

# THE SHANGHAI EXCHANGE SCANDAL AND CHINESE BONDS LAW

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*The Chinese people have a passion for gambling.*

—Guan Jinsheng, 1995<sup>1</sup>

For the past sixteen years China's economy has grown at an impressive rate.<sup>2</sup> China has doubled its national wealth in just 16 years, 5 years ahead of its schedule. A profound, sustainable growth has been predicted for the coming 15 years.<sup>3</sup> This enormous growth invites a rapid expansion of funding needs. China, in displaying its skill of adopting western concepts and adapting them to suit its own needs, has used its fledgling capital markets to infuse sorely needed capital into the economy.

In order to tap the huge private savings of Chinese citizens, which totaled 3 trillion *yuan* at the end of 1995,<sup>4</sup> the Chinese government began to issue Treasury bonds in 1981, which signaled the takeoff of China's securities industry.<sup>5</sup> In 1983, companies began to issue stocks in China.<sup>6</sup> In

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1. Joseph Kahn, *Guan Gambled and Lost in Shanghai Bond Scandal*, *ASIAN WALL ST. J.*, Apr. 28, 1995, at 12. Guan Jinsheng, a son of peasants, was the chief executive of China's largest brokerage house, Shanghai International. Mr. Guan rose to study law and finance in Belgium in the 1980's. He built Shanghai International from a tiny reseller of state-issued bonds into China's first international securities house, which was the key player in the Shanghai Bond Scandal, *infra*.

2. The annual average growth rate of China's economy has been 8.8% since 1979. Lan Cao, *The Cat That Catches Mice: China's Challenge to the Dominant Privatization Model*, 21 *BROOK. J. INT'L L.* 97 (1995). The rate was 13% for 1992 and 1993. Joyce Barnathan, *China: Birth of a New Economy*, *BUS. WK.*, Jan. 31, 1994, at 42. The rate was 12.6% for 1994 and was about 10% in 1995. Joyce Barnathan, *A Chill Wind Blows from Beijing*, *BUS. WK.*, Jan. 15, 1996, at 44.

3. China hopes that its economy will grow at an average annual rate between 8% and 9% for the coming 15 to 20 years, and the World Bank believes this will be "sustainable." Jan Kristiansen, *World Bank Says China's Rapid Growth 'Sustainable'*, *AGENCE FR. -PRESSE*, Jan. 10, 1996.

4. Interview with the XINHUA News Agency by Xianglong Dai, the Chairman of the People's Bank of China. *China Has Established a Macro-control System by Central Bank*, *THE CHINA PRESS*, April 4, 1996, at 4 (Translation on file with the Columbia Journal of Asian Law). The RMB is the official domestic currency of China and the *Yuan* is the unit of the RMB. On Oct. 18, 1996, the official exchange rate was 8.2970 *yuan* to one U.S. dollar. See *THE WORLD JOURNAL*, Aug. 19, 1996, at C3.

5. See Andrew X. Qian, *Riding Two Horses: Corporatizing Enterprises and the Emerging Securities Regulatory Regime in China*, 12 *U.C.L.A. PAC. BASIN L.J.* 62, 66; *ZHONGGUO ZHENGQUAN SHOUCE* [CHINA SECURITIES HANDBOOK] 530 (Hongru Liu ed., 1992) [CHINA SECURITIES

August, 1986, the People's Bank of China, Shenyang Branch, approved a pilot project for bonds trading.<sup>7</sup> One month later, 5 million *yuan* of stocks in two collective enterprises were put on the market.<sup>8</sup> The country's first national stock exchange, the Shanghai Securities Exchange (hereinafter "SSE"), was opened on December 19, 1990.<sup>9</sup> It was soon followed by the official establishment of the Shenzhen Stock Market (hereinafter the "SSM"), which opened its doors to investors on July 3, 1991.<sup>10</sup> China went further in its effort to attract capital in December 1991, when it allowed the first "B shares" to be offered at the SSM to foreign investors.<sup>11</sup> In January, 1992, Deng Xiaoping, the architect of the Chinese social and economic reform, called for bold experiments with the securities markets.<sup>12</sup> China's securities markets then experienced quite a bullish period from 1992 to 1994. The total value of stocks in the SSE and the SSM stood over 100 billion *yuan* in 1992.<sup>13</sup> Average daily transactions in the Shanghai market alone reached a record of 1.5 billion *yuan* in early 1993, comparable to a slow day on the Hong Kong market.<sup>14</sup> From 1981 to 1994, moreover, China had floated more than 310 billion *yuan* in bonds.<sup>15</sup>

The markets have been quite successful in obtaining investment capital for China's economic growth. However, fraud and corruption have plagued the markets, prompting Chinese officials to admit candidly that the markets in the southern economic region of Shenzhen and in Shanghai are among the riskiest in the world.<sup>16</sup> The most recent example is the February,

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HANDBOOK].

6. Lee B. Spencer, Jr., *Chinese Issuers and the U.S. Market*, in INTERNATIONAL SECURITIES MARKETS 1994 (1993).

7. Shoujia Zhengquan Jiaoyi Shichang Zai Shenyang Kaiye [*The First Securities Exchange Open Business in Shenyang*], PEOPLE'S DAILY, Aug. 8, 1986, at 1.

8. Qian, *supra* note 5, at 65.

9. Benjamin R. Tarbutton, *China — A National Regulatory Framework for the PRC's Stock Markets Begins to Emerge*, 24 GA. J. INT'L & COMP. L. 411, 412.

10. *Id.*

11. *Id.*

12. Matthew D. Bersani, *Privatization and the Creation of Stock Companies in China*, 1993 COLUM. BUS. L. REV. 301, 301.

13. Qian, *supra* note 5, at 67.

14. Sheryl WuDunn, *Booming China Is Dream Market for West*, N.Y. TIMES, Feb. 15, 1993, at A1, A6.

15. *Chinese Legislation Would Help Nurture Budding Bond Market*, AP-Dow Jones News Service, ASIAN WALL ST. J., Apr. 14, 1995, at 22.

16. Tony Walker & Deirdre Nickerson, *Chinese Regulators Face an Unenviable Task*, FIN. TIMES, Mar. 25, 1993, at 28.

1995 Shanghai Exchange Scandal (hereinafter the "Scandal") in which bond prices were manipulated.<sup>17</sup>

This note examines the Scandal and considers its implications for the budding Chinese bonds markets. Particularly, it strives to address the appropriateness of the measures taken by the government in response to the Scandal. This note will identify the root causes of the Scandal, assess the deficiencies of the government's responses, and suggest alternatives for preventing similar events in the future. The note is organized as follows. Part I discusses the background, the development, and the aftermath of the Scandal. Part II examines the possible social and cultural roots, especially Chinese investors' and securities markets operators' gambling mentalities, which may have led to the Scandal. In light of this examination, Part III argues that the government's response fell short of its objective to develop well-regulated bond markets and it failed in using the existing regulatory scheme as a vehicle to establish the rule of law in securities markets. Finally, Part IV suggests alternatives which might be worth discussing for a Chinese bonds law, if China is serious in building an institutional base for obtaining capital to serve its fast-growing economy.

## I. THE EVENT AND THE RESPONSE

The Shanghai Exchange Scandal was not an isolated event. This part will give the background, the development, and the aftermath of the Scandal and show how it leads to broader legal and social issues in China.

### A. *The Background*

Securities and securities markets are not entirely new to China.<sup>18</sup> They existed in China during three separate historical periods: (1) the late 19th century (the late Qing Dynasty) to the 1920's;<sup>19</sup> (2) the 1930's under the

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17. Joseph Kahn, *Beijing Steps in to Clear Books in Bond Scandal*, ASIAN WALL ST. J., Feb. 28, 1995, at 1.

18. For a more detailed account of historical development of Chinese securities market, see Qian, *supra* note 5, at 64.

19. As a result of the Opium War of 1840, foreign investment came into China, and foreign firms were soon established to issue and trade stocks. The Shanghai Stock Market (*Shanghai Gufen Gongsuo*) was first set up in 1869 by foreign firms in Shanghai and restructured in 1905 as the Shanghai Business Market (*Shanghai Zongye Gongsuo*). In 1918, Japan set up the Shanghai Securities Branch (*Shanghai Quyin Suo*) with its headquarters in Osaka, Japan. The Shanghai General Bureau of Shipbuilding and Commerce (*Shanghai Zaochuan Tongshang Zongju*) issued China's first stock in 1872. Between 1918 and 1920, China established three large securities markets: the Beijing Securities Exchange, the Shanghai Securities and Products Exchange, and the Shanghai Huashang

Japanese occupation until the suspension of the Chinese civil war in 1949;<sup>20</sup> and (3) after the founding of the People's Republic of China (hereinafter the "PRC") in 1949 until the early 1950's.<sup>21</sup> It is interesting to notice that during most of these three periods, Shanghai was at the center of securities development in China. Consequently, Shanghai accumulated the relatively rich experience and necessary institutional base in dealing with securities markets. It is not surprising, therefore, that Shanghai has become a vibrant, national financial center in the 1990's.

Nor are bonds strangers to the Chinese.<sup>22</sup> As early as the beginning of the 20th century, the Qing Dynasty issued bonds to finance railroad construction.<sup>23</sup> The Nationalist government issued bonds for various projects.<sup>24</sup> In the 1950's, and particularly during the Korean War, the PRC made heavy use of treasury notes to finance the economy.<sup>25</sup>

When Deng Xiaoping initiated economic reform and opened up China to the outside world after Mao in 1978, the Chinese government once again issued treasury notes nationwide, but this time the scope was far reaching in terms of variety and volume.<sup>26</sup> Today there are at least eight

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Securities Exchange. CHINA SECURITIES HANDBOOK, *supra* note 5, at 513-14.

20. Chinese securities markets were on and off during this period. In the 1930's, securities were traded in Shanghai's concession area until the Shanghai Business Market was closed when Japan occupied the concession area during the Pacific War. After Japan's surrender, the Nationalist government initially prohibited securities trading, but then in 1946 set up the Shanghai Securities Exchange. *Id.* at 514-16.

21. Apparently, the Chinese Communist Party was trying to use securities to finance the rebuilding works after the civil war. The Tianjin Securities Exchange and the Beijing Securities Exchange were established in 1949 and 1950 with approval from the Financial Committee of the Northern Region Government. However, the two stock exchanges were accused of spawning corruption and were closed around 1952 when the government launched the "three antis" and "five antis" movements against corruption, bureaucracy and smuggling. *Id.* at 527-29.

22. Bonds (*zhaijuan*) in China are defined as evidence of debts with a face value and date of payment. The holders of bonds are entitled to interest and principal but may not participate in business management and are not accountable for the liabilities of the issuers. See Henry R. Zheng, *Business Organization and Securities Laws of the People's Republic of China*, 43 BUS. LAW. 549, 611 (1988).

23. See *Jackson v. People's Republic of China*, 550 F. Supp. 869 (N.D. Ala. 1982) (dispute over responsibility for the so-called Huguang railway bearer bonds originally issued in 1911 by the Imperial Government of China and renegotiated in 1937 by the Chinese Nationalist Government).

24. CHINA SECURITIES HANDBOOK, *supra* note 5, at 514-16.

25. However, by the 1960's, the PRC had already paid the bonds off and considered it a matter of national pride that "China had neither internal nor external debts." See Zheng, *supra* note 22, at 606.

26. Qian, *supra* note 5.

varieties of bonds which can be traded in the Chinese securities markets.<sup>27</sup> The total volume of bonds floating in markets exceeds 460 billion *yuan*.<sup>28</sup> People can trade bonds in more than 60 securities markets scattered throughout the country.<sup>29</sup> More than 300,000 people are employed by two thousand plus securities firms and trading offices. The securities industry has become one of the most attractive professions in China.<sup>30</sup>

The competition among the securities markets for investors' capital is keen. In 1994, China's two most active markets for bonds trading were the Beijing and Wuhan securities markets, which attracted funds partly because of their lax trading regulations.<sup>31</sup> Such lax regulations have, however, led to several trading scandals and prompted traders to shift their funds to Shanghai's market, which is generally considered to be better regulated.<sup>32</sup> Consequently, Shanghai's securities market became the most

27. The Circular of the State Council for Further Strengthening Macro Administration of Securities Markets (issued Dec. 17, 1992 by the State Council) identifies the eight varieties of bonds as follows:

- (1) *Treasury Bills*, issued by the Ministry of Finance;
- (2) *Financial Institution Bonds*, issued by financial institutions with the approval of the People's Bank;
- (3) *Investment Fund Certificates*, issued by financial institutions and state enterprises with the approval of the People's Bank;
- (4) *State Investment Bonds*, issued by financial institutions with the approval of the State Planning Commission;
- (5) *State Investment Company Bonds*, issued by state priority enterprises with the approval of the State Planning Commission;
- (6) *State Enterprise Bonds*, issued by financial institutions and state enterprises with the approval of the People's Bank and the State Planning Commission;
- (7) *Local Enterprise Bonds*, issued by local financial institutions and enterprises with the approval of provincial or budget-independent city government; and
- (8) *Local Investment Company Bonds*, issued by local priority enterprises with the approval of provincial or budget-independent city government.

THE CLASSIFIED ASSEMBLAGE OF THE LAW OF THE PEOPLE'S REPUBLIC OF CHINA (ECONOMIC LAW) 468-469 (1994) [hereinafter ASSEMBLAGE I].

28. Chinese Legislation Would Help Nurture Budding Bond Market, *supra* note 15. From 1981 to the end of 1994, China had floated more than 310 billion *yuan* in bonds. In 1995, China planned to issue a total of 153.5 billion *yuan* in bonds for a total float of about 460 billion *yuan*.

29. In April 21, 1988, the State Council designated 7 cities (Shenyang, Harbin, Shanghai, Chongqin, Wuhan, Guangzhou, and Shenzhen) as "experimental cities" to open securities markets where Treasury Bills and bonds could be traded. Only two months later, 54 more cities were allowed to set up their own securities markets to issue and trade bonds. ASSEMBLAGE I, *supra* note 27, at 498, 502.

30. Qian, *supra* note 5, at 68.

31. For example, both exchanges required trading margins below 30% and promoted off-market trading, in which participants set their own contract durations and interest rates. *China Issues Rules in Markets for Repurchases*, ASIAN WALL ST. J., Aug. 10, 1995, at 13.

32. *Id.*

active one in the country in 1995, until it was suspended for nearly a week at the end of February and then indefinitely closed in May, 1995.<sup>33</sup>

### B. The Event

Trouble emerged on Thursday, February 23, 1995.<sup>34</sup> The Shanghai International Securities (hereinafter "Sisco"), then China's biggest brokerage firm,<sup>35</sup> and Liaoning Guofa Group (hereinafter "Guofa") attempted to manipulate the market to save themselves from huge losses incurred by betting the wrong way on bond futures contracts in the midst of a wild market.<sup>36</sup> According to the official reports of a seven-month investigation by the Ministry of Supervision and the China Securities Regulatory Commission (hereinafter the "CSRC"), the watchdog of Chinese securities markets, Sisco blatantly ignored trading limits on bonds futures and then flouted exchange rules by selling short in an effort to drive prices down.<sup>37</sup> During the day, Sisco held a short position of around three million 327 contracts, which was six times their legal position limit.<sup>38</sup> Guofa pursued a similar strategy, but then began building massive positions to create a false impression of the prices of the 327 bonds futures.<sup>39</sup> In the closing minutes of trading, Sisco sold massively trying to push the market down. More than U.S. \$100 billion in bond commitments changed hands through the day, whereas the daily volume of futures contracts traded was only about U.S. \$6 billion in January, 1995.<sup>40</sup>

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33. Seth Faison, *Shanghai Stock Market Cited for Scandal*, N.Y. TIMES, Sept. 22, 1995, at D3.

34. Henry Sender, *No Longer Golden: How Ambition Set the Scene for Chinese Bond Scandal*, FAR E. ECON. REV., Sept. 28, 1995, at 95.

35. Sisco was transformed by Guan Jinsheng, its CEO, from a tiny reseller of state-issued bonds into China's first international securities house. The firm became the largest issuer of Chinese corporate shares to foreign investors and had branch offices in New York, London and Hong Kong, as well as two dozen other offices around China. Kahn, *supra* note 1.

36. Faison, *supra* note 33. The particular type of bond futures contract at issue is the key 327 contract (hereinafter "327"), a futures contract corresponding to a three-year bond expiring in June, 1995. Therefore, the Scandal is also known as the "327" incident. *Ban Seen as Major Setback*, S. CHINA MORNING POST, May 21, 1995, at 5.

37. Faison, *supra* note 33.

38. Sender, *supra* note 34.

39. Faison, *supra* note 33.

40. *Id.* See also *Scandalous Shanghai*, ASIAN WALL ST. J., Mar. 3, 1995, at 6.

### C. The Response

The SSE took action after suspecting Sisco of illegal trading. It canceled the last eight minutes of trading.<sup>41</sup> Sisco stepped forward and admitted that "its traders broke every rule in the book."<sup>42</sup> Since then, the SSE, later joined (or superseded) by the Ministry of Supervision and the CSRC, have taken the following measures:

1. The bond futures market was suspended for three days. A deadline was imposed by which traders had to "renegotiate" the contracts which had been sold. Thereafter, the market was partially resumed;<sup>43</sup>
2. At the end of March, 1995, the CSRC released an "urgent" circular requiring both the SSE and the SSM to raise the minimum margin requirements for trading in state bonds futures;<sup>44</sup>
3. On April 14, 1995, Mr. Jian Gao, director of the treasury bonds department of the Chinese Ministry of Finance, announced that China was drafting a law on treasury bonds to better regulate the bond markets;<sup>45</sup>
4. In May, 1995, with the permission of the State Council, the CSRC banned trading on state treasury bonds futures and the Shanghai bonds futures markets were closed;<sup>46</sup>

41. *Id.*

42. *Id.*

43. *Id.* This is a very unusual measure that was intended to undo the trades which had been completed in the previous market session. Apparently, all contracts sold by Sisco, including those sold by Sisco and then resold to third parties in the market, had to be "renegotiated."

44. Previously, securities firms were required to deposit only 500 yuan per contract (each contract on the Shanghai and Shenzhen exchanges is worth 10,000 yuan). Effective April 14, 1995, the new regulations require securities firms, whether trading for customers or their own portfolio, to deposit 1,550 yuan per contract with the exchange. Additionally, individual investors must deposit a minimum of 1,550 yuan per contract, up from 1,000 yuan. *China Raises Margins for Bond Futures*, ASIAN WALL ST. J., April 5, 1995, at 17.

45. In an interview with the Xinhua news agency, Mr. Gao said that lack of law is part of the cause of the "irregularities" in China's fledgling bond market, in a veiled reference to the Shanghai Exchange Scandal. However, the report did not indicate what measures the future bonds law would contain. Chinese Legislation Would Help Nurture Budding Bond Market, *supra* note 15.

46. *Shanghai Exchange Scandal Uncovered*, CHINA PRESS, Sept. 21, 1995, at 4. The ban on the Treasury Bill futures is understood as a temporary measure. Other forms of Treasury Bill trading are still going on. For instance, the bond repurchase market is still active. China Issues Rules in Markets for Repurchases, *supra* note 31.

5. In July, 1995, Mr. Guan Jinsheng, Sisco's chief executive, was arrested on charges of illegally using public funds and of embezzlement;<sup>47</sup>

6. In early September, 1995, the Ministry of Supervision and the CSRC completed their seven-month investigation and imposed administrative punishments on responsible parties.<sup>48</sup> The CSRC discharged Mr. Wenyuan Wei as the head of the Shanghai Stock Exchange, imposed monetary penalties on Sisco and Guofa, and transferred the case to the judiciary for further criminal investigations.<sup>49</sup>

The Government's responses were quite impressive in terms of speed and scope. These actions set a new tone - less risk and more supervision - for Shanghai's fast-growing securities markets. In announcing the results of the investigation, the CSRC made it known that it was "taking resolute measures, . . . to control decisively over speculation and profiteering, to prevent big securities firms [Dahu] from manipulating the market, to strengthen risk management, and to make sure the experimental Chinese futures markets can progress healthily in a normal way."<sup>50</sup>

The question is whether these measures were adequate to achieve these ends in general and to prevent similar scandals from recurring in particular.

## II. THE SOCIAL AND CULTURAL ROOTS

In reference to the Scandal, government officials pleaded that China's bond markets were "young" and "experimental."<sup>51</sup> Moreover, they concluded that the lack of laws was part of the cause of "irregularities" in China's bond markets,<sup>52</sup> but the extent that the lack of laws played in the Scandal was not explained.

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47. Guan resigned in April, and an investigation into his activities later led to his arrest in July, 1995. Faison, *supra* note 33.

48. *Id.*

49. See *Shanghai Exchange Scandal Uncovered*, *supra* note 46.

50. *Id.*

51. In an interview with the Xinhua news agency, Mr. Gao remarked, "It will take time to standardize China's Treasury Bill futures trading market, as it is still young." See Chinese Legislation Would Help Nurture Budding Bond Market, *supra* note 15; Shanghai Exchange Scandal Uncovered, *supra* note 46.

52. Chinese Legislation Would Help Nurture Budding Bond Market, *supra* note 15.



### A. *The Regulatory Framework*

It is true that China does not yet have a bonds law. However, there are a number of government regulations that regulate the bond markets. As early as 1990, the Ministry of Finance issued the Circular on Increasing Varieties of Market Trading Treasury Bills (hereinafter "1990 Circular").<sup>53</sup> The 1990 Circular sets forth guidelines for trading Treasury Bills, which has the legal effect of a ministry-level regulation.<sup>54</sup> In Art. 5, the 1990 Circular specifically prohibits the manipulation of markets:

1. [All bond-trading organizations] must operate according to law, buying and selling short are prohibited, whoever increases varieties of market trading Treasury Bills without permission and intentionally purchases Treasury Bills at a depressed price or buying and selling short will be dealt with according to the Regulation of Cracking Down on Illegal Treasury Bill Trading Activities, in addition to being forced to shut down for reorganization or being disqualified for bond trading.<sup>55</sup>

The Regulation of Cracking Down on Illegal Treasury Bill Trading Activities was jointly issued by the Ministry of Finance, the People's Bank of China, the State Administration of Industry and Commerce, and the Ministry of Public Security on May 22, 1990, just two days ahead of the 1990 Circular.<sup>56</sup>

Furthermore, on September 2, 1993 the CSRC, with the approval of the State Council, issued The Temporary Measure of Forbidding Securities

53. ASSEMBLAGE I, at 525.

54. The 1990 Circular still does not, however, have the status of a law promulgated by the National People's Congress and may be superseded by any national bonds law promulgated in the future.

55. ASSEMBLAGE I, at 526.

56. The pertinent parts of the Regulation provide:

Art. 3(4). For illegal trading of Treasury Bills with accumulated value over 50,000 yuan, the engaged trading parties will be fined from 100 to 150% of the trading value.

...

Art. 4. If the illegal trading of Treasury Bills violates the Criminal Law, the case will be transferred to the judiciary for further criminal investigation.

...

ASSEMBLAGE I, at 525.

Frauds [hereinafter the "1993 Measure"].<sup>57</sup> In Art. 2, the 1993 Measure defines the scope of the regulation:

2. The securities fraud in this Measure includes insider trading, market manipulation, deceiving clients, and misrepresentation in the course of securities offering, trading and related activities.<sup>58</sup>

Specifically, Art. 7 of the 1993 Measure identifies the parties involved in securities fraud, and Art. 8 lists the prohibited conduct of market participants.<sup>59</sup>

A comparison between the 1990 Circular and the 1993 Measure reveals that they share a common objective of regulating Chinese securities markets by prohibiting securities fraud. The 1993 Measure was an improvement over the 1990 Circular in the sense that it clarified what conduct constituted securities fraud. Furthermore, Art. 15 of the 1993 Measure sets out the penalties for violations of Art. 7 and Art. 8 by an organization in the securities industry,<sup>60</sup> Art. 16 sets out the penalties for

57. THE CLASSIFIED ASSEMBLAGE OF THE LAW OF THE PEOPLE'S REPUBLIC OF CHINA (CIVIL LAW) 767 (1994) [hereinafter ASSEMBLAGE II].

58. *Id.*

59. The relevant sections are:

7. Forbid any organization and individual, for the purpose of making profit or reducing loss, to take advantage of his capital, information, etc. or misuse his functions and powers to manipulate market, to affect price of securities markets, to create a false impression of securities markets, to induce or lead investors to make investment decisions without knowing the facts of the markets, and to disturb the market order.

8. The conduct of manipulating market in the previous article includes:

- (1) Manipulating price of securities markets by conspiracy or by amassing capital;
- (2) Affecting securities issuing and trading by spreading false, misleading information;
- (3) Making false buy and sell without transferring the ownership of securities by conspiring with others to create a false price of securities;
- (4) Selling or offering to sell securities, which seller does not have possession, to disturb market order;
- (5) Trading one kind of securities continuously for the purpose of forcing up or down the trading price of the security;
- (6) Forcing up or down price of securities artificially by taking advantage of one's functions and powers; and
- (7) Other conduct of manipulating market.

*Id.*

60. Art. 15 of the 1993 Measure provides:

Securities trading organization, securities exchange market or any other organization conducting business in securities industry that has conduct of manipulating markets

any organization *not* covered by Art. 15,<sup>61</sup> and Art. 17 sets out the penalties for an individual.<sup>62</sup> It is interesting to note that the 1993 Measure gives a mandatory fine for an individual's violation of Art. 7, but not for an organization's.<sup>63</sup> Additionally, Art. 24 delegates authority to the CSRC to investigate securities frauds and Art. 25 gives the CSRC, by itself or with other related agencies, the power to punish and fine an individual or an organization which is found guilty of securities fraud.<sup>64</sup> Finally, Art. 25 clarifies that there must be only a single penalty per violation.<sup>65</sup>

Moreover, a significant number of rules and regulations governing the issuance and trading of securities, the conduct of securities firms and stock exchanges, and the relations between traders and investors have been promulgated at the local level.<sup>66</sup> The Shanghai Securities Transaction Regulations (hereinafter the "SSTR") were issued on November 27, 1990 by the Shanghai municipal government together with the People's Bank Shanghai Branch.<sup>67</sup> The SSTR was quite a sophisticated regulation.<sup>68</sup> Chap. 1, Art. 3 defines the types of securities to be traded in the Shanghai

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will be punished, according to different situations, by a single penalty or multiple penalties of warning, confiscating illegal income, fining, limiting or suspending [securities trading organization's] securities trading business or [securities exchange or any other organization conducting business in securities industry's] securities business, or revoking its license for securities trading or its permit for securities business.

ASSEMBLAGE II, at 769.

61. Art. 16 of the 1993 Measure provides:

Any organization not covered by Art. 15 that has conduct of manipulating markets will be punished, according to different situations, by a single penalty or multiple penalties of warning, confiscating illegal income, fining; For issuer of securities in public trading, his listing may be suspended or revoked if his conduct of manipulating market is a serious violation.

*Id.*

62. Art. 17 of the 1993 Measure provides:

Any individual who has conduct of manipulating market will be punished, according to different situations, by confiscating his illegal monetary income and other illegal gains and a fine between 50,000 yuan and 500,000 yuan.

*Id.*

63. *Id.* These inconsistencies in the treatment of an individual and of an organization were manifested in the Government's response. See *supra* notes 43-47.

64. ASSEMBLAGE II, at 770.

65. When different government agencies all have authority to deal with a violation by a party, they must coordinate their actions so as to punish the guilty party only once. *Id.*

66. Qian, *supra* note 5, at 68-69.

67. ASSEMBLAGE I, at 657.

68. These regulations "are mostly drawn from foreign legislation and are surprisingly sophisticated given the current comparatively moderate level of market activity in Shanghai." Mary Riley, *Seeking a Regulatory Middle Ground*, CHINA BUS. REV., May-June, 1991, at 30.

exchange,<sup>69</sup> and Chap. 3, Art. 39 lists prohibited conduct in securities trading.<sup>70</sup> It is worthwhile to note that there is a "catch-all" clause in Art. 39(6).<sup>71</sup> Finally, Chap. 8, Art. 75 sets out the penalties for each violation, and a violation of Art. 39 calls for the highest fine.<sup>72</sup>

It was not clear whether the 1990 Circular and the SSTR had been superseded by the 1993 Measure. Apparently, all of them were still good law. A potential problem is that the inconsistencies among them may generate some loopholes. For instance, the scope of the penalty for manipulating the market by buying or selling bonds short is quite different from one regulation to another.<sup>73</sup> If the 1993 Measure was controlling, securities firms might find it to their advantage to participate in securities fraud since there was no mandatory fine if they were caught and they could profit enormously if they were not.<sup>74</sup> Moreover, a careful reading of these regulations reveals that there are few, if any, rules on price movements and

69. Chap. 1 Art. 3 of the SSTR provides:

The so called securities in this regulation are defined as follows:

- (1) Government bonds;
- (2) Financial bonds;
- (3) Company (enterprise) bonds;
- (4) Company stocks or initial public offering certificate of stocks;
- (5) Investment trust beneficiary certificate; and
- (6) Other valuable securities with approval of trading.

ASSEMBLAGE I, at 657.

70. Chap. 3 Art. 39 of the SSTR provides:

In securities trading, the following conduct are prohibited for any organization and individual:

...

(3) For the purpose of inducing others to trade, make or spread false, misleading information;

(4) For the purpose of manipulating market, continuously force up price of a security by buying or continuously force down price of a security by selling;

...

(6) Using other direct or indirect methods to manipulate market or disturb market order.

ASSEMBLAGE I, at 661.

71. *Id.*

72. Chap. 8 Art. 75(6) of the SSTR provides:

Violation of Art. 39 will be fined between 50,000 *yuan* and 100,000 *yuan*; but for serious violation, the fine will be between 100,000 *yuan* and 200,000 *yuan*.

ASSEMBLAGE I, at 664.

73. If the accumulated value of the bonds involved in the fraud is over 50,000 *yuan*, the guilty party would be fined from 100 to 150% of the trading value per Art. 5 of the 1990 Circular, *supra* note 56; no more than 100,000 *yuan* for a violation ( 200,000 *yuan* for a serious violation) per Art. 75(6) of the SSTR, *supra* note 72; or an amount between 50,000 *yuan* and 500,000 *yuan* if the guilty party is an individual, but no mandatory fine for an organization, per Art. 17 of the 1993 Measure, *supra* note 62.

74. *Supra* note 73.

margin requirements. Nevertheless, at the time of the Scandal, a regulatory scheme for the bond markets, however imperfect and inchoate, was in place.

Sisco engaged in bond trading and thus was covered by Art. 2 of the 1993 Measure,<sup>75</sup> Art. 5 of the 1990 Circular,<sup>76</sup> and Art. 3 of the SSTR.<sup>77</sup> On February 23, 1995, Sisco violated Art. 39(6) of the SSTR by blatantly ignoring trading limits on bond futures in an attempt to manipulate the market to save itself from huge losses.<sup>78</sup> Additionally, Sisco short sold three-year Treasury Bills in an effort to drive prices down, which constituted "selling or offering to sell securities [of] which [the] seller does not have possession" and "continuously forc[ing] down [the] price of a security by selling . . . for the purpose of manipulating [the] market." The former was a violation of Art. 8(4) of the 1993 Measure and a violation of Art. 5 of the 1990 Circular, and the latter was a violation of Art. 8(5) of the 1993 Measure and a violation of Art. 39 (4) of the SSTR.<sup>79</sup> Moreover, Sisco's activities created a false impression of the market price of three-year Treasury Bills and misled the market. Consequently, it violated Art. 8(3) and 8(5) of the 1993 Measure and Art. 39(3) of the SSTR.<sup>80</sup> In short, the Shanghai Exchange Scandal was *not* an incident in a lawless land. Instead, the participants challenged the bonds trading rules and regulations and "broke every rule in the book," as one foreign commentator observed.<sup>81</sup>

### B. *The Social and Cultural Roots*

If the lack of bonds law was not the cause of the Shanghai Exchange Scandal, as indicated by some Chinese government officials,<sup>82</sup> then what was the actual cause?

Social realities in China indicate that there is a deep social and cultural root of the problem: a mentality of gambling in Chinese investors and securities market operators.

Take Xiaodong Liu as an example. Mr. Liu, a 39-year-old worker, had lived an ordinary and hard life with his wife in Shanghai. In May, 1992, Mr. Liu used about 20,000 *yuan*, including 13,500 *yuan* borrowed

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75. *Supra* note 58.

76. *Supra* note 55.

77. *Supra* note 69.

78. *Supra* note 70.

79. *Supra* notes 59, 55, 70.

80. *Supra* notes 59, 70.

81. Scandalous Shanghai, *supra* note 40.

82. *See supra* note 15.

from his father-in-law and neighbors, to buy shares with the hope of making a fortune. Considering an average Shanghai worker earned about 2,600 *yuan* annually at that time, Mr. Liu was taking a great risk to invest that amount of money in the securities markets.<sup>83</sup> Unfortunately, when the market turned, Mr. Liu lost 4,000 *yuan*. Ironically, Liu then played "lucky-draw" to determine his fate - he subsequently killed himself by electrocution after choosing death in the "lucky draw."<sup>84</sup>

Mr. Liu was not the first casualty linked to losses in the SSE trading. Only a month earlier, another Shanghai worker committed suicide after his stocks plunged and he lost 6,000 *yuan*.<sup>85</sup> Indeed, with regular reports of suicides linked to losses in Shanghai trading, the Chinese government listed market volatility, together with inflation, unemployment and official corruption, as a major threat to "social stability."<sup>86</sup>

Certainly, one can argue that any developing securities market would go through its Dodge City days and that investors need to expose themselves to the market frenzy to become mature investors. However, institutional investors and market operators should play a leadership role by using sound investment fundamentals in order to establish a mature securities market. It is disturbing to see that Chinese market operators often acted otherwise.

Guan Jinsheng, president and chief executive officer of Sisco,<sup>87</sup> studied finance and law in Belgium and should have known the principles of investing. Nevertheless, he viewed the Chinese as passionate gamblers, and he ran the markets as computerized casinos.<sup>88</sup> Despite his prominent role as the head of China's biggest securities house, Guan became the most

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83. Kelly McParland, *Shanghai Looks to Capitalism for Shelter*, FIN. POST, Oct. 17, 1991 at 13 (the average Shanghai worker makes only about \$350 a year).

84. *A Second Shanghai Stock Shock Suicide*, CHINA DAILY, July 3, 1992, at 34. Mr. Liu was found dead on June 27, 1992 with electric wires binding his wrists and a multi-functional socket on his chest.

85. Xiangwei Wang, *China's Two Stock Exchanges Dashed to New Records*, BUS. WKLY., May 18, 1992, at 47. The new records of the SSE stock index were reached only a week after the victim committed suicide. Had he held his stocks for a week longer, he would have made sizable gains.

86. Joseph Kahn, *A Tale of 3 Cities: Beijing Warily Pushes Shanghai to Resume Role in Global Finance*, WALL ST. J. EUR., Nov. 28, 1994, at 1.

87. Guan was also vice-chairman of the Shanghai Stock Exchange. See Steven Mufson, *Peddling Stocks Becomes Big Business in China*, WASH. POST, Aug. 16, 1994, at A01. It is interesting to note that Guan had a conflicting dual role of being both a market participant and part of the market watchdog.

88. Kahn, *supra* note 1. Guan once made an observation to a journalist: "The Chinese people have a gift for gambling and taking risks." Mufson, *supra* note 87.

speculative player in a speculative market that had few rules on price movements and margin requirements.<sup>89</sup>

In his unsuccessful attempt to drive down the price of the key 327 contracts on February 23, 1995, Guan and his firm lost at least 1 billion yuan (U.S. \$120 million), which was four times Sisco's capital.<sup>90</sup> Moreover, Sisco also held a short position of around three million contracts, which was six times Sisco's legal position limit.<sup>91</sup> In the end, while Xiaodong Liu's gambling in the market cost his life, Guan's grand scale betting on the market not only cost his job and led to his arrest, but had a far reaching effect on the development of Chinese securities markets.

Liu's and Guan's investment behaviors reflect the gambling mentality that is prevalent among many investors in Chinese securities markets. People made fortunes by gambling or manipulating the markets. Ma Xiao was another example.<sup>92</sup> Nicknamed "Ma Qianwan" (Tens of Millions Ma), Ma made a fortune by his "buy at the last minute, drag the price up" strategy. Aided by computers and a staff of five, he picked lightly traded issues, bought heavily just before trading ended in order to induce others to jump on his bandwagon the next morning. He then sold fiercely and often profited hugely.<sup>93</sup> For Ma's trick to be successful, there must have existed a sizable group of market participants who bet on market direction constantly. Apparently, there was no shortage of speculators or gamblers in the SSE. Consequently, China has been called "the gambling capital of the world," and Shanghai "the gambling capital of China."<sup>94</sup>

Sadly, the gambling mentality in China is not limited to the field of investing.<sup>95</sup> As early as 1987, gambling became China's most common crime.<sup>96</sup> Gamblers sold their children, committed suicide, or went on to rob and kill people after losing their money.<sup>97</sup> People attribute the gambling to a general loosening of social controls, to the growth of a market economy, and to increased personal incomes which makes people believe they can

89. See Sender, *supra* note 34.

90. *Id.*

91. *Id.*

92. Kahn, *supra* note 86.

93. *Id.*

94. *Id.*

95. Khaw Wei Kang, *In China, The Only Outlawed Gambling Is Out Loud Gambling*, ASIAN WALL ST. J., Aug. 4, 1994, at 6; David Holley, *Joy for Some, Tragedy for Others Gambling, Outlawed in China, Making Comeback*, L.A. TIMES, May 9, 1988, at 1.

96. In 1987 alone, 635,000 gamblers were arrested in China. *Id.*

97. *Id.*

afford to lose a few *yuan*.<sup>98</sup> Traditional culture may also be a factor.<sup>99</sup> Since gambling has been outlawed in China, the fast-growing securities markets, with its inherent risk and potential return, is a perfect alternative to traditional gambling. Therefore, it is not surprising that Chinese securities markets have attracted many gamblers and have become a "casino,"<sup>100</sup> or that investing has become a form of legalized gambling.<sup>101</sup>

In summary, the Shanghai Exchange Scandal was not an incident in a lawless wonderland. It plainly violated the existing state and local regulations. While the weaknesses of the existing regulatory scheme might have been exploited, the Scandal underscored a widespread gambling mentality among the Chinese investors and market operators.

### III. THE RIGHT MEDICINE TO CURE

The Shanghai Exchange Scandal was not the only fraud in the SSE,<sup>102</sup> but its scope was unprecedented - the losses were estimated at U.S. \$200 million.<sup>103</sup> It led to the closure of the Chinese bonds futures market in May, 1995,<sup>104</sup> the revamping of China's two major exchanges, the SSE and the SSM,<sup>105</sup> and more importantly, the delay of Shanghai's aim to become a global financial center.<sup>106</sup> Even a year later, the Chinese securities markets still remember the pain and frustration.<sup>107</sup>

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98. *Id.*

99. Whether for fun or for money, gaming or gambling is a socially acceptable practice in many, if not all, Chinese communities. Kang, *supra* note 95. For instance, Chinese gamblers from around the world represent 25% of Atlantic City's \$1.5 billion business in table games, and they have been called "the biggest gamblers in the world right now." Bruce Einhorn, *Where Beijing Meets the Broadwalk*, BUS. WK., Mar. 28, 1994, at 22D.

100. Mufson, *supra* note 87.

101. *Id.*

102. Qian, *supra* note 5, at 69.

103. Peter Montagnon, *China Blames Two Firms for Bonds Scandal*, FIN. TIMES (London), Sept. 22, 1995, at 5.

104. *Id.*

105. Wenyuan Wei, head of Shanghai's Securities Exchange, stepped down and was succeeded by Xianghai Yang, a local regulator, on Sept. 18, 1995 and Bin Xia, president of the Shenzhen Stock Market, was reported to have resigned from his position. Craig Smith, *China Appears to be Revamping Its 2 Exchanges*, WALL ST. J., Sept 20, 1995, at A12.

106. Last year, Yingling Mao, president of the Central Bank's Shanghai Branch, predicted that "it may take five years to overtake Hong Kong" and "it may take 10 years, but not much more" to overtake New York as a global financial center. Kahn, *supra* note 86.

107. Xu Yaping, director of the CSRC's research and information department, candidly admitted that "1995 was really a very troublesome year for our two stock exchanges [the SSE and the SSM]." Kevin Murphy, *China Is Learning from Its Market Mistakes*, INT'L HERALD TRIB., May 30, 1996, at 17.



Nevertheless, the Scandal could also be viewed as a growing pain and a golden opportunity for the government to shape a more mature securities market by strengthening existing regulations and supervising their proper implementation. In response to the Scandal, the Chinese regulatory agencies adopted a series of measures to help the markets to regain credibility. The speedy and swift measures, however, were not well received.<sup>108</sup> It is the purpose of this section to identify where and why these measures fell short of their objectives.

The first issue is whether the government agencies acted within their authority as defined by the existing regulatory scheme. It is true that the government had legitimate reason and power to shut down the markets after the Scandal per Art. 15 of the 1993 Measure.<sup>109</sup> But the order that traders had to "renegotiate" the contracts which had been sold was "bizarre."<sup>110</sup> Close examination of the relevant regulations reveals that they are silent on the legality of the government's action. There is simply no provision in the 1990 Circular, the 1993 Measure or the SSTR which gives the government the power to order market participants other than the guilty party in the Scandal to "renegotiate" the deals.<sup>111</sup> It indicates that the government might have abused its power in the way it intervened in the markets. Moreover, by rewinding the tape on other market participants, the government effectively set a precedent that trades were not final in China's security markets. A market where trades are not final can hardly gain credibility from market participants. In short, the measures taken by the government not only failed to help the markets to regain credibility but might have further damaged it through the government's abuse of power.

The next issue is whether the government's response was adequate in terms of punishments and penalties. On the surface, the government's measures were "resolute."<sup>112</sup> A careful analysis, however, casts some doubts about their adequacy. It is true that Guan Jinsheng, the man primarily responsible for the Scandal, was arrested on criminal charges for his actions.<sup>113</sup> However, it is unclear whether he was given *any* monetary penalties.<sup>114</sup> Guan should have paid a statutory fine of between 50,000 *yuan*

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108. Ban Seen as Major Setback, *supra* note 36.

109. *See supra* note 60.

110. Scandalous Shanghai, *supra* note 40.

111. *See supra* notes 53, 57, 67.

112. Shanghai Exchange Scandal Uncovered, *supra* note 46.

113. Faison, *supra* note 33.

114. *Id.* *See also* Shanghai Exchange Scandal Uncovered, *supra* note 46.

and 500,000 *yuan* according to Art. 17 of the 1993 Measure,<sup>115</sup> or between 50,000 *yuan* and 200,000 *yuan* per Art. 75(6) of the SSTR.<sup>116</sup> Arguably, the very simplicity of these provisions, that a guilty party must pay a fine, should have a substantial deterrent effect.<sup>117</sup> A failure to punish Guan Jinsheng financially would be a great mistake because it would have pulled the regulations' teeth, at least partially. Moreover, Sisco should be required to take the responsibility for its loss. While the exact amount of the monetary penalties on Sisco is unknown,<sup>118</sup> apparently it was not enough. Per Art. 5 of the 1990 Circular, Sisco should have been fined from 100 to 150% of the trading value involved in the fraud.<sup>119</sup> Sisco held a short position of around three million 327 contracts,<sup>120</sup> and each contract was worth 10,000 *yuan*.<sup>121</sup> The trading volume involved was about 30 billion *yuan*, which was 120 times Sisco's capital.<sup>122</sup> A fine equaling 100% of the trading value, which was the lower threshold required by the Art. 5 of the 1990 Circular,<sup>123</sup> would have sent Sisco to bankruptcy. Unfortunately, the government again failed to act properly. After all, Sisco was still there and its loss was shifted to other market participants by the renegotiation order.<sup>124</sup>

Furthermore, and more importantly, these measures failed to prevent similar events from recurring. The investigation of the Scandal was a "black box" operation. The details of the Scandal were kept away from the public at large and the markets. Today, both the magnitude of the fines (if any) that the CSRC imposed on Sisco, Guofa, and Guan and the ultimate

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115. *Supra* note 62.

116. *Supra* note 72.

117. *Compare* *Anderson v. Commissioner*, 480 F.2d 1304, 1308 (7th Cir. 1973) (§16(b) of the Securities Exchange Act was designed to prohibit short swing trading and "the liability is, as a practical matter, inexorable.")

118. *Supra* note 114.

119. *Supra* note 56.

120. *Sender, supra* note 34.

121. *China Raises Margins for Bond Futures, supra* note 44.

122. *Sender, supra* note 34. Sisco's capital assets were around 250 million *yuan*.

123. *Supra* note 56.

124. Some suggested that Guan and Sisco, which were backed by some factions of the government, were set up by competitors, which were supported by other factions of the government. *Sender, supra* note 34. A full exploration of the interaction between Chinese politics and securities markets is obviously beyond the scope of this note and may deserve further investigation in its own right. Still, the fact that the Shanghai Scandal could happen this way raises broader questions about China's approach to building its securities markets, which is the issue that the author is most interested in. The latest news about Sisco was that it was expected to merge with other Chinese securities houses to form a new securities house, Shanghai New Securities. Andrew Taylor, *Chinese Securities Houses Expected to Merge*, FIN. TIMES, Dec. 28, 1995, at 13.

results of the criminal investigations conducted by the judiciary with respect to the Scandal are still unknown.<sup>125</sup> Withholding the specifics about the investigation and the punishment undermined the government's effort to develop the securities markets by the regulatory scheme or the rule of law. This tainted the markets with more political clouds by leaving room for people to speculate concerning the source of the Scandal and the scope of the government's response.<sup>126</sup> Moreover, the government's response, at best, only scratched the surface of the causes of the Scandal. It did not address the gambling mentality of many Chinese market participants. In a country where "to get rich is glorious" is the theme of the day, scandal is bound to occur if investing is a game of gambling and Ma Qianwan is a role model to market participants.<sup>127</sup> It wouldn't come as a surprise if the Shanghai equities market was now very speculative.<sup>128</sup> Furthermore, only two and half months after the Scandal and the partial resumption of the market, Guofa and other firms again tried to manipulate the market in key 319 contracts to recoup losses suffered on key 327 contracts.<sup>129</sup> There were more than 570,000 key 319 contracts traded in one day, as total volume reached 92.7 billion *yuan*.<sup>130</sup> This apparently led to the final closure of the bonds futures market.<sup>131</sup>

In short, by abusing its power in shifting the loss caused by Sisco to other market participants, taking inadequate actions against the guilty parties in the Scandal, dealing with the Scandal without openness, and ignoring the gambling mentality of the market participants, the government agencies failed in using the existing regulatory scheme as a vehicle to reform market participants and better securities markets.

#### IV. THE ALTERNATIVES

If the government's measures were not the proper solution, then what alternatives are available? More importantly, in light of the Shanghai

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125. *Supra* note 114.

126. See, e.g., Kirsti Hastings, *Shanghai Signals New Era at Its Bourse*, *ASIAN WALL ST. J.*, Sept. 22, 1995, at 19. Some analysts in Shanghai suggested that "[t]he verdicts in the Scandal case represent the outcome of a struggle between Shanghai and Beijing."

127. Kahn, *supra* note 86.

128. Just one day after the closure of the bonds futures market, the Shanghai stock index closed at 855.80, up 92.30 points or 12.09% as cash from the bonds futures market moved into equities. Ban Seen as Major Setback, *supra* note 36.

129. *Id.*

130. *Id.*

131. *Id.*

Scandal, what should be included in a Chinese bonds law if China is striving to build a more sophisticated securities market? Drafting a comprehensive bonds law is beyond the scope of this note, but the following alternatives merit further consideration.

First, China must establish a national framework of laws and rules for building securities markets. One of the critical factors in the Shanghai Scandal was that the SSE and, in particular, Wei were reluctant to strictly control the market according to the SSE's regulations for fear of losing business.<sup>132</sup> It was reported that Wei removed restrictions on price movements and the size of open positions "because he needed to keep up trading volume . . . He thought if Shanghai had restrictions, then everyone would go to Wuhan or Beijing or Shenzhen to trade."<sup>133</sup> A uniform, national legal framework would level the playing field so that the integrity of a securities market would not be undermined by its fear of losing business to competitors because of local perks. It would be a great advance for the Chinese securities markets if local regulations were preempted by a national securities law.

Second, China must delegate to the CSRC exclusive power to regulate the market. A national regulatory scheme invites a government agency which has enforcement and rule-making powers to uniformly implement the laws and rules. The U.S. Securities and Exchange Commission is an apt model to follow. The responses to the Shanghai Scandal indicated that the State Council was behind the decisions to halt trading in bond futures in May and the subsequent personnel changes in the SSE and the SSM.<sup>134</sup> While direct government intervention in the securities markets is necessary under special circumstances, too much intervention from different government agencies could send mixed signals to the markets, and discrepancies in the various policies could invite exploitation.

Third, in order to regulate the securities markets, the CSRC itself must do a better job in its own institutional development. It should implement a rule that a market regulator cannot be a market participant at the same time to avoid conflicts of interest. Indeed, it was hardly possible for the SSE to monitor Guan Jinsheng's misconduct when Guan himself was vice-chairman of the SSE.<sup>135</sup>

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132. Sender, *supra* note 34.

133. *Id.*

134. *Id.*

135. *Id.*

Fourth, China should focus more attention on risk management in the securities markets. It must establish an adequate reserve fund and require brokerage firms to purchase insurance to cover clients' accounts.<sup>136</sup> Moreover, given the current developing stage of the Chinese securities markets, it might be a good idea to set higher minimum margin requirements to limit the magnitude of trading securities short.

Fifth, brokers and brokerage firms should be liable for their wrongdoings. The liability should reach to their personal wealth for intentional securities frauds to deter such misbehavior. Since the Chinese securities markets are in the infant stage, strict regulations should be enforced. In order to deter the gambling mentality of the market participants, the scope of the penalties should be proportional to the trading volume involved in the fraud, but not less than a fixed statutory amount. The fixed fine would deter ordinary investor from fraudulent activities, and variable penalty related to the trading volume would deter securities firms from frauds of the scope of the Shanghai Scandal. Basically, this suggestion is a combination of Art. 5 of the 1990 Circular,<sup>137</sup> Art. 17 of the 1993 Measure,<sup>138</sup> and Art. 75(6) of the SSTR.<sup>139</sup> Moreover, to maintain the integrity of the securities markets and to deter potential wrongdoers, intentional wrongdoers should be banned from working in the financial industry.<sup>140</sup>

Sixth, China needs to attract foreign investments and institutional capital (such as pension funds) to its securities markets. It will not only supply the much needed capital necessary for China to sustain its economic growth, but may also bring a stabilizing factor to its securities markets. Whenever a market is dominated by few local players, opportunities exist for easy manipulation and exploitation. Therefore, it is unwise to limit the foreign investments to the domain of B shares and H shares. Moreover, the Chinese securities markets will also benefit by learning from the experience of the foreign institutions in risk management, accounting practices, and technology.

Seventh, China could use its governmental powers to encourage investors to invest for long term gain and to discourage investors' short

136. The size of the reserve fund at the SSE clearing house is only U.S. \$6.5 million. When trading volume is substantial, such a small amount is clearly inadequate. Sender, *supra* note 34.

137. *Supra* note 56.

138. *Supra* note 62.

139. *Supra* note 72.

140. It is interesting to note that Guan is soon expected to return to head a new private bank. Kahn, *supra* note 1.

term activities. One choice is to design a tax structure that favors long term capital gain over short term trading profits.

Finally, and most crucially, China must educate its people and institutions that investing is not gambling. A market cannot be well developed if its participants are gamblers. As a Chinese scholar suggested, "The more mature the investors, the better the securities market will be."<sup>141</sup> Attracting people to participate in the securities markets is a great way to get people involved in China's ambitious modernization program and would have a positive economic and social impact. China needs to make an effort to promote the public's awareness of investment risks, fundamentals of investing, and appropriate goals of investment. Proper enforcement and public awareness of the enforcement would be a great way to educate people. The Chinese legal system has a tradition of using the law as a vehicle to further social goals.<sup>142</sup> A well drafted Chinese bonds law along with proper implementation could adequately further its goal of getting people involved in the country's modernization and obtain the badly needed capital for economic growth.

## V. CONCLUSION

The Shanghai Exchange Scandal was a serious setback to China's budding bond markets and the broader securities markets. The measures taken by the government were swift, but inadequate, to prevent similar events from happening again. The author argues that the gambling mentality of Chinese market participants was a major factor in the Scandal and has to be addressed if China is going to develop a more mature securities market. Drafting a Chinese bond law is a good start, but proper implementation of the law is equally important. The author suggests, in light of the Shanghai Scandal and the gambling mentality theory, several alternatives which are worth exploring in a Chinese bond law. While the bonds futures markets are closed now, given that bond futures are the main force in the development of a government securities industry, provide greater liquidity in the market, and can give securities firms a device for

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141. Li Yining, *Shenzhen Must Be Prepared for Shanghai Threat*, S. CHINA MORNING POST, Dec. 13, 1993, at 2.

142. See, e.g., In Re Hsu Chung-Wei (1780), in 1 LAW IN THE PEOPLE'S REPUBLIC OF CHINA 12 (Randle Edwards ed. 1995) (In a fascinating ruling that sent a son to jail for his father's guilt, the Board of Punishment of Qing Dynasty stated: "Only by so doing can we adequately further the paramount goal of educating the people and enlightening them on the purpose of punishments.").

hedging,<sup>143</sup> it can reasonably be expected that the bonds futures market will be resumed in the near future, hopefully within an adequate framework of a Chinese bond law.

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143. Chinese Legislation Would Help Nurture Budding Bond Market, *supra* note 15.





# GLOSSARY OF CHINESE PERIODICALS

FAXUE	Jurisprudence
FAXUE YANJIU	Studies in Jurisprudence
FAXUE ZAZHI	Journal of Jurisprudence
FAZHI RIBAO	Legal System Daily
GONGYE CHANQUAN	Industrial Property
HEILONGJIANG RIBAO	Heilongjiang Daily
LIAOWANG	Outlook
MINZHU YU FAZHI	Democracy and Law
RENMIN RIBAO	People's Daily
RENMIN RIBAO	People's Daily
(HAIWAI BAN)	(Overseas Edition)
SHEHUI KEXUE	Social Science
TIANJIN RIBAO	Tianjin Daily
XIANDAI FAXUE	Modern Jurisprudence
ZHENGFA LUNTAN	Tribune of Political Science and Law
ZHENGFA YANJIU	Political-Legal Studies
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