Cross-Border Securitized Transactions: The Missing Link in Establishing a Viable Chinese Securitization Market

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INTRODUCTION

China’s banking industry has struggled since the 1990s, partly as a result of numerous Non-Performing Loans ("NPLs"). While the People’s Republic of China managed to avoid the severe financial crises suffered by many of its East Asian neighbors, the large volume of these distressed NPLs, as well as poorly performing state-owned enterprises ("SOEs") and underdeveloped and underutilized capital markets, demonstrates that the People’s Republic of China is essentially hindered by many of the same short-comings affecting its neighbors in crisis. In an effort to shore up a fragile banking system, there have been several attempts to jump-start asset securitization in the region. Unfortunately, these attempts have met with little success. Despite a great deal of effort on all sides, securitization has lagged in China for several reasons including the immaturity of China’s capital markets, the inadequacy of China’s legal infrastructure for securities, a shortage of regional investors, fundamental philosophical contrasts between aspects of the Chinese Law and the characteristics

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2 Schena, supra note 1, at 35; see generally Cao, supra note 1, at 570–72.

3 With the Communist takeover in 1949, the People’s Republic of China quickly abolished the [Republic of China’s] legal codes and attempted to create a system of socialist law copied from the Soviet Union . . . . In drafting the new laws, the PRC has declined to copy any other legal system wholesale, and the general pattern has been to issue laws for a specific topic or location. Often laws are drafted

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requisite of healthy securities markets.\(^4\)

Recent changes in China’s securities regulation legislation in 2001\(^5\) have led to growing speculation that China is moving towards becoming a viable market for securitization.\(^6\) In February 2004, a statement by the State Council of the People’s Republic of China reasserted its objective to reform and develop China’s capital markets.\(^7\) This commitment could keep China on the path towards developing a new legal framework for China’s securities markets, “including formal implementation of the parallel development of specific securities and banking regulations.”\(^8\) Currently, China simply has not come far enough in developing a legal infrastructure to handle such a highly specialized and regulated field as asset-backed securitization.\(^9\)

This article proposes that asset-backed securitization in China could be jump-started by first focusing on cross-border (sometimes called transnational) securitization, and by establishing a dependable group of regional investors. Cross-border securitization transactions would enable China to experiment with various packaging of state-owned securities on a trial basis through a transaction-by-transaction process. Thus far, the focus has been specifically on reforming the legal infrastructure so that China eventually would be able to attract investors and capitalize on an emerging market.\(^10\) Rather than attempting to both build an infrastructure and attract asset-backed securitization investors with large, sweeping changes, the market would be better served by building up the securitization infrastructure gradually and by developing a core group of regional investors at the same time.

Part I of this article discusses the history of the People’s Republic of China in developing a securities market. Starting with the Communist Party’s rise in 1949, China has moved from a strict nationalization of the

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\(^{5}\) See Schena, supra note 1, at 35.


\(^{7}\) Schena, supra note 1, at 35.

\(^{8}\) Id.

\(^{9}\) See Lee, supra note 6, at 2–3.

\(^{10}\) See generally Kong, supra note 4, at 249–55.
market towards the current state-dubbed "socialism with Chinese characteristics."\(^{11}\) Deng Xiaoping's\(^{12}\) strategy in the late 1970s aimed to incorporate the use of "market mechanisms and foreign capital and technology to expedite and promote the growth and modernization of the economy."\(^{13}\)

Part II discusses Chinese reform and its goals. This includes the push towards corporatization, securitization, and limited privatization,\(^{14}\) as well as the goal of these strategies: to bring about private sector investment of its capital into the Chinese securities market.\(^{15}\) Part II also discusses the specific limitations China faces in moving towards a system of limited privatization, as well as the benefits the People's Republic hopes to reap.

Part III discusses the current state of the Chinese securities infrastructure. This includes a discussion of the inherent conflicts that result when the requirements for an effective securities infrastructure are pitted against limitations that China's political philosophies place on currently developing securities laws.\(^{16}\)

Part IV introduces the general principles of cross-border securitization. This includes the importance of contract law in cross-border securitized transactions, as well as the process of establishing a set of industry best practices. Part V explores the possibility of applying this process to China's burgeoning securities markets. Part VI concludes by discussing the potential for future growth.

I. HISTORY

After assuming power in 1949, the Communist Party implemented a "centrally controlled" economic system in the People's Republic of China.\(^{17}\) This included an abolition of China's free markets and a nationalization of the nation's private companies.\(^{18}\) True to the Marxist model, the Chinese Communist Party intended to maximize productivity by rallying all workers to the common cause of the good of the country. In practice, however, the Marxist model provided little incentive for workers to meet high levels of

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\(^{12}\) A revolutionary elder in the Communist Party of China, Xiaoping served as China's de facto ruler from the late 1970s to the early 1990s, a period in which China became one of the fastest growing economies in the world. Deng Xiaoping, WIKIPEDIA, at http://en.wikipedia.org/wiki/Deng_Xiaoping (last visited Oct. 20, 2005).

\(^{13}\) Lee, supra note 6, at 5.

\(^{14}\) See Friedman, supra note 11, at 477-78.

\(^{15}\) Id. at 478.

\(^{16}\) Id. at 479-81.

\(^{17}\) ZHU SANZHU, SECURITIES REGULATION IN CHINA 3–4 (2000).

\(^{18}\) Id.
efficiency.\textsuperscript{19} Furthermore, across the board, there was little to no accountability regarding successes and failures, profits and losses.\textsuperscript{20} Instead of the efficient and productive machine the Communist Party envisioned, China’s economy wallowed in an atmosphere of massive waste and loss.\textsuperscript{21}

As the state sector continued to struggle, the private sector began to generate profits. As a result, a large slice of the nation’s capital fell into the hands of the populace.\textsuperscript{22} As the trend continued throughout the 1970s, the Communist Party began to feel the effects of the ailing economy, and the state-owned enterprises fell further into financial troubles.\textsuperscript{23} If capital was not generated soon, it was likely that a large portion of the state sector would teeter off the brink into dissolution and bankruptcy.\textsuperscript{24}

This came to a head in 1978 when Deng Xiaoping, the leading Chinese senior official, pushed China’s foreign policy in a new direction. Deemed “socialism with Chinese characteristics,” Xiaoping adopted an open-door policy “centering on economic reforms utilizing market mechanisms and foreign resources to speed up the growth and modernization of the economy.”\textsuperscript{25}

The 1990s were highlighted by a banking system that had fallen prey to non-performing loans. Bank loans are currently the most dominant source of funds for the Chinese financial system.\textsuperscript{26} As recently as 2002, approximately 20 percent of these loans were considered non-performing by international standards—the equivalent of around 20 percent of China’s GDP.\textsuperscript{27} This is the albatross around the neck of China’s securities market. The establishment of a viable asset-backed securitization market is severely hampered by such a lack of funds, particularly in light of the fact that the available pool of diversified assets is limited and relatively unstable.\textsuperscript{28} The essential problem facing China is that although there is a desire to reform—

\begin{itemize}
  \item[19] See Friedman, supra note 11, at 477.
  \item[20] Id.
  \item[21] Id.
  \item[22] This resulting disparity was troublesome to the Communist Party. Id. at 478 (“The government viewed the disparity in wealth between the state-owned sector and the private sector as politically threatening.”)
  \item[23] Id.
  \item[24] Id.
  \item[25] Id.
  \item[26] As of 2005, bank loans “constitut[ed] more than 80 percent of the annual increase in average fund flows for the last three years.” Schena, supra note 1, at 36.
  \item[27] Id. at 36–37.
  \item[28] Id. at 37. Such a high concentration of financial assets in a single class, burdened further by suspect quality, severely hampers building the diversified pools of assets required for effective securitization. Moreover, where the benefits of securitization in the form of asset management, liquidity, and capital management flexibility would otherwise accrue to China’s banks, their distressed loans, in at least this respect, imprison them.
\end{itemize}
with compelling reasons to do so—no clear-cut direction has been established by the government that would effectively lead to a stable market for securitization.

In an attempt to keep an ailing state sector afloat, China has started down the road towards the use of securitization as a means to tap into private equity.\textsuperscript{29} As a result, economic reform has yielded for China an economy with one of the most rapid growth rates in the world.\textsuperscript{30} Much of this has to do with the lessening of the government's hold over its industries, and it is clear that the Communist Party will have to open up even further to the idea of privatization and less government interference if China is to continue its economic growth, especially in the state owned sector. These ideas are discussed further in Part II.

II. CHINA'S GOALS IN REFORM

The Communist Party's strategy for economic reform centers around three core principles, all of which are still being developed to this day.\textsuperscript{31} The first is "corporatization."\textsuperscript{32} This is the idea that state-owned enterprises can be converted into shareholding companies.\textsuperscript{33} However, there is an inherent difficulty in applying the principles of corporatization to a communist regime. In order for the Chinese government to maintain absolute control over state enterprises, it is a theoretical impossibility to open up these enterprises to shareholders (specifically potential international investors).

The second principle, put in motion by Xiaoping's reform and still being developed today, is "securitization."\textsuperscript{34} In this context, securitization is "the sale of shares of state-owned enterprises in the securities market."\textsuperscript{35} This practice has come to be seen as a possible saving grace for China's state-sector.\textsuperscript{36} It would allow the state-run enterprises to generate capital by appealing to private sector investors, but would require a loosening of government control over the enterprises.

The third and final principle China plans to fully implement is the idea of "limited privatization." This is the missing link that will allow the corporatization and securitization of the state sector to effectively function in a communist environment. Limited privatization involves the "minority private equity participation in state-owned enterprises so as to enable the

\textsuperscript{29} See generally Friedman, supra note 11, at 478–81.
\textsuperscript{30} Id. at 479.
\textsuperscript{31} See generally id. at 478–80.
\textsuperscript{32} Id. at 478.
\textsuperscript{33} Id.
\textsuperscript{34} See id.
\textsuperscript{35} See Friedman, supra note 11, at 478.
\textsuperscript{36} See Kong, supra note 10, at 237–40.
government to retain majority control of the market." In order to adequately regulate such an industry and attract investors, it is necessary to create a certain level of transparency that the Communist Party may not be ready to permit.

While the general principles of privatization may not appear to go hand in hand with China's political ideologies, China has historically shown itself to be adept at utilizing western concepts in the context of Chinese need. In this instance, the government retains the controlling interest in "privatized" entities. The resulting transaction resembles less of a private sale of state assets and more of a mechanism for funneling private funds into state-controlled enterprises. The goal is to infuse the excess private capital of Chinese citizens into a more productive system of state-run enterprises. The state continues to hold a controlling share in state-owned enterprises, faithfully adhering to the Marxist principle that "ownership of the means of production" shall remain in the hands of the state as a surrogate for the people.

III. CURRENT STATE OF CHINESE LAW AND OBSTACLES TO OVERCOME

China's securities regulatory framework has been described as a "patchwork system," evolving primarily through landmark laws and follow-up "clarification and application" through national government regulation. This has been a slow evolution from the original state of the securities

Matthew D. Bersani states:

The term 'privatization' means something very different in the Chinese context than in Eastern Europe, South America, or other places where privatization has occurred. Privatization in China does not involve a radical departure from past practices, inspired by political necessity. Rather, it is the continuation of a process begun 15 years ago, and is motivated largely by excessive capital accumulation by private individuals in [China], rather than by the state's dire economic needs.

Matthew D. Bersani, Privatization and the Creation of Stock Companies in China, 1993 COLUM. BUS. L. REV. 301, 303 (1993). For more explanation, see Friedman, supra note 11, at 478.

Bersani, supra note 37, at 302. "The phrase 'make foreign things serve China' dates back to the late Qing (Ch'ing) dynasty (1616–1911) and has since proved to be an indispensable part of the Chinese cultural heritage." WEI JIA, CHINESE FOREIGN INVESTMENT LAWS AND POLICIES: EVOLUTION AND TRANSFORMATION 2 (1994). For a study of this principle, see generally id. at 2–4.

Bersani, supra note 37, at 303.


See Bersani, supra note 37, at 305.

See Kong, supra note 4, at 249.
infrastructure which focused primarily on local regulation.\textsuperscript{43} It was not until December of 1998 that the Standing Committee of the National People's Congress adopted a legal framework that began to resemble that of the United States Securities Act of 1933 and the Financial Services Act of 1986 in the United Kingdom.\textsuperscript{44} In addition to these regulations, development in other areas of law helped to promote a promising securities regulatory system in China.\textsuperscript{45} However, the framework in place is still insufficient to support a truly viable securities market.\textsuperscript{46} This is especially true regarding foreign regional investors.\textsuperscript{47} Furthermore, the current state of Chinese capital markets and the lack of institutional investors have made transparency and the availability of information all the more critical, yet these are still greatly lacking.\textsuperscript{48} While Chinese-based securitized transactions are a step in the right direction and certainly play a large role in increasing corporatization and securitization of China's state-owned enterprises, shutting out foreign investors is counter-productive to the ultimate goal of maximizing capital.\textsuperscript{49} Given the right legal infrastructure,

\textsuperscript{43} Sanzhu states:

The development of a securities regulatory framework in China has passed through two stages distinguished by the creation of the national securities commission in 1992. In the early stage, the People's Bank of China ("PBOC") was designated as a watchdog to oversee the securities market in conjunction with various bodies of the central and local governments. In that stage, securities regulations issued by certain local authorities were the main form of regulation.

\textsuperscript{44} Id. at 13.

\textsuperscript{45} Id.

\textsuperscript{46} See generally Friedman, supra note 4, at 478–81.

\textsuperscript{47} Kong, supra note 4, at 251–52 ("China currently lacks a comprehensive national legal system for the successful transplantation of the U.S. model of asset securitization. Instead, a patchwork of related Chinese laws and regulations on the creation of a security interest provides only an ad hoc framework for supporting domestic Chinese based asset securitization transactions.")

\textsuperscript{48} Schena states:

[D]ue to the current state of capital market development, there are few institutional investors in China, thus making information structures that much more important. Yet these credit rating, accounting, and audit services remain weak and therefore undermine the credibility of information disclosure. With specific reference to credit ratings, local agencies lack reputational value, while overseas agencies frequently constrain local corporate ratings in order to remain below central government levels. Pricing mechanisms are underdeveloped, and as a result, risk is not effectively incorporated into bond spreads.

\textsuperscript{49} For an overview of China's encouragement of foreign investment and trade opportunities in various areas, see generally PRICE, WATERHOUSE, DOING BUSINESS AND

\textsuperscript{47} Kong, supra note 4, at 251–52 ("China currently lacks a comprehensive national legal system for the successful transplantation of the U.S. model of asset securitization. Instead, a patchwork of related Chinese laws and regulations on the creation of a security interest provides only an ad hoc framework for supporting domestic Chinese based asset securitization transactions.")
China's focus on limited privatization should adequately address concerns the Communist Party has regarding foreign investment. Unfortunately, the infrastructure, as is, cannot support this.

Securities regulation is a vital component of any successful securities market. In order for China to attract and maintain the requisite investors, the market must adequately protect the interests of the investors. It must safeguard the economic order and public interest, and promote the development of a socialist market economy. In China's case, the issue of regulation is an important one for foreign businesses and foreign investors in all aspects of business, not just securitized transactions. Within the context of securitization, this is an issue that could be resolved as the infrastructure more fully develops, and as the needs of the investors and the

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50 Bersani states:

China's policy of "limited privatization" may be reconciled with the Marxist principle demanding state ownership of the means of production on the theory that, as long as the state retains a controlling interest in the enterprise, no assets have been sold; rather, private capital has been brought under the state's control. "Limited privatization" thus provides the [People's Republic of China] government with a vehicle by which it can harness privately held capital and thereby, at least theoretically, politically neutralize the private sector's vast economic resources. Where a privatized state enterprise receives foreign investment, the state also may be viewed as simply absorbing foreign capital, not ceding ultimate control over the means of production.

Bersani, *supra* note 37, at 306.


53 Schena states:

Legal infrastructure is a necessary precondition of the development of indigenous [Asset-Backed Securities] markets. Such infrastructure supports: 1) the transfer or sale of assets; 2) the establishment of independent special purpose entities, in the form of either a company or trust, to acquire the transferred assets; and 3) the issuance of debt securities. In China's case, each of these presents a practical hurdle to effective securitization.

Schena, *supra* note 1, at 44.

54 PITMAN B. POTTER, FOREIGN BUSINESS LAW IN CHINA: PAST PROGRESS AND FUTURE CHALLENGES 81 (1995) ("A discussion of the content and performance of the legal regimes governing selected aspects of China's foreign business relations and of the attitudes that affect performance suggest that the goals guiding Chinese regulatory efforts are at odds with the main concerns of foreign business.") For a detailed discussion on Chinese regulatory issues, see generally SANZHU, *supra* note 17, at 72–77. For a recent summation of the regulatory environment in China from an investor's standpoint, see generally PRICE, WATERHOUSE, *supra* note 49, at 43–51. For an interesting debate on the reform of Chinese laws and regulation regarding foreign direct investment, see generally YAN WANG, CHINESE LEGAL REFORM: THE CASE OF FOREIGN INVESTMENT LAW 70–122, 176–84 (2002).
government are each taken into account.

The primary problem facing the Communist Party is how to balance the need to maintain control over the state-sector while creating a viable Western-style securities market that can attract investment from regional investors. To some this appears to be impossible, ultimately dooming the Communist Party to failure. The sweeping changes and bold moves that would likely come from a government desperate to maintain control are not what the securities market needs. Such changes would do more harm than good, creating a jumbled and unusable securities infrastructure. Of course, if the fall of the Communist Party in the People's Republic of China could be brought about by the securities market, it is hardly likely that the government would go without a fight. When all is said and done, however, China's largest obstacle in

55 See Friedman, supra note 11, at 479–80.
56 Friedman states:

[W]ith the implementation of these Western capitalist market theories into the Chinese marketplace, the survival of the [Communist] Party will be at stake. The inherent conflict of one country having two systems — a communist government with a capitalist securities market structure — makes it impossible for the [Communist] Party to retain control over China without disposing of its securities market. Since the Securities Law of the People’s Republic of China ... is subservient to [Communist] Party ideology and objectives — primarily state control over the securities market and its participating enterprises — the Law does not work. Accordingly, either the securities market will fall or the current government will fall. Because its failing state-run economy is in dire need of capital, the government has no other alternative than to support the nation's securities market. Hence, it is inevitable that China's current government will fall at the expense of its capitalist securities market.

57 This would most likely manifest itself in the Chinese government enacting Securities Laws in an effort to force transactions through the system. The danger is that with little to no transactional experience, it is highly probable that even if a transaction was successful the first time through, the Laws would not be comprehensive enough to foster further transactions. Even more dangerous is the likelihood that the Laws would not be successful at all, but would nonetheless be integrated into China's already deficient Securities Infrastructure. In such an instance, China would be taking two steps back in an effort to prematurely jump one step forward.

58 This is why the idea of "limited privatization" is so important. It allows for the government to retain control, while drawing capital into the state-owned enterprises and simultaneously redistributing the growing private wealth that threatens the Party's security. Specifically, the government hopes to shift its title in state-owned enterprises from "manager" to "controlling stock holder." The hope is that private stock holders will increase managerial accountability and encourage more efficient and profitable state-owned enterprises. Taken a step further, employees can be given the option of owning shares of the state-owned enterprises, which would hopefully provide the incentive to work harder and perform more efficiently (something which has been missing in China's state sector). See Bersani, supra note 37, at 305.

59 See id.
creating and maintaining a viable Western-style securities market is not solely the lack of securities infrastructure or the lack of investors, but rather the existence of both shortcomings at the same time. Theoretically, a market with a viable securities infrastructure could implement slight changes in law, or practice, to attract investors. Likewise, a core group of investors could effectively influence change in various “problem areas” inherent in any securities infrastructure.\(^6\) In fact, without the investors, it will be difficult to build and fine tune an infrastructure to provide the requisite transactions to uncover and explore the ins and outs of China’s securities laws and how they can best serve the needs of the Communist Party and the state sector without compromising transparency and fairness among the private investors.\(^6\) Likewise, without an infrastructure that can, at a minimum, guarantee transparency and fairness, it is highly unlikely China will be able to build up such an investor base, especially with other regional options readily available in the Eastern Asia market.\(^6\)

Interestingly, investment banks such as JP Morgan have recently made a push towards establishing traditional asset-backed securitization in China.\(^6\) The efforts of these investment banks have recently resulted in Standard & Poor’s Ratings Services raising both foreign currency ratings on the People’s Republic of China by one notch, to “BBB+/A-2”, in February of 2004.\(^6\) The onus now falls on China and the investment banks to try and maintain momentum in an environment laden with the pitfalls of an underdeveloped securities infrastructure. So the question becomes, what will China do?

While some theorize that the market will eventually be liberalized and the reins will be loosened by the Communist Party, it is difficult to set this to any sort of timetable. Eventually, China will have to alter its securities infrastructure to one that more closely resembles the Western framework if it is to become a permanent fixture in the international securities market.\(^6\) China’s liquidity needs and ailing state-sector, however, require an

\(^6\) This idea is expanded on in Part V. It speaks directly to the natural evolution of securitized transactions. Essentially, the legitimacy of securitized transactions, especially from an investor’s standpoint, relies a great deal on past successes. Therefore, a market’s continued success, often due to changes facilitated by attorneys to meet investor demands, ultimately comes together to form a sort of market “Best Practices.”

\(^6\) See Friedman, supra note 11, at 515–16.

\(^6\) See Cao, supra note 1, at 570.

\(^6\) JP Morgan has been at the forefront in stimulating the Chinese market. See generally Friedman, supra note 11, at 514.


immediate boost, and may not be able to sustain a prolonged battle between the capitalist securities market structure and the desire for the Communist Party to retain control. A solution that has yet to be thoroughly explored is cross-border (transnational) securitization. If properly implemented and nurtured, cross-border securitization may be one way to jump-start China's securities market, attract investors, and allow for a steady and efficient development of a Western-style securities infrastructure that can fit into the Communist Party's idea of limited privatization.

IV. TRANSNATIONAL (CROSS-BORDER) SECURITIZED TRANSACTIONS

A. A Brief Overview of How International Systems for Securities are Established

An essential element of international systems for securities—a category under which cross-border securitization falls—is the idea that legal rules can be manifested not only through common law and statute but also through the willful acceptance of terms between contracting parties. Article 1134 of the Code Napoleon formulates this idea in stating, "les conventions legalement formees tiennent lieu de loi a ceux qui les ont faites" or "contracts that have lawfully been entered into stand for the law as between the parties that have made them." This is an extremely important concept in dealing with international securities markets. While there may not be specific statutes guiding the international securities markets, there is an understanding and acceptance that the contracts that parties have entered into—in other words, previous transactions of a similar nature—are to stand as a source of legal rules and body of law. In essence, these legal rules are created through trial and error in an effort to maximize fairness and satisfaction on the sides of all parties involved.

The general principle is that systems of contracts, drawn up by many lawyers over time, eventually lead to a "petrification" of contractual content. This means that repeated transactions, and the contracts accompanying them, form a sort of "best practices" for the particular market. This is underscored by the market and the market participants' "drive for widely-accepted and predictable solutions to business disputes

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66 See generally Kong, supra note 4, at 238–40.
67 See Friedman, supra note 11, at 480.
69 Id.
70 Id. at 501–03.
71 Id.
between merchants trading different places in the world." This principle is directly applicable to international securities markets. The development of a standardized legal practice is highly desirable in areas where intricate legal schemes are involved.

Applying the Code Napoleon model to the securities market, it is evident why contractual history makes for a more workable framework than specified statutes when dealing with parties in different countries. "Efficiency, economies of scale, and risk aversion ... are [generally] among the major factors underlying development [in a given area of international business]." Participants in securitized transactions – investors, sellers, underwriters, purchasers, etc. – likewise want a dependable and predictable system in which to operate. These systems are established through continued work and the success of previous contractual transactions. Using this foundation, it is possible for such a system to be further utilized through a cross-border securitization framework in gradually building a viable Western-style securities market in China – one that adequately takes into account the Communist Party’s desire to maintain limited privatization.

B. An Introduction to Cross-Border/Transnational Securitized Transactions and General Practices

Cross-border securitized transactions traditionally develop because of opportunities presented in existing international business practices. The general structure for these transactions is:

(i) The company originating the asset is in one country; (ii) a trust or other special purpose entity in another country purchases the originator’s receivables; (iii) the payors on the receivables are outside the originator’s country; (iv) the receivables are largely denominated in the same currency as the securities; and (v) the trust receives payments directly from the payors and makes distributions directly to investors.

This structure allows for certain transactional practices in Country A to be combined with business practices in Country B in a complimentary

72 Id. at 503.
73 Id.
74 Here, success is likely defined as transactions that do not result in litigation. Ultimately, any two parties could undertake a transaction without seeking legal guidance. However, the high transaction costs and the desire to do continual business within a transaction’s framework (sometimes referred to as a program deal) reinforce the need for a level of security and legitimacy that can only be guaranteed by experienced attorneys providing a continual showing of successful transactions.
manner. In such an instance, a cross-border securitized transaction attempts to utilize both countries' laws in order to maximize profitability for all parties involved.\textsuperscript{76}

The key aspect of cross-border securitization is that it does not rely entirely on one country's laws.\textsuperscript{77} Instead, parties can draft transactional contracts based on beneficial aspects of multiple countries' laws.\textsuperscript{78} These contracts are then applied to a transactional framework that is often at least loosely-based on the Securities and Exchange Commission ("SEC") standards. These transactions are then fine-tuned through the process of repeated work by the attorneys drafting the various contracts over the course of various transactions.

Once this loose structure of rules is applied to the transaction, the fine-tuning of the terms for the transaction is hashed-out through the transactional documents. In this way, lawyers act as "vectors" for developing a common body of concepts, techniques, and the like to be applied to securitized transactions that will take place in the future.\textsuperscript{79} Each transaction adds to the body of cross-border transactional contractual law while simultaneously permitting a degree of freedom in which attorneys can expand the scope of the market itself.\textsuperscript{80} All of this is underscored by investor confidence. Because this body of law is created through continual contractual work, keeping in mind the best interest of all parties involved, investors are encouraged to continually work with sellers and attorneys to try variously structured transactions in an attempt to maximize capital.

A great deal of this investor confidence also stems from the fact that most of these transactions are loosely modeled after SEC practices.\textsuperscript{81} Generally, the school of thought is that if certain transactions can be structured to work within an SEC framework, they could likewise be

\textsuperscript{76} Usually the cross-border securitizations are structured using a United States model, as the United States presents the largest securitization market in the world. It is important to note, however, that the United States is not the only country in the world with an established securitization market and developed financial infrastructure. See Dvorak, \textit{supra} note 75, at 542–43.


\textsuperscript{78} This is important, in that countries like China, who present many opportunities for potential securitized transactions, are often the same countries that could benefit the most from securitization were it not for a lack of fine-tuned securities infrastructures. See Dvorak, \textit{supra} note 75, at 543.

\textsuperscript{79} See Wymeersch, \textit{supra} note 68, at 502–04.

\textsuperscript{80} The unique aspect of such an evolution is that attorneys are creating a body of contractual law that can continually be fine-tuned to deal with any troubles previous transactions have encountered. Likewise, because of the nature of the international securities market, attorneys can also continue to branch off into new areas where securitized transactions may not have yet been attempted.

\textsuperscript{81} See generally Wymeersch, \textit{supra} note 68, at 502–04.
structured to utilize similar aspects of another country’s laws. These cross-border deals have the benefit of developing along the lines of international business practices with which investors may be familiar or comfortable. These deals are also applied to the United States’ proven SEC framework. The ultimate rationale for this mentality—and high level of investor confidence—is stated by Eddy Wymeersch in “The Law of Cross-Border Securitization”:

The movement [involving cross-border securitized transactions] is driven by many factors such as acceptability in the international securities markets, the aversion of underwriters, banks, and lawyers to introduce new rules to which unknown risks are attached, the international recognition of good practice and a certain form of competition for excellence, resulting in best practice. The lawyers working on these deals are the vectors for developing this common body of concepts, techniques, phrases, presentations, and the like.

So long as transactions continue to prove fruitful, investors will remain confident. This provides attorneys with the requisite body of transactions to create an effective and dependable body of law to help govern the cross-border securitization market.

C. Establishing Program Transactions

Program transactions are sequential securitized transactions in which the general structure of a transaction is used over a period of time on a scheduled basis. In order for these transactions to arise, it is first important that a particular concept or area of law and a securitization technique have been found to produce a successful end. This would entail a transaction that has not been litigated, and moreover, one that would provide something to the parties involved that would make them want to do it again. This is characterized by the transaction being profitable and manageable by both sides and is at times quantified using one of two efficiency models.

Efficiency is generally defined using either the Pareto or Kaldor-Hicks efficiency model. The Pareto efficiency model states, “in the context of a securitization transaction, [the transaction is efficient if it] would make the parties to the securitization—the originator and the [Special Purpose Vehicle]—better off, and no parties worse off.” Generally, the parties

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82 Id.
83 Id. at 503.
84 Id. at 503-04.
86 Id.
87 Id.
who are potentially made worse off would be the unsecured creditors, but in China’s case there might also be a question of the State being made worse off. The Kaldor-Hicks efficiency model states, “in the context of a securitization transaction, [the transaction is efficient if] the aggregate benefit to the parties to the securitization exceeds any net harm to other parties.” The Kaldor-Hicks model tends to be used with more frequency because “the conditions for Pareto superiority are almost never satisfied in the real world.” That is, it is highly unlikely that no party is at all worse off after securitization. The general consensus in the law and economics universe, then, is that a transaction is efficient if “the aggregate benefit to the [Special Purpose Vehicle’s] investors and the originator exceeds any net harm to the originator’s unsecured creditors.”

The next requirement is that the transaction be sound from an investor’s point of view, which is usually characterized by its profitability. However, many securitized transactions boast high profitability at the cost of high risk. For example, asset-backed securitized transactions involving pooled loans bear the risk that the notes will not ultimately be paid out if the pool of loans is not sustained. Thus, the transaction must be a sound investment in that the pooled securities are rated highly by a rating agency, or are seen as dependable investments based on past performance of similar securities.

Finally, the transaction must be duplicable. This means that the pool
from which the assets were drawn and securitized must continue to contain assets which can, in turn, be pooled and securitized in the future. Using the example above, there may be a class of loans pooled and securitized by Bank A that yields a profitable and seemingly dependable transaction. However, unless the bank has a larger supply of that particular class of loan, the transactional structure may not be as profitable if repeated. That is, the structure may not be as successful at yielding positive results when a different class of loan is pooled and securitized.

In practice, this works well with the idea that a continually growing body of contractual law is mutually beneficial for all. The success of one transaction between two parties, even if it does not result in the establishment of a program deal, can open the door for other transactions between other parties with similar assets. Furthermore, program deals would then inherently have the benefit of providing a stable transaction that can be subtly adjusted in an effort to maximize profits. For example, a successful pooling and securitizing of Loan Group A under a specific transactional structure may eventually evolve into a securitizing of Loan Group A and Loan Group B simply by merit of slight adjustments made periodically to the program deal. Over time, the structure evolves into a more efficient and profitable mechanism that can be applied now to two groups rather than one. Currently, such transactions are widespread and continue to flourish in various securities markets across the globe.

V. APPLYING CROSS-BORDER SECURITIZED TRANSACTIONS TO CHINA: CREATING A MARKET AND AN INFRASTRUCTURE FOR INVESTORS

A. The Benefits of Cross-Border Securitized Transactions Over Traditional Asset-Backed Securitized Transactions

As discussed earlier, traditional asset-backed securitization has failed to gain steam in the Chinese market. So long as there is neither a satisfactory securities market infrastructure in China nor a core group of investors to provide a base for the securities market, it will be difficult to attract the needed foreign investors—and their capital—into such a high risk and unproven market. Asset-backed securitized transactions simply

protected, the ideas underlying the transaction itself cannot be copyrighted. Thus, competitors can duplicate transactions by making small changes while operating under the same transactional ideology. See id. at 270.

95 See generally id. at 268–72.
96 See generally Schena, supra note 1, at 35–37.
97 See Kong, supra note 4, at 251–52. See generally Dvorak, supra note 75, at 574–75. The general concerns explored by Dvorak are prevalent in the Chinese example and are discussed again in Part V.B.
do not fit the Chinese market at this time. Therefore, the leading
securitization lawyers and investment banks should be focusing their efforts
on cross-border securitized transactions.

As discussed earlier, the primary draw of cross-border transactions is
that they develop because of opportunities presented by a combination of
beneficial laws in one or more countries and existing international business
practices that have been proven to maximize profitability for investors.98
After a successful combination has been repeatedly utilized in multiple
contractualized transactions, there remains the possibility that a profitable
program deal can emerge, encouraging an influx of investment and
securitization of the profitable pooled securities. Such an influx is exactly
what China has been looking for to provide much needed capital to the state
sector.99

Even if there is not an immediate jump in regional foreign investment,
it is possible that China could help itself in demonstrating the benefits of
investment. There exists an ample base of private wealth in China which
could be tapped by an initial group of investors.100 The key factor that
could attract this group of investors is the abundance of excess wealth in the
hands of private individuals who are facing low and unattractive interest
rates in Chinese banks—rates often lower than the rate of inflation.101
Individual investors could be attracted to the higher returns that would
come from securities investment. Moreover, from the perspective of the
Communist Party, this provides an opportunity to steer private savings into
“an arena susceptible to the control of the state.”102 Indeed, even if foreign
and regional investors were to jump at the opportunity to kick-start China’s
securities market through cross-border transactions, the Chinese
government would be wise to heavily court private Chinese investors as
well.

Since Chinese securities laws are still insufficient, with the exception
of the occasional Chinese-based asset-backed transaction, it is unlikely that
asset-backed transactions will be adequately attractive to the savvy foreign
investor.103 There simply is not a profitable advantage to investing in
Chinese securities, given the extent of government control, the lack of
transparency, and the overall lack of protection for investors.104 The bottom
line for investors, then, is that China does not have an independently

98 See Wymeersch, supra note 68, at 503–04.
99 See Friedman, supra note 11, at 477–79.
100 Lan Cao, Chinese Privatization: Between Plan and Market, 63 LAW & CONTEMP.
PROBS. 13, 44 (2000).
101 Id.
102 Id.
103 See Kong, supra note 4, at 251–52.
104 See generally SANZHU, supra note 17, at 127–31.
profitable securities infrastructure worthy of investment.\textsuperscript{105} To draw investors in, law firms and investment banks could instead push stability as the primary selling point for utilizing cross-border securitizations.

The initial establishment of this class of securities would be difficult. These securities would have to draw stability from a combination of successful private market investment and state-sector shares achieved through corporatization. One possible way of accomplishing this would be to have the cross-border securitized transactions made up of several classes of securities, including, but not limited to, a small section of state-sector shares, a group of securities pooled for low risk, low profit private entities, and possibly a cross-section of pooled securities for an established cross-border transaction. The transaction would then need to be structured such that investment in groups of these securities is encouraged so as to provide a stable, but not necessarily an immensely profitable investment.\textsuperscript{106} While initially this seems like a Herculean task, with little upside for investors, a closer look reveals that the specific classes of securities that could be created by such a cross-border, joint security offering could be very attractive for larger foreign investors. The success of such a transaction is best examined in the context of how China specifically benefits.

B. China’s Benefits from Cross-Border Secured Transactions and the Benefits Passed on to Investors

The examination of the benefits of a cross-border, low-risk securitized Chinese transaction must start with state-sector shares, which is the investment group China is trying to improve.\textsuperscript{107} The first point to note is that this set of shares is drawn from the corporatization of small parts of China’s state sector. In other words, a percentage of the shares in various state-owned enterprises or state-owned shares of other companies are placed into an asset pool. China’s government has retained control in the securities market thus far, as a result of the segregated share structure.\textsuperscript{108} While this segregation has limited investment in the past, it could be utilized by the Chinese government to customize a class of securities consisting of a specific pooled group of the state-owned enterprises.\textsuperscript{109}

\textsuperscript{105} \textit{Id.}; see generally Schena, \textit{supra} note 1, at 35–37.

\textsuperscript{106} There is also a distinct possibility that mortgage-backed securities could eventually be utilized to create an attractive pool for cross-border transactions. \textit{See infra} note 117. \textit{See generally} Joyce Palomar, \textit{Contributions Legal Scholars Can Make to Development Economics: Examples from China}, 45 WM. & MARY L. REV. 1011, 1021–22 (2004).

\textsuperscript{107} \textit{See} Friedman, \textit{supra} note 11, at 478.

\textsuperscript{108} \textit{See generally id.} at 495–96.

\textsuperscript{109} In practice, the Chinese government would have to work with the firms drafting the documents for the transaction in order to determine the correct makeup of this pool. It would be important to open up ownership possibilities to interested investors, but in a limited capacity (at least to start).
Currently, China subdivides its share structure into four groups: 1) state shares; 2) legal person shares ("C Shares"); 3) individual shares ("A Shares"); and 4) foreign investor shares ("B Shares"). The parties involved in the transaction could use a larger percentage of a small group of state-owned enterprises, or could instead choose to use a very small percentage of a larger group of state-owned enterprises. Either way, the benefit is that this would be a gradual process of securitizing a small section of the state sector, either through direct shares of state-owned entities or through portions of shares owned by state entities. The catch here is that currently, state shares and legal person shares are prohibited from being converted, transferred, or traded in the securities market in almost all instances. Again, the benefit of using a cross-border transaction is evident: China would be able to use a cross-border transaction as a test case without changing this law.

Ultimately, the goal would be to fine-tune the current segregated groups, possibly by creating a fifth group that would consist of state shares that are permitted to be traded, such as a preferred state share. Since state shares and legal person shares make up approximately 60 to 70% of the total shares issued in China, it would follow that the Chinese government will eventually wish to tap into these potential assets. Until that point, however, cross-border transactions would allow China to test the water before diving in head first. An influx of capital could be funneled into the state-owned enterprises without the sweeping legal changes that would provide the transparency and control that most investors require. In fact, at the start, the state shares that the Chinese government is concerned with protecting would only be a small aspect of the transaction. Hopefully, this initial protection would not drastically affect the performance of the pool itself, either negatively or positively.

As discussed earlier, much of what is now common practice in international securities markets is the result of fine-tuning contractual-based...
law over the course of many transactions. This is an optimal path for China to take in establishing how it will deal with securitizing its state shares. Because the state shares only need to make up a small percentage of the total pooled securities, China will be able to control the flow of shares into the transactional pools at as slow a rate as it deems necessary. As the body of transactional contract law increases, the potential pitfalls of investment—as well as the sale of the state shares—will become evident. The Chinese government can then specifically legislate these matters.

In essence, using this approach, China will be shown the direction it needs to head in order to create a successful securities market. This is a drastic contrast to simply taking Western models and trying to apply them to a socialist ideology. The result would be, first, the formation of a body of contractual law guiding the evolution of the cross-border transactions. Second, based on how these transactions progress and how the state-shares perform as packaged securities, despite limited transparency and other short-comings discussed earlier, China would be better informed as it drafts statutes to foster direct investment.

At first glance then, this seems to be a viable course of action for China to take. Unfortunately, this is still only half of the equation. Although there is a logical progression as far as China's securities infrastructure is concerned, there is still the question of investors. What will attract them, and how will the initial cross-border securitized transactions provide these incentives? The answer lies in the combination of the state shares with the private market securities.

As discussed earlier, the private sector in China has fared well. By pooling private sector assets together with state shares, investors would be afforded a constant, low-risk, reasonably-profitable investment opportunity. Because securitized transactions bring with them the usual label of high-risk/high-yield opportunities, it is not only conceivable, but likely, that large investors would be interested in diversifying their securities investment portfolio by also investing in low-risk/low-yield securities. The tight leash the Communist Party keeps on the state sector, normally seen as a

113 See Wymeersch, supra note 68, at 503–04.

114 Repeated transactions will yield increasingly efficient and all-encompassing contractual law. Taking this information into account, China would have a body of information not yet available involving the ins-and-outs of its state-shares and how they might perform once pooled and offered to international investors. The implication seems to be that the impasses and pitfalls encountered during the transactions would be beneficial in the long run because they would serve as examples to China of how not to set up their infrastructure. It is much easier to redraft a contract to account for problems on a transaction-by-transaction basis than to implement ineffective law and try to work around it.

115 See Friedman, supra note 11, at 478.

116 This should be seen, not as the difference between high-risk and blue chip stocks, but rather between high-risk stock and savings bonds.
hindrance to investment, actually could be utilized as a way of adding consistency to a group of pooled securities.\textsuperscript{117}

The counter-argument to this is that there already exist low-risk/low-yield investment opportunities that can be reached outside of the securities market. The added incentive to investors in the case of China, however, is that they would be opening up an entire market. True, initially these transactions would not be extremely profitable. However, a skillful combination of the state shares, private shares, and an established international share would certainly provide a stable investment, even at a profit level lower than the average securitized transaction. To be sure, the benefit to the investor is minimal at the start, but the future upside would be immense.

VI. CONCLUSION: FUTURE GROWTH IN THE CHINESE SECURITIES MARKET

The true upside to implementing a cross-border securitized transaction practice in China is the potential positive impact it could have, turning China into a hot-bed for investment. Currently, China is stuck trying to implement sweeping changes throughout its securities infrastructure in order to facilitate participation by investors. Moreover, these changes are based almost exclusively on Western-style frameworks, and stand little to no chance of ever succeeding in the communist People’s Republic of China. By contrast, the proposed cross-border securitized transactions would allow

\textsuperscript{117} There also exists the possibility that mortgage-backed securities could eventually be pooled into such a transaction as well. There is evidence that such pooled mortgage loans could be highly profitable and enticing for investors and for China:

[S]ince China amended its Constitution and Land Administration Law to permit the transfer of “land use rights” to private persons, the market for privately owned apartments has more than flourished. Individuals finance their purchases with twenty- or thirty-year home mortgage loans. At this time, the Bank of China finances all these residential mortgage loans with state money. If, instead of holding all this debt for twenty or thirty years, the Bank of China could sell packages of thousands of its residential mortgage loans into the world’s securities markets and, thus, make private capital available for residential mortgage lending, this process could generate trillions in state resources for the funding of other projects. This source of capital for residential mortgage loans, however, will not become available until China’s property rights institution and other institutions complement one another. Private mortgages must be proven enforceable over a long enough period of time to permit rating agencies and investment banks to rate China’s residential mortgage-backed securities highly, and the necessary financing techniques and legal structures must be made available for modern securitization of mortgage-backed debt.

Palomar, supra note 106, at 1021–22. If mortgage-backed securities are not ready to be implemented into a cross-border securities transaction, the existence of such a lucrative pool of loans “waiting in the wings” seems an enticing incentive for investors to push for the development of China’s legal infrastructure sooner rather than later.
China to slowly figure out how to take aspects of the Western model and apply them effectively and efficiently into their ideological framework.

Once one successful transaction is completed, and then another, investors will gain confidence. As soon as a specific transaction type is perfected (i.e., the desired level of stability of investment has been proven to be attainable and duplicable), program deals can start to arise. It is from these program deals that China will be able to begin branching out to other areas of securitization or to other areas of the state sector.

Program deals will afford investors and attorneys the leeway necessary to experiment on a relatively small level, while yielding results that would be true to the market. As these successes and failures are documented, China's securities infrastructure can slowly be updated to account for what aspects of the Western model can be applied. It would only take a little nudging before regional investors would begin to gobble up any securitized transactions that could be offered. The initial stages of opening up the market to securitization will, in fact, provide a more profitable alternative to investors than they might be able to find even in traditional "American-style" securitization.\footnote{Traditionally, securitizations are most desirable in those jurisdictions that can provide established financial infrastructures. While there are generally lower risks and lower transaction costs, returns on securitization in "safe" jurisdictions are also lower. See Dvorak, \textit{supra} note 75, at 573. Similarly, there are generally lower returns on securitizations of tried and tested products as opposed to using innovative techniques that may result in higher profits—but not always without a substantial risk of failure. \textit{Id.} (In an example of high risk-high-yield securitization, a prominent New York law firm was able to securitize a kimono collection, resulting in unusually large profits for investors involved in the transaction). Furthermore, many of these "safe" jurisdictions that are more attractive to investors for the reasons listed above (low transaction cost and risk) actually have a lower demand for securitizations. "Countries with domestic banks in a strong financial position and well-developed mortgage finance systems are less eager to begin large-scale 'American style' securitization . . . [while] Asian countries have a greater need to generate new capital, giving their governments an incentive to pass new securitization laws." \textit{Id.} at 573–74.}

Again, it is essential to note that the primary selling point is the fact that Chinese law does not exclusively govern these transactions. Because established international business practices will be the foundation on which the cross-border transactions are structured, there should be an increased likelihood that investors will continue to invest in the evolving transactions. As always, there is a chance that investors will simply not be interested, but it seems to be the best alternative—and one not yet explored.

The benefits to both China and investors are clear. China's state sector is given an immediate boost and investors are given a profitable reason to invest in China's state shares. Furthermore, state enterprises continue to be an important sector in the Chinese economy. Finished goods manufactured by state-owned enterprise are central to the economy, and the sector itself is
a major employer of a large percentage of the population. Not only will the capital redistributed into the state-owned enterprises help to offset some of the waste that is inherent in Chinese state enterprise, but the state-owned enterprises will become more efficient. For investors, the growth of China's securitization infrastructure is the crown jewel. As the infrastructure grows, investors will be more confident in investing in the higher-risk/higher-yield enterprises. The result will be competing law firms, each looking to work with China to utilize new innovations that will be made possible as the framework is developed and as contractual successes in cross-border transactions begin to accumulate. Ultimately, China will emerge with a sophisticated securities market based on aspects of the Western-style transactional framework, while maximizing the idea of limited privatization that might not have otherwise been attainable.

This seems an optimal time to try something new in China. The region is ripe for securitization and needs only to get over the initial hump before successes begin to snowball into a flourishing securitization market. It is also clear that securitization will provide an answer to some of China's internal needs for economic reform. But cross-border securitized transactions can provide this outcome only if the necessary effort is put forth at the ground level.

119 Wong, supra note 111, at 1226.

120 Wong addresses the issue of waste in his exploration of economic reforms and state enterprises:

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

Id. at 1227. While reforms have begun to deal with this issue, it will ultimately be limited to privatization that will yield the necessary managerial accountability to eliminate the majority of the "waste." See Bersani, supra note 37, at 305.

121 See supra note 58.

122 See generally Frankel, supra note 77, at 268–72. Some of the more innovative cross-border transactions and their mechanisms would likely be widely shared throughout the securitization industry to encourage more transactions at a rapid pace, in order to determine a broad adoption. "A broad adoption of an innovation verifies and enhances its value, thus proving the success of the innovation." Id. at 271.