This is the published version:


Available from Deakin Research Online:

[http://hdl.handle.net/10536/DRO/DU:30002405](http://hdl.handle.net/10536/DRO/DU:30002405)

Reproduced with the kind permission of the copyright owner

*Copyright*: 2004, Centre for National Corporate Law Research, University of Canberra
Information disclosure and corporate governance in listed companies in China: From Yinguangxia to Enron

Jian Fu*

China’s path to the development of a modern securities market has not been a smooth one. This article argues that efforts to impose Western securities market models on China have been fraught with difficulty. This is especially clear from the adoption of information disclosure principles and practices. While the integrity of disclosure practices is a fundamental element in maintaining investors’ confidence in securities markets, disclosure practices need to be attuned to China’s systemic features, especially in regard to its legal structure and rules. Market failures, such as the collapse of Enron in the United States, have led to a realisation that US disclosure models have their own difficulties and that these should not be uncritically used. This article reviews recent Chinese law and practice (using the Yinguangxia false disclosure scandal as an example) in this area and calls for the adoption of a more critical approach towards the use of Western models with particular regard to China’s own distinctive pathways of reform.

I. Introduction

Lucian Bebchuk and Mark Roe argue that although economies and business practices have converged in many countries since World War II, corporate structures in different countries around the world have remained different.1 According to their theory of path dependence, earlier corporate structures have a direct effect on subsequent corporate structures and have a heavy influence on prevailing corporate rules.2 The theory of path dependence is extremely important for countries with transitional economies, such as the People’s Republic of China (PRC).3 This article uses disclosure rules to illustrate this point. It argues that the theory of path dependence applies to the PRC and suggests that while trying to adopt foreign corporate disclosure rules, the PRC should realise that its own corporate disclosure regime should be based on its own corporate structures which are significantly different to those within advanced economies, such as the United States.

This article consists of four parts. Part II provides a brief introduction to the development of the PRC securities markets and identifies major problems in the area of corporate disclosure. This article then examines the disclosure regulatory regime under PRC law and explores the reasons for breaches of disclosure rules. The disclosure regime has important functions in directing the securities markets. This article also considers the most important issue that

---

* School of Law, Deakin University, Australia.
2 Ibid, at 128, 154.
the PRC has yet to deal with, namely, how to best adopt Western models.

In addition, this article argues that the PRC must further improve its securities regulation and enforcement of these regulations by analysing the impact of the collapse of Yinguangxia in the PRC and Enron in the United States. It concludes that the PRC should adopt a critical approach in adopting US disclosure models in developing its own pathway of corporate reform due to its own corporate structures and distinctive legal system. Finally, this article argues that the enhancement of continuous disclosure and the enforcement of corporate disclosure rules are two major tasks that the PRC has yet to urgently fulfil if its securities markets are to function effectively.

II. Brief review of the development of the PRC securities markets

The PRC securities markets emerged in relatively recent times and its current securities markets only arose in the early 1990s. To date, these markets have made significant progress; by April 2002 there were 1175 listed companies which had raised capital of RMB¥810.1 billion; the market value of these securities was RMB¥4540 billion; there were 67 million investors and 118 securities companies. From the mid-1980s, the capital-raising needs by small business organisations and small companies, which were unable to get loans from the state-owned banks, has made share issue an attractive means of capital raising. To regulate securities issue and trading, the Shanghai and Shenzhen municipal governments respectively established the Shanghai Stock Exchange and the Shenzhen Stock Exchange. These two exchanges became

---

4 The history of corporate securities in China can be traced back to 1869 when the Changli Company traded in the shares of foreign companies. Foreign business people set up the first stock exchange in China in 1904. The first Chinese securities dealers organisation was the Shanghai Shares Business Association which was established by Shanghaiese business people with the approval of the then North Ocean Government in 1914. In the same year, the North Ocean Government enacted the Stock Exchange Law which was the first national securities law in China. In 1919, the first Chinese stock exchange was established. Subsequently, other stock exchanges were also set up. The Nationalist Government (which succeeded the North Ocean Government) enacted its Stock Exchange Law in 1929. This was more comprehensive than that enacted by the North Ocean Government and was later inherited by Taiwan and provided the foundation for the current Taiwanese securities legislation. At the beginning of 1949 the Chinese Communist Party established its first stock exchange in Tianjin and then another one in Beijing in early 1950. With the so-called 'socialist reform movement' the PRC government adopted a USSR type of planned economy and stopped the issue and trading of shares and other securities. The stock exchanges were converted into state-owned companies in the late 1950s. With the adoption of the open-door policy and the economic reform in the late 1970s, the issue of debentures and shares gradually became a means of capital-raising. After a number of experimental issues of shares in some major cities, the Shanghai Stock and the Shenzhen Stock Exchanges were formally established in 1990 and 1991 respectively. See H Zhang, 'Improvement of the Chinese Securities Legal System and its Theoretical Development' (2000) 2 Civil and Commercial L Rev 154–221 at 160–5.

5 The speech of Zhou Xiaochuan, the then Chairman of the CSRC, at the Second International Symposium on China's Securities Market, Beijing, 7 June 2002.
the two national securities markets in mainland China respectively in December 1990\(^6\) and July 1991\(^7\) following receipt of approval from the State Council.\(^8\)

Until the end of 1992, these two stock exchanges were under the leadership of their local municipal governments, who also issued regulatory rules.\(^9\) Apart from local governments, the People's Bank of China and other ministries of the State Council also released numerous rules regarding the issue and trading of company shares and debentures.\(^10\) The China Securities Regulatory Commission (CSRC) was first established as a working commission of the State Securities Commission in 1992. After the August 10th Incident,\(^11\) the central government decided to interfere in the regulation of its securities markets.

When the Shanghai and the Shenzhen Stock Exchanges were established, the State Council had agreed that they were to operate under the administration of their local governments, while being supervised by the CSRC.\(^12\) This structure was confirmed in the Interim Measures of Administration of Stock Exchanges passed in July 1993 (Interim Regulation 1993). However, other ministries and commissions under the State Council that had regulatory powers within their functional areas of responsibility also affected the stock markets.\(^13\) Each department had its own regulatory rules; some departments also released joint regulatory rules if they thought this to be necessary. This duplication in leadership and rules imposed additional costs and was inefficient to the securities markets. Because the CSRC and the local governments had different priorities in regard to securities regulation, the multiple leadership of the stock exchanges meant that these markets could not function effectively.

The central government changed this situation in August 1996 by releasing the Measures for the Administration of Stock Exchanges. Under this administrative regulation, stock exchanges were gradually separated from their local governments and were placed under the direct administration of the CSRC.\(^14\) But local governments still had a say in the appointment of senior positions within these exchanges.\(^15\)

As more companies were listed, these two stock exchanges became national

---


\(^7\) Ibid, p 180.

\(^8\) The State Council is the executive body in the PRC.

\(^9\) The Shenzhen Interim Measures for Share Issue and Trading 1991 were passed by the Shenzhen Municipal Government.

\(^10\) Above n 6, pp 138, 141, 180.

\(^11\) The investors in the Shenzhen Stock Exchange had fought for buying the subscription certificates to shares and had a bloody clash with the police.

\(^12\) The State Council’s Circular on Further Strengthening Macro-Administration of Securities Markets, December 1992.

\(^13\) Before 1992, the securities markets were regulated by 12 ministries and commissions of the State Council in addition to the Supreme People’s Court and the Supreme People’s Procuratorate.

\(^14\) Under Art 22, the chairman of the council of a stock exchange is to be nominated by the CSRC. Under Art 23, the general manager and deputy general managers are also to be nominated by the CSRC.

\(^15\) Ibid.
markets and it became clearly inappropriate to have them administered by local governments. On 15 August 1997, the State Council gave the CSRC the power to directly regulate securities markets and to make regulatory rules. Local governments were thereby excluded from regulating securities markets. With the abolition of the State Securities Commission in early 1998, the CSRC became the sole body to manage the day-to-day regulation of Chinese securities markets. The securities regulatory offices of the Shanghai and Shenzhen municipal governments were also transferred to the CSRC.

These enhanced powers of the CSRC were modelled on the US Securities and Exchange Commission (SEC).\textsuperscript{16} In the early 1990s, as securities markets were relatively unfamiliar to the general public and the senior officials, the PRC recruited a number of professionals who were educated in the United States; some even had work experience on Wall Street. One of them, Mr Gao Xiqing, was first appointed as the CSRC’s Chief Counsel and was later appointed as the executive Deputy Chairman of the CSRC; the former Special Counsel of the CSRC, Mr Anthony Neoh, was a former Chairman of the Hong Kong Securities and Futures Commission; a Deputy Chairwoman of the CSRC, Ms Laura Cha, was a former Deputy Chairwoman of Hong Kong Securities and Futures Commission.

These appointments no doubt brought US and Hong Kong experiences into the PRC. As acknowledged in an official publication of the CSRC, Disclosure Requirements of China Securities Market 2001:

We [the CSRC] have basically formed the fundamental regulatory structure of information disclosure by listed companies by drawing lessons and experience from the US, Hong Kong and other countries and areas.\textsuperscript{17}

Although the PRC securities markets have seen great achievements, they have been fraught with misconduct since the early 1990s, especially in the area of corporate disclosure. On 7 July 1992, the Shenzhen Yuanye Industry Corporation was delisted from the Shenzhen Stock Exchange for illegal conduct, including false disclosure of investment capital.\textsuperscript{18} This was the first delisting to have occurred in the PRC securities markets.\textsuperscript{19} Since the Shenzhen Yuanye company, false disclosure in the PRC has occurred from time to time, for example in 1996 with the Qiongminyuan company, in 1998 with the Sichuan Hongguang company, in 2001 with the Yingunagxia company, and in 2004 with the Jiangsu Qionghua Hi-tech Limited company, breaches of disclosure rules as a result of false disclosure or major omission in the disclosure documents. These cases of contravention of disclosure rules have become well-known in the PRC.\textsuperscript{20}

Due to the seriousness of false disclosure as a form of securities market misconduct, the CSRC named 2001 as the Year of Disclosure, focusing on the inspection and punishment of corporate fraud. According to the China

\begin{footnotes}
\item[17] Ibid, p 1.
\item[18] Above n 6, p 308.
\item[19] Ibid, p 231.
\item[20] Unlike in Western jurisdictions, in the PRC such 'cases' have tended to be dealt with administratively, rather than by the courts.
\end{footnotes}
Securities Daily, the PRC’s largest official securities newspaper, false disclosure cases occurred every month that year. In 2001, one of the biggest fraud disclosure cases in China’s corporate history, the Yinguangxia case, was exposed. According to the PRC’s most influential business magazine, Business & Finance Review, in 1999 and 2000, the share price of the Yinguangxia company had gone up 400%. According to its annual report, Yinguangxia’s income from its exports to Germany reached Deutschmark 180 million in 2000, though in fact the company’s total income from exports to Germany was less than US$30,000. These breaches of corporate disclosure rules brought into question the corporate disclosure regime that the PRC had in place, how it worked and what defects it had. In the following part, this article deals with these questions.

III. Major rules dealing with disclosure in securities markets

To assess the function of the PRC’s corporate disclosure regime, it is necessary to first provide an overview of these disclosure rules. Securities legislation is essentially concerned with information regulation and market conduct. In the securities markets, investors make decisions on buying and selling securities, based on the information that is available to them. Those who seek to raise capital can do so after disclosing material information to the market. The key function of securities’ regulators is to supervise companies listed within this market to ensure that they disclose accurate and important information to allow investors to make informed investment decisions.

One of the key purposes of securities legislation is to provide investors with informed access to the securities market. This is the main reason why in many Western countries a duty of information disclosure is imposed on companies as well as upon their directors. The US Securities Act 1933 and the US Securities Exchange Act 1934 illustrate this approach to information disclosure. The aim of these Acts was to ensure the availability of adequate and reliable information about securities which were to be offered to the public. In the PRC, one of the purposes of the PRC securities regulation has become to provide investors with equal access to the securities markets.

The PRC has a distinctive legal system. As the PRC is a civil law country, legislation is the primary source of law. In drafting its national laws, administrative regulations and administrative decrees, the PRC has drawn many lessons from Western countries. When the PRC securities market began to re-emerge in the mid-1980s, after its 40 year abeyance, it was clearly in great need of experienced advice and input from other jurisdictions. Many legal concepts and principles were borrowed from Western countries. The officials of the CSRC who had been educated in the United States naturally found it easy to adopt the US model of securities regulation, particularly as it was regarded as developed and advanced.

23 Ibid, p 104.
24 The PRC Securities Law 1998 Art 3; the 1993 Interim Regulation Art 3.
As Hong Kong was seen as a major financial centre in Asia and it was culturally, geographically and economically closer to the PRC than any other jurisdiction, the experience of securities regulation in Hong Kong also became a model that the Chinese central government thought could be more appropriate and easy to adopt. Since 1993, the PRC has learnt a great deal from Hong Kong's experience during its trial of state-owned enterprises seeking listing on the Hong Kong Stock Exchange. Of course, the rule makers also drew from their own experience in developing China's domestic securities markets. To solve the inevitable implementation problems, they began to make rules which had 'Chinese characteristics'.

A. Where can we find PRC disclosure rules?

Under the PRC legal system there are four legal sources on disclosure: the most authoritative are national laws (enacted by the National People's Congress or its Standing Committee); administrative regulations (made by the State Council) and provincial regulations (made by the provincial people's congresses and their standing committees); the least authoritative are administrative decrees (made by ministries and/or commissions of the State Council).25

The relevant national laws include the Securities Law 1998, the Company Law 1993 (Articles 59–63) and the Criminal Law 1979 (Articles 160, 161 and 181). Major relevant administrative regulations are also national rules in the PRC, these include the Interim Regulations Concerning Administration of Share Issue and Trading 1993, the Regulations Concerning Domestic Listing of Foreign Investment Shares by Shareholding Companies 1995; major relevant administrative decrees and directives include the CSRC's Implementing Rules on Disclosure by Public Shareholding Companies (for Trial) 1993, Rules No 1–19 on the Content and Format of Disclosure by Public Shareholding Companies; Rules No 1–13 on Preparation of Disclosure by Public Shareholding Companies. In addition to national laws, national regulations and ministerial administrative decrees, the CSRC releases Interpretations of Disclosure Rules as well as Opinions on Relevant Cases and Case Citations. These interpretations and opinions do not bind the courts but in practice have directive functions. These various laws, regulations and rules on information disclosure will be discussed below.

B. The disclosure rules under the national laws

Articles governing corporate disclosure are to be found in three pieces of legislation passed by the National People's Congress (NPC) and its Standing Committee; these are the Company Law 1993, the Securities Law 1998 and the Amendments to the Criminal Law 1999. But all these laws are written in very general terms in regard to disclosure issues and are difficult to implement in practice. They are worth referring to briefly.

(a) The Company Law

The Company Law was passed in December 1993. This is the PRC's first national company law and was passed by the Standing Committee of the NPC.

25 The PRC Constitution 1982 Arts 66, 67, 89
to regulate companies, including shareholding companies. However, the Company Law only touched on disclosure issues with few articles requiring listed companies to provide a prospectus. As this law was focused on establishing a modern enterprise system, most of its articles are concerned with company registration and organisation. Although Art 140 requires that a company planning to issue shares to the public must publish its prospectus, there is no criteria for disclosure. The PRC government at that time had not put the protection of shareholders into its law-making agenda and it had not realised the urgency of enacting a Securities Law.

In addition, there is no clear statement in the PRC Company Law regarding directors’ duties to information disclosure. Nevertheless, according to the law, directors must comply with the articles of association of the company, faithfully perform their duties and maintain the interests of the company. Furthermore, they must not take advantage of their positions, functions and powers in the company for personal gain. Directors must not accept bribes or other unlawful incomes nor misappropriate the property of the company by taking advantage of their functions and powers. Directors must not misappropriate company funds or lend company funds to others. Directors must not use company assets as security for the personal debts of shareholders of the company or other individuals.

Directors must not personally engage in, or on behalf of others, conduct the same category of business as the company they are serving or, engage in activities which may cause damage to the interests of the company. Directors must not enter into contracts or conduct transactions with the company except as provided for in the company’s articles of association or as approved by the shareholders’ meeting. These are the basic duties imposed on directors in the Company Law. To comply with these duties directors must disclose any relevant information about personal interests as required under administrative regulations and administrative decrees so as to avoid a breach of their statutory duties.

(b) The Securities Law

The Securities Law (enacted in December 1998) is the first PRC national law to contain specific disclosure rules. It was 10 years after the emergence of the securities market and took seven years of drafting and revision. It drew upon the experiences of Western countries and sought to relate this to its own practice. The Securities Law is more heavily focused on disclosure than the Company Law, and not only does it set out the principle of disclosure but it also specifies the requirements for disclosure documents, administrative liabilities and criminal liabilities. What the Securities Law neglects is a regime regarding civil liabilities. This has left loopholes in the protection of minority shareholders. This has become one of the biggest defects of the Securities Law.

26 Article 1.
27 The PRC Company Law 1993 Art 123.
28 Ibid, Art 59.
29 Ibid.
30 Ibid, Art 60.
31 Ibid, Art 61.
In the chapter setting out the General Principles of the Securities Law, openness, fairness and justice are stipulated as three basic objectives governing share issue and trading.\(^\text{32}\) Article 5 of the law prohibits fraud, insider trading and securities manipulation. Article 17 requires the issuer to publish its share issue documents by public notice and display these documents at public places. Article 13 requires the issuer to provide share issue documents which are true, precise and complete. Article 24 provides that underwriters must examine whether the disclosure documents are true, precise and complete. These articles duplicate those in the State Council's 1993 Interim Regulation.\(^\text{33}\) The upgrade of these disclosure rules from administrative regulations to national laws means that PRC legislators have gradually realised the importance of compulsory disclosure.

A big breakthrough in disclosure regulation in the Securities Law was the introduction of continuous disclosure.\(^\text{34}\) Laws of most Western countries not only require companies to disclose at the time of the first issue of securities but they also require companies to continue to provide information which may have a major effect on the company's share price. The PRC Securities Law also provides for three kinds of periodic disclosure: the annual report,\(^\text{35}\) the half-yearly report\(^\text{36}\) and the interim report.\(^\text{37}\) However, in the PRC, periodic disclosure is known as continuous disclosure.\(^\text{38}\)

These articles in the Securities Law came from Articles 57–60 of the 1993 Interim Regulation. The major difference is that the Securities Law uses the term 'interim report' to refer to the major events which may have a major impact on the trading price of the shares, while the 1993 Interim Regulation uses the term 'major events'. However, the requirement of an interim report does not really work effectively as neither the Securities Law nor the 1993 Interim Regulation clearly states when a major event should be disclosed. The absence of a precise rule of timely disclosure means that there is no adequate requirement for continuous disclosure.

(c) The Criminal Law 1979

The amendments to the 1979 Criminal Law were enacted in March 1997 following the need to find appropriate criminal punishments for securities crimes which had not been previously provided for in the Criminal Law. These amendments impose criminal liabilities on companies and employees who are directly in charge of the company's business where they engage in false disclosure and misstatement.\(^\text{39}\) These amendments thereby provide criminal liabilities for breach of the disclosure rules. Before these amendments were introduced, only civil liabilities and administrative liabilities were imposed on companies and employees who were directly in charge of the company's business.

\(^{32}\) Article 3.
\(^{33}\) Articles 3, 16, 17.
\(^{34}\) Chapter 3 the PRC Securities Law 1998.
\(^{35}\) Article 61.
\(^{36}\) Article 60.
\(^{37}\) Article 62.
\(^{38}\) These three documents are called continuous disclosure documents in s 3 of Ch 3 of the PRC Securities Law 1998.
\(^{39}\) The Criminal Law 1979 Arts 160, 161.
Under Art 160 of the amended PRC Criminal Law, companies which have made omissions or false statements in their prospectus, in the subscription of shares or in their bonds issue procedures, will be heavily fined; individuals who have committed the same conduct and were directly in charge of the company’s business may be given a penalty of detention or imprisonment of no more than five years. Under Art 180, insiders who leak information, which has a fundamental effect on the price of securities and causes serious effects, may be sentenced to detention or to a term of imprisonment of no more than five years. They may also be fined between one to five times their illegal gains from this conduct.

If the conduct is especially serious, they may be sentenced to at least five years and no more than 10 years of imprisonment as well as being required to pay one to five times of the illegal gains from this transaction. These amendments impose the penalty of detention or imprisonment on the individuals who were responsible for the company’s affairs; these individuals include the company’s directors and managers. If an enterprise engages in the conduct of forging and passing false information affecting securities transactions, it may be fined at least RMB¥10,000, and the individuals who were found to be responsible for this conduct may be subject to criminal detention or be given a penalty of imprisonment of up to five years.⁴⁰

There is a problem with fines imposed on the company and the employees who are directly in charge of the company’s business. Under the Company Law, a company employee who gives a false statement or makes a misstatement in the company’s financial report may be subject to a fine of between RMB¥10,000 and RMB¥100,000.⁴¹ This fine is called an administrative fine. Under the Criminal Law, for the same kind of conduct, the employee who is directly in charge of the company’s business may be subject to a fine of between RMB¥20,000 and RMB¥200,000.⁴² This fine is called a criminal fine. Neither the Company Law nor the Criminal Law clarifies whether a person may be subject to two kinds of fine or whether one kind of fine may replace the other kind of fine. As the courts in the PRC do not have the power to interpret law,⁴³ there may be problems for the courts dealing with the application of a criminal fine. According to the literal rule of interpretation which is used in the PRC, an employee who is directly in charge of the company’s business may be subject to two penalties for the same conduct. If this is the effect of the law, it is clearly too harsh.

C. Disclosure provisions under administrative regulation

(a) The State Council’s Interim Regulation 1993

Before the PRC Company Law was enacted, the State Council had issued two provisional regulations which sought to standardise the conduct of companies. In accordance with these two regulations, the State Council issued the Interim Regulation in April 1993.

---

⁴⁰ The PRC Criminal Law 1979 Art 181.
⁴¹ Article 212.
⁴² Article 161.
⁴³ Under Art 86 of the PRC Constitution 1982, only the National People’s Standing Committee has the power to interpret law with a binding effect.
This administrative regulation set out for the first time three basic principles for share issue and trading: (i) openness, (ii) fairness and (iii) honesty and accountability.\textsuperscript{44} It further provides that all promoters and directors must sign off on the accuracy of their prospectus.\textsuperscript{45} They must ensure that there was no false or seriously misleading statement, nor any gross omission in the prospectus. Joint and several liability is imposed for breach of these provisions.\textsuperscript{46} These provisions make it clear that the duty of information disclosure is not only imposed on companies, but is also imposed on their directors. The 1993 Interim Regulation also requires that any major lawsuits or arbitration cases involving the company or the company’s directors, as well as details concerning the backgrounds of directors, must be disclosed.\textsuperscript{47}

Under the 1993 Interim Regulation, a listed company must also provide a listing announcement in which its shareholding structure and the 10 biggest shareholders of this company must be disclosed; the shareholdings of the directors must also be disclosed.\textsuperscript{48} In Ch 6 of this Interim Regulation, a listed company is required to provide continuous disclosure documents; these include its annual report, its half-yearly report and its interim report. The directors of the company have the duty to disclose information although the listed company also has a duty of disclosure.

The 1993 Interim Regulation laid a foundation for establishing the present disclosure regime in the PRC. Some of its principles and provisions on disclosure have now been incorporated into the Securities Law. The 1993 Interim Regulation is still used as a supplement to national laws although those of its provisions which are inconsistent with the Company Law and the Securities Law are automatically invalid.

(b) The Regulation Concerning the Issue of Foreign Shares by Listed Companies Inside China 1995

To standardise the issue of B shares the State Council released the Regulation Concerning the Issue of Foreign Shares by Listed Companies inside China in December 1995. Article 16 provides that listed companies issuing B shares must first disclose information to the public in accordance with the law. Although these regulations do not contain provisions regarding the duty of disclosure by directors, Art 6 clearly provides that directors, supervisors, managers and other senior managerial staff of the company owe fiduciary duties to the company. This article implies that directors have a duty of disclosure.

(c) The Special Provisions on Share Issue and Listing outside China by Listed Companies 1994

To standardise the issue of H shares and N shares the State Council released the Special Provisions on Share Issue and Listing outside China by Listed Companies. According to Art 23 of this administrative regulation, the

\textsuperscript{44} Article 3.
\textsuperscript{45} The 1993 Interim Regulation Art 17.
\textsuperscript{46} Ibid.
\textsuperscript{47} Ibid, Art 15.
\textsuperscript{48} Ibid, Art 34.
directors' duty of information disclosure is one aspect of directors' fiduciary duties to the company. According to Art 13, the State Council's Securities Commission (its functions were later assumed by the CSRC) has the power to impose articles into a company's articles of association. With the authority of this provision, the State Council's Securities Commission and the State Commission for Restructuring the Economic System jointly issued the Compulsory Provisions in the Articles of Association of Companies Seeking Listing outside China in August 1994. These provisions contain more details in regard to companies' and company directors' duty of information disclosure than those found in the previous law. Although the relevant regulatory powers of the State Commission for Restructuring the Economic System were transferred to the CSRC in 1998, the CSRC still uses most of these original provisions.

This 1994 document repeats the basic duties of directors set out in a more detailed form in Arts 59–61 of the PRC Company Law.

D. Other disclosure rules in administrative decrees and other regulatory rules of the CSRC

(a) Rules concerning disclosure by listed companies

As noted above, the CSRC exercises day-to-day administration and supervision over the securities market. After reviewing common disclosure problems prevalent on the securities market in the early 1990s, the CSRC released several new rules governing information disclosure prior to the PRC Company Law. In June 1993, the CSRC released the Implementation Rules on Information Disclosure by Listed Companies (for trial). Article 4 lists the disclosure documents to which this applies. Under Art 5, directors must ensure that there is no false or seriously misleading statement or gross omission in the disclosed documents; where such conduct occurs, directors and promoters of the company bear joint liability. Under Item 2 of Art 22, the details regarding directors must be disclosed in the take-over announcement; the shareholding of the directors must also be disclosed. Most provisions of this administrative decree have been revised and adopted in the later decrees of the CSRC. This decree has yet to be replaced or invalidated.

(b) Rules on Content and Form of Information Disclosure by Listed Companies

Since March 1993, the CSRC has issued a set of rules regulating the content and form of information disclosure by listed companies. These rules have been amended from time to time to meet the needs of the Chinese securities market. By the end of February 2002, the CSRC had released Rules No 1–17 on the Content and Form of Information Disclosure by Listed Companies (Content and Form Rules). These rules cover the main issues of information disclosure including the use of the prospectus, the annual report, the half-yearly report, the report of changes in shareholding, the share-listing announcement and the prospectus for issuing new shares. These rules constitute the core of the

securities disclosure regime. The model relied upon in adopting these rules is to be found in the rules of the SEC in the United States.

(c) The Making and Reporting Rules Concerning Disclosure by Listed Companies

From November 2000 the CSRC started releasing the Making and Reporting Rules Concerning Disclosure by Listed Companies so as to standardise disclosure in the implementation of the Content and Form Rules in specific industries, such as those involving finance, energy and real estate. These rules are very detailed. Some cover the manner in which the Content and Form Rules should be applied in specific industries while others cover how these rules should be applied in takeovers or acquisitions. The CSRC has realised that the Making and Reporting Rules are among the most urgent rules to be developed.

(d) Other documents with regulatory functions

In addition to the formal rules, the CSRC also started releasing Questions & Answers (Q&A) Concerning Disclosure Standards by Listed Companies from April 2001. These are the directives of the CSRC on particular questions raised by listed companies. These documents are not enforceable by courts under the Chinese legal system and thus they only direct the conduct of listed companies. In practice, as the CSRC is the sole securities regulator, most listed companies will inevitably follow these Q&A documents.

(e) Opinions on individual cases and case analysis

In 2001, the CSRC decided to publish its administrative decisions on the cases which involved a breach of disclosure rules. The commission’s purpose was to increase transparency and to provide warnings for other listed companies.

E. Disclosure under the listing rules of the Shanghai and the Shenzhen Stock Exchanges

As discussed above, the PRC’s two stock exchanges were first established by local governments, with the approval of the central government. Their first listing rules were also made by their respective local governments. But Art 113 of the Securities Law clearly states that the listing rules and trading rules of the stock exchanges must be approved by the CSRC. In fact, when these two stock exchanges were placed under the authority of the CSRC in 1997 their listing rules were unified by the CSRC. These two exchanges now use the same listing rules. The listing rules repeat the criteria for disclosure already contained in the Securities Law and go on to summarise the information which must be disclosed.

F. Brief comments on the PRC disclosure regime

As China’s securities market is still in a transitional stage of development, the CSRC has had to update its regulatory rules from time to time. This updating

51 Ibid.
has been beneficial in directing the development of China’s securities market. But under the Chinese legal system, national laws have higher authority than the CSRC’s rules; the real function of the CSRC’s rules depends on the degree of consistency between national laws and the administrative decrees of the CSRC.

A major problem in this context is that the amendment of national law is a lengthy process, for example, the amendments to the Civil Procedure Law 1992 took almost nine years to enact. CSRC regulations may be issued and amended more quickly. The frequent updating of the CSRC’s administrative rules cannot wait for the amendment of national laws. Nevertheless, whenever there is inconsistency, listed companies and investors often face the dilemma of having to decide whether they should follow out-of-date national laws or the CSRC’s rules.

Apart from the inconsistency between national laws and rules there are some other major problems in China’s national laws; first, the Securities Law does not contain provisions on civil liabilities for breach of market regulations, including the breach of disclosure rules. Innocent investors are therefore left without effective legal protection; secondly, the Securities Law does not contain provisions on derivative actions. This is because some have argued that joint actions provided under the Civil Procedure Law could be used instead of enacting new derivative action procedures. But this ignores the fact that the purpose of class actions is different to that of joint actions. These defects have affected investors’ confidence in the Chinese securities market.

A final problem is the poor enforcement of law in China. Of course, this problem is not unique to securities laws.

IV. Major issues on disclosure

A. The theories of government regulation of securities markets

Economists in the PRC argue that the securities market has seven basic functions:

1. the process of selling and buying shares is the process of allocating and re-allocating capital resources;
2. the securities market provides investors with another way of investment and therefore increases the efficiency of investment;
3. investment in the securities market is seen as a way for investors to evaluate the operation of companies and encourages companies to improve their operations;
4. what investors buy and sell is not the value of the securities themselves but the prospective profits which may be brought by the holding of the securities together with any associated risks;
5. securities capital is movable and this provides the incentive for companies to improve their operations;

---

53 The first amendments were made in 1991.
(6) the securities market accelerates the move of interchange of information and reduces transaction costs; and
(7) for the government, the securities market is an effective means of fulfilling the macro-economic objectives of market control.

PRC economists further argue that a fully functioning market economy depends on a valid securities market. However, in reality, such a securities market does not yet exist in China. The reality is that market failure causes low efficiency of resource allocation. This reality provides the basis for government regulation of the securities market. PRC economists believe that in Western countries the market failure theory became the basis for government regulation.55 The original purpose of securities regulation was seen as being to overcome and improve such failures in the securities market.56

Information is a fundamental ingredient that affects the functioning of securities markets. Information failure is the major reflection of market failure. The regulation of disclosure naturally becomes a most important part of securities regulation and the focus of regulatory action.57 According to a senior Chinese securities regulator, the most common and serious breaches of law in the securities market are directly related to the width, depth and timeliness of disclosure.58 Ensuring fair access to information is the key to enhancing investors' confidence and the protection of investors' interests. Only a well regulated securities regime can ensure the completeness and symmetry of information so as to reduce market failures.

In the United States, two major theories of disclosure regulation have surfaced; first, the theory of compulsory disclosure states that in order to avoid market failures (such as fraud and insider trading) the government should force securities issuers to disclose relevant information. Louis Brandeis was one of the first persons to advocate the importance of such disclosure.59 The other theory objects to compulsory disclosure. A representative of this theory is George Stigler; he cites the fact that in the first two years after the SEC was established, share prices did not change as a result of compulsory disclosure. He then argues that compulsory disclosure did not increase the profits of investors and therefore that it was ineffective.60

The Great Depression of 1929–1932 was in part caused by fraud, false disclosure and manipulation, leading to the breakdown of the US securities market. This breakdown led the US government to adopt compulsory regulation, such as compulsory disclosure. In the PRC little theoretical research on the disclosure system occurred before the Securities Law was enacted. The PRC issued a number of disclosure rules following numerous serious breaches of the principles of openness, fairness and justice.

55 Ibid, p 34.
56 Ibid.
57 Ibid, p 84.
59 L Brandeis, Other People's Money and How the Bankers Use It, National Home Library Foundation, 1933, p 62.
60 G Stigler, 'Public Regulation of Securities Market' (1964) 37(2) Journal of Business.
B. Why should the PRC adopt compulsory disclosure?

In the United States, apart from Stigler's opposition to compulsory disclosure, the US Congress had adopted an anti-regulatory ideology in the 1990s. The then Chairman of the House of Representative's Commission of Telecommunications and Finance, Jack Fields, proposed to delete the provisions on the protection of investors and to reduce investors' access to information. His reasons for this included: reducing costs of dealing in the securities market; compulsory disclosure might legalise misleading conduct; the SEC's full disclosure requirement may weaken the company's agents' power; and finally, the reduction of investors' access to information may reduce the cost of the SEC.61

What kind of disclosure regulation a country should adopt depends on the level of development of its economy. Taking the PRC as an example, in view of the traditional top down approach in China's economy, the government has always been actively involved in almost every area of administration of the country. Without a sound financial system and a developed market, government regulation will not push for the establishment and improvement of the domestic capital market. In the past, regulation in China has made the adoption of market solutions impossible.62 Another major reason for compulsory disclosure in a new market economy is that a country with a new securities market faces a serious problem of information failure. Low economic development, less development of information related industry and a lack of sound information law, weakens the new securities market with inevitable asymmetry, manipulation and fraud. These problems require that the government adopt a rigid and direct regulation of the market.

Shareholders make decisions based on the information available to them. The securities market should provide them with an open and fair trading site. This requires that the securities market adopt basic principles, such as the principles of openness, fairness and justice.63 Information disclosure is an effective way to implement these three principles. What kind of information must be disclosed? To what extent should it be disclosed? How should it be disclosed? These questions require a sound Securities Law to set the more detailed criteria for disclosure.

C. Criteria for disclosure

Openness, fairness and justice are the three principles which are believed to be fundamental in the PRC disclosure system.64 'Openness' means all the major events in regard to investment must be disclosed, all the securities regulatory regulations should be published and all relevant information and state policy must be published. 'Fairness' means that all participants in the securities market, such as listed companies, investors and securities firms, are equal under the law. 'Justice' means that disclosure should be available to all investors, not just selectively, such as to well connected investors.
