares are primarily governed by the State Council Special Regulations on the Overseas Offering and Listing of Shares by Joint Stock Limited Companies\textsuperscript{120} promulgated on and effective from August 4, 1994 which were formulated under articles 85 and 155 of the Company Law.

Other important laws and regulations include the Provisional Measures for Prohibiting Securities Fraud\textsuperscript{121} promulgated on and effective from September 24, 1993 which forbid four categories of fraud, namely, insider trading, market manipulation, deceptive practices and false statements.\textsuperscript{122}

In general, violation of laws and regulations regarding the issue and trading of securities can amount to criminal, civil and administration sanctions like delisting and revocation of business licences. Both civil and criminal remedies are important for the supervision and regulation of the securities markets. To allow for criminal sanction for securities-related wrongdoings shows the gravity of the crimes and help to send a message to the markets that such violations are intolerable.\textsuperscript{123} However only when the investors are encouraged

\textsuperscript{118} Guowuyi Quanmi Gufei Youxian Gansi Jingnei Shangshi Waizi Gu Guiding de Guiding [Regulations of the State Council Concerning Foreign Investment Shares Listed in the People's Republic of China of Joint Stock Companies].

\textsuperscript{119} Gufei Youxian Gansi Jingnei Shangshi Waizi Gu Guiding de Shishi Xize [Detailed Implementing Rules Concerning Foreign Investment Shares Listed in the PRC of Joint Stock Companies].

\textsuperscript{120} Jingwai Wugu Shangshi Tebie Guiding [Special Regulations on the Overseas Offering and Listing of Shares by Joint Stock Limited Companies].

\textsuperscript{121} Jinzhui Zhengquan Qizha Xingwei Zanxing Banfa [Provisional Measures for Prohibiting Securities Fraud].

\textsuperscript{122} Provisional Measures for Prohibiting Securities Fraud, art. 2.

\textsuperscript{123} The Criminal Law of the PRC (hereinafter "Criminal Law") was amended on and took effect from Dec. 25, 1999 to provide criminal sanction for a number of economic crimes relating to the securities markets.
to ask for compensation through civil cases that shareholders will take a more active part in supervising the securities market.\textsuperscript{124}

B. Introduction to the Hong Kong Securities Markets

1. Historical Background

The history of the Hong Kong securities markets is an example of the consolidation of stock markets. Economic growth in the 60s and 70s was accomplished with the establishment of various securities exchanges for raising capital in Hong Kong. As globalization has spread, international competition has become more intense and in order to survive, local competition gave way to consolidation and through this process, securities exchanges could benefit from the economies of scale and enhanced their competitive edge.

a. Securities Markets

Reports of Securities trading in Hong Kong could be traced back to mid-19\textsuperscript{th} century\textsuperscript{125} but the first formal market was not founded in Hong Kong until 1891 with the establishment of the Association of Stockbrokers.\textsuperscript{126} The Association was later re-named the Hong Kong Stock Exchange in 1914.\textsuperscript{127} The Hong Kong Stockbrokers' Association was incorporated in 1921 as the second exchange and merged with the Hong Kong Stock Exchange ("HKSE")\textsuperscript{128} in 1947 under the name of the latter.\textsuperscript{129}


\textsuperscript{126} See id.

\textsuperscript{127} See id.

\textsuperscript{128} The full name is The Stock Exchange of Hong Kong Limited.

\textsuperscript{129} See id.
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The rapid growth of the Hong Kong economy after the Second World War resulted in the establishment of three other exchanges — the Far East Exchange in 1969130, the Kam Ngan Stock Exchange in 1971 and the Kowloon Stock Exchange in 1972. 131 To strengthen market regulation, the four stock exchanges were united to form the HKSE in 1980. 132 They ceased business on March 27, 1986 and the new exchange started trading on April 2, 1986 with the new computerized system.133 The HKSE was a limited company with the exclusive right to establish, operate and maintain a stock market in Hong Kong and owed by its member brokers who must hold at least one “A” share134 which confers membership and trading privileges. 135 It was a recognized Exchange Company under the Stock Exchanges Unification Ordinance.136

Derivatives Market

Formerly known as the Hong Kong Commodity Exchange Limited137, Hong Kong Futures Exchange Limited (“HKFE”) was established in 1976 under the

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130 The Far East Exchange was established by Mr. Ronald Li Fook Shiu in 1969 and it catered to the Chinese business community by relaxing the listing requirements for small companies and selling shares in small board lots to investors. See Suzanne Lee Young, Hong Kong’s Financial Markets in The Hong Kong Securities Industry 42 (Leslie S.F. Young & Raymond C.P. Chiang eds. 3rd ed., The Stock Exchange of Hong Kong Limited & The Chinese University of Hong Kong 1997).

131 See id.

132 See id.

133 Please note that this “A” share in Hong Kong is different from the A shares in the PRC. The former grants the owners of such shares membership of and trading privileges in the HKSE.

134 See Suzanne Lee Young, Hong Kong’s Financial Markets in The Hong Kong Securities Industry 43 (Leslie S.F. Young & Raymond C.P. Chiang eds. 3rd ed., The Stock Exchange of Hong Kong Limited & The Chinese University of Hong Kong 1997).


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Companies Ordinance as a public company limited by share.\textsuperscript{138} It was also a mutual non-profit organization, recognized as an exchange under the Commodity Trading Ordinance\textsuperscript{139} and it soon becomes a derivatives leader in Asia-Pacific region.\textsuperscript{140} It was also the only exchange trading financial derivatives, but unlike the HKSE\textsuperscript{141}, it did not have a statutory monopoly.

b. Stock Settlement

Hong Kong Securities Clearing Company Limited ("HKSCC") was established in 1989\textsuperscript{142} on the recommendation of the Securities Review Committee appointed by the Governor after the 1987 Crash\textsuperscript{143}. It was a non-profit company limited by guarantee.\textsuperscript{144} It was a recognized clearing house under the Securities and Futures (Clearing Houses) Ordinance\textsuperscript{145} but it did not enjoy statutory monopoly.\textsuperscript{146} It created Central Clearing and Settlement System

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\textsuperscript{138} See generally Companies Ordinance (H.K.).

\textsuperscript{139} See Commodity Trading Ordinance § 13 (H.K.).


\textsuperscript{141} See Stock Exchanges Unification Ordinance § 27(1); Securities Ordinance § 20(1) (H.K.).


\textsuperscript{143} Betty M. Ho, Demutualization of Organized Securities Exchanges in Hong Kong: The Great Leap Forward, 33 Law & Pol’y Int’l Bus. 283, 289.

\textsuperscript{144} A company limited by guarantee allows members to enjoy limited liability by agreeing to pay an agreed amount in the event of liquidation. This form is widely used by charitable and quasi-charitable organizations and no sharing of profits is contemplated. See Gowers PRINCIPLES OF MODERN COMPANY LAW 10-11 (Paul L. Davies ed., 6th ed. 1997).

\textsuperscript{145} See Securities and Futures (Clearing Houses) Ordinance § 3 (H.K.).

\textsuperscript{146} Other than HKSCC, Hong Kong has two other clearing houses. HKSE Options Clearing House ("SEOCCH") provides clearing and settlement service to stock options trade on the HKSE while HKFE Clearing Company ("HKCC") provides services for the clearing and settlement of transactions on the Futures Exchange. They are both wholly-owned subsidiaries of their respective exchanges. After demutualization, the three clearing houses will fully integrate as a stand-alone clearing entity. See William Pearson, The Conversion to a Demutualized Exchange – The Hong Kong Regulator’s Experience, Regional Seminar organized by Asia Development Bank, Aug. 13-14, 2001 available at http://www.adb.org/Projects/APEC/Demutualization/Conversion.pdf. (William Pearson is the Director of Corporate Finance Group of SFC.)
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(“CCASS”), the central clearing and settlement system, which began its operation in 1992 and became the central counterparty for all the CCASS participants. The clearing operation will not require physical transfer of share certificates which are stored in a central depository. Share settlement is on a continuous net settlement basis by electronic book entry to participants’ stock account in CCASS.

Hong Kong Exchanges and Clearing Limited

Hong Kong’s Financial Secretary announced comprehensive market reform of the stock and futures in his 1999 Budget Speech. Under the reform, the HKSE and HKFE were demutualized and together with HKSCC, they became wholly owned subsidiaries under a single holding company, HKEx. The merger was completed on March 6, 2000 and HKEx listed its shares by introduction on the Hong Kong stock exchange on June 27, 2000. After demutualization, the HKSE, HKFE and HKSCC become wholly-owned subsidiaries of HKEx.

2. Hong Kong Model: Laissez faire economic policy

Historically Hong Kong government adopted free trade and the policy of non-intervention and it has never been changed since. Non-intervention policy does not mean that the government does not do anything. The role of the

147 See id.
148 See id.
150 For a detailed history and general discussion of the demutualization, see Betty M. Ho, Demutualization of Organized Securities Exchanges in Hong Kong: The Great Leap Forward, 33 Law & Pol’y Int’l Bus. 283 (the author argued the demutualization was initiated top down by the Hong Kong government and rushed through the legislature without adequate consultation. The Hong Kong government had hastily assumed that demutualization is a world wide trend and investor-ownership model is the most efficient model. The author seriously doubted whether there would be benefits conferred by such demutualization without creation of a competitive market environment.)
government is limited to provide a business friendly environment and the
government will leave the economy to be led by the market forces.152 The last
two Financial Secretaries of Hong Kong, Donald Tsang153 and Antony
Leung154, both reiterated the importance of government non-intervention policy
in their budget speeches.

The rationale behind the government non-intervention policy is that “investors
and entrepreneurs understand markets far better than officials and that private
initiatives are a surer way to build Hong Kong’s prosperity than any
bureaucrat’s blueprints.”155 Hong Kong has successfully transformed from an
entreport to a manufacturing centre and then to an international financial centre
and it owed its success to the market-led economy.156

The Government’s primary role is to “provide the fundamental ‘software’: personal liberty, the rule of law, a clean and efficient administration, and a
level playing field for all businesses. It must also provide the land and the
infrastructural ‘hardware’ such as schools, roads and airports that Hong Kong
needs for its growth.”157

The Government also has a duty to protect and promote Hong Kong’s
commercial interests in the national and international arenas through their
representation in, for example, the World Trade Organization and the Asia-

152 See the Financial Secretary, Donald Tsang, The 2000-01 Budget: Scaling New Heights,
address moving the Second Reading of the Appropriation Bill 2000 (Mar. 8, 2000) at
153 See id.
154 Financial Secretary Antony Leung, in his 2002/2003 Budget stressed a firm belief in the
free market’s ability to make the best use of resources, foster creativity, provide economic
impetus and create employment opportunities. See the Financial Secretary, The Hon. Antony
Leung, address moving the Second Reading of the Appropriation Bill 2002 (Mar. 6, 2002),
155 See Tsang, supra note 152, at para. 17.
156 See id. para.18.
157 See id. para. 20.
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Pacific Economic Cooperation and through negotiating and entering into bilateral arrangements with other countries.158

It is in this spirit that the Government has minimized intervention in the market over the last 50 years. The most notable example of government intervention was the establishment 16 years ago of the linked exchange rate system which stabilized Hong Kong currency against the US dollar.159 Other government initiatives have included the development of the Mass Transit Railway System and the construction of the Convention and Exhibition Centre.160 One can argue that such initiatives only improve the business environment and they fit into the non-intervention policy rather than being exemptions to the rule.

The most controversial government intervention is its intervention in the stock market and the related futures market on August 14, 1998.161

The Hong Kong Monetary Authority ("HKMA") drew its authority for such a move from its role as protector of the currency and in particular the link between the Hong Kong dollar and US dollar. The HKMA alleged that "manipulators" were profiting from a "double play". It involved speculators shorting the Hong Kong dollar in the money markets in the hope of driving up

158 See id. para. 22.

159 See id. para. 26.

160 See id.

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interest rates, thereby causing the stock market to fall; from which, having taken out short positions in the futures market and/or the stock market, they could profit. The Hong Kong government is estimated to have spent around US$15 billion buying stocks to fight speculators who bet the market would fall. By doing so, the Hong Kong government had successfully defended the peg between Hong Kong and US dollars.

The Exchange Fund Investment Limited was established by the Government in October 1998 to advise on the disposal of the shares purchased during the intervention in an orderly manner. The whole idea is to make sure that HKMA had handed over management of the equity holdings to an independent company that would operate at arm's length for the government until conditions were appropriate to place them to the market. Finally, the Hong Kong government launched the Tracker Fund of Hong Kong ("TraHK") as the first stage of its plan to dispose of its share portfolio - now worth around US$28 billion. TraHK is a unit trust that tracks the Hang Seng Index and investors buy "units" that have a value of one-thousandth of the Hang Seng. State Street Global Advisors Asia Ltd was appointed as the Fund Manager and State Street Bank and Trust Company was appointed as the Trustee of TraHK. At the time of launch, the HK$33.3 billion (approximately US$ 4.3


167 See id.

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billion) TraHK’s initial public offering was the largest ever in Asia outside Japan.169

The Hong Kong government, however, has lived up to its reputation as a defender of laissez faire economic policy and the drastic stock market intervention in 1998 remains an exception rather than the norm.170

3. Market Functions

The statutory regulatory objectives as set out in the Securities and Futures Ordinance ("SFO") are set out in section 4 of the SFO.171 The functions of HKEx in Hong Kong are in line with the international standards. According to Objectives and Principles of Securities Regulation issued by International Organization of Securities Commissions ("IOSCO") (September 1998), the three objectives of securities regulation are: 1) the protection of investors; 2) ensuring that markets are fair, efficient and transparent and 3) the reduction of systemic risk to the financial system.172 However the SFO shows that HKEx also serves additional social and political functions. The former refers to its educational role173 and the latter refers to its role in assisting the Financial Secretary in maintaining the financial stability of Hong Kong.174 Nevertheless such functions are closely related to the core objectives of IOSCO.

169 See id.

170 Chairman of the HKSF, Lee Hon Chiu, Recent Developments in Hong Kong’s Securities Markets, Dec. 1998 – Jan 1999 at http://www.csis.org/asia/hkupdate/hk141hc.html. (The former chairman of the Stock Exchange remarked that “the market intervention was indeed exceptional, but so were the circumstances” and continued to reiterate that there was not a slightest hint that Hong Kong might depart from its policy of keeping its market open to investors and financial intermediaries on a global basis and ensuring a level playing field.)


173 See SFO, art. 4(b): to promote understanding by the public of the operation and functioning of the securities and futures industry.

174 See SFO, art. 4(f).
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4. Equity Share Characteristics

Ordinary shares are the most popular security listed on the HKEx and account for most of the market's turnover whereas preference shares are rare in Hong Kong.\textsuperscript{175}

The stock market in Hong Kong is frequently used by the family companies to raise capital from the public without relinquishing the family's control of the companies. Family control is a significant feature of the corporate scene in the listed company with 66\% being family owned.\textsuperscript{176} Typically, a single extended family owns a significant portion of the shares with the dominant family members or their nominees holding the management positions.\textsuperscript{177} One study found that the top 15 families held shares with their market capitalization equivalent to 84\% of 1996 GDP\textsuperscript{178}. It is not unusual for the Chief executive officer and the Chairman to be the same person representing a single family. A survey has found that 15\% and 2\% of the Hang Seng 100 Index in 1998 and 1999 respectively have CEO and Chairman the same person representing the controlling family.\textsuperscript{179} Interlinked share holdings\textsuperscript{180} can often be found in the

\textsuperscript{175} The advantage of preference shares over ordinary shares lies in the former's fixed dividend payments and such advantage does not appeal to the general investors and fails to compensate for the lack of voting powers. Additional benefits were sometimes given to attract investors like offering additional dividends when the company prospers or permitting the investors to convert a certain quantity of preference shares to ordinary shares. See Suzanne Lee Young, \textit{Hong Kong's Financial Markets} in \textit{The Hong Kong Securities Industry} 51 (Leslie S.F. Young & Raymond C.F. Chiang eds. 3rd ed., The Stock Exchange of Hong Kong Limited & The Chinese University of Hong Kong 1997).


\textsuperscript{177} Judy Tsui & S. Lynn, \textit{Family Control, CEO Dominant and Firm Performance in Hong Kong}, Working Paper, City University of Hong Kong, 2001.

\textsuperscript{178} \textit{Family Control and the Asian Crisis}, Business Post, SCMP, Sept. 20, 2000.


\textsuperscript{180} By employing a pyramid or cross-shareholding structure, a small group can maintain a high degree of control over a corporation with relatively low ownership. For example, a family owns 50\% of a company A, which owns 40\% of company B, which owns 30\% of company C. For company A this results in a 6\% ownership of company C but...
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HKSE with the Territory’s 15 most powerful families together accounting for half of the HKSE’s total market capitalization.\(^{181}\) In view of this, protection of minority interests is particularly important for the Hong Kong stock market.\(^{182}\)

Hong Kong’s stock market is also “top heavy” with over half of the total market capitalization concentrating in just ten firms.\(^{183}\) Looking at the stock market capitalization by sector, one can find that the finance sector dominates the HKSE, accounting for over 35% of total market capitalization in 2002.\(^{184}\) Together with the consolidated enterprises which accounts for over 30%, the two sectors accounts for over 65% of the market capitalization in 2002.\(^{185}\)

5. Regulatory Agencies

The Hong Kong stock exchange is governed by a three-tier regulatory structure (the Government, the Securities and Futures Commission (“SFC”) and the

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\(^{181}\) David Ibeson, *Family Virtues Under Challenge*, SCMP (Apr. 21, 1996). See also Asia Times Online, *Li vs Lee... and a Black Eye for Singapore*, Mar. 2, 2000 at [www.atimes.com/edito/BC02Ba01.html](http://www.atimes.com/edito/BC02Ba01.html) (With Hong Kong tycoon Li Ka-shing controlling principal mobile-phone operator Hutchison Whampoa and his son, Richard Li Tzar-kai controlling CyberWorks-HKT, the combined market capitalization of these two companies accounts for 30% of the Hong Kong stock market capitalization.)

\(^{182}\) A study by Professor Larry Lang and Professor Leslie Young at the Chinese University of Hong Kong reports that a small group of elite owners controls more than 25% of all listed companies in Asia and uses corporate pyramids to “systematically siphon wealth from minority shareholders.” The researchers traced ownership and control of 2,603 listed companies in nine East Asian countries and found evidence of “systematic expropriation” of outside shareholders. The authors conclude that the problem is one of political as well as corporate governance and state the need for greater transparency and regulatory and legal reform. *Small Number of Elite Owners Control Over 25% of Asian Companies* at [www.thecorporatelibrary.com/news/2000/09_20_00.html](http://www.thecorporatelibrary.com/news/2000/09_20_00.html); see also *Asian Elite Milks Minority Shareholders* at [www.corpgov.net/news/archives/archived0010.html](http://www.corpgov.net/news/archives/archived0010.html) and *Back to the Future for Corporate Reform*, SCMP, Nov. 23, 2000.


\(^{185}\) See id.
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Hong Kong Exchanges and Clearing Limited). The SFC is an independent statutory body accountable to the Chief Executive and the HKEx is a self-regulatory body.

a. Securities and Futures Commission

At present, the principal regulator of Hong Kong’s securities and futures markets is the SFC, established in 1989 under the SFO.

Until the mid-1970s, stock and commodities markets in Hong Kong were largely unregulated. After the stock market crash of 1973-1974, the Government intervened and the core legislation governing the securities and futures industry was enacted.

The legislation was administered by two part-time Commissions (one for securities and the other for commodities trading) and the Commissioner for

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186 On September, 2002, the then Financial Secretary, Mr. Antony Leung, announced the appointment of a 3-person independent Expert Group to review the lines of communication and delineation of roles and functions under the three-tier regulatory structure. See Legislative Council, FS appoints Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure (LC Paper No. CB(1)2603/01-02). The report was released on March 21, 2003 and immediately endorsing the report’s recommendation which, among other things, will transfer the regulatory role of HKEx to the SFC, following the North American model (Enoch Yiu, Watchdogs Edge Closer to Deal on Listing Approval, SCMP July 31, 2003). Upon Mr. Leung’s decision, the GEM listing committee chairman Lo Ka-shui resigned and HKEx argued that the report would undermine Hong Kong’s competitiveness and create an overly powerful regulator with unchecked powers (Simon Pritchard & Enoch Yiu, Market Reform Delay Under Fire, SCMP, June 5, 2003). The HKEx is particular keen to keep the right to approve new listings which will enable HKEx to provide a one-stop service for listed firms. (Enoch Yiu, HKEx Willing to Hand Part of Regulatory Role to SFC, SCMP, June 14, 2003). Chief Executive, however, was believed to order a delay in implementation and the Financial Secretary withdrew the plan in April, pending further public consultation. The Government is accused of caving in to a “small minority” of vested interests. The change was supposed to improve the market quality and resolve the conflict of interests issue regarding the HKEx as Peter Clarke, one of the persons in the Expert Group, said that listing fees represent a significant part of HKEx’s revenues and some listed companies can see the benefits of less-than-effective corporate regulation. (See Stephen Seawright, Good Governance Harmed by Dodgy Presumptions, SCMP, July 21, 2003 and Enoch Yiu, Watchdogs Edge Closer to Deal on Listing Approval, SCMP July 31, 2003).


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Securities and Commodities Trading.\textsuperscript{189} The Commissioner for Securities and Trading was the executive arm of the Commissions and he headed the Office of the Commissioner for Securities and Commodities Trading which was set up as part of the government office.\textsuperscript{190} This structure remained largely unchanged for over a decade, during which time there was rapid change in the securities and futures markets, both internationally and in Hong Kong.\textsuperscript{191} Soon, the existing regulatory structure fails to adequately monitor the market.

The October crash in 1987 fully exposed the ineffectiveness of the structure, which resulted in the closure of both the Hong Kong stock and stock index futures markets for four days.\textsuperscript{192} In the aftermath of the crash, a six-member Securities Review Committee, chaired by Ian Hay Davison, was set up to examine Hong Kong’s regulatory structure and regime to see how they could be improved so as to minimize the chances of a repeat of the disruption and chaos of October 1987.\textsuperscript{193}

In May 1988, the Committee released its report, which concluded that the Office of the Commissioner for Securities and Commodities Trading had insufficient resources properly to regulate the ever changing and growing Hong Kong market.\textsuperscript{194} The Committee suggested that there should be active surveillance and monitoring of markets and intermediaries instead of ineffective routine vetting.\textsuperscript{195} It also concluded that the two commissions lacked strong direction and had become passive and reactive, instead of being active and proactive.\textsuperscript{196} The Committee recommended that the then existing

\textsuperscript{189} See id.

\textsuperscript{190} See id.

\textsuperscript{191} See id.

\textsuperscript{192} See id.

\textsuperscript{193} See id.


\textsuperscript{195} See id.

\textsuperscript{196} See id.
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structure should be replaced with a single statutory body outside the civil service. 197 Such statutory body should be headed and staffed by full-time professional regulators and funded primarily by the market with broad investigative and disciplinary powers to enable it to perform its regulatory functions effectively. 198 Thus, the SFC was born in May 1989.199

The SFC is an independent statutory body established under the Securities and Futures Commission Ordinance ("SFO")200 but still forming part of the wider machinery of the Hong Kong government. It was accountable to the Governor, and after 1997, it is accountable to the Chief Executive of Hong Kong, for the discharge of its responsibilities, and is also responsible for advising the Financial Secretary on all matters relating to the securities, futures, and leveraged foreign exchange market.201

The SFC is responsible for administering the laws governing the securities and futures markets in Hong Kong and facilitating the development of these markets. It is divided into four operational divisions: Corporate Finance, Intermediaries and Investment Products, Enforcement, and Supervision of Markets. Each division has its distinct responsibilities. 202

b. The Stock Exchange of Hong Kong Limited

HKSE has the exclusive right, under the SFO, to establish, operate and

197 See id.

198 See id.


200 SFC, Regulatory Objectives at http://www.hksfc.org.hk/eng/about_sfc/html/index/index1.html (last updated July 15, 2003). The SFCO and nine other securities and futures related ordinances were consolidated into the SFO, which came into operation on April 1, 2003.

201 The Chief Executive shall appoint the chairman of the SFC (see SFO, Schedule 2, Part 1, Art. 1) and give directions to the SFC if it is in the interest of the public (the SFO, §11). One of the objectives of the SFC is to assist the Financial Secretary (the SFO, §4) and the SFC has to furnish information required by the Financial Secretary (the SFO, §12).

maintain a stock market in Hong Kong.\footnote{The SFO (Cap 571), §19.} Under the SFO, the stock exchange has the duty to ensure an orderly, informed and fair market and acts in the interest of the public especially the investing public.\footnote{The SFO (Cap 571), §21.} HKSE is the primary regulator for Stock Exchange participants with respect to trading matters\footnote{The SFO (Cap 571), §21(4) and (5).} and the primary regulator of companies listed on the Main Board and GEM.\footnote{HKEx, Structure and regulation of Hong Kong’s securities and futures market at http://www.hkex.com.hk/index.htm.}

6. Securities Laws and Regulations of Hong Kong

Consistent with the government’s non-intervention policy, the activities of the stock markets and commodities markets were left virtually unregulated until the mid-seventies. The proliferation of stock exchanges in the early seventies followed by the 1973-74 stock market crash prompted a series of measures to regulate the markets and to protect investors, resulting in the enactment of the Securities Ordinance and the Protection of Investors Ordinance in early 1974, the establishment of the Securities Commission and the Office for the Commissioner of Securities and Commodity Trading in the same year, the promulgation of the Code on Takeovers and Mergers in 1975.\footnote{Niu Tiehang, Regional Stock Market Integration in China and Hong Kong (CAER Discussion Paper No. 16, Dec. 1996) at http://www.cid.harvard.edu/caer2/htm/content/papers/paper16/paper16.htm (last visited Jan. 2, 2005).}

This regulatory framework remained largely unchanged through the seventies and eighties but the rapid change and growing sophistication of securities and futures markets both world-wide and in Hong Kong prompted Hong Kong legislators to formulate sophisticated laws governing stock market operations. As a result, Hong Kong’s securities and futures legislation was spread over 13 Ordinances, 6 Codes (including the Hong Kong Code on Takeovers and
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Mergers, Code on Unit Trusts and Mutual Funds, etc.) and 11 Guidelines, creating inconsistencies and duplication. 208

Hong Kong government understood a complete overhaul of the securities regulation was required. The law governing the securities market should be consolidated to avoid duplication; the law should cater for the latest market innovation and technological development; the division of labour between the HKSE and SFC in their regulatory roles should be rationalized; there should be a single clearing arrangement of securities, stock options and future transactions. The Hong Kong government decided to accomplish all these tasks with the promulgation of one law and the Securities and Futures Bill came into being. The Bill was divided into 17 parts and it comprised 9 appendices and 653 sections that spread across more than 1,100 pages 209. Since submission to the legislature in December 2000, fifty-five meetings had been held, involving more than 300 documents. 210 The ordinance was enacted on March 13, 2002 and finally became effective on April 1, 2003. 211

208 See id.


210 See id.

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SFO consolidated 10 ordinances and subsidiary legislations have been passed. SFO includes, among other things, the following initiatives: introduction of a single licensing regime to streamline the existing registration requirement; strengthening the SFC's power to inquire into listed companies misconduct; the establishment of a Market Misconduct Tribunal ("MMT") to promote a fair market; tightening the disclosure requirements for securities interests, providing a private cause of action to investors who suffer losses arising from false or misleading public communication of the listed corporations or market misconduct and providing efficient channels of appeal against SFC decisions for aggrieved parties.

C. The Rationale for a Single Securities Market in China

What benefits would accrue to Hong Kong and the PRC if their stock markets were to integrate? This article argues that three objectives, namely, a) wealth-maximization, b) cost minimization and c) a level playing field for all economic players, should be the criteria by which to judge the benefits of integration to both Hong Kong and the PRC.

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212 The following 10 ordinances have been consolidated into the SFO and were repealed accordingly:

(1) Securities and Futures Commission Ordinance (Cap. 24) (enacted 1989)
(2) Commodities Trading Ordinance (Cap. 250) (enacted 1976)
(3) Securities Ordinance (Cap. 333) (enacted 1974)
(4) Protection of Investors Ordinance (Cap. 335) (enacted 1974)
(5) Stock Exchanges Unification Ordinance (Cap. 361) (enacted 1980)
(6) Securities (Insider Dealing) Ordinance (Cap. 395) (enacted 1990)
(7) Securities (Disclosure of Interests) Ordinance (Cap. 396) (enacted 1988)
(8) Securities and Futures (Clearing Houses) Ordinance (Cap. 420) (enacted 1992)
(9) Leveraged Foreign Exchange Trading Ordinance (Cap. 451) (enacted 1994)
(10) Exchanges and Clearing Houses (Merger) Ordinance (Cap. 555) (enacted 2000)

See Legislative Council Brief, Regulatory Reform for the Securities and Futures Market - The Securities and Futures Bill (SU B38/31, 2000) and §406 of the SFO.


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The first criterion is wealth maximization, an objective that Posner urged policy-makers to adopt regardless of who benefited. Wealth-maximization originates from the idea of welfare maximization which is rooted in a utilitarianism that claims that the morally right policy is that which produces the greatest happiness for the greatest number of people. In this context the word “happiness” may be translated into “welfare”, “well-being”, “utility” or even “efficiency”. Utilitarianism has been adopted by economists and translated into a notion of welfare maximization. Utilitarians are consequentialists who measure whether a policy is right or not by looking at the consequences (in the present context, a change in human welfare). The concept of utilitarianism has taken many forms but a constant element in the utilitarian philosophy is its bias towards any policy that seeks to satisfy the greatest number of informed and rational preferences among people in a society. Welfare maximization is broad and includes factors like well-being

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217 Examples of different variants of utilitarianism include welfare hedonism, non-hedonistic mental-state utility, preference satisfaction, informed preferences, act utilitarianism, rule utilitarianism and indirect utilitarianism. For details of their differences, see id. 13-20, 28-32. Utilitarianism is criticized for failing to recognize special relationships (by treating everyone as equal) and failing to exclude illegitimate preferences (such as selfish preferences at the expense of others). See id. 42-43.

218 Utilitarianism is concerned with making the right decision and our decision depends on our preferences. There are three preferences that utilitarians do not want to take into consideration, namely, preferences that are adaptive, irrational and due to a lack of information. Human preferences are adaptive in the sense that if one cannot achieve certain desired goals, one will lose their desire for it. Such adaptive preferences are not desirable as a repressive regime that deprive people of their opportunities can become their preferences if they cannot
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that are difficult to measure whereas positivists tend to translate it into wealth maximization which is easier to measure.

The second criterion is cost minimization, notably expounded in Coase's famous theorem which advocates adopting any law and alternative institutional devices that minimize the transaction costs of operating a stock market including the costs borne by investors and financial intermediaries. Such costs in the context of a stock market may include research and information costs, financial infrastructural costs, human resources costs and supervisory and enforcement costs.219

The third criterion is a level playing field for all players. Equity in the sense that everyone should be treated equally and fairly is the cornerstone of all plausible political philosophy.220 It is arguable that a level playing field may not achieve equity as it may not be fair to domestic players as they are less competitive. Such arguments are often voiced in the area of development law which is rooted in two fundamental but opposing viewpoints namely

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220 Kymlicka, supra note 216, at 4. Equity is different from equality which is more controversial. The meaning of equality and how it can be achieved differ significantly under different political philosophies. Under Rawl's difference principle, the more fortunate only receive extra resources if it benefits the unfortunate otherwise all social primary goods, i.e. liberty and opportunity, income and wealth, and the bases of self-respect, are to be distributed equally. See JOHN RAWL, A THEORY OF JUSTICE 303 (Oxford University Press, 1971). Dworkin's liberal theory of equality of resources and various socialist theories of "compensatory justice" aim at an ambition-sensitive, endowment-insensitive distribution. Dworkin's policy focuses on ex post correction to the inequalities created by the market instead of creating ex ante equality. Examples of ex ante equality include Bruce Ackerman's stakeholder society, Philippe Van Parijs's basic income, John Roemer's coupon capitalism and egalitarian planner. Kymlicka, supra note 216, at 83-85. Marxist equality requires socializing the means of production whereas Nozick's "Entitlement Theory", a form of libertarianism, assumes that everyone is entitled to the goods they currently possess so long as they are justly acquired, so Nozick's equality arises from distribution resulting from people's free exchange. Kymlicka, supra note 216, at 103 and 176.

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modernization theories and dependency theories. The former argues for a free market economy while the latter argues for protectionism as “underdevelopment” is the result of a system of world capitalism that perpetuates extractive and exploitative relations with the developing world.

A middle ground can be struck between the ahistorical approach of the modernization theorists and the entrenched protectionist approach by allowing a gradual opening of the economy based on the development and characteristics of the country concerned, a strategy adopted by the PRC government.

Arguments for the integration of Hong Kong and PRC stock markets are therefore crucially based on notions of wealth maximization and cost minimization with a level playing field among all players, especially between domestic and international players with its appeal to foreign investors, a further important element. The integration of the Hong Kong and PRC stock markets should provide a win-win situation and the following section will attempt to highlight the benefits that such an integration would bring about.

1. Advantages for the PRC

a. Effective Rules and Regulations

Regulators in both the Hong Kong and PRC stock markets understand the importance of corporate governance and as they upgrade their laws and regulations.

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222 Id. at 28.

223 Rumu Sarkar’s value-neutral Janus Law Principle takes into consideration the time and the spatial dimension of development. See Id. at 40-41.

regulations for protecting investors, their laws and regulations gradually move closer to each other and substantial rules and regulations become more amenable to harmonization. Recently, the Mexican and Asian economic crisis and the downfall of corporate giants in the US such as Enron and WorldCom have rung alarm bells for both Hong Kong and PRC and have highlighted the importance of good corporate governance. Finding the political will to legislate for good corporate governance and to implement such legislations is vital for creating a solid foundation for the integration of Hong Kong and the PRC.

With its established common law tradition, its sophisticated legislature and a well established system of public consultation, Hong Kong's legal edicts are much more transparent than most of its PRC counterparts. Law-making in the PRC tends to be more paternalistic and policy-led225 despite the fact that it is also based on international standards, intermittent public consultation and discussion with its own legal scholars. 226 Harmonizing the laws and regulations of the PRC and Hong Kong capital markets will upgrade the quality


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of rules and regulations in the PRC and make them more effective in achieving their objectives.

As a member of the Financial Stability Forum, Hong Kong is an active advocate of closer international co-operation in raising the disclosure and regulatory standards of international or offshore financial centres.\textsuperscript{227} The Hong Kong government is involved in discussions with the international community on the development and implementation of a voluntary code of conduct for market participants, including highly leveraged institutions. The aim is to ensure fair and orderly transactions in the foreign exchange market.\textsuperscript{228}

In Hong Kong, the new Securities and Futures Ordinance ("SFO"), which came into effect on April 1, 2003, consolidates ten previous securities-related ordinances\textsuperscript{229}. This ordinance aims to enhance the efficiency, transparency and accountability of the regulatory regime in Hong Kong as well as establishing measures that encourage listed companies to behave in a more open and responsible manner towards their shareholders. The Ordinance also improves the roles and investigative powers of existing regulatory authorities.

Hong Kong's ongoing determination to enhance corporate governance\textsuperscript{230} is part of a global trend; it is already an exemplar of corporate governance in its

\textsuperscript{227} See Tsang, supra note 152, at para. 73.

\textsuperscript{228} See id.

\textsuperscript{229} The following 10 ordinances have been consolidated into the SFO and were repealed accordingly:

(1) Securities and Futures Commission Ordinance (Cap. 24) (enacted 1989)
(2) Commodities Trading Ordinance (Cap. 250) (enacted 1976)
(3) Securities Ordinance (Cap. 333) (enacted 1974)
(4) Protection of Investors Ordinance (Cap. 335) (enacted 1974)
(5) Stock Exchanges Unification Ordinance (Cap. 361) (enacted 1980)
(6) Securities (Insider Dealing) Ordinance (Cap. 395) (enacted 1990)
(7) Securities (Disclosure of Interests) Ordinance (Cap. 396) (enacted 1988)
(8) Securities and Futures (Clearing Houses) Ordinance (Cap. 420) (enacted 1992)
(9) Leveraged Foreign Exchange Trading Ordinance (Cap. 451) (enacted 1994)
(10) Exchanges and Clearing Houses (Merger) Ordinance (Cap. 555) (enacted 2000)

See Legislative Council Brief, Regulatory Reform for the Securities and Futures Market – The Securities and Futures Bill (SU B38/31, 2000) and §406 of the SFO.

\textsuperscript{230} See Tsang, supra note 152, at para. 77.
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This determination can be illustrated with reference to a comprehensive study launched in 2000 by the Hong Kong government, with the help of the Standing Committee on Company Law Reform aimed at identifying and plugging any gaps in the corporate governance regime in Hong Kong in order to make it a benchmark for the region.232

In order to maintain Hong Kong's status as an international financial centre, the Financial Services and the Treasury Bureau is working with Hong Kong Securities Futures Commission ("SFC") and Hong Kong Exchanges and Clearing Limited ("HKEx")233 to implement the Corporate Governance Action Plan announced on January 10, 2003.234 This Plan upgrades the standard of governance for listed companies and the quality of the equity market.235 Since

231 Id. The sixth annual corporate governance survey conducted in 2005 by CLSA Asia-Pacific and the Asian Corporate Governance Association ranks Hong Kong second just one point less than Singapore after reviewing companies in ten Asian markets on their corporate governance standards. See Enoch Yiu, Hong Kong Narrows Gap as Singapore Slips, South China Morning Post ("SCMP"), Nov. 23, 2005.

232 See id; the consultation was conducted in two stages. The first one is a survey and analysis of the attitudes of international institutional investors towards corporate governance standards in Hong Kong with particular reference to the PRC listings. The second one is a comparative survey and analysis of development of corporate governance standards in both competitor jurisdictions in South East Asia and jurisdiction elsewhere in the world. The survey covers Singapore, Taiwan, Malaysia, the UK, the USA and Australia and was conducted by Professor Judy Tsui and Professor Ferdinand Gul. See also Standing Committee on Company Law Reform, Corporate Governance Review: A Consultation Paper on Proposal made in Phase I of the Review, July 2001 available at http://www.info.gov.hk/cf/download/scclr/cgr2_e.pdf and Standing Committee on Company Law Reform, Corporate Governance Review: A Consultation Paper on Proposal made in Phase I of the Review, June 2003 at http://www.info.gov.hk/cf/download/scclr/Rpt_e.pdf.

233 Hong Kong's Financial Secretary announced comprehensive market reform of the stock and futures in his 1999 Budget Speech. Under the reform, The Stock Exchange of Hong Kong Limited and Hong Kong Futures Exchange Limited were demutualized and together with Hong Kong Securities Clearing Company Limited, they became wholly owned subsidiaries under a single holding company, Hong Kong Exchanges and Clearing Limited ("HKEx"). The merger was completed on March 6, 2000 and HKEx listed its shares by introduction on the Hong Kong stock exchange on June 27, 2000. After demutualization, the HKSE, Hong Kong Futures Exchange Limited and Hong Kong Securities Clearing Company Limited become wholly-owned subsidiaries of HKEx. See Betty M. Ho, Demutualization of Organized Securities Exchanges in Hong Kong: The Great Leap Forward, 33 Law & Pol'y Int’l Bus. 283.


235 The Corporate Governance Action Plan identified five priority areas: (a) upgrading the Listing Rules and Listing Functions; (b) tightening the regulation of Initial Public Offering
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the launching of the Action Plan, the SFO has been successfully implemented and consultation paper on the regulation of sponsors and independent financial advisers were jointly published by the SFC and HKEx in May 2003. A further indication of the high level of corporate governance can be found in the fact that even some non-government organizations have taken up the initiative on their own volition to improve the corporate governance.

The PRC government also aspires to achieve good corporate governance. In the PRC, Dr. Zhou Xiaochuan, speaking as the chairman of China Securities Regulatory Commission ("CSRC"), explicitly stated that corporate governance would be a major focus for the CSRC and as part of this focus, the CSRC promulgated the ninety-five articles, the Code of Corporate Governance for Listed Companies in China (the "Code"), on January 7, 2001 and was effective on the same day. The Code set out the standards by which good

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237 The Hong Kong Institute of Directors, a non-government body comprising a membership of more than 700 directors and senior decision makers, is also planning to publish a handbook, "Corporate Governance Guidelines for SMEs" to improve the corporate governance of small and medium-sized enterprises in Hong Kong. Financial Services and Treasury Bureau, Corporate Governance and Investors at http://www.info.gov.hk/fsf/article-e-1.htm (last modified Sept. 30, 2003). Also see Hong Kong Institute of Directors at http://www.hkid.com.


corporate governance could be measured against.\textsuperscript{240} The Code follows the Principles of Organization for Economic Co-operation and Development adopted in May 1999 and covers the five main areas elucidated by the Principles, namely, (1) the right of shareholders and their protection; (2) the equitable treatment of all categories of shareholders, including minority and foreign shareholders; (3) the role of employees and other stakeholders; (4) timely disclosure and transparency of financial and non-financial information; and (5) the responsibilities of the board of directors.\textsuperscript{241}

The PRC's quest for good corporate governance is not only restricted to listed companies but also extends to financial intermediaries. Existing CSRC Chairman, Shang Fulin, in his first major speech since taking office in 2002 told securities brokers in August 2003 that he intended to implement new measures to crack down on kind of the financial irregularities that have tainted the reputation of the PRC stock markets.\textsuperscript{242} Results of this crackdown can be seen in the fact that in the following two and a half years, 19 PRC brokerages were closed down and taken over due to identified malpractices. However establishing widespread good corporate governance is still an uphill struggle; in 2004 PRC's securities firms lost at least RMB15 billion\textsuperscript{243} with both government and big foreign investment banks having to bail out the brokers and the government taking over or closing down 20 of the worst cases.\textsuperscript{244} Despite these obstacles the CSRC, like similar regulators in Hong Kong, is committed to improving the standards of its financial intermediaries and listed companies.

\textsuperscript{240} See the Code, the Preamble.


\textsuperscript{243} Jamil Anderlini, Mainland Brokerage Losses Top 15b Yuan, SCMP, June 15, 2005.

\textsuperscript{244} Mark A DeWeaver, New Hope for Chinese Stocks, CHINESE BUSINESS, Dec. 16, 2005.
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b. Effective Supervision of the Capital Market

Effective supervision of the capital market is essential for the prosperity of the stock market and there is much the PRC government can learn from Hong Kong. The problem lies not so much in the financial laws themselves, as most PRC financial laws are of international standard, but more in the enforcement of these laws.

There is a widespread belief in the West that the PRC is tolerant of financial malpractice, especially when important communist officials are involved; corrupt officials are suspected of being dealt with quietly and leniently in order to avoid any political backlash against the PRC government. But in early 2002, when US regulators fined the Bank of China US$20 million for lending misconduct the PRC government was forced to act publicly against the culprits. Besides a loss of face, the scandal nearly wrecked the Bank of China’s US2.3 billion fund-raising exercise in Hong Kong in the summer of 2002. As a result of the government’s investigations into the scandal three important communist party officials, Zhu Xiaohua (the former head of the Everbright Bank), Wang Xuebing (former head of the Construction Bank of China), and Duan Xiaoxing (former head of Huaxia Bank) were all charged, the former two being sentenced to death\textsuperscript{245} and Duan being sentenced to seven-year imprisonment. During this period the government was also involved in pursuing three other Bank of China officials who had absconded with US$483 million from a small branch in southern China. In 2002, the State Administration of Auditing conducted an in-depth investigation and found 22 cases of major fraud involving US$326 million of banking malpractices\textsuperscript{246} and actively pursued the culprits involved despite their senior positions. In the same year, according to CSRC statistics, 16 board members of various listed companies were convicted


\textsuperscript{246}Louise Do Rosario, China – China Cleans up Tainted Image – After a Succession of High-profile Bank Officials have been Accused and Convicted of Fraud, China is Tightening Regulation so the Banks can Raise Much-needed Capital from the Stock Market, The Banker, Oct. 1, 2002.
of disseminating false or misleading information.\textsuperscript{247} The PRC has prosecuted and punished nearly 50,000 corrupt officials at various levels in their anti-corruption campaigns during the period of 2004 and 2005,\textsuperscript{248} a not inconsiderable achievement. On April 19, 2005 the PRC also formally became a member of a regional anti-corruption initiative, namely, \textit{the Asia Development Bank/ Organization for Economic and Co-operation and Development Anti-Corruption Initiative for Asia Pacific}.\textsuperscript{249} Other than government measures, investigative reporting in the PRC financial press also helped to expose the perpetrators of market malpractice.\textsuperscript{250} Despite these successes in bringing the perpetrators of financial malpractice to account, broad legal enforcement against corrupt senior officials in key financial positions is still a distant goal with the present court system still far from being an independent body.\textsuperscript{251}


\textsuperscript{250}In 2001, Beijing-based financial newspaper "Caijing" exposed false information released by the Shenzhen-listed Guangxia Group and led to the trading of its stocks to be suspended. Caijing can be so outspoken because its corporate parent is the Stock Exchange Executive Council, the think-tank that helped the establishment of the national securities exchanges. (See Nailene Chou Wiest, Financial Journalism and Market Reforms in China, 2002 available at http://www.rthk.org.hk/mediadigest/20020614_76_29681.html).

\textsuperscript{251}Historically, the qualifications and competence of judges in the PRC vary greatly as no legal training was necessary for a judge during the Cultural Revolution. Since the opening of the PRC, the competence and shortage of judges are partly due to the low remuneration package they receive in the PRC compared with other professions that require similar qualifications. E Xiang Wan, Vice Chairman of the Supreme People's Court, said that salary for a lawyer could be 100 times more than a judge. He was reported to say that most law students would prefer to be a lawyer, to be followed by working in a big corporation before they would finally consider to be a judge. Hong Tao Shi, A Shortage of More Than 10,000 Judges – Government Officials Laments the Fact that Law Students do not Want to be Judges, XINHUANET quoting from CHINA YOUTH DAILY, March 11, 2005 at http://big5.xinhuanet.com/gate/big5/news.xinhuanet.com/newscenter/2005-03/11/content_2681103.htm (in Chinese). Ironically it has been specified that one of the rights of the judges is to be free from interference from administrative organs although it is not perceived as such by the outside world due to the appointment and funding systems (from the municipalities instead of the central government) and the hierarchy of the government structure. See Judge Law promulgated on July 28, 1995 and amended on June 30, 2001 available at http://www.law-lib.com/law/law_view.asp?id=15374, art.8(2).
Compared with the PRC, the *laissez faire* market economy of Hong Kong offers better supervision of capital markets based on the rule of law; this in turn contributes towards a more favourable investment environment. In his budget speech of 1997, the Financial Secretary, Donald Tsang, underscored this by saying that Hong Kong was supported by "four pillars of wisdom"\(^\text{252}\); the rule of law, a level playing field, corruption-free government and the free flow of information.\(^\text{253}\) In Hong Kong the rule of law is enforced by independent courts which are fair, open to all and which provides a level playing field. The protection afforded by the rule of law is crucial for the healthy working of competitive markets and for conducting business efficiently. Hong Kong's relatively corruption-free government, essential to the preservation of the rule of law and the maintenance of a level playing field, has been aided in its fight to maintain high standards by the work of the ICAC, an active and effective anti-corruption agency.\(^\text{254}\) Finally, the free flow of information leading to transparency and accountability in both the public and the private sectors has been fostered by a free media and public consultation on any major new legal government initiatives. Hong Kong, therefore, can act as a good role model for the PRC in its attempts to improve legal enforcement of good corporate governance.


\(^{253}\) See id.

\(^{254}\) For a general discussion of the corruption situation in Hong Kong, see T. Wing Lo, *Corruption and Politics in Hong Kong and China* (Open University Press, 1993). Hong Kong Independent Commission Against Corruption (ICAC), which was established in Feb. 1974, was significant for the fight of corruption in Hong Kong. It has a three-tiered approach to tackle corruption, that is, investigation, prevention and education. ICAC was set up upon the recommendation of the report released by Sir Alastair Blair-Kerr. The report stated that to fight corruption and be effective, an independent commission had to be set up separated from the police force. See ICAC website at [http://www.icac.org.hk](http://www.icac.org.hk) for a brief history of the Commission. According to statistics from KPMG quoted by SCMP, there was a steady increase of corruption reports and corruption reported was more than four times in 2002 than in 1974. See Enoch Yiu, *White-Collar Crime Loss Soars* (the accompanied table), SCMP, Sept. 30, 2003. However such an increase of corruption reports might also due to a more public awareness against corruption.
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c. Established Financial Infrastructure Based on International Standards

The rapid development of internet finance in both Hong Kong and the PRC is perhaps the single most important factor in facilitating integration of the markets. The internet transcends physical boundaries and enables real-time information flow. By tapping into the sophisticated technology used in Hong Kong’s financial centres, the PRC can reduce costs and increase efficiency in raising capital. Consolidation of stock markets does not require the actual physical integration of stock markets into the same geographic location; markets can be effectively merged through the connection of computer terminals and networks.

The Hong Kong government has long acknowledged that in a fast growing hi-tech international community, Hong Kong has to keep abreast of technological innovation to remain competitive as a major international financial centre.\(^\text{255}\) In 1999 the Hong Kong government listed technological improvement as one of three major and equally important areas for development in its three-prong reform programs for the securities and futures markets.\(^\text{256}\) The first listed area was market structure reform with the stated aim of demutualizing and merging the exchanges and clearing houses; this was effected on March 6, 2000. The second area concerned regulatory and legislative reform through the implementation of the SFO; this was achieved on April 1, 2003. The third area was the enhancement of the financial infrastructure through improved

\(^{255}\) The Hong Kong government has also adopted the “Digital 21” strategy in 1998. “Digital 21” is a response to the vision of Mr. Tung Chee Hwa, the Chief Executive of Hong Kong in 1997 that Hong Kong is to be “a leader and not a follower in the information world of tomorrow”. The 1998 Digital 21 Strategy aimed to “enhance and promote Hong Kong’s information infrastructure and service so as to make Hong Kong a leading digital city in the globally connected world of the 21\(^{\text{st}}\) century.” In 2001, the Strategy focused on five areas: enhancing the e-business environment, building e-government, developing the IT workforce, strengthening the community capability to exploit the digital world, and exploiting enabling technologies. (See Digital 21 Strategy, Hong Kong: Connecting the World, May 2001, 4 at http://www.info.gov.hk/itbb and http://www.info.gov.hk/dig21/engstrategy2004/strategy_main.html.)

\(^{256}\) Financial Services Branch of Financial Services and Treasury Bureau (Hong Kong), Positioning Hong Kong’s Securities and Futures Market for the Next Millennium available at http://www.fstb.gov.hk/fsb/topical/doc/sec_2.doc (last viewed Jan. 23, 2006).
technology to improve management, increase efficiency, and reduce costs.\textsuperscript{257} Technological improvement was to be initiated by importing and developing state-of-the-art technology and systems for the markets to maintain the competitive edge of the HKEx stock and future markets.\textsuperscript{258} To achieve this goal, three issues had to be addressed\textsuperscript{259}: (i) setting up a single clearing arrangement for securities, stock options, futures and other exchange-related transactions; (ii) enhancing the financial technology infrastructure to facilitate straight-through processing of transactions across financial markets; and (iii) moving towards a secure, scripless securities market.\textsuperscript{260}

The launch of the Third Generation Automatic Order Matching and Execution System ("AMS/3")\textsuperscript{261} and Internet Initial Public Offering\textsuperscript{262} in 2000 also made it easier for investors to invest through the internet free from geographical restriction.


\textsuperscript{259} See id, 3.

\textsuperscript{260} The government and the SFC have wanted to move Hong Kong towards a scripless market since the fiasco of the Mass Transit Railway Corp's initial public offering ("IPO") in Oct. 2000, when 1,508 duplicated share certificates were wrongly distributed to investor, causing more than HK$5.5 million loss to Central Registration which is responsible for printing and distributing in order to remedy the situation. (Enoch Yiu, HKEx Paper Proposes Scripless IPOs, SCMP, Oct. 22, 2003). The whole consultation and implementation process takes time and it was estimated that it would take three years till 2006 before Hong Kong can change into a market without physical share certificates (See Enoch Yiu, \textit{Paperless Trading at Least Three Years Away}, SCMP, Oct. 25, 2003). However in terms of the government bonds, Hong Kong has an advanced scripless book entry and remote auction system. See RAUL FABELLA & SRINIVASA MADHUK, \textit{BOND MARKET DEVELOPMENT IN EAST ASIA: ISSUES AND CHALLENGES 5} (Asia Development Bank, ERD Working Paper Series No. 35, 2003).


Although systems used in PRC stock exchanges are not as advanced as in Hong Kong, the number of internet users in the PRC is substantial and growing, by the first quarter of 2001 it had reached 30 million of which one million accessed the internet by mobile phone or broadband. According to the 16th Statistical Survey Report on Internet Development in China, by the end of July 2005, the number of internet users had increased to 103 million. Such statistics show that there is widespread interest in electronic commerce with a significant number of people having potential access to the financial services being offered on the internet. The extensive popularity of the internet in the PRC is part of an international phenomenon and also a reflection of the internet's ability to transcend the sheer physical size of the PRC.

The PRC government holds an ambivalent attitude towards the internet. On one hand it views the internet with suspicion, regarding it as a potential source of uncontrollable and potentially subversive foreign influence and politically undesirable information. On the other hand it recognizes the potential of the internet to expand the economy through e-commerce and internet finance and a number of policy initiatives have been made to encourage the use of the internet as a benign vehicle for economic progress. This focus on the internet as a vehicle for economic progress has been further stimulated by the rapid development of telecommunication in the PRC which has attracted foreign capital, essential to its further technological development. Under the WTO,

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foreign companies may invest in PRC internet content providers, subject to a 49% limit shareholding. 266

A major area of technological application in the securities markets is the provision of on-line securities trading. The major governing legislation for online securities trading in the PRC is, The Provisional Regulations on the Online Securities Brokerage Services 267 promulgated on March 30, 2000 which standardized the operations of the PRC's online securities brokerages. The rule received a mixed response some quarters feeling that a regulatory framework for online securities trading would help contribute to its healthy development while others were concerned that overregulation might hinder its growth. 268

The use of the internet has also become increasingly important for both listed companies and companies seeking to list on any of the PRC stock markets. Since 2000, all companies undertaking IPOs in the PRC have been required to conduct on-line road shows 269 and once listed financial statements, interim announcements and other relevant documentation of the listed companies have to be disclosed on stock exchange websites. In 2001 an average of 5000 downloads of financial statements was made for each listed company. 270

Online trading is developing at an impressive pace in the PRC. Within the first quarter of 2001, 33 brokerage firms in the PRC were licensed to carry out online trading. 271 During the same period of time, over 2.4 million investors,


267 The regulation has also been translated as "Provisional Measures for the Administration of Online Securities Instruction Services". See BAKER & MCKENZIE, CHINA AND THE INTERNET — ESSENTIAL LEGISLATION 179 (AIAIL, 2001).


269 Zhou, supra note 263, at 1.

270 See id.

271 Zhou, supra note 263. However some said that there were 23 licensed brokerage firms. See 23 China Securities Brokerages Readyfor Online Trading (Feb. 14, 2001) at http://www.internetnews.com/bus-news/print.php/588721 (names of the 22 brokerage firms provided) and
representing 8% of total investors and about 10% of all PRC internet subscribers entered their order on the net, amounting to 3.6% of the total trading volume. For the first two months of 2002, nearly US$5.15 billion worth of shares were traded online in the PRC, representing 6.24% of the total turnover of the two national securities exchanges and the number of online investors in the PRC reached 3.76 million by the end of February 2002.

Major incentives for the introduction of online trading are the speed and comprehensiveness it brings to both information dissemination and financial transactions and the economies it brings through reducing transaction costs. However the introduction of the internet into market operations can also bring many potential problems: (1) non-internet users will be less well informed and therefore disadvantaged; (2) fraudsters may find it easier to disseminate misleading or fabricated information; (3) technological problems in the system may cause major systemic problems; (4) dissatisfaction can be quickly communicated resulting in social unrest and; (5) law enforcement agents have to continuously update their IT knowledge as law enforcement of this medium becomes increasingly complex and challenging.

The development of online securities trading depends on various factors: the sophistication of investors, the cost involved, the quality of service

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272 Zhou, supra note 263, at 1.


274 See id. at 2-3.

275 SSIC, a PRC polling organization, conducted a study on 1,100 investors in a number of major cities including Beijing, Tianjin, Shanghai, Guangzhou, Harbin and Wuhan and found that only 39% of the respondents knew about the option of online trading and only 14% were familiar with the actual procedures. See Yue, supra note 268.

276 The CSRC allows no discount for online trading commission but the investors have to pay extra charge for Internet fee. See Du Minghua, Online Stock Trading Promises No Optimism (May 2001) at http://english.people.com.cn/english/200105/10/eng20010510_69587.html (last viewed Jan. 18, 2006).
provided by the online brokerages\textsuperscript{277} and the safety\textsuperscript{278} of transmitting information over the net.\textsuperscript{279} Integration of the PRC and Hong Kong stock markets can pool vital resources to develop safe and efficient online trading and the smooth and successful listing of new companies.

d. Significant Human Resources in Hong Kong

Human resources are the foundation of a successful knowledge-based economy\textsuperscript{280} and Hong Kong, being a sophisticated city with a highly developed primary, secondary and tertiary education system, can provide valuable sources of human capital in a range of professions including lawyers, accountants, businessmen, bankers, regulators and judges.\textsuperscript{281}

There are a number of eminent people of solid international financial expertise in Hong Kong who have achieved international recognition as well as recognition from the PRC government. In 1996 Anthony Neoh, during his employment as the former chairman of the SFC, was elected Chairman of the Technical Committee of the International Organization of Securities Commissions ("IOSCO"), a committee that develops uniform regulatory standards for developed markets. He was later invited by Premier Zhu Rongji

\textsuperscript{277} Most brokerages pay more attention to technology than provision of personalized services that meet the demand of the investors. See id.

\textsuperscript{278} SSIC found that 72% of the investors were concerned with the issue of safety. See SSIC, \textit{supra} note 275 and Yue, \textit{supra} note 268.

Three risks have been identified by the experts: (i) the authorized technological system may be invaded or damaged, leading to failure of online transmission of instruction; (ii) commission instruction, client information and data may be stolen or corrupted leading to monetary loss; (iii) publication of false information, leading to misrepresentation and market manipulation. See Du Minghua, \textit{supra} note 276.

\textsuperscript{279} See Du Minghua, \textit{supra} note 276.

\textsuperscript{280} The Financial Secretary, Antony Leung, address moving the Second Reading of the Appropriation Bill 2003, para. 32 at \url{http://www.budget.gov.hk/2003/eng/budget.htm} #Introduction (last viewed Mar. 23, 2006).

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in late 1998 to serve as the chief adviser to the CSRC. In February 2001, the CSRC appointed Laura Cha, former Deputy Chairman of the SFC, to the position of Vice-Chairman in charge of corporate governance. In November 22, 1999, former Chairman of SFC, Andrew Sheng was appointed to chair the Financial Stability Forum Task Force on Implementation of Standards to examine ways of fostering the implementation of international standards relevant to the strengthening of financial systems. David Carse, the long-serving bank regulator in Hong Kong, is also a member of the Council of International Advisers to the China Banking Regulatory Commission.

Since the final decades of the twentieth century Hong Kong’s economy has been moving away from a dependence on manufacturing towards a prime focus on knowledge-based and technology-intensive industries with substantial help from multi-national enterprises. As a major international financial centre, multinational business activities have also led to the spread of knowledge and advanced technology and the productive cross-fertilization of business cultures. The latest figures of the Hong Kong government show that 13 per cent of the labour force in Hong Kong is employed by multinational companies.

The PRC has increasingly been able to capitalize on the rich pool of human resources specializing in financial matters located right on its doorstep, e.g., Anthony Neoh and Laura Cha (see above). Under the senior staff secondment programme, three staff from the SFC were seconded to the CSRC while the


286 Tsang, supra note 152, at para. 53.

287 See id. para. 60.
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SFC received eight staff from the CSRC. As for the rank and file, the SFC, the HKSE, and the Hong Kong Futures Exchange Limited have a training programme for PRC regulators and exchange officials, as well as ongoing programmes for executives of H-share companies on the regulatory system, listing rules, take-over and mergers rules, and investor relations.

Both Hong Kong and the PRC have also intensified their regulatory partnership so that the PRC regulators can benefit from exposure to regulatory cultures in Hong Kong. For example, both annual reports in 1997-98 and 1998-99 of the SFC stated that the CSRC assisted the SFC in its investigations regarding securities regulatory matters. On October 14, 1999, the CSRC and the SFC signed Letter of Exchange regarding regulatory cooperation between the CSRC and the SFC, reaffirming the Memorandum of Regulatory Cooperation signed on June 19, 1993 and established additional arrangements for the Growth Enterprises Market ("GEM"). In January 2002, the SFC hosted a forum in which executives from the CSRC, the SFC, the HKEx, the Shanghai Stock Exchange, and the Shenzhen Stock Exchange exchanged views on various policies as well as practical issues concerning the regulation of securities market leading to the 28th Memorandum of Regulatory Cooperation. Both the Enforcement Division and the Supervision of Markets Division of the SFC also met their counterparts in CSRC to discuss various enforcement and cooperation issues respectively.

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289 See id.


294 See id.
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e. A Culture of Financial Innovation

Hong Kong people are well-known for being adaptable to circumstances and when it comes to the area of finance, this adaptability has been translated into a tradition of financial innovation. Continuing in this innovatory tradition the Hong Kong government has suggested to the PRC government the creation of two novel plans, namely; a) a new form of financial instrument, the China Depository Receipts ("CDRs"), and b) a new investment scheme, the Qualified Domestic Institutional Investors ("QDIIs").

China Depository Receipts ("CDRs")

A CDR is a yuan-denominated financial instrument issued by a Hong Kong listed company for PRC investors to purchase. The underlying shares which are denominated in Hong Kong dollars are not traded but held by a custodian. The mechanism is similar to the American Depository Receipts issued by PRC companies for trading on the NYSE.

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295 Anthony Neoh, Hong Kong's Future: The View of a Hong Kong Lawyer, 22 CAL. W. INT'L J. 309 (1992) (The author said that throughout the history of Hong Kong, if given an opportunity, the Hong Kong people showed that they would succeed and prosper.)

296 Yuan-denominated CDRs are suggested by the CSRC to prevent outflow of foreign exchange reserves from the PRC. See CSRC Suggests Foreign Firms to Issue CDRs in Yuan - Report, AFX News, Sept. 3, 2001, LEXIS, News Library, All News File. The key technical question is whether such CDRs will be convertible to Hong Kong shares. See China Mobile Yr to Date Subscribers Up 25 pct at 56.6 Mln, AFX News, Jun. 13, 2001, LEXIS, News Library, All News File.


298 Anthony Neoh argued that CDRs would "allow domestic investors to have a better choice [of companies to buy], and also encourage local companies to compete with the better earnings per share and corporate governance practices." Since yuan is non-convertible, proceeds raised have to be used in the PRC and will particularly be beneficial to companies whose operations are all PRC-based so that they could balance their local-currency needs with their local-currency supply by issuing CDRs. See China – China Depository Receipts Could Improve A-share Markets, Analysts Say, China Online, June 18, 2001, LEXIS, News Library, All News File.
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Despite considering this idea for some time, the PRC government has not to date produced any blueprints for the issuance of the CDRs. If CDRs were to be issued, it would give the PRC investors a further investment opportunity other than investing through the two national securities exchanges. It would also help to sustain the Hong Kong stock market's continuing recovery from the Asian economic crisis.

Qualified Domestic Institutional Investors ("QDIIs")

The QDIIs scheme, first proposed after the Asian Financial Crisis in 1997, allows certain institutional investors in the PRC to invest in the Hong Kong stock market as well as in overseas markets.

Rationale and Possible Impact of CDRs and QDIIs

Further benefits in issuing CDRs or adopting the QDIIs scheme include raising PRC investors' expected returns, broadening Hong Kong's potential pool of investors and raising the price-earning ratios of Hong Kong share offers. Both moves would strengthen the Hong Kong stock market and increase the confidence of its investors. By allowing PRC investors to invest in Hong Kong shares, it would also introduce high corporate governance standards to the PRC and accordingly help to improve the management of PRC


\[300 \text{However PRC commentators were worried that the scheme would encourage retail investors to dump their PRC stocks in favour of Hong Kong stocks and drain the liquidity of B share markets. See Wu Zhong, Mainland Ire at SAR Stock Flair, Hong Kong Imail, Mar. 19, 2002, LEXIS, News Library, All News File and Shanghai B-shares Drop 1.5 percent in Lacklustre Trade, Agence France Presse, Apr. 2, 2002, LEXIS, News Library, All News File.}

\[301 \text{It has been argued that although the listing of CDRs would benefit the SAR, it would not be of great significance to the PRC firms as their real need was for yuan capital to fund PRC expansion. See Simon Pritchard, Level Playing Field Would Spoil the Profits Bonanza, SCMP, Dec. 5, 2001, LEXIS, News Library, All News File.}

\[302 \text{Wang Xiangwei, Investors from Mainland to Get Market Access, SCMP, May 26, 2003.}

\[303 \text{Bei Hu & Mark O'Neill, Watchdog Stalls Share Scheme, SCMP, July 14, 2003.}

\[304 \text{Wang, supra note 302.}
companies.\textsuperscript{305} However the proposed introduction of CDRs and QDIIs has attracted some criticism. This criticism centres on the belief that the introduction of these schemes might exacerbate capital flight, affecting the closed capital account in the PRC and adversely affecting both the PRC stock markets\textsuperscript{306} and the liquidity of troubled banks within the PRC. However given the considerable extent of the PRC foreign reserve\textsuperscript{307}, any negative impact on the PRC stock markets caused by the introduction of CDRs and QDIIs could be absorbed.

QDIIs were finally approved for designated financial institutions in April 2006. Together with the possible implementation of CDRs in the future, they will represent a major step towards bringing the integration of the Hong Kong and PRC securities markets closer to reality.\textsuperscript{308}

2. Advantages for Hong Kong

a. Increased Liquidity and Enhanced Competitiveness

Research by the Harvard Institute for International Development indicates that the economies which have most benefited from globalization in the 15 years prior to 2001 share some common features: adopting an open trade policy, having a clean and accountable government, upholding the rule of law, placing

\textsuperscript{305} Lawrence Fok, CDRs and QDII and their impact on Hong Kong stock Market, speech in Shanghai, Apr. 29, 2002 available at \url{http://www.hkex.com.hk/library/speeches/020430speech_e.htm} (in Chinese).

\textsuperscript{306} See id.


\textsuperscript{308} See Enoch Yiu, Beijing Confident of QDII Impact on Markets, SCMP, April 20, 2006. Moreover, the Hong Kong government and the PRC government reached agreement on the main parts of the CEPA on June 29, 2003 and signed on the same day. Under CEPA, the HKEx is permitted to set up a representative office in Beijing and Hong Kong professionals can apply to practice in the PRC according to relevant procedures. (See Mainland and Hong Kong Closer Economic Partnership Agreement available at \url{http://www.tid.gov.hk/print/english/cepa/cepa_bg.html}.) CEPA will allow more communication channel between the HKEx and the stock markets in the PRC with its representative office in Beijing and therefore it will further facilitate integration between the securities markets in these two places.
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a high premium on education, having low tax rates and a flexible labour market.\textsuperscript{309} Hong Kong is often cited as a prime example in fulfilling the above criteria. It is therefore important that Hong Kong maintains these features in order to continue to reap the full benefits of globalization. Another key feature in Hong Kong's success is its use and development of technology to maximizes the benefits of globalization and minimizes its risks.\textsuperscript{310}

Integration of the Hong Kong and the PRC stock markets is desirable for both the secondary and primary markets in Hong Kong and the PRC. In the secondary market, it is easy to understand that three is better than one in terms of liquidity and hence an integrated stock exchange will be more liquid than three separate stock exchanges. In the primary market, Hong Kong needs the PRC's capital because of its restrictive growth potential and the unbalanced industry profile for the listed companies. Hong Kong's domestic economy is too small and it needs to sell its goods and services throughout the PRC, around the Asian region and to the rest of the world to keep a GDP per head of US$24,500.\textsuperscript{311} Hong Kong also needs to attract as large a share as possible of the world's trade and investment transactions to maintain its high level of development.

When, from 1992 to 1994, Mr. Charles Lee, as Chairman of SEHK Council was conducting discussions on introducing H share issues with the PRC side\textsuperscript{312}, he reasoned as follows: "The Hong Kong stock market is now quite mature; and if we were just dependent on our own companies for new listings, the growth of the market would be very slow."\textsuperscript{313} The fact was that most of the big local companies in Hong Kong had already been listed yet there were

\textsuperscript{309} Tsang, supra note 152, at para. 63.

\textsuperscript{310} See id.

\textsuperscript{311} Tsang, supra note 252, at para. 16.


significant numbers of state-owned enterprises ("SOEs") in the PRC which represented tremendous growth prospects for the Hong Kong market. Mr. Lee expressed the hope that "Hong Kong will become as important to China (meaning the PRC) as Manhattan is to the US." He felt it would be in the best interests of Hong Kong if the Hong Kong stock market could cater to the needs and wants not only of 6.8 million people in Hong Kong but also to 1.2 billion people in the PRC. This vision remains true today.

There is also a strong case letting PRC companies list on HKSE, a review of the composition of Hong Kong's own listed companies reveals a high preponderance of property based company, admitting PRC companies would diversify the range of types of companies and thus strengthen the market. In 1996, just under a third of companies listed on the HKSE were in the property sector with less than ten percent represented by industrial companies. The trading volume of industrial sector companies was less than half the volume of companies trading in the property sector. However, in the PRC, most SOEs are in the heavy industrial sector and so the listing of PRC companies in Hong Kong addresses the historical unequal weighting of industrial companies on the Hong Kong stock market. Other than changing the composition of the listed

314 See id.

315 In 1996, the properties sector, accounting for 31.05% of market capitalization, is over-represented on the Hong Kong Stock Exchange and industrial sector, accounting for 7.25% of market capitalization, is under-represented. See Suzanne Lee Young, Hong Kong's Financial Markets in THE HONG KONG SECURITIES INDUSTRY 51 (Leslie S.F. Young & Raymond C.P. Chiang eds. 3rd ed., The Stock Exchange of Hong Kong Limited & The Chinese University of Hong Kong 1997); also see HKSE, Fact Book 1996, The Stock Exchange of Hong Kong, 1996.

316 In 1996, the property sector accounted for about 32% of the average daily turnover while industrial sector only accounted for about 13% of the average daily turnover. It has significantly changed in the second quarter of 2003 where the property sector only accounted for about 11% of the average daily turnover while the industrial sector accounted for 25% of the average daily turnover. The average daily turnover of the finance sector has increased from 16% in 1996 to 25% in the second quarter of 2003. See SFC, Research Papers and Statistics/Market and Industry Statistics – Table B7-Average Daily Turnover By Industry available at http://www.sfc.hk/sfc/doc/EN/research/stat/b06.doc (last viewed Mar. 18, 2006).

317 In the second quarter of 2003, the industrial sector accounted for about 15% of the market capitalization and the property sector only accounted for 10% of the market capitalization. As Hong Kong is becoming an international financial centre, the finance sector accounted for about 38% of the market capitalization (in 1996, the finance sector only accounted for about 23% of the market capitalization). See SFC, Research Papers and Statistics/Market and
companies, integration also helps Hong Kong as an international centre for bond trading by expanding the PRC bond market. The Hong Kong government has publicly expressed its wish for more PRC bonds to be issued and listed in Hong Kong, as announced in November 2005 by Hong Kong's Secretary for Financial Services and the Treasury, Mr. Fredrick Ma Si-hang.

The above advantages to the HKEx can be obtained without integrating the stock markets i.e., through the introduction of H shares (see below) or by allowing PRC bonds to be listed on the Hong Kong bond market. However integration of the Hong Kong and PRC stock markets will allow PRC investors to invest in the Hong Kong stock market thus giving it a flood of welcome liquidity. Integration would also increase funds raised by the Hong Kong stock markets through an enlarged catchment area.

b. Invigorating the Growth Enterprise Market ("GEM")

Before the launch of a small and medium-sized enterprises ("SME") board on the Shenzhen Stock Exchange in 2004 PRC enterprises that could not meet the requirements of the PRC or HKEx stock exchanges could turn to GEM in Hong Kong. With the launch of the SME board, GEM suffered a diminution of trading. This setback, compounded with the negative effects of the bursting of the hi-tech bubble, considerably weakened it. It would therefore be very much in the interest of GEM if it were to merge with the SME board and be reinvigorated by renewed access to the listing of small and medium sized PRC companies.

The development of venture capital companies in the PRC is a recent phenomenon. Venture capital funds may have been active in the PRC for more
than 20 years but the new kind of venture capital targeting emerging high-tech companies only began to appear in 1993. Venture capital has been defined as “investment by special venture capital organizations in high-growth, high-risk, often high-technological firms that need capital to finance product development or growth and must, by the nature of their business, obtain this capital largely in the form of equity rather than debt”. The activities of venture capital companies paved the way for the establishment of a “growth enterprise market” similar to the one in Hong Kong as an exit venue. Venture capital investment was further encouraged with the promulgation of the Several Opinions on Establishing a Venture Investment Mechanism (the “Opinions”), approved by the State Council in November 1999.

To rationalize and justify the existence of two stock markets in the PRC, some commentators have suggested transforming the Shenzhen Stock Market into a “growth enterprise market”. Pending such a change, listing of new enterprises was suspended in September 2000. A new set of listing rules for such a “growth enterprise market” was drafted and the public was consulted.

320 Francis Bassolino, In Search of Growth, China turns to High-Tech Venture Capital Funds, 2 HARVARD CHINA REVIEW 1 (spring/summe r 2000), at pp. 48-51.


323 It was expected that Beijing would allow A-Share listings again on the SZSE in 2003 as over 100 companies have been queuing up for initial public offerings after regulatory approval of their listing plans and Shenzhen has been lobbying for the ban to be lifted. See Beijing May Clear Shenzhen Listings, SCMP, Apr. 11, 2003. In January 2004, the IPO of consumer electronics and mobile phone maker TCL Corp. on the SZSE was the first IPO in the SZSE since October 2000. See SZ Stock Exchange’s First IPO in 3 Years, Shenzhen Daily, Jan. 8, 2004 available at http://www.szed.com/szdailv/20040108/ca718775.htm (last viewed Jan. 18, 2006).
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However the Asian crisis and the bursting of the hi-tech bubble delayed indefinitely the implementation of such a plan. In May 2004, the CSRC approved the establishment of the SME board in the Shenzhen Stock Exchange.\textsuperscript{324} As stated above it would be greatly in the interest of GEM if it were to merge with SME board and be revitalized by access to the listing of hi-tech, small and medium sized PRC companies.

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3. Favourable Factors for Integration

There exist potent and compelling factors for the integration of the Hong Kong and PRC stock markets: geographical proximity and therefore a similar trading time, cultural synergy that arises from sharing similar cultures, the same written language, and historically close economic cooperation between Hong Kong and the PRC.

The introduction of H shares to the HKSE in the early nineties, although not overtly intended as such, was indirectly a major practical step in bringing the stock markets closer together. H shares help to harmonize listing rules between the Hong Kong and the PRC stock markets and also further pave the way for the integration of these markets. In 1993, H shares issued by PRC companies were allowed to cross-list on the Hong Kong Stock Exchange\(^{325}\) and they were also allowed to cross-list on GEM\(^{326}\) (the second board which was launched on the Hong Kong Stock Exchange in late 1999\(^{327}\)). The H share listing was made possible by the introduction of a new set of legal and operational rules in the PRC and Hong Kong and it was a first step towards the harmonization of laws and rules between the two jurisdictions.\(^{328}\)

\(^{325}\) BAO MING GAO & YAN MEI FU, SECURITIES MARKETS IN CHINA 127 (Henry M.K. Mok et al. eds. 1997).

\(^{326}\) GEM allows companies with potential growth to list on the Hong Kong stock market even though they cannot meet the requirements to be listed on the Main Board. Investors are reminded that investment in companies listed on GEM is riskier than those on the Main Board. The GEM adopts a disclosure-based philosophy rather than a merit-based one. The Exchange will review all listing documents to see if they comply with the Companies Ordinance, the Securities and Futures Ordinance and the GEM Listing Rules but it will not assess the commercial viability of the listing applicants. It works on the principle of caveat emptor or buyers beware. See GEM, Regulatory Philosophy and Major Features of GEM at http://www.hkgem.com/aboutgem/e_default.htm (GEM: About GEM/ Regulatory Philosophy and Major Features of GEM).


\(^{328}\) See Wu, supra note 312.
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the Hong Kong Stock Exchange in late 1999\textsuperscript{327}). The H share listing was made possible by the introduction of a new set of legal and operational rules in the PRC and Hong Kong and it was a first step towards the harmonization of laws and rules between the two jurisdictions.\textsuperscript{328}


\textsuperscript{328} See Wu, supra note 312.
D. Provisional Conclusions – Integration Offers Significant Benefits to both the HK and PRC Stock Markets

The preceding brief outline of the PRC and Hong Kong securities markets shows that they possess distinct features which are very different from each other. The PRC practices a socialist market economy whereas Hong Kong implements a laissez faire economic policy. The former emphasizes government planning and the latter minimum government intervention. The main function of the PRC stock markets is to raise funds for the SOEs (corporatization without privatization329) while the main function of the Hong Kong stock markets is for corporate financing and privatization. The equity structure in the PRC stock markets is heavily segmented but the equity structure in the Hong Kong stock markets is much more integrated. The regulators in the PRC securities markets are government officials and the CSRC is a government ministry under the State Council, while the SFC is an independent statutory body accountable to the Chief Executive. Unlike its PRC counterparts, the self-regulatory body in Hong Kong, the HKEx, has been demutualized and listed on the Hong Kong stock exchange and it shares a regulatory role over trading and listing matters on the stock market. The latest disagreement over its regulatory role with the government shows that it has significant influence on the government policy as well.330

However economic models are not static and the PRC government policy has been changing over the years. The abolition of the quota system331, opening up

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329 The mere share listing will inevitably facilitate a certain degree of privatization but the emphasis is on corporatization (the conversion of SOEs into shareholding companies) and securitization (the sale of shares of such companies in the securities market) as the PRC government is still the majority shareholder of such companies. See William I. Friedman, One Country, Two Systems: The Inherent Conflict Between China’s Communist Politics and Capitalist Securities Market, 27 Brook. J. Int’l L. 477 (2002). Also see C. Lan Cao, Chinese Privatization: Between Plan and Market, 63 Law & Contemp. Probs. 13, 43-44 (2000).

330 See supra note 186.

331 The quota system is consistent with its central planning policy. The quota system is divided into two parts. The first part is the top-down quota rationing and the second part is the bottom-up application for approval. For the quota rationing, the SCSC and the SPC with the approval from the State Council fix the amount of shares to be issued each year. The two departments will then distribute the quota to the provincial level local government and ministries. They will then further distribute to the enterprises under their direct control. Once the quota is obtained,
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B shares market to PRC investors, the adoption of QFII scheme\(^{332}\) and the PRC's accession to the WTO\(^{333}\) all show that the PRC is committed to its market reform and Hong Kong can provide valuable input to this evolutionary process. The integration of the Hong Kong and the PRC securities markets can bring benefits to both places. Even back in 1997, Hong Kong was the world's eighth largest trading economy, the ninth largest exporter of services and the fifth largest foreign exchange market.\(^{334}\) It has a politically stable government, an autonomous economy guaranteed by the Basic Law, an independent judiciary, an absence of exchange controls and low taxation. All in all, it provides a favourable investment environment to local and overseas investors. It also has a sophisticated, innovative workforce with solid international experience. The state-of-the-art technology in the securities markets and its international network rank among the best in the world. The problem with Hong Kong is that it has a small domestic market and depends on foreign investment. The PRC securities markets may deter investment because of strong government control but due to its sheer size and its recent economic growth, it has a huge market which overseas investors are keen to exploit. If Hong Kong and the PRC work together, it will bring immense advantages to both places.

The above arguments are based on welfare maximization and cost minimization. As for the question of equity, consolidation of stock markets then the second part of the quota system begins with the enterprise obtaining all the documents required for listing including asset appraisal, auditing reports and legal opinions. Such documents will be sent to its supervisory ministry or local government which will give a written decision. The documents with the decision will be sent to SCSC and CSRC for the latter's re-examination and approval. With the approval from CSRC, the enterprise can then make the formal application to the stock exchange with the documents required by law. (See Provisional Regulations, arts. 13-14.) The quota system was abolished in accordance with the Rules on Approval for Stock Issuance promulgated by the State Council in Mar. 2000.

\(^{332}\) In Dec. 2002, the PRC allowed QFIIs to participate in the A share and bond markets with the launch of the QFIIs Scheme. This also allowed certain restricted capital account convertibility for the first time provided that the foreign investors must apply to the SAFE to repatriate their profits and investments under the Scheme.

\(^{333}\) With the accession to WTO, foreign securities firms may deal directly in the B share business without domestic intermediaries. Three years after accession, foreign securities firm may form joint venture with their Chinese counterpart by owning not exceeding one-thirds of the shares and they are allowed to trade in A share, B share, H share as well as Government and corporate bonds. They can also launch new funds.

\(^{334}\) Tsang, supra note 252, at para. 16.
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will provide a level playing field for local and foreign investors. It will also get rid of artificial pricing as the same company receives very different PE ratio if it is listed on Hong Kong and one of the stock exchanges in the PRC because of complete segregation of the two stock markets. Dependency theory under the development law may argue that such consolidation should only take place gradually.

The gap between the Hong Kong and the PRC securities market has become narrower over the years. Both places are committed to better corporate governance and effective law enforcement against fraud and malpractice. A closer scrutiny reveals that the differences between Hong Kong and the PRC stock markets are not as great as might at first appear. The PRC does not want to privatize state-owned firms because it is afraid of losing control and to this end it has created state shares to protect the state assets from dissipation. Even though there is no state share in Hong Kong, Hong Kong stock markets are dominated by family-owned enterprises which managed to keep control without resorting to state shares. The majority of shares are controlled by the government in the PRC and the majority of shares are controlled by families in Hong Kong. Therefore the issue of control is the same in both places and lessons learnt in Hong Kong over the years through trial and error can be usefully applied to the PRC.

Integration of the two markets poses many problems and this thesis will discuss these later, but there are also favourable factors that may help facilitate integration. The securities markets in Hong Kong and the PRC are in the same time zone, share the same language, enjoy cultural synergy and have a long history of economic partnership which bode well for future integration.
CHAPTER II

THE H SHARE EXPERIMENT, ITS MECHANISM, ACCOMPLISHMENTS AND PROBLEMS

A. Introduction

PRC enterprises account for a significant share of funds raised through IPOs on the Hong Kong stock exchange. Of the HK$313.3 billion raised by a total of 431 IPOs during 1997-2002, HK$232.8 billion, accounting for 74.3% of the total, was raised for 73 PRC enterprises. This included HK$113.9 billion raised for 50 H shares and HK$118.9 billion raised for 23 red chip companies. The remaining HK$80.5 billion was raised by 358 non-PRC enterprises. H shares are issued on the Hong Kong stock market to raise funds for PRC companies and the word 'H' stands for “Hong Kong” while red chip shares are issued by Hong Kong incorporated companies with main business interest in the PRC or with substantial direct and indirect ownership by the PRC government.

On average PRC enterprises listed on the Hong Kong stock exchange from 1997-2002 raised three to four times more than the overall average listing on the Hong Kong stock exchange. The average PRC listing was able to raise HK$3.2 billion while the overall average raised only HK$0.73 billion. If all PRC enterprises on the Hong Kong stock exchange were excluded from the

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1 This chapter was published as an article in 2005 (the published article is an expanded version of the present chapter). See Chi Kuen Simon Wu, The H Share Experiment: Its Mechanism, Accomplishments and Problems, GLOBAL FINANCIAL SECTOR DEVELOPMENT 293-340 (British Institute of International and Comparative Law, 2005).

2 “Hong Kong” is a short form of “Hong Kong Special Administrative Zone”.


4 Id.

5 Id.
calculation, the average fund raised by a non-PRC enterprise was even smaller. A non-PRC enterprise raised an average of HK$0.22 billion during the same period of time while most non-PRC enterprise raised even less with HK$0.1 billion.\footnote{Id.}

Of the top ten IPOs listed between 1997 and 2002 on the Hong Kong stock exchange, eight were PRC enterprises and the funds were mainly raised from international markets.\footnote{Id.} Hong Kong is therefore an important fund-raising centre and a preferred venue for overseas listings for PRC enterprises.\footnote{Not only is Hong Kong the preferred venue, the trading of the PRC stocks in Hong Kong is more active than in the US or the UK. As of the end of June 2004, 18 PRC stocks were traded in both Hong Kong, and in the US and the UK. By the second half of 2003, the market shares of Hong Kong, the US and the UK in terms of the turnover of their PRC stocks were 73%, 20% and 6.9% respectively. Joseph Lee & Joanna Poon, \textit{The Listing of Mainland Companies on HKEx and the Implications for Hong Kong} 4, 5 (Securities and Futures Commission of Hong Kong research, Research Paper No. 17, September 2004) at \url{http://www.sfc.hk/sfc/doc/EN/research/research/ny%20paper%2017.pdf}. (Securities and Futures Commission: Research Papers & Statistics/ Research Papers/ RS Paper 17).} By the end of 2002, PRC enterprises had a total of 76 overseas listings of which 74 were listed in Hong Kong of which 60 were listed solely in Hong Kong, 11 were listed both in Hong Kong and the United States ("US"), two were listed both in Hong Kong and the United Kingdom ("UK") and one was listed in Hong Kong, the US and the UK).\footnote{Lee & Chang, supra note 3.} Only two IPOs were listed outside Hong Kong during that period with one listed only in the US and the other one only in Singapore.\footnote{Id.}

Hong Kong is frequently chosen as the fund-raising venue for PRC companies\footnote{See Annex 1 for H share companies listed on the Main Board and the GEM of the Hong Kong stock market by the end of 2004.} because it offers:
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- access to foreign exchange
- a broader investor base, international visibility
- a sound legal and regulatory framework that meets international standards
- a deep market with a wide product range and liquidity provided by institutional and retail as well as local and overseas investors
- a critical mass of professionals and service-providers that adopt practices at international standard
- access to the rest of the world while geographically close to the PRC.  

This chapter sets out a critical examination of the role and function of H shares, examining their history and introducing the essential elements in the H share listing process. The extent to which the H share experiment has helped achieve a harmonization of laws and regulations between Hong Kong and the PRC will also be examined.

B. What are H Shares?

H shares refer to Renminbi-denominated ordinary shares issued by PRC incorporated companies, listed on the Hong Kong Stock Exchange\(^\text{13}\) ("HKSE"), subscribed and traded in Hong Kong dollars.\(^\text{14}\)

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12 Lee & Poon, supra note 8.

13 The full name is The Stock Exchange of Hong Kong Ltd. Hong Kong’s Financial Secretary announced comprehensive market reform of the stock and futures in his 1999 Budget Speech. Under the reform, the HKSE and Hong Kong Futures Exchange Limited were demutualized and together with Hong Kong Securities Clearing Company Limited ("HKSCC"), they became wholly owned subsidiaries under a single holding company, Hong Kong Exchanges and Clearing Limited (HKEx). The merger was completed on March 6, 2000 and HKEx listed its shares by introduction on the Hong Kong stock exchange on June 27, 2000. After demutualization, the HKSE, HKFE and HKSCC become wholly-owned subsidiaries of HKEx. For a detailed history and general discussion of the demutualization, see Betty M. Ho, Demutualization of Organized Securities Exchanges in Hong Kong: The Great Leap Forward, 33 Law & Pol'y Int'l Bus. 283 (2000) (the author argued the demutualization was initiated top down by the Hong Kong government and rushed through the legislature without adequate consultation. The Hong Kong government had hastily assumed that demutualization is a world wide trend and investor-ownership model is the most efficient model. The author seriously doubted whether there would be benefits conferred by such demutualization without creation of a competitive market environment).

H shares were created by the PRC companies to raise funds from foreign investors. PRC incorporated companies can raise funds from foreign investors by issuing shares to them in the SSE and SZSE in the form of B shares. They are registered shares, denominated in Renminbi ("RMB") but subscribed and traded in foreign currencies. They can also raise funds in designated foreign stock exchanges. Besides listing in Hong Kong as H shares, PRC incorporated companies also list on the New York Stock Exchange, NASDAQ, the London Stock Exchange and the Singapore Stock Exchange. However due to liquidity, valuation, regulatory and other reasons, most PRC incorporated companies seek either to list on the PRC or Hong Kong stock markets.

C. History of H Shares

In 1991, HKSE set up a China Study Group made up of key players in the PRC-Hong Kong financial field. Shortly after, in February 1992, the Group completed an Interim Report on the Way Forward (the "Interim Report") for the PRC securities officials. The report sets out the general issues, including legal, accounting and regulatory issues that must be addressed before a PRC company can be listed in Hong Kong. In July 1992, it set up the Sino-Hong Kong Securities Joint Liaison Group. Following on from this various legal, accounting and regulatory obstacles were overcome and various rules and regulations promulgated with the cooperation of the regulatory authorities,

15 Tse Wai Chun, Quesifer, PRC Enterprises Listing in the Hong Kong Stock Exchange 9 (1994) (unpublished MBA dissertation, the University of Hong Kong) (on file with the University of Hong Kong). The Interim Report has considered three different ways for PRC issuers to be listed on Hong Kong stock market. First, the listing of collective investment schemes which specialize in PRC companies. Second, listing of HK incorporated company with assets in the PRC. Third, direct listing of PRC enterprise. The PRC government was interested in the direct listing. In terms of listing method, the PRC government has considered the establishment of a separate China board for the PRC enterprise but finally it settled for a special RMB denominated shares alongside with other Hong Kong companies by modifying the then Listing Rules, incorporating extra safeguard measures to protect H-share shareholders.

16 Gao Bao-ming & Fu Yan-mei, Underwriting and Issuing H Shares and N shares Overseas in SECURITIES MARKETS IN CHINA (Zhongguo Zhengquan Shichang Toushi) 127 (Henry M.K. Mok & Leslie Young eds. The Chinese University of Hong Kong, 1997).
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securities professionals, lawyers and accountants in both the PRC and Hong Kong.

In June 1993, the relevant Hong Kong and PRC regulatory authorities signed a cooperation memorandum of understanding, paving the way for the listing of the first H shares in July of the same year.17

D. H Share Statistics

The H share experiment has seen a solid increase in listings of PRC companies on the Hong Kong stock exchange. The first listing took place in 1993 with nine PRC enterprises being listed.18 The following year the second batch, consisting of 22 enterprises, were selected to be listed and in 1995 a further seven enterprises were also selected to be listed.19 As at December 31, 2004, there were 72 listed H share companies on the main board and 37 listed H share companies on the Growth Enterprise Market ("GEM"), comprising approximately 8.1%20 and 18.1% of the enterprises respectively listed in Hong Kong.21

E. Compartmentalization and the Search for Equivalence

The drive and success of the H share experiment is in large part due to the mutual advantages it can bring to both Hong Kong and the PRC. Advantages

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17 The cooperation, consultation and technical assistance memorandum signed between the US and the PRC regulatory authorities in April 1994 also paved the way for the listing of N shares in the States.

18 Gao & Fu, supra note 16, at 127.

19 See id.

20 As at December 31, 2004, there were also 81 red chip companies listed on the main board of the HKSE and together with the H share companies, they comprised approximately 17.2% of the companies listed on the main board. See Section G for more detail about the red chip companies. China Stock Markets Web, Market Highlights at http://www.hkex.com.hk/csm/highlight.asp?LangCode=en (HKEx: China Stock Markets Web/Market Highlights) (last visited Jan. 2, 2005).

21 Id.
for the Hong Kong stock market include increasing its liquidity and enhancing its competitiveness, helping to establish Hong Kong as an international centre for bond trading and invigorating its Growth Enterprise Market. While advantages for the PRC corporations include the ability to raise substantial funds on the Hong Kong market and attracting increased international investment in PRC listed enterprises due to confidence in the well-regulated Hong Kong stock exchange.

The Hong Kong stock exchange cannot afford to compromise its high standards and it has to ascertain that the PRC companies listed in Hong Kong will attain equivalent standards to other listed companies. However the HKSE does take into consideration the special characteristics of PRC companies and as a result, special laws and regulations have been passed in both the PRC and Hong Kong to accommodate these characteristics through the Listing Rules specifically formulated for H share issuance. Hong Kong companies are not, however, allowed to be listed on PRC stock exchanges and so this set of rules

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22 When Mr. Charles Lee, as Chairman of HKSE Council from 1992 to 1994, started discussing H share issues with the Chinese side, he reasoned as follows: "The Hong Kong stock market is now quite mature; and if we were just dependent on our own companies for new listings, the growth of the market would be very slow." Mr. Lee hopes that "Hong Kong will become as important to China as Manhattan is to the US." See Niu Tichang, Regional Stock Market Integration in China and Hong Kong (CAER Discussion Paper No. 16, Dec. 1996) at http://ovww.cid.harvard.edu/caer2/html/content/papers/paper16/paper16.htm (last visited Jan. 2, 2005).


24 The full name is "Listing Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Ltd."
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and regulations is used only by PRC companies to facilitate their fund raising activities on the HKSE.

Despite this non-mutuality the search for equivalent standards can be seen as a process of harmonization. As the Listing Rules and the relevant provisions governing H share issuance do not allow for any addition and deletion, it can be seen as an attempt towards maximum "harmonization". However the word "harmonization" may be misleading as it suggests that rules and regulations apply to both PRC and non-PRC companies. The fact is that there is a separate set of rules and regulations for the H share companies that have been created so that the H share companies can reach an equivalent standard in terms of corporate governance equal to other non-H share companies listed on the Hong Kong stock exchange. It is possible that at some future date, by applying the same principles, the same equivalence can be reached by a separate set of regulations allowing Hong Kong companies to be listed in the PRC.

This chapter will refer to the principle and philosophy behind H shares as "equivalent compartmentalization". "Compartmentalization" means that H shares are separate from other kinds of shares with their distinct listing requirements. "Equivalent" means that H shares try to achieve equivalent listing standards comparable to non-PRC companies listing on the Hong Kong stock exchange.

H shares will now be examined in more detail to find out how such equivalence can be achieved.

F. Laws and Regulations relating to H Shares

The three-tier model of regulation as shown in Figure 1 below exists in most countries and is a standard model of the issue of securities and the subsequent trading of those securities among investors.
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Company law represents the bottom tier as it applies generally to all companies, even though public companies may be subject to a different set of rules from private companies under company law. Different rules are also applicable to domestic and foreign companies. Mandatory rules may be found in company law that deals specifically with the issue of shares.

Securities law is represented in the second tier. This does not apply to all companies as only companies that make public issues of securities are affected. Unlike listing rules, it also covers unlisted public companies.

Listing rules are represented in the top tier as they only apply to companies which seek listing or whose securities are admitted to listing. Listing Rules are applied by the stock market and do not have the force of law. Listing rules lay down the conditions under which public companies can gain access to capital markets. Within a single jurisdiction, the three tiers of regulation should be carefully coordinated so that conflict and overlapping can be avoided.25

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The law governing the listing of PRC shares in Hong Kong is Hong Kong law only because the listing of shares is governed by the place where they are listed. However, the actual listing is the last stage of a long and complex process. The first stage of this process involves setting up a shareholding company from the state-owned enterprise ("SOE") in accordance with the Company Law\(^\text{26}\) in the PRC. Therefore, before looking at Hong Kong law, Company Law should be taken into consideration as it is particularly relevant for the listing candidate in the restructuring process.

As far as securities laws are concerned, in July 1994, the State Council promulgated the Special Regulations Concerning Overseas Offering and Listing of Shares by Joint Stock Limited Companies (the "Special Regulations") to prepare for H share listing.\(^\text{27}\) The Special Regulations govern foreign invested shares that are listed overseas and cover areas such as share issuance, share management, protection of shareholders' interests, etc. In addition, the operation of a company depends heavily on its articles of association, being the constitution of an enterprise. To ensure that the PRC companies operate in accordance with international standards, the SCSC and SCREC jointly issued the Mandatory Provisions in the Articles of Association for Companies Listing Overseas (the "Mandatory Provisions") on August 27, 1994\(^\text{28}\) to specify minimum standards and model requirements.\(^\text{29}\) The Mandatory Provisions cover registered capital, reduction of capital, share repurchase, financial assistance, share and shareholder registers, shareholders' rights and obligations,

\(^{26}\) Zonghua Renmin Gongheguo Gongsi Fa [the Company Law of the PRC] adopted at the Fifth Session of the Standing Committee of the Fifth National People’s Congress on December 29, 1993, promulgated as the Presidential Decree No. 16 of the People’s Republic of China on the same day and effective as of July 1, 1994. Revised based on the decision of revision of the Company Law of the People’s Republic of China at 13th Session of the Standing Committee of the Ninth National People’s Congress on December 25, 1999 and effective as the Presidential Decree No. 29 of the People’s Republic of China on December 25, 1999, effective as of the same day.

\(^{27}\) Gao & Fu, supra note 16, at 129.


\(^{29}\) See id.
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procedures regarding annual general meetings and board of directors’ meetings, qualifications and obligations of directors, company secretary, supervisors, general managers and senior management personnel, accounting systems, profit allocation, mergers and spin-off, liquidation procedures, dispute settlement, amendments of articles of association etc. The Mandatory Provision was amended by the Letter Concerning Opinion on Supplementary Revision of the Articles of Association of Companies to be Listed on the Hong Kong Stock Exchange promulgated by the China Securities Regulatory Commission (“CSRC”) and SCREC on April 3, 1995 in response to the then new Appendix 3 and Appendix 13 Part D Section I of the Listing Rules.

For PRC listed companies to be listed abroad, the Notice on Several Issues Concerning Regulating Overseas Initial Public Offerings of the Enterprise Affiliated to the Domestic Listed Companies is also applicable.30 The Notice is intended to keep profitable assets of Chinese companies in domestic markets and avoid dissipation of state assets. The Securities Law31 promulgated on December 29, 1998 and effective from July 1, 1999 only governs companies which seek to be listed in the PRC.

As the PRC legal system is based mainly on the civil law system and not the common law system, the legal protection rendered to investors under PRC law is not well-developed and extra safeguard mechanisms are required for the listing of PRC companies in Hong Kong.

As the listing vehicles are incorporated in the PRC, the main relevance of the company law in Hong Kong is Part XII of, and the Third Schedule to, the Companies Ordinance which stipulates certain mandatory disclosures in the

30 Guanyu Guifan Xingnei Shangsi Gongsi Suoshu Qiye Dao Jingwai Shangsi Youguan Wenti de Tongzhi issued by the CSRC on Aug. 10, 2004. Para. 8 of the Notice states that this Notice does not apply to PRC incorporated companies which seek to list domestically and abroad at the same time.

31 Zhonghua Renmin Gongheguo Zhengquan Fa adopted by the Sixth Session of the Standing Committee of the Ninth National People’s Congress of the PRC promulgated as Presidential Decree No. 12.
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prospectus for companies seeking to be listed on the HKSE. The Securities and Futures Ordinance ("SFO") which consolidated ten previous ordinances was enacted on March 13, 2002 and finally became effective on April 1, 2003. It governs the licensing requirements of the financial intermediaries, disclosure of interests, market misconduct, the extent of power of the SFC and remedies of aggrieved investors.

As far as the listing requirements in Hong Kong are concerned, the governing rules were laid down in the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Ltd. (the "Listing Rules") published by the HKSE. In addition to Chapters 3 and 8 of the Listing Rules, special provisions in Chapter 19A and Appendix 13 Part D have been added to modify the listing requirements for the PRC companies tailor-made specifically for such companies. Chapter 13 and Appendix 16 of the Listing Rules contains the listing agreement between the HKSE and the PRC issuer which stipulates further listing requirements and post-listing continuing obligations for the PRC issuer.

Under schedule 1 of the Companies (Amendment) Ordinance, Ord. No. 30 of 2004 A1777, which came into force on December 3, 2004, the newly added Seventeenth, Eighteenth, Twentieth and Twenty-first Schedules are also relevant as they clarify the definition of "prospectus" and envisage "programme" prospectuses which are particularly useful for debt offerings. However such changes will have little impact on H share offerings.

The following 10 ordinances have been consolidated into the SFO and were repealed accordingly:

(21) Securities and Futures Commission Ordinance (Cap. 24) (enacted 1989)
(22) Commodities Trading Ordinance (Cap. 250) (enacted 1976)
(23) Securities Ordinance (Cap. 333) (enacted 1974)
(24) Protection of Investors Ordinance (Cap. 335) (enacted 1974)
(25) Stock Exchanges Unification Ordinance (Cap. 361) (enacted 1980)
(26) Securities (Insider Dealing) Ordinance (Cap. 395) (enacted 1990)
(27) Securities (Disclosure of Interests) Ordinance (Cap. 396) (enacted 1988)
(28) Securities and Futures (Clearing Houses) Ordinance (Cap. 420) (enacted 1992)
(29) Leveraged Foreign Exchange Trading Ordinance (Cap. 451) (enacted 1994)
(30) Exchanges and Clearing Houses (Merger) Ordinance (Cap. 555) (enacted 2000)

See Legislative Council Brief, Regulatory Reform for the Securities and Futures Market - The Securities and Futures Bill (SU B38/31, 2000) and §406 of the SFO.

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To facilitate mutual assistance, exchange of information, regular liaison and exchange of personnel to pave the way for an H share listing, the HKSE entered into a non-binding, five-sided Memorandum of Regulatory Cooperation with the Securities and Futures Commission ("SFC") on the one side, and the CSRC and SZSE and SSE on the other in June 1993 (the "MRC"). The MRC indicates a willingness on the part of the signatories to cooperate with each other in the regulation of their respective markets and articulates all the basic principles of securities market regulation important to any international market.35

G. Alternative Methods for PRC Companies to be Listed on the Hong Kong Stock Exchange

Other than being listed as an H share company incorporated in the PRC, a PRC company can be listed on the Hong Kong Stock Exchange through a Hong Kong incorporated vehicle with controlling shareholders from the PRC entities.36

In the early stage of the H share experiment a number of PRC companies bypassed the official listing channels through reverse take-over, commonly known as "backdoor listing".37 Backdoor listing is the acquisition of a listed company or the shell company by an unlisted company to gain a listing on the securities exchange. It may happen where a listed company acquires a non-listed company's assets or shares, and the value of the acquired assets, based on the criteria set by each Exchange, is larger than the acquirer's original assets, resulting in a change in the control of the listed company to major shareholders of the non-listed company. As a result, it allows companies that may not be able to meet the listing requirements of the Hong Kong Stock Exchange to be listed on the Hong Kong Stock Exchange.

35 See also The Stock Exchange of Hong Kong, LISTING CHINESE COMPANIES IN HONG KONG 70 (The Stock Exchange of Hong Kong, 1998).


37 See HKEx Listing Rules, R. 14.06(6) for a detailed definition of "reverse takeover".

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listed on it and it will also enable private companies to be listed on the Stock Exchange much faster than companies which have to go through the listing procedures formally.

Red chip companies are predominately diversified conglomerates which have grown rapidly due to the asset injection from the parent companies in the PRC. They include China Telecom, Beijing Enterprises Holdings, China Everbright, Shanghai Industrial Holdings, China Resources Enterprises and the “window-companies” or “International Trust and Investment Corporations (ITICs)” of provincial governments.

Strictly speaking, red chip companies did not originally fall within the jurisdiction of the PRC authorities. However in June 1997, the CSRC in conjunction with the State Council introduced the Notice Concerning Further Strengthening Administration of Share Offering and Listing Overseas (commonly known as “Red Chip Guidelines”) to prevent the dissipation of state assets. The PRC government was worried that state assets would be injected into the red chip companies and they might be sold off indirectly to overseas investors at a discount. The Red Chip Guidelines provides more stringent requirement for reporting to, and obtaining approval from, the Chinese authorities. Under the 1997 guidelines Chinese shareholders who controlled foreign listed companies or Chinese shareholders who intended to inject assets to red chip companies were either required to report to the CSRC or alternatively required to obtain consent from the local provincial government or relevant department of the State Council depending on their circumstances.

38 Su, supra note 36, at 54.
39 Id.
40 Guanyu Xnyibu Xqjiang zal Jingwai Faxing Gupiao he Shengshi Guanli de Tongzhi [Notice promulgated by State Council Concerning Further Strengthening Administration of Share Offering and Listing Overseas] (June 20, 1997 Guofa [1997], effective as of the same day).
41 Red Chip Guidelines, paras. 1, 2 & 3.

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On January 30, 2004, the HKEx announced a number of changes to the Listing rules which came into effect on March 31, 2004. Among them, reverse takeovers were added as a new category of notifiable transactions, making it more difficult to achieve back door listings. Such notifiable transactions require notification and approval from the HKEx, approval from the shareholders, an accountant's report on the preceding three financial years of the business or companies acquired, publication on the newspaper and circular to the shareholders. With the new amendments, the HKSE was determined to stop companies from circumventing the Listing Rules by using reverse takeovers.

Within the first four months of 2005, the State Administration of Foreign Exchange (“SAFE”) issued two notices that in effect had frozen PRC investments involving offshore companies controlled by PRC resident individuals. The SAFE notices is to track and control the establishment of offshore tax haven companies by PRC residents and the so-called “Roundtrip Investments” have been key elements in the restructuring of PRC enterprises prior to their IPOs in Hong Kong and other overseas stock markets which

42 HKEx, Note to Subscribers for the Amendments to the Rules Governing the Listing of Securities – Update No. 80 (March 31, 2004).
43 HKEx Listing Rules, R. 14.33.
44 Notice on Questions in Relation to the Enhancement of Foreign Exchange Administration for Mergers and Acquisitions by Foreign Investors came into effect on Jan. 24, 2005 (“Jan. 24 Notice”) and State Administration of Foreign Exchange Notice on Questions Regarding Registration of Foreign Investment by Domestic Residents and Registration of Foreign Exchange for Mergers and Acquisitions by Foreign Investors came into effect on Apr. 8, 2005. The two notices in effect require domestic residents of the PRC to attend to examination, approval and/or registration of SAFE and approval from MOFCOM. Jan. 24 Notice requires PRC resident who directly or indirectly assumes control of an offshore company to attend to the examination, approval and registration pursuant to the Offshore Investment Foreign Exchange Administration Measures (“Offshore FOREX Measures”) which originally applied to offshore investments by non-FIE PRC companies only. The approval from MOFCOM posed as a great administrative hurdle as the State Council’s Document No. 5 of 2003 stated that approvals under the Offshore FOREX Measures are no longer within the jurisdiction of MOFCOM to approve. It is therefore unclear whether MOFCOM can issue such an approval and it is also not clear whether domestic residents include legal persons. See Carson Wen & Katherine U, Update on PRC State Administration of Foreign Exchange (SAFE) Regulations 1, Heller Ehrman, October 17, 2005 available at http://www.hewm.com/docs/en/PRC_SAFERegulations_HK_Lawyer.pdf.
45 Id.
46 Id.
adversely affects the listing of red chips in Hong Kong. PRC domestic enterprises converted to FIEs through Roundtrip Investments often enjoy preferential tax treatment meant for foreign enterprises and this will result in a loss of tax revenue for the PRC government.\textsuperscript{47} There is also concern about money laundering and the possible channeling out of wealth acquired through corruption and other economic crimes.\textsuperscript{48} The two notices had the side effect of preventing bona fide investments into the PRC by foreign investors, in particular private equity funds,\textsuperscript{49} and resulted in an abrupt fall in offshore listings and venture capital-style investments into the PRC through offshore companies in the first three quarters of 2005. These two notices were finally repealed by the \textit{Circular on Issues Relevant to Foreign Exchange Control with Respect to the Roundtrip Investment of Funds Raised by Domestic Residents Through Offshore Special Purpose Companies} issued on October 21, 2005 and this Circular is effective from November 1, 2005.\textsuperscript{50} Under the new Circular, domestic residents include both legal persons and natural and the approvals from SAFE and Ministry of Commerce ("MOFCOM") are no longer required for the SAFE registration of domestic residents. It also requires that proceeds raised by domestic residents through offshore SPVs must be invested in accordance with those reported in the SAFE registration and except in the case of IPOs, funds so raised through SPVs must not be retained in the SPVs.\textsuperscript{51} If the Circular is interpreted positively, there may be a strong rebound in activity in 2006.\textsuperscript{52}

\textsuperscript{47} Id.

\textsuperscript{48} Id. 2.

\textsuperscript{49} Id.


\textsuperscript{52} Id. See also Bei Hu, \textit{China Clears Individual Offshore Forays}, SCMP, Oct. 24, 2005.
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H. Strengths and Shortcomings of H Share Companies

1. Accounting Systems

Accountants are generally regarded as the guard dog for investors and for them to be effective, they have to raise the alarm in times of danger. The Listing Rules applicable to PRC companies ensure that the accounting standards employed by PRC companies seeking to be listed on the Hong Kong stock exchange should be the same as those for other companies listed there. PRC issuers can choose to adopt the Hong Kong Financial Reporting Standards ("HKFRS") or International Financial Reporting Standards ("IFRS"). PRC issuers that adopt IFRS are exempt from disclosing differences of accounting practice between IFRS and HKFRS and compiling a statement of the financial effect of any such differences. A PRC issuer may, in addition, report separately financial information confirming with applicable PRC accounting rules and regulations provided that the report contains a statement of the financial effect of the material differences (if any) from HKFRS or IFRS, as the case may be.

H share companies tend to have better governance than the other PRC companies not only because of adopting international accounting standards but also because of other professional requirements that support the accounting profession in Hong Kong. H share companies require the use of professional accountants who are qualified under the Professional Accountants Ordinance and they must be independent both of the issuer and of any other company in accordance with the Companies Ordinance and the requirements on independence issued by the Hong Kong Society of Accountants.

53 Listing Rules, R.19A.10.
54 Listing Rules, R. 19A.10 (note).
55 Listing Rules, R. 19A.08 & R. 4.03.
56 Id.
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Although the scale of accounting fraud in the PRC cannot be compared with the Enron case, commentators often remark that accounting fraud in the PRC is more blatant than in the West. The Shanghai Stock Exchange found problems in 1999 annual reports of 38.06% of companies listed at that time, while the Shenzhen stock Exchange discovered problems with 25.67%. The frequency of accounting fraud in the PRC can be illustrated with reference to the National Audit Office carried out in December 2001 as a random check of 32 audit reports prepared by 16 accounting firms licensed to audit PRC listed companies. Of these, 23 audit reports prepared by 14 accounting firms were described as "gravely inaccurate." Such errors amounted to a combined RMB7.14 billion. The long list of offences included forging sales revenue and bank deposits as well as dishonestly altering debt, profit and losses data. In 2001, Chinese Institute of Certified Public Accountants has disciplined more than 100 accounting firms and 120 certified public accountants in more than 220 cases of irregularity since 2000.

The 2002 litigated Macat case is a telling example. Macat Optics and Electronics Company, Limited obtained approval from the CSRC and launched an IPO on the Shenzhen Stock Market in August 2000. "Biochemical firm Gangxia (Yinchuan) Industry, the Shenzhen-listed A-share company whose deception caught the most public attention in 2001, declared total assets of about RMB3.15 billion at the end of 2000. It was exposed by Beijing's influential Caijing magazine to have inflated its profits. This was only a small fraction of Enron's total assets of US$61.78 billion at the end of September 2001. Chinese Cookery Books, SCMP, Mar. 26, 2002.

58 Ernst & Young's head of the PRC and Hong Kong, Anthony Wu Ting-yuk pointed out that Chinese accounting fraud cases are more blatant fraud while Enron, whose account massaging with off-balance-sheet activities and off-shore vehicle took advantage of a very grey area of accounting principles. See id.

59 Id.
60 Id.
61 Id.
62 Id.
63 Id.
64 Id.

65 See Huawei Ling et al., Maikete E'Meng - Yitiao Kongqian Wanzheng de Zhengquan Shichang Zaojia Liushuixian de Wanzheng Baoguang [Macat's Nightmare - A Whole
November 2000, the CSRC identified that Macat had falsified hundreds of millions of dollars of profit and revenue in its financial statements.  

According to both the CSRC report and court judgment of the case, “not only did the company, a small entity without any substantial assets, purposely defraud the public, but all the intermediaries, including an accounting firm, an asset valuation institution, a law firm, and a securities company also helped Macat to fabricate the false statements.” The case was therefore characterized as involving a “sophisticated production line for producing false accounting reports and numbers in the securities market.”

Although some commented that the PRC’s endemic accounting fraud is no different from early days of the US securities market, the root causes of the PRC’s accounting fraud plague are believed to be structural and historical.

Structurally, unless the accounting firms are financially strong and have a broad audit and accounting business, it is very difficult for them to remain independent. However the Chinese accounting profession is still dominated by numerous small firms. The Chinese accounting market was estimated to be worth Renminbi seven to eight billion in 2000 with 4,446 accounting firms and 52,000 practising certified public accountants sharing the pie. Of them, only

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68 See Ling, supra note 65.

69 One professional who held this view is Ernst & Young’s China executive partner Alfred Shum. See SCMP, supra note 57.

70 Id.

71 Id.

72 Id.
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a few dozen firms employed more than 100 CPAs. Small accounting firms, especially those outside of the major cities, are dependent on the particular industry or business in that particular locality. They may risk losing a client if they issue qualified opinions which may result in a customer’s failure to gain a listing or suspension from trading.

Historically, the PRC’s accounting fraud is also believed to be a legacy of its planned economy. Under the planned economy, accounting was viewed more as a paper game to meet official targets. More than 40% of Chinese accountants are older than 50 and they were trained under the planned economic system. Until 1998, most Chinese accounting firms were operated by government agencies and as such, the accounting practice was prone to government interference. A number of issuers were appointed by the Chinese government or state-owned enterprises not to “restructure into modern enterprises”, but simply to raise capital to alleviate financial difficulties. Accountants tended to act according to their instructions. During an interview, Fung Liufang stated that:

“When a SOE obtains a quota for IPO, even though it has suffered loss in the past three years [which hence cannot meet the initial legal requirement for IPO], it can immediately have profit earnings in the past three consecutive years simply by requesting those “securities accountants” to cook accounting statements for them, of course with extra high pay to those accountants … The issuers

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73 Id.
74 Id.
75 Id.
76 Id.
77 Id.
78 Id.
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"make-up" fee is eventually absorbed by the "issuance cost", which shall be deducted from the capital contribution paid by investors purchasing the shares. SOE's made-up intermediaries provide make-up service - investors pay the bill: this is the entire process of the game.80

H share companies are comparatively less susceptible to accounting fraud not only because of the international accounting standards that they have had to adopt but also because they are monitored by large, international accounting firms. This does not necessarily guarantee that they are fraud free as even Arthur Anderson failed to whistle blow in the case of Enron, but it does mean that it is more difficult for blatant accounting fraud to succeed. However accountants may only examine figures and, unlike forensic accountants, they may not examine what are behind those figures. To stamp out accounting fraud, internal accounting control should be in place alongside good corporate governance.

2. Connected Transactions

A connected transaction is, among other things, a transaction between a listed issuer and a connected person. A connected person is broadly defined as a director, chief executive, substantial shareholders, or the associate of the listed issuer. In the case of a PRC issuer, it will include its promoter, supervisor or associate of its promoter or its supervisors. However, a connected person does not include any wholly-owned subsidiary of the listed issuer. Such connected transactions need to be announced publicly and a circular must be sent to shareholders giving information about the transaction. The approval of the shareholders given at a general meeting is required before the transaction can proceed. Some categories of connected transactions are exempt from disclosure and independent shareholders' approval requirements and certain transactions are subject only to disclosure requirements. Connected

transactions can be one-off or continuing. The reason for imposing such requirements is to protect the interests of shareholders and provide certain safeguards against listed issuer’s directors, chief executives or substantial shareholders (or their associates) from taking advantage of their positions as a listed issuer.

As discussed earlier, the H share companies are all SOEs before the quota system was scrapped. Although the PRC Governmental Body as defined by the Listing Rules is not regarded as a connected person, entities under the PRC Government that are engaging in commercial business or operating another commercial entity are excluded from the definition of PRC Governmental Body. SOEs also carry out political and social functions and through restructuring, such functions have to be transferred to the parent companies so as to boost the profit of the proposed listed SOEs. The parent company will become a non-productive, loss-making entity which is burdened with pensions and various administrative expenses. To close down the parent company will create massive unemployment and hence social unrest. To cope with the situation, the issuer will provide sweeteners to the parent company through connected transactions. The Hong Kong stock exchange will ensure that such connected transactions are conducted properly without adversely affecting the shareholders’ interests. For the sale of consumer goods or consumer services, the Hong Kong stock exchange will ensure, among other things, that the sale or purchase is conducted in the ordinary and usual course of business and it must be on normal commercial terms. It can pose a problem in the early days of market economy as most SOEs are monopolies with no alternative market and a market mechanism is not available in the planned economy. Payment is then usually set on reasonable assumption and estimation.

In addition, the separation of the listed issuer and its parent company is more legal than factual. The management of the listed company and its parent company originally belonged to one team and their previous relationship and their political hierarchy in the government will enable the continued influence of the parent company over the listed company. As a result, some decisions taken by the listed issuer are believed to benefit the parent company rather than
investors as a whole.

3. Accountability

Under the Listing Rules which incorporate the Mandatory Provisions for Companies Listing Overseas, the articles of association of the listed issuers provide that there are three tiers of control over a company’s operations: the shareholders’ general meeting, the board of directors and supervisors, and the management. The shareholders’ general meeting is the highest authority in the listed company and has the final say over key issues of the listed company. The board of directors makes investment decisions and the board of supervisor oversees the decision making process and performance of the directors and senior management. The management is responsible for the day to day management of the listed company and implements the decisions made by the board of directors. The division of labour is to ensure the accountability of directors, supervisors and managers. With checks and balances in place, it is difficult for any parties to abuse their positions.

However the PRC government remains the largest shareholders for all SOEs which have listed on the Hong Kong stock exchange. The state is, after all, an abstract owner and typically, the PRC government does not exercise its rights as a shareholder to influence management effectively. In practice, key

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81 Listing Rules, App. 13 Part D Section 1(a).

82 Mandatory Provisions, arts 49 & 50.

83 Id. art. 88.

84 Id. art. 108.

85 Id. arts. 97 (for company secretary) & 100 (for managers).

86 According to the Mandatory Provisions, the board of directors and the board of supervisors are both accountable to the shareholders in general meeting and the managers are accountable to the board of directors. See Mandatory Provisions, arts. 88, 100, 108.

managers can sometimes gain control over the shareholders’ meeting so it functions like a rubber stamp approving everything decided by the management. When everything belongs to the state, it belongs to no one and creates a moral hazard. Most directors on the board are the same management personnel for the pre-listed company. They tend to manage the company in the old ways. The prevalent mindset among SOEs managers is that capital raised in the stock market is free, an attitude rooted in the era of the planned economy when SOE managers would receive loans from state-owned banks with no obligation to repay them. Such a mindset does not encourage responsibility and accountability and proceeds raised in such a way are not always allocated to their best use.

In addition, most Chinese investors are retail investors who focus more on the names of the company’s key institutional investors and its relationship with the PRC government than on a company’s basic performance. There is also a lack of incentive mechanisms that is linked to their performance. As a result, with a lack of accountability and incentive and a poor salary package, managers and directors alike are more prone to use their positions to divert money to their personal accounts. This situation is more commonly found in companies listed in the PRC than in Hong Kong. One possible reason is that the H share companies are more high profile and the Chinese government will keep a closer eye on such companies. The lack of profitability of H share companies is still a major concern and it reflects on the efficiency and

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88 Id.
89 Id.
90 Id.
91 Id.
92 Since the beginning of 2001, there were a series of scandals for companies listed on the stock exchanges in the PRC, namely, Guanxia (Yinchuan) Industry Co. Ltd., Lantian Co. Ltd., Zhenzhou Baiwen Co. Ltd, Sanjiu Pharmaceutical Co. and Macat Optics and Electronics Co., Ltd. For details, see id.
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accountability of the management level of such companies.

4. Executive and Managerial Competence

Other than accountability, the other problem in the PRC is the competence of directors and company secretaries in discharging their duties. The Listing Rules have tried to ensure that the directors and company secretaries have the necessary experience and competence to deal with the listed companies through the use of a sponsor and detailed qualification requirements.

In the past, the appointment of a sponsor was required to assist the issuer regarding listing application and after the listing, it had the responsibilities of educating the senior management level about all relevant laws. For non-PRC issuers, the Hong Kong stock exchange recommends retaining the services of its sponsor for at least one year following the listing. However for PRC issuers this is not a recommendation but a requirement. A sponsor must be any corporation or authorized financial institution licensed or registered to advise on corporate finance matters and appointed as a sponsor by the issuer. In practice, the sponsor is usually the lead underwriter of the IPO. Under the new rule effective on 1 January 2005, the sponsor’s responsibilities are limited to preparing the issuer for listing, for lodging the formal listing application and all supporting documents and for dealing with the Hong Kong stock exchange on all matters arising in connection with the application. It also needs to carry out due diligence inquiries and ensure that the information submitted to the Hong Kong stock exchange be true in all material aspects with no material omission. For PRC issuers, they have to ensure that the PRC issuers are suitable to be listed and the directors and supervisors understand their

93 The Listing Rules, R. 3.02 (now repealed).
94 Id. R. 19A.05 (1) (now repealed).
95 Id. Ch. 1.
96 Id. R. 3A.11 (1).
97 Id. R. 3A.11 (2) and Practice Note 21.
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responsibilities and can be expected to honour their obligations.98 A sponsor must perform its duties with impartiality99 and at least one sponsor must be independent from the issuer under the test set out under the Listing Rules.100 Their work will come to an end immediately upon the listing of the issuer.101

Compliance advisers are any corporation or authorized financial institution licensed or registered to advise on corporate finance matters and appointed as a compliance adviser by the issuer. They are appointed during the Fixed Period to assist the issuers on all compliance issues and they have to perform their duties with impartiality.102 Compliance advisers must inform the PRC issuers on a timely basis of any amendment or supplement to the Listing Rules and any new or amended law, regulation or code in Hong Kong applicable to such issuers.103 In other words, the compliance advisers have the responsibilities of educating the senior management level about all relevant laws. They also have to provide advice on the continuing requirements under the above laws.104 In addition, they have to be the channel of communication with the Hong Kong stock exchange if the authorized representatives of the issuers are not in Hong Kong.105 The new Listing Rules requires both the sponsors and compliance advisers to ensure corporate governance of the issuer instead of relying on the sponsors alone. By separating the role of the sponsors and compliance advisors, the independence of sponsors from the issuers can be better facilitated.

The duties of directors are also spelt out in the Listing Rules. Each director has to satisfy the Hong Kong stock exchange that he has the necessary character,

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98 The Listing Rules, R. 19A.06 (1).
99 Id. R. 3A.06.
100 Id. R. 3A.07.
101 Id. R. 3A.02.
102 Id. R. 3A.25.
103 Id. R. 19A.06 (3).
104 Id.
105 Id. R. 19A.06 (4).
experience and integrity and to demonstrate that he has a standard of competence commensurate with his position as a director of a listed issuer. Every board of directors of a listed issuer has recently been increased to include at least three independent non-executive directors and for the first time, it states that at least one of the independent non-executive directors must have appropriate professional qualifications or accounting or related financial management expertise. For PRC issuers, one of the independent non-executive directors must also demonstrate an acceptable standard of competence and adequate commercial or professional experience to ensure that the interests of the general body of shareholders will be adequately represented. Furthermore, at least two of the executive directors and one of the independent non-executive directors must be ordinarily resident in Hong Kong. Supervisors also need to demonstrate a standard of competence commensurate with their position as supervisors.

The company secretary of a PRC issuer need not be ordinarily resident in Hong Kong but has to have the requisite knowledge and experience to discharge the functions of a secretary. Such a person has to be a member of The Hong Kong Institute of Company Secretaries, a solicitor or barrister as defined in the Legal Practitioners Ordinance or a professional accountant. If not the holder

106 Id. R. 3.08 & R. 3.09.
107 Id. R. 3.10(1).
108 Id. R. 3.10(2).
109 Id. R. 19A.18(1).
110 Id. R. 19A.15.
111 Id.
112 Id. 19A.18(2).
113 Id. R. 19A.16.
114 When the PRC company secretaries do not possess either one of these qualifications, they may make a submission to the Hong Kong stock exchange that they can discharge the function of company secretaries by pleading that they have the relevant experience. Among other things, the Hong Kong stock exchange will take into consideration the period of their employment with the PRC issuers and their familiarity with the Listing Rules. See id. R. 19A.16 (note).
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of this position has to have suitable academic or professional qualifications or relevant experience in discharging the functions of this position. For an issuer listed before December 1, 1989, a candidate for the post could meet the requirement if he or she held the office of secretary of the issuer before that date.115 Such strict requirements are important as a number of listed companies in the PRC have had members of the senior management or accountants who have been incompetent in discharging their duties.116

In the early day of H share issue, all the issuers were SOEs. They are large monopolistic organizations with expertise in certain areas such as energy, airlines, highways etc. The senior management of such companies had acquired invaluable specialized knowledge of such industry that was very difficult to be replaced. When the SOEs were listed, understandably they retained the senior management especially when more often than not, the listing was initiated by them. The management level might have expertise in their areas but they started their management when the PRC was still a planned economy and they were government officials and party members. The management method under a planned economy is very different from the way a company should be operated under a market economy, especially when it is publicly listed. After listing new management methods need to be learned and senior management needs to change their mindset as they are no longer government officials but directors who should protect the interests of shareholders. Such a transition may take time but the Listing Rules are paving the way for such transition with the use of sponsors and independent non-executive directors.

115 Id. R. 8.17.

116 One of the examples is Anhui Gujing Distillery Company Limited which was set up in 1959. In 1996, the stocks of Gujing Gong B and A were issued on the Shenzhen Stock Market. The company admitted in its board of directors' resolutions that accounting methods were adopted improperly due to the negligence and insufficiency of relevant financial personnel's understanding of relevant rules and regulations and the company has organized relevant personnel to further study Accounting Rules for Stock Limited Companies and Enterprise Accounting Rules. See Bulletin on Resolutions of the 10th Session of the 3rd Board of Directors of Anhui Gujing Distillery Company Limited, Bulletin No. 2004-02 Para. III, 4, 5 & 6, Feb. 23, 2004 at http://www.wenweipo.com/special/anhui-gujing/anhui-gujing.html.
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5. Full Disclosure

There are many differences between a PRC company and a Hong Kong company which an investor may not be aware of. The investors should have an adequate understanding of the risks involved in subscribing for H shares. Based on similar principle as the US securities law, the HKSE Listing Rules demand full disclosure as the best way to deal with such potential problems.

Under the Listing Rules, a PRC issuer has to disclose in its prospectus risk factors that will include, among other things, a brief summary of\(^{117}\):

- the relevant PRC laws and regulations;

- the political structure and economic environment of the PRC;

- foreign exchange controls in the PRC and the exchange rate risk of the Renminbi;

- the different regulatory framework for PRC issuers listing outside the PRC;

- specific risk factors related to the business of the PRC issuer and/or its products; and

- the law(s) governing the resolution of disputes arising from the PRC issuer’s article of association and the transfer of the PRC issuer’s shares.

There will also be a description of applicable company law matters including material differences between the requirements of the PRC and of Hong Kong. Such description should include the following\(^{118}\):

\(^{117}\) The Listing Rules, R. 19A.42 (para.64).

\(^{118}\) Id. R. 19A.42 (para.65).
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- the quorum and voting requirements for general meetings of shareholders and for separate meetings of holders of domestic shares, foreign shares and H shares;

- the PRC issuer's ability, by way of a special resolution in a general meeting, to issue, allot or grant up to 20% of its existing share capital in domestic shares, foreign shares and H shares once every 12 months, without a separate vote by holder of foreign shares;

- the PRC issuer's ability to issue domestic shares, foreign shares and H shares pursuant to a share issue plan adopted at the inaugural meeting of the PRC issuer without a separate vote by holders of foreign shares;

- any right of action a shareholder may have against director of the PRC issuer;

- the special features of arbitration; and

- the standard of shareholder protection, which is different from that generally available in Hong Kong.

Such disclosure is to allow the investors to have a full picture of the H share company and if they are well-informed and understand the risks investors can make an informed decision about whether to apply for the shares of such companies.

I. Provisional Conclusions – H Shares Form a Bridge between the IPO Regulatory Regimes in Hong Kong and the PRC

The legal regime governing H shares is to facilitate the listing of PRC enterprises on the Hong Kong stock exchange. The philosophy behind such a
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regime is to ensure that PRC companies will meet the international standards required by the Hong Kong stock exchange.\textsuperscript{119} Listing on the HKSE enables the PRC companies to access foreign funds from the Hong Kong capital market while affording investors proper protection.

As shown by the statistics quoted earlier, H shares were very popular when they were first launched as such share companies were handpicked by the Chinese government and therefore most investors assumed that they would have the backing of the PRC government even though the profitability of some such enterprises was of a dubious nature. Prices of the H shares were easily affected by the policies adopted by the PRC government or the relevant ministries and corruption was also allegedly widespread among concerned communist officials.

Evidence from different countries seems to suggest that both the legal protection of investors and some form of concentrated ownership are essential to ensure managerial accountability.\textsuperscript{120} The Listing Rules and the relevant Securities and Futures Ordinance aim to protect investors by equipping them with some legal recourse. However the concentrated ownership is in the hands of the PRC government and the resulting moral hazard from such an “abstract” owner is not helpful in ensuring the accountability of directors and managers.

Despite all these problems, the SOEs have undergone a rapid transformation showing improved performance and a separation of enterprises from government intervention. The enterprise reform programmes in the PRC have come a long way since adoption of the open door policy in 1979. Considering that the PRC was still a planned economy less than three decades ago, the improvement in corporate governance and the protection of shareholders’ interests has been remarkable.

\textsuperscript{119}Robert Nottle, \textit{The Development of Securities Markets in China in the 1990s} in Securities and Futures Commission, \textit{Securities Regulation in Hong Kong} 116 (Securities and Futures Commission, ed. 2002).

\textsuperscript{120}Andrei Shleifer & Robert W. Vishny, \textit{A Survey of Corporate Governance}, \textit{Journal of Finance}, 52, 737-83.
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To put such progress in context, it is important to trace its development. Dramatic changes in the PRC’s reform policies began between 1984 and 1988 when enterprises became the focus of the reform and decentralization was formally adopted on a national scale. The decentralization programme aimed at two goals—to separate the government from enterprise operations and remove the Party from direct enterprise management, with the director as the main decision-maker supported by the Party. In 1989 the reforms were put on hold with the political upheavals and the fall of Zhao Ziyang, who favoured the market economy. The market economy was still largely labeled as capitalism and the opposite of socialism. Many reform projects were in limbo until 1992 when Deng Xiaoping toured southern China and restarted the reform momentum. The partial market programme was replaced by comprehensive markets. The reform effort after 1992 was aimed at

121 Yuan Lu, Management Decision-Making in Chinese Enterprises 18 (Macmillan Press, 1996). On May 10, 1984, the State Council published Guanyu Jiubu Kuoda Guoting Gongye Qite Zizuoquan de Zhanxing Guiding [Temporary regulations on further expansion of autonomy in large and medium-sized state enterprises] by granting enterprises autonomy in 10 areas including production planning, product sales, pricing, supplies, the use of capital retained from profits, disposal of unnecessary assets, management of labour and personnel, organizational design, rewards and salary and the formation of industrial groups among enterprises. In the same month, the SCRES circulated Guanyu Chenshi Jindui Tiehe Garge Shizhan Gongzuo Zuoan Hui de Jiayao [Key Points of the Working Conference on an Experiment of Economic Institutional Reform in Urban Cities] to simplify government administrative systems and create a context to ensure enterprise autonomy.

122 Id. 19.

123 Id. 22.

124 Id. 23.

125 Id.

126 Party Congress Introduces Market Economy, 42 BEIJING REVIEW, 5-6; Fang Sheng, Opening Up and Making Use of Capitalism, 12 BEIJING REVIEW, 17-19. In July 1992, the State Council published Guanyu Zhiuanhuan Guoting Qite Jingting Jihi de Guiding [Regulation on the Changes in the Operating Mechanisms of State-Owned Enterprises] which delegate 14 decision-making powers, namely, production planning, pricing, purchasing, foreign trade, investment, use of retained profits, disposal of fixed assets, formation of alliances with other firms, employment recruitment and selection, personnel management, labour management, allocation of wages and bonuses, organizational design and change and the rights to reuse funds, materials and services allocated by government agencies. Li, supra note 121, at 158-159.
clarifying the ownership structure and introducing a new enterprise governance based on market economy. 127

Developments since 1992 showed that the market economy had progressed at full speed. In his report to the 15th Communist Party Congress held in September 1997 President Jiang Zemin in his “Report to the Congress” stated that the PRC favoured a joint stock system which separated ownership and management, this helped raise the efficiency of the operation of enterprises and capital. 128 In 1993, the first batch of H share companies were listed on the Hong Kong stock exchanges. The number of domestic joint stock companies in the PRC is reported to have risen from 3600 in 1995 to 9000 by the end of 1997. 129 At the same time the managements of the SOEs had been granted a considerable degree of decision-making autonomy. 130 As a result, their accountability and governance constitute the natural next step in the PRC’s economic reform. 131

Listing of H shares helps PRC companies to raise funds from international investors. However with the stringent listing requirements imposed by the Hong Kong stock exchange, it also helps to restructure the proposed PRC companies by making full use of a ready pool of international financial and legal intermediaries existing in Hong Kong. The listing rules stress the importance of full disclosure and so the listing of H shares and the introduction of foreign capital have required a significant increase in the transparency of the SOEs concerned, and it is thus a force for the reform of their corporate governance. 132 The Listing Rules and the relevant SFO also formalize the relationship between the Hong Kong stock exchange and the SOEs and provide

127 Lu, supra note 121, at 159.
129 Child, supra note 87, at 42.
130 Id. 41 & App.
131 Id. 41.
132 Child, supra note 87, at 18.
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more structural support. As a result, it can minimize the impact of the guanxi network\textsuperscript{133} and ensure a level playing field based on competence and market mechanism.\textsuperscript{134}

The listing of H shares may not solve all, or even most of, the problems of the SOEs regarding corporate governance but it is the right move in the right direction. The relevant rules in the Listing Rules and the SFO take into consideration the international standard required by the Hong Kong stock exchange and also the particular characteristics of PRC companies. Although such rules and laws were not created to harmonize the laws between Hong Kong and the PRC, they indirectly paved the way for such harmonization. If the same "equivalent compartmentalization" can be devised by the PRC companies for Hong Kong or foreign companies, it will draw the legal requirements between the PRC and Hong Kong even closer and harmonization may eventually be achieved.

\textsuperscript{133} Guanxi refers to a special relationship due to the existence of particularistic ties. It involves some sort of family or achieved relationship between two parties. Examples of guanxi bases include individuals' having worked together previously, having studied together, having been labours, having been teacher or student to each other, or being members of the same family (immediate or extended). Native origin is also a common basis of guanxi in the PRC by coming from the same home town or having the same ancestral roots. Through identification, friendship and felt obligations, guanxi promotes interpersonal trust, interpersonal liking, loyalty and favouritism that affect the operation of a company. See Anne S. Tsui et al., Guanxi in the Chinese Context, in LU, supra note 121, at 225-228 & fig. 8.1.

\textsuperscript{134} It has been proposed that guanxi is a substitute for formal institutional support and a guanxi network takes on more importance for private-sector firms because of the lack of a reliable rule of law.
Chapter III


Chapter I explains the backgrounds of the Hong Kong and the PRC stock markets and notes that integration of the stock markets of these two jurisdictions is beneficial to both. For Hong Kong, it will enhance its status as an international financial centre, increasing the liquidity and diversity of its stock market. For the PRC, it can make use of the pool of highly skilled human resources and sophisticated financial infrastructure, increasing others’ confidence in its stock markets. Geographical, cultural and economic factors also encourage such integration. Chapter II explains the use of “equivalent compartmentalization” by the Hong Kong stock exchange to allow PRC companies to be listed on its exchange in the form of H shares.

The H share experiment alone is not sufficient enough to consolidate the stock markets of Hong Kong and the PRC as it is only related to listing matters. Are there other factors that contribute to harmonization of law between these two jurisdictions which is conducive to such integration? This chapter explains the importance of soft laws in the harmonization process. It then proceeds to examine the Mainland and Hong Kong Closer Economic Partnership Agreement (“CEPA”) and see how it facilitates mutual recognition of qualifications of the financial intermediaries in Hong Kong and the PRC. This chapter concludes by examining how both the international soft laws and CEPA foster integration of the clearing and settlement systems.
Chapter Three

A. Harmonization of Laws and Regulations

Harmonization of laws and regulations\(^1\) is a process of increasing the compatibility and consistency of legal practices by setting bounds to their degree of variation. It can be distinguished from standardization which is the process which leads to uniformity of laws and regulations. Harmonization is a process ranging from minimum harmonization to maximum harmonization. Minimum harmonization is to set out minimum standards to be achieved in two jurisdictions while, on the other side of the spectrum, maximum harmonization is the state at which laws and regulations of two jurisdictions will become identical.

It is advocated that structural reform on corporate governance based on international soft laws is required for the harmonization of securities laws in Hong Kong and the PRC in light of the Asian crisis in 1997 and large corporate failures like Enron and Worldcom. Accountability and building up a workable incentive system are two main issues that make rules and regulations work and they are singled out for discussion after the corporate governance issues.

As far as financial intermediaries are concerned, this chapter continues by examining the mutual recognition concepts in relation to CEPA, CEPA II and CEPA III. Both the international soft laws and CEPAs also contribute to the consolidation of the clearing and settlement systems in these two jurisdictions.

1. Structural Reform: Corporate Governance Culture (International Soft Law)

a. Corporate Governance – Overview

Corporate governance is affected by the relationships among participants in the governance system and their relative powers vary from one jurisdiction to another. Governance problems result from the separation of ownership and

\(^1\) A more detailed definition of harmonization of law can be found in Chapter V (Harmonization of Law and Four Models of Integration).
control. However, this is not simply an issue of the relationship between shareholders and management, although that is the central element. Governance issues may also arise from the power of certain controlling shareholders over minority shareholders. Stake-holders have also become increasingly important as employees and creditors have important legal rights and their rights also vary from jurisdiction to jurisdiction. Effective corporate governance should also adopt this broad approach to the operation of checks and balances. Some of the other issues relevant to a company's decision-making processes, such as environmental, anti-corruption or ethical concerns, are also taken into account in some jurisdictions.  

Corporate governance is an important issue for the PRC. Take the banking sector as an example, Premier Wen Jianbo showed great concern in his annual press conference on March 14, 2005 with the competence and accountability of state banks' management. Moral hazard, lack of internal controls, coupled with incompetence of bank staff resulted in a number of bank scandals recently. Shortly after its successful December 2003 initial public offering, China Life Insurance was faced with class-action lawsuits in the United States for failing to disclose in listing documents an ongoing central government audit that revealed RMB 5.4 billion of financial irregularities within the company.

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2 OCED, OCED Principles of Corporate Governance 2004, 12.

3 A junior clerk in a sub-branch of the Bank of China in Harbin left the country with more than RMB 1 billion from the bank reserve. The China Construction Bank was investigating the disappearance of more than US$8 million from one of its branches in Jilin Province. The Industrial and Commercial Bank of China and the China Agriculture Development Bank were also dealing with several massive scandals. Zhang Erzhao was sacked as the chairman of the China Construction Bank and China International Capital Corp., a joint venture investment bank mainly between China Construction Bank and Morgan Stanley after Mr. Zhang was named in a lawsuit filed in California court late in 2004 which alleged that he received about US$1 million in kickbacks in a deal to procure financial management software for the bank. (Xiangwei Wang, Leaders must Get Priorities Straight before Floating Scandal-Prone Banks, SCMP, March 21, 2005.) In a separate news report, the main Beijing branch of the Bank of China has been cheated of more than RMB 600 million in a mortgage linked to a real estate project. The Bank of China has endured five major scandals in recent years, involving billions of yuan losses at branches in Harbin, Guangdong and Heilongjiang and the scandals have brought down its president, a former head of its Hong Kong division and two Hong Kong vice-presidents. Shi Ting, Another Huge Fraud Rocks Bank of China, SCMP, April 3, 2005.

4 Bei Hu, Mainland Banks Scrub Up Tatty Image, SCMP, April 8, 2005.
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On the other hand, the problem with corporate governance in Hong Kong is the strong business lobby which advocates minimum intervention from the Hong Kong government. The history of securities regulatory reform in Hong Kong is a history of policy flip-flops and compromise, rather than a concise effort to give the regulator sharper teeth. It was proposed by the government in its January consultation in 2005 to give the listing rules the statutory backing and as a result, the SFC have the ability to impose fines of up to HK$5 million on anyone breaching the listing rules - a measure for small and medium-sized breaches, with the harder cases to be referred to the Market Misconduct Tribunal ("MMT") or criminal courts. Without fining power, the SFC is left with the options of public reprimands, disgorgement orders or banning directors. Fining power will reduce the time, effort and cost of court hearings and the MMT - a weapon so important to the SFC that for the first time in the history of the SFC, it publicly objected the possible government's decision to scrap such fining powers. If the fining power of the SFC is scraped, it is not the first time that compromise with vested interest groups has watered down the power of the SFC. In 2002, an expert group proposed to have a single-regulator model in Hong Kong instead of having a division of labour between the stock market and the SFC in regulating the Hong Kong stock market. As the stock market is a profit-making organization, there is a serious conflict of interests for it to act as a regulator at the same time. Due to opposition from vested interest groups, the government retreated from the idea.

b. Global Corporate Governance

Large corporate failures have created repercussion all over the world and often stimulated debate about corporate governance. Such intense debate usually led to regulatory action and other reforms:

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5 Jane Moir, Watchdog to be Kept on Short Leash, SCMP, April 6, 2005.
6 See id.
7 See id.
8 Survey of Corporate Governance Development in OECD Countries, 9.
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- Collapse of the Maxwell publishing group at the end of 1980s led to the Cadbury code of 1992;

- Collapses like Poly Peck and BCCI in the 1990s and the Marconi (formerly GEC) collapse in 2001 resulted in further enquiries and recommendations;

- Cases of Holtzman, Berliner Bank and more recently Babcock in Germany also served as catalyst for reform;

- Collapse of HIH (a larger insurer), Ansett Airlines and One Tel in Australia also called for further investigation and reform;

- Both banks and chaebol (in Korea) and Credit Lyonnaise (in France) in the early 1990s and Vivendi (in France) in early 2000s and the scandal with Swissair (in Switzerland) in 2001 have raised many governance issues;

- Large failure of financial and non-financial institutions in Japan in the 1990s have also led to regulatory responses and legal changes;

- Cases of Enron, WorldCom and Tyco have sparked off major debate and legislative changes in the US.

Large corporate failures or large scale crisis like the Asian crisis in 1997 often triggered re-examination of the corporate structure, practice and corporate behaviour. The inter-connectedness of our economy and the significant adverse externalities of any corporate failings prompt international action for higher corporate standards and governance. International standards set by international organization are frequently referred to as “soft law”. In practice, soft law refers to a great variety of instruments including declarations of general principles, codes of practice, recommendations, guidelines, standards,
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charters and resolutions. Although these kinds of documents are not legally binding, there is a strong expectation that their provisions will be respected and followed by the international community. According to Bothe\(^9\) (1980):

> "A non legal commitment is... often much easier for a state to accept than a legal one. In all probability, here lies the reason why states do not reject resolutions the terms of which they would by no means accept as a treaty. This presents both an opportunity and a danger. As resolutions also give rise to expectations, they trigger a certain pressure for compliance that is often, as has been shown, effective in the long run. They influence practice, and practice influences law."

Soft law helps to harmonize law and practice globally. Soft law is developed by various international organizations, some of them organized on national lines (e.g. OECD) and some on organizational/professional lines (e.g. IOSCO, IASB and IAASB). Soft law affects member countries while sometimes it also affects non-member countries if such non-member countries have adopted the principles or standards. Both Hong Kong and the PRC are not members of OECD but both of them have adopted the Anti-Corruption Action Plan for Asia-Pacific (which is one of the initiatives of OECD) and they are influenced by OECD Principles of Corporate Governance.\(^10\) As for IOSCO, both Hong Kong and the PRC are members. More than one chairman of the SFC is the chairman of the Technical Committee of the IOSCO (Technical Committee is made up of 15 agencies that regulate some of the World's larger, more

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\(^10\) As a response to OECD, the G7 agreed in 1999 to launch a Financial Stability Forum, involving all of the major players in the international financial system, including a number of emerging economies such as Singapore and Hong Kong. This Forum adopted 12 key standards considered essential for countries to follow in order to promote international financial stability. Daniel Blume, *Experiences with the OECD Corporate Governance Principles* (Middle East and North Africa Corporate Governance Workshop, Cairo, Egypt, September 7, 2003) at http://www.gegf.org/ifext/gegf/rsf/AttachmentsByTitle/MENA_Sep_03_Exp_with_OECD_CG_Principles/SFLE/MENA_Sep_03 +OECD +Blume.pdf. The SSE Guidelines in the PRC drew heavily on the OECD Principles and UK Combined Code. See Asia Law & Practice, *STRUCTURING FOR SUCCESS - THE FIRST 10 YEARS OF CAPITAL MARKETS IN CHINA* 30 (Asia Law & Practice, June 2001).
developed and internationalized stock markets) and the PRC is one of the 19
member Executive Committee in 2004.11

2. Structural Reform: Accountability System

Accountability is associated with delegated authority and the party with the
delegated authority has to answer for actions to the entity from which authority
is derived, usually against agreed-to performance standards. Originally,
accountability referred mainly to compliance with established norms of
financial management. In recent years, the meaning of accountability has
broadened to include the achievement of performance targets and compliance
with norms external to the organization - such as protection of human rights or
preservation of the environment. For a company, the management owes a duty
both to the shareholders and arguably to stakeholders. Accountability usually
also involves taking actions to correct problems, ensuring they do not reoccur
and the imposition of various forms of penalties for failure. It is the liability of
a board of directors to shareholders and stakeholders for corporate performance
and actions of the corporation.12

One common misconception regarding the stock market in the PRC is the
suggestion that government intervention in the management of the companies
should be curbed as there should be a separation of the management from the
government control. The problem with the state-owned government is not
government intervention. As the government is the largest shareholder, they
have the majority voting power to legitimately influence the decisions of the
companies. The real problem of the state-owned enterprise is a lack of
accountability. The government is an abstract concept and in the daily
management of the companies, it translates into layers of bureaucracy,
corruption and non-profit making goals. Separation of the government control
and the management advocated in the early days of the corporatization did not


12 A number of definitions can be found in the Google websites (e.g. see
enable the state-owned companies to turn the table around and make any profits. The state-owned companies were accountable to the majority shareholders who now happened to be the government and it means that they were accountable to nobody other than bureaucrats and possible corrupted government officials. The government is not one single entity and it is operated at different levels, central, provincial and municipal levels. In an interview with China Central Television in 2005, State-owned Asset Supervision and Administration ("SASAC") chairman Li Rongrong said that a key issue was to hold local state-assets bureaus accountable to their counterparts at the higher levels. The issue of accountability does not only apply to the relationship between government ownership and the management of the SOEs but also the chain of commands within the government structure.

The remedy is not to stop the government intervention. In fact, the government, as a shareholder, should have more intervention but it should exercise its rights in a way similar to institutional investors. However given a general lack of accountability as described above and that the PRC government is also concerned with non-economic goals like local development and employment generation, the ideal system to ensure economic efficiency is to replace the

13 There were heated talks about growing fraud and corruption at state firms at the NPC closed on March 14, 2005. Procurator-General Jia Chunwang said in his NPC report in March 2005 that 10,407 officials were found to have misappropriated or stolen state assets during restructuring programmes in 2004. Elaine Chan, Beijing Plans Clampdown on Illegal Sales of State Assets, SCMP, March 15, 2005.

14 SASAC was established in March 2003 to manage the country's problematic 196 SOEs which absorbed 80% of its total resources but contributed to only 40% of the industrial output. As at March 14, 2005, it controls 179 of the country's biggest SOEs with assets worth RMB 9.2 trillion and it aims to cut the number of companies under its control to between 80 and 100. Eventually the goal is to groom only 30 to 50 internationally competitive state-owned corporations. See id. and Shi Ting, State-Owned Firms to Face Faster Cuts, SCMP, March 14, 2005.

15 See id. In November 2003, SASAC announced five measures to restructure and reorganize SOEs: 1) to encourage more SOEs to list in the domestic markets; 2) to encourage merger and acquisition of large SOEs; 3) to establish an exit mechanism for non-competitive industries; 4) to encourage SOEs to invest abroad, set up branch offices and participate in international merger and acquisition and 5) to create opportunities for foreign enterprises to participate in the merger and acquisition of the PRC's merger and acquisition. SASAC Announces Five Measures to Promote China's SOE Reform, PEOPLE'S DAILY ONLINE, Nov. 20, 2003 available at http://english.people.com.cn/200311/20/eng20031120_128595.shtml

16 It is the reason why it takes such a long time for the PRC government to introduce bankruptcy laws and exit mechanism for listed companies.
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government with institutional investors as the majority shareholders. If institutional investors are majority shareholders, their voice and concern can be better heard and the interests of the shareholders are better protected. To achieve this goal, the first step is for the government to sell off its state shares to the private sectors.

Non-floating state shares of more than 1,200 listed companies account for 66% of the RMB 3.53 trillion in market capitalization and therefore comprise the majority of the shares issued by the listed PRC companies in the PRC stock markets. The high concentration of non-tradable shares may create moral hazard as the managers of listed companies do not have to worry about falling stock prices, and becoming a target for takeover as in the west.

The non-tradable shares are also one of the most important obstacles for the integration of stock markets in Hong Kong and the PRC. Non-tradable shares

17 The advantages of diversified ownership may probably be over-rated as the influence of small shareholders usually is limited and small shareholders tend to be more passive as they may be preoccupied with their jobs and the money at stake tends to be smaller.

18The words "Institutional investors" should be qualified. It should be noted that there are different types of institutional investors. Some institutional investors may be fund managers affiliated with commercial or investment banks. The client of such banks may be the listed companies the fund managers will invest in. There will be a conflict of interests as fund managers do not want to be seen as criticizing their client. In any events, other than public information through disclosure, fund managers may depend on access to the management of companies for their information, any public criticism of the companies may risk being shut out from the companies and any further access to important financial information. See David Webbs, The HAMS Initiative: Representing & Activating Minority Shareholders at http://www.webb-site.com/articles/hams.htm (last modified: July 1, 2001). Some institutional investors are less accountable to their "owners" than are corporate managements to their shareholders. John Coffee, Liquidity versus Control: The Institutional Investor Voice, 91 COLUMBIA LAW REVIEW, 1277-1338, 1331 (1991). Despite such institutional investors, other institutional investors like the California Public Employees' Retirement System (CalPERS) are recognized as standard-bearers for the movement that advocates ownership rights so as to increase share value. Indeed, CalPERS is generally credited as a founder of shareholder activism stemming from its heightened proxy voting activity at selected companies in the mid-1980s. See James Hawley et. al., Getting the Herd to Run: Shareholder Activism at the California Employees' Retirement System, BUSINESS AND THE CONTEMPORARY WORLD, 11-12 (Fall 1994). See also CalPERS Shareowner Forum, CalPERS Viewpoint at http://www.calpers-governance.org/viewpoint/default.asp.

distort share prices and it is the main reason that results in different share valuation of the same companies in Hong Kong and the PRC. The state share reform in 2005 is a major step in the right direction which is discussed in the last chapter.

3. **Structural Reform: Incentive System**

An incentive system is essential to motivate the management of the companies to comply with the rules and regulations. If enforcement of laws and regulations is the cure of the issue of compliance, to provide an incentive system to comply with laws and regulations is the prevention of non-compliance issue. Not any incentive system works as there is also a strong incentive for people not to comply with laws and regulations. By laying down the rules does not mean that they will or want to comply with them. The incentive to comply with rules and regulations has to outweigh the incentive of not complying with them.

Incentive systems including bonus schemes and stock option plans are commonly used. In order not to defeat the purpose of incentive system, such schemes and plans have to be carefully devised. The incentive system should help to align the directors’ interests with shareholders and give the directors incentives to perform at the highest levels. To avoid short term profit at the expense of long term performance of the enterprises, shares granted or other forms of deferred payment should not be vested, and options should not be exercisable, for a period of time, usually three years and directors should be encouraged to hold on the shares for a further period after vesting or exercise. Incentives schemes should be subject to challenging performance criteria reflecting the company’s objectives. Any grant or incentive awards should be phased rather than one-off. Further, any new incentive schemes and

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20 The UK Combined Code on Corporate Governance (July 2003), Code B.1.1.

21 Id. Schedule A(2).

22 Id. Schedule A(4).

23 Id. Schedule A(5).
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significant change of existing plans should be approved by shareholders to
avoid over-remuneration of the management at the expense of the listed
companies.\textsuperscript{24}

Incentive may prone to abuse by the management as they may want to hide
losses and pump up profit figures to maximize their gains through bonus
schemes or stock options. Therefore, an incentive system is equally important
for the whistle-blowers, mainly accountants and auditors but whistle-blowers
should also include employees. Such incentive systems include rights to
protect them from improper dismissal or a certain degree of immunity from
prosecution.\textsuperscript{25} Incentive system also applies to stakeholders. Performance
enhancing mechanisms range from explicit economic incentives such as share
distributions and forms of performance-related pay to the establishment of a
corporate culture to motivate employees, employee consultation and
representation on the boards. Creditors could also include undertakings about
corporate disclosure by which the firm voluntarily commits to tighter standards
than those required by applicable law.\textsuperscript{26}

Proper incentives are important to supplement the market mechanism
especially in an environment where the rule of law is questionable. If the law
is not proper enforced, best corporate practice will depend on the conscience of
the workforce and the general working culture. Incentives that help achieve
the company's goal and protect the investors' interests can eliminate moral
hazard that prevails in SOEs. One of the classic problems of SOEs in the PRC
is that even senior management or directors do not receive high remuneration
packages although they have considerable power and influence in the listed
companies. The combination of poor remuneration and substantial power,

\textsuperscript{24} Id. Code B.2.4.

\textsuperscript{25} In Hong Kong, auditors of listed companies are granted immunity from civil liability for
reporting suspected fraud to the SFC. See Part XVI of SFO. There are also whistle-blowers
laws in Canada. See Canadian Law Site.com, \textit{Canadian Whistleblower Laws at
http://www.canadianlawsite.com/whistle-blower.htm.}

\textsuperscript{26} OECD, \textit{Survey of Corporate Governance Development in OECD Countries at
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coupled with a lack of accountability, tends to foster corruption practices, power abuse, embezzlement or appropriation of companies' assets.

Other than securities laws and regulations, integration requires synergy and similar corporate practice with the support of the whole legal environment. Integration of stock markets also requires appropriate legal and non-legal incentives to be in place to overcome the moral hazard within the organizations of the SOEs.

It is not the intention of this chapter to list all the corporate governance issues and the above discussion is far from exhaustive in relation to the vast area of corporate governance. The above discussion is to tackle the corporate governance issues in the context of integration between the Hong Kong and the PRC stock markets. It has already been pointed out in Chapter II that H share rules and regulations have already laid down the foundation for the harmonization of rules and regulations if the stock markets were to be consolidated despite some of their shortcomings. Soft laws and the work of some international organizations have also assisted the harmonization of laws and practices. This chapter on corporate governance particularly singles out accountability and incentive issues. Accountability is a very important issue in governance and it is concluded that state shares have to be phased out before integration of stock markets can ever happen which is already in progress. In addition to the legal environment, incentives are important to illustrate the significant impact of informal rules and practices on integration.

B. Mutual Recognition of Stock Market Intermediaries

1. Mainland-Hong Kong Closer Economic Partnership Arrangement - Structure and Operation

One of the main factors that facilitates integration of the Hong Kong and PRC stock markets is the mutual recognition of qualifications of the financial intermediaries of these two jurisdictions. Mutual recognition of stock market intermediaries between Hong Kong and the PRC was partly achieved by the
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Mainland-Hong Kong Closer Economic Partnership Arrangement (CEPA). CEPA covers three major areas of liberalization: trade in goods, trade in services and trade and investment facilitation. Trade and investment facilitation, although more general in nature than the other two, is potentially most important since it sets the groundwork for co-operation between the PRC and Hong Kong governments for implementation of the concessions provided in the other two areas.

Liberalization regarding trade in goods is not discussed here as it is outside the scope of this thesis. This thesis mainly examines CEPA's impact on the service industry in Hong Kong in general and securities industry in particular. The discussion of the financial intermediaries is limited to securities dealers and advisers, accountants and solicitors.

CEPA is an organic and a forward-looking arrangement as both the PRC and Hong Kong governments have agreed to pursue further trade liberalization measures through consultation under the terms and conditions of CEPA. CEPA I was first concluded in June 2003 and implemented from January 1, 2004. Under the CEPA framework, the PRC and Hong Kong agreed on a second phase of liberalization measures (CEPA II) in August 2004 to further relax the access to the PRC’s services market. In addition, further liberalization (CEPA III) took effect in January 2006. It is true that market liberalization measures associated with the PRC's WTO accession are applicable to Hong Kong but CEPA measures are above and beyond the WTO commitments and it only applies to those qualified as "Hong Kong companies" as defined by CEPA. CEPA not only provide enhanced access for Hong Kong's service providers to the PRC market, but it also creates opportunities for Hong Kong professionals and residents to establish business or work in the PRC.

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28 Under CEPA, it is clearly stated that the PRC supports the full utilization of financial intermediaries in Hong Kong during the process of reform, restructuring and development of the financial sector in the PRC. See CEPA, Art. 13(3).

29 Under CEPA, consultation and negotiation are held by the Steering Committee and the liaison offices and working groups set up under it. See CEPA, art. 19.
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CEPA I covers market access to 18 service industries. On August 27, 2004 the two sides agreed, under CEPA II, to further relax the market access conditions for Hong Kong services and service suppliers in the following areas, namely: legal, accounting, medical, audiovisual, construction, distribution, banking, securities, transport, freight forwarding agency and individually owned stores.

Under CEPA II, it was further agreed that eight more areas were opened up for preferential access to Hong Kong service suppliers from January 1, 2005. They include: airport services, cultural entertainment, information technology, job referral agency, job intermediary, patent agency, trade mark agency and professional qualification examinations. In other words, the PRC government was committed to opening a total of 26 sectors to Hong Kong services and Hong Kong services providers with CEPA I and II combined. There are 23 liberalization measures under CEPA III, covering ten areas.

Authorities and professional bodies of both sides will continue to hold consultation meetings to consider specific methodologies for mutual recognition of professional qualifications.

2. CEPA Terms Applicable to Financial Intermediaries

In response to CEPA, SFC and the CSRC signed in December 2003 the "Mainland/ Hong Kong Closer Economic Partnership Arrangement -
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Arrangements relating to Qualifications of Securities and Futures Industry Practitioners" to implement CEPA in the securities industry.

a. CEPA Terms Applicable to Securities Firms and Brokers

Comparison between HK and PRC Qualifications of Securities and Future Industry Practitioners

In Hong Kong, under the new SFO, a new single licensing system was introduced on April 1, 2003. Under the new system, a license holder may engage in different types of regulated activities falling into nine categories. Each license issued will clearly define the type of regulated activities allowed by the holder to participate in. 35

Pursuant to the following mapping table 36, PRC professionals applying for Hong Kong licences or Hong Kong securities and futures professionals applying for qualifications to practise in the PRC are deemed as having possessed the necessary industry qualifications in the corresponding jurisdiction 37:

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35 See Annex 2 for the nine regulated activities under the SFO in Hong Kong.


<table>
<thead>
<tr>
<th>Practising Qualifications in the PRC</th>
<th>Regulated Activities specified in Hong Kong Licences</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities Practising Qualification</td>
<td>Dealing in Securities</td>
</tr>
<tr>
<td>(having passed the Special Paper on Securities Dealing)</td>
<td>(Type 1 regulated activity)</td>
</tr>
<tr>
<td>Securities Practising Qualification</td>
<td>Advising on Securities</td>
</tr>
<tr>
<td>(having passed the Special Paper on Securities Investment Analysis)</td>
<td>(Type 4 regulated activity)</td>
</tr>
<tr>
<td>Securities Practising Qualification</td>
<td>Advising on Corporate Finance</td>
</tr>
<tr>
<td>(having passed the Special Paper on Securities Issuance and Underwriting)</td>
<td>(Type 6 regulated activity)</td>
</tr>
<tr>
<td>Futures Practising Qualification</td>
<td>Dealing in Futures Contracts</td>
</tr>
<tr>
<td>(having passed the Special Paper on Futures)</td>
<td>(Type 2 regulated activity)</td>
</tr>
<tr>
<td>Futures Practising Qualification</td>
<td>Advising on Futures Contracts</td>
</tr>
<tr>
<td>(having passed the Special Paper on Futures)</td>
<td>(Type 5 regulated activity)</td>
</tr>
<tr>
<td>Securities Practising Qualification</td>
<td>Asset Management</td>
</tr>
<tr>
<td>(having passed the Special Paper on Securities Investment Funds)</td>
<td>(Type 9 regulated activity)</td>
</tr>
</tbody>
</table>

To practise in the securities and futures industry either in Hong Kong or the PRC requires both the industry and practising qualifications. An individual has to obtain the industry qualification before applying for the practicing qualification. Industry qualifications are academic qualifications that can be
obtained through examinations. Practising qualifications are usually concerned with regulatory requirements like experience and conduct.

In essence, the CEPAs work in a similar way as the Home Country Rule adopted by the EU in a number of its directives (see Chapter IV). In this case, as Hong Kong and the PRC are not two countries, it can be called a home jurisdiction rule. This thesis now examines in more detail the operation of this home jurisdiction rule in the securities, legal and accountancy industries:

i. **Hong Kong Professionals applying to work in the PRC Securities and Futures Industry**

In the PRC, the Securities Association of China ("SAC") and China Futures Association ("CFA") are responsible for administering the industry qualification. 38 CSRC has delegated the authority to grant practising qualification to SAC and CFA. 39

The first "PRC Securities Regulations Examination" for Hong Kong securities and futures professionals was held in Shenzhen in March 2004. The SAC and CFA have appointed the Hong Kong Securities Institute ("HKSI") to make enrolment by Hong Kong professionals, so Hong Kong professionals can enrol for the above examination through HKSI.

After obtaining the industry qualification, such an individual will need to secure an employment with a PRC intermediary firm and apply to SAC and CFA for the practising qualification. However if such an individual wants to take up senior management role and in such a case, that individual has to apply directly to the CSRC.

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39 See id.
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ii. PRC Professionals applying to work in HK Securities and Futures Industry

The PRC professionals have to sit for a licensing examination to obtain the industry qualification. The HKSA is responsible for administering the examination. The "Licensing Examination for Securities and Futures Intermediaries" (Paper 1) was held in Shenzhen on April 23, 2005 (Saturday) on a reciprocal basis for PRC professionals. The "Licensing Examination for Securities and Futures Intermediaries" (Paper 1) in Shenzhen had been organized by the HKSI, assisted by the SAC, the CFA and supported by the Growth Enterprises Training Centre, Shenzhen Stock Exchange. The examination was administered locally by the Adult Education College of Shenzhen University.

Notwithstanding satisfying the "Recognized Industry Qualifications" of the SFC, PRC professionals are still required to pass the relevant regulatory examinations in Hong Kong to satisfy "Local Regulatory Framework Papers" requirements. Those applying for a Hong Kong licence must comply with the requirements set out under the "Fit and Proper Guidelines" and "Guidelines on Competence". Unlike the two-tier system in the PRC, anyone who satisfies the above test can apply for a representative license and/or approval as a responsible officer in Hong Kong.

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41 The SFC shall have regard to a number of matters in assessing whether a professional is fit and proper to be licensed, including the person's:
(a) financial status or solvency;
(b) educational or other qualifications or experience having regard to the nature of the functions to be performed;
(c) ability to carry on the regulated activity competently, honestly and fairly; and
(d) reputation, character, reliability and financial integrity.
Such assessment includes a test of competence on knowledge (which includes industry qualification) and experience. SFC, Topic 3 Closer Economic Partnership Agreement - Arrangement Relating to Qualifications of Securities and Futures Industry Practitioners 22 at http://www.sfc.hk/sfc/doc/EN/intermediaries/licensing/topic_03_cepa_eng_1.12.03.pdf.
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iii. CEPA III Opening More Opportunities for PRC Securities and Futures Companies

Under CEPA III, the PRC government allows certain qualified PRC securities and futures companies to set up subsidiaries in Hong Kong. Hong Kong will be increasing use as a financial platform for PRC securities and futures companies, with the expectations of generating more cross-border business opportunities for Hong Kong and the PRC.

b. CEPA Terms Applicable to Solicitors

CEPA allows Hong Kong law firms (offices) that have set up representative offices in the PRC to operate in association with PRC law firms, except in the form of partnership. Such association may save costs and share resources and provide a one-stop service for clients dealing with cross-boundary securities business that may require legal knowledge of both

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43 Xianggang Tebeiyingzhegou he Aomen Tebeiyingzhegou Lushi Shiwusu Ju Neidi Lushi Shiwusu Liangying Guanli Banfa [Measures for the Management of Associations Formed by Law Firms of the Hong Kong Special Administrative Region or the Macao Special Administrative Region with Mainland Law Firms] promulgated by the Ministry of Justice on November 27, 2003 and effective on January 1, 2004 available at http://www.legalinfo.gov.cn/ggl/2003-12/01/content_62497.htm and Sifabu Guanyu Pangfa Xianggang Aomen Tebeiyingzhegou he Neidi Lushi Shiwusu Liangying Xikezheng Youguan Shiyi de Banfa Tongzhi [Notice of the Ministry of Justice on Matters Concerning the Issuance of Licenses for Association Formed by Law Firms of the Hong Kong Special Administrative Region or the Macao Special Administrative Region with Mainland Law Firms] to be issued on February 23, 2004 available at http://www.mofcom.gov.cn/article/bj/bj/200403/20040300199637.html. A Hong Kong law firm can form an association with a foreign law firm under art. 39(c) of the Legal Practitioners Ordinance. Unlike a partnership, an association does not share joint professional liability.

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jurisdictions. Only law firms with representative offices in the PRC are allowed to form such association because it is believed that they have acquired the requisite experience and establish the working relationship with the PRC law firms.

Under CEPA, PRC law firms can employ Hong Kong legal practitioners to practise non-litigious matters although a Hong Kong law firm in the PRC cannot employ a PRC practitioner as there is a general rule that Hong Kong law firms cannot practise PRC laws. Such legal practitioners must have practiced for two years in Hong Kong. They should have never been punished for any criminal offence, professional misconduct or any violation of the code of practice. In addition, such a legal practitioner must have secured an employment with a PRC law firm.

CEPA also allows Hong Kong permanent residents with Chinese citizenship to sit for the legal qualifying examination in the PRC and acquire PRC legal professional qualification in accordance with the Rules on Entering for the State Judicial Examination for Residents of the Hong Kong Special Administrative Region and the Macao Special Administrative Region. For
those who have passed the above examination, they can engage in non-litigation legal work in PRC law firms in accordance with the Law of the People’s Republic of China on Lawyers.\(^5\)

CEPA also enables Hong Kong residents to identify greater employment and business opportunities in the PRC. In the case of Hong Kong lawyers, they may find additional business opportunities by offering professional assistance requested by the PRC law firms in respect of individual cases, as they will not be subject to the requirement of a Hong Kong legal consultant permit as required before because of the CEPA II provisions.\(^5\)

Examples of the special convenience provided by CEPA to enhance partnership within the Greater Pearl River Delta include waiving Hong Kong lawyers' residency requirements to operate in Guangzhou and Shenzhen.\(^5\) For the Hong Kong representatives working in the PRC representative offices of Hong Kong law firms (offices) located in places other than Shenzhen and Guangzhou, their minimum residency requirement is shortened from six months to two months each year.\(^5\)

c. CEPA Terms Applicable to Accountants

Hong Kong residents intending to apply for the PRC’s accounting qualification certificate should do so in accordance with the Measures on the Administration

\(^5\) Id. para. 5. According to arts. 6 & 11 of the Legal Qualification Measures, Hong Kong residents, after obtaining the certificate of legal profession qualification and having completed internship of one year may apply to practice as lawyers.


\(^5\) CEPA, annex 4, Table 1, 1(A)(a) para.6. See also Hong Kong Trade Development Council, CEPA I&II: Opportunities for Hong Kong Services Industries – Overview (December 31, 2004) at http://www.tdctrade.com/econforum/tdc/tdc041205.htm.

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of Accounting Qualification, promulgated by the Ministry of Finance of the PRC. 54

Hong Kong accountants who have already qualified as Chinese Certified Public Accountants (“CPAs”) and practised in the PRC (including partnership) are treated on par with PRC CPAs in respect of the requirement for annual residency in the PRC. 55 The validity period of the “Temporary Auditing Business Permit” applied by Hong Kong accounting firms to conduct temporary auditing services in the PRC is one year. 56 CEPA III has extended the Permit to two years.

The Hong Kong Institute of Certified Public Accountants (“HKICPA”) and the Ministry of Finance as well as the Chinese Institute of Certified Public Accountants (“CICPA”) in the PRC have reached consensus regarding the mutual exemption of papers under the professional examinations in the PRC and Hong Kong. The mutual exemption of equivalent examination papers will facilitate accountants in the PRC and Hong Kong to acquire the professional qualifications in both places as soon as possible, with a view to enhancing the cooperation of the accounting sectors in the PRC and Hong Kong. 57

Under CEPA II, Hong Kong accountants providing bookkeeping services should have obtained the PRC’s accounting qualification certificate. 58 Consultancy companies in the PRC established by Hong Kong accountants can provide book-keeping service if they can satisfy the requirements specified


55 CEPA, annex 4, Table 1, 1(A)(b) para.1.

56 Id, para. 2.


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under the Provisional Measures for the Administration of the Provision of Bookkeeping Services. Those who provide book-keeping service in the PRC should hold the PRC professional qualifications of accountants or above. When Hong Kong accountants apply for a practising licence in the PRC, the length of auditing experience they acquired in Hong Kong is equivalent to the auditing experience acquired in the PRC.

d. Other Securities-related CEPA

CEPA allows the Hong Kong Exchanges and Clearing Limited to set up a representative office in Beijing. HKEx's representative office was opened on November 17, 2003. The opening of the office enables HKEx to provide better information services to PRC companies and help them get a better understanding of the Hong Kong market. It is also part of the efforts made by Hong Kong to facilitate the listing of more PRC companies and shorten the time of such preparations. The office helps bring benefits to the Hong Kong securities industry as a whole, and not merely for HKEx. Discussion is now in progress to open other representative offices in other PRC cities. All in all, the office is expected to improve links between Hong Kong stock markets and PRC supervision bodies, and facilitate communication between the HKEx and PRC enterprises wanting to list.

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59 Id.
60 Id.
61 Id. para. 2.
62 CEPA, annex 4, Table 1, 7(B) Securities- para. 1.
65 PEOPLE'S DAILY ONLINE, supra note 63.
CEPA II also allows intermediaries which are licensed with the SFC and which satisfy the requirements of the CSRC to set up joint venture futures brokerage companies in the PRC. The percentage of shareholding owned by Hong Kong licensed intermediaries should not exceed 49% (including shareholding of related parties).66

3. Integration Contribution by CEPA

Under CEPAs, securities intermediaries in Hong Kong and the PRC have held discussions and reached a consensus in respect of collaboration on examinations, mapping of PRC/Hong Kong qualifications, arrangements for approval of qualifications, regulatory co-operation, and breaches and investigation.67

Mr. Gary Cheung, Chief Executive of the HKSI, said,

"... Through taking the relevant training courses, PRC practitioners can gain a better understanding of the regulatory framework and laws governing the Hong Kong securities and futures markets, hence boosting their industry expertise... It is our hope that the examination will encourage talents in the PRC and Hong Kong to learn from each other and exchange expertise, helping to lay a solid foundation for assimilation into the global financial markets."68

66CEPA II, annex 3, 7(B) – Securities – Futures available at http://www.tid.gov.hk/english/cepa/files/aa_annex3_e.doc. For the purpose of comparison, under WTO, foreign securities firms can establish joint ventures (with foreign ownership less than 1/3) to engage (without Chinese intermediary) in underwriting A shares, and in underwriting and trading B and H shares, as well as government and corporate debt. See also Rules Governing the Establishment of Foreign invested Securities Companies promulgated by the China Securities Regulatory Commission on December 16, 2002, effective February 1, 2003, r10. Please note that CEPA II refers to the joint venture futures brokerage companies only.


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The mutual recognition of professional qualifications between the securities and futures industries in the PRC and Hong Kong encourages communication and exchange of knowledge and views of practitioners. The collaboration also facilitates the cooperation between securities regulatory bodies, and the linkage and development of the securities and futures markets between the PRC and Hong Kong. The same can be said about accountants, auditors and bookkeepers in the field of accounting. Mutual recognition relating to legal services tends to be more restrictive as it is more sensitive. Hong Kong legal firms still cannot practise the PRC laws and even if HK legal practitioners have passed the legal examination in the PRC, their work is restricted to non-litigation work. However in terms of the securities industry, Hong Kong law firms can still provide one-stop service dealing with cross-border securities issues by setting up representative offices in the PRC and by setting up associations with the PRC law firms.

As commented by Lucinda Wong, Director of Licensing of the SFC, CEPA has brought the financial services industry of the PRC and Hong Kong much closer through promoting the flow of expertise across the border, cultivating a sound environment for securities and futures practitioners and enhancing the globalization and modernization of the securities markets.69

Other inter-governmental negotiations between Hong Kong and the PRC include the conduct of offshore RMB business in Hong Kong and introduction of a Qualified Domestic Institutional Investors scheme to facilitate PRC investors investing in Hong Kong70 (both of which are currently under consideration).71

69 See id.


71 Hong Kong Trade Development Council, CEPA I&II: Opportunities for Hong Kong Services Industries – Overview (December 31, 2004) at http://www.tdctrade.com/events/forum/tdc/trd041205.htm.
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C. Unified Clearing and Settlement

In the financial markets, clearing and settlement systems refer to “the arrangements (not just the machinery) for the clearing and subsequent settlement of transfer of funds or securities between financial institutions. These funds or securities could be denominated in local or foreign currencies and the transfer could take place within the same jurisdiction or across the border.”\(^72\)

Technically, it may take time to integrate the clearing and settlement systems in Hong Kong and in the PRC but Hong Kong Monetary Authority Chief Executive Joseph Yam was reported saying that cross-border clearing and settlement linkages between PRC and Hong Kong had been expanding in recent years both to satisfy growing demand and in anticipation of future liberalization and it is more the latter than the former that can better explain for such expansion\(^73\). It is the intention of the PRC government to prepare Hong Kong to be the international financial centre of the PRC.\(^74\) Although there are still many restrictions on the PRC on cross-border and cross-currency flow of funds, these restrictions are likely to be progressively removed to generate more traffic of money between the two economies as the reform and liberalization of the PRC continues.\(^75\)

1. International Standards Integration

Apart from the mechanism of clearing and settlement, the arrangement for the clearing and settlement is just as important. International standards, codes and best practice have also helped to harmonize and sometimes standardize the

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\(^74\) Id.

\(^75\) Id.
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systems and models to be adopted for clearing and settlement. Examples of such international standards include the ISSA Recommendation 2000\textsuperscript{76}, the Group of 30's recommendations on global clearing and settlement\textsuperscript{77} and CPSS\textsuperscript{78} - IOSCO Task Force's Core Principles for Systemically Important Payment Systems\textsuperscript{79} and Recommendations for Central Counterparties\textsuperscript{80} prepared in 2001 and 2004 respectively.

The two Giovannini reports commissioned under the EU identified 15 barriers, divided into technical or market practice barriers, barriers related to tax procedures and legal barriers\textsuperscript{81} The present inefficiencies of cross-border arrangements are a result of a lack of global technical standards, the existence of differing business practices and inconsistent fiscal, legal and regulatory underpinnings.\textsuperscript{82} This thesis focuses on the legal obstacles only. International soft laws have tried to address the problems of legal certainty and systemic risks by promoting international standards and practices that safeguard the countries from systemic risks. Either Hong Kong or the PRC is a member of the following international professional groups which issue international standards and best practices. Such standards and best practices help to overcome the obstacles and hurdles of cross-border clearing and settlement between Hong Kong and the PRC.

\textsuperscript{76} See Compliance to the ISSA Recommendations 2000 - Market: Hong Kong at \url{http://www.issanet.org/projects/rec2000-hk6.html} (last updated: October 2, 2001) and Compliance to the ISSA Recommendations 2000 - Market: China at \url{http://www.issanet.org/projects/rec2000-cn.html} (last updated: October 31, 2001) for details regarding the status of implementation of the ISSA Recommendations 2000 by Hong Kong and the PRC.

\textsuperscript{77} Group of 30, Global Clearing and Settlement - A Plan of Action, January 2003 available at \url{http://www.group30.org/docs/executive_summary.pdf}.

\textsuperscript{78} CPSS stands for Committee on Payment and Settlement Systems of the central banks of the Group of Ten Countries.

\textsuperscript{79} CPSS-IOSCO Joint Task Force on Securities Settlement Systems, CPSS-IOSCO Consultative Report 2001 - Recommendations for Securities Settlement Systems available at \url{http://www.bis.org/publ/cpss42.pdf}.

\textsuperscript{80} CPSS-IOSCO Joint Task Force, Recommendations on Central Counterparties, November 2004 available at \url{http://www.bis.org/publ/cpss64.pdf}.

\textsuperscript{81} Id.

\textsuperscript{82} Id. 6.
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2. Foreign Exchange Control – Integration Obstacle

Current account transactions of the PRC are no longer subject to exchange controls\(^3\) but there is still foreign exchange control on capital account transactions, which not only restricts currency convertibility for investment purposes but also cross-border capital flows, even if they are denominated in RMB.\(^4\)

Other than the mutual recognition of qualifications discussed above, CEPA facilitated the continued cooperation in depth and breadth between Hong Kong and the RRC in terms of payment settlement, and helped raise the efficiency of clearing funds between the two places.\(^5\)

Under the framework of CEPA, the People's Bank of China and the Hong Kong Monetary Authority signed a Memorandum of Cooperation concerning the operation of personal RMB business in Hong Kong in November 2003.\(^6\) Hong Kong became the first place outside the PRC to conduct personal RMB business, including deposit-taking, currency exchange, remittances and credit cards.\(^7\) Even before the memorandum, RMB had a large circulation in Hong Kong and had become the largest unofficial convertible currency after Hong Kong dollar.\(^8\)

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\(^8\) Trade Development Council, *supra* note 85.
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An even more significant development under the new arrangement was the creation of a RMB clearing system in Hong Kong. All these signify the commencement of partial convertibility for offshore RMB.

However the fact remains that the RMB is still not fully convertible and the current arrangement is only a preferential treatment for Hong Kong. Hong Kong's RMB business is restricted to individual customers, with deposit business offered solely to Hong Kong residents (holding Hong Kong identity card), excluding business entities and non-residents. This implies that Hong Kong's business is of retail scale only. Besides, Hong Kong is restricted to conduct deposit-taking, currency exchange, remittances and credit cards and it cannot conduct other businesses like lending, securities and derivatives.

Even if Hong Kong is not yet an offshore RMB centre with the restrictions mentioned above, the establishment of the offshore RMB market would make Hong Kong well prepared to evolve into an offshore RMB centre. Once the RMB becomes fully convertible, Hong Kong would take the lead. Moreover, the early operation of offshore RMB business in Hong Kong, together with the creation of the clearing system, related rules and framework as well as the early development of the market, would shape customary market practices in favour of Hong Kong against its competitors. They also signify that many restrictions on the PRC on cross-border and cross-currency flows of funds are likely to be progressively removed and they mark the first step in the smooth evolution of RMB to full convertibility. This is the declared intention in the reform and liberalization of the PRC.


90 See supra note 86. See also CEPA, annex 4 Table 1, para. 7B (3) at http://www.tid.gov.hk/english/cepa/files/annex4.doc.

91 See id.

92 Hong Kong Trade Development Council, CEPA I&II: Opportunities for Hong Kong Services Industries – Overview (December 31, 2004) at http://www.tdctrade.com/econforum/tdctrade441205.htm.

The financial system in Hong Kong is playing an important role of channelling foreign savings into the PRC investments by allowing the PRC companies to list on the Hong Kong stock exchange but it is not allowed to channel domestic savings of the PRC into foreign and PRC investments. While PRC enterprises are given permission, on a case-by-case basis, to raise funds in Hong Kong, there is no mechanism yet to allow the many individual or institutional PRC investors to invest outside of the PRC. The listing of PRC enterprises on the Hong Kong stock market only attracts, and leads to the inflow of, foreign (including Hong Kong) funds without catering for the demands of investors on the PRC. The one-sided flow of capital is expected to give way to two-way capital traffic as QDIIs have already been gradually implemented and CDRs schemes may be implemented in the future. However, in the long run, full convertibility is the answer to the integration of the clearing and settlement systems in Hong Kong and the PRC. Compared with the rest of the world, Hong Kong is one step ahead as far as the relaxation of foreign exchange control is concerned.

3. Integrating Clearing and Settlement Systems – A Slow but Achievable Objective

To link up the clearing and settlement systems in the stock markets in Shanghai, Shenzhen and Hong Kong may take time but with the current technology, it is an achievable aim. International organizations like ISSA, G30 and CPSS-IOSCO (most of them were initiated and formed by private banking institutions) have set up standards, codes and best practice where clearing and settlement institutions all over the world will observe or be measured against. Small scale integration among clearing and settlement institutions has already taken place


96 See id.
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in Hong Kong and Shenzhen and Guangdong. 97

In addition, a RMB clearing bank in Hong Kong is appointed for the RMB business in Hong Kong. The main obstacle of integration is the foreign exchange control of the capital account transactions imposed by the PRC. However with the accession to the WTO, liberalization is on the agenda in the PRC and since Hong Kong is already one step ahead in dealing with RMB business, it can adapt to the full convertibility of RMB very quickly and hopefully by that time, a unified clearing and settlement system for securities can be established, making it possible for the integration of the stock markets in Hong Kong and the PRC.

D. Provisional Conclusions – International Standards and Mutual Recognition Foster Integration

This chapter examined how the regulatory and institutional framework based on mutual recognition and international standards could facilitate the integration of stock markets in Hong Kong and the PRC.

Structural reform that adopted international standards issued by international professional bodies was advocated and in particular how such reform would address issues in corporate governance with effective accountability and incentive systems.

Other concerns of the securities industry were then addressed, namely a) the qualifications of the intermediaries and b) the clearing and settlement system:

a) In the area of mutual recognition of qualifications, CEPA, a product of bilateral negotiation between the governments of Hong Kong and the PRC, pioneered the means for achieving mutual recognition of

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qualifications for individuals working in the securities industry. However mutual recognition of establishment in relation to investment firms is still not allowed. Foreign firms established in Hong Kong are still regarded as foreign firms and WTO agreements relating to foreign investment firms are applicable to Hong Kong.

b) The main issue identified for the clearing and settlement system was the need to create greater certainty in the payment process and to reduce systemic risk.98 Under the EU Model, the two Giovannini reports have singled out a number of clearing and settlement obstacles which are frequently referred to as the Giovannini Barriers. International bodies like ISSA, G30 and CPSS have issued international standards and best practices that help to overcome some of the Giovannini Barriers for cross-border clearing and settlement system. As Hong Kong or PRC institutions are members of the above groups, it will eventually help to facilitate integration of clearing and settlement system of these jurisdictions.

A limited scale of integration has already been facilitated by establishing the Real Time Gross Settlement (“RTGS”) linkages with Shenzhen and Guangdong in relation to clearing and settlement of Hong Kong and US dollars. Further, a RMB clearing bank in Hong Kong was appointed for conducting RMB business in Hong Kong. Hong Kong also became the first place outside the PRC to conduct personal RMB business, including deposit-taking, currency exchange, remittances and credit cards under a Memorandum of Cooperation signed in November 2003. The main obstacle of cross-border clearing and settlement is the non-convertibility of RMB on capital account transactions.

CHAPTER IV

EU AND US MODELS

A. Introduction

Chapter two focuses on H shares and the whole H share experiment. The mechanism, the strengths and the weaknesses of H shares are explained in detail. The question to be addressed is how the consolidation of the stock markets in Hong Kong and the PRC can be achieved taking into consideration the advantages and readiness of such consolidation (see Chapter I) and the first step taken by the H share experiment (see Chapter II). Chapter III continues by examining other legal development that favours integration between the HK and PRC stock markets. This chapter further makes a comparative study of the European Union model and certain key features of the US model.

The PRC–Hong Kong situation resembles the federalism practiced in the US. Politically the PRC and Hong Kong are one country and Hong Kong has no say in, among other things, its foreign policy. It corresponds with the federalism practiced in the US as the federal government and the state governments form one country and the federal government is, among other things, responsible for the country's foreign policy. The US securities market is also the largest securities market in the world and it is therefore worth examining the US model to see if it is applicable to the case in question. In contrast, it seems that the European Union model comprises different nations which are significantly different from the PRC–Hong Kong situation. It may be that the political union some EU Member States are driving towards with the recent proposed European constitution is not relevant to the PRC–Hong Kong situation as politically the PRC and Hong Kong are already united. However the legal systems¹, economic and cultural development between the PRC and Hong Kong falls within the common law jurisdiction whereas the PRC primarily belongs to the civil law jurisdiction.

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Kong are sometimes as great as those between different European states. From this perspective, the EU model can be very enlightening and inspiring.

There are currently many debates on different issues relating to the US and the EU models. This thesis has made no attempt to discuss all the major issues regarding the US and the EU stock markets in detail. The discussion is focused on what can be learnt from these models in light of the possible integration of the PRC and the Hong Kong stock markets.

Securities law and company law are intertwined in the capital market. This thesis only focuses on securities law issues. As previously stated, this thesis mainly discusses the equity issues in detail and any bond issues, if ever discussed, are only discussed in general terms.

B. European Union Model

International relations theories provide the first step and the framework to understand the integration process taken place in the EU. Even though different international relations may be reviewed critically, this thesis does not make any attempt to assess the empirical data to see how accurate such international relations theories can describe the EU integration process or the dynamics between different EU institutions. The focus is not whether the EU integration process can be more truthfully described by one particular theory or a combination of such theories. The focus is on what one can learn from the international relations theories and the actual EU integration process so that if ever the PRC and the Hong Kong stock markets integrate, certain factors should be taken into consideration.

1. Origin and Early Development of European Integration

Being the architect of the European Union, Jean Monnet has a vision of Europe which throws light on the integration process in Europe. Proposed to Robert Schuman, the French Foreign Minister, Jean Monnet drafted the Schuman Plan in 1949 which eventually established the European Coal and Steel Community
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(“ECSC”) in 1952. Monnet was the president of the High Authority\(^2\) of ECSC from 1952 to 1955. He conceived the ECSC to be the first step towards European economic union which would then facilitate political union, thereby creating a European Union.\(^3\)

Monnet was responsible for French economic revival after the Second World War and thus he was strongly influenced by technocrats trained in the *Grands Écoles* within the French bureaucracy.\(^4\) The importance of High Authority in the structure of the ECSC\(^5\) explained the importance of technocrats\(^6\). As experts, they took the lead to initiate most work that needed to be done. Interest groups were institutionalized in the ESCS in the form of the Consultative

\(^2\) The High Authority was later renamed the Commission. See Kevin Featherstone, *Jean Monnet and the “Democratic Deficit” in the European Union*, 32 JCMS 149, 158-9 (June 1994).

\(^3\) Monnet’s previous experience in the inter-allied executive committees in the First World War and the president of the Committee of Co-operation of the Allied War Effort in the Second World War led him to recognize the advantages of international cooperation and accept a system of shared management. Kevin Featherstone, *Jean Monnet and the “Democratic Deficit” in the European Union*, 32 JCMS 149, 152 (June 1994).

\(^4\) Paul Craig, *The Nature of the Community: Integration, Democracy, and Legitimacy* in *The Evolution of EU Law* (Paul Craig & Grânne de Bûca eds., Oxford Univ. Press, 1999). Monnet has been accused of being motivated by a “vision of a Europe united by a bureaucracy” (Michael Burgess, *Federalism and European Union* 59 (Routledge, 1989)).

\(^5\) Monnet “was strongly attracted by the formula of a High Authority formed not by representatives of states, but by independent personalities, chosen for their competence, and not in receipt of instructions from governments (Pierre Gerbet, *Les origines du Plan Schuman: Le choix de la méthode communautaire par le gouvernement français in Histoire des Debut de la Construction Européenne, mars 1948-mai 1950 221 [Origins of the European Integration, March 1948-1950] (Raymond Poidevin ed., Bryulant, 1986). Before the ECSC negotiations began with the British government, Monnet insisted that “all parties to the talks must accept before hand the principle of the existence of a High Authority whose decisions would be binding” (Alan Milward, *The Reconstruction of Western Europe 1945-1951* 401 (Methuen, 1984)). Such a notion was seemingly sacrosanct. Also see Kevin Featherstone, *Jean Monnet and the “Democratic Deficit” in the European Union*, 32 JCMS 149, 157 (June 1994).

\(^6\) The concept of technocracy, always stronger in France than in Britain, implies the control of policy by a disinterested elite of experts, with technical knowledge or at least technical outlook, differing both from the traditional businessman and from the party politician or bureaucrat. Their strength in France derives ... from the high reputation of their main breeding-ground, the great engineering colleges known as the *Grands Écoles.*” John Ardagh, *The New French Revolution: A Social & Economic Survey of France 1945-1967* 18,19 (Secker & Warburg, 1968).
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Committee. Driven by corporatist style management7, the momentum of integration was built up by a combination of the benevolent technocrats and interest-propelled interest groups which formed transnational coalitions in support of the European policies.8 Monnet’s strategy has been termed elite-led gradualism9 as opposed to the more dramatic leap towards federalism favoured by those such as Spinelli.10 Neo-functionalism was a proper vehicle for technocratic, elite-led gradualism as the idea of spillover fitted perfectly with the idea of gradualism as an effective strategy for further integration.

2. Revised Theories of Market Integration Based on International Relations Theories

Market integration theories are probably the economic counterpart of the international relations theories and the market integration theories referred in this thesis are derived from the international relations theories.

The study of international relations is the study of the states and how they interact with each other. It is an important subject because in our modern history, people live in states and they affect our lives immensely. States, although legally independent from each other, interact with one another to form the international system. One of the main goals of the international system is for the states to act together to preserve peace and one of the main goals of individual states in the international system is to maintain their security and survival.

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7 “Specifically, it was the practice of consulting representatives of industry to work out the details of policy.” Kevin Featherstone, Jean Monnet and the “Democratic Deficit” in the European Union, 32 JCMS 149, 155 (June 1994)

8 Helen Wallace, European Governance in Turbulent Times, 31 JCMS 293, 300 (1993)


10 Craig, supra note 4, at 6.
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By studying how different states interact, international relations theories inspire market integration theories. As shown below, debates and reasoning concerning international relations theories are equally relevant to market integration although the emphasis is shifted from preservation of peace and the uphold of freedom, justice and order to how markets cooperate and integrate with one another.

Broadly speaking, international relations theories are the debate between realism and liberalism, each with its own variations. The former is pessimists who believe the international relations are conflictual and all states seek their own interests. Realists preoccupy with power as power politics is the international relations and the balance of power is important for the preservation of peace. The latter is optimists who believe cooperation can shape international relations and the states include individuals and collectivities of individuals. As far as market integration is concerned, it is the liberalist ideas that are more relevant as the realists tend to prefer self-help to cooperation.

As mentioned earlier, liberalism takes many different forms. Depending on what liberal school one subscribe, agents for change and cooperation include: 1) the states (inter-governmentalism); 2) technical experts (functionalism and social constructivism) and politicians (neo-functionalism); 3) issue groups (social constructivism); 4) common understanding and values (English School); 5) institutions especially international institutions (institutionalism and new institutionalism, neo-functionalism, multi-governance theory, transnational theory). Some theories may combine with other theories but the above five agents are the main agents for integration to take place.
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a. Functionalism and Neo-functionalism

Functionalism was advocated by David Mitrany who believed that cooperation should be arranged by technical experts and not by politicians. Such experts work in different functional areas such as transport, finance and IT and they will devise solutions to common problems. Their collaboration will increase over time when they see the benefit of cooperation. Increase welfare will also enable the citizens to see the benefit of modernization and shift their loyalty from the states to international organizations.

Neo-functionalism, developed by Ernest Haas, builds on functionalism but believe that technical issues cannot be separated from politics. Political actors have to be persuaded to intensify their cooperation. Neo-functionalism embodies a pluralist theory of international politics. The central focus of neo-functionalists is the concept of "spillover" which embraces both a functional and political dimensions. As far as functional spillover is concerned, integration of one sphere would create the urgency for integration to proceed in other areas due to the interconnectedness of the economy. Political spillover involves the "build-up of political pressure in favour of further integration within the states involved." Such neo-functionalism was challenged by its failure to explain the EU's actual development with empirical fact like the Luxembourg crisis of 1965, when Member States reasserted state interests through the de facto unanimity principle over the majority voting with the Luxembourg Accord. The theory also fails to explain why states seek to engage in international cooperation. Despite all the challenges the neo-

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12 See id. 113.
13 See id. 113.
15 Craig, supra note 4, at 4.
16 Id. 4-5.
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functionalishts are likely to receive, international bargains will lead to task expansion in new areas as actors will have the incentive to protect gains already achieved.

b. Inter-governmentalism

An alternative to neo-functionalism is known as liberal inter-governmentalism expounded by Andrew Moravcsik. The three core elements of the theory are “the assumption of rational state behaviour, a liberal theory of national preference formation, and an inter-governmentalist analysis of interstate negotiation.” The theory is based on economics and its literature is specifically derived from public choice theory. Liberal inter-governmentalists put forward the idea that integration is determined by demand and supply. The demand for integration is “a function of domestic preference formation.” The relationship between the government and the society is one of principal and agent in which societal principals has delegated power to government agents. The primary objective of the government is to retain power. To do so, they have to secure the support of societal actors by promising to attain their articulated preferences. Economic interdependence and trade creates “international policy externalities”. International policy externalities arise when “the policies of one government create costs and

18 Id. 480.
19 Craig, supra note 4, at 8.
20 Id.
21 Id.
22 Id.
23 Id.
24 Id.
25 Moravcsik, supra note 17, at 485.
benefits for politically social groups outside its national jurisdiction.\textsuperscript{26} Such externalities require international policy co-ordination and they provide the incentive for the creation of a single market. The supply of integration is "a function of interstate bargaining and interstate strategic interaction."\textsuperscript{27} The primary rationale for the existence of supranational institutions is efficiency.\textsuperscript{28} As International Regime Theory\textsuperscript{29} states that such institutions can reduce transaction costs, stable institution setting for resolving interstate bargains is more cost effective than ad hoc interstate bargains.\textsuperscript{30} It also enables states to overcome domestic opposition to governmental policy by according governmental policy initiatives greater domestic political legitimacy and by granting them greater domestic agenda-setting power.\textsuperscript{31} Supranational institutions can also play an important role by acting as scapegoat for unpopular policies.\textsuperscript{32} The essence of the liberal intergovernmental model is that the states are the driving force behind integration and that supranational national actors are acting on their behalf. The European community is not regarded as a challenge to the national state, but as a mechanism for strengthening state sovereignty. Supranational institutions will help bring about benefits to individual countries which could not be obtained by independent action.

\begin{itemize}
  \item \textsuperscript{26} k.l.
  \item \textsuperscript{27} Craig, supra note 4, at 9.
  \item \textsuperscript{28} k.l. 10.
  \item \textsuperscript{29} An international regime is viewed as "a set of implicit and explicit principles, norms, rules, and procedures around which actors' expectations converge in a given [issue-area]." INTERNATIONAL REGIMES 2 (Stephen Krasner ed., Cornell Univ. Press, 1983). The convergence of expectation means that everyone expects to play by the same rule. A basic idea behind international regimes is that they provide for transparent state behaviour and a degree of stability under conditions of anarchy in the international system. International regimes overcome collective goods dilemma by coordinating the behaviours of individual states.
  \item \textsuperscript{30} Craig, supra note 4, at 10.
  \item \textsuperscript{31} Moravcsik, supra note 17, at 514-517.
  \item \textsuperscript{32} Id. 516.
\end{itemize}
c. Multi-governance Theory

The state-centric inter-governmentalism was challenged by multi-level governance theory. Multi-level governance theory is a theory of governance that postulates that "states do not monopolize links between domestic and European actors, but are among a variety of actors contesting decisions that are made at a variety of levels." The essence of the theory is that integration is a "polity creating process in which authority and policy-making are shared across multiple levels of government - subnational, national and supranational." The theory is supported by a two stage argument. The first stage considers the circumstances under which national executives might voluntarily or involuntarily lose their grip on power. The state actors only have a relatively limited tenure of office and they may not give priority to the state as an institution. By transferring decisions to the supranational level, they can shift responsibility of unpopular decisions because in such cases, the political benefits outweigh the costs of the political control. The ability of Member States as principals to control the agents is limited by a number of factors, including the "multiplicity of principals, the mistrust that exists among them, impediments to coherent principal action, informational asymmetries between principals and agents and by the unintended consequences of institutional change." The second stage looks at the policy-making process in the EU and concludes that agenda-setting is not monopolized by the Council, the European Council, the European Parliament ("EP") and the European Court of Justice ("ECJ") but it is seen as a "shared and contested competence" among the four Community institutions. Subnational actors such as interest groups, also play an important part in this context.


Id. 342.

Craig, supra note 4, at 17.

Marks, supra note 33, at 353-4.

Craig, supra note 4, at 18; See also Martin Westlake, The Style and the Machinery: The Role of the European Parliament in the EU's Legislative Progress, in LAWMAKING IN THE EUROPEAN UNION (Paul Craig & Carol Harlow eds., Kluwer, 1998).
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The multi-governance theory considerably broadens the fields of inquiry and invites contributions from other sub-disciplines of political science. The old battle of grand theories such as neo-functionalism and inter-governmentalism may only be of interest to only a small fraction of scholars but with multi-governance theory, European integration suddenly opens up to other scholars who are interested in the governance issues. Modern states are increasingly faced with largely autonomous functional sub-systems and corporate actors. International system and domestic systems are therefore increasingly blurred. From the governance perspective, the distinction is not states and international system. Rather, the distinction is between different institutional forms of governance and the negotiating systems that develop through which different actors struggle for their influence.

Although multi-governance theory broadens the analytical horizon as compared to classical integration theory, governance is too broad an issue and there is a tendency that one will risk increasing information without increasing knowledge. By including too many variables, the theory may become less coherent and less insightful and each expert may specialize in certain areas of governance which can be so specialized that makes comparative studies difficult, if not impossible.

39 Id.
40 Id. 258.
41 Id. 258.
42 Id. 258.
43 Id. 259.
44 Id. 258-259.
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d. Institutionalism and New Institutionalism

The basic assumption of institutionalism is that institutions matter and the new institutionalism usually lead to the analysis of international regimes. The new institutionalism advanced by March and Olsen suggests that "[t]he state is not only affected by society but affects it...Bureaucratic agencies, legislative committees, and appellate courts are arenas for contending social forces, but they are also collections of standard operating procedures and structures that define and defend values, norms, interests, identities, and beliefs."45 New institutionalism may be confused with contextualism46 and reductionism47 but it is distinguished from them by treating "political institutions as determining, ordering, or modifying individual motives, and as acting autonomously in terms of institutional interests."48 It challenged utilitarianism by stating that "political behaviour was embedded in an institutional structure of rules, norms, expectations, and traditions that severely limited the free play of individual will and calculation."49 Unlike instrumentalism, it gives primacy to process rather than outcomes by seeing political decisions as "a process for developing a sense of purpose, direction, identity and belonging."50

45 James March & Johan Olsen, Rediscovering Institutions: The Organizational Basis of Politics 17 (Free Press, 1989).
46 Contextualism assumes that exogenous events in the realm of international politics have structured the development of international relations. Brian Schmidt, On the History and Historiography of International Relations at http://www.sagepub.co.uk/PDF/Books/0087722601.pdf.
47 Reductionism defines the systems as attributes or interaction of units and treats the international system as the sum of its parts. However Waltz noticed that "the same causes sometimes lead to different effects, and the same effects sometimes follow from different causes," and that "in international politics, systems-level forces seem to be at work," meaning that "outcomes are affected not only by the properties and interconnections of variables but also by the way in which they are organized" See Kenneth Waltz, Theory of International Politics 18, 37, 39(McGraw-Hill, 1979).
48 Id. 4.
49 Id. 5.
50 Id. 6.
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It is new in two ways. It includes broader aspects of governance than the formal institutions of state and government and includes less formalized arena of politics like community and policy networks of actors with expertise and interests in a certain policy area. It is also concerned with the “beliefs, paradigms, codes, cultures and knowledge” embedded with institutions. Institutions represent sets of formal and informal rules that “prescribe behaviour roles, constrain states, and shape expectations.”

Hall and Taylor distinguished three institutionalisms — rationalists, sociological and historical. For all of them, the basic premise is that institutions affect outcomes. Rooted in economic analysis, rationalists regard institutions as “long-lived equilibrium patterns of rational behaviour” and thus realized outcomes in a strategic game “that society plays”. Rationalists assume players to make strategic decision making to achieve their preferred outcome. Sociological institutionalists borrow the idea from sociology and regard institutions as inseparable from human identity and behavioural choice.

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57 Individual and institutions pursue their rationally predicted maximum self-interests in a manner analogous to games players trying to calculate not only their own advantages, but the likely moves of their opponents. The result, paradoxically, is often neither the maximum individual nor the maximum collective self-interest. See ROBERT ABRAMS, FOUNDATIONS OF POLITICAL ANALYSIS — AN INTRODUCTION TO THE THEORY OF COLLECTIVE CHOICE 189-231 (Columbia University Press, 1979).
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Historical institutionalists take the middle ground, believing in the short run, strategic interaction is possible but in the long run, it will affect choice and behaviour. They emphasize prior institutional commitments which further action, limit the scope of what is possible and cause agents to redefine their interests.58

e. Hybrid Theory - Multi-Governance and New Institutionalism

Stone Sweet and Sandholtz attempted to combine the multi-governance theory with new institutionalism. They postulated a theory of integration based on the assumptions underlying multi-level governance and the new institutionalism.59 While government can influence the pace of integration, “they do not drive the process or fully control it”.60 The shifting importance between pure intergovernmental politics on one end of the spectrum and supranational politics at the other depends on “the levels of cross-border transactions and the consequential need for supranational co-ordination within that area.”61 The existence of supranational within certain areas institutionalizes the process by which rules are created and applied by those who are subject to them, and shapes the perception which they have of their own self-interests.62

f. Transnational Relations Theory, Social Constructivism and the English School

Research work on transnational relations will further illuminate the complexity of the international decision-making.63 The notion of transnational relations

58 “History creates context, which shape choice.” See id. 10.


60 Id. 306.

61 Craig, supra note 4 at 21.

62 Sweet & Sandholtz, supra note 59, at 310-11. See also Craig, supra note 4, at 22.

63 Theorists focusing on transnationalism often de-emphasize the state as primary and unitary actor. INTERNATIONAL RELATIONS THEORY: REALISM, PLURALISM, GLOBALISM (Viotti Paul & Mark Kauppi eds., Macmillan Publishing, 2nd ed. 1993).
challenges the view that the state is the only significant actor in international relations while the concept of transgovernmental relations questions the idea that national governments can be treated as unitary actors. Transnational relations are defined as "transboundary relations include at least one non-governmental actor" and transgovernmental relations are defined as "cross-boundary relations among sub-units of national governments in the absence of centralized decisions by state executives."

Social constructivism, coupled with the studies on principled issue-networks and on "epistemic communities," suggests that "transnational coalitions are often held together not by instrumentally defined self-interests, but by shared values and beliefs, and by the dense exchange of information and services, working internationally on an issue..." The members usually work together in a constant but informal, uncoordinated, and nonhierarchical manner. Kathryn Sikkink, Human Rights, Principled Issue Networks, and Sovereignty in Latin America, 47 INTERNATIONAL ORGANIZATION 411, 415-417 (1993).

Epistemic communities are a network of experts who share technical knowledge of a particular field as well as normative principles, causal beliefs, shared interests and common practices associated with a set of policy problems. (Peter Haas) defined it as a "professional group that believes in the same cause and effect relationships, trust tests to accept them, and share common values; its members share a common understanding of the problem and its solution." Peter Haas, SAVING THE MEDITERRANEAN: THE POLITICS OF INTERNATIONAL ENVIRONMENTAL CO-OPERATION 55 (Columbia Univ. Press, 1990). Its growth is related to increasing western professionalism and bureaucratization of policy-making. (Peter Haas, Introduction: Epistemic Communities and International Policy Coordination 46 INTERNATIONAL ORGANIZATION 1, 8-9 (1992). "It is the political infiltration of an epistemic community into governing institutions which lays the groundwork for a broader acceptance of the community's beliefs and ideas about the proper construction of social reality." (Id. 27)
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but also by collectively shared values and consensual knowledge.”\(^70\) Unlike the claim made by realists\(^71\), identities and interests of the state are socially contingent and they are subject to changes through social interaction and a change in political/policy process. Such interaction includes negotiating, bargaining, arguing and communication.

Close to constructivism, the English School\(^72\) made contributions to the international relations theory with its skepticism towards the value of behaviouralist social science for the study of international politics, and its claim that international politics is more than simply an anarchical system as it has a societal quality to it.\(^73\) The English School distinguishes a system of states (or international system) from a society of states (or international society). The former refers to the interaction of states so that they will have mutual

\(^70\) Risse-Kappen, supra note 64, at 59.

\(^71\) Realism believes that the world is anarchic and a realist thinks in terms of interest defined as power. States are independent political units and are the primary actors in international relations. World politics is a self-help system involves a struggle for power between states in the pursuit of their national interests and in maintenance of national sovereignty. These interests are intrinsic to the states. Even though diplomacy is one instrument for gaining a state's objectives, ultimately the key instrument is military force. For Morgenthau's six principles of political realism and his discussion of politics, see Hans Morgenthau & Kenneth Thompson, Politics Among Nation: The Struggle for Power and Peace (Brief ed., 1992). See also Kenneth Waltz, Theory of International Politics (Addison-Wesley, 1979) for neo-realism which stresses the importance of balance of power, see pp. 116-128. Also see Neorealism and Neoliberalism: The Contemporary Debate (David Baldwin ed., Columbia Univ. Press, 1993).

\(^72\) The development of the English School dates back to the founding of the British Committee for the Study of International Politics in 1958 which brought together academics who were at that time teaching at British universities, and practitioners. Many of the members were not even British. Thomas Diez & Richard Whitman, Analysing European Integration: Reflecting on the English School - Scenarios for an Encounter, 40 JCMS 43, 46 (2002). Notable works of English School include Hedley Bull (The Anarchical Society: A Study of Order in World Politics (Macmillan 1977)), Jørgensen's study of the emergence of a "diplomatic republic of Europe" (Poco: The Diplomatic Republic of Europe in Reflective Approaches to European Governance (Knud-Erik Jørgensen ed., Macmillan 1997)), Adrian Hyde-Price's work on Germany and the emerging European order (Germany and European Order: Enlarging NATO and the EU 59 (Manchester Univ. Press, 2000)) and The OSCE and European Security in Rethinking Security in Post-Cold War Europe (William Park & G. Wyn Rees eds., Longman 1998)) and Nick Rengger's contextualization of the EU in a neo-medieval international system (European Communities in a Neo-Medieval Global Polity: The Dilemmas of Fairyland? In International Relations Theory and the Politics of European Integration: Power, Security and Community (Morten Kelstrup & Michael C. Williams eds., Routledge, 2000) – a system of overlapping authority and conflicting loyalties where the states compete with other actors for authority and loyalty.

\(^73\) Diez & Whitman, supra note 72, at 46.
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influences on each other in such a way that they behave as parts of a whole. The latter refers to a group of states conscious of certain common interests and common values so that they conceive themselves to be bound by a common set of rules in their relations with one another, and in the working of common institutions. The EU can be described as an “EU world” society as first, they share the European “consciousness” with a common European history and a “common intellectual culture”; second, there are “common values” from human rights to a “social” form of market liberalism; third, there is significant transnational activities among civil society actors on an EU level, from common interest representations to student exchange programmes. The “values and shared understandings that mark out international society must be culturally generated and sustained”. This does not mean uniformity of culture but a shared general consensus of what the basic foundations of this society are. It involves a self-identification of their members with common interests and values, and the acceptance of being bound by rules and institutions.

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75 Id. 13.
76 Diez & Whitman, supra note 72, at 52-53.
78 Adrian Hyde-Price, Germany and European Order: Enlarging NATO and the EU 59 (Manchester Univ. Press, 2000).
79 Diez & Whitman, supra note 72, at 53.
80 Hyde-Price, supra note 78, at 59.
82 Diez & Whitman, supra note 72, at 53.
83 Id. 56.
Garrett and Weingast\textsuperscript{84} have stressed the importance of focus point in resolving coordination problem. Such focal point is extended to "constructed" focal point that is intentionally chosen and promoted by international actors. The use of mutual recognition as a method to facilitate internal market by the European Court of Justice as the constructed focal point helped to increase its influence despite its lack of enforcement power (at least until recently).\textsuperscript{85}

\textbf{g. Key Integration Insights from the International Relations Theories}

The previous discussion covers the debate between the state-centric model represented by inter-governmentalists and the diffusion model represented by neo-functionalists. The debate is further opened up with multi-governance model by looking at the influence and contributions of supranational, national and sub-national actors in international relation. The complexities of international relations are further illustrated by the notion of transnational and transgovernmental relations. The former points out that the state is not the only significant actor in international relations and the latter challenges the idea that national governments can be treated as unitary actors. New institutionalists, historical institutionalists and international regime\textsuperscript{86} supporters focus their attention on the importance of international organizations in achieving effective integration among member states. Constructivists and the English School delve further into the make-up of networking and come up with the conclusion that shared values and consensual knowledge are the driving force towards integration.


\textsuperscript{86} "International regime" is defined as "principles, norms, rules, and decision-making procedures around which actor expectations converge in a given issue-area." Stephen D. Krasner, \textit{Structural Causes and Regime Consequences: Regimes as Intervening Variables} 36(2) INT'L ORG. 185 (1982).
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As regards the debate between state-centric and diffusion model, this thesis supports Golub in pointing out that the state-centric and diffusion models are just speaking at cross purposes and either one taken alone lacks explanatory power. The diffusion model is inadequate because it confuses influence with power. By examining the Packaging Waste Directive, Golub concluded that the diffusion literature often equates influence at draft and pre-draft stages with having power over final decisions. EP and the Commission can provide a range of policy options but they cannot prescribe specific policy outcomes. On the other hand, state-centric models are also of limited value because they overestimate the ability of the Council to dominate the other institutions. When the involvement of multiple actions produces ideas which the Commission and EP adopt into the final directive through amendments, diffusion of power away from the Council is unavoidable. Whereas state-centric models focus exclusively on power, diffusion models centre on influence. The fundamental differences between the two have to be made clear at the outset.

Although rational institutionalists agree with the realists that the international system is anarchic, they believe that institutions and regimes can influence state behavior. The institutionalists argue that states that cooperate through institutions and regimes are often cost-efficient because these arrangements reduce transaction costs, enhance the predictability of state behavior, and promote a decentralized enforcement of rules through reciprocal situations.

Constructivism emphasizes that it is ultimately individuals (usually acting on behalf of states) who are the decision makers in international politics, so the perceptions that individuals have of the international structure is important.

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89 Golub, supra note 87, at 330-332.


Constructivists view the international arena as socially constructed and the interests and identities of states can be changed through their interaction. Common values and common cultures unite people into interest and pressure groups and different international organizations. They also form policy platforms and consolidate votes. Action springs from belief. Although constructivism may be difficult to prove empirically and it is difficult to conduct comparative studies due to its subjective elements, it is undeniably one of the most important factors that will affect the success of any integration.

The above summary will help to throw light on some of the issues left unanswered under the section on methodology in Chapter I:

- **Driving force:** The top down approach is supported by inter-governmentalists but neo-functionalism, multi-governance theory, transnational legal theory, English School and constructivism all show that integration is better achieved bottom up than top down in the long run. As Golub pointed out, the government has the power but non-government agencies have considerable influence if their interests or expertise unite them together;

- **Timing:** unless the inter-governmentalist approach is adopted, many of the other international relations theories require the convergence of beliefs, values and culture which needs time to achieve. A gradual integration is more desirable than a shocking “all at once” process;

- **Sequencing:** Government action including its economic reform is governed by its political ideology and it seems logical to believe that any significant economic reform should be preceded by corresponding political reform. Such belief fails to take into consideration the fact that the government is far from being a unitary actor and different factions and interest groups in the government result in negotiation,

92 Id.
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compromise and trade-offs. As in the example of the PRC, political reform may be regarded as seriously damaging to the Communist Party but economic reform, on the other hand, is regarded as beneficial if the living standards of the people are raised. Further, economic reform is often engineering by international organizations, business or interest groups and within each group, they tend to share similar values or culture;

- Institutions: institutionalists and international regime theorists both stress the importance of institutions in reducing transaction costs and promoting similar interests.

As this thesis takes an institutional approach to market integration, a closer examination of institutionalism follows. All institutions simultaneously empower and control.93 New institutions are going to assume independent and integration functions and rules both in terms of policy formation and implementation which is autonomous from political intervention.

One distinctive characteristic of the modern institutions within international law is a strong discourse of institutional autonomy. Discussion within the confines of institutions shifts an issue from the self-interest, coercive political discourse to the legal and policy-making discourse where legal reasoning and argument become the legitimate form of action. To resolve issues by legal rules and institutional procedures will bring a certain discipline, structure and predictability to decision making process.94 Rational choice institutionalists who base their analysis on game theories argue that institutions shape the strategies of the actors within them. However, this thesis agrees with the historical institutionalists that institutional context does not only shape the


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strategies of the actors but also affect their goals. An appropriate institutional framework will, therefore, focus the participants' mind on the goal of market integration and provide an independent and autonomous environment removed from the political realm for discussion of its feasibility and implementation.

3. Mutual Recognition

Mutual Recognition is the main device used to facilitate legal harmonization and integration in the EU. Mutual recognition has been used so frequently in a number of different contexts that its meanings vary accordingly. Mutual recognition, used in the context of mutual recognition of professional qualifications and mutual recognition of companies and legal person, envisaged mutual recognition as an “outcome” of an EU legislative process. This also applies to the CEPA discussed in Chapter III. However mutual recognition, in the context of the Single Market, is regarded as an “alternative” to EU legislative action where legislation is controlled primarily by national governments. It is this second type of mutual recognition that is the focus of the present discussion. This thesis also analyzes the correlation between the concept of mutual recognition and the international theories.


96 EC Treaty, Art. 57(1) (“In order to make it easier for persons to take up and pursue activities as self employed persons, the Council shall, acting in accordance with the procedure referred to in Article 189b, issue directives for the mutual recognition of diplomas, certificates and other evidence of formal qualifications.”)

97 Id. Art. 220 (“Member States shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals: ... the mutual recognition of companies or firms within the meaning of the second paragraph of Article 58, the retention of legal personality in the event of transfer of their seat from one country to another, and the possibility of mergers between companies or firms governed by the laws of different countries...”)


99 Id. 226.
During the evolutionary process of the concept of mutual recognition, Armstrong pointed out that mutual recognition serves at least two purposes. Mutual recognition places limits upon the regulatory autonomy of Member States to ensure that unjustifiable barriers to free movement will be dismantled. This purpose flowed from the ruling of the ECJ in the well-known Cassis de Dijon judgment although the words "mutual recognition" did not appear in the judgement expressly. The European Commission in a Communication issued in 1980 interpret mutual recognition more or less synonymous with home state control by placing limitations on the ability of Member States to exercise their regulatory power. This emphasis was furthered in the Commission's 1985 White Paper on "Completing the Internal Market".

The second purpose of mutual recognition is to act as a means of determining when legislative harmonization by the Community might be required. Harmonization would not be required if mutual recognition could serve the purpose. This aspect of mutual recognition provides the basis for the "New Approach" in 1985. The "New Approach" provides a division between EU and the national levels under which EU legislative action would be necessary to harmonize the "essential requirements" of products whereas Member States would mutually recognize any additional national technical requirements. The Commission further adopted a Communication on mutual recognition as a

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100 Id. 226.
103 Communication from the Commission Concerning the Consequences of the Judgment Given by the Court of Justice on 20 February 1979 in Case 120/78, 3.10.80, O.J. (C 256).
104 European Commission, Completing the Internal Market, COM(85)310 final, 77.
105 Armstrong, supra note 98, at 227.
106 Id.
follow-up to its "Action Plan for the Single Market".107 The second purpose of mutual recognition acts as a restriction on the EU action while the first purpose of mutual recognition places the restriction on the power of the Member States.108

How does mutual recognition relate to the integration model? Three possible models can be adopted regarding integration and regulation of the European market. The first model is the use of "host" state control with the application of the non-discrimination principle. Under "host" state control, market access is only allowed if substantive and procedural rules of the state in which market access is sought have been complied with. The non-discrimination principle is to ensure fair and equal treatment between the host state and the other Member States.109 However by adopting this model, market access will remain segmented requiring the exporters and service providers to comply with multiple sets of regulations.110

The second model is the use of "home" state control under which market access is allowed if substantive and procedural rules of the state which seek market access have been complied with.111 Each goods or service will only need to comply with one set of regulations under "home" state control112 but the same goods or service may be subject to different standards depending on the rules and regulations of different home states.


108 Armstrong, supra note 98, at 227.

109 Id. 229.

110 Id. 230.

111 Id. 229.

112 Id. 229.
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The third model is the creation of one set of harmonized rules and regulations so that market access can be achieved by following such set of rules. Diverse national regulatory requirements will be eliminated. 113

Most people mistakenly regard “mutual recognition” as the synonym for “home” state control as mutual recognition may frequently result in “home” state control. 114 However as pointed out by Armstrong, mutual recognition is hovering between “host” state control and “home” state control.115

Mutual recognition is both a policy consideration for the host state regulator and a substantive restriction on regulatory autonomy. 116

Mutual recognition is more than the requirement for the host state regulators not to discriminate based on nationality. It requires the national regulators to be, in Armstrong’s word, “other-regarding”. 117 In other words, national regulators have to recognize the regulatory history of the product or service and give due consideration to such information in determining their regulatory control over such product or service under their domestic rules. The process facilitates the search for equivalences between home and host state regulatory requirements so that there will not be any duplication of regulatory processes. 118 Mutual recognition therefore “encourages a Europeanization of regulation not through the adoption and enforcement of harmonized European norms (a vertical Europeanization) but instead through an openness to the other

113 Id. 229.

114 Walker, supra note 102, Chapter 6 generally for further discussion on the differences between mutual recognition and home country rule and their application in the banking and financial area (the author argues that home country rule converts mutual recognition into a doctrine of licensed recognition or licence or systems validation but mutual recognition fails to fully imply home country rule as pre-market entry requirements cannot be extended to include full post-market entry supervision and continuing regulation).

115 Armstrong, supra note 98, at 227.

116 Id. 230-240.

117 Id. 231.

118 Id. 231.
regulatory systems of Member States (a horizontal Europeanization)." As law is structurally attached to the social system in which it operates, the search for equivalence brings forth the question of "transplantability" of the law from one state to another. However mutual recognition does not transfer regulatory activities outside the national systems as the host state regulators is left with the exercise of the supervisory functions and they have the final say in the outcome.

Mutual recognition is also a substantive restriction on regulatory autonomy. If the Member State seeks to impose its own domestic control on a product or service legalized in the home state, the action must be necessary to achieve that goal and it has to be proportionate. The concept of mutual recognition is used to undermine the argument that such action is necessary and proportionate. Mutual recognition is therefore a means to police attempts by a host state to insist upon the application of its control. Such policing will be taken up by ECJ if cases are brought in front of them. Armstrong has pointed out that evidently, "the ECJ seems to create a significant space for Member States to apply their regulatory controls for the protection of the consumer as regards the

119 Id. 231, 232.
121 Armstrong, supra note 98, at 232.
122 Id.
123 Id.
124 Id. 232, 233
125 Other than Cassis de Dijon, please also see Case 27/80, Criminal Proceedings against Anton Adriaan Fiets [1980] E.C.R. 3839 (whether compliance with home state controls were enough to ensure equivalent regulatory protection); Case C-30/99, Commission v. Ireland (Precious Metals) [2001] E.C.R. I-4619 (example of mutual recognition as a substantive restriction on Member States regulatory powers); Case C-154/89, Commission v. France (Tour Guides) [1991] E.C.R. I-659 (strong presumption in favour of home state control); Case C-384/93, Alpine Investments v. Minister van Financien [1995] E.C.R. I-1141 (the home state was best placed to control the activities of the company concerned); Case C-400/96, Criminal Proceedings Against Harpeées [1998] E.C.R. I-1512 (the national authorities were required to take into account of the regulatory history of the product concerned); Case C-184/96, Commission v. France (Feie Gras) [1998] E.C.R. I-6197 (when legislating, legislatures should ensure that products complying with equivalent rules or standards to that of the host state should be permitted market access).
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provision of financial services\textsuperscript{126}, while in respect of goods, the ECJ tends to cut down that regulatory space by assuming that the average consumer can be protected by the provision of equivalent information to that required in the host state.\textsuperscript{127}

Despite its appealing idea, the application of mutual recognition is, to say the least, problematic. As the Commission has noted, "significant barriers to the application of the principle of mutual recognition arise at the administrative level e.g. allocating organizational responsibility for handling the request for recognition; the unwillingness of individual administrators to take responsibility for permitting market access on the basis of mutual recognition; and the wide discretion which administrators may possess."\textsuperscript{128}

The distinction between "passive" and "active" mutual recognition made by Armstrong\textsuperscript{129}, provides an important insight into its relationship with some of the international relation theories. Passive mutual recognition refers to the host state giving practical and legal effect to a regulatory process which has already been carried out in another state.\textsuperscript{130} Recognition is symbolic and it does not involve comparisons of functions like the recognition of foreign judgments\textsuperscript{131} and qualifications.\textsuperscript{132} Active mutual recognition, however, requires national regulators to seek out functional equivalencies between the regulatory processes between the host state and the home state by the domestification of

\textsuperscript{126} "The ECJ has repeated that in the absence of harmonization, it is for the Member States to regulate for risk." See Armstrong, \textit{supra} note 98, at 238.

\textsuperscript{127} Id. 237, 238.

\textsuperscript{128} The Commission's first biennial report \textit{On the Application of the Principle of Mutual Recognition in Product and Services Markets} quoted by Armstrong, \textit{supra} note 98, at 239.

\textsuperscript{129} Id. 240-245.

\textsuperscript{130} Id. 240, 241.

\textsuperscript{131} E.g. EC Treaty, art. 220: "Member States shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals: the simplification of formalities governing the reciprocal recognition and enforcement of judgments of courts or tribunals and of arbitration awards."

\textsuperscript{132} Id. 241.

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the foreign regulatory process through its translation into some equivalent national regulatory requirement either in whole or in part.\textsuperscript{133} Although active mutual recognition may be more response to changing circumstances and technical progress, it does not give rise to a certain outcome and the result of non-recognition may be time-consuming and costly legal challenges.\textsuperscript{134}

Mutual recognition may be considered to facilitate competition among rules and regulators so that it will produce a competitive process of regulatory adjustment and limit the possibility for “regulatory failure.”\textsuperscript{135} However if the differences between the regulations of home and host state are too great, market access will be denied and mutual recognition cannot be applied.\textsuperscript{136}

More significantly, another advantage of mutual recognition is to regard it as an educational process for regulators.\textsuperscript{137} To expose the national regulators to a completely set of regulations with a different history also stimulate a bureaucratic learning process as to how other systems regulate.\textsuperscript{138} However for it to be successful, it will also depend on factors like the willingness to share information and knowledge among national regulators and the mutual trusts among national regulators. Bureaucracies may be resistant to learning and prefer routinized work.\textsuperscript{139}

The concept of mutual recognition embodies and illustrates different international relation theories. The fact that the concept was first invented by ECJ and then strengthened and reinterpreted by the Commission illustrates how supranational actors can contribute to the integration process as understood by transnational theorists and the multi-governance theorists. The whole EU
structures and its drive towards integration also demonstrate the belief of neo-functionalists and institutionalists. The importance of shared values and common cultures in active mutual recognition is central to constructivism and the English School. However, the power of the host state regulators in having the final say in the application of the mutual recognition concepts shows us that the importance of the state-centric theories like the inter-governmentalists should not be under-estimated.

In the capital market, EU is moving from the broader concept of mutual recognition to a narrower concept of home state rule within the former (see the Prospectus Directive below) to quicken the integration process. Yet the establishment of European Securities Committee ("ESC") \(^{140}\), comprised Member State Finance Ministry representatives, to act as a regulatory committee, and a Committee of European Securities Regulators ("CESR") \(^{141}\) to act as an advisory body under the Lamfalussy report (see below) are important steps leading to further integration of the EU. The former creates a network for governments to communicate and negotiate while the latter creates epistemic communities among experts with shared values and knowledge. Such networks and communities are cornerstone to build an integrated EU community.

4. Single European Market

The European Community expanded from six Member States\(^{142}\) to nine\(^{143}\) in 1973, to twelve by 1986\(^{144}\), and to fifteen in 1995\(^{145}\). The EU enlargement on May 1, 2004 includes Hungary, Poland, the Czech Republic, the Slovak


\(^{141}\) Id. 43.

\(^{142}\) Belgium, France, Germany, Italy, Luxembourg and The Netherlands.

\(^{143}\) The new Member States are Ireland, Denmark and the United Kingdom.

\(^{144}\) The new Member States were Greece in 1981, Spain and Portugal in 1986.

\(^{145}\) The new Member States were Austria, Finland and Sweden.
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Republic, Slovenia, plus the Baltic states of Estonia, Latvia and Lithuania, and the Mediterranean islands of Malta and Cyprus.

a. Institutions

The basic institution framework set out in the 1950 Treaties founding the original three European Communities have remained relatively intact. Other than the four main institutions, i.e. the Council, Commission, Parliament, and the Court, a fifth institution, the Court of Auditors was first established in 1975. Its primary role is financial supervision and it has influence over policy through its annual auditing and reporting role. The institutional balance has shifted over the year which elevated the European Parliament as a purely consultative body to a range of powers from consultation to shared legislative powers with the Council of Ministers. Overall speaking, the Commission remains the sole initiative of legislation, with Council as the ultimate decision-maker on most major issues, and the Parliament playing the consultative or shared decision-making role depending on the circumstances.

There are also a number of less prominent “quasi-institutions” mentioned by the Treaties including the Economic and Social Committee and the Committee of the Regions. They perform relatively weak consultative functions and have

146 The European Council comprises the Heads of State or Government of each Member State, the Foreign Ministers of the EU Member States, and the President of the Commission.

147 Since enlargement on May 1, 2004, the Commission consists of 30 members. France, Italy, Spain, the UK and Germany appoint two Commissioners each, whereas all other Member States appoint one each.

148 Since 1979 the 787 Members of the European Parliament are directly elected to the European Parliament by the citizens of the EU for a five year term.

149 Since enlargement on May 1, 2004, the Court has twenty five judges (one per Member State) each of whom is appointed for a six year term. There are eight Advocates-General, who present reasoned opinions on cases before the Court.

150 The Court of Auditors has 15 Members, one from each Member State, who are appointed for terms of six years.

no standing to call on the Court of Justice under Article 230 EC to ensure that their functions are respected.152

The various checks within the balance have included the Commission’s oversight of all the Community’s activities, its obligation for annual reporting and its duty to answer Parliament’s questions regularly, the budgetary control of the Council and the Parliament, the safeguards within the various legislative procedures, the jurisdiction of the Ombudsman to investigate any maladministration or malpractices, the administrative principles laid down by the Treaty and by the Court of Justice, and the general oversight of the Court of Auditors and the Court of Justice.153

The formal constitution is laid down by the Treaty and the jurisprudence of the Court (through its rulings, concepts like “direct effect”, “supremacy”, “the general principles of EC law and the “rule of law” also apply), being the foundation legal rules which allocate and govern the exercise of power within the polity.154 The “real” constitution concerns the way in which political power is actually exercised, to the conventions and practices of the actors and institutions which exercise public power. Such real constitutions involve secondary legislation other than the Treaty, non-legal or “soft” legal measures like the Luxembourg Accords and various inter-institutional agreements such as those on the budgetary and comitology procedures.155 As a result, the EU has been criticized that fundamental principles of accountability, coherence, openness and fairness are wanting.156

152 Id. 60.
153 Id. 60.
154 Id. 61.
155 Id. 61.
156 Id. 80.
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b. Legal Framework

The regulatory framework of the EU includes:  

- The EU Treaties (see below) as the EU’s “constitution” and they are regarded as the primary legislation;

- Community Law or the *aquis communautaire* which is composed of regulations, directives, decisions, opinions/recommendations and the case law of the ECJ;

- Explanations and resolutions adopted within the framework of the European Union;

- Legal instruments within the framework of the Common Foreign and Security Policy (the second pillar: see the section on *EU Treaties* below);

- Legal instruments within the framework of the cooperation in the areas of Justice and Home Affairs (the third pillar: see the section on *EU Treaties* below);

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158 Regulations are binding in their entirety and directly applicable in all Member States. See Europa: *Glossary: Community Legal Instruments* at http://europa.eu.int/scadplus/leg/en/cig/g4000c.htm#c18.

159 Directives bind the Member States as to the results to be achieved; they have to be transposed into the national legal framework and thus leave a margin for manoeuvre as to the form and means of implementation. See Europa: *Glossary: Community Legal Instruments* at http://europa.eu.int/scadplus/leg/en/cig/g4000c.htm#c18.

160 Decisions are binding on those to whom they are addressed. See Europa: *Glossary: Community Legal Instruments* at http://europa.eu.int/scadplus/leg/en/cig/g4000c.htm#c18.

161 Opinions and recommendations are non-binding, declaratory instruments. See Europa: *Glossary: Community Legal Instruments* at http://europa.eu.int/scadplus/leg/en/cig/g4000c.htm#c18.
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- International agreements which the Community has signed and mutual agreements of the Member States within the areas of activity of the Union.

**EU Treaties**

European integration is based on four founding treaties:\(^{162}\):

- The Treaty of Paris establishing the European Coal and Steel Community, which was signed on April 18, 1951 and came into force on July 23, 1952. It was expired on July 23, 2002;

- The Treaty of Rome establishing the European Economic Community, which was signed on March 25, 1957 and came into force on January 1, 1958;

- The treaty establishing the European Atomic Energy Community, which was signed and came into force the same time as the Treaty of Rome, together the "Treaties of Rome";

- The Treaty of European Union, which was signed in Maastricht on February 7, 1992 and came into force on November 1, 1993. The Treaty renamed the European Economic Community to simply "European Community". It also created a new structure with three "pillars"\(^{163}\) which is political as well as economic and introduced new

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\(^{162}\)See European Treaties (EUROPA: The EU at a glance/Treaties and law) at [http://europa.eu.int/abc/treaties_en.htm](http://europa.eu.int/abc/treaties_en.htm).

\(^{163}\) The first pillar comprised the European Communities, covering matters related to the Single Market and the "four freedoms", i.e. the free movement of persons, goods, services and capital across borders. It also includes cooperation in fiscal and monetary issues, i.e. the development of the Economic and Monetary Union. The second pillar consists of the Common Foreign and Security Policy. The third pillar is composed of police cooperation and cooperation in the area of criminal law. Only within the first pillar have the Member States relinquished parts of their sovereignty to the institutions of the EU while in the other pillars decisions are mainly taken at intergovernmental level. See The Swedish Presidency website, The Regulatory Framework of the EU: The Three Pillars at [http://www.eu2001.se/static/eng/eu_info/korhet_pelare.asp](http://www.eu2001.se/static/eng/eu_info/korhet_pelare.asp).
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form of cooperation between Member States in the areas of defence and "justice and home affairs." 164

The founding treaties have been amended in 1973, 1981, 1986 and 1995 when new members have joined the Member States. The treaties have also been modified, resulting in important institutional changes and introducing new areas of responsibility for the European institutions165:

- The Merger Treaty, signed in Brussels on April 8, 1965 and came into force on July 1, 1967 (provision of a Single Commission and a Single Council of the then three European Communities);

- The Single European Act, signed in Luxembourg and the Hague and came into force on July 1, 1987 (changes required for the achievement of the internal market);

- The Treaty of Amsterdam, signed on October 2, 1987 and came into force on May 1, 1999 (amending and renumbering of the Treaty of EU and the Treaty of the EC);

- The Treaty of Nice, signed on February 26, 2001 and came into force on February 1, 2003 (consolidating the former Treaty of EU and the Treaty of the EC).

Further changes to the Treaties are expected as a result of the Convention on the Future of Europe and the Treaty of Accession of 10 new Member States, signed on April 16, 2003 and came into force on May 1, 2004.

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165 Id.
c. Internal Market

In a narrow sense, single European market ("SEM") refers to the goal of completing the "internal market". The focus is on the legislative programme, beginning with the 1985 Commission White Paper on "Completing the Internal Market" and ending with the deadline on December 31, 1992.

It is important to view the SEM not merely as a description of a set of programmes to remove frontiers within the internal market. It is a development of strategies which are both symbolic and functional. The 1985 White Paper contained a list of legislative measure grouped under three headings (the removal of fiscal, physical, and technical barriers to trade) and for each, a target deadline for its adoption. After the 1992 deadlines have passed, proposed measures on company law harmonization remained unadopted while problems of transposition and enforcement continued to exist as set out in its 1993 Strategic Programme for the SEM.

To revitalize the momentum and inspired by the Sutherland report in 1992, the Commission published a communication on "The Impact and Effectiveness of the Single Market" by giving renewed attention to the SEM. To enhance monitoring and surveillance of the activities of the Member States and

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166 See Article 7a EC.
167 COM(85)310 final.
169 Id. 753.
170 Id.
171 Making the Most of the Internal Market: Strategic Programme, COM(93)632 final.
172 The report is chaired by former Commissioner, Peter Sutherland, to examine the development of the Internal Market. The Internal Market After 1992: Meeting the Challenge (EC Commission, 1992).
173 COM(96)520 final.
economic actors, an Acton Plan for the Single Market was launched. The Action Plan was “a development of the methodology employed in the 1985 internal market White Paper” with the use of strategic targets, deadlines, and compliance scoreboards – a method which was frequently used to enhance bureaucratic efficiency. It continued on the deregulation theme of the 1985 White Paper and recommended strengthening the legal framework of the SEM. Harmonization is a mechanism to remove multiple sources of regulation, so the whole process can also be packaged as a simplification process.

d. Single Market for Financial Services

It has been reported that a single market for financial services is crucial for economic growth and job creation in the European Union. However financial markets in the EU remained segmented and the integration process was slow. As a consequence, in May 1999, the Commission adopted an Action Plan for Financial Services to identify the key areas where action should be taken. At both the Lisbon European Council in March 2000, and the Stockholm European Council in March 2001, the European Head of State or Government also urged the full implementation of the Action Plan by 2005.

Headed by Baron Alexandre Lamfalussy, former President of the European Monetary Institute, a Committee of Wise Men on the Regulation of European Securities Markets was set up by the Council in July 2000 and it delivered its final report in February 2001. The report concluded that the EU’s 1999 comitology procedure should be extended to securities market legislation (i.e.}

175 Armstrong, supra note 168, at 754.
176 Id.
178 Most EU regulation is not enacted as legislation by the Council and EP but as implementing measures under the executive duties of the Commission. Such regulation can be adopted when the Council has conferred executive powers on the Commission and an implementation committee, composed of policy experts from the Member States, has given its opinion on or approved the Commission’s proposed implementing measures. The committee procedures are
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the technical aspects of legislation would be delegated to new committees).
Two new committees were established under the Committee's recommendations: a new high-level ESC, comprised Member State Finance Ministry representatives, to act as a regulatory committee, and a CESR to act as an advisory body both to the Commission and the ESC about technical implementing measures.

The report also called for a four-level regulatory approach to speed up the regulatory process and to make it more flexible and efficient. On the basis of a Commission proposal, level 1 will consist of legislative acts (including regulations and directives) adopted under the co-decision procedure by the Council and the European Parliament on the basis of the EC Treaty. In consultation with the ESC, technical implementing measures will be adopted by CESR at level 2 under Council Decision 1999/468/EC of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred by the Commission. Level 3 is to ensure consistent and timely implementation of level 1 and 2 acts by enhanced cooperation and networking among EU securities regulators through the CESR. Finally at level 4, the Commission and the Member States should strengthen the enforcement of Community law.

e. Single Market for Issue and Trading of Securities

The objective of the EU directives is "the harmonization of essential elements of listing and public offers within the EU and the application of the principle of mutual recognition to listing particulars and prospectuses which have been approved by the competent authority of the Member States." The main directives that affect the stock exchanges in Europe are summarized as follows:


179 Regulators would work on joint interpretation recommendations, consistent guidelines and common standards, peer review, and compare regulatory practice to ensure consistent implementation and applications.

180 Iain MacNeil and Alex Lau, International Corporate Regulation: Listing Rules and Overseas Companies, 50 ICLQ 787, 795. See also Guido Ferrarini, Towards a European Law
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i. The Admission Directive\textsuperscript{181} sets out the necessary conditions required for the admission of securities to listing.

ii. The Listing Particulars Directive\textsuperscript{182} sets out the contents, vetting and distribution of the listing particulars.

iii. The Continuing Obligations Directive\textsuperscript{183} sets out the information required to be published on a regular basis by companies whose shares have been listed.


v. Directive 89/298/EEC of April 17, 1989\textsuperscript{184} sets out the requirements for the drawing up, scrutiny and distribution of prospectuses to be published when transferable securities are offered to the public.

The first four directives were consolidated into Directive 2001/34/EC of the European Parliament and of the Council of May 28, 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities (generally known as the Consolidated Admission and Reporting Directive – “CARD”) to enhance clarity and rationality. Directives ii and v above created a partial and complex mutual recognition system but

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they failed to achieve the objectives of creating a single passport. Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (the “Prospectus Directive”) therefore came into force on November 4, 2003. Certain articles in CARD were repealed as a result. As the title suggests, the Prospectus Directive amended Directive 2001/34/EC by consolidating Directive 5 above. On April 29, 2004, Commission Regulation EC No. 809/2004 (the “Implementing Regulation”) implemented the Prospectus Directive as regards information contained in the prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements was adopted to flesh out Directive 2003/71/EC. The Implementing Regulation should come into force from July 1, 2005.

The European Commission had made public a working document related to the Prospectus Directive (IP/03/1018). The working document was based on advice given to the Commission by the Committee of European Securities Regulators after an extensive consultation process and to make such working document public was to enhance the open and transparent regulatory process for drawing up technical implementing measures. It is also part of the procedures agreed to implement the March 2001 Stockholm European Council Resolution to improve decision-making concerning securities markets (IP/02/195).

Other directives relating to the securities include the Market Abuse Directive (2003/6/EC) which was implemented on January 28, 2003 (implementation of

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186 Prospectus Directive, art. 27.

187 Id. preamble (3).


189 Implementing Regulation, art. 36.

the Market Abuse Directive by the Member States into their national legislations must not be later than October 12, 2004\(^\text{191}\) and the Directive on disclosure requirements for publicly-traded companies (Transparency Directive) which has yet to be adopted.

Other directives related to the capital markets in the EU are UCITS Directives, New Investment Services Directive (see definition below) and directives and Commission communication related to inter-EU clearing and settlement system. Distance Marketing Directive\(^\text{192}\) is not discussed here as it relates only to the retail business and the Take-over Directive\(^\text{193}\) is also not discussed as it is not related to the IPO regime.

i. Prospectus Directive

Objectives

The Directive constitutes a major step in integrating the European capital markets and the first attempt to legislate for the European financial markets by implementing Lamfalussy four-level regulatory model. The main aim of the Prospectus Directive is to replace the current mutual recognition procedure and in its stead, introduce a new pan-European single-passport procedure.\(^\text{194}\) The single passport procedure requires the publication of a prospectus\(^\text{195}\) and once approved by the competent authority in the relevant home Member State\(^\text{196}\), it can be used all across countries that belong to the European Union upon notification to the competent authorities in the other Member States in which a

\(^{191}\) Market Abuse Directive, art. 18.


\(^{194}\) Prospectus Directive, preamble (1).

\(^{195}\) Id. art. 3.

\(^{196}\) Id. art. 13.
listing is sought or a public offer is made. 197 As far as the home Member States are concerned, they have to approve the prospectus in accordance with the disclosure requirements from the Prospectus Directive. The Prospectus Directive is therefore different from the CARD, the Market Abuse Directive and the Transparency Directive as, for example, the CARD will allow the home Member States to add more stringent requirements and additional conditions and obligations regarding the admission of securities to official listing provided that such additional requirements “apply generally for all issuers or individual classes of issuer and that they have been published before application for admission of such securities is made.” 198 Both the Market Abuse Directive and the Transparency Directive aim at minimum harmonization among the laws of the Member States whereas the Prospectus Directive aims at maximum harmonization and setting common standards across European Union. 199

The aim of the Prospectus Directive is to “ensure investor protection and market efficiency in accordance with high regulatory standards adopted in the relevant international fora.” 200 Following from this aim, it is clear that the Prospectus Directive is not a race to the bottom but the aim is begging the question of how to ensure investor protection (which usually implies stringent requirements and providing for the different needs and circumstances in different Member States) and market efficiency (which implies avoiding duplication and overlapping approval procedures by simplifying rules and regulations and creating uniform legal standards and procedures) at the same time.

197 Id. arts. 17 and 18.

198 CARD, art. 8.


200 Prospectus Directive, preamble (10).
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Scope

The Prospectus Directive does not apply to unit trusts and investment companies.\(^{201}\) For details of the scope of the Prospectus Directive, see article 1(2) of the Prospectus Directive.

Exempt Offers and Exemptions

Any offer of the securities to the public will require the publication of a prospectus. "Offer of securities to the public" is defined broadly as "a communication to persons in any form and by any means, presenting sufficient information on the terms of the offer and the securities to be offered, so as to enable an investor to decide to purchase or subscribe to these securities."\(^{202}\) The Prospectus Directive contains exempt offers that exempt certain kinds of offer from the obligation to publish a prospectus.\(^{203}\)

General standard for fair presentation of recommendations and disclosure of interests and conflict of interests are provided in the Fair Representation Directive.

Format and Content of the Prospectus

Under the Prospectus Directive, a prospectus consists of three principal documents, which can be combined in a single prospectus or be kept separate:\(^{204}\):

1. a summary;

\(^{201}\) Id. arts. 1(2)(a) and 2(1)(b).

\(^{202}\) Id. art. 2(1)(d).


\(^{204}\) Prospectus Directive, art. 5(3).
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2. a registration document containing information relating to the issuer; and
3. a securities note providing information relating to the securities to be offered or admitted to trading.

The summary "shall, in a brief manner and in non-technical language, convey the essential characteristics and risks associated with the issuer, any guarantor and the securities, in the language in which the prospectus was originally drawn up." The information required for the summary note is provided under Annex IV and article 5(2) of the Prospectus Directive. The Commission Regulation No. 809/2004 (the "Implementing Regulation") implements CESR Level 2 advice in connection with certain articles of the Prospective Directive and it does not provide for substantive disclosure requirements regarding the summary note. The summary is an attractive marketing document because it may be the only document translated into the official language(s) of the host or/and home Member States and also the summary will only incur civil liability including its translation unless it is misleading, inaccurate or inconsistent when read together with the other parts of the prospectus.

205 For certain types of non-equity securities including warrants issued under an offering programme or certain non-equity securities issued in a continuous or repeated manner by credit institutions. The tripartite prospectus may be replaced by a base prospectus at the option of the issuer. At the time when the base prospectus is filed, the final terms of the offer may not be known and the issuer is allowed to file the final terms as soon as they are available without additional approval. Prospectus Directive, art. 5(4).
206 Preamble (21) of the Prospectus Directive provides that the summary normally should not exceed 2,500 words.
207 Preamble (35) provides that if the prospectus is drawn up in a language that is customary in the sphere of international finance, the host or home Member State should only be entitled to require a summary in its official language(s) so as to minimize costs. As a result, summary of the prospectus becomes very important as it may be the only document written in a language that certain prospective retail investors know.
208 Prospectus Directive, art. 5(2).
209 Id. preamble (35).
210 Id. art. 6(2).
The information required to be disclosed in the prospectus is specified in detail in the Implementing Regulation by the use of schedules and building blocks. "Schedule" means a list of minimum information requirements adapted to the particular nature of the different types of issuers and/or the different securities involved whereas "building block" means a list of additional information requirements, not included in one of the schedules, to be added to one or more schedules, depending on the type of instrument and/or transaction for which a prospectus or a base prospectus is drawn up. Registration document schedules include those for share212, wholesale debt and derivative securities (at least EUR50,000)213, retail debt and derivative securities (less than EUR50,000)214, asset backed securities215, depository receipts216, banks issuing securities217, securities issued by sovereign states and their regional and local authorities218, securities issued by public international bodies and debt securities guaranteed by a member state of the OECD219. Securities note schedules include those for shares220, wholesale debt securities221, retail debt securities222, derivative securities223 and collective investment undertakings of the closed-end type224. Building blocks include registration building blocks for

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211 Implementing Regulations, arts. 2(1) & 2(2).
212 Id. annex I.
213 Id. annex IX.
214 Id. annex IV.
215 Id. annex VII.
216 Id. annex X.
217 Id. annex XI.
218 Id. annex XVI.
219 Id. annex XVII.
220 Id. annex III.
221 Id. annex XII.
222 Id. annex V.
223 Id. annex XII.
224 Id. annex XV.
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pro forma financial information\textsuperscript{225}, securities note building blocks for guarantees\textsuperscript{226}, asset backed securities\textsuperscript{227}, equity securities underlying convertible and exchangeable securities\textsuperscript{228}. The schedules are based on the information items required in the IOSCO Disclosure Standards and the annexes in CARD.\textsuperscript{229}

Incorporation by Reference

To achieve efficiency by lowering cost and not endangering investor protection\textsuperscript{230}, the Prospectus Directive introduces the concept of incorporation by reference. Issuers may under the Prospectus Directive to incorporate latest available published documents that have been approved by, and filed with the competent authority of the home Member by reference to them.\textsuperscript{231} Such incorporation by reference cannot be used in the summary notes.\textsuperscript{232} The Implementing Regulation provides a non-exhaustive list of documents that may be incorporated by reference and they include annual and interim financial information, mergers or demergers documents, audit reports and financial statements, memorandum and articles of associations, earlier approved and published prospectuses, regulated information and circulars to shareholders.\textsuperscript{233}

Restrictions are, however, imposed on the use of incorporation by reference and as a result, they lessen its usefulness in efficiency but help safeguard investor protection. For instance, the language used for the information

\begin{footnotesize}
\textsuperscript{225}Id. annex II.
\textsuperscript{226}Id. annex VI.
\textsuperscript{227}Id. annex VIII.
\textsuperscript{228}Id. annex XIV.
\textsuperscript{229}Implementing Regulation, preamble (2) & Prospectus Directive, preamble (22) and art. 7(3).
\textsuperscript{230}Prospective Directive, preamble (29).
\textsuperscript{231}Id. art. 11(1).
\textsuperscript{232}See id.
\textsuperscript{233}Implementing Regulation, art. 28.
\end{footnotesize}
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incorporated by reference has to be consistent with the prospectus\textsuperscript{234} and the information should be accessible and comprehensible.\textsuperscript{235} Only previously or simultaneously published documents may be used.\textsuperscript{236} New updated information may only be incorporated through a supplement to the prospectus and such supplement requires prior approval from the competent authority.\textsuperscript{237} Finally, as a general principle, the issuer has to consider whether "the natural location of the information required is the prospectus, and that the information should be presented in an easily and comprehensible form."\textsuperscript{238}

Approval

All prospectuses should be approved by the home Member State before publication\textsuperscript{239} to avoid duplication of the approval authorities and to facilitate a single point of clearance.

Only one single competent authority should be designated to approve prospectuses in each Member State to avoid unnecessary costs and overlapping of responsibilities. Under strict conditions, if the Member State has more than one competent authority, only one will assume the duties for international cooperation.\textsuperscript{240}

\textsuperscript{234} Id. preamble (30).
\textsuperscript{235} Id. art. 28(5).
\textsuperscript{236} Prospectus Directive, art. 11(1).
\textsuperscript{237} Id. art. 16(1). The Prospectus Directive requires the filing and publication of a supplement to the prospectus (including the summary and translation thereof, if appropriate) if there is any "significant new factor, material mistake or inaccuracy relating to the information included in the prospectus" after the prospectus is approved but before the final closing of the offer to the public or the trading beings, as the case may be. The Directive does not give examples of such information but any new financial information may justify a supplement which may have significant impact on the offering as the investors who have already agreed to purchase or subscribe for the securities will have the right to withdraw their offers to purchase or subscribe within a prescribed period of not shorter than two working days after the publication of the supplement. Id. art. 16(2).
\textsuperscript{238} Implementing Regulation, preamble (30).
\textsuperscript{239} Prospectus Directive, art. 13(1).
\textsuperscript{240} Id. preamble (37).
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Publication

The approved prospectus should be filed with competent authority of the home Member State and made available to the public as soon as practicable.\textsuperscript{241} In the case of initial public offering of a class of shares not already admitted to trading on regulated market before, the prospectus should be available at least six working days before the end of the offer.\textsuperscript{242}

A home Member State may also require publication of a notice stating how the prospectus has been made available and where it can be obtained by the public.\textsuperscript{243} The Implementing Regulation has set out the information required for such a notice if it is required by the home Member State.\textsuperscript{244}

ii. Market Abuse Directive

Market Abuse Directive was adopted on January 28, 2003\textsuperscript{245} and was effective as of that date. Since then, three directives and one regulation have been passed to implement the Market Abuse Directive, namely:

- Directive of December 22, 2003 regarding fair presentation of investment recommendations and the disclosure of conflicts of interest (the "Fair Presentation Directive")\textsuperscript{246};

\textsuperscript{241} Id. art. 14.
\textsuperscript{242} Id.
\textsuperscript{243} Id. art. 14(3).
\textsuperscript{244} Implementing Regulation, art. 31.
\textsuperscript{245} Directive 2003/6/EC, 2003 O.J. (L 96)16.
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- Regulation of December 22, 2003 regarding exemptions for buy-back programmes and stabilization of financial instruments (the “Buy-back Regulation”)\(^{247}\);

- Directive of December 22, 2003 regarding definition and public disclosure of inside information and the definition of market manipulation (the “Definition Directive”)\(^{248}\);

- Directive of April 29, 2004 regarding accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers’ transaction and the notification of suspicious transactions (the “Market Practices Directive”)\(^{249}\).

Objectives

The Market Abuse Directive provides a common framework for market abuse which, according to the Directive, consists of insider dealing and market manipulation\(^{250}\) so as to enhance integrity of financial markets and public confidence in securities and derivatives.\(^{251}\) The insider dealing legislation should be consistent with the market manipulation legislation. Before its enactment, legal requirements vary from one Member State to another, leaving economic actors often uncertain over concepts, definitions and enforcement.\(^{252}\) Technological development further complicates the problem by providing incentives, means and opportunities for market abuse.\(^{253}\) In addition, the last

\(^{247}\) Commission Regulation (EC) No. 2273/2003, 2003 O.J. (L 336)\(^{34}\).


\(^{249}\) Commission Directive 2004/2/EC, 2004 O.J. (L 62)\(^{71}\).

\(^{250}\) Market Abuse Directive, preamble (12).

\(^{251}\) Id. preamble (2).

\(^{252}\) Id. preamble (11).

\(^{253}\) Id. preamble (10).
directive dealing with insider dealing ("Insider Dealing Directive") was enacted on November 13, 1989\textsuperscript{254} which is more than a decade ago and therefore needs updating. New events like the terrorist attacks on September 11, 2001 also prompted the Member States to safeguard themselves from financing terrorist activities.\textsuperscript{255}

**Scope**

The Market Abuse Directive will apply to all financial instruments trading on a regulated market in at least one Member State, or for which a request for admission to trading on such a market has been made, irrespective of whether or not the transaction itself actually takes place on that market.\textsuperscript{256} Insider trading will also be applied to financial instruments not admitted to trading on a regulated market in a Member State but whose value depends on a financial instrument on a regulated market, or for which a request for admission to trading on such a market has been made i.e. derivative instruments.\textsuperscript{257} As a result, it includes trading on regulated markets, grey markets and off-market transactions and it also includes secondary as well as primary and grey markets.\textsuperscript{258} Financial instruments include but not limited to transferable securities, units in collective investment undertakings, money-market instruments, financial-futures contracts, forward interest-rate agreements, interest-rate, currency and equity swaps, options (particularly on currency and interest rates) and derivatives on commodities.\textsuperscript{259} The wide scope and

\textsuperscript{254} 1989 O.J. (L 334)30

\textsuperscript{255} Market Abuse Directive, preamble (14).

\textsuperscript{256} Id. art. 9, the first para.

\textsuperscript{257} Id. art. 9, the second para.

\textsuperscript{258} Cf. Insider Dealing Directive, art. 5. Its application is restricted to transferable securities which are "admitted to trading on a market of a Member State", so it only refers to transferable securities traded on the secondary market.

\textsuperscript{259} Market Abuse Directive, art. 1(3).
application of the Market Abuse Directive is to guarantee the integrity of the EU financial markets.\textsuperscript{260}

The Market Abuse Directive specifies in detail what constitute insider trading\textsuperscript{261} and market manipulation\textsuperscript{262}.

Exemptions

The Market Abuse Directive will not apply to Member States and their federated states or similar local authority, the European System of Central Banks, a national central bank or any other officially designed bank or by any person acting on their behalf if they carry out transactions relating to fiscal or monetary policies.\textsuperscript{263}

The prohibition under the Market Abuse Directive will not apply to trading in own shares in “buy-back” programme or to the stabilization of a financial instrument.\textsuperscript{264} Details of the buy-back programme and stabilization allowed are provided in the Buy-back Regulation.\textsuperscript{265}

Sanctions

Like the Prospectus Directive, each Member State must designate a single competent authority to ensure that the Directive is complied with.\textsuperscript{266} In addition to criminal sanctions, each Member State must ensure appropriate administrative measures can be taken and sanctions can be imposed on those

\begin{footnotesize}
\begin{enumerate}
\item Id. preamble (34).
\item Definition Directive, arts. 4-5 & Market Abuse Directive, art. 1(2).
\item Market Abuse Directive, art. 7.
\item Id. art. 8.
\item See Buy-back Regulation, arts. 5 & 7-11.
\item Market Abuse Directive, art. 11.
\end{enumerate}
\end{footnotesize}
who do not comply with the Market Abuse Directive. A list of the administrative measures and sanctions should be drawn up by the Commission.

iii. Transparency Directive

The Transparency Directive ("Transparency Directive") deals mainly with the post-listing continuing obligations. Unlike the Prospectus Directive but similar to the Market Abuse Directive, it aims at minimum harmonization. The Transparency Directive does not impose a ceiling on the requirements imposed by Home Member States. Home Member States are allowed to impose additional requirements, commonly known as "super-equivalent" requirements, on the issuers. As the Transparency Directive deals with financial reporting requirements, the choice of Home Member States will have significant impact on continuing cost incurred by the issuers. However, the Host Member States are not allowed to impose more stringent requirements than provided by the Transparency Directive and article 6 of the Market Abuse Directive.

The Transparency Directive also establishes the home Member State control and provides for filing disclosed information and notification required under the Transparency Directive with the competent authority of relevant Home Member States.

Objectives

The Transparency Directive is to "enhance both investor protection and market efficiency" by ensuring accurate, comprehensive and timely information about

267 Id. art. 14(1).
268 Id. art. 14(2).
269 Transparency Directive, art. 3(1).
270 Id. art. 3(2).
271 Id. art. 15.
security issuers\(^{272}\), furthering convergence and integration by the adoption of common international accounting standards\(^{273}\), and enhancing effective control of share issuers and overall market transparency on important capital movement by informing the public changes to major holdings in issuers.\(^{274}\) The end result is an efficient, transparent and integrated securities market that will attract investors, foster economic growth and increase employment.\(^{275}\)

To achieve this purpose, the Transparency Directive establishes requirements regarding the publication of periodic and ongoing financial reports and information about major holdings. The Transparency Directive forms part of the European Union’s Financial Services Action plan that aims to create a single market in financial services for the European Union by 2005.\(^{276}\)

**Scope**

The Transparency Directive will establish disclosure requirements for issuers whose securities are already admitted to trading on a regulated market situated within a Member State. It will not apply to unit trusts and investment companies.

**Accounting Standards and Periodic Reports**

The Transparency Directive requires annual\(^{277}\) and half-yearly\(^{278}\) reports to include consolidated financial statements prepared in accordance with

\(^{272}\) Id. preamble (1).
\(^{273}\) Id. preamble (7).
\(^{274}\) Id. preamble (11).
\(^{275}\) Id. preamble (1).
\(^{276}\) Id. preamble (3).
\(^{277}\) Transparency Directive, art. 4(3) and Regulation 1606/2002, arts. 2 & 3.
\(^{278}\) Transparency Directive, art. 5(3) and Regulation 1606/2002, arts. 2 & 3.
International Financial Reporting Standards ("IFRS") 279 unless they are prepared in accordance with financial standards that are considered to be equivalent.280 The use of IFRS for the publicly listed companies in the EU regulated market is an important step in integrating the capital market within the EU. The common accounting standards can facilitate comparability in terms of financial information.

Equivalent accounting standards are only allowed for a third country and the Transparency Directive has not specified what accounting standards are equivalent to IFRS. It is likely that the European Commission will take the view that US GAAP should be considered as equivalent to IFRS.281 If an issuer whose registered office is in a third country prepared its financial statements in accordance with internationally accepted standards, it may adopt IFRS starting on or after January 2007282 whereas publicly traded companies governed by the law of a Member State has to adopt IFRS starting on or after January 1, 2005.283 The same exemption applies to issuers which are admitted

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279 IFRS is originated and developed from the International Account Standards ("IASs"). IASs are developed by the International Accounting Standards Committee ("IASC"), whose purpose is to develop a single act of global accounting standards. Further the restructuring of the IASC, the new Board on April 1, 2001 renamed the IASC as the International Accounting Board ("IASB") and, as far as the future international accounting standards are concerned, renamed IASs as IFRS. These standards should ensure a high standard of transparency and comparability for financial reporting in the European Union. See Regulation (EC) no. 1606/2002 of July 19, 2002 on the application of international accounting standards, 2002 O.J. (I. 243) ("Regulation 1606/2002"), preamble (7). International accounting standard should be adopted provided that firstly, they are not contrary to the principle that the financial reporting should give a true and fair view of the company's assets, liabilities, financial position and profit or loss; secondly it is conducive to the European public good and lastly, they meet the criteria of understandability, relevance, reliability and comparability required for making economic decisions and assessing the stewardship of management. See Regulation 1606/2002, preamble (9) and art. 3. International accounting standards above shall mean IASs, IFRS and related interpretations, subsequent amendments to those standards and related interpretations, future standards and interpretation issued by the IASB. See Regulation 1606/2002, art. 2.


282 Transparency Directive, art. 19(1a) and Regulation 1606/2002, art. 9.

283 Regulation 1606/2002, art. 4.
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on a regulated market of any Member State and issue only debt securities\(^{284}\) (not including convertible and exchangeable bonds)\(^{285}\).

Such issuers, if unconditionally and irrevocably guaranteed by the home Member State or by one of its local authorities and if they were already existing at the time the Prospectus Directive entered into force (i.e. November 4, 2003), may choose to be exempt from the obligation of publishing half yearly reports.\(^{286}\) Half-yearly report may also apply to certain credit institutions acting as small-size issuers of debt securities.\(^{287}\) During a transitional period of ten years, the Member State may grant an exemption from producing half-yearly reports to issuers admitted to trading on a regulated market prior to January 1, 2005 who exclusively issue debt securities to professional investors only.\(^{288}\)

The Transparency Directive also provides for several exemptions for certain types of issuers from the reporting requirements\(^{289}\).

The annual financial report requires the financial statements to be audited in accordance with Articles 51 and 51\(^{290}\) of Council Directive 78/660/EEC\(^{291}\) on the annual accounts of certain types of companies\(^{292}\) whereas the half-yearly financial report requires the condensed set of financial statements which may

\(^{284}\) Id. art. 9.

\(^{285}\) Transparency Directive, art. 2(1)b.

\(^{286}\) Id. art. 8(1b).

\(^{287}\) Id. preamble (8b) and art. 8(1a).

\(^{288}\) Id. preamble 8(b) & art. 26(3a).

\(^{289}\) Id. arts. 8(1a) (See id. preamble (3a)) and preamble (8e) & art. 8(1b).


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or may not be audited. Both the annual and half-yearly report shall comprise a management report. The financial statements in both the annual and half-yearly report should include a “true and fair view” certification regarding the accounts whereas the management report should include a “fair view” certification. If the issuers are required to prepare consolidated accounts, it should be prepared in accordance with Directive 83/349/EEC of June 13, 1983 on consolidated accounts.

Quarterly financial reporting is not required although national legislation and the rules of the regulated market may require it and the issuers themselves may also do it out of its own initiative. However share issuers are required to publish a less extensive quarterly financial report for the first and third quarter of a financial report for the first and third quarter in accordance with article 6 of the Transparency Directive.

Electronic Communication

The Transparency Directive will facilitate electronic communication between issuers and their shareholders. This will enable Europe to move to a system of EU-wide dissemination of corporate and financial information which will be available to investors in all Member States.

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293 Id. arts. 5(2) & 5(4).
294 Id. arts. 4(2)(b) & 5(2)(b).
295 Id. arts. 4(2)(c), 4(5) & 5(2)(c).
298 Id. art. 13(3).
Sanctions

In addition to criminal sanctions, Member States may impose civil and/or administrative sanctions. Member States may also disclose to the public every measure taken or sanction imposed provided that it will not damage the financial markets or cause disproportionate damage to the parties involved.

iv. UCITS Directives


The Management Directive makes significant changes to the previous UCITS regime. Among them, it introduces an EU-wide passport for UCITS management and investment companies by use of mutual recognition and home Member State supervision; it allows UCITS management companies which are subject to prudential supervision to carry out activities such as discretionary

300 Transparency Directive, art. 24(1).
301 Id. art. 24(2).
305 The Management Directive, preamble (6), art. 1(3) (replacing art. 5 of the UCITS Directive regarding management companies – see art. 5(1)) and art. 1(5) (replacing art. 12 of the UCITS Directive regarding investment companies – investment companies may only manage assets of their own portfolio and unlike management companies, they may not receive any mandate to manage assets on behalf of a third party. See art. 1(5) inserting, amongst other clauses, art. 13b to the UCITS Directive).
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client-by-client portfolio management\textsuperscript{306} and (in certain cases) investment advice\textsuperscript{307}, it introduces a simplified prospectus as a marketing document in the EU\textsuperscript{304}; it introduces new prospectus requirements for all UCITS schemes\textsuperscript{309} and imposes new financial resources requirements\textsuperscript{310} and conduct of business rules on UCITS management and investment companies.\textsuperscript{311}

Regarding the simplified prospectus, it is no longer necessary to offer the full prospectus to investor prior to conclusion of a sale although a simplified prospectus has to be offered to subscribers free of charge before the conclusion of a sale.\textsuperscript{312} The simplified prospectus is supposed to be investor-friendly and provide key valuable information for the average investors.\textsuperscript{313} However the full prospectus must be supplied upon request.\textsuperscript{314} Contents requirements for the simplified prospectus are set out in Schedule C, Annex 1 to the Management Directive and Member State can neither add to nor delete the information which must be included.\textsuperscript{315} A maximum harmonization approach is adopted for the simplified prospectus like the Prospectus Directive although the Management Directive sets out to provide for minimum harmonization.\textsuperscript{316}

\textsuperscript{304}Id. preamble (9), art. 1(3) (replacing art. 5 of the UCITS Directive – see art. 5(3)(a)).

\textsuperscript{307}Id. art. 1(3) (replacing art. 5 of the UCITS Directive – see art. 5(3)(b)).

\textsuperscript{308}Id. preamble (15), art. 1(9) (replacing art. 28 of the UCITS Directive – see particularly art. 28(3)).

\textsuperscript{309}Id. preamble (15), art. 1(9) (replacing art. 28 of the UCITS Directive).

\textsuperscript{310}Id. art. 1(3) (replacing art. 5 of the UCITS Directive – see art. 5a for management companies) & art. 6 (inserting, amongst other clauses, art. 13a of the UCITS Directive – see art. 13a(1) for investment companies).

\textsuperscript{311}Id. art. 1(3) (replacing art. 5 of the UCITS Directive – see art. 5f for management companies) & art. 1(5) (inserting, amongst other clauses, art. 13 of the UCITS Directive – see art. 13c for investment companies).

\textsuperscript{312}Id. art. 1(13) (replacing art. 33 of the UCITS Directive – see art. 33(1)).

\textsuperscript{313}Id. art. 1(9) (replacing art. 28 of the UCITS Directive – see art. 28(3)).

\textsuperscript{314}Id. art. 1(13) (replacing art. 33 of the UCITS Directive – see art. 33(1)).

\textsuperscript{315}Id. art. 1(9) (replacing art. 28 of the UCITS Directive – see art. 28(3)).

\textsuperscript{316}Id. preamble (16).
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The Product Directive widens the scope of the UCITS Directive beyond mere bonds and shares and widens the range of financial assets in which collect investment undertakings covered by the single authorization may invest. They all combine to help UCITS to achieve financial targets or risk profile in their prospectuses. The definition of transferable securities is also clarified.

Both the Management and Product Directives were effective as of February 13, 2002. Relevant laws and regulations complying with the Management and Product Directives should be adopted no later than August 13, 2003 and applied not later than February 13, 2004.

v. New Investment Services Directive

Objectives

The New Investment Services Directive (the “MiFID”) attempts to provide legal framework to encompass the full range of investor-oriented activities. It also establishes a comprehensive, risk-sensitive regulatory regime governing the execution of transactions in financial instruments irrespective of the trading methods used to conclude those transactions so as to ensure a high quality of execution of investor transactions and to uphold the integrity and overall efficiency of the financial system. It also aims to harmonize the

317 Product Directive, preambles (2), (4), (5), (8), (9), (11) & (12).
318 Id. preambles (6) and (11).
319 Id. art. 1(2) (inserting art. 1(8) of the UCITS Directive).
322 Id. preamble (2).
323 “Measures to protect investors should be adapted to the particularities of each category of investors (retail, professional and counterparties).” See id. preamble (31).
324 Id. preamble (5).
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initial authorization and operating requirements for investment firms including conducts of business rules and provide for the harmonization of some conditions governing the operation of regulated markets.325

The MiFID is characterized by its risk-sensitive approach and it sets out to provide:

• an effective Pan-European passport for investment firms (issues include initial authorization of the establishment of investment firms and home country rule)

• a legal framework for the operation of investment firms which is more efficient and provide better protection for investors (issues include ongoing supervision, conflicts of interests, conduct of business rule and best executed orders and relation between investment firms and their tied agents, market transparency and integrity)

• effective competition between regulated markets, multilateral trading facilities ("MTF") and systematic internalizers (issues include the abolition of "no concentration rule" and their respective obligations)

• free access to clearing and settlement

• supervision and enforcement of the MiFID (issues include administrative sanctions, right to appeal to court and extra-judicial mechanism for investors' complaints and international cooperation and exchange of information)

325 Id. preamble (1).
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Scope

The MiFID does not apply to insurance undertaking, collective investment undertakings, pension funds, employee-participation scheme, persons providing an investment service that is incidental to his regulated professional work and persons dealing on their own account in financial instruments or providing investment services in commodity derivatives provided that on a group basis, such investment services are only an ancillary activity to their main business. Optional exemptions are also available for Member States.

Initial Authorization and Home Country Rule

Performance of investment services requires prior authorization and such authorization is granted by the home Member State. Jurisdiction shopping is discouraged by requiring any investment firm which is a legal person to have its head office in the same Member State as its registered office. If the investment firm is not a legal person or is a legal person without a registered office, it should have its head office in the Member State in which it actually carried on its business. The authorization should refer to specific activities and once authorized, the firm will have a pan-European passport to operate its business in any Member States.

The only exception to the home country rule is the supervision of branches of investment firms as the host Member States will assume responsibility for ensuring that the services provided by the branch fulfill conduct of business

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326 Id. art. 2(lXa), (c), (e), (h) & (k). See art. 2(1) for the full list.
327 Id. art. 3.
328 Id. art. 5(l).
329 Id. art. 5(4).
330 Id. art. 6.
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obligations, client order handling rules and adopt best execution orders for clients. 331

Risk-sensitive Approach

The MiFID rejected the one size-fit all regulatory approach. One of the objectives of the ISD is to protect investors’ interests but different trading activities involve different risks. 332 As a result, in order to protect investors, different rules should be tailor-made for different activities in accordance with the risks they pose. In the case of regulated exchanges and MTFs, the MiFID emphasizes the organization, transparency and fairness of the trading systems run by the market. 333 As far as banks are concerned, the emphasis is placed on avoiding conflicts of interests 334, ensuring that banks meet all their obligations to clients, and full disclosure to clients. 335

Investment firms that provide only investment advice do not involve handling clients’ money so capital requirements arising from the Capital Adequacy Directive 336 can be exempt. 337 Instead, the risks they may suffer are the possibility to be sued by clients and in such a case, professional indemnity insurance should be in place. 338

331 Id. art. 32(7).

332 Id. preamble (31).

333 Id. arts. 13 & 14 for MTF and arts. 36-40 for regulated markets.

334 Id. art. 18.

335 Id. arts. 13, 19, 21 & 22.


337 The MiFID, art. 67(1) (amending art. 2(2) of the Capital Adequacy Directive).

338 Id. art. 67(3) (inserting after art. 3, art. 4a & 4b). (There is probably a typo in the MiFID as the articles to be inserted should be 3a and 3b). Please note that all investment firms have to meet its obligation under Directive 97/9/EC of March 3, 1997 (26.03.97, O.J. (L 84)22) on investor-compensation scheme upon authorization. See id. art. 11.
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Eligible counterparties, being investment firms, credit institutions, insurance companies, UCITS and their management companies, pension funds and their management companies, are professional investors. As such, when investment firms deal with eligible counterparties, they do not need to comply with conduct of business rules, best orders execution and part of the client order handling rules under articles 19, 21 and 22(1) of the MiFID.

The quote disclosure rule which require investment firms and market operators to make public current bid and offer prices and the depth of trading interests at these prices may allow for small dealers, which are unlikely to be significant contributors to liquidity or price-formation for shares, to be exempted from the scope of the pre-trade transparency requirements. The details of the exemption will be determined by the implementing measures to be adopted by the Commission under the 'comitology' arrangements.

Enforcement and Cooperation

Member States are encouraged to set up procedures for efficient and effective out-of-court settlement of consumer disputes involving services provided by investment firms. Member States are encouraged to use existing cross-border cooperation mechanisms, notably the Financial Services Complaints Network (FIN-Net) and followed the adversarial principle and the principles of independence, transparency, effectiveness, legality, liberty and representation of the Commission Recommendation 98/257/EC of March 30, 1998. Administration sanction has to be effective, proportionate and dissuasive and

339 Id. art. 24(2).
340 Id. art. 24(1).
341 Id. art. 29(3)(b)&(c) and art. 44(3)(b)&(c).
342 Id. art. 29(3) & art. 44(3).
343 Id. art. 53.
344 Id. preamble (61).
345 Id. art. 51.
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the aggrieved parties should always be given the right to apply to court to appeal.346 International cooperation in supervisory activities, on-the-spot verification or in investigations347, exchange of information348 and inter-authority consultation prior to authorization are provided for.349

vi. Clearing and Settlement

The Commission has noted the costs of cross-border clearing and settlement are much higher than in the US and it is far too complex. As a result, it not only hinders competition, it also may create uncertainty in the payment process and increase systemic risk350 in payment and securities settlement system. Clearing refers to the activities that have as effect to guarantee from the potential losses arising in the event of default of a counterparty to a trade ("replacement cost risk"). It will usually involve netting with novation because it reduces the size of credit and liquidity exposures of participants, thus reducing the costs in the transactions. Clearing Members and Central Counterparties provide intermediary services in the clearing activities. Settlement includes the pre-settlement (the process of calculating the mutual obligations, on a gross or net basis, prior to settlement), settlement and custody functions. This service is usually provided by Central Securities Depositories and custodians.

Because of the above situation, the Commission issued consultation papers considering the need for EU measures to improve clearing and settlement followed by a Commission Communication in April 2004 (the

346 Id. art. 52.
347 Id. arts. 56 & 57.
348 Id. art. 58.
349 Id. art. 60.
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"Communication").\textsuperscript{351} At present, only the Settlement Finality Directive\textsuperscript{352} deals with clearing and settlement of securities of a cross border nature. The Directive was effective on June 11, 1998\textsuperscript{353} and was to implement by December 11, 1999.\textsuperscript{354} The objective of the Directive is to create greater certainty in the payment process\textsuperscript{355} and to reduce systemic risk.\textsuperscript{356} Systemic risk in this context, refers to the risk that the bankruptcy of one participant (such as bank, securities institutions or clearing house) in a settlement will have "knock-on" effect leading to bankruptcy of the other participants, ultimately leading to a widespread financial crisis. The Settlement Finality Directive deals with settlement situation in times of insolvency by providing that netting and transfer orders that are entered into a system before the opening of insolvency proceedings, are legally enforceable.\textsuperscript{357} The more notable contribution of the Directive is to treat securities as being located at the register, account or system where it has been recorded rather than the jurisdiction where a security is located (common known as the place of the relevant intermediary approach, PRIMA).\textsuperscript{358} The Directive, however, applies only to securities offered as collateral to central banks and to payment and settlement system.\textsuperscript{359} As such, the Directive, together with the Directive on Financial Collateral Arrangements\textsuperscript{360}, managed to address differences in the

\begin{footnotesize}


\textsuperscript{353} Id. art. 13.

\textsuperscript{354} Id. art. 11(1).

\textsuperscript{355} Id. preamble (4).

\textsuperscript{356} Id. preamble (1).

\textsuperscript{357} Id. art. 3(1).

\textsuperscript{358} Id. art. 9(2).

\textsuperscript{359} Id. art. 1.

\end{footnotesize}
legal treatment of netting and conflict of law issues discussed in the Giovannini Reports\(^{361}\) (see below).

The Communication aims to ensure an efficient, integrated and safe market for securities and settlement.\(^{362}\) Such integration will require coordination between private sector bodies, regulators and legislators and the legal underpinnings of clearing and settlement in the EU should be clear, reliable and coherent.\(^{363}\) It points out that the present inefficiencies of cross-border arrangements are a result of a lack of global technical standards, the existence of differing business practices and inconsistent fiscal, legal and regulatory underpinnings.\(^{364}\) The two reports of the Giovannini Group identified 15 barriers, divided into technical or market practice barriers, barriers related to tax procedures and legal barriers\(^{365}\) ("the Giovannini Barriers")\(^{366}\). This thesis will focus on the legal barriers.

In the absence of a common regulatory framework, The European System of Central Banks (ESCB) and the CESR launched a joint working group to develop common standards for entities providing clearing and settlement services in the EU\(^{367}\) based on an adaptation of the CPSS-IOSCO Recommendations.\(^{368}\) The legislative framework should also provide a level

\(^{361}\) The Communication, supra note 351, 22-26.

\(^{362}\) Id. 3.

\(^{363}\) Id. 3-4.

\(^{364}\) Id. 6.

\(^{365}\) Id.

\(^{366}\) See Annex 3 for the Giovannini Barriers.


\(^{368}\) See Annex 4 for the CPSS-IOSCO Technical Committee Recommendations for Central Counterparties.
playing field for banks/investment firms and providers of clearing and settlement services which are not banks/investment firms. 369

The Commission is considering proposing a directive that will complement the removal of Giovannini barriers so that restrictions and barriers as regards the location of clearing and settlement are lifted. 370 The proposed directive should provide for a functional approach (introducing common functional definitions of clearing and settlement activities to ensure consistency of action and avoidance of regulatory conflicts), initial and on-going prudential and investor protection requirements (including capital adequacy requirements, high level principles on risk management such as Delivery Versus Payment, together with some further principles on investor protection such as proper accounting practices and reconciliation procedures of book-entry holdings throughout the chain of intermediaries) and supervisory co-operation (which will be based on the principle of home country rule as enshrined in several other EU Directives and the supervisory model should provide for a framework for the regular exchange of information and cooperation between supervisors). 371 Other than a common regulatory framework, the proposed directive should also introduce a comprehensive rights of access and choice (including the right to choose the settlement location and the right to make use of the services of Central Counterparties in other Member States) 372 and appropriate governance arrangements (including: “(i) the ownership and group structure; (ii) the composition of the board of directors; (iii) the reporting lines between management and the board of directors; and (iv) the management incentives and the process that makes it accountable for its performance, e.g. audit committees.” 373) 374

369 The Communication, *supra* note 351, 8.

370 Id. 11, 12.

371 Id. 16-19.

372 Id. 13-16.

373 Id. 19.

374 Id. 19-22.
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C. US Model

As discussed earlier in the introduction of this chapter, this thesis will not discuss the US model in the same detail as the EU model. US capital market, having the largest capitalization, is a good case study. The securities law in the US is disclosure-based and very complex. This thesis will look briefly at the history of the US securities laws with an emphasis on issues relating to legal integration and regulatory convergence. The US model will not be discussed in full but instead based on the EU model, it will be insightful to look at the alternatives the US model can bring regarding integration and convergence.

1. Brief Historical Account of US Securities Laws

a. State Laws

State laws, the so-called blue sky laws, were enacted in response to the increasing prevalence of overvalued, speculative, and fraudulent securities. Between 1911, when Kansas adopted the first blue sky law, and 1933, when the first federal securities statute was adopted, all states, except Nevada, implemented such laws.


376 Although Kansas is generally regarded as the state which passed the first blue sky law in 1911, Connecticut as early as 1903 adopted a brief statute which made it unlawful for any mining or oil corporation to offer its shares until certain filing conditions had been met. See LOUIS LOSS & EDWARD M. COWETT, BLUE SKY LAW 5 (Little, Brown and Company, 1958).

377 Nevada was the second state after Connecticut to regulate the issuance and sale of non-utility securities in 1909 but the act was watered down in 1911 and repealed in 1915 and Nevada has not had any blue sky law since. See id. 5 & 6. The last state to adopt the blue sky law was Delaware. Since then, the blue sky law was repealed in Delaware. See id. 17.

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The main objective of the blue sky laws is to protect public investors but three regulatory devices are used based on a different philosophical approach: "(1) anti-fraud provisions; (2) provisions requiring the registration or licensing of certain persons in the securities business; and (3) provisions requiring the registration or licensing of securities." 379 They are supposed to be complimentary and support each other. States may adopt one or two of the above regulatory devices or a combination of all. 380

Attempts have been made to create a nationwide uniform model state securities law in 1947. At that time, no two blue sky laws were identical with 47 statutes containing 2800 exemptions. 381 In 1956, a model act called the Uniform Standards Act of 1956 was approved. This Act, or variations thereon, was subsequently adopted in 39 jurisdictions. The Uniform Standards Act was revised in 1985 but was only adopted by a few states. It was later redrafted in 2002. 382 The enforcement of the state laws also varies. The administrator is the official or agency exercising day-to-day control over the operation of the blue sky laws. Their scope of authority, their positions in the governmental hierarchy, their titles, salaries, staff and budgets all vary from state to state depending on factors like the state's constitution and constitutional precedents, its administrative traditions, the legislative and administrative history of its statute, general budgetary considerations and the personalities of the administrator and his predecessors. 383

Despite the state regulations, there was widespread demand for the federal government to assume a role in policing the markets due to an upsurge in

379 Id. 19.
380 Id. 20.
383 Loss & Cowett, supra note 376, at 46.
market misconduct.\footnote{See Remarks, \textit{supra} note 378.} State-only enforcement allows securities fraudsters to operate in a state which has less stringent securities law and it is difficult to apply to interstate sales of securities.\footnote{Id.} Federal legislation, therefore, is to provide uniform standards for offering securities to the public\footnote{Recognition of the importance of national uniformity in securities laws arose before the adoption of the federal securities laws. In 1929, a more uniform approach to securities law started with the development of the Uniform Sale of Securities Act by the National Conference of Commissioners on Uniform State Laws. However this model state statute was adopted by only seven states. Dennis C. Hensley, \textit{The Development of a Revised Uniform Securities Act}, 40 Bus. Law. 721, 722 (Feb. 1985).} and to prevent scammers from "taking advantage of state boundaries".\footnote{\textit{Economic and Legal Study, supra note 378, 101.}}

The federal laws, the 1933 and 1934 Acts, were not implemented to replace the blue sky laws as the Congress' intent at that stage was to "supplement and strengthen" the existing state regimes.\footnote{Id.} However a new priority soon came into the horizon. In 1980, Congress passed the Small Business Investment Incentive Act, adding Section 19(c) (now section 19(d)) to the Securities Act of 1933 which required greater federal/state cooperation in order to, among other things, maximize uniformity in federal and state standards, reduce transaction costs and paperwork and minimize "interference" with capital formation.\footnote{\textit{Securities Uniformity: Annual Conference on Uniformity of Securities Laws} 1-2, Release No. 8072 (March 20, 2002) quoted by the Remark, \textit{supra} note 378.}

This Act, like the 1933 and 1934 Acts, explicitly preserved existing state authority.\footnote{Securities Act, 15 U.S.C. §19(c)(3)(C).}

However it is a concern that state regulation over securities vary and the effort to develop a consensus model act for all states remains thus far fruitless.\footnote{The Remarks, \textit{supra} note 378.} In 1996, Congress passed the National Securities Markets Improvement Act ("NSMIA") which unlike the previous federal securities laws, pre-empted vast
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areas of state regulation.\textsuperscript{392} In a joint statement by the Conference Committee that approved NSMIA, it stated that "[T]he system of dual Federal and state securities regulation has resulted in a degree of duplicative and unnecessary regulation ... that, in many instances, is redundant, costly, and ineffective."\textsuperscript{393} Congress were worried that the dual system of regulation had become dueling systems, making it difficult for capital formation, job creation, and commercial innovation.\textsuperscript{394} However drafters of NSMIA made it clear that the states were to "continue to exercise their police power to prevent fraud and broker-dealer sales practice abuses"\textsuperscript{395} but abstained from regulation of "the securities registration and offering process."\textsuperscript{396} The prohibitions on state authority "applied both to direct and indirect state action."\textsuperscript{397} It meant that the states should not rely on their residual power to set regulatory standards for the national markets.\textsuperscript{398}


\textsuperscript{394} Remarks, supra note 378. See also §2(b) of the Securities Act. It provides that in rule-making and in considering whether certain action is necessary and appropriate, the SEC shall consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.


\textsuperscript{396} Id. If the securities offered are listed or authorized for listing on the New York or American Stock Exchange or traded on the National Market System of the Nasdaq Stock Market, offerings of such securities are exempt from state registration requirements. See §18(b)(1) of the Securities Act of 1933, enacted as part of the NSMIA. As far as state registration is concerned, there are three types of registration, namely, registration by coordination, registration by notification and notification by qualification. The last one goes beyond full disclosure and requires merit regulation as the state securities administrators will analyze the securities to be offered to see if the offering is "fair, just and equitable." Some states reject merit regulation while others still adopt it. See MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 123 (Lexis Publishing, 3\textsuperscript{rd} ed. 2001) (1989).


\textsuperscript{398} Remarks, supra note 378.
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b. **Federal Securities Law**

There are seven federal legislations governing the securities industry:\(^{399}\):

- Securities Act of 1933
- Securities Exchange Act of 1934
- Public Utility Holding Company Act of 1935
- Trust Indenture Act of 1939
- Investment Company Act of 1940
- Investment Advisers Act of 1940
- Securities Investor Protection Act of 1970
- Sarbanes-Oxley Act of 2002

i. **Securities Act of 1933**

The objective of this Act is to require that investors receive financial and other significant information concerning securities being offered for public sale, and prohibit deceit, misrepresentations, and other fraud in the sale of securities.\(^{400}\) Disclosure of important financial information through the registration of securities is the main method to achieve these goals. Generally, securities sold in the US must be registered.\(^{401}\) Registration forms are used to minimize the

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\(^{400}\) Id.

\(^{401}\) Securities Act 15 U.S.C. § 77a et seq., §5 (It is unlawful to make use of any means of communication in interstate commerce or any mail to offer to sell or buy any securities unless it is registered with the SEC.)
costs and paperwork to comply with the law. A Registration statements and prospectuses will make public shortly after filing with the Securities Exchange Commission ("SEC"), the securities regulator in the US. Such information will help investors to make informed decisions. Investors who purchase securities and suffer losses have recovery rights if they can prove that the disclosure they are based upon is incomplete or inaccurate.

Small offerings may be exempt from the registration process to lower the cost of offering securities to the public and foster capital formation. Other than that, private offerings to a limited number of persons or institutions, intrastate offerings and securities of municipal, state, and federal government may be exempt from registration requirements.

ii. Securities Exchange Act of 1934

The SEC is created by this Act and it empowers the SEC with broad authority over securities industry in the US. Among them, it includes power to register, regulate and oversee brokerage firms, transfer agents, and clearing agencies and self regulatory organizations like the New York Stock Exchange, American Stock Exchange and the National Association of

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403 Securities Act, supra note 401, §6(d).
404 Securities Act, supra note 401, §11(a).
405 Securities Act 17 C.F.R. Part 230, Regulation A.
406 Id. Regulation D.
408 Id. §15.
409 Id. §17A.
410 Id.
411 Id. §19
412 Id. §6.
Securities Dealers. The Act also prohibits certain market misconducts like insider trading and provides the SEC with disciplinary powers over regulated entities and persons involved. It also empowers the SEC to require periodic reporting of information from publicly listed companies, disclosure of important information by any person seeking to acquire more than 5% of a company’s securities by direct purchase or tender offers and govern the disclosure in materials used to solicit shareholders’ votes in annual or special meetings of the publicly listed companies.

iii. Sarbanes-Oxley Act of 2002

Sarbanes-Oxley Act became effective on July 30, 2002 to initiate reforms to enhance corporate responsibility, further facilitate financial disclosures and combat corporate and accounting fraud, and created the “Public Company Accounting Oversight Board” (“PCAOB”) to oversee the activities of the auditing profession.

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413 Id.
414 Id. §11A.
415 Id. §20A.
416 For example, Securities Exchange Act, supra note 399, §15(b)(4).
417 Id. §13(a).
418 Id. §13(d).
419 Id. §14(d).
420 Id. §14(a).
421 Sarbanes-Oxley Act, Title III, §§301-308.
422 Id. Title IV, §§401-409.
423 Id. Titles VIII & XI, §§801-807, §§1101-1107.
424 Id. §101(a).
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iv. Other Securities-related Acts

Public Utility Holding Company Act governs interstate holding companies engaged, through subsidiaries, in the electric utility business or in the retail distribution of natural or manufactured gas.\textsuperscript{425} Debt securities such as bonds, debentures, and notes that are offered for public sale are subject to the Trust Indenture Act. Such securities may be registered under the Securities Act but the trust indenture (which is a formal agreement between the issuer of bonds and the bondholders) has to conform to the standards of this Act, otherwise it may not be allowed to offer for sale to the public.\textsuperscript{426}

The Investment Company Act\textsuperscript{427} regulates the organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the public investors. This Act is designed to minimize conflicts of interest that may arise in these complex operations.\textsuperscript{428}

The Investment Advisers Act\textsuperscript{429}, as it were, applies to and regulates investment advisers. Firms or sole practitioners that advise on securities investment with at least $25 million of assets under management or those that advise a registered investment company must register with the SEC\textsuperscript{430} and conform to regulations that protect investors.

\textsuperscript{426} Id.
\textsuperscript{427} 15 USC § 80a-1 et seq.
\textsuperscript{429} 15 USC § 80b-1 et seq.
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The goal of the Securities Investor Protection is to arrest the domino effect created by the bankruptcy of insolvent brokerage houses, restore investor confidence in the capital markets, and upgrade the financial responsibility requirements for registered brokers and dealers. The Act is designed to create a new form of liquidation proceeding. It is applicable only to firms which registered with the SEC and became a member of the Securities Investor Protection Corporation. It is designed to accomplish the completion of open transactions and the speedy return of most customer property. The maximum protection provided is $500,000 of customer assets held as securities by a broker-dealer. SIPC provides up to $100,000 of protection for cash.

2. Key Characteristics of US Securities System


The SEC is the sole independent regulatory agency of the US government responsible for administering and enforcing federal securities law. A large body of precedent was created through regulations, interpretive ruling, “no-action letters”, administrative orders and cases instituted in federal court.

b. Disclosure Based System

The US securities laws are based on disclosure, on the assumption that full disclosure of the material facts about an issuer and its business will lead to the fair pricing of its securities and the maintenance of fair and efficient capital


404 Loss & Seligman, supra note 432, at 60-61.


406 Id.
Investors can then make informed investment decisions. The Securities Act which is also known as the "truth-in-securities" act, is an act to defeat caveat emptor ("let the buyers beware") by a statutory requirement making "seller beware" as requested by Roosevelt. It can be achieved by two means, first, by full public disclosure of information about new securities issues as mentioned above and second, by imposition of stiff penalties for failure to comply with the law.

The disclosure is in the form of registration statement and it mainly consists of two parts, the first part being the prospectus and the second part being supplemental information. The latter is not given to investors but is available for inspection at the SEC's offices or at the SEC's website. To ensure that the information is user friendly and intelligible to investors, plain English has to be used. The SEC has published different forms and rules which specify the information required by a registration statement under different situations.

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437 Id. 1.


440 Securities Act, supra note 1031, §5(a).

441 Id. §2(10).

442 Registrants must use plain English principles in the organization, language and design of the cover page, summary and risk factors section of their prospectuses in connection with their public offerings. See Securities Act, supra note 401, §421(d)(1). The plain English principles include the use of the following: active voice; short sentences; definite, concrete, everyday words; tabular presentation or "bullet" lists for complex material, whenever possible; no legal jargon or highly technical business terms; and no multiple negatives. See Securities Act, Rule 421(d)(2) available at http://www.law.uc.edu/CCL/33ActRLs/rule421.html (last viewed Jan. 4, 2006). It became effective on October 1, 1998.

443 For example, Form S-1 is the most commonly used form of registration statement for US companies; Form SB-1 may be used by "small business issuer" as defined in Securities Act, Rule 405 as US or Canadian company with less than $25 million in revenues and under $25 million in public float, Form F-1 is the general form for foreign private issuers.
c. Other Rule Relaxation – Regulation S and Rule 144A

Regulation S444 is a series of rules that allows securities offered outside the US not to be registered with the SEC under Section 5 of the Securities Act.445 It reflects the decision of the SEC not to exercise administrative jurisdiction through registration over securities offered and sold in the US despite incidental US conduct or roots.446

Rule 144A provides a non-exclusive safe harbour exemption from registration under Section 4(1) of the Securities Act for resales of certain restricted securities by persons other than the issuer (and Section 4(3) for dealers) to qualified institutional buyers447.448 The philosophy behind is that certain institutions are assumed to be sophisticated and therefore do not need the protection of the registration requirement of the federal securities laws and sales to such parties are not regarded as a public offering.449

d. Encouragement of Private Securities Litigation – Section 11, Rule 10b-5 and Class Action

When the SEC declares a registration statement effective, it only means that it has completed the review of the registration statement to see whether, on the surface, it appears to comply with the proper form and appears to provide the proper disclosure. It does not mean that it approves the contents of the registration statement.

444 Securities Act, supra note 405, Regulation S (Rules 901-905).
445 Id. Rule 901.
446 LANDER, supra note 435, at 47.
447 For full definition of qualified institutional buyer, see Securities Act 17 C.F.R. Part 230, Rule 144A(a)(1).
448 Securities Act, supra note 405, Rule 144A(b), (c) & (d)(1).
449 LANDER, supra note 435, at 41.
Section 11(a) of the Securities Act is a strict liability provision which empowers the investors with an express right of action when a registration statement contains untrue statements of material fact or misleading omissions of material fact. Section 11(b)(3) provides the defence for all other parties except the company. The defendant needs to show that, after reasonable investigation, there is a reasonable ground to believe and did believe, at the time the registration statement became effective, that the statement therein were true and there was no omission to state a material fact required to be stated therein or necessary to make the statement therein not misleading. There is no requirement of a "reasonable investigation" if the defendant is acting on the authority of an expert. The "reasonable investigation" in Section 11(b)(3) is generally known as the "due diligence" investigation.450

Rule 10b-5 under Section 10(b) of the Securities Exchange Act is the most commonly used remedy in private securities remedy. The rule applies in many situations including provision of misleading information, omission to disclose material information, mismanagement of a corporation in ways that connected with the purchase and sale of securities, fraud cases and insider-trading cases. Violation of Section 10(b) and Rule 10b-5 carry civil and criminal penalties.451

Class actions are civil suits brought by an individual plaintiff or group who seek to represent the interests of a much large group with similar situation (the "class").452 They make possible legal battles against defendant companies by small retail investors. Class actions are usually brought when an individual plaintiff's claimed damages are not large but when the total damages alleged to have been suffered by the entire group was significant. A typical example will be a class action on behalf of shareholders who purchased stock on the basis of allegedly misleading information published by a company which is filed with the SEC.

450 LANDER, supra note 435, at 12.


452 Id. §21D.
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3. Convergence and Mutual Recognition

The concept of mutual recognition is the cornerstone of the EU integration model. The evolution of the mutual recognition and its shortcomings have been discussed earlier. From a historical perspective, the EU started the regulatory integration process through piecemeal harmonization by enacting directives in specific areas. Through the ECJ and encouraged by the Commission, mutual recognition became an acceptable legal device to facilitate integration on a wider scale. As discussed earlier, mutual recognition became a search for "equivalence" by the regulators in the host countries among Member States. The philosophy behind the search is the acceptance of diversity and the spirit of integration is to find equivalent standards rather than conformity. However such search is bound to fail if the differences between Member States are great. In such a case the regulators in the host countries will refuse to compromise as the political and economic stakes to do so will be very high for them. Recent development was to use home country rule with maximum harmonization (no addition or deletion is allowed e.g. the Prospective Directive) or minimum harmonization (by setting a minimum standards and the Member States can impose stricter measures e.g. the Market Abuse Directive) to replace the concept of mutual recognition. By doing so, the EU took the power from the host country regulators and transferred it to the home country regulators. Such action might violate national interests and the subsequent directives and legislation might prove unpopular with the Member States. Politicians might accept such a compromise as it might divert attention from them for unpopular issues and measures. Despite such a development, home country rule continues to uphold the respect of diversity. The problem with such a rule is that it does not provide a level playing ground and this is partly remedied with the use of maximum or minimum harmonization.

The US model as discussed earlier is rather complex. The SEC's primary concern in legislating for and regulating US markets is investor protection.453

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The earlier discussion shows that the US legislation provides accommodations to small size business, professional investors and foreign players. However the starting point of the US regulation is to treat everyone the same. The Sarbanes-Oxley Act is a good example to show that the SEC treated domestic and foreign market participants the same. But in implementing such act, accommodations are provided because of conflicting home country regulations. 454

Regarding the issue of integration, the concept of convergence is the cornerstone in the US. 455 Convergence is "the movement of two or more sets of standards towards each other at a relatively high level, producing identical or nearly identical principles of regulatory purpose". 456 The question is: What is the difference between "equivalence" and "convergence"? Doesn't "equivalence" also lead to "convergence"? 457

The starting point to understand "convergence" is important to understand the US’s fear of a "race to the bottom". "Convergence" does not denote a process but it also carries substantive restriction. For the SEC, "convergence" of international standards for securities legislation must occur based on best practices. 458 In this respect, the SEC has recognized the development of international standards principally through the work of the IOSCO. The Commissioner of the SEC has once queried the EU model by posing three very

454 Id.


456 Commissioner's Speech, supra note 453. (Convergence has also been defined as "the process by which the rules, regulations, or political institutions governing economic activity in different countries become more similar. Under this definition, regulatory convergence implies that regulations in two or more countries become more similar over time, but it does not necessarily imply that regulatory structures are, or will become, identical." See Henry Laurence, Symposium: The Rule Of Law In The Era Of Globalization: Spawning the SEC, 6 Ind. J. Global Leg. Stud. 647, 649 (Spring, 1999).)

457 Commissioner's Speech, supra note 453.

458 Id.
similar questions: Can you determine that equivalence has occurred if there is no harmonization? Can you reach "equivalence" if you have only a small amount of "harmonization"? How much harmonization produces equivalence?\(^459\) The Commissioner is asking for a standard upon which equivalence can be measured. For the SEC, the standard has to be high and it has to be similar to the US standards.\(^460\) The SEC Commissioner has used the example of Canada to show how "convergence" works.\(^461\) For almost 15 years, the US and Canada have been engaged in the Multi-jurisdictional Disclosure System ("MJDS") which came from the concept published in 1985 on Facilitation of Multi-national Securities Offerings. MJDS is regarded by the SEC Commissioner as a post-convergence model and it gained the SEC support because the Canadian and US systems were in almost every respect converged.\(^462\)

How about for countries which the SEC is not sure whether their systems are converged with them? In such a case, dialogues have to be held on regulatory

\(^{459}\) Id.


\(^{461}\) The US/Canadian Multijurisdictional Disclosure System, for example, does not evidence significant regulatory compromise on the part of the SEC. the principle of mutual recognition ...is followed only to the extent that the foreign rules satisfy the SEC's regulatory goals ...in some cases, other jurisdictions are changing their laws to get into a position to reach [similar] agreements with the SEC." Joel P. Trachtman, *Unilateralism, Bilateralism, Regionalism, Multilateralism, and Functionalism: A Comparison with Reference to Securities Regulation*, 4 Transnat'l L. & Contemp. Probs. 69, 95 (1994) quoted by Kal Raustiala, *The Architecture of International Cooperation: Transgovernmental Networks and the Future of International Law*, 43 Va. J. Int'l L. 1, 35 (Fall, 2002).

\(^{462}\) Commissioner's Speech, supra note 453. See also the Background Paper, supra note 455 (One of the conclusions of the US Unit on regulatory convergence is that regulatory convergence is more attainable if the policies involved share common economic and regulatory objectives).
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issues to achieve cooperation or convergence. In the former case, the purpose is to enhance cooperation so that new regulations, at a minimum, do not conflict. In the latter case, the dialogue may result in convergence or partial convergence of regulatory standards.463

If "mutual recognition" is an acceptance of diversity and the search for "equivalence", "convergence" is the search for conformity among countries with similar regulatory standards and systems.464

D. Provisional Conclusions – EU Model More Appropriate Than US Model

This chapter examined the EU model of integration in some detail and certain aspects of the EU model were compared to the US model of integration. It began by examining the EU model, looking into its philosophical basis through an evaluation of its current international relation theories. Insights gained from these international relation theories threw light on some of the questions posed under the "Methodology" section in the opening chapter and the prevailing literature tend to support that: governments have the immediate power to facilitate integration although technocrats and other interest groups have

463 Id. (examples of such dialogue include the US-EU financial markets regulatory dialogue, a brand-new dialogue between the SEC and the Committee of European Securities Regulators, the Trans-Atlantic legislative dialogue, the Trans-Atlantic business dialogue and the formation of IFAC to deal with International Standards of Auditing). "The IASB has pledged to work with national standard setters such as the Financial Accounting Standards Board (FASB), an independent private standard setter in the United States, to create high quality global accounting standards. The SEC has been encouraging the IASB and FASB to address the significant differences between US GAAP and IAS. Through cooperative efforts between the IASB and national standard setting bodies such as the FASB, significant progress in achieving convergence to the highest quality international accounting standards can occur." Quoted from See Felicia H. Kung, Banner Issue: The International Harmonization Of Securities Laws: The Rationalization of Regulatory Internationalization, 33 Law & Pol'y Int'l Bus. 443, 476-477 (2002) based on the following: John M. Morrissey, Deputy Chief Accountant, Office of the Chief Accountant, US Securities and Exchange Commission, Remarks at the 28th Annual National Conference on Current SEC Developments (Dec. 5, 2000).

464 The difference between the US and the European models on securities regulation cannot be over-exaggerated. Laurence argued that the United Kingdom, Japan, and Germany all consciously chose to remodel their institutions of financial oversight along broadly American lines whereas all countries, beginning with the United States, reformed their regulatory institutions in response to predominantly domestic political pressures. See Henry Laurence, Symposium: The Rule Of Law In The Era Of Globalization: Spawning the SEC, 6 Ind. J. Global Leg. Stud. 647, 648 (Spring, 1999).
considerable influence over governments regarding integration if they unite together; integration should be a gradual process; political reform does not necessarily need to precede economic reform and; the establishment of institutions is important to facilitate integration.

Following on from this discussion of international theories, “mutual recognition”, a device that forms the cornerstone of the EU directives, was scrutinized and its different strands of meaning reviewed. It was shown that the concept of mutual recognition illustrates how different international theories work. Mutual recognition was first invented by the ECJ and was strengthened and reinterpreted by the Commission and by doing so it shows how supranational actors can contribute to the integration process as understood by transnational and multi-governance theorists. The emphasis on shared values and common cultures in active mutual recognition is also central to constructivism and the English School.

Mutual recognition is often wrongly treated as a synonym for home country rule. It could be more accurately described as hovering between host and home state control or as a search for equivalence by host country regulators. The recent trend for law-making in the EU is to replace mutual recognition with home country rule although the spirit of mutual recognition lives on with its search for equivalence in diversity.

The construct of the EU was then examined, looking first at its institutional set-up and the legal framework or treaties that it is based upon. It was seen that EU institutional structures and their drive towards integration demonstrate the belief of neo-functionalists and institutionalists. To explore the integration issues, the Commission’s 1985 initiative to complete the internal market was examined. To accelerate the momentum, the Commission adopted the 1997 Action Plan for the Single Market to enhance its bureaucratic efficiency by laying down concrete agenda, strategies and deadlines. Further EU initiatives on the internal market include the EU’s effort to simplify laws and regulations.
Equipped with the general understanding of the internal market, the scope of this chapter was narrowed down to the integration of financial market in the EU with the adoption of the Financial Services Action Plan in 1999. The Lamfalussy Report was examined as it affects the whole legislative process in the EU with the creation of the ESC and CESR and its four-level regulatory approach. The scope of this chapter was then further narrowed down to legislation relating to the issue and trading of securities. The following directives/areas were examined in detail: 1) the Prospectus Directive; 2) the Market Abuse Directive; 3) the Transparency Directive; 4) the UCITS Directives; 5) New Financial Services Directive; 6) Clearing and settlement issues with the discussion of the two Giovannini reports. By examining the above directives in detail, it can be shown that home country rule has been used to supplement the mutual recognition principle in all directives recently adopted. Some directives aim to provide minimum harmonization by setting the minimum standards whereas some other directives aim to provide maximum harmonization under which any addition and deletion from their requirements are not allowed. The directives apply different requirements to different financial activities depending on the nature of their risks.

Some key features of the US model were then examined. US federalism with its federal and state securities law (the latter commonly known as the blue sky laws) were examined. The US model is based on full disclosure and in general it is easier for US investors to take legal action on securities misconduct. Although the federal laws accommodate small business issuers and foreign private issuers by lowering their legal burden, the US approach tends to impose uniform laws and standards on all issuers. The US federal government’s attempt to achieve uniformity in state securities laws is an ongoing struggle. In contrast, the EU approach tends to respect diversity and its legal framework is risk-sensitive and therefore different rules will apply to businesses with different risk profiles. The difference between the EU and US approach can be illustrated by the differences between “mutual recognition” (a concept frequently used by the EU in law-making until they have been recently replaced with the use of “home country rule”) and “convergence” (a concept embraced by the US regulators). Both mutual recognition and home country
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rule accept different standards whereas convergence denotes one standard and according to the SEC, it should be a high standard comparable to the US. The SEC has made clear that convergence is more feasible with countries with the same political and economic climate and the example given is between the US and Canada. Following from this analysis, convergence seems to be an impossible task especially with the enlarged EU.

This chapter discussed the EU model in more detail than the US model because even at the beginning, the author has noted that the differences between Hong Kong and the PRC bear more resemblance to differences between European countries than differences between the federal and the state governments in the US, e.g. the political and economic development of both Hong Kong and the PRC are very different in ways more closely resembling the differences between European countries.\(^{465}\) In addition, Hong Kong has a long history of common law tradition while the PRC legal system more resembles the civil law system than the common law system. As such, comparison between the EU model and the PRC-HK model was thought to be more appropriate and insightful. However the US model was discussed because it offered a very important alternative to the EU model. The following chapter will therefore concentrate on examining how the EU model can apply to the Hong Kong-PRC scenario.

\(^{465}\) Please see Chapter 1.

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CHAPTER V

Four Models of Integration and New Proposed Institutional Framework for the PRC and Hong Kong Stock Markets

Many factors favour integration of the stock markets in Hong Kong and the PRC. A noticeable feature of the 2004 Hong Kong stock market was the major surge in PRC listings. Of the 892 company stocks listed in Hong Kong on December 31, 2004, 81 were red chips and 72 were PRC-incorporated enterprises known as H shares. During the same period, 204 securities were listed on the GEM of the HKEx, of which 3 were red chips and 37 were PRC-incorporated enterprises. The average daily turnover of shares traded during 2005 was approximately HK$15,960 million (approximately US$2,046 million) of which H shares in the Main Board and the GEM account for approximately 39%. By the end of 2004, the market capitalization of the H shares and red-chips topped 28% of the total capitalization in the Hong Kong stock market (including both the Main Board and the GEM) and by the end of the third quarter of 2005, the market capitalization of the H shares has increased to

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1 See SFC, Table B4: Number of Listed Companies by Stock Type at http://www.sfc.hk/sfc/doc/EN/research/stat/b04.doc (Research Papers and Statistics/Market and Industry Statistics).


3 See id.

4 See id.
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32\%\,^5\textsuperscript{5} Red chips, H shares and other PRC private enterprises were clearly playing an increasingly dominant role in Hong Kong stock market\,^6. So far, no Hong Kong company stock is listed in the PRC.

A. Preamble

This thesis has attempted to achieve the following objectives:

- A factual description of the Hong Kong and PRC stock markets and the legal rules and regulations governing their operation;
- An exploration of the possible advantages to Hong Kong and the PRC if the stock markets in Hong Kong and the PRC were integrated;
- A definition of H shares and a discussion of how they help to harmonize the securities laws and regulations in Hong Kong and the PRC;
- An analysis of the EU model with special attention to the directives relating to the stock markets (notably their extent of harmonization) and the concept of mutual recognition;
- An examination of various theories of international relations;
- An analysis of the US model and the concept of convergence;
- A factual description of various international organizations relating to the securities industry and their legal initiatives;

\textsuperscript{5} See SFC, Table B8: Capitalization by Stock Type at http://www.sfc.hk/sfc/doc/EN/research/stat/b08.doc (Research Papers and Statistics/Market and Industry Statistics).

\textsuperscript{6} Bank of China (Hong Kong), Examining Hong Kong Stock Market's Development, February 1, 2005 at http://www.ttktrade.com/econforum/boc/boc050201.htm.
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- Reviewing all other initiatives taken by Hong Kong and the PRC that facilitate integration between the two jurisdictions, including a detailed analysis of the two CEPAs.

B. Challenges and the Latest Development – Capital Account Non-Convertibility, Segmentation of Shares, Brokerages Problems and Lack of Investors’ Protection

This chapter examines the meaning of harmonization of laws and rules and proposes four models of integration. Harmonization of laws and rules will provide a legal environment for the integration of the stock markets but such integration also requires political will and corresponding government policies and a general readiness by all parties to embrace and make full use of such a move. For this to happen the PRC government will need to continue its attempts to overcome major obstacles to integration such as foreign exchange control and segmentation of the share system.

Adoption of Qualified Foreign Institutional Investors (“QFIIs”) Prior to Achieving a Fully Convertible Currency

In June 2005, speaking on foreign exchange control Vice Premier Huang Ju said that the PRC government would take a step-by-step approach to achieving capital account convertibility including items such as direct investments and securities investments.7

Implemented in December 2002 before the adoption of a fully convertible currency, the QFII program was an attempt to open up the local market to a limited number of foreign investors. The PRC government based its QFII program on the Taiwanese and Korean models of the early 1990s. Licences were granted to a limited number of foreign participants to invest in the A share market instead of allowing them to convert their forex into

7 Agence France-Presse in Beijing, China to Gradually Make Currency Fully Convertible: Vice Premier, SCMP, June 6, 2005.
yuan. In this scheme capital outflow is therefore controlled by requiring QFIIs to hold their quotas in yuan for at least one year. In addition, repatriation of funds must be approved by SAFE and must be carried out in measured instalments. Under the existing system, after a one-year lock up period it may take four months for a closed-end fund and twelve months for other QFIIs to remit the entire principal overseas.\footnote{Mark A DeWeaver, \textit{New Hope for Chinese Stocks}, \textit{Chinese Business}, Dec. 16, 2005.}

The rules governing the QFIIs are the \textit{Provisional Rules on the Management of Investment in Domestic Securities by Qualified Foreign Institutional Investors} (the “QFII Rules”) issued on November 5, 2002 by the CSRC and the People’s Bank of China (“PBOC”). According to these rules, QFIIs are defined as; fund management institutions, insurance companies, securities companies, or commercial banks with at least US$10 billion in securities assets under management. Since the start of the program, the licences have mainly been granted to investment banks such as UBS Limited, Citigroup Global Markets Limited and Deutsche Bank AG\footnote{Stella S. Leung & Yi Zhang, \textit{Qualified Foreign Institutional Investors ("QFIIs") in China}, An O’Melveny & Myers LLP Research Report, May 2004 available at http://www.onm.com/webcode/webdata/content/publications/topics_2004_05.pdf (last viewed December 20, 2005).} and to fund managers such as Jardine Flemming Asset Management and Franklin Templeton Investments.\footnote{DeWeaver, \textit{supra} note 8.}

At the end of 2004 QFII quotas totalled US$4 billion and an additional US$6 billion was added the following year increasing the quota to $10 billion. However by the end of 2005 demand for shares by QFIIs was exceeding supply by as much as ten times.\footnote{See id.} There was, therefore, still room for the quota granted to QFIIs to further expand. During this period the Shanghai and Shenzhen market capitalization was approximately US$400 billion.\footnote{See id.} If two-thirds of this were in state shares, which cannot
be bought and sold by the QFIIs, the total value of non-state shares would still amount to approximately US$140 billion and US$10 billion would only be sufficient to buy less than 7% of that amount

QFIIs still face many problems under the existing QFII scheme: entry threshold requirements to join the QFII scheme are very high allowing only the largest institutional investors to participate. The fund repatriation restrictions, particularly the one year lock up period mentioned above, are another disincentive. Further limitations stem from the PRC’s reluctance to allow QFIIs to acquire control of the companies they invest in. To this end shares that can be bought in a single company are limited by the government with shares held by an individual QFII not permitted to exceed 10% of the total shares of that listed company, and the shares held by all QFIIs in an individual company not permitted to exceed 20% of the total shares of the listed company and in addition QFIIs are not allowed to buy non-tradable state-owned shares and legal person shares. Unclear tax guidelines are a further problem for QFIIs and uncertainty stemming from this can act as a disincentive to investment; no clear tax rules and guidelines have been promulgated in regard to the scheme. Arguably dividends and capital gains relating to the sale of shares by a QFII should be exempt from tax in the same way that B shares are exempt and a 10% withholding tax could apply to the sale of bonds similar to those currently applied to foreign investors who sell bonds on the PRC market. Despite all these problems and a prolonged bearish market, QFIIs are still keen on investing in the PRC’s stock markets but if the above problems are not resolved, this interest could eventually wane.

Reducing the Segmentation of the PRC Share Structure by the Sale of State Shares

The segmentation of the PRC share structure into state shares, legal person shares, A, B, H and N shares, poses as a big obstacle for market integration

13 Leung & Zhang, supra note 9.
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with Hong Kong. The problems are threefold. Firstly foreigners, before the introduction of the QFII scheme, are, in the vast majority of cases, not allowed to buy A shares. Second, it is difficult for PRC citizens to hold foreign listed shares because of foreign exchange control. Thirdly, almost two thirds of shares issued, namely non-floating state shares and legal person shares, are unavailable to either domestic or foreign investors.

The issue of curtailing foreign investment has been addressed by the introduction of the QFII scheme which has given increased, but still limited access to the PRC markets (see above). The issue of limiting PRC national as investors in non-PRC listed companies has been addressed by the implementation of the QDIIs and the possible implementation of CDR scheme in the future (see above).

The PRC government has attempted to address the problem of non-floating state shares by allowing foreigners to acquire non-tradable shares outside the market in off-market deals. It has also tried to gradually float non-tradable shares in the public market. Acquiring non-tradable shares off-market is attractive to foreign investors who want to buy shares in PRC companies but who are not operating within the QFII scheme. However the progress of such sales is rather slow, the main problem being that the supporting legal framework is sketchy and the approval process somewhat untested. The law governing such transactions, The PRC Administrative Measures Relating to Acquisition of Listed Companies, usually referred to as the PRC Public Takeovers Code, is an attempt to regulate the trade of

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14 About 65% of the shares of the PRC listed firms are non-tradable state shares and legal person shares held by central and local governments and state-owned companies and in terms of market value, it amounts to 2.08 trillion yuan. See Enoch Yiu, Warrants Suggested as a Solution, SCMP, June 2, 2005.

15 See id. For the procedure required for the transfer of non-tradable shares of listed companies, please see Rules on Handling Transfer of Non-Publicly Tradable Listed Company Shares promulgated by Shanghai Stock Exchange, Shenzhen Stock Exchange and China Securities Depository and Clearing Corporation Limited ("CSDCCL") effective on Jan. 1, 2005 which requires such transfer to be conducted either by the Shanghai Stock Exchange or Shenzhen Stock Exchange and it has to be conducted through CSDCCL.

16 It became effective on Dec. 1, 2002.
non-tradeable shares to investors that has met with only limited success. On the positive side this Measure does support a pragmatic valuing of off-market shares close to the net asset value per share which is far better than the inflated prices on the stock market with the average price to earning ratio as high as 34 to one. However the stipulated legal requirements to complete a sale make it difficult to finalize the sale and where the potential investment is from overseas investors, the Ministry of Commerce requires that the board of director’s of the target company to be invested in should approve all sales of non-tradable shares, giving the board a veto power even over small transactions. Furthermore, if the transaction requires amendments to the listed companies, a vote of two-thirds of the shareholders is required and a CSRC waiver granted on an ad hoc basis is required to avoid a general offer if its stake in the target reaches 30% and if a general offer is required, it is untenable because foreign investors still cannot buy the remaining listed A shares. The only successful examples of foreign buyers taking a controlling stake in domestic companies are the overseas arm of the PRC companies which in effect are attempts to move the immediate ownership offshore. There is also a significant risk of non-completion for foreign investors. Foreign investors in state shares must pay in full before the transfer of title is completed. Due to difficulties in implementing a traditional escrow arrangement within the PRC banking system the approval of the Ministry of Commerce is usually required.

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17 Such sale share requires the approval of the State Assets Supervision and Administration Commission which follows a similar approach.


19 See id.

20 Administrative Measures Relating to Acquisition of Listed Companies does not provide for acquisitions of non-tradable shares as a basis for granting a waiver.

21 In the absence of waiver, sometimes foreign investors can make a general offer of A shares through PRC-incorporated wholly foreign-owned enterprises or QFIs as nominees. See Markel, supra note 18 at 38.

22 Id. at 37 & 38.
however it is difficult to enter a legally binding agreement with a PRC seller before that approval is obtained.23

Other than the off-market sale of non-tradable state shares to foreign investors, the government has also attempted to float an increasing number of state shares.24 The April 2005 promulgation of the Notice Concerning Issues in relation to Experimental Reforms for the Re-designation of Shares in Listed Companies by the CSRC set the scene for state share reform. The PRC government chose four small private and local government backed firms to launch the trial scheme to sell non-tradable shares in May 2005.25 Guidelines from the CSRC and the State-owned Asset Supervision and Administration ("SASAC")26 expanded the scheme to include larger state-owned enterprises.27 On August 24, 2005, the PRC government further extended the scheme to float all non-tradable shares in more than 1,300 listed PRC firms which involved shares amounting to US$270 billion, this represented a major and highly significant capital market shake-up.28 On September 4, 2005, the CSRC issued the Administrative Measures of Listed Companies Stock Right Allocation Reform extending the state share reform

23 See id.

24 It is unsure what the status of foreigners who own non-tradable shares but are not under the QFII's scheme is when the state share reform has converted the non-tradable state share into A shares. The conversion will make the holding of such shares illegal as the only foreign investors who can hold A shares are those under the QFII scheme. See Elaine Chan & Anette Jonsson, China Bites Bullet by Floating all its Shares, SCMP, Aug. 25, 2005.

25 Yiu, supra note 14.

26 In November 2003, the SASAC issued Several Opinions on the Rationalization of the Reorganization of State-owned Enterprises which stressed the importance of increasing transparency in SOE sale transactions and facilitation and acceleration of the sale of state assets to either domestic or foreign private entities. On December 31, 2003, the SASAC and the MOF jointly issued the Provisional Procedures for the Administration of the Transfer of Enterprise State-owned Assets effective on February 1, 2004 which establishes a compulsory regime to conduct the transfer of state-owned assets in enterprises through qualified equity exchanges. About 20 equity exchanges have been set up and approved by the SASAC and a number of local regulations have been enacted to govern the establishment and management of such equity exchanges. See Jean Marc Deschandol, Breaking New Ground in State-owned Assets Transfers, CHINA LAW & PRACTICE, April 2, 2004.

27 Yiu, supra note 14.

28 Chan & Jonsson, supra note 24.
to all listed companies requiring the listed companies to draw up plans to sell their state shares. In practice, at least two thirds of holders of non-tradable shares were required to put forward a joint motion requiring the company’s board of directors to convene a shareholders’ meeting. The decision to float the company’s non-tradable shares then had to be approved by two thirds of all attending shareholders (including two thirds of attending holders of tradable shares). Approval by shareholders of the share reform scheme does not, however, mean that shares will be immediately floatable, in fact the non-tradable shares will be frozen for at least a year and will be floated in limited amounts each year, for example a maximum of 5% for the first 12 months after the lockup with no more than 10% to be sold in the following two-year period. The scheme also offers provision for the protection of minority shareholders whose shares might be diluted in the process of such a market share flotation although strictly speaking, such conversion should have no dilutive effect as the total number of shares remains the same and listed and non-listed shares convey the same ownership rights, so the ownership rights should not be affected either. In fact, it is the value of the shares owned by the state that stand to be diluted with expensive state funded compensation schemes such as the granting of bonus shares to listed shareholders. In effect the

29 Up till Sept. 12, 2005, 46 companies have published their plans, with 44 offering compensation to the holders of their tradable shares which on average, holders of tradable shares have been offered two free shares for every 10 they hold. Mark O’Neill, China Hastens Sale of State Shares, SCMP, Sept. 12, 2005.

30 Holders of tradable shares may demand more compensation than the state shareholders are willing to pay. For example, in the case of Tsinghua Tongang – A, the plan was rejected because an insufficient number of shareholders voted for it. Mark O’Neill, Make or Break for Share Reform, SCMP, Sept. 19, 2005.


32 DeWeaver, supra note 8.

33See id. In order to mitigate share dilution effects and to ensure market stability, the CSRC issued the Provisional Measures on the Administration of the Buyback of Tradable Shares by Listed Companies issued on and effective from June 16, 2005 which allows listed companies to implement share buyback plans to reduce their registered share capital. On the same day, the CSRC issued Circular on Matters Relevant to Tradable Shareholding Increase by Listed Companies’ Controlling Shareholders after the Listed Companies Stock Rights Allocation Pilot Reform allowing shareholders of a listed company to increase their holding of tradable shares after the 12-month lockup period without triggering the mandatory tender offer requirement. See Jean-Marc Deschandol, Unclogging PRC Stock Exchanges, Norton Rose’s China Legal
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compensation is for the loss of value of the shares held by the listed shareholders due to a potential fall in market price of the said shares because of an increase supply of shares in the market.

It is important to note that state share reform is primarily a domestic one applicable only to holders of A shares; compensation for holders of B and H shares has been ruled out even though the share prices of B and H shares may be adversely affected by such the conversion of state shares to tradeable A shares. No matter what impact state share reform will have on existing issuers, the state share reform will have significant repercussions on the future listing of PRC companies. Such an impact can be seen in the listing of the China Construction Bank Corporation ("CCB") in October 2005 on the Hong Kong stock exchange. CCB's listing is a landmark initial public offering ("IPO") being the biggest ever HKEx IPO of any bank or indeed of any PRC enterprise, and the biggest in global markets for the first five years of the new millennium. It is also a landmark IPO as it is the first time that the state-owned share reform has been extended to a PRC company with a listing solely outside the PRC. To launch the IPO, CCB obtained approval from the State Council, the CSRC and from shareholders, for the conversion of all of its domestic shares (held by its promoters) and its unlisted foreign shares (held by overseas strategic investors) into H shares and for their listing on the Hong Kong Stock Exchange. CCB's promoters could continue to hold H shares converted from domestic shares and still freely tradable on the Hong Kong Stock Exchange, subject to the expiration of the relevant lock-up period agreed between the promoters and the underwriters. The listed H shares of CCB constitute a single class of shares, equal in all respects with each other, and in particular, they rank equally for all dividends and other distributions. Dividends on the H shares

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are paid in Hong Kong dollars while dividends on the H shares converted from domestic shares are payable in Renminbi.\textsuperscript{35}

The success of this flotation may indicate the effectiveness of state share reform in helping the PRC stock markets to recover from a prolonged bearish period that began in 2001. The A share market had been suffering due to a lack of confidence in the PRC stock markets due to the government's constantly fluctuating policies on state shares\textsuperscript{36} and the state share reforms, though not perfect, have helped to rebuild confidence. Problems in selling non-floating state-owned shares may take time to sort out, a legacy of the government's past policies of retaining full control of state-owned enterprises. To achieve a gradual and successful conversion under the guidelines of the present reform, listed companies in the PRC must first suspend trading of their shares to decide on the implementation of the flotation to be followed by a 12-month lockup period after which the conversion of non-tradable state shares to A shares will take place. In the first twelve after the lock-up no more than 5% of company shares can be traded in the market and no more than 10% can be traded in the following 24 month period.\textsuperscript{37} This system does, however, take time; a total of three years being required to sell more than 10% of newly converted A shares in the market and even longer before government ownership is lower than 50%.\textsuperscript{38} Although the progress is slow\textsuperscript{39}, it is in the right direction and it


\textsuperscript{36} There is fear that Beijing will mismanage the sale of two trillion yuan in state shares, allowing too many to be sold and flooding the market. See id.

\textsuperscript{37} DeWeaver, supra note 8.

\textsuperscript{38} See id.

\textsuperscript{39} Even the momentum of the state share reform was rather slow and as a result, officials from every province and city in the PRC were summoned by top government officials, including CSRC chairman Shang Fulin and the PRC's Vice Premier Huang Ju to a meeting in Beijing on Nov. 10, 2005 to speed up the state share reform and explain its importance. Jamil Anderlini, Mainland Orders Firms to Hustle on State-Share Reform, SCMP, Nov. 11, 2005.
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does not destabilize the stock market in any significant way. Perhaps most importantly of all, such measures will make help to reassure investors that a way is being paved for the orderly transfer of non-tradable shares to the open market. This measure, in the context of a regulated time-table, will also help boost the confidence of genuine investors and deter speculators hoping for quick profits.

PRC state share reform leading to the gradual convergence of state shares into floating shares is helping the PRC stock markets to move closer towards harmonization with the Hong Kong stock market. A further indicator of this growing harmonization can be found in the steady fall in share prices on the PRC stock exchanges bringing the PE ratio of A shares closer to those of H shares. 41

Brokerages Problems

The PRC has approximately 130 brokerages and their problems have been a major obstacle to the development of the stock markets. Xinhua Far East Ratings has estimated that even for the best 23 capitalized brokerages, an additional financing of 20 billion yuan (approximately US$2.48 billion) is required. 42 A survey of 2,000 urban households published in June 2005 by the central bank that only 5.6% of them wanted to buy stocks, down from 10.6% a year earlier, while 17.3% preferred bonds, up from 14.6%. 43 The CSRC reacted to eight-year low in the stock markets by summoning 45 institutional underwriters to an emergency meeting in Beijing to devise

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40 People's Bank of China governor Zhou Xiaochuan said in an international conference that “Maintaining balance and control is the key” when he talked about globalization and the development of the financial and capital markets. CSRC chairman Shang Fulin responded by saying that changes “should be gradual and take into account the PRC’s reform and opening up timetable, legal framework and the capabilities of companies and specialists working in this industry.” Jamil Anderlini & Bei Hu, China Must Keep Balance and Control, SCMP, Oct. 19, 2005.

41 Tom Holland, Foreign Interest Grows as A Shares Fall Into Line, SCMP, April 6, 2005.

42 See id.

The lack of confidence in the stock market coupled with the poor management of the PRC brokerages took its toll on the latter. Another reason for the poor performance of the PRC brokerages is because of their keen competition. In the first eleven months of 2005, the top three brokers had a share of over 5% of Shanghai market turnover, while the top 10 accounted for 44%. The average daily turnover in Shanghai and Shenzhen stock markets needed to be three times the present level (i.e. at least 60 billion yuan) in order to make all the brokerages a profit. In the past two and a half year, 19 PRC brokerages have been closed and taken over with at least 33% of the 129 securities companies suffering losses. The PRC's securities firms lost at least RMB15 billion in 2004. A recent survey conducted by China Securities Association showed that the top three brokerages by revenue have gone down even more than the other brokerages.

Both the government and big investment banks are involved in bailing out the brokers. The former took over or closed down 20 of the worst cases. In 2005, the PBOC bailed out Guotai Junan, China Galaxy, and Shenyin Wanguo with over 15 billion yuan. The PBOC and CITIC Securities announced that they would jointly take over both Huaxia Securities and China Securities. The latter involved in the bailing out as a means of getting access to local underwriting opportunities. In September 2005, UBS said it would take a 20% stake in 16th ranked Beijing Securities for US$210 million.

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44 Id.
45 CSRC published a list on November 24, 2005 a list of 21 best performing brokerages (mostly smaller companies) to shame the other 100 or so brokerages into improving corporate governance and overhauling management structure. The 21 favoured companies will be granted special CSRC approval to act as agents for mergers and acquisitions, sales of state-owned assets and business related to the continuing reform of non-tradable shares. Financial derivatives such as futures and options would also be pioneered by them. Jamil Anderlini, *Watchdog Names 21 Best Brokerages*, SCMP, Nov. 23, 2005.
46 50% to 60% of revenue of brokerages came from brokerage commissions. See id.
47 DeWeaver, *supra* note 8.
49 See id.
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million. Citigroup, HSBC, and CSFB are all interested in a stake in 12th ranked Xiangcai Securities while HSBC has applied for a brokerage licence by collaborating with 22nd ranked Shanzi Securities. Merrill Lynch is setting up a joint venture with 51st ranked Huaan Securities and JP Morgan may take over the 59th ranked Liaoning Securities.50

Lack of Investors' Protection

A number of short term measures have been taken by the PRC government to reverse the bearish trends that beset PRC stock markets in the early years of the twenty-first century. But in the long run, laws have to be changed to protect investors' interests to address more fundamental issues.

The short term initiatives adopted by the PRC include the following four measures. Firstly, as a confidence-building initiative, the Ministry of Finance and the CSRC announced in 2005 that tax liabilities on shareholder dividend payments would be halved from 20% to 10%, effective from the date of announcement;51 Secondly, corporate, individual and stamp taxes were repealed for transactions involving the transfer of non-tradable state and legal person shares.52 Thirdly the CSRC also decreed in June 2005 that listed companies would be allowed to buy back shares from the open market and cancel them to reduce share liquidity and enhance valuations.53 Finally the CSRC also proposed in June 2005 that parent companies involved in state-share reforms should be allowed to buy shares in their listed subsidiaries directly from the secondary market and sell them after a lock-up period of six months.54

50 DeWeaver, supra note 8.
51 Jamil Anderlini, Beijing Slashes Taxes on Share Trade, SCMP, June 14, 2005.
52 Id.
53 Id.
54 Id.
More substantial long term measures to increase shareholder protection and boost their confidence include revision of the Securities Law and Company Law. A revised version of the 1999 Securities Law took effect on January 1, 2006 with increased investor protection and more business opportunities for financial institutions. The Revised Securities Law prohibits any publicity or leaking of information before such information is announced in accordance with the relevant laws and regulations. Revised articles on underwriting now extend the range of financial misdemeanors liable to penalties from inaccurate or misleading information or material omissions from official reports to inaccurate or misleading information or material omission from any other information disclosure. It also outlaws "improper competitive methods" adopted by some underwriters when touting for business and penalizes issuers using the funds they raise for purposes other than those stated in their offering documents. The revised law also allows for offending individuals to be temporarily or even permanently banned from working in the markets.

The Revised Securities Law also affords brokerage clients better protection from wrongful misappropriation by their brokers. The newly added article forbids "any unit or individual to misappropriate (nuoyung) in any manner funds or shares [intended] for client trade settlement". Under the same article, it also specifically provides that in the event of bankruptcy, client funds cannot be used to pay off a brokerage's creditors. The securities companies are required to implement an efficient internal control

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56 DeWeaver, \textit{supra} note 8.

57 Revised Securities Law, arts. 25 & 71.

58 Cf. art. 63 of the Securities Law with art. 69 of the Revised Securities Law.

59 Revised Securities Law, art. 29.

60 Id. art. 15.

61 Id. art. 233.
system and avoid conflict of interests among clients and between clients and the securities companies.62

On September 28, 2005, the CSRC, the Ministry of Finance and the PBOC jointly set up a new company with registered capital of 6.3 billion yuan to manage a fund that will protect investors by compensating the clients of troubled brokerage firms63 based on article 134 of the revised Securities Law. The fund, which is called the “Fund to Protect Securities Investors,” offers a comparable level of protection as that offered by the Securities Investor Protection Corporation in the US.64 Brokerages and other securities houses in the PRC are required to finance the investor protection fund. The fund is not used to protect investors against normal market risks and fluctuations, instead, it is used to compensate the loss of the customers’ assets when a brokerage house has been shut down by the PRC regulators due to financial difficulties.65

The CSRC is also given more power to conduct investigation including the power to freeze the accounts of people or units under investigation without an order from a judicial organ 66, and make on-the-spot inspections (xianchang fancha).67 “Records of communications”68 has been added to the list of documents that it may inspect and copy, evidence that is important in cases of share price manipulation.

62 Id. art. 136.
64 Tiano, supra note 63.
65 See id.
66 Cf. Securities Law, art. 168(4) & Revised Securities Law, art. 180(6).
67 Revised Securities Law, art. 180(1).
68 Id. art. 180(4).
New business opportunities for the brokerages include margin and stock lending and derivatives trading, both permitted subject to the issuance of relevant regulations by the State Council.\footnote{Id. arts. 142 & 2. See also Circular on Issues Concerning Warrant Investment by Securities Investment Funds in the Split Share Reform promulgated by the CSRC on Aug. 15, 2005 available at http://www.csrc.gov.cn/en.jsp?infoid=11292788380100&type=CMS.STD. Under the state share reforms, PRC companies has issued six warrants up till Dec. 22, 2005 and has a recorded a combined turnover of 8.38 billion yuan on Dec. 21, 2005 compared with 1,669 warrants in Hong Kong securing a turnover of approximately 4 billion yuan (HK$3.89 billion). The PRC warrants market may overtake Hong Kong's if it is able to sustain their turnovers. Fiona Lau, Mainland Challenges for Top Spot on Warrants, SCMP, Dec. 22, 2005.}\footnote{Revised Securities Law, art. 6.} Securities companies were strictly separated from banks, trusts and insurance companies but the Revised Securities Law now allows the government to make exceptions to such requirements.\footnote{Revised Securities Law, art. 6.}

The Company Law in the PRC (the “Company Law”) was also revised and came into force on January 1, 2006.\footnote{Revised Company law, see http://legal.people.com.cn/GB/42735/3807519.html (in Chinese, last viewed on Dec. 20, 2005).}\footnote{Pinsent Masons, Introduction to China’s New Company Law, Dec. 2005 available at http://www.pinsentmasons.com/media/1186002219.pdf (last viewed on Dec. 20, 2005).} The Company Law mainly affects local companies as there are usually specific laws and regulations for foreign-invested companies. However if there are no clear indications in the specific laws and regulations, the Company Law will also apply to the foreign-invested companies, unless otherwise stated. Many of the revised articles are not related to or targeted at listed companies. Yet it is important to note that the Company Law in the past was drafted to give primacy to government control rather than corporate autonomy and the present revisions is a move by the PRC government towards a western style of corporate entities in terms of organization structures and division of powers.\footnote{Pinsent Masons, Introduction to China’s New Company Law, Dec. 2005 available at http://www.pinsentmasons.com/media/1186002219.pdf (last viewed on Dec. 20, 2005).}

The Revised Company Law makes many significant amendments and among them it: provides for a lower incorporation threshold to encourage
private enterprises, expands forms of capital contribution (including intangible assets), allows for the one shareholder limited liability company\textsuperscript{73} and introduces the legal doctrine of piercing the corporate veil.\textsuperscript{74}

In terms of corporate governance, the Revised Company Law reduces the power of the all-powerful chairman of the board of directors by providing that, other than the chairman of the company, a managing director or manager may serve as the legal representative of a company.\textsuperscript{75} Under the new Company Law, if a company provides a guarantee for its shareholder or actual controller, this must be approved by the resolution of a shareholders' meeting or general shareholders' meeting; interested shareholders or those controlled by the actual controller are not allowed to vote.\textsuperscript{76} Moreover, shareholders holding one-tenth of the shares may convene shareholders' meeting if the directors or supervisors fail to do so\textsuperscript{77} and shareholders representing one-tenth of the voting rights may propose to convene an extraordinary board meeting.\textsuperscript{78} Ten days prior to the shareholders' meeting, shareholders representing 3\% of the shares can formulate proposals to the board of directors on items they think should be discussed at shareholders' meeting\textsuperscript{79} and they also have the rights to petition to the People's Court for the dissolution of the companies if they believe its continued existence will result in significant financial loss to

\textsuperscript{73} New Company Law, ch. 3 (arts. 58-64).

\textsuperscript{74} Id. art. 20. Also see Five Major Amendments in Company Law – Allowing for One Shareholder Companies, Oct. 27, 2005 at http://hpe.people.com.cn/GB/15017/3806689.html (in Chinese, last viewed on Dec. 20, 2005).

\textsuperscript{75} Id. art. 13. See also Faegre & Benson, China Law Update – September – October 2005, Nov. 11, 2005 at http://www.fawgre.com/articles/article_1738.aspx (last viewed on Dec. 20, 2005).

\textsuperscript{76} Id. art. 16.

\textsuperscript{77} Id. art. 102 for companies limited by shares.

\textsuperscript{78} Id. art. 111. Supervisors can also propose to convene an extraordinary board meeting. Id. art. 120.

\textsuperscript{79} Id. art. 103. See also Deschandol, supra note 33.
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shareholders. Shareholders have the right to sue the company's officers and directors in the company's name, i.e. to bring a derivative action. A cumulative voting system is set down for shareholders' meetings for the appointment of directors under which the number of votes available to a shareholder is equal to the number of shares held by the shareholder times the number of positions up for voting. There is also a requirement for listed companies to have at least one third of their board composed of independent directors and such directors are involved in important decision such as major related party transactions and the appointment of accountants.

The Revised Securities Law and the Revised Company Law are designed to shake off the image of a policy market with low quality companies, poor corporate governance and plagued with fraud and corruption and
replace it with the image of a well regulated but free market that will salvage investors’ confidence.

C. The Significance of the Institutional Approach

To speed up the integration process, an institutional approach to the integration of the PRC and Hong Kong stock markets is explored and the role of H share rules and regulations as agents of integration is examined. Adopting an institutional approach to the integration of stock markets in an Asian context is a novel undertaking.

The Institutional Approach

In the past institutions were studied as formal, static organizations. The study of institutions was vitalized by innovative research conducted by March and Olsen in 1980s to be followed by the “new” institutionalist research in the field of European integration in the mid-nineties. The study of the institution as a dynamic and changing entity is still in its early stages especially in relation to historical and sociological institutionalism which takes a broader approach to institutions than the International Regime theorists. Under the international relations theory, the concern for culture and interests by historical and sociological institutionalism has also been shared by constructivists and followers of the English School and the concern for transnational and subnational actors by the institutionalists has also been shared by transnational and transgovernmental relations. All these international relations theories disagree with the intergovernmentalists who believe that integration can only be facilitated by governments. They further question governments as the only unitary actor and suggest an alternative for realists’ power politics.

The concept of globalization is now a well established one. However the concept of an institutionalist approach to examining large-scale international integration is fairly recent, and when it is adopted, it is usually
in the area of European integration. It is rare to employ concepts of institutionalism when examining integration issues in an Asian context, particularly when the integration being examined is integration of regional stock markets within a transnational rather than an international context. In the present study only two jurisdictions are focused on – Hong Kong and the PRC. Due to a complex, post-colonial background, these two jurisdictions are now, in a political context, somewhat paradoxically referred to as “one country, two systems.”

How can institutionalism throw light on two jurisdictions which take a completely different political and economic approach but which are, nevertheless, rooted in the same culture? This thesis cannot quantitatively answer this question since the integration of the two systems has not yet been completed (in other words, data cannot be collected for an event which has not occurred). However this thesis can normatively examine the complex legal and regulatory regimes in both jurisdictions and seek to assess the international climate.

D. Rationale for an Institutionalist Approach

The function of Institutions can be identified as follows:

- Institutions affect outcome; this is a core assumption made by all institutionalists.

- Spill-over Effect of Neo-functionalism: An institution is an agent and it may sometimes have its own agenda through an identification of new issues, proposed solutions and establishment of alliances (an institution will over a period of time strive both to legitimize itself by increasing

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its members and create a demand for its goods). As an agent, an institution often exploits their superior knowledge and experience to reach its goals (especially if the principals do not have a clear idea how certain action should be taken).

- Well-organized Mobilization and Positive Coercion: Institutions are useful for non-state actors and policy networks to unite in their support for norms and therefore mobilize and coerce decision-makers to change state policy.

- Efficient Decision-Making: Institutions are two-edged sword. Although institutions may act as a constraint especially on actors’ opportunity sets, it is at the same time liberating and enabling as they reduce the number of options available for the actors to consider and thus help them to act in complex environments.

- Favouring Gradual Rather than Radical Changes: Institutions being a two-edged sword also apply here. During time of crisis, institutions provide stability, not optimality but only when a new order stabilizes that society can return normal before optimization start again. According to historical institutionalists, institutional changes tend to be incremental rather than radical in a stable and settled society and over time, it will also be incremental-transformative (by transforming the character of the government). However the “stickiness” of institutions and longevity of prior structural arrangements may prove inefficient over a period of time as social changes may not be met with a

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87 Id. 4.
88 Id. 7.
89 Id. 32.
90 Id. 99.
91 Id. 100.
92 Id. 81 & 83.
corresponding evolution of the institutional framework. Further, institutions as "congealed" preferences can constrain other preferences and behaviour. Change in institutions is path-dependent as initial choices determine later developments i.e. once a particular pathway is chosen, alternatives tend to be ruled out afterwards.

- Shape Identities, Values and Preferences: An institution may help to achieve shared cultural and cognitive-based understandings may promote common actions while different understandings may act as a constraint. Nationally-rooted cultural features "establish a system of common reference" among actors, including their perception of the outside world, and they also establish a common identity rooted in both history and an anticipated future. Institutions supply identities and preferences which assist actors to define what they are, what they want and what is appropriate for them, thus reducing behavioural uncertainty, increasing successful co-ordination, facilitating social learning (by holding constant certain factors in the flow of events). Those who lack a strong party identification are more responsive to institutional incentives from the inside.

E. Applying Institutionalism

Institutions constitute actors and their interests. Actors in the integration of stock markets in Hong Kong and the PRC are:

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93 Id. 10.
94 Id. 41.
95 Id. 81.
96 Id. 3.
99 Id. 21.
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1. Governments

A government is not a unitary actor as it includes central and municipal governments. Politically being one country, both Hong Kong and the PRC are eager to cooperate with each other. Being the sovereign country, the PRC will have a better bargaining and agenda-setting power but being an international financial centre for some time, Hong Kong has much to offer and the PRC government also realizes its importance. Hong Kong has also close ties with Shenzhen and Guangdong Municipality Government due to its proximity and similar economic outlook.

Their interests are to ensure the success of the stock markets and avoid any systemic risks that may endanger their economies. The success of the stock markets depends on investors’ confidence in the stock markets which in turn depends on the corporate governance of the listed issuers.

2. Stock Exchanges

HKEx is profit-making company and is very active in promoting itself to the PRC. It has its own representative office in Beijing under CEPA. HKEx also held meetings with the Shanghai and Shenzhen Stock Markets especially related to technical and trading matters. When it comes to substantial rule and policy changes, HKEx has to take the matters to the CSRC as the stock markets in the PRC have few powers than HKEx (see Chapter I: Stock Markets in the PRC under Regulatory Agencies).

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3. Settlement and Clearing Houses

The concern of settlement and clearing houses are mainly commercial and technical but a high standard is imperative to avoid any systemic risks in the stock markets.

4. Regulators

There is fairly close cooperation between the CSRC in the PRC and the SFC in Hong Kong in terms of training and standard-setting. However, in terms of integration, enforcement issues are usually the stumbling block. It is difficult to envisage the two regulators to merge as they work under very difficult legal systems. For instance, the independence of judiciary in Hong Kong and the non-independence of judiciary in the PRC will create very different impression of the enforcement environments. However the objective is to create similar enforcement rules and standards in administrative, civil and criminal regimes and the regulators are particular concerned with the first one.

5. Financial Intermediaries

Utility maximization which is usually translated into profit maximization, better remuneration package and further career advancement is the main concern of securities firms, their brokers, solicitors and accountants. However they are also the frontline regulators and whistle-blowers for any illegal dealings through their own due diligence.

6. Interest Groups

Shareholder activism is not well developed in both Hong Kong and the PRC and their interests are mainly protected by laws and regulators and other actors in the stock markets.
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F. Existing International Organizations or Negotiation Channels

Existing negotiation channels and international organizations are organized along supranational, national, organization, professional lines\(^{101}\) and lines of specific interests:

- **Supranational:** Among different national states including Hong Kong and the PRC governments e.g. OCED and New York Convention

- **National:** Between PRC Government and Hong Kong Government e.g. CEPA and arbitration arrangement relating to H shares

- **Organizational:** Among bankers and settlement and clearing houses e.g. CLS System for cross-border foreign exchange transaction effective December 6, 2004; the linkage between HKD RTGS in Hong Kong and HKD RTGS in Shenzhen effective 12 December 2002; CPSS-BIS

- **Organizational:** Among regulating bodies e.g. IOSCO

- **Professional:** Among professional bodies of financial intermediaries e.g. IASB, IAASB

- **Interests:** Among interest groups and one of them is shareholders concern groups which are lacking in both Hong Kong and the PRC

\(^{101}\) Schneider & Aspinwall, *supra* note 86 at 14.
especially those that are strived to protect the interests of minority shareholders. David Webbs, one of the few who advocates shareholder activism in Hong Kong, has proposed the establishment of Hongkong Association of Minority Shareholders ("HAMS") which lobbies for better laws and regulations to protect investors, runs a Corporate Governance Ratings Division staffed by experienced lawyers, accountants and investment professionals and bring a quasi class action on behalf of aggrieved investors through HAMS Enforcement Division. The HAMS is proposed to be funded by a Good Governance Levy since all investors will benefit from good corporate governance. The Hong Kong government is required to propose a bill to be passed by the Legislative Council for this reason.\footnote{David Webbs, The HAMS Initiative: Representing & Activating Minority Shareholders at http://www.webb-site.com/articles/hams.htm (last updated: July 1, 2001).} Although HAMS is novel, it is well-thought out and it is one of the few suggestions that try to tackle the root problem\footnote{The root problem of securities market in Hong Kong is that companies are controlled by families and the interests of minority shareholders are frequently ignored.} inherent in the stock market in Hong Kong. By representing the shareholders, Webbs has also drafted responses to consultation papers published by the Hong Kong government or the stock markets. It is hoped that similar groups can spring up from the
PRC and Hong Kong as minority shareholders should also play a part in the negotiation and bargaining table.

International negotiation channels and international organizations may sometimes be cross-sectored:

- HKEx to the PRC Government (from a representative organization to a government) e.g. H share rules and regulations

- the Joint Forum is composed of representatives from banking, securities and insurance supervisory bodies. The Joint Forum ultimately resulted from an initiative of the Basel Committee seeking to promote cross-sector collaboration and a basic harmonization of supervisory rules between the international supervisory regulatory bodies for the banking, securities trading (IOSCO) and insurance (International Association of Insurance Supervisors) industries.

- the CPSS-IOSCO Joint Task Force on Securities Settlement Systems in December 1999 in line with efforts of the Financial Stability Forum to address vulnerabilities in the international financial system. The Task Force comprises 28 central bankers and securities regulators from 18 countries and regions and the European Union.

G. What Institutions to Establish for Further Integration?

Further integration can be facilitated along supranational, national, organizational, professional and subnational lines. It should be noted that cross-sectored negotiation is desirable as the stock markets will affect and be affected by different sectors of societies:
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- Supranational Line: both the PRC and Hong Kong governments should encourage its ministries and departments to participate in international organizations and communities.

- National Line: According to the Basic Law, Hong Kong will maintain its autonomy for fifty years from 1997. Hong Kong and the PRC will eventually become one system but any drastic changes may bring along undesirable effects if the economy and society are not prepared for it. It is time for Hong Kong and the PRC to start now and maintain close cooperation so that the two economic systems can draw closer to each other.

- Organizational Line: Regular meetings/fora between stock exchanges of Hong Kong and the PRC should be encouraged especially in relation to technical cooperation and assistance.

- Professional Line: Delegation and learning programmes should be encouraged among financial intermediaries. The Hong Kong and the PRC governments should establish formal venues or organizations for regular meetings of legal and technical groups under the stock exchanges and the governments.

- Subnational Line: Shareholders should understand the risks of the stock markets and how their interests can be better protected. Shareholder activism should be encouraged. It is hoped that more shareholders monitoring groups may be able to establish in the future.
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H. Committee Appointment, Legislative Proposal and the Proposed Institutional Framework

This thesis adopts a law-based approach. Laws include more than listing rules, securities and company laws as laws may be used to establish institutions. This thesis argues that institutions are potent and important forces not only to advocate integration but they also affect our values and shape our preferences.

Institutions take time to set up and too many changes enacted within a short period of time may cause confusion. This thesis proposes the establishment of institutional support in stages within an improved institutional framework. The improved institutional framework involves the establishment of institutions for policy deliberation and institutions for dealing with implementation and technical issues.

A policy making institution with clearly defined power and with a mission to investigate the possibility of integrating the stock markets of Hong Kong and the PRC is instrumental to integration. It should have powers to initiate policies and implement legislative decisions in the same way that the Council of European Union is able to. The first suggested stage of setting up this institutional framework would involve the creation of a Joint Capital Market Steering Committee with government representatives from the Central Policy Unit\textsuperscript{105}, the Financial Services and Treasury Bureau\textsuperscript{106}

\textsuperscript{104} See Methodology.

\textsuperscript{105} Central Policy Unit is a simple and flexible organization formed primarily by researchers to conduct policy research including researches affecting “cross bureaux” policies and it also assesses public opinions for government’s reference in decision-making. It has already established the Strategic Development Research Group under the Hong Kong Guangdong Cooperation Joint Conference with the CPU representing Hong Kong in collaboration with Guangdong organizations to initiate research in support of Hong Kong/Guangdong cooperation. The Central Policy Unit is therefore relevant in the discussion of stock market integration. See Central Policy Unit, About CPU at \url{http://www.cpu.gov.hk/english/index.htm} (last viewed on March 10, 2006). See Annex 5 for the government organizational chart in Hong Kong.

\textsuperscript{106} “The policy responsibility of the Financial Services Branch is to maintain and enhance Hong Kong’s status as a major international financial centre, ensuring through the provision of an appropriate economic and legal environment...” See Financial Services Branch, About Us – 282
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and the Beijing Office under the Chief Secretary for Administration\textsuperscript{107} and non-government representatives from the SFC with delegates from HKEx (on the Hong Kong side) and representatives from the Standing Committee of the NPC\textsuperscript{108} and State Council\textsuperscript{109} (with delegates from the CSRC and the two exchanges in the PRC all represented by the State Council). The Steering Committee should be headed by a reputable figure in the financial world independent of the Hong Kong and PRC governments. This Steering Committee would examine the reasons for harmonization of laws regarding the capital markets and how integration of the PRC and Hong Kong could be achieved.

The Steering Committee may suffer from being an unelected body without democratic legitimacy. It is therefore important that the Steering Committee is not only accountable to the Chief Executive in Hong Kong and the National People's Congress in the PRC but should also be accountable to the public by publishing its initiatives and carrying out public consultations. As regards public consultation, the establishment of an advisory body (for example, a PRC-HK Economic and Social Committee) similar to the European Economic and Social Committee is important as it would act as the sounding board for interest groups.

On the technical side, existing cooperation along professional lines should be strengthened and institutionalized. In terms of the frontline regulators, both the CSRC and SFC have relevant departments dealing with international cooperation. The SFC and the CSRC signed a memorandum of regulatory cooperation in June 1993 and later in July 1995, the latter

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\textsuperscript{107} Beijing Office means the office of HK government in Beijing and is therefore relevant to the liaison between the Hong Kong and the PRC governments.

\textsuperscript{108} NPC is the highest legislative and policy making organ in the PRC but it is composed of delegates elected from all over China, so the highest permanent policy making organ is the Standing Committee of the NPC.

\textsuperscript{109} See Annex 6 for a list of PRC government departments directly under the State Council.
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concerning futures transactions. As mentioned above, there were also
secondment and training programmes between the two departments.\textsuperscript{110} This
thesis proposes the establishment of a PRC-HK Regulatory Harmonization
Committee with representatives from the CSRC, Financial Services Branch
of the HK government and SFC with delegates from the HKEx and
Shanghai and Shenzhen Stock Exchanges. Under the Committee and based
on existing departments, the PRC-HK Regulatory Harmonization
Committee should include the following divisions: the PRC-HK
Cooperation Division\textsuperscript{111}, PRC-HK Legal Affairs Division\textsuperscript{112}, PRC-HK
Information Division\textsuperscript{113}, PRC-HK Research Division\textsuperscript{114} and PRC-HK
Technical Infrastructure Research Division.\textsuperscript{115}

Stock markets in the PRC have little say in policy making matters but there
needs to be greater cooperation between the PRC-HK stock markets
regarding technical matters so as to harmonize systems and trading
practices which will be beneficial to them in the long run even if

\textsuperscript{110} See Chapter 1, p. 90.

\textsuperscript{111} This Division should be under the Department of International Cooperation (CSRC),
Business Development – Beijing Representative Office (HKEx), Global Business
Development Department (Shanghai Stock Exchange), Strategy & International (Shenzhen
Stock Exchange), China Policy Team and International Policy Team under Chairman’s Office
about2_en.jsp} (viewed on March 10, 2006); HKEx, About HKEx – Organizational Chart at
\url{http://www.hkex.com.hk/exchange/org/org_chart.htm} (last updated February 3, 2006); SSF,
Organization Structure of the SSE at \url{http://www.sse.com.cn/sseoportal/en_web/yy/about/ys.shtml}
(last viewed on March 10, 2006); SZSE, Organization Structure at \url{http://www.szse.cn/main/
en/Catalog1377.asp} (last viewed March 10, 2006) and SFC, Organizational Structure at
\url{http://www.sfc.hk/sfc/html/EN/aboutsfc/structure/structure.html} (last updated September 30,
2005).

\textsuperscript{112} This Division should be under the Department of Legal Affairs (CSRC), Legal Services
(HKEx), Legal Affairs Department (Shanghai and Shenzhen Stock Exchanges), and Legal
Services (SFC).

\textsuperscript{113} This Division should be under the Information Centre (CSRC), Information Services
(HKEx), Information Centre (Shanghai Stock Exchange), Information Service (Shenzhen
Stock Exchange) and probably Research Department (SFC).

\textsuperscript{114} This Division should be under the Research Centre (CSRC), Research and Planning / Risk
Management (HKEx), Research Centre (Shanghai Stock Exchange), Research Institute
(Shenzhen Stock Exchange) and Research Department under Supervision of Markets (SFC).

\textsuperscript{115} This Division should be under the Research Centre (CSRC), Information Technology
(HKEx), Technology Centre (Shanghai Stock Exchange), System Operation (Shenzhen Stock
Exchange) and Information Technology (SFC).
integration does not take place. This thesis proposes the establishment of a PRC-HK Cross-trading Facilitation Committee for such purposes.

The proposed Steering Committee would support an inter-governmental approach with the proposed technical committees and the PRC-HK Advisory Committee reflecting the influence from the other decentralized international relations theories. The first stage of the proposed institutional framework is as follows:
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PEOPLE'S REPUBLIC OF CHINA

CROSS-BORDER COMMITTEES

HONG KONG

NPC

NPC Standing Committee

State Council

Economic and Social Advisory Commission

Joint Capital Market Steering Committee

headed by a reputable independent financial figure

PRC-HK Regulatory Harmonization Committee

PRC-HK Cooperation Division

PRC-HK Legal Affairs Division

PRC-HK Information Division

PRC-HK Research Division

PRC-HK Cross-Border Technical Infrastructure Division

SFC

HKEX

NPC Standing
Committee

Central Policy Unit

Chief Secretary for Administration

Beijing Office

Financial Secretary

Secretary for Financial Services

Financial Services and Treasury Bureau

CSRC

SSE

SZSE
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Under this proposed institutional framework, when the PRC and HK governments, in consultation with the public, are resolved to harmonize law and regulations regarding the capital markets in these two jurisdictions, further institutions could be established, as part of a second stage of institutional development, to enforce the policies and laws laid down by the Joint Capital Market Steering Committee and the PRC-HK Regulatory Harmonization Committee and to review its performance.

The second stage of institutional development would involve the setting up of three new committees. First, the setting up of a HK-PRC Judicial Committee for further judicial cooperation, similar to Eurojust. This would be effected by the Ministry of Justice in the PRC and the Department of Justice in Hong Kong. Such a Committee would facilitate mutual legal assistance and deal with extradition requests. It would also examine the possibility of the establishment of an MMT in the PRC which would be equivalent to the one in Hong Kong, and if this were found possible, the proposed Committee would also ensure close cooperation between the MMT in Hong Kong and in the PRC.

Secondly, the setting up of a Cross-Border Police Assistance Unit approved by the Ministry of Public Security in the PRC and Secretary of Security in Hong Kong to further cooperation between the public security officers in the PRC and the police in Hong Kong to tackle cross-border financial crimes. Its functions would be similar to Europol and OLAF.

Governmental administration should be regularly monitored and any discovered maladministration promptly dealt with; in Hong Kong there already exists an Office of the Ombudsman directly under the Chief Executive to deal with any such maladministration. The third proposed committee would be a committee established under the Ombudsman whose

116 An organization like the ECJ is desirable to deal with cross-border misconducts. However it seems to be a waste of public resources to create supranational court systems just for two jurisdictions in a certain area of legal practice. The suggestion of a unified MMT is a compromised suggestion as it will be easier to form as it is a tribunal and the jurisdiction of the MMT is more limited. Please see Annex 7 for the use of MMT as an instrument for market integration.
function would be specifically to deal with any maladministration uncovered in the following government committees: the Joint Capital Market Steering Committee, the PRC-HK Regulatory Harmonization Committee and any other government organizations dealing with cross-listing and cross-trading matters.

The establishment of a specific committee under the Hong Kong Ombudsmen and of an Ombudsman in the PRC would help to protect both Hong Kong and PRC investors by addressing public complaints involving government maladministration at an early stage. The Hong Kong committee under the Ombudsman together with the PRC Ombudsmen would serve a similar function to that of the European Ombudsman.

The four-level regulatory approach for the legislation of securities laws as suggested by Lamfalussy Report\(^\text{117}\) could therefore apply to the situation in Hong Kong and the PRC with slight modification. The policy making organ similar to the European Council would be the Joint Capital Market Steering Committee. This is the first level. In consultation with the Joint Capital Market Steering Committee, technical implementing measures could be drafted by the PRC-HK Regulatory Harmonization Committee in level 2. Level 3 is to ensure consistent and timely implementation of level 1 and 2 acts by the PRC-HK Cross-trading Facilitation Committee in consultation with the PRC-HK Regulatory Harmonization Committee. Finally at level 4, the Joint Capital Market Steering Committee, the HK-PRC Regulatory Harmonization Committee with the assistance from the MMT, the HKPRC Judicial Committee, the Cross-Border Police Assistance Unit and Ombudsmen should strengthen the enforcement of cross-border securities laws and regulations.

As the whole institutional framework may suffer from a lack of democratic legitimacy, the organizations should be accountable to the public through public consultation for a reasonable period of time and the involvement of

\(^{117}\) See Chapter IV, pp.202-3.
interest and professional groups in their decision making. The organizations should also uphold the principle of transparency by ensuring easy public access to their documents. It is essential that all institutions created should follow the principle of accountability and transparency.

I. Harmonization of Law and Four Models of Integration

This thesis has proposed four models of integration based on different degrees of law harmonization. Before examining the four models of proposed integration, it is important to revisit the concept of harmonization of law. Harmonization does not require the adoption of a single, model set of rules, but instead implies a wide range of ways in which differences in legal concepts in different jurisdictions are accommodated. In the present context, such accommodation can take place through meetings and negotiations between and within: governments, securities regulators, international organizations and academics. Harmonization results from conscious efforts to mediate differences between legal regimes rather than any one-sided imposition of conformity.

After reviewing the literature on the subject of harmonization of law, Professor Martin Boodman noted that "in a legal context harmonization is merely synonymous with the process of problem solving and is as infinite in its configurations as are potential problems in law" and found little analytical and theoretical use of this term. It is true that harmonization may be identical with the process of problem solving but since harmonization is not equivalent to standardization (although harmonization can also include

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118 A short discussion of harmonization of law can also be found under Chapter III (A).

119 Harmonization should not be taken as a synonym for homogenization. A system of separate jurisdictions applying harmonious laws should be able to simultaneously respect local differences. Stephen Zamora, NAFTA and the Harmonization of Domestic Legal Systems, 12 Ariz. J. Int'l & Comp. L. 401, 405 (Fall, 1995).

120 Id. 403.

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standardization), the extent of harmonization required to achieve the
desired result becomes a good analytical or theoretical tool for problem-
solving.

What are the optimal results from a harmonization of law? Harmonization
of law is, in itself, value neutral and justification of its desirability is
required. Harmonization of law is a big step forward in bringing about the
consolidation of stock markets in Hong Kong and the PRC. Arguments for
the desirability of consolidating the HK and PRC stock markets has been
discussed in more specific terms in Chapter 1. To recap the main
advantages of such a consolidation: it is potentially an efficient cost saving
scheme under which economies of scale can be achieved and greater
liquidity be generated by pooling order flow; attaining easier access to
more markets by both investors and issuers and lowering user costs by
sharing technological and legal costs. Arthur Rosett also points out,
"harmonization of results, that is, general consistency in substantive
outcomes, will allow those who engage in transactions a higher level of
confidence in a worldwide market." 122

To achieve the advantages of law harmonization, the EU has experimented
with different degree of harmonization. Lowest Common Denominator
(LCD) harmonization endeavours to identify areas of similarity and then
adopt standards which are commonly held by all of the member states. 123
The optimal harmonization or maximum approach, however, will
inevitably involve changes in the laws of member states to achieve newly
defined and desirable legal standards. 124 A third approach is known as
minimal harmonization which recognizes the value of attempting to
achieve a desirable standard, but also recognizes the desirability and

122 Arthur Rosett, Unification, Harmonization, Restatement, Codification, and Reform in

123 Louis F. Del Duca, Teachings of the European Community Experience for Developing
Regional Organizations, 11 DICK. J. INT'L L. 485, 498 (Spring, 1993)

124 Id.
importance of the retention of local options. To speed up the harmonization process, the EU readily embraced the concept of mutual recognition which was created out of the judicial process. The concept of mutual recognition has been discussed in detail in Chapter IV. Broadly speaking, it is a flexible concept that embodies both the concept of minimum harmonization and optimal or maximum harmonization.

The Four Models of Harmonization

The four models of law harmonization regarding the securities laws also reflect four stages of integration. Although all the modals are fundamentally law based and underpinned by the stock market, each has a different focus and is driven by different entities. Model 1 is stock exchange driven and law based, Model 2 is also primarily stock exchange driven and system based, Model 3 is government led and law based and Model 4 is an ideal model for full integration incorporating the three previous models.

1. H Share Model (“Model 1”)

Model 1, the H share model, is stock exchange driven and law based integration model involving the harmonization of the listing rules between the Hong Kong and PRC stock markets as a first step towards further law harmonization and market integration. This thesis has argued that harmonizing listing rules is an essential step towards the integration of the HK and PRC stock markets.

H share rules and regulations have been developed to enable PRC companies to be listed on the Hong Kong stock exchange. It is an attempt to harmonize listing rules between the two jurisdictions based on a method similar to mutual recognition used in the EU rather than the convergence approach adopted by the US. As explained in Chapter IV, mutual

\[123\] Id. 498-9.
recognition requires the national regulators to be “other-regarding”. 126 This means that national regulators have to recognize the regulatory history of the product or service and give due consideration to such information in determining their regulatory control over such product or service under their domestic rules. Mutual recognition became a search for “equivalence” by the regulators in the host countries among EU Member States. The philosophy behind the search is the acceptance of diversity, and the spirit of integration is to find equivalent standards rather than conformity. This is exactly what the Hong Kong stock exchange has done. H share rules and regulations have taken into consideration historical characteristics of PRC companies and have brought them up to international standards required by the Hong Kong stock market. This may sound like “convergence” as “convergence” of international standards for securities legislation must occur based on best practices and it is an attempt by the US to avoid a “race to the bottom”. In practice, however, convergence in the US sense of the word tends to require the other jurisdictions to live up to the US standard and therefore it may be regarded as the search for conformity among countries with similar regulatory standards and systems. This is not the situation between Hong Kong and the PRC as their regulatory systems are very different.

This thesis argues that H share rules and regulations can act as a blueprint for the harmonization of securities laws between Hong Kong and the PRC. Harmonization of laws in turn lays the foundation for the integration of stock markets in Hong Kong and the PRC. As discussed in Chapter II, H share listing rules have their own advantages and shortcomings. Other than all its merits and weaknesses, the scope of H share rules and regulations is limited, mainly covering the listing requirements and continuing obligations of the issuers which, when compared with the EU counterpart, is equivalent to the areas of laws covered by the Prospective Directive and Transparency Directive.

Further harmonization of law in the areas of Market Abuse Directive and New Investment Services Directive is required. A few principles can be deducted from our previous discussion of the Market Abuse and New Investment Services Directives in Chapter IV.

Under the Market Abuse Directive, it has been said that insider dealing legislation should be consistent with market manipulation legislation. Such legislations should be constantly updated as technological development will provide new incentives, means and opportunities for market abuse. There should be administrative, civil and criminal remedies available which serves different purposes. These include: administrative measures designed to help deal with market misconduct swiftly and are more appropriate for minor misconducts; civil remedies that can compensate aggrieved investors and which are the best remedies for any misconduct that may incur significant financial losses to individual investors so that they can recover their loss, and criminal remedies for serious offence that send a strong signal to the whole community to avoid any systemic risks. The problem with criminal remedies for crimes such as insider dealing is that they can be extremely difficult and complicated to prove and therefore instances of litigation on insider dealing are rare in all jurisdictions.

As far as financial intermediaries are concerned, CEPAs mainly cover mutual recognition of professional qualifications for individuals. CEPA II allows Hong Kong to set up joint venture future brokerages if its shareholding does not exceed 49%. For other securities firms, Hong Kong has to follow the Rules Governing the Establishment of Foreign invested Securities Companies as a result of the PRC’s accession to the WTO in which foreign securities firms can establish joint ventures (with foreign ownership less than 1/3) to engage (without Chinese intermediary) in

\[^{127}\text{The Rules were promulgated by the China Securities Regulatory Commission on 16 December 2002, effective 1 February 2003, r10.}\]
underwriting A shares, and in underwriting and trading B and H shares, as well as government and corporate debt.

When the PRC government decides that the time is suitable for the opening of the securities industries to foreign competition, the New Investment Directive can provide guidance for the further integration of the stock markets of Hong Kong and the PRC. Home country rule may be adopted for the authorization of the establishment of an investment firm. The risk sensitive approach adopted by the EU is sensible as different rules should be tailor-made for different financial activities in accordance with the risks they pose. As far as clearing and settlement is concerned, there should be equal access to central counterparty, clearing and settlement for all investment firms and they should be subjected to non-discriminatory, transparent and objective criteria. Efficient and effective out-of-court settlement should be encouraged for cross-border disputes and administrative sanctions have to be effective, proportionate and dissuasive. The party should always be given the right to appeal. They should also consider tapping into existing cross-border cooperation mechanisms like the Financial Services Complaints Network which follows the adversarial principle along with principles of independence, transparency, effectiveness, legality, liberty and representation.128

Chapter II explains that the principle and philosophy behind H shares is "equivalent compartmentalization" and concludes that if the same "equivalent compartmentalization" can be devised by the PRC companies for Hong Kong or foreign companies, the listing rules between the PRC and Hong Kong may then be harmonized. There will only be an incentive to do so if the PRC government abolishes foreign exchange control over capital accounts. However, it can be argued that if this is implemented and harmonization of rules does not take place, integration may not necessarily occur. Yet if harmonization of law takes place, it will create a level playing

field for Hong Kong and PRC investors and issuers and lays down a solid foundation for integration.

Relative Advantages and Disadvantages of Model 1

Advantages

a. Listing rules are essential to issuers and harmonized listing rules ensure the standards of listed issuers.

b. Harmonizing listing rules also imply harmonizing continuing obligations of the issuers which may provide sufficient protection to investors.

c. By harmonizing listing rules, dual listing can be made possible and streamlined. It also saves the cost of producing different documents to meet the various requirements of the listing rules from different stock exchanges. As far as the issuers are concerned, the secondary market is only important because it indicates how successful their companies are and it acts as a thermometer of the investors’ confidence in their companies. It may also be useful if they want to raise more capital by placement or spin-off. However the primary capital is usually of a more direct concern to the issuers and if they can raise capital simultaneously in different capital markets, it is more likely that their target proceeds will be achieved and it also enhances its profile in the jurisdiction it is listed in. That is the main reason why some companies prefer dual listing in more than one jurisdiction.

Disadvantages

a. The scope of harmonization under this model is rather limited if only listing rules are harmonized. To ensure that the integrated stock market works properly, trading rules, membership rules and securities laws
(especially regarding civil redress and criminal penalties) are equally important.

b. As a cost-saving device, harmonization of the clearing and settlement system is of paramount importance but it is not covered by the H share model.

2. System Harmonization Model ("Model 2")

Model 2, a primarily stock exchange driven and system based model of integration, involving harmonization of trading and operating systems in which consolidation is usually achieved through mergers, joint ventures and alliances. The main concern of the integrating stock markets is to minimize transaction costs and to ensure that the system continues to function properly and efficiently.

Model 2 is similar to the early stage business-driven Euronext model. Euronext was created from the merger of the former national cash and derivatives markets in Amsterdam, Brussels and Paris, and later Lisbon and also London (although only for derivative trading) with an aim to create a Pan-European \(^{129}\) order-driven \(^{130}\) capital market through merger and horizontal integration. Unlike the Frankfurt vertical silo model \(^{131}\) which is also adopted by Deutsche Börse SA, Euronext prefers a linkage which is based exclusively on listing/trading activity and increases its trade capture through cross-border integration.

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129 At the end of 2004, a total of 284 members were connected to Euronext’s cash markets. A total of 440 permits for cash trading access were provided to 208 active members in fourteen countries around Europe. See Euronext website at http://www.euronext.com/editorial/anchors/ wide/0.5371.1732.4525263.00.html (last viewed December 15, 2005)

130 Euronext is fully automated with an electronic central order book, automatic order matching, execution of different type of orders and full anonymity for orders and trade. See id.

131 A "vertical silo" model is one under which listing/trading/clearing and settlement services are provided by one entity or the same group of entities. See Appendix I: Significant Errors As Concerns Euronext available at http://europa.eu.int/comm/competition/general_info/securities/comments/euronext_appendix_1_en.pdf.
It seems that if the driving force for integration is based on business rather than politics, it will be more efficient and has a higher chance of succeeding. Common business interests among the participating members, such as increasing market share, draw the stock exchanges of Paris, Amsterdam, Belgium and Portugal together. Euronext NV, formed on September 22, 2000, is a holding company incorporated under Dutch Law that operates through local subsidiaries. In early 2002 the Euronext group further acquired the London International Financial Futures and Options Exchange ("LIFFE") and merged with the Portuguese exchange BVLP. Trading is centralized, and a uniform trading platform, the Paris Bourse's NSC (electronic) trading engine, is used, allowing a single trade price to be established. Cross-border transactions can be facilitated through this single trading platform, NSC, and cleared through a single system, Clearing 21®. Listing applicants are free to choose their point of entry to the market (Amsterdam, Brussels, Paris or Lisbon) and companies can select their trading venue from among participating exchanges. Apart from the harmonization of law, integration took place in three phases: 1) The first phrase took place between 2000 and 2002 and involved the consolidation of trading across four national markets; 2) The second phase, from 2002 to 2003, involved the consolidation of national clearinghouses from five different countries into a single clearinghouse, LCH.Clearnet. 132 3) The final phase, which began in 2001, involves the consolidation of settlement services in partnership with Euroclear. 133 By consolidation, Euronext has

132 In February 2001, Clearnet SA became the sole clearing house and central counterparty for markets operated by Euronext following the merger of the French, Belgian and Dutch clearing houses. In November 2003, Clearnet SA also became the sole clearing house for the Lisbon cash market. In June 2003, London Clearing House (LCH), UK's largest, member-owned clearing house, and Clearnet SA announced their intention to merge and the merger was completed on December 22, 2003. Under the merging agreement, Euronext remains the largest shareholder with a 41.5% stake, although its voting rights are limited to 24.9% and as such, Euronext is no longer regarded as the majority shareholder of LCH. Clearnet. The benefits predicted by LCH.Clearnet include: "economies of scale leading to reduce clearing fees charged to users over time; lower back offices costs; more efficient use of capital; facilitation of initial margin offsets; faster development of new products and services; and responsiveness to users." London Economics - DG Competition, Overview of EU25 Securities Trading, Clearing, Central Counterparties, and Securities Settlement - An Overview of Current Arrangements, February 2004.

133 The Euroclear System is operated by Euroclear Bank SA, a Belgian credit institution that was set up in 2000. Euroclear has developed a non-exclusive partnership with Euronext. France and the Netherlands employ the service of Euroclear France and Euroclear Nederland

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successfully reduced its trading fees by about 30% on equity and by 20% on equity derivatives. For instance, in cash trading activity, the average fee per trade was reduced from 1.60 euro in the third quarter of 2001 to 1.08 euro in the same period in 2004.\textsuperscript{134} As far as IPO was concerned, 9.4 billion euros were raised on Euronext's market in 2004, being the largest cash securities market in Europe by the quantity and the value of the trading proceeded through its central order book and by comparison, 9.4 billion euros is more than three times the amount raised on the HKSE.\textsuperscript{135}

Technology successfully facilitated this integration by creating identical platforms. Technology like the NSC trading system quickens integration but harmonization of rules takes a longer time to achieve and is an ongoing process. In the cash market, Euronext trading rules are harmonized using the Euronext Cash Markets Trading Manual and the Euronext Rules Book I. Euronext Rules Book I contains harmonized rules while Euronext Rules Book II addresses national rules for a particular country. Although Euronext now has a set of common trading rules and employs the same trading systems, initially each Euronext market had its own separate listing rules. The memorandum of understanding signed by the Euronext regulators on March 22, 2001\textsuperscript{136} provided a framework to further harmonize the listing and trading rules. The harmonization of the cash markets' rule book was only completed in February 2005.

Creating a single trading platform across several exchanges takes years to accomplish. It took Lisbon was almost two years to be successfully transferred to NSC Euronext's cash trading platform, accomplished in late

\textsuperscript{134} Europe China Information Centre, \textit{Euronext: The Gateway to Opportunities} at http://www.europechina.cn/gesdt-show.asp?id=299 (last viewed on Dec. 12, 2005).

\textsuperscript{135} See id.

\textsuperscript{136} Euronext at http://www.euronext.com/editorial/wide/0,5371,1732_4528690,00.html
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2003, and it was only in 2004 that it completed a four year project in which it migrated its markets to harmonized IT platforms for cash trading (NSC), derivatives (LIFFE CONNECT®) and clearing.

The Euronext fee structure was itself only harmonized in January 2004, four years after Euronext was established. At first shares were listed on the national markets and it was only on April 4, 2004 that Euronext launched the Eurolist, a single list for its cash markets across the geographical borders. Eurolist classified companies in alphabetical order and identified them on the basis of their market capitalization sorting them into three categories: A, for large caps (more than 1 billion euros), B, for mid caps (between the 150 million euros and 1 billion euros) and C, for small caps (less than 150 million euros).\(^{137}\) It was also on May 17, 2005 that Euronext launched Alternext, a less regulated market focused on the small and medium size enterprises both for the Euro Zone and internationally.\(^{138}\)

The creation of Euronext provides an example of minimum integration especially in the early stages. Operational rules were mostly standardized but not the listing rules. Harmonization started in the secondary market with the trading rules and then moved onto the primary market. The establishment of Euronext also illustrates how integration is an on-going process facilitated through a single trading platform. In its later stages of establishment it also shows that harmonization can be further achieved through a single clearing and settlement system with one or more entities.

As it continues to evolve, Euronext is becoming more integrated. As far as membership is concerned, one single membership is applicable. Common membership status regarding trading and/or clearing can be attained

\(^{137}\) Europe China Information Centre, Euronext: The Gateway to Opportunities at http://www.europechina.cn/egdt-show.asp?id=299 (last viewed on Dec. 12, 2005). Also see Euronext official website.

\(^{138}\) See id. Also see Euronext official website at http://www.euronext.com.
through automatic cross-membership based on the EU passport
notifications\textsuperscript{139} under the MiFID.

Although its activities are supervised by the enforcement agency in which
each market is located, the regulatory bodies of each jurisdiction work
closely together and as mentioned earlier, a memorandum of understanding
was signed among the participating authorities to form a chairmen’s
committee (composed of chairmen of each regulatory authorities) and a
steering committee (composed of representative from each regulatory
authorities) and there are regular meetings between the chairmen’s
committee and the management board of Euronext.\textsuperscript{140} The main regulators
are Autorité des Marchés Financiers (“AMF”) (after the merging of
Commission des Opérateurs de Bourse (“COB”) and Conseil des Marchés
Financiers (“CMF”) in 2003) (France), AFM (the Netherlands Authority
for Financial Markets, formerly known as STE) (the Netherlands),
Commission Bancaire, Financière et des Assurances (“CBFA”) (formerly
known as CBF) (Belgium) and Comissão do Mercado de Valores
Mobiliários (“CMVM”) (Securities Market Commission) (Portugal).

Three lessons can be derived from the Euronext experiences\textsuperscript{141}:

a. Even with a merger between exchanges, separate national identities of
the constituent exchanges can still be retained, or at least be separately
marketed, while creating a new trans-national institution;

b. Anticipated technological efficiencies through a merger such as the
single trading platform, can take several years to be realized;

\textsuperscript{139} Paul – François Dubroeucq, \textit{General Overview of Euronext} 12, IOSCO Conference

\textsuperscript{140} Annual Report of Euronext 2003, 174 available at \url{http://www.euronext.com/file/view/0.4245.1626_53424_368147802.00.pdf}.

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c. Technological aspects of a merger are comparatively quicker to implement than regulatory harmonization.

Relative Advantages and Disadvantages of Model 2

Advantages

a. System harmonization models such as Euronext are frequently driven by business interests and as a result the integration process is faster than the government driven Model 3.

b. Stock markets that participate in integration can retain national characteristics despite the harmonization effect and may therefore be more politically acceptable.

c. Stock markets that participate in integration will usually share a similar political, economic and cultural outlook and these similarities will maintain investors' confidence in cross-border sale and purchase of shares. Such similarities are also conducive to efficient law enforcement because similar political, economic and cultural backgrounds facilitate negotiation with and understanding among member bodies.

d. System harmonization sets out the correct series of procedures for successful market integration. This has been illustrated with reference to Euronext. Euronext illustrates the advantages of the system harmonization model by harmonizing the trading rules first and thus minimizing the disruption to trading brought about by the merger. By harmonizing trading rules secondary trading is facilitated and liquidity of the listed issuers is increased through rights issue, placement and spin-off. Following the harmonization of the trading rules, the second phase, as illustrated by Euronext, involves the launching of the single trading platform with NSC, followed by the harmonization of clearing
Chapter Five

and settlement systems and listing rules. Such a development sequence is practical and logical as it is not essential to harmonize all rules and laws at the very outset.

Disadvantages

a. If securities laws are not harmonized it will create systemic risks, a main cause of financial crises. This has been illustrated with reference to Euronext. It is not within the legal ambit of Euronext, being a privately run enterprise, to harmonize securities laws. However, securities laws especially in the area of market abuse need to be harmonized as market abuse may lead to systemic risks and it is usually one of the main causes of financial crises. However although the Euronext model does not tackle securities law issues, Euronext benefits from the initiatives made by the EU as the four participating stock exchanges are situated in the Member States of the EU. The EU Market Abuse Directive has laid down minimum standards to tackle the problem of market abuse.

b. Other than securities laws, system harmonization models do not cover harmonization of company law. The harmonization of company laws will guarantee the quality of the listed companies by standardizing the establishment, the operation and the demise of the companies and provides suitable safeguards against fraudulent activities. Without harmonization the standard of corporate governance cannot be guaranteed and as a result investors may suffer unnecessary losses.

c. A system harmonization model similar to Euronext cannot be directly applied to the Hong Kong and PRC stock markets. Hong Kong and the PRC share different political, economic and business outlooks. The Hong Kong and PRC governments may therefore need to contribute more to the integration process by standardizing legal practice, legal standards and legal enforcement in order to gain investor confidence in market consolidation.
Chapter Five

d. System harmonization through merging the Hong Kong and PRC stock markets is politically sensitive and potentially economically damaging. The PRC government is unlikely to relinquish control over its stock markets as it tends to be rather protective towards sensitive national industries. The potential merger may also potentially undermine the “One Country, Two Systems” policy. The Hong Kong stock market took a lot of time to build up its reputation and investor confidence may be adversely affected by a merger as investors may suspect that the PRC government will not be committed to maintaining the same high international standing achieved by the Hong Kong stock market and the PRC government may be too interventionist.

3. Mixed Harmonization and Mutual Recognition Model (“Model 3”)

Model Three, a government led and law based model is a government driven EU model based on law harmonization through mutual recognition and other harmonization concepts such as home country rule. Rules concerning listing, market misconducts and financial intermediaries are harmonized through a series of directives. Harmonization ranges from setting up minimum standards to full standardization. Such harmonization goes beyond the rule books of the stock exchanges and affects the securities and company laws of the Member States if they are adopted.

Due to the number of Member States involved, there is no centralized clearing and settlement system and supervision remains in the hands of the enforcement and supervisory agency in each Member States. The EU model is an example of partial integration. A full description of the EU model can be found in Chapter IV and Annex 8 shows a table comparing the directives in EU with the laws and regulations in Hong Kong and the PRC.

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142 See Chapter IV (4(e)) for a list of such directives.
Relative Advantages and Disadvantages of Model 3

Advantages

a. Governments can harmonize laws and regulations that are not within the power of the business entities. As this model involves government-to-government negotiation, individual governments may tackle harmonization of laws although business concerns may lobby for law amendments.

b. Government laws which are investor oriented rather than business oriented, can set the precedent for market standards. The Prospectus Directive provides an example as it sets a precedent for prospectus related requirements. The more the Member States there are, the more important maximum harmonization becomes. If too much deviation is allowed by each Member State, the whole system will become too complicated to be user friendly and it will minimize its usefulness. Such maximization is well-suited to the PRC-HK scenario as it only involves two jurisdictions.

c. Model 3 does not require mergers or consolidation. It only requires the harmonization of law so that cross-listing and cross-trading is possible. This option is politically more feasible than Model 2 and avoids any drastic changes in terms of control of the stock markets.

Disadvantages

a. Model 3 can be very time-consuming as it requires a much longer process of integration than Model 2, involving, as it does, cross-government negotiation and legislation. Furthermore, different governments may have their own self-interests. Political negotiation may result in lengthy discussions resulting in an only partially adequate solution. An example of this is the EU’s political tug-of-war over the Takeover Directive.
b. Model 3 can be problematic in that it can be difficult to reach agreement on the extent of harmonization. For example, as many countries are involved in the EU, some of them with different political, economic and cultural realities, it can be difficult to reach an agreement. The two Giovannini Reports has identified many hurdles for the harmonization of clearing and settlement systems in the EU but it has been difficult for the EU as a whole to agree to a strategy for overcoming them.

4. Full Harmonization Model ("Model 4")

Model Four is an ideal model for full integration incorporating the three previous models. Under this model, the following requirement should be fulfilled:

- listing rules including accounting standards are harmonized;
- there are common trading and operation rules;
- issuers are free to choose their point of market entry;
- single trading platform;
- centralized clearing and settlement system;
- mutual recognition of qualifications of financial intermediaries and single membership rules;
- common law enforcement agency

Relative Advantages and Disadvantages

The full integration model is the ideal model. The only problem with such a model is that it is almost impossible to achieve. Due to different political, social and cultural differences among different countries, harmonization of all the elements mentioned above would take a very long time to achieve if it could be achieved at all. However the model is useful as it categories and
Chapter Five

identifies different factors affecting the stock markets for further discussion and debate about how to proceed with market integration.

5. Legal Readiness of Hong Kong and the PRC Regarding the Four Models

The applicability of the four models mentioned above depends on the nature of the stock markets and the countries in which they are located. Hong Kong and the PRC involve only two jurisdictions (and one country). In many ways they are in a better position to consolidate than the EU Member States or even the four Euronext’s market places. The obstacle to consolidation lies mainly in the fact that Hong Kong and the PRC adopt very different approaches to the market mechanism (see the PRC Model and Hong Kong Model in Chapter 1) and their development histories also differ significantly (see Historical Background under the Introduction to the PRC Securities Market and Introduction to the Hong Kong Securities Market in Chapter 1).

<table>
<thead>
<tr>
<th>Models</th>
<th>Model 2</th>
<th>Model 3</th>
<th>Model 4</th>
<th>Hong Kong-PRC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Integration</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Harmonization of listing rules including the harmonization of accounting standards</td>
<td>✓ (adoption of IFRS\textsuperscript{143} and harmonization is an ongoing process)</td>
<td>Prospectus Directive and the use of IFRS\textsuperscript{144}</td>
<td>✓</td>
<td>One way only: H shares listing rules* (HK: IFRS but not in the PRC)\textsuperscript{145}</td>
</tr>
</tbody>
</table>


\textsuperscript{144} See Chapter III.

\textsuperscript{145} Hong Kong companies were required to adopt the IFRS at the beginning of 2005. All H share companies are also required to adopt the IFRS. Although the IFRS is not adopted in the
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<table>
<thead>
<tr>
<th>Integration</th>
<th>Models</th>
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<th>Model 3</th>
<th>Model 4</th>
<th>Hong Kong-PRC</th>
</tr>
</thead>
<tbody>
<tr>
<td>3. Harmonization of company law</td>
<td>X</td>
<td>A series of Company Law Directives, Takeover Directive and directives relating to financial disclosures</td>
<td>✓</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>4. Harmonization of trading and operational rules</td>
<td>✓</td>
<td>X (other than ensuring a high quality of execution by MiFID)</td>
<td>✓</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>5. Harmonization of trading systems</td>
<td>✓</td>
<td>X</td>
<td>✓</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>6. Single trading platform</td>
<td>✓</td>
<td>X</td>
<td>✓</td>
<td>X</td>
<td></td>
</tr>
</tbody>
</table>

PRC, formal talks on converging the PRC and IFRS will begin in October 2005. See Kelvin Wong, *Date Set for Accounting Rule Talks*, SCMP, June 19, 2005.
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<table>
<thead>
<tr>
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<th>Model 3</th>
<th>Model 4</th>
<th>Hong Kong-PRC</th>
</tr>
</thead>
<tbody>
<tr>
<td>7. Centralized and unified clearing and settlement system</td>
<td>✓</td>
<td>X</td>
<td>✓</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>8. Mutual recognition of qualifications of financial intermediaries (i.e. brokers and dealers, solicitors and accountants) and single membership rules</td>
<td>MiFID</td>
<td>MiFID (for investment firms only)</td>
<td>✓</td>
<td>For professionals only and not for investment firms</td>
<td></td>
</tr>
<tr>
<td>9. Issuers are free to their point of market entry</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>Foreign firms are not allowed to be listed on the stock exchanges in the PRC</td>
<td></td>
</tr>
<tr>
<td>10. Centralized enforcement agency</td>
<td>X (working together through MOU signed among them)</td>
<td>ECJ (and Europol, Eurojust and European Anti-Fraud Office (OLAF))</td>
<td>✓</td>
<td>x (other than arbitration for cross-border securities disputes)**</td>
<td></td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>Integration</th>
<th>Model 2</th>
<th>Model 3</th>
<th>Model 4</th>
<th>Hong Kong-PRC</th>
</tr>
</thead>
<tbody>
<tr>
<td>11. Merger or Consolidation</td>
<td>✓</td>
<td>X</td>
<td>X (not necessary)</td>
<td>X</td>
</tr>
</tbody>
</table>

Notes: * H share listing rules follow the principle of mutual recognition and, in this thesis, are termed "equivalent compartmentalization", as explained in Chapter II. Chapter II concludes by saying that H share listing rules can be used as a blueprint for law harmonization as soon as foreign companies are allowed to be listed on the PRC stock exchanges. If this can be achieved, Model I can then be applied, although strictly speaking, Model I is not an integration model, it is a stepping stone for further integration. At present, one of the problems of implementing further harmonization is the quality of potential issuers in the PRC. Only the best issuers in terms of size, growth potentials and profitability are encouraged to be listed on the Hong Kong stock market as H shares. However if the standards of H shares have to be applied across the board to all listed issuers in the PRC, not many PRC companies would qualify. In the interim period, Model I should apply and ultimately H share rules should apply to all companies leaving the small and medium size companies to be listed on special board like the SME board in Shenzhen. Such an SME board can also, over time, be integrated with the GEM board in Hong Kong using the H share rules under the GEM Listing Rules.

146 State-owned Assets Supervision and Administration Commission chairman Li Rongrong told the HKEx to keep up its regulatory standards and do not lower them for PRC enterprises as such standards will help the PRC companies to compete internationally. Any enterprises that do not meet the high disclosure and corporate governance standards will not be able to survive in the long term. See Enoch Yiu, Stay Strict on Listing, HKEx Told, SCMP, June 3, 2005.
The Euronext model shows that a centralized enforcement agency is not a prerequisite for integration of stock markets to take place. If a centralized enforcement agency cannot be established, the second best alternatives is to harmonize enforcement standards and practice through training and secondment programmes and regular talks and meetings between enforcement agencies in Hong Kong and the PRC. However law enforcement is an important issue despite the Euronext model as Hong Kong and the PRC are subject to different legal systems and the PRC law and law enforcement does not generally inspire investor confidence, doubts remaining in the competence, independence and impartiality of PRC law and enforcement. Reassurance is required for foreign investors to have confidence in the PRC markets. The arbitration provision of the H shares helps to reassure potential investors but arbitration is subject to a number of limitations as described in Annex 7.

Criminal offences need to be tried in the courts of Hong Kong or the PRC depending on their jurisdiction. Annex 7 suggests that a cross-border MMT and its appeal court can be established to adjudicate cases arising from the integrated stock markets. If it cannot be formed, at least the PRC can learn from establishing tribunals similar to the MMT in Hong Kong. The MMT functions like a specialized court with simplified procedures for civil action and such a tribunal is useful as financial misconduct tends to be complex and the judges need to understand the operation of the stock markets. A specialized court will allow the judges to develop expertise in adjudicating cases relating to financial complaints and market misconduct.

Cross-border cooperation can be facilitated by appropriate supranational organizations. Take the example of the EU, Europol is the European Union law enforcement organization.
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that assists the law enforcement authorities of Member States in their fight against serious organized crime and terrorism; Eurojust improves the co-ordination of investigations and prosecutions between competent authorities in the Member States and; OLAF is an independent organization within the European Commission that protects the interests of the European Union by fighting fraud, corruption and any other irregular activity, including misconduct within the European institutions. Cross-border problems relating to police investigation, legal assistance and specific cross-border misconduct that significantly increases systemic risks should be addressed by appropriate institutions.

Hong Kong and the PRC governments can also make use of existing cross-border cooperation mechanism similar to the Financial Services Complaints Network in the EU.

Points 4-7 are not yet integrated into the Hong Kong - PRC scenario but this thesis has pointed out in previous chapters that technically they are ready for integration. Points 8 and 10 have been discussed in full in Chapter III and Annex 7 respectively. Point 9 will be automatically overcome if integration of stock markets takes place.


148 See the official website of Eurojust at http://www.eurojust.eu.int/. It was established in 2002.


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J. Closing Comments – A New Beginning for Progressive Integration

Signs of the convergence between the Hong Kong and the PRC stock markets are readily identifiable: convergence of law is progressing with the promulgation of H share listing rules which have been a first attempt to harmonize listing requirements between the Hong Kong and PRC stock markets\(^{151}\); the PE ratios of A and H shares of the same listed companies are drawing ever closer\(^{152}\); segregation of shares in the PRC is being phased out\(^{153}\); capital account convertibility is being gradually implemented in the PRC\(^{154}\), investor protection in the capital market is being prioritized by the PRC government\(^{155}\) and in pursuit of this, the PRC government is showing a sustained willingness to adopt international standards similar to those in Hong Kong. Above all, the Hong Kong and the PRC economies are becoming increasingly interdependent.\(^{156}\)

Obstacles to the integration of the PRC and the Hong Kong stock markets are being lifted in stages despite the fact that no significant individual or organization has specifically advocated such integration or been made responsible for it. Although the most prevalent notion of market integration is through merger or acquisition, such as in the creation of the Euronext; it is not difficult to understand why both Hong Kong and the PRC governments are reluctant to pursue integration this way. Despite the fact that there is no legal impediment to the PRC government acquiring a

\(^{151}\) See Chapter II generally.

\(^{152}\) See Chapter I (Provisional Conclusion), footnote 1104 and Chapter V(H).

\(^{153}\) See this chapter (B) for the state share reform.

\(^{154}\) See Chapter III(C) and Chapter V(B).

\(^{155}\) See Chapter I(C(1)(a)), this chapter (A(1)(a) and B).

\(^{156}\) Hong Kong has been the largest investor in the PRC since the open door policy in 1979, see Lin Hong and Liu Bing, *The Impact of Asian Crisis on the Hong Kong’s Economy*, 1 Studies on Hong Kong and Macau 19, 21 (1998) (in Chinese) and Donald Tsang OBE JP, *The 1997-98 Budget Prelude*, address (Feb. 27, 1997) at http://www.info.gov.hk/fsfb/ebudget/budget97/eng/eprelude.htm. At the same time, the PRC is one of the largest investors in Hong Kong, only second to the UK, see Zhu Youlan, *Hong Kong’s China-funded Companies*, HONG KONG BUSINESS, Feb. 1998, 29.
majority shareholding in the Hong Kong stock market, it has exhibited no inclination to acquire such a shareholding as politically this would send out a signal hostile to the concept of “One Country, Two Systems”157. Any kind of direct PRC involvement in the operation of the Hong Kong stock market may also seriously undermine investor confidence, both locally and abroad, as most investors would be skeptical about the PRC government’s commitment to maintaining high international standards in the operation of a major world stock market. It would also be difficult for the Hong Kong stock market, as a listed company, to take over PRC stock markets. The PRC government tends to be protective of sensitive national sectors, such as key industrial and financial areas, and it is therefore highly unlikely that the PRC government would allow its stock markets to move out of its immediate control.

Merger and acquisition as a means of integrating the PRC and Hong Kong markets clearly present insuperable problems. There remains, however, a possible pathway to integration that is not so problematic, namely, through a harmonization of laws158 based on the EU model. This would allow the Hong Kong and PRC governments to retain immediate control of their own stock markets but at the same time permit them to enact laws and regulations that can converge cross-listing and cross-trading with minimum transaction costs. Modern technology, as discussed in Chapter I, is capable of making this technically possible.159

Legally, laws and regulations can be harmonized under operational principles such as mutual recognition or home country rule. Mutual recognition is a broad and flexible term and may have different meanings depending on its use and contexts. 160 It essentially advocates

157 See Introduction, for the concept of “One Country, Two Systems”.

158 See Chapter III (Section A) and Chapter V (Section I) for the discussion on harmonization of law.

159 See Chapter I (Section C(1)(c)).

160 See Chapter IV (Section B(3)).
comparability and equivalence (or a notion of "other-regarding").\textsuperscript{161} It could include other operational principles such as minimum harmonization, maximum harmonization and home country rule. It is important that if this concept is used during the process of integration, the exact meaning of the term should be clearly defined to avoid problems of legal uncertainty and miscommunication which have on occasion arisen within the European context.

One of the attractions of using the concept of "mutual recognition" is that it refers to a process of cross-identification and cross-validation of the exercise of jurisdictional powers rather than a single activity.\textsuperscript{162} Integration is a gradual process that may take many years to accomplish.\textsuperscript{163} In addition to this, it is recommended that certain revised institutional frameworks are considered\textsuperscript{164} based on the EU model\textsuperscript{165} in order to speed up such a process. The use of a number of strengthened institutions within a new framework can act as a catalyst for further integration. This has strong theoretical backing in international relations theories including functionalism, neo-functionalism, social constructivism, the English School, institutionalism and new institutionalism\textsuperscript{166}. If the relevant government institutions can be set up, the possibility of further integration of the PRC and the Hong Kong stock markets could be moved substantially closer.

Enhanced institutional support is essential because an improved institutional framework provides an independent and politically autonomous environment for efficient and effective policy formation and

\textsuperscript{161}See id.

\textsuperscript{162}GEORGE ALEXANDER WALKER, EUROPEAN BANKING LAW – POLICY AND PROGRAMME CONSTRUCTION 305-306 (British Institute of International and Comparative Law and the London Institute of International Banking, Finance and Development Law, 2005).

\textsuperscript{163}Please refer to the questions inspired by development law under Methodology and the attempts to answer such questions under Chapter IV(B(2)(g).

\textsuperscript{164}See Chapter V (Section II).

\textsuperscript{165}See Chapter IV (Section B(4)) for the discussion of the EU model.

\textsuperscript{166}See Chapter IV (Section B(2)) for a discussion of international relations theories.
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implementation, and for resolving technical issues free from undesirable
government interference.\textsuperscript{167}

PRC and Hong Kong stock markets have achieved substantial progress in
cross-listing through the use of H share. The benefit of a more substantial
and complete level of integration can still be realized. This will, however,
require some fundamental changes in current regulatory and political
thinking and policies. Hopefully this can still be achieved and both
economies merged into a new level of closer integration and cooperation.

\textsuperscript{167}Institutionalists define institutions as, "established rules, norms, and conventions," and they
believe that the establishment of institutions can mitigate the negative effects of anarchy by
reducing transaction costs, encouraging iteration, providing information, monitoring, issue-
linkage, and reputational benefits and thus promoting cooperation. See Samuel P.
(Winter, 2004)
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ANNEX 1: H Share Companies Listed on the Main Board and the GEM of the Hong Kong Stock Market by the End of 2004
(See Ch. II: Footnote 11)

Source: The following tables are compiled with the following sources:

- Stock Exchange Fact Books ("Fact Books") from 1994 to 2004;
- Fact Books dating back to 1999 available at the HKEx official website (last visited January 3, 2005) (the 1998 Fact Book was previously included on the site);
- The number of shares offered by each listed company before 1998 is extracted from the prospectuses of the relevant listed company.

*Note: (a) Hong Kong offer price (b) International offer price

(a) Main Board

<table>
<thead>
<tr>
<th>Listing Date (dd/mm/yy)</th>
<th>Company</th>
<th>Listing Method/ Business Sector</th>
<th>No. of Shares Offered</th>
<th>Offer Price* (HK$)</th>
<th>Funds Raised (HK$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>15/07/93</td>
<td>Tsingtao Brewery Co. Ltd.</td>
<td>Offer for subscription</td>
<td>317,600,000</td>
<td>2.8</td>
<td>889,280,000</td>
</tr>
<tr>
<td>26/07/93</td>
<td>Shanghai Petrochemical Co. Ltd.</td>
<td>Offer for subscription</td>
<td>1,680,000,000</td>
<td>1.74</td>
<td>2,654,400,000</td>
</tr>
</tbody>
</table>

1 Please note that as some information comes from different sources, the figures may not tally with each other but the differences are generally slight. Business sector information is not given for companies listed before 1997 in this table.

2 Information regarding the number of shares offered is not given in the 1997 Fact Book or in any other fact books prior to that date; information regarding "Business Sector" is not given in the 1996 Fact Book or any other fact books prior to that date.
<table>
<thead>
<tr>
<th>Listing Date (dd/mm/yy)</th>
<th>Company</th>
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<th>Offer Price* (HK$)</th>
<th>Funds Raised (HK$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>06/08/93</td>
<td>Guangzhou Shipyard International Co. Ltd.</td>
<td>Offer for subscription</td>
<td>145,000,000</td>
<td>2.08</td>
<td>301,600,000</td>
</tr>
<tr>
<td>06/08/93</td>
<td>Beiren Printing Machinery Holdings Ltd.</td>
<td>Offer for subscription</td>
<td>100,000,000</td>
<td>2.08</td>
<td>208,000,000</td>
</tr>
<tr>
<td>03/11/93</td>
<td>Maanshan Iron &amp; Steel Co. Ltd.</td>
<td>Offer for subscription</td>
<td>1,732,930,000</td>
<td>2.27</td>
<td>3,933,750,000</td>
</tr>
<tr>
<td>07/12/93</td>
<td>Kuming Machine Tool Co. Ltd.</td>
<td>Offer for subscription</td>
<td>65,000,000</td>
<td>1.98</td>
<td>128,700,000</td>
</tr>
<tr>
<td>29/03/94</td>
<td>Yizheng Chemical Fibre Co. Ltd.</td>
<td>Offer for subscription</td>
<td>1,000,000,000</td>
<td>2.38</td>
<td>2,380,000,000</td>
</tr>
<tr>
<td>17/05/94</td>
<td>Tianjin Bohai Chemical Industry (Group) Co. Ltd.</td>
<td>Offer for subscription</td>
<td>340,000,000</td>
<td>1.20</td>
<td>408,000,000</td>
</tr>
<tr>
<td>06/06/94</td>
<td>Dongfeng Electrical Machinery Co. Ltd.</td>
<td>Offer for subscription</td>
<td>170,000,000</td>
<td>2.83</td>
<td>481,100,000</td>
</tr>
<tr>
<td>08/07/94</td>
<td>Luoyang Glass Co. Ltd.</td>
<td>Offer for subscription</td>
<td>250,000,000</td>
<td>3.65</td>
<td>912,500,000</td>
</tr>
</tbody>
</table>

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## ANXEXES

<table>
<thead>
<tr>
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<th>Funds Raised (HK$)</th>
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</thead>
<tbody>
<tr>
<td>17/08/94</td>
<td>Qingling Motors Co. Ltd.</td>
<td>Offer for subscription</td>
<td>500,000,000</td>
<td>2.07</td>
<td>1,035,000,000</td>
</tr>
<tr>
<td>11/11/94</td>
<td>Shanghai Hai Xing Shipping Co. Ltd.</td>
<td>Offer for subscription</td>
<td>1,080,000,000</td>
<td>1.46</td>
<td>1,576,800,000</td>
</tr>
<tr>
<td>02/12/94</td>
<td>Zhenhai Refining &amp; Chemical Co. Ltd.</td>
<td>Offer for subscription</td>
<td>600,000,000</td>
<td>2.38</td>
<td>1,428,000,000</td>
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<td>13/12/94</td>
<td>Chengdu Tele Cable Co. Ltd.</td>
<td>Offer for subscription</td>
<td>160,000,000</td>
<td>2.80</td>
<td>448,000,000</td>
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<tr>
<td>16/12/94</td>
<td>Harbin Power Equipment Co. Ltd.</td>
<td>Offer for subscription</td>
<td>435,000,000</td>
<td>2.58</td>
<td>1,122,300,000</td>
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<tr>
<td>23/05/95</td>
<td>Jilin Chemical Industrial Co. Ltd.</td>
<td>Offer for subscription/Offer for placing</td>
<td>893,027,000</td>
<td>1.589 (a) 1.605 (b)</td>
<td>1,431,880,000</td>
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<td>06/07/95</td>
<td>Northeast Elec T&amp;T Machinery Mfg. Co. Ltd.</td>
<td>Offer for subscription/Offer for placing</td>
<td>247,950,000</td>
<td>1.80</td>
<td>446,310,000</td>
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<td>02/02/96</td>
<td>Jiangwei Textile Machinery Co. Ltd.</td>
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<td>160,000,000</td>
<td>1.29</td>
<td>233,230,000</td>
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Note: Offers for subscription: Offered through a public subscription process. Offers for placing: Offered through private placements to institutional investors.
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<tr>
<th>Listing Date (dd/mm/yy)</th>
<th>Company Name and Details</th>
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<td>02/05/96</td>
<td>Nanjing Panda Electronics Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing</td>
<td>242,000,000</td>
<td>2.13</td>
<td>515,460,000</td>
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<td>14/05/96</td>
<td>Guangshen Railway Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing</td>
<td>1,244,650,000</td>
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<td>633,832,920 (3,567,047,976)</td>
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<td>23/07/96</td>
<td>Guangdong Kelon Electrical Holdings Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing</td>
<td>201,352,000</td>
<td>3.67</td>
<td>738,961,840</td>
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<td>13/11/96</td>
<td>Anhui Expressway Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing</td>
<td>483,010,000</td>
<td>1.77</td>
<td>872,627,700</td>
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<td>31/12/96</td>
<td>Shandong Xinhua Pharm Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing</td>
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<td>273,000,000</td>
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<td>05/02/97</td>
<td>China Eastern Airlines Corp. Ltd.</td>
<td>Offer for subscription/ Offer for placing/ Consolidated enterprises</td>
<td>483,000,000 1,083,950,000</td>
<td>1.38 (a) 1.39 (b)</td>
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<td>12/03/97</td>
<td>Shenzhen Expressway Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing/ Industrials</td>
<td>747,500,000</td>
<td>2.20</td>
<td>1,644,500,000</td>
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<td>14/05/97</td>
<td>Beijing North Star Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing/ Properties</td>
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<td>2.40</td>
<td>1,696,848,000</td>
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<td>15/05/97</td>
<td>Zhejiang Expressway Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing/ Industrials</td>
<td>1,433,854,500</td>
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<td>3,412,573,710</td>
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<td>21/03/97</td>
<td>Beijing Datang Power Generation Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing/ Public utilities</td>
<td>1,430,669,000</td>
<td>2.52</td>
<td>3,605,285,880</td>
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<th>Listing Date (dd/mm/yy)</th>
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<td>12/06/97</td>
<td>Jiangxi Copper Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing/ Industrials</td>
<td>656,482,000</td>
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<td>1,674,029,100</td>
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<td>23/06/97</td>
<td>First Tractor Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing/ Industrials</td>
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<td>4.50</td>
<td>1,507,500,000</td>
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<td>25/06/97</td>
<td>Beijing Yanhua Petrochemical Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing/ Industrials</td>
<td>144,210,000 867,790,000</td>
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<td>253,809,600 1,544,666,200</td>
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<td>27/06/97</td>
<td>Jiangsu Expressway Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing/ Industrials</td>
<td>1,222,000,000</td>
<td>3.11</td>
<td>3,800,420,000</td>
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<td>24/07/97</td>
<td>Angang New Steel Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing/ Industrials</td>
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<td>1.63</td>
<td>1,450,700,000</td>
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<td>Listing Date (dd/mm/yy)</td>
<td>Company</td>
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<td>31/07/97</td>
<td>China Southern Airlines Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing/ Consolidated enterprises</td>
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<td>4.70 (a) 4.75 (b)</td>
<td>333,700,000 5,240,095,500</td>
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<td>29/09/97</td>
<td>CATIC Shenzhen Holdings Ltd.</td>
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<td>418,660,000</td>
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<td>Sichuan Expressway Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing/ Industrials</td>
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<td>17/10/97</td>
<td>Chongqing Iron &amp; Steel Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing/ Industrials</td>
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<td>707,844,240</td>
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<td>21/10/97</td>
<td>Anhui Conch Cement Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing/ Industrials</td>
<td>361,000,000</td>
<td>2.28</td>
<td>823,080,000</td>
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<td>30/10/97</td>
<td>Guangzhou Pharmaceutical Co. Ltd.</td>
<td>Offer for subscription/ Offer for placing/ Industrials</td>
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<td>1.65</td>
<td>362,835,000</td>
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<td>21/01/98</td>
<td>Huaneng Power Int'l Inc.</td>
<td>Introduction/ Utilities</td>
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<td>01/04/98</td>
<td>Yanzhou Coal Mining Co. Ltd.</td>
<td>Offer for subscription/ Industrials</td>
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<td>2.42 (a) 2.44 (b)</td>
<td>198,440,000 2,072,360,000</td>
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<td>30/06/99</td>
<td>Shangdong Int'l Power Development Co. Ltd. (1071)</td>
<td>Offer for subscription/ Offer for placing/ Utilities</td>
<td>64,678,000 1,366,350,000</td>
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<td>102,191,240 2,158,833,000</td>
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<td>05/08/99</td>
<td>Great Wall Technology Co. Ltd. (0074)</td>
<td>Offer for subscription/ Offer for placing/ Industrials</td>
<td>142,222,000 266,662,000</td>
<td>3.15 (a) 3.15 (b)</td>
<td>447,999,300 839,985,300</td>
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<th>Company</th>
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<th>Offer Price* (HK$)</th>
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<tr>
<td>16/12/99</td>
<td>Shenyang Public Utility Holdings Co. Ltd. (0747)</td>
<td>Offer for subscription/ Offer for placing/ Utilities</td>
<td>90,300,000 330,100,000</td>
<td>1.70 (a) 1.70 (b)</td>
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<td>01/02/00</td>
<td>Beijing Capital International Airport Co. Ltd. (0694)</td>
<td>Offer for subscription/ Offer for placing/ Consolidated enterprises</td>
<td>26,470,000 935,450,000 384,230,000</td>
<td>1.87 (a) 1.87 (b) 2.4497 (b)</td>
<td>49,498,900 1,749,291,500 941,248,231</td>
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<tr>
<td>07/04/00</td>
<td>PetroChina Co. Ltd. (0857)</td>
<td>Offer for subscription/ Offer for placing/ Miscellaneous</td>
<td>879,122,000 16,703,296,000</td>
<td>1.27 (a) 1.27 (b)</td>
<td>1,116,484,940 21,213,185,920</td>
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<td>19/10/00</td>
<td>China Petroleum &amp; Chemical Corporation (0386)</td>
<td>Offer for subscription/ Offer for placing/ Industrials</td>
<td>839,024,000 15,941,464,000</td>
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<td>07/02/01</td>
<td>Travelsky Technology Ltd. (0696)</td>
<td>Offer for subscription/ Offer for placing/ Consolidated enterprises</td>
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<td>4.10 (a) 4.10 (b)</td>
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<td>Offer Price* (HK$)</td>
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<td>10/12/01</td>
<td>Zhejiang Glass Co. Ltd. (0739)</td>
<td>Offer for subscription/Offer for placing/Industrials</td>
<td>85,000,000&lt;br&gt;93,713,000</td>
<td>2.96 (a)&lt;br&gt;2.96 (b)</td>
<td>251,600,000&lt;br&gt;277,390,480</td>
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<tr>
<td>12/12/01</td>
<td>Aluminium Corporation of China Ltd. (2600)</td>
<td>Offer for subscription/Offer for placing/Offer for sale/Offer for placing/Industrials</td>
<td>235,294,000&lt;br&gt;249,989,815&lt;br&gt;2,264,605,553</td>
<td>1.37 (a)&lt;br&gt;1.37 (b)</td>
<td>354,588,880&lt;br&gt;3,191,294,440</td>
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<td>BYD Co. Ltd. (1211)</td>
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<td>15/11/02</td>
<td>China Telecom Corporation (0728)</td>
<td>Offer for subscription/Offer for sale/Offer for placing/Consolidated enterprises</td>
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<td>Hainan Meilon Airport Co. Ltd. (0357)</td>
<td>Offer for subscription/Offer for sale/Offer for placing/Consolidated</td>
<td>16,470,000&lt;br&gt;3,700,000&lt;br&gt;206,743,000</td>
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<td>20/11/02</td>
<td>China Oilfield Services Ltd. (2883)</td>
<td>Offer for subscription/ Offer for sale/ Offer for placing/ Industrials</td>
<td>400,396,000 139,532,000 994,924,000</td>
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<td>672,665,280 1,905,886,080</td>
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<td>13/02/03</td>
<td>Sinotrans Ltd. (0698)</td>
<td>Offer for subscription/ Offer for sale/ Offer for placing/ Consolidated enterprises</td>
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<td>Beijing Capital Land Ltd. (2868)</td>
<td>Offer for subscription/ Offer for sale/ Offer for placing/ Properties</td>
<td>56,464,000 51,330,000 456,836,000</td>
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<td>Lianhua Supermarket Holding Co. Ltd. (0980)</td>
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<td>30/10/03 AviChina Industry &amp; Technology Co. Ltd. (2357)</td>
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<td>18/12/03</td>
<td>China Life Insurance Company Ltd. (2628)</td>
<td>Offer for subscription/ Offer for sale/ Offer for placing/ Finance</td>
<td>1,294,118,000 676,470,000 5,470,587,000</td>
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<td>4,645,883,620 22,067,934,630</td>
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<td>Fujian Zijin Mining Industry Co. Ltd. (2899)</td>
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<td>Shanghai Forte Land Co. Ltd.</td>
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<td>Weichai Power Co. Ltd.</td>
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<td>China Shipping Container Lines Co. Ltd.</td>
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<td>Ping An Insurance (Group) Co. of China Ltd.</td>
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<td>ZTE Corporation</td>
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<td>Air China Ltd.</td>
<td>Offer for subscription/ Offer for sale/ Offer for placing/ Consolidated Enterprises</td>
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<td>9,615,070,000</td>
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<td>20.12/04</td>
<td>IRICO Group Electronics Co. Ltd.</td>
<td>Offer for subscription/ Offer for sale/ Offer for placing/ Industrials</td>
<td>48,530,000 44,120,000 392,644,000</td>
<td>1.58</td>
<td>766,760,000</td>
</tr>
<tr>
<td>Listing Date (dd/mm/yy)</td>
<td>Company</td>
<td>Listing Method/ Business Sector</td>
<td>No. of Shares Offered</td>
<td>Offer Price* (HK$)</td>
<td>Funds Raised (HK$)</td>
</tr>
<tr>
<td>------------------------</td>
<td>---------</td>
<td>---------------------------------</td>
<td>-----------------------</td>
<td>-------------------</td>
<td>-------------------</td>
</tr>
<tr>
<td>22/12/04</td>
<td>Beijing Media Corporation Ltd.</td>
<td>Offer for subscription/ Offer for sale/ Offer for placing/ Consolidated Enterprises</td>
<td>23,870,000 4,991,000 26,040,000</td>
<td>1.42</td>
<td>1,040,370,000</td>
</tr>
</tbody>
</table>
### ANNEXES

**Note:** (a) Hong Kong Offers  
(b) International Offers  

### (b) GEM

<table>
<thead>
<tr>
<th>Listing Date (dd/mm/yy)</th>
<th>Company</th>
<th>Listing</th>
<th>No. of Shares Offered</th>
<th>Offer Price (HK$)</th>
<th>Funds Raised (HK$) (in million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>27/07/00</td>
<td>Beijing Beida Jade Bird Universal Sci-Tech Co. Ltd.</td>
<td>Offer for 26,400,000 placing/ IC software design</td>
<td>11.00</td>
<td>290.40</td>
<td></td>
</tr>
<tr>
<td>04/08/00</td>
<td>Shanghai Fudan Microelectronics Co. Ltd.</td>
<td>Offer for 143,750,000 placing/ IC software design</td>
<td>0.80</td>
<td>115.00</td>
<td></td>
</tr>
<tr>
<td>31/10/00</td>
<td>Tong Ran Tang Technologies Co. Ltd.</td>
<td>Offer for 72,800,000 placing/ Pharmaceutical</td>
<td>3.28</td>
<td>238.78</td>
<td></td>
</tr>
<tr>
<td>30/03/01</td>
<td>Changdu Top Sci-Tech Co. Ltd.</td>
<td>Offer for 169,000,000 placing/ Enterprise software</td>
<td>0.72</td>
<td>121.68</td>
<td></td>
</tr>
<tr>
<td>24/04/01</td>
<td>Jiangsu Nandasoft Co. Ltd.</td>
<td>Offer for 234,000,000 placing/ Enterprise software</td>
<td>0.36</td>
<td>84.24</td>
<td></td>
</tr>
<tr>
<td>24/05/01</td>
<td>Jilin Province Huinan Changlong Biopharmacy Co. Ltd.</td>
<td>Offer for 172,500,000 placing/ Pharmaceutical</td>
<td>0.50</td>
<td>86.25</td>
<td></td>
</tr>
</tbody>
</table>

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### Listing Details

<table>
<thead>
<tr>
<th>Listing Date (dd/mm/yy)</th>
<th>Company</th>
<th>Listing Method/ Business Sector</th>
<th>No. of Shares Offered</th>
<th>Offer Price (HK$)</th>
<th>Funds Raised (HK$) (in million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>18/12/01</td>
<td>Mudan Automobile Shares Co. Ltd.</td>
<td>Offer for 7,700,000 subscription/</td>
<td>1.13</td>
<td>100.06</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Offer for 80,850,000 placing/ Automobile</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21/12/01</td>
<td>Capinfo Co. Ltd.</td>
<td>Offer for sale/ 70,408,909</td>
<td>0.48</td>
<td>371.76</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Offer for 704,089,091 placing/ Internet solution</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>28/02/02</td>
<td>Northeast Tiger Pharmaceutical Co. Ltd.</td>
<td>Offer for 207,000,000 placing/ Pharmaceutical</td>
<td>0.26</td>
<td>53.82</td>
<td></td>
</tr>
<tr>
<td>03/05/02</td>
<td>Zheda Lande Scitech Ltd.</td>
<td>Offer for 112,125,000 placing/ Telecom solutions</td>
<td>0.83</td>
<td>93.06</td>
<td></td>
</tr>
<tr>
<td>18/06/02</td>
<td>Tianjin TEDA Biomedical Engineering Co. Ltd.</td>
<td>Offer for 100,000,000 placing/ Medical &amp; health</td>
<td>0.98</td>
<td>98.00</td>
<td></td>
</tr>
<tr>
<td>28/06/02</td>
<td>Changchun Da Xing Pharmaceutical Co. Ltd.</td>
<td>Offer for 161,000,000 placing/ Pharmaceutical</td>
<td>0.45</td>
<td>72.45</td>
<td></td>
</tr>
<tr>
<td>28/06/02</td>
<td>Changmao Biochemical Engineering Co.</td>
<td>Offer for 183,700,000 placing/ Chemical</td>
<td>0.55</td>
<td>101.04</td>
<td></td>
</tr>
</tbody>
</table>
### ANNEXES

<table>
<thead>
<tr>
<th>Listing Date (dd/mm/yy)</th>
<th>Company</th>
<th>Listing Method/ Business Sector</th>
<th>No. of Shares Offered</th>
<th>Offer Price (HK$)</th>
<th>Funds Raised (HK$) (in million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>31/07/02</td>
<td>Shanghai Jiaoda Withub Information Industrial Co. Ltd.</td>
<td>Offer for sale/ System developer</td>
<td>12,000,000</td>
<td>0.66</td>
<td>87.12</td>
</tr>
<tr>
<td>13/08/02</td>
<td>Shanghai Fudan-Zhangjiang Bio-Pharmaceutical Co. Ltd.</td>
<td>Offer for sale/ Place/ Pharmaceutical</td>
<td>18,000,000</td>
<td>0.80</td>
<td>158.40</td>
</tr>
<tr>
<td>07/10/02</td>
<td>Launch Tech Co. Ltd.</td>
<td>Offer for sale/ Automobile related service</td>
<td>110,000,000</td>
<td>0.72</td>
<td>79.20</td>
</tr>
<tr>
<td>29/10/02</td>
<td>Zhengzhou Gas Co. Ltd.</td>
<td>Offer for sale/ Place/ Energy</td>
<td>50,000,000</td>
<td>0.25</td>
<td>137.67</td>
</tr>
<tr>
<td>08/11/02</td>
<td>Zhejiang Yonglong Enterprises Co. Ltd.</td>
<td>Offer for sale/ Textile</td>
<td>250,000,000</td>
<td>0.26</td>
<td>65.00</td>
</tr>
<tr>
<td>Listing Date (dd/mm/yy)</td>
<td>Company</td>
<td>Listing Method/ Business Sector</td>
<td>No. of Shares Offered</td>
<td>Offer Price (HK$)</td>
<td>Funds Raised (HK$ (in million))</td>
</tr>
<tr>
<td>------------------------</td>
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<td>------------------------</td>
<td>------------------</td>
<td>-------------------------------</td>
</tr>
<tr>
<td>12/12/02</td>
<td>CCID Consulting Co. Ltd.</td>
<td>Offer for sale/ Consulting services for IT industry</td>
<td>19,000,000</td>
<td>0.25</td>
<td>52.25</td>
</tr>
<tr>
<td>12/12/02</td>
<td>Powerleader Science &amp; Technology Co. Ltd.</td>
<td>Offer for placing/ Server solution provider</td>
<td>220,000,000</td>
<td>0.28</td>
<td>61.60</td>
</tr>
<tr>
<td>29/01/03</td>
<td>Shenzhen Dongjiang Environmental Co. Ltd.</td>
<td>Offer for sale/ Environmental protection</td>
<td>177,900,000</td>
<td>0.34</td>
<td>60.13</td>
</tr>
<tr>
<td>22/04/03</td>
<td>Yantai North Andre Juice Co. Ltd.</td>
<td>Offer for placing/ Production and sale of juice</td>
<td>38,000,000</td>
<td>3.70</td>
<td>140.60</td>
</tr>
<tr>
<td>03/07/03</td>
<td>Shaanxi Northwest New Technology Industry Co. Ltd.</td>
<td>Offer for placing/ Energy Products</td>
<td>230,000,000</td>
<td>0.25</td>
<td>57.50</td>
</tr>
<tr>
<td>Listing Date (dd/mm/yy)</td>
<td>Company</td>
<td>Listing Method/ Business Sector</td>
<td>No. of Shares Offered</td>
<td>Offer Price (HK$)</td>
<td>Funds Raised (HK$) (in million)</td>
</tr>
<tr>
<td>------------------------</td>
<td>---------</td>
<td>---------------------------------</td>
<td>------------------------</td>
<td>------------------</td>
<td>-------------------------------</td>
</tr>
<tr>
<td>10/10/03</td>
<td>Shenzhen EVOC Intelligent Technology Co. Ltd.</td>
<td>Offer for placing/ EIP Provider</td>
<td>116,800,000</td>
<td>0.90</td>
<td>105.12</td>
</tr>
<tr>
<td>05/11/2003</td>
<td>Xi'an Haitian Antenna Technologies Co. Ltd.</td>
<td>Offer for sale/ Antenna provider</td>
<td>161,764,706</td>
<td>0.68</td>
<td>110.00</td>
</tr>
<tr>
<td>13/11/03</td>
<td>Nanjing Dahe Outdoor Media Co. Ltd.</td>
<td>Offer for placing/ Advertising</td>
<td>250,000,000</td>
<td>0.53</td>
<td>132.50</td>
</tr>
<tr>
<td>14/11/03</td>
<td>Ningbo Yidong Electronic Co. Ltd.</td>
<td>Offer for placing/ Controller systems</td>
<td>130,000,000</td>
<td>0.50</td>
<td>65.00</td>
</tr>
<tr>
<td>21/11/03</td>
<td>Wumart Stores, Inc.</td>
<td>Offer for placing/ Retail chain store</td>
<td>87,952,000</td>
<td>6.22</td>
<td>547.06</td>
</tr>
</tbody>
</table>
## ANNEXES

<table>
<thead>
<tr>
<th>Listing Date (dd/mm/yy)</th>
<th>Company</th>
<th>Listing Method/ Business Sector</th>
<th>No. of Shares Offered</th>
<th>Offer Price (HK$)</th>
<th>Funds Raised (HK$) (in million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>09/01/04</td>
<td>Tianjin Tianlian Public Utilities Co. Ltd.</td>
<td>Offer for 330,000,000 placing/ Energy</td>
<td>0.25</td>
<td>82.50</td>
<td></td>
</tr>
<tr>
<td>18/02/04</td>
<td>Zhejiang Prospect Co. Ltd.</td>
<td>Offer for 23,000,000 placing/ Automotive parts &amp; components</td>
<td>1.33</td>
<td>30.59</td>
<td></td>
</tr>
<tr>
<td>27/02/04</td>
<td>Shangdong Weigao Group Medical Polymer Co. Ltd.</td>
<td>Offer for 264,500,000 placing/ Medical equipment</td>
<td>0.62</td>
<td>163.99</td>
<td></td>
</tr>
<tr>
<td>15/04/04</td>
<td>Shangdong Molong Petroleum Machinery Co. Ltd.</td>
<td>Offer for 27,656,000 subscription/ 3,278,000 Offer for 107,342,000 saleplacing/ Petroleum Machine</td>
<td>0.70</td>
<td>96.79</td>
<td></td>
</tr>
<tr>
<td>09/06/04</td>
<td>Nanjing Sample Technology Co. Ltd.</td>
<td>Offer for sale/ 900,000 placing/ Video Security System Solutions</td>
<td>4.15</td>
<td>84.66</td>
<td></td>
</tr>
</tbody>
</table>
## ANNEXES

<table>
<thead>
<tr>
<th>Listing Date (dd/mm/yy)</th>
<th>Company</th>
<th>Listing Method/ Business Sector</th>
<th>No. of Shares Offered</th>
<th>Offer Price (HK$)</th>
<th>Funds Raised (HK$) (in million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>30/06/04</td>
<td>Shanghai Qingpu Fire-Fighting Equipment Co. Ltd.</td>
<td>Offer for subscription/ Fire Fighting Equipment</td>
<td>5,556,000</td>
<td>0.54</td>
<td>30.00</td>
</tr>
<tr>
<td>07/07/04</td>
<td>Shenzhen Mingwah Aohan High Technology Corporation Ltd.</td>
<td>Offer for sale/ placing/ Non-IC Cards &amp; IC Cards</td>
<td>18,200,000</td>
<td>0.28</td>
<td>56.06</td>
</tr>
<tr>
<td>13/07/04</td>
<td>Sanmenxia Tianyuan Aluminum Co. Ltd.</td>
<td>Offer for sale/ placing/ Aluminum Industry</td>
<td>18,200,000</td>
<td>0.30</td>
<td>105.01</td>
</tr>
</tbody>
</table>
ANNEX 2: Nine Regulated Activities under the SFO in Hong Kong
(Ch. III: Footnote 35)

The nine regulated activities are as follows:\(^1\):

<table>
<thead>
<tr>
<th>Type</th>
<th>Regulated Activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type 1</td>
<td>Dealing in securities</td>
</tr>
<tr>
<td>Type 2</td>
<td>Dealings in futures contracts</td>
</tr>
<tr>
<td>Type 3</td>
<td>Leverage foreign exchange trading</td>
</tr>
<tr>
<td>Type 4</td>
<td>Advising on securities</td>
</tr>
<tr>
<td>Type 5</td>
<td>Advising on futures contracts</td>
</tr>
<tr>
<td>Type 6</td>
<td>Advising on corporate finance</td>
</tr>
<tr>
<td>Type 7</td>
<td>Providing automated trading services</td>
</tr>
<tr>
<td>Type 8</td>
<td>Securities margin financing</td>
</tr>
<tr>
<td>Type 9</td>
<td>Asset management</td>
</tr>
</tbody>
</table>

As securities practitioner qualifications are slightly different between representative (general practitioners in the PRC) and responsible officers

---

(senior management personnel in the PRC), the following mapping table shows the corresponding terms used in Hong Kong and the PRC:\(^2\):

<table>
<thead>
<tr>
<th>Hong Kong licence type</th>
<th>PRC practicing qualification</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Representative</strong></td>
<td>Securities general practicing qualification</td>
</tr>
<tr>
<td>- dealing in securities</td>
<td>- securities dealing</td>
</tr>
<tr>
<td>- advising on securities</td>
<td>- securities investment analysis</td>
</tr>
<tr>
<td>- advising on corporate finance</td>
<td>- securities insurance and underwriting</td>
</tr>
<tr>
<td>- asset management</td>
<td>- securities investment funds</td>
</tr>
<tr>
<td><strong>Representative</strong></td>
<td>Futures general practicing qualification</td>
</tr>
<tr>
<td>- dealing in futures contracts</td>
<td>- futures</td>
</tr>
<tr>
<td>- advising on futures contracts</td>
<td>- futures</td>
</tr>
<tr>
<td><strong>Responsible officer</strong></td>
<td>Securities senior management personnel practicing qualification</td>
</tr>
<tr>
<td>- dealing in securities</td>
<td>- securities dealing</td>
</tr>
<tr>
<td>- advising on securities</td>
<td>- securities investment analysis</td>
</tr>
<tr>
<td>- advising on corporate finance</td>
<td>- securities insurance and underwriting</td>
</tr>
<tr>
<td>- asset management</td>
<td>- securities investment funds</td>
</tr>
<tr>
<td><strong>Responsible officer</strong></td>
<td>Securities senior management personnel practicing qualification</td>
</tr>
<tr>
<td>- dealing in futures contracts</td>
<td>- futures</td>
</tr>
<tr>
<td>- advising on futures contracts</td>
<td>- futures</td>
</tr>
</tbody>
</table>

ANNEXES

ANNEX 3: Giovannini Barriers
(Ch. IV: Footnote 366)


Technical Requirements/Market Practices

- Diversity of IT platforms/interfaces
- Needs to maintain multiple membership of settlement systems
- National differences in rules governing corporate actions
- Differences in the availability/timing of intra-day settlement finality
- Impediments to remote access
- National differences in settlement periods
- National differences in operating hours/settlement deadlines
- National differences in securities issuance practice
- Restriction on the location of securities
- Restriction on the activity of primary dealers and market-makers

Taxation
Annexes

- Withholding tax procedures disadvantaging foreign intermediaries
- Tax collection functionality integrated into settlement system

Legal Certainty

- National differences in the legal treatment of securities
- National differences in the legal treatment of bilateral netting
- Uneven application of conflict of law rules
ANNEXES

ANNEX 4: CPSS-IOSCO Technical Committee Recommendations for Central Counterparties
Ch. IV: Footnote 368

Source: CPSS-IOSCO Technical Committee Recommendations for Central Counterparties (CCPs) at IOSCO website (http://www.iiosco.org/library/pubdocs/pdf/IOSCPD165.pdf)

1. Legal risk
A CCP should have a well founded, transparent and enforceable legal framework for each aspect of its activities in all relevant jurisdictions.

2. Participation requirements
A CCP should require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the CCP. A CCP should have procedures in place to monitor that participation requirements are met on an ongoing basis. A CCP's participation requirements should be objective, publicly disclosed, and permit fair and open access.

3. Collateral requirements
A CCP should calculate its credit exposures to participants on a daily basis and hold collateral that in normal market conditions covers its potential losses from closing out positions held by a defaulting participant.

4. Financial resources
A CCP should maintain sufficient financial resources to withstand a default by the participant to which it has the largest exposure in extreme but plausible market conditions that produces losses not fully covered by collateral requirements.

5. Default procedures
A CCP's default procedures should be clear and transparent, and they should ensure that the CCP can take timely action to contain losses and liquidity pressures and to continue meeting its obligations.

6. Custody and investment risks
A CCP should hold assets in a manner whereby risk of loss or of delay in its access to them is minimised. Assets invested by a CCP should be held in instruments with minimal credit, market and liquidity risks.

7. Operational risk
A CCP should identify sources of operational risk and minimise them through the development of appropriate systems, control and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Business continuity plans should allow for timely recovery of operations and fulfilment of a CCP's obligations.

8. Money settlements
A CCP should employ money settlement arrangements that eliminate or strictly limit its settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants. Funds transfers to the CCP should be final when effected.
ANNEXES

9. Physical deliveries
A CCP should clearly state its obligations with respect to physical deliveries. The risks from these obligations should be identified and managed.

10. Risks in links between CCPs
CCPs that establish links either cross-border or domestically to clear trades should design and operate such links in ways that observe the other recommendations in this report.

11. Efficiency
While maintaining safe and secure operations, CCPs should be cost-effective in meeting the requirements of users.

12. Governance
Governance arrangements for a CCP should be effective, clear and transparent to fulfill public interest requirements and to support the objectives of owners and users. In particular, they should promote the effectiveness of the CCP's risk management procedures.

13. Transparency
A CCP should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using its services.

14. Regulation and oversight
A CCP should be subject to transparent and effective regulation and oversight. In both a domestic and an international context, central banks and securities regulators should cooperate with each other and with other relevant authorities.
ANNEXES

ANNEX 5: Government Organizational Chart in Hong Kong
(Ch. V: Footnote 106)

Source: Hong Kong SAR Government, Organizational Chart of the
Government of the Hong Kong Special Administrative Region at
http://www.info.gov.hk/govcht_e.htm (last updated May 2005)

[See Next Page]
ANNEXES

ANNEX 6: List of PRC Government Departments Directly under the State Council
(Ch. V: Footnote 110)

Source: The Organizational Structure of the State Council at http://www.china.org.cn/english/kuaitxun/64784.htm (last viewed March 9, 2006)

In 1998, the State Council underwent a major reform of its structure. Now it is composed of the General Affairs Office, 28 ministries and commissions (including the People’s Bank of China and the National Auditing Office), 17 directly affiliated organs and 7 working offices, in addition to a number of directly administered institutions.

Specifically:

1. The General Affairs Office
2. Ministry of Foreign Affairs
3. Ministry of National Defence
4. National Development and Reform Commission
5. Ministry of Education
6. Ministry of Science and Technology
7. Commission of Science, Technology and Industry for National Defence
8. State Commission of Ethnic Affairs
9. Ministry of Public Security
10. Ministry of State Security
11. Ministry of Supervision
12. Ministry of Civil Affairs
13. Ministry of Justice
14. Ministry of Finance
15. Ministry of Personnel
16. Ministry of Labour and Social Security
17. Ministry of Land and Resources
18. Ministry of Construction
19. Ministry of Railways
20. Ministry of Transportation
21. Ministry of Information Industry
22. Ministry of Water Resources
23. Ministry of Agriculture
24. Ministry of Commerce
25. Ministry of Culture
26. Ministry of Health
27. State Population and Family Planning Commission
28. People’s Bank of China
29. National Auditing Office
ANNEXES

Organizations directly under the State Council
1. General Administration of Customs
2. State Administration of Taxation
3. State Environmental Protection Administration
4. General Administration of Civil Aviation of China
5. State Administration of Radio, Film and Television
6. State General Administration of Sports
8. State Administration of Industry and Commerce
9. General Administration of Press and Publication
10. State Forestry Administration
11. State Bureau of Quality and Technical Supervision and Quarantine
12. State Food and Drug Supervision Administration
13. State Intellectual Property Office
14. National Tourism Administration
15. State Administration of Religious Affairs
16. Counsellors' Office of the State Council
17. Government Offices Administration of the State Council

Administrative Offices under the State Council
1. Foreign Affairs Office of the State Council
2. Overseas Chinese Affairs Office of the State Council
3. Hong Kong and Macao Affairs Office of the State Council
4. Legislative Affairs Office of the State Council
5. Research Office of the State Council
6. Taiwan Affairs Office of the State Council
7. Information Office of the State Council

Institutions Directly under the State Council
1. Xinhua News Agency
2. Chinese Academy of Sciences
3. Chinese Academy of Social Sciences
4. Chinese Academy of Engineering
5. Development Research Center of the State Council
6. National School of Administration
7. China Seismological Bureau
8. China Meteorological Administration
9. China Securities Regulatory Commission
10. China Insurance Regulatory Commission
11. State-owned Assets Supervision and Administration Commission
12. China Banking Regulatory Commission
ANNEXES

13. National Social Securities Fund Council
14. National Natural Science Foundation of China

(China.org.cn May 20, 2003)
ANNEX 7: The Use of MMT as an Instrument for Market Integration
(Ch. V: Footnote 117)

CROSS-BORDER ENFORCEMENT OF LAWS AND REGULATIONS

If the stock markets in Hong Kong and the PRC were integrated, what type of organization could be used if a cross-border securities dispute arose? Should they be resolved by arbitration, law court or specialized tribunal?

Currently under the H share regulation in Hong Kong, any dispute regarding H shares is required to be settled by arbitration. In general, arbitration tribunals

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1 The Arbitration Law of the PRC was promulgated on August 31, 1994 by the NPC and came into effect on September 1, 1995. Almost all the international arbitration cases and all H share disputes are filed to CIETAC for arbitration. CIETAC is also called the Arbitration Court of China Chamber of International Commerce since 2000. It was established in 1956 with its original name being Foreign Trade Arbitration Commission. In 1980 the Arbitration Commission was renamed as the Foreign Economic and Trade Arbitration Commission, later in 1988 changed to its current name. The rules adopted by CIETAC were amended in 1998, 1999, 1995, 1998 and 2000. The new arbitration rule has come into force on May 1, 2005. In terms of recognition and enforcement of arbitral awards, the PRC is party to the New York Convention of 1986 (accession in 1987). The PRC is also a member state to the Hague Convention on the Service Abroad of Judicial and Extra-judicial Documents in Civil or Commercial Matters, reservations were made relating to Articles 8 and 9, Article 10, subparagraph a, Article 10, sub-paragraph b and c, Article 11 and Articles 24 and 25). The PRC has also recently acceded to the Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters. There are therefore strict internal control mechanism for the court to set aside (e.g. the Supreme People's Court on April 23, 1998 issued the official document concerning setting aside of the award - "The Supreme People's Court Notice on the Relevant Issues Concerning Setting-Aside by the People's Court of the Foreign-Related Arbitral Awards", No. FA/40/1998) or refuse awards. Setting aside and refusing awards require approval from higher court and ultimately from the Supreme People's Court in the PRC. CIETAC has established its headquarters in Beijing and its sub-commission in Shanghai and Shenzhen. In theory, ICC International Arbitration Court may conduct its arbitration proceedings in the PRC although its proceedings must be in compliance with the Arbitration Law. For the Arbitration Law, some procedural aspects concerning the validity of the arbitration agreement and the appointment of the arbitrators are different from the counterpart of the ICC Arbitration Rules. (See Li Hu, Introduction to Commercial Arbitration in China at http://www.softic.or.jp/symposium/open_materials/11th/evLiHu.pdf (last visited: 11 May 2005); CIETAC, The New CIETAC Arbitration Rules Will Come into Force on May 1st, 2005 at http://www.cietac.org.cn/english/news/news.htm (last visited: 11 May 2005); APEC - International Commercial Disputes, A Guide to Arbitration and ADR in APEC Member Economies: People's Republic of China at http://www.arbitration.co.nz/content.aspx?section=Overview&country=CHN (last visited: 11 May 2005).

In Hong Kong, the Arbitration Ordinance (Chapter 341 of the Laws of Hong Kong) is the primary source of law for dispute resolution outside the courts and Order 73 of the Rules of the High Court (Chapter 4A of the Laws of Hong Kong) lays down the procedural rules governing arbitration related proceedings in the High Court such as an application to the Court for the enforcement of settlement agreement or arbitration award. (See APEC - International Commercial Disputes, A Guide to Arbitration and ADR in APEC Member Economies: Hong
have many advantages over judicial courts. They are less formal, quicker and therefore less costly. The arbitrators are usually elected because they are a respectable member of the industry to which the disputing parties belong and therefore have the expertise to deal with the cases. Arbitration is a private procedure and the case is not reported publicly and so it will encourage the disclosure of all information including sensitive information resulting in a fairer decision. The informality also means that compromise and mediation are encouraged before and during the process of arbitration and so the process is less adversarial than the court.

In addition to these general reasons, there are also practical reasons for arbitration to be used particular in the Hong Kong – PRC scenario. As Hong Kong adopts the common law system and the PRC the civil law system, they may have divergent views over what constitutes law (e.g. the applicability of case laws), how laws are applied and the precedent value of the decided case. The court system in the PRC also does not inspire confidence of international investors as the qualifications and competence of judges in the PRC vary greatly. Corruption is still a major problem, not to mention the protectionism prevailed in some local provinces.

Other than historical reason, the competence and shortage of judges are partly due to the low remuneration package they receive in the PRC compared with other professions that require similar qualifications. E Xiang Wan, Vice Chairman of the Supreme People’s Court, said that the income of a lawyer in the PRC could be 100 times more than a judge. He was reported saying that most law students would prefer to be a lawyer, to be followed by working in a big corporation before they would finally consider being a judge. The shortage of judges is serious. For example, in Guizhou alone, there was a shortage of 694 judges.²

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²Kong, China at [http://www.arbitration.co.nz/content.asp?country=HKG](http://www.arbitration.co.nz/content.asp?country=HKG) (Last visited: 11 May 2005)) The substantive provisions of the New York Convention have been incorporated into domestic law of Hong Kong under the Arbitration Ordinance. See Arbitration Ordinance (Chapter 341), Part IV.
As discussed in Chapter I, corruption in the PRC is ripe. In terms of corruption, the PRC government has much to learn from the ICAC in Hong Kong. The ICAC is a separate independent organization directly under and accountable to the Chief Executive. The ICAC Commissioner reports regularly to the Executive Council on major policy issues and attend meetings of the Legislative Council to answer questions on policy matters and funding. Due to its organization structure, the ICAC has impressive records fighting corruption.3

However there are problems associated with arbitration. As arbitration proceedings are private, the arbitrators do not have the benefit of previous decisions. But the more serious problem is the lack of investors’ protection. Although the speedy and less formal arbitration means lower cost, the court system offers legal aid for poor applicants and some jurisdictions offer class action suit for groups of investors, lowering the cost of each investor in bringing a lawsuit.4

How about the use of a supranational court in enforcing cross-border securities disputes? In terms of track records, both the PRC and Hong Kong courts are

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3 In March 2004, the ICAC arrested 20 people on bribery allegations relating to textile firm Kwong Hing International Holdings and LeRoi Holdings. In another well-publicized case, the ICAC in July 2004 arrested nine people, including Derek Wong Chong-kwong, chairman of Semtech International Holdings, for allegedly bribing banks and analysts to manipulate the share price of Semtech. The ICAC in March 2005 charged former chairman of Skyworth Digital Holdings, Stephen Wong Pui-sin with misappropriating HK$48 million in company funds and operating a fraudulent share-option scheme. Other recent ICAC arrests include chairman and executives at Global Trend, Yue Fung International Group Holding, Fu Cheong International Holdings and Gold Wo International Holdings. The number of corruption reports received by the ICAC in 2004 was 3,745, down 13% from 4,310 in 2003. Enoch Yiu, ICAC Forum to Put Ethics in Spotlight, SCMP, April 11, 2005.

4 In the PRC, the NPC that opened on March 5, 2005 had considered a revised draft of the Securities Law that, among other things, will make it easier for “class action suits” by groups of investors involving false statements, insider trading fraud and market manipulation. See Mark O’Neill, Stock Market Woes Swept Under Carpet at NPC, SCMP, March 14, 2005.
rather prohibitive for the plaintiffs as there are very few successful securities-related cases.

As at March 2005, PRC courts have accepted only cases involving false statements and so far only one has been successful. It was a suit brought by 546 investors against Shanghai-listed Daqing Lianyi Petrochemical. In August 2004, a court in Harbin ruled for the plaintiffs and ordered the company to pay damages and the underwriter involved was to take responsibility for its role. Due to complicated procedures, onerous burden of proof and the difficulties in establishing scienter, there are not many cases relating to false disclosure being brought to the court and even few which are successful.

In Hong Kong, as at April 2005, only two cases were brought about by the SFC regarding disclosure-related offence. The first case was Huafeng Textile International Group which was successfully prosecuted and its director Cai Yang Bo were successfully prosecuted for providing false and misleading information in July 2003 with both Huafeng and Cai being fined HK$50,000 each and they were ordered to pay investigation costs of HK$28,000 to the SFC. The second case was brought by the SFC in 2005 against Benby Chan Yiu-tuan, managing director of Hong Kong listed Asia Aluminum Holdings for knowingly publishing a false or misleading clarification announcement to the SFC. The maximum penalty for such an offence is a fine of HK$100,000 and 12 months' imprisonment.

In any event, due to the different legal systems as mentioned above, it would be rather difficult to set up a law court to deal with cross-border securities dispute that could be agreeable on both sides if the Hong Kong and the PRC securities markets were integrated.

As for specialized tribunals, there is much to learn from the recently established Market Misconduct Tribunal under the SFO in Hong Kong.

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5 See id.

6 Andy Cheng, *Director Denies Lying to HKEx*, SCMP, April 8, 2005.
1. Market Misconduct Tribunal ("MMT")

SFC was first established in 1989 with Securities and Futures Appeals Panel ("SFAP") to hear appeals from decisions of the SFC and an Insider Dealing Tribunal to hear insider trading cases. The separation of the adjudicative functions and the introduction of civil proceedings for hearing insider trading cases have been in operation for more than a decade in Hong Kong.

The Securities and Futures Ordinance ("SFO") was enacted on March 13, 2002 and the SFO came into operation on April 1, 2003. Under the new SFO, the SFAP was upgraded to a status of statutory tribunal with its jurisdiction expanded.

Under the SFO the civil regime has been considerably extended so that the remit of the Market Misconduct Tribunal ("MMT") (which replaces the Insider Dealing Tribunal ("IDT")) extends to all types of market misconduct and not just insider dealing, as previously.

Under the current regime in Hong Kong, market misconduct can be referred to the SFC, Department of Justice or the police:

Disciplinary sanctions by SFC on the primary targets

Summary prosecution under s.318 by SFC

Referral to the Department of Justice

Referral to Commercial Crime Bureau of the Police

Magistracy

Advise Financial Secretary to institute MMT proceedings under Part XIII

Prosecution by Department of Justice under Part XIV

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The present system allows a number of sanctions under section 257 of the SFO but it was proposed by the Hong Kong government that it should be allowed to publicly reprimand primary targets, namely, issuers, directors and officers and to impose civil fine on the issuers and directors. Civil fine was not proposed to be imposed on officers of the issuers because of human right concerns. It was also proposed that statutory backing should be given to the listing rules. Under the proposed scheme, the MMT would operate on a two-tiered sanctioning regime.9

<table>
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<tr>
<th>Sanctions</th>
<th>Applicable to</th>
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<tr>
<td><strong>1st Tier</strong></td>
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<tr>
<td>• Reprimand</td>
<td>• Issuers</td>
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<tr>
<td>• Civil fines of up to HK$8 million</td>
<td>• Directors</td>
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<tr>
<td>• Civil fines of up to HK$8 million</td>
<td>• Issuers</td>
</tr>
<tr>
<td>• Civil fines of up to HK$8 million</td>
<td>• Directors</td>
</tr>
<tr>
<td><strong>2nd Tier</strong></td>
<td>• All persons,</td>
</tr>
<tr>
<td>• Existing sanctions under s.257 of the SFO</td>
<td>including issuers,</td>
</tr>
<tr>
<td>• disqualification order</td>
<td>directors and</td>
</tr>
<tr>
<td>• disgorgement order</td>
<td>officers</td>
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<tr>
<td>• &quot;cold shoulder&quot; order</td>
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<tr>
<td>• &quot;cease and desist&quot; order</td>
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<tr>
<td>• referral order</td>
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<tr>
<td>• cost order</td>
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It was proposed that the SFC should also have fining powers. It would result in a concurrent fining regime. However the government’s rationale was that the SFC was to deal with minor breaches in a timely manner whereas MMT was to deal with more serious breaches. As a result, it was proposed the maximum fine allowed for the SFC was 5 million Hong Kong dollars while the maximum fine allowed for the MMT was 8 million Hong Kong dollars.10 The SFC had also published its opinion saying that although the proposed fine might be

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9 It is afraid that the term "officers" are too wide and it may turn the proceeding into a criminal one, breaching human rights of those concerned. See id. 23, para. 3.7.

9 See id. 29, para. 3.20.

10 See id. 5 (para. 5).
adequate in some cases, the more realistic fining levels to underpin the new
civil regime for listing regulation would be up to $10 million for the SFC (i.e.
the same maximum level of fines as may be imposed on regulated persons
already under Part IX of the SFO) and unlimited fines for the MMT (as in the
UK). Double jeopardy could be avoided under sections 283 and 307 of the
SFO and such no double jeopardy clause was also proposed to apply to the
proposed sanctions.

It was proposed that the SFC was able to impose civil fine because it was
believed that it had satisfied three criteria. First, it only applied fine to a
restricted and specific class of people i.e. the issuers and the directors. Second,
the fines were only imposed for a regulatory purpose i.e. to maintain a high
standard for the securities market and it was not meant to be punitive. Third,
there was a full right to appeal to a judicial body i.e. SFAP.

Other than civil sanctions imposed by the Market Misconduct Tribunal under
Part XIII of the SFO, criminal sanctions under Part XIV of the SFO is possible
following prosecution. The criminal regime for market misconduct is expanded
to include insider dealing, a maximum jail sentence of 10 years and fines of up
to $10 million are provided for.

The SFO also provides a statutory civil right of action for those who have
suffered losses as a result of relying on any false or misleading public
communication concerning securities or futures contracts which has been
knowingly, recklessly or negligently disclosed to the public.

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11 SFC, Proposals to Strengthen the Enforcement of Listing Requirements, Press Release,
12 See id. 13 (para. 2.15).
13 See id. 22 (para. 3.4).
14 See s. 303 of the SFO.
15 See s. 107 of the SFO. Certain persons such as printers, live broadcasters or Internet services
may rely on certain exemptions under the SFO, for example, based on the fact that they have
been acting in good faith as mere conduits of information and they have not altered the
information which they were given to disseminate. See s. 103 of the SFO.
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For damages to be paid, the judge in the MMT has to be satisfied that it is “fair, just and reasonable” that compensation should be paid in such circumstances. Appeal from the MMT will be handled by the Court of Appeal in Hong Kong.

2. MMT – A Tool for Cross-Border Law Enforcement

In essence, tribunals are courts with simplified procedures and they combine the advantages of arbitration and the court system. Due to the simplified procedures, cases can be dealt with more swiftly than in the court and therefore are less costly. The judges in the tribunals are experts in dealing with the cases as provided within its jurisdiction (and in our present case, securities matters). As the findings will be publicly recorded, the tribunals will have the benefit and guidelines from previous decisions. The parties in the tribunal may also recourse to legal aid and they may even enjoy class action rights if the laws so provided.

The Hong Kong model shows that aggrieved investors can bring criminal (through the law courts), civil (through the MMT) or administrative action (through the SFC) against the wrongdoers. Various remedies can be imposed ranging from public reprimand, to civil fines to imprisonment.

This thesis proposes that since the legal systems in Hong Kong and the PRC are different, a MMT should be established in the PRC along the Hong Kong model and should replace the Hong Kong MMT. The MMT should be presided by a panel of judges from Hong Kong and the PRC. Any appeal should be handled by the Supreme People’s Court or the Court of Appeal in Hong Kong, depending on the defendant’s jurisdiction.

16 S. 281 of the SFO. Also see Olivia S. Lee, A New Era for the Securities and Futures Market in Hong Kong at http://newsweaver.co.uk/minternational/e_article000141190.cfm, (last visited 10 April, 2005).

17 See the next paragraph for the rationale in choosing the Supreme People’s Court rather than the higher court of the same region.
Alternatively, a Hong Kong resident can bring an action in the MMT in Hong Kong while a PRC resident can bring a legal action in the MMT in the PRC. An agreement has to be made between Hong Kong and the PRC so that any judgement can be mutually enforced in the other jurisdiction. Any appeal should be handled by the Court of Appeal in Hong Kong and the Supreme People’s Court in the PRC. As the MMT is regarded as substitute for the court of first instance, the court of appeal is a natural and obvious venue for appeal. In the PRC, a specialized court like the MMT will be equivalent to an intermediate court. The usual venue for appeal from the intermediate courts will be the higher People’s courts of the same region but such courts are established and judges are appointed by their municipalities and municipal governments will have considerable influence over their higher People’s courts. Any appeal from the MMT in the PRC involving cross-border dispute should go directly to the Supreme People’s Court to avoid regional protectionism. For this model to work, it may require frequent cooperation and discussion between the two MMTs so that they can maintain the same procedures and standards. Trust based on frequent interchange of information and standard setting has to be built up between the two jurisdictions.

The quality of judges is very important. In terms of competence, the expertise of the judges can be built up over the years if the judges specialize in the securities law. As there is only one MMT (or two MMTs, one for Shenzhen and one for Shanghai catering for both stock markets in the PRC) and the judges may come from other provinces, local protectionism will then not be an issue. However, it is necessary that judges in the PRC are independent to

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18 The MMT is similar to the special courts in the PRC. Special courts include the military court, maritime court, railway transportation court, forestry court, agricultural reclamation court and petroleum court. Other than the military courts, appeal to other special courts should be handled by higher courts of the same region. See The National Court Organizations at http://www.china.org.cn/english/features/state_structure/65040.htm (last modified May 20, 2003).

19 The academic qualifications and working experience required have been raised after the amendment of the Judge Law promulgated on July 28, 1995 and amended on June 30, 2001 available at http://www.law-lib.com/law/law_view.asp?id=15374. See Judge Law, art. 9(6).
ensure the impartiality of the above systems. Judges from Higher People’s Courts should be appointed by the central government instead of People’s Congress of the same level and the funding of the courts should be prescribed by the Central Government. Judges should have security of tenure and cannot be easily dismissed by the local government. They should also be well paid to provide incentives against corruption. As there will be lay members judging the case, the findings will be more independent from the government control.

For aggrieved investors, civil remedies are the most important as their main concern would be to have their losses recovered. As a result, the rule harmonization of the MMT is very important as MMT is for civil actions. Other than civil remedies, administrative remedies from the CSRC (in the PRC) or SFC (in Hong Kong) and the criminal remedies from the People’s courts in the PRC or the courts in Hong Kong are important to the securities industry as a whole. The former is important for keeping the standards of the securities industry if the authorities would like to deal with minor market misconduct swiftly and in a timely manner. The latter is important for high profile cases to boost investors’ confidence in the securities industry. As investors tend to be comparatively less concerned with the administrative and criminal measures and such issues also tend to be more political, this thesis proposes that Hong Kong and the PRC should be allowed to device their own rules and remedies but it is recommended that the regulatory agencies and the court personnel should meet regularly to continue their dialogue, voice their concern and eliminate their differences. This thesis also proposes that a cross-border securities law enforcement steering group can be established with members from policy-makers, representatives from the SFC and the CSRC, court personnel and academia.

20 Ironically it has been specified that one of the rights of the judges is to be free from interference from administrative organs although it is not perceived as such by the outside world due to the appointment and funding systems and the hierarchy of the government structure. See Judge Law, art. 8(2).

21 Judge Law, art. 11. For appointment of judges in special courts, its method is decided by the Standing Committee of the NPC. See Judge Law, art. 11.
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ANNEX 8: Comparison Table for the EU Securities-related Directives, Hong Kong and PRC Securities Laws and Regulations

(See p. 303)

The list of PRC and Hong Kong laws and regulations in the following table is not exhaustive and only the main laws and regulations are listed for comparison only.

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<th>1) Powers of Stock Exchanges and Admission of Securities to Listing</th>
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<td><strong>PRC</strong></td>
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<tr>
<td>• Consolidated Admission and Reporting Directive (CARD)</td>
<td>• Securities Law 1998</td>
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<tr>
<td><strong>Hong Kong</strong></td>
<td>• Provisional Provisions on the Management of the Issuing and Trading of Stocks, issued by the State Council of China on Apr. 22, 1993</td>
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<tr>
<td>• Securities and Futures Ordinance (SFO) (e.g. s.19, s.21, s.23 etc.)</td>
<td>• Measures for the Administration of Securities Exchanges approved by the State Council on Nov. 30, 1997 and promulgated by the Securities Committee of the State Council on Dec. 10, 1997; re-promulgated by the CSRC on Dec. 12, 2001</td>
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<tr>
<td>• Companies Ordinance</td>
<td>• Revised Shanghai and Shenzhen Stock Exchange Listing Rules effective on Dec. 10, 2004</td>
</tr>
<tr>
<td>• Trading Rules of Hong Kong Exchanges and Clearing Limited</td>
<td>• Trading Rules Governing Shanghai and Shenzhen Stock Exchanges were approved by the CSRC and promulgated on Aug. 31, 2001, effective three months from the date of promulgation</td>
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<tr>
<td>• Listing Rules of Hong Kong Exchanges and Clearing Limited</td>
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<tr>
<td>• On suspension and termination: Circular of the CSRC Concerning the Issue of the Implementation Measures for Suspending and Terminating the Listing of Failing Listed Companies (Revised) on Jan 1, 2002 and Notice of CSRC on promulgating the “Supplementary Provisions on Implementing the ‘Implementation Measures for Suspending and Terminating the Listing of Failing Listed Companies (Revised)’” on Mar. 18, 2003</td>
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<tr>
<td>• Company Law</td>
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<tr>
<td>• B Shares: (1) Regulations of the State Council Concerning Foreign Investment Shares Listed in the PRC of China of Joint Stock Companies; (2) Detailed Implementing Rules Concerning Foreign Investment Shares Listed in the PRC of China of Joint Stock Companies and; (3) Notice promulgated by the CSRC Concerning Domestic Residents May Invest in the B Share Market, effective from 19 Feb. 2001</td>
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<td>• H shares: (1) Special Regulations on the Overseas Offering and Listing of Shares by Joint Stock Limited Companies promulgated on and effective from Aug. 4, 1994; (2) the State Council Securities Committee and State Commission for Restructuring the Economic</td>
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<tr>
<th>System jointly issued the Mandatory Provisions in the Articles of Association for Companies Listing Overseas on Aug. 27, 1994; (3) Letter Concerning Opinion on Supplementary Revision of the Articles of Association of Companies to be Listed on the Hong Kong Stock Exchange promulgated by the CSRC and SCREC on Apr. 3, 1995; (4) Notice Regarding Questions on Standardizing Subsidiaries of Domestic Listed Companies to be Listed Abroad promulgated by the CSRC on July 21, 2004 and; (5) Circular on Issues Relevant to Foreign Exchange Control with Respect to the Round-trip Investment of Funds Raised by Domestic Residents Through Offshore Special Purpose Companies issued on Oct. 21, 2005 and effective on Nov. 1, 2005</th>
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<tr>
<td>• Administrative Measures on the Split Share Structure Reform of Listed Companies on Sept. 4, 2005</td>
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<th>2) Prospective Requirements</th>
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<td>• Prospective Directive</td>
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<td>• GEM Listing Rules of Hong Kong Exchanges and Clearing Limited</td>
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<td>• Securities Law 1998</td>
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<td>• Market Abuse Directive</td>
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<tr>
<td><strong>Hong Kong</strong></td>
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<tr>
<td>• SFO (Insiders dealing, market manipulation, false trading, price rigging, disclosure of false or misleading information, Market Misconduct Tribunal – Schedule 9 etc.)</td>
</tr>
<tr>
<td>• Companies Ordinance (e.g. ss. 41A(2) and 343(2A), ss. 40 and 342E, s. 40(7) and the Twenty-Second Schedule etc.)</td>
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<tr>
<td><strong>PRC</strong></td>
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<tr>
<td>• Securities Law 1998</td>
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<tr>
<td>• Provisional Measures for Prohibiting Securities Fraud promulgated on and effective from Sept. 24, 1993</td>
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<tr>
<td>• Criminal Law of the PRC amended on and effective from Dec. 25, 1999 providing criminal sanction for a number of economic crimes relating to the securities markets</td>
</tr>
<tr>
<td>• Notice of the Supreme People’s Court Concerning Several Questions Relating to Handling Civil Infringement Cases Arising from Misrepresentation in the Securities Market promulgated on Jan. 15, 2002</td>
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<th><strong>4) Post-Listing Obligations</strong></th>
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<td><strong>PRC</strong></td>
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<tr>
<td>• Securities Law</td>
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<td>• Provisional measures of Shenzhen Municipality for</td>
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<th><strong>Hong Kong</strong></th>
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<tbody>
<tr>
<td>• SFO (e.g. s.15 – Accounts and Annual Report etc.)</td>
<td>• Measures for the Administration of the Listed Company Issuing New Shares, promulgated by the CSRC and effective on Feb. 25, 2001</td>
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<tr>
<td>• GEM Listing Rules of Hong Kong Exchanges and Clearing Limited</td>
<td>• Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies promulgated by the CSRC on Aug. 16, 2001</td>
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<tr>
<td>• Rules on the Corporate Governance Report</td>
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<tr>
<td>• Model Code for Securities Transactions by Directors of Listed Companies</td>
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<tr>
<td>• HKSA Corporate Governance Disclosure in Annual Reports</td>
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<td>• HKSA Guide for Effective Audit Committees</td>
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<tr>
<td>• Reference for Disclosure in Annual Reports</td>
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5) **Rules Governing UCITS**

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<th><strong>PRC</strong></th>
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<tbody>
<tr>
<td>• UCITS Directives</td>
<td>• Securities Law 1998</td>
</tr>
<tr>
<td><strong>Hong Kong</strong></td>
<td>• Provisional Measures of the Administration of Securities Investment Funds (approved by the State Council on Nov. 15, 1997 and promulgated by the Securities Committee of the State Council on Nov. 14, 1997)</td>
</tr>
<tr>
<td>• SFO (e.g. s.104-authorization)</td>
<td>• Measures of the Administration of Securities Investment Funds Enterprises promulgated by</td>
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<tr>
<td>• Listing Rules of Hong Kong Exchanges and Clearing Limited</td>
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<td>• GEM Listing Rules of Hong Kong Exchanges and Clearing Limited</td>
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<tr>
<td>the CSRC on Sept. 27, 2004</td>
<td>• Practice Guidelines for Primary Underwriters of Listing Open-ended Mutual Funds in the Shenzhen Stock Market promulgated by the Shenzhen Stock Market on and effective Dec. 5, 2004</td>
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<tr>
<td>• Notice on Matters Regarding Fund Investment by Fund Management Companies Using their Own Capital promulgated by CSRC on June 8, 2005</td>
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6) Rules Governing Financial Intermediaries

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<td>• Markets in Financial Instruments Directive (MiFID)</td>
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<td>Hong Kong</td>
<td>• Provisional Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors (QFII) (promulgated by China Securities Regulatory Commission and the People's Bank of China on Nov. 8, 2002 and effective Dec. 1, 2002)</td>
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<tr>
<td>• SFO (Registered institutions, licensing representatives, responsible officers, Fit and Proper Rules, Financial Resources Rules etc.)</td>
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<td>• Companies Ordinance</td>
<td>• Measures on the Administration of Securities Companies promulgated by the CSRC on 28 Dec., 2001 and effective on Mar. 1, 2002</td>
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<th>7) Clearing and settlement system</th>
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<td><strong>Europe</strong></td>
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<td>• Settlement Finality Directive</td>
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<td>• Two Giovannini Reports</td>
<td>• Rules on the Management of the China Securities Depository and Clearing Corporation Limited Securities Accounts promulgated on Apr. 29, 2002</td>
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<td><strong>Hong Kong</strong></td>
<td>• Provisional Measures on the Administration of Securities Settlement Risk Funds promulgated by the CSRC on April, 4, 2000</td>
</tr>
<tr>
<td>• Clearing and Settlement Systems Ordinance</td>
<td>• Operating rules of the Shenzhen Securities Exchange for trading and clearing of B shares promulgated by the Shenzhen Securities Exchange on, and effective from January 31, 1992</td>
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<td>• SFO (e.g. s.37, s.38, s.40, Schedule 3 etc.)</td>
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