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## Integration of International Financial Regulatory Standards for the Chinese Economic Area: The Challenge for China, Hong Kong, and Taiwan

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ARTICLES

Integration of International Financial  
Regulatory Standards for the Chinese  
Economic Area: The Challenge for  
China, Hong Kong, and Taiwan

*Lawrence L. C. Lee\**

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## I. INTRODUCTION

The increasing trade among the Republic of China ("Taiwan"), the People's Republic of China ("China"),<sup>1</sup> and China's Hong Kong Special

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<sup>1</sup> Unless otherwise indicated, the Republic of China (Taiwan) refers to the government of the Republic of China, present in Taiwan since 1949. The full area of Taiwan under the control of the Kuomintang ("KMT") includes the islands of Taiwan, Pescadores (Penghu), and the offshore islands Quemoy and Matsu. The People's Republic of China ("China") re-

Administrative Region ("Hong Kong")<sup>2</sup> has led to the formation of an informal economic region, known as the Chinese Economic Area ("CEA").<sup>3</sup> Although the CEA does not have a written agreement such as the European

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fers to the government of the People's Republic of China in control of Mainland China since 1949.

The administration of the KMT moved to Taiwan following the victory of the Chinese Communist Party ("CCP") in the Chinese Civil War of 1949. The CCP established communist China in place of the Republic of China and took Taiwan's seat in the United Nations on October 26, 1971. The Republic of China, however, has never renounced its claim to being the sole legitimate government of all China, nor does it view itself as an independent country. In fact, political tensions exist between the People's Republic of China and the Republic of China because both governments consider Taiwan to be an integral part of China. Following the Chinese Civil War, both the CCP and the KMT claimed sovereignty over mainland China. Presently, the People's Republic of China presides over the largest geographic region of China. See Parris Chang & Kok-ui Lim, *Point-Counterpoint: The International Status of Taiwan: Taiwan's Case for United National Membership*, 1 UCLA J. INT'L L. & FOR. AFF. 393, 393-397 (1996). Also, the People's Republic of China gained sovereignty over Hong Kong on July 1, 1997, and will take over Macao on December 20, 1999. See Paul Fifoot, *One Country, Two Systems – Mark II: From Hong Kong to Macao*, Int'l Rel. 25 (1994).

<sup>2</sup>In order to transfer the colony of Hong Kong, Britain signed the Basic Law of the Hong Kong Special Administrative Region of China [hereinafter Basic Law] with China at the Joint Declaration on the Question of Hong Kong in 1984. Under the Basic Law, Hong Kong is a Special Administrative Region of China which is to retain its own financial and political system for at least fifty years. Therefore, in this article, Hong Kong is referred to as an independent economic entity. See The Basic Law of the Hong Kong Special Administrative Region of the Peoples' Republic of China, April 4, 1990, China-G. Brit. 29 I.L.M. 1520 (ratified March 1990; adopted by the National People's Congress, April 1990).

<sup>3</sup>Taiwan's trade and investment with China has been growing at a remarkable rate. Indirect trade between Taiwan and China reached US\$7.32 billion in the first six months of 1997, up nearly 5.5 percent from the same period in 1996. Taiwan's trade with China is conducted mainly through Hong Kong and accounted for 16 percent to 17 percent of Taiwan's total global trade in 1998. See *Trade with Mainland Grows*, FREE CHINA J. Feb. 14, 1997, at 3; RANDALL JONES ET AL., THE CHINESE ECONOMIC AREA: ECONOMIC INTEGRATION WITHOUT A FREE TRADE AGREEMENT 1, 5 (Organization for Economic Co-operation and Development Research Working Paper No. 124, 1992) (stating that the opening of China's economy and *de facto* economic integration with the economies of Hong Kong and Taiwan results in an informal economic area which may be called the Chinese Economic Area).

Other terms also refer to the Chinese Economic Area, such as "Greater China," "Chinese Triangle," "South China Economic Community," and "Chinese Productivity Triangle." However, all of these different terms describe the same geographic area. See Sally Stewart et al., *The South China Economic Community*, 27 COLUM. J. WORLD BUS., 30, 31 (1992); Paul S. P. Hsu, *Taiwan, Hong Kong, and China: The Chinese Productivity Triangle*, 27 INT'L LAW. 523 (1993); Jeffrey C. Y. Li, COMMENT: *Strategic Negotiation in the Greater Chinese Economic Area: A New American Perspective*, 59 ALB. L. REV. 1035, 1037 n.8, (1996), [Daoliang Zha, A "Great China"? *The Political Economy of Chinese National Reunification*, 5 J. CONTEMP. CHINA 40 (1994); Harry Harding, *The Concept of "Greater China": Themes, Variations and Reservations*, in GREATER CHINA THE NEXT SUPERPOWER? 8 (David Shambaugh ed. 1995), GREATER CHINA: LAW, SOCIETY, AND TRADE 1 (Alice E-S Tay & Conita S. C. Leung eds., 1995); and PENELOPE HARTLAND-THUNBERG, CHINA, HONG KONG AND THE WORLD TRADING SYSTEM 97 (1995).

Union ("EU")<sup>4</sup> and the North American Free Trade Agreement,<sup>5</sup> current economic integration in the CEA has resulted in advancement for the entire region.<sup>6</sup> Due to existing political tensions between Taiwan<sup>7</sup> and China, the trade between the two entities occurs indirectly through the private sector via Hong Kong and other countries.

The soundness of the banking system reflects the health of the economy.<sup>8</sup> The informal economic relations among Taiwan, Hong Kong, and China create one of the giant regional economic areas of the world. In addition, vigorous economic growth has fostered the development of the CEA's financial markets. Opportunities in construction, energy, high-tech production, and exports contribute to a favorable economic climate and ample business opportunities for financial service providers.<sup>9</sup> In theory, the relationship between economic development and banking development is interdependent; the successes and failures of one produce consequences for

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<sup>4</sup>The European Economic Community, building on the experience of the European Coal and Steel Community, envisioned a customs union, enhanced by the free establishment of enterprises and a competition policy to assure the development and maintenance of a free market economy within the economic area. As of 1995, the E.U. consists of Austria, Belgium, Denmark, Finland, France, unified Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom. Turkey, Malta, Cyprus, Hungary, and Poland have applications pending for 1995 and most Central and Eastern European countries have applied for membership. See RALPH H. FOLSOM & MICHAEL W. GORDON, INTERNATIONAL BUSINESS TRANSACTIONS 27.28 (1995).

<sup>5</sup>North American Free Trade Agreement [hereinafter NAFTA], Dec. 17, 1992, reprinted in 32 I.L.M. 289, 297 (1993) (indicating that the NAFTA attempts to reduce distortions of trade between Canada, the United States, and Mexico).

<sup>6</sup>See Robert F. Ash and Y.Y. Kueh, *Economic Integration within Greater China: Trade and Investment Flows between China, Hong Kong, and Taiwan*, CHINA Q. 711, 742-45 (1993).

<sup>7</sup>The political disputes between Taiwan and China began in 1949 when the KMT government was driven from mainland China by the CCP. In order to mediate the dependence on the Chinese market and in consideration of national security, Taiwan designed the "no haste, be patient" economic policy toward China. On the matter of economic cooperation between the two sides (China and Taiwan), Taiwanese President Lee Teng-hui on January 7th 1998 explained Taiwan's "no haste, be patient" policy on investment in mainland China by saying that the policy is "aimed at protecting Taiwan's entrepreneurs and Taiwan's overall interests." See Maurice Hinchey, *Congratulating President Lee*, Taiwan Research Institute (Feb. 5, 1998) <<http://www.taiwaninformation.org/view/speeches/hinchey-020598.html>>. Furthermore, in July 1999, President Lee also declared that Taiwan intended to apply a "special state-to-state" policy with China which increased the political tension over the Taiwan Strait. See Johanna Mc Gerary, *Playing with Fire*, TIME, July 26, 1999, at 62-3.

<sup>8</sup>See CARL-JOHAN LINDGREN ET AL., BANK SOUNDNESS AND MACROECONOMIC POLICY 46 (1996) (finding that banking system soundness reflects in large measure the health of the economy).

<sup>9</sup>See Sung Yun-Wing, *Patterns of Economic Interdependence in the National Economic Territory, in SOUTHERN CHINA, HONG KONG, AND TAIWAN: EVOLUTION OF A SUBREGIONAL ECONOMY* 14 (Jane Khanna ed., 1995).

the other.<sup>10</sup> Therefore, the liberalization and globalization of the CEA's financial sectors serve to further promote the CEA's economic development and speed the internationalization of the domestic financial industry.<sup>11</sup>

The prosperity of the CEA's economy has led a number of foreign financial institutions to establish offices in the CEA in order to participate in its financial markets for decades. While foreign financial institutions have substantially contributed to the development in CEA,<sup>12</sup> foreign financial institutions operating in Hong Kong, China and Taiwan are, however, subjected to a two-tiered system of regulation. The region in which a corporation operates determines how it will be treated.

National treatment is applied to a different degree in different countries. Foreign financial institutions operating in Taiwan and Hong Kong are treated in a manner similar to domestic institutions. In contrast, foreign financial institutions operating in China are treated very differently from their domestic counterparts. Responding to the requirements of foreign institutions and preparing to apply for membership to the World Trade Organization ("WTO"),<sup>13</sup> China is considering reforming its regulations to encourage further international participation in financial services.<sup>14</sup>

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<sup>10</sup> See Sean Beckett & Gordon H. Sellon, Jr. *Has Financial Market Volatility Increased?*, in *FINANCIAL MARKET VOLATILITY AND THE ECONOMY* 3, 4 (Federal Reserve Bank of Kansas City ed., 1990) (exploring the possible links between financial market volatility, the functioning of the financial system, and aggregate economic behavior).

<sup>11</sup> As used in this article, "financial liberalization" refers to the relaxation of restrictions of financial activities, such as the deregulation of interest rates, the liberalization of foreign exchange rates, and the relaxation of restrictions on capital. In addition, liberalization eases both business restrictions and barriers to entry in the financial services sectors. See Alan Greenspan, *The Globalization of Finance*, 17(3) *CATO J.*, 243-50 (1998) (emphasizing that the liberalization of international trade and the development of technology furthers the globalization of financial markets that shapes deregulation, promotes the removal of barriers, and enhances the flow of capital). "Financial globalization," in contrast, refers to the use and accommodation of funds by all kinds of economic agents in world financial markets. See A. T. Aburachis, *International Financial Markets Integration: An Overview*, in *INTERNATIONAL FINANCIAL MARKET INTEGRATION* 26, 37 (Stanley R. Stansell ed., 1993).

<sup>12</sup> This is similar to the case of Poland, a former communist country that had success transforming its economic system from a communist to a market-oriented model. This case provides a model for China to privatize its state-owned enterprise. See Thomas S. Mondschian & Timothy P. Opiela, *Banking Reform in a Transition Economy: The Case of Poland*, in *ECONOMIC PERSPECTIVES* 16, 26 (Federal Reserve Bank of Chicago ed., 1996) (providing evidence that the role of foreign financial institutions in Poland's transition economy was to help the banking system expand to meet the needs of Poland's growing economy, and explaining further that competition from foreign banks induced Polish banks to become more efficient and offer customers better services).

<sup>13</sup> The World Trade Organization [hereinafter WTO] is designed to facilitate international cooperation on trade and economic relations. The WTO, which came into being on January 1, 1995, enforces the General Agreement on Tariffs of Trade [hereinafter GATT] according to the Final Act of the Uruguay Round. The WTO was created by the General Agreement on Tariffs and Trade: Multilateral Trade Negotiations Final Act Embodying the Results of the Uruguay Round of Trade Negotiations [hereinafter Final Act], which closed Dec. 15, 1993,

Thus, in the future, access to the WTO may enable the CEA to further integrate with the world economy by lowering import barriers, and increasing the transparency and predictability of trade. Hong Kong has been a member of the WTO since 1986,<sup>15</sup> while Taiwan<sup>16</sup> and China<sup>17</sup> are applying for membership to the WTO. While in the process of applying for WTO membership, both Taiwan and China have been accepted as WTO observers. Because Taiwan and China are the larger economic entities outside the WTO, the induction of all CEA members into the WTO will instill market discipline and create trade opportunities with other WTO members.<sup>18</sup>

Globalization of trade was a catalyst for this integration which will allow China, Hong Kong, and Taiwan to form a financial region similar to the European Union.<sup>19</sup> Such potential financial integration is likely to expedite the flow of capital to promote the growth of the CEA's economies. In ad-

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Art. I, reprinted in 33 I.L.M. 1125, 1144 (1994), and the Agreement Establishing the World Trade Organization, which were signed on April 15, 1994. Although the WTO enforces the GATT, the GATT remains the foundation for international trade law.

<sup>14</sup> See China to Lift Restrictions on Foreign Bank Branches Beijing, Asia Pulse April 1, 1999, <<http://www.asiapulse.com>> (reporting that the People's Bank of China announced permission for foreign to establish regional branches in 1999 in a less restrictive manner than under previous regulations).

<sup>15</sup> Hong Kong was granted admission to the WTO's predecessor, the GATT, as a separate customs territory from Britain in 1986. Hong Kong will keep its WTO status as China wages battle for membership after July 1, 1997. See Donald Clark, *GATT Membership for China?*, 17 U. PUGET SOUND L.REV. 517 (1994). To avoid any possible objections from China to Taiwan's application for WTO membership, Taiwan did not use its national name, the Republic of China, but applied for WTO membership as a customs territory as the Customs Territory of Taiwan, Penghu, Kinmen and Matsu. See Ing-Wen Tsai & Connie Guang-Hwa Yang, *Taiwan's GATT Accession & The Changing Environment for Competition and Antitrust Enforcement*, in INTERNATIONAL HARMONIZATION OF COMPETITION LAWS 297, 298 (Chia-Jui Cheng, et al. eds., 1995).

<sup>16</sup> Taiwan applied to join the WTO's predecessor, GATT, as an independent customs territory in 1990, while China filed its application in 1986. As of March 1998, Taiwan has held talks with the United States and twenty-five other WTO members since the early 1990's. Of the twenty-six members that sought talks with Taiwan, twenty-four have reached agreements with Taiwan and twenty-three have signed pacts, leaving only the European Union and Swaziland outstanding. Prospective WTO members must complete bilateral trade negotiations with any WTO member that requests such talks in order to become eligible for entry.

<sup>17</sup> China expressed a strong desire to rejoin the WTO in the late 1980's. On July 10, 1986, China submitted an application to GATT demanding a restoration of signatory status. See Clark, *supra* note 15, at 517. In 1987, the GATT established a China Work Group to process China's application. See *China and the World Trading*, 19 WTO FOCUS, May 1997, at 5. On November 15, 1999, China and the United States signed an agreement which facilitates China's admission to the WTO in the year 2000. See *China and the WTO*, THE ECONOMIST, Nov. 20, 1999, at 25-27.

<sup>18</sup> *Id.* (analyzing the entry of China into the WTO will bind China by international trade rules).

<sup>19</sup> See *China and the WTO*, FINANCIAL TIMES, Oct. 16, 1997, at 15.

dition, an integrated CEA financial system would also become part of the international financial market.<sup>20</sup> Furthermore, the integration of the CEA's financial sector will discourage the further development of the "underground financial system" such as that which now links Shanghai, Hong Kong, and Taipei.<sup>21</sup>

In order to extend the scope of trade from goods to services including financial services, telecommunication services, specific commitments, and professional services,<sup>22</sup> multilateral standards for the open trade of services were initially proposed and discussed in the 1986 Uruguay Round of the GATT negotiations.<sup>23</sup> These multilateral standards for financial services were adopted as the General Agreement on Trade in Services ("GATS").<sup>24</sup> With respect to the application of free trade to financial services, the GATS addresses the liberalization of financial services and non-discriminatory market access for firms of WTO signatories.

Ratification of the GATS full-market access proposal, which was agreed upon by seventy WTO members on December 13, 1997<sup>25</sup> and the

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<sup>20</sup> See Institute of International Banker, GLOBAL SURVEY [hereinafter Global Survey] 1998 (Sept. 1998) (noting that no country can escape the global financial system under the trends towards globalization of financial markets and convergence of regulatory system around the world).

<sup>21</sup> Interview with Professor Edward Friedman, Hawkins Professor of Political Science at the University of Wisconsin, in Madison, Wisconsin (Apr. 25, 1997) (stating that under the current political situation, there are no formal channels for financial transactions between Taiwan and China. Thus, to meet current needs, Taiwan's investors have cooperated with Hong Kong and China in establishing an informal underground banking system, which funnels Taiwanese funds into China).

<sup>22</sup> See General Agreement on Tariffs and Trade: Multilateral Trade Negotiations Final Act Embodying the Results of the Uruguay Round of Trade Negotiations, *reprinted in* 33 I.L.M. 1125 (1994).

<sup>23</sup> The General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A3, 55 U.N.T.S. 187.

<sup>24</sup> The General Agreement on Trade in Service [hereinafter "GATS"] brought the service industry into the WTO, which became the umbrella organization for the GATT. See GATT: Multilateral Trade Negotiations Final Act Embodying the Results of the Uruguay Round of Trade Negotiations, Apr. 15, 1994, 33 I.L.M. 1125 (1994).

<sup>25</sup> While the discouraging effect of financial market turmoil in Southeast Asia at the end of 1997 weighed heavily in the GATS negotiations, on December 13, 1997 seventy countries reached an agreement to open their financial institutions to foreigners. The negotiations were part of the unfinished agendas of the Uruguay Round multilateral trade negotiations, which concluded in 1993. The first offers to liberalize trade in financial services made during the Uruguay Round were approved in 1995 in an interim agreement, which entered into force on September 1, 1996. See Helene Cooper, *WTO Reaches Accords as Asians Agree to Open Finance Industry to Foreigners*, WALL ST. J. Dec. 15, 1997 at A3. Seventy members of the World Trade Organization have taken part in the financial services negotiations which began in April, 1997. One hundred and two governments have made commitments in the financial services market under the GATS. The results of the GATS negotiation were part of a protocol, which was open for governments to accept until January 29, 1999. The GATS



approval of the GATS, which has been in force since March 1, 1999,<sup>26</sup> have influenced the structure of international finance.<sup>27</sup> In order to protect the sovereignty of the member states to the greatest extent possible,<sup>28</sup> the WTO's dispute settlement mechanism, which is charged with resolving disputes among members and compelling members to obey the obligations of the WTO's principles and agreements,<sup>29</sup> assists the GATS in achieving reciprocal solutions, rather than national treatment for regional banking institutions.<sup>30</sup> In addition, the GATS liberalization principle is likely to facilitate the CEA's gradual integration with global financial markets.

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agreement will entered into force on March 1, 1999. See WTO Reaches Accords on Financial services, Ban's Banking Report, Dec. 22, 1997.

<sup>26</sup>Following the signature of the WTO financial services accords, thirty-five countries completed domestic legislative procedures to open banking, insurance, and securities markets to foreign competition. See *World Trade Organization – Financial Service Accord*, FINANCIAL TIMES, January 23/24 1999, at 4.

<sup>27</sup>See France William, *Hope High for Financial Service Pact*, FINANCIAL TIMES, September 19, 1997, at 12.

<sup>28</sup>To encourage a more rule-oriented approach to dispute resolution than had previously characterized GATT disputes, the WTO adopted the understanding on Rules and Procedures Governing the Settlement of Disputes [hereinafter "DSU"]. See Final Act, *supra* note 13, Art II, Ann. 2 (DSU), Art. IV-V. Supranational dispute resolution is necessary in order to infuse the settlement of international trade disputes with impartiality and fairness, characteristics foreign plaintiffs may find lacking in national courts and a national review process that may be tainted with protectionism or national interest. Independent third party adjudication also furthers the development of predictable rules that can provide guidance to diplomats and entrepreneurs. See John H. Jackson, *THE WORLD TRADE ORGANIZATION CONSTITUTION AND JURISPRUDENCE* 2 (1998).

<sup>29</sup>The dispute settlement procedure is one of the WTO's most important contributions to the stability of the global economy. Without enforcement, the rules-based system would be worthless. The WTO's procedure underscores the rule of law, and it makes the trading system more secure and predictable. It is clearly structured, with flexible timetables set for completing a case. First rulings are made by a panel. Appeals based on points of law are possible. All final rulings or decisions are made by the WTO's full membership. No single country can block these. See Jackson, *id.* at 68.

<sup>30</sup>The GATS is the first multilateral agreement to provide legally enforceable rights to trade in all services. With a built-in commitment to continuous liberalization through periodic negotiations, the GATS covers not just cross-border trade but every possible means of supplying a service, including the right to set up a commercial presence in the export market. See Joel P. Trachtman, *Trade in Financial Services under GATS, NAFTA and the EC: A Regulatory Jurisdiction Analysis*, 34 COLUM. J. TRANS. L. 37, 47 (1995).

The GATS has three basic principles: first, it covers all services except those provided in the exercise of governmental authority; second, it prohibits discrimination in favor of national providers – the national treatment principle; and third, it prohibits discrimination between Members of the Agreement – the most-favored-nation principle [hereinafter "MFN"]. *Id.* at 98. The GATS powerfully requests that no tariff or other generalized protection mechanism is applied in services. Nevertheless, in order to take into account the individual situation of member states, the GATS does provide important exceptions to all three of these principles. First, governments can choose the services in which they make market access and national treatment commitments. *Id.* at 68. Second, they can limit the degree of market access and national treatment they provide. *Id.* Third, they can create exceptions to the

Under the GATS, Taiwan and China will have to make some adjustments to their policies regarding the "national treatment" of foreign financial institutions.<sup>31</sup> Hong Kong, however, already requires equal treatment for banking institutions from every region.<sup>32</sup> China welcomes foreign banks from most regions, but treats foreign institutions differently from their domestic counterparts.<sup>33</sup> Taiwan offers equal treatment for banks from every region, except for China. Thus, Taiwan allows the establishment of branches in Taiwan for foreign banks whose home country also empowers Taiwan's banks to operate in its jurisdictions.<sup>34</sup> As a prerequisite for WTO access, Taiwan may encounter some pressure to accord "Most Favored Nation" ("MFN")<sup>35</sup> status to China and thus to permit China's financial institutions to enter its domestic markets. Similarly, China may be required to treat domestic and foreign banks equally. By lowering financial barriers, China and Taiwan will have greater opportunities to conduct business with one another.

Participation in the international financial market will promote increased financial integration within the CEA. To encourage further progress in the area of financial services, the CEA should work toward combating the disparities among the financial systems of China, Hong Kong, and Taiwan. Comprehensive financial integration of the CEA will be facilitated by the implementation of the supervisory regulations of the Basle Accords, issued by the Basle Committee on Banking Supervision ("Basle Committee").<sup>36</sup> The Basle Accords recommend strengthening in-

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Most Favored Nation status obligation, in principle only for ten years, in order to give more favorable treatment to some countries. *Id.*

<sup>31</sup> National treatment is addressed in GATS, art XVII(1) (defining national treatment in the area of financial services as requiring equality of competitive opportunity between foreign and domestic firms has been maintained. However, equality of competitive opportunity does not require identical treatment of foreign and domestic financial institutions. Differential treatment is sometimes necessary to accommodate legal and regulatory systems and banking structures in a domestic country that differ from those in foreign countries).

<sup>32</sup> See US DEPARTMENT OF THE TREASURY, 1998 NATIONAL TREATMENT STUDY [hereinafter "National Treatment"] 218 (1998).

<sup>33</sup> National Treatment, *Id.* at 177.

<sup>34</sup> National Treatment, *Id.* at 456.

<sup>35</sup> The term MFN in GATS refers to the equal treatment that each state of the WTO should accord to all other state parties. See Final Act, *supra* note 13, art II, § 2, in 1 Uruguay Round of Multilateral Trade Negotiations 137 (1994). Because of this cornerstone provision of the WTO, once China and Taiwan become WTO members, China's financial institutions can establish their branches in Taiwan similar to the manner in which other foreign institutions from WTO states have established branches. See GATS, *supra* note 24.

<sup>36</sup> The Basle Committee on Banking Supervision [hereinafter Basle Committee] was established at the end of 1974 at the Bank for International Settlements at Basle, Switzerland. The Basle Committee is endorsed by the Central Bank Governors of the Group of Ten (now twelve countries) comprised of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States (Luxembourg and Switzerland

ternational financial supervision and promoting international coordination to prevent international financial crises.

The goal of the Basle Committee is to strengthen the supervision of international financial activities by unifying diverse approaches to these activities.<sup>37</sup> The Basle Committee is an informal group and the Basle Accords are not legally binding. However, as a result of the wide acceptance of the Basle Accords by the international financial sector,<sup>38</sup> the Basle Accords qualify as "soft law."<sup>39</sup>

Soft law exhibits distinctive advantages over hard law in areas where agreements are difficult or not viable.<sup>40</sup> A soft law is an international convention recognized by a group of specific national authorities and adopted into their nations' laws or administrative codes. Soft law is a concept in international law designed to provide legal terms or informal duties without requiring the adoption of formal or informal treaties or agreements.<sup>41</sup> Fur-

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joined later). See Ethan B. Kapstein, SUPERVISING INTERNATIONAL BANKS: ORIGINS AND IMPLICATIONS OF THE BASLE ACCORD 185 (Int'l Fin. Section Essay No. 185, 1991).

The goal of establishing the Basle Committee was to achieve an international agreement on standards of good practice and collaboration in international banking supervision. See *id.* at 5-6. Additionally, the Basle Committee has created a body of recommended banking supervisory standards, known as the Basle Accords. See *id.* at 6. However, because the Basle Accords lack legal validity or binding force, the effective enforcement of the Basle Accords depends on each authority's willingness and preference to enforce them. See *id.*

<sup>37</sup> Since 1975, the Basle Committee has strengthened the supervision of international banking by unifying approaches to supervising cross-border banking activities and issuing recommendations. See *Committee on Banking and Supervisory Practices; Revised Basle Concordat on Principles for the Supervision of Banks' Foreign Establishments*, 22 I.L.M. 900 (1983).

<sup>38</sup> The Basle Accords have been fully implemented by all Basle Committee member countries. A number of nonmember countries with significant international banking presence have either adopted or are working to adopt the Basle Accords. Further, adherence to the Basle Accords has resulted in a buildup of banking capital funds. See Joseph J. Norton & Christopher D. Olive, *The Ongoing Process of International Bank Regulatory and Supervisory Convergence: A New Regulatory-Market "Partnership,"* 16 ANN. REV. BANKING L. 227, 241 (1997).

<sup>39</sup> For more information and discussion about "soft law," see generally Jonathan Carlson, *Hunger, Agriculture Trade Liberalization, and Soft International Law: Addressing the Legal Dimensions of a Political Problem*, 70 Iowa L. Rev. 1187 (1985); John King Gamble, Jr., *The 1982 United Nations Convention on the Law of the Sea as Soft Law*, 8 HOUSTON J. INT'L L. 37 (1985); Joseph Gold, *Strengthening the Soft International Law of Exchange Arrangements*, 77 Am. J. INT'L L. 443, 443 (1983); Tadeusz Gruchalla-Wesierski, *A Framework for Understanding "Soft Law,"* 30 MCGILL L. J. 37 (1984); W. Riphagen, *From Soft Law to Jus Cogens and Back*, 17 VICTORIA U. WELLINGTON L. REV. 81 (1987); and K. C. Wellens & G. M. Borchardt, *Soft Law in European Community Law*, 14 EUR. L. REV. 267 (1989).

<sup>40</sup> The term "hard law" or "firm law" means a signed treaty or agreement that is precisely worded and which specifies the exact obligations undertaken or the rights granted. See C. M. Chinkin, *The Challenge of Soft Law: Development and Change in International Law*, 38 INT'L & COMP. L. Q. 850, 851 (Oct. 1989).

<sup>41</sup> See Francis Snyder, *SOFT LAW AND INSTITUTIONAL PRACTICE IN THE EUROPEAN COMMUNITY* 2 (1993).

ther, soft law presumes consent to basic principles of law, especially in rapidly developing fields such as international financial regulation.

By using mutual-recognition, moral persuasion, and market practices, soft law allows a country the flexibility to implement rules while taking into account different regulatory systems.<sup>42</sup> The more countries and international organizations adopt the Basle Accords, the more the Basle Accords function as soft law. As a result of applying the theory of soft law, the Basle Committee is able to exert its influence even though it does not have the authority to impose a new international legal framework or to interfere with national sovereignty.<sup>43</sup>

This article initially reviews the current development of financial services that converge regulatory systems around the world.<sup>44</sup> Along with focusing on banking and securities, this article assesses financial systems and regulators within China, Hong Kong, and Taiwan respectively. The evaluation of the CEA's financial system is based on recommendations issued by the Basle Committee. In addition, with respect to the principle of national treatment, this article evaluates the operations of foreign financial institutions in the CEA. In the future, participation in the WTO will enable the CEA to experience greater growth and increase its participation in the internationalization of financial sectors. This article argues that the implementation of the Basle Accords as soft law is important for the establishment of a sound financial system in the CEA. This article concludes with an evaluation of the prospects of future financial development in the CEA.

## II. ORIGINS OF THE CURRENT FINANCIAL AND BANKING SYSTEMS IN THE CHINESE ECONOMIC AREA

The members of the CEA, China, Hong Kong, and Taiwan, have each developed their own unique financial systems that reflect their diverse political, economic, and historical roots. China organized a state-owned banking system to support its economic development in accordance with Marxian doctrines.<sup>45</sup> By contrast, Hong Kong and Taiwan enforce market-oriented economics. However, while Hong Kong developed free-market

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<sup>42</sup> See Carlson, *supra* note 39, at 1203.

<sup>43</sup> See Thomas F. McInerney III, Note, *Towards the Next Phase in International Banking Regulation*, 7 DEPAUL BUS. L. J. 143, 155 (1994).

<sup>44</sup> Theoretically, financial institutions refer to business organization that offer a broad base of financial services or specialize in specific functions, productions, or services. Financial institutions include commercial banks, thrift institutions, investment banks (merchant banks) credit unions, pension funds, mutual funds, investment companies, insurance companies, securities brokers and dealers, real estate investment trusts, stock exchanges, and others. Unless otherwise indicated, financial institutions in the article insinuate banks (including commercial and investment banks) and securities. See K. J. Thygeson, FINANCIAL MARKETS AND INSTITUTIONS (1993).

<sup>45</sup> For more detail discussion about the Marxian Doctrine, see Joseph A. Schumpeter, CAPITALISM, SOCIALISM, AND DEMOCRACY 1-45 (3<sup>rd</sup> ed. 1942).

economic policies favoring financial markets, Taiwan built its financial system on a predominately state-owned banking model because of its concern for national security. In spite of adopting diverse policies to construct individual financial systems, each member of the CEA benefits from the financial market development.

From a Western perspective, China's financial system is outmoded and extremely fragile. All of China's banks are state-owned, woefully undercapitalized, and literally function as cashiers to state-owned enterprises. Under these conditions, banks have still played a large role in China's reformed economy as financiers.<sup>46</sup> In addition, China's banks have also issued large undisclosed amounts of non-performing loans to state enterprises. As a consequence, Chinese banks' outstanding loan portfolio equaled about ninety percent of the country's gross domestic product in 1995.<sup>47</sup> In light of the state-owned enterprises' outstanding bank debts, China has proposed radical commercialization of its deficit-ridden public businesses.<sup>48</sup>

The formation of the People's Bank of China ("PBOC") reflects these new reforms. In order to Westernize China's financial system, the PBOC became the central bank of China in 1983 and the lender of last resort for state-run banks.<sup>49</sup> Rather than use a single centralized bank, China separated the businesses of the commercial banks into four consolidated, state-controlled commercial banks, effectively creating four new state-run banks.<sup>50</sup>

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<sup>46</sup> See Liu Hongru, *Development in the Reform of China's Banking and Financial Systems*, 2 J. CHINESE L. 324 (1988) (finding that because they are under highly centralized control, China's banks traditionally played the passive roles of bookkeepers and cashiers).

<sup>47</sup> The failure to resolve these banks' bad loans will slow China's long-term economic success. China's financial institutions' total outstanding loans expanded from under 200 billion *renminbi* in 1978 (when reforms began) to more than 5 trillion *renminbi* at the end of 1995. See David J. Ratway, Note and Comment: *National Depositor Preference: In an Attempt to Raise Revenues, Congress Completely Ignores a Potential Disaster*, 19 NOVA L. REV. 1121, 1140 (Spring 1995). Loans outstanding at the outset of reform were about half of the gross domestic product in 1978. *Id.* In 1995, the portfolio of loans outstanding was equal to ninety percent of gross domestic product. *Id.*

<sup>48</sup> See Anthony Spaeth, *Meeting Jiang Zemin*, TIME, October 27, 1997, at 56.

<sup>49</sup> China's State Council, Measures on the People's Bank of China, promulgated on September 12, 1983, required that the People's Bank of China undertake all central banking functions and bear responsibility for the reform of China's banking sector. See I.A. Tokley & Tina Ravn, BANKING LAW IN CHINA 13 (1997).

<sup>50</sup> Under the Interim Regulations on Bank Management of the PRC Concerning the Administration of Banks ordered on January 7, 1986, China created four policy banks to separate commercial-lending business from the People's Bank of China. See D.K. Srivastava and Wang Chenguang, *The Role of the Central Bank of China*, in LEGAL DEVELOPMENTS IN CHINA: MARKET ECONOMY AND LAW, 217-225 (Wang Guiguo and Wei Zhenying eds., 1996).

In 1994, China converted four "specialized" banks to control the domestic banking system of commercial banks by transferring the responsibility of making non-commercial *loans* to three newly established "policy" banks. These "policy" banks include: the Import-Export Bank, which helps finance major trade deals, the State Development Bank, which funds infrastructural projects, and the Agricultural Development Bank of China, which funds agricultural procurement for rural development.

Meanwhile, several other banks were established. These include: the Bank of Communication, the China International Trust and Investment Corporation Industrial Bank, the Hun Xia Bank and the China Investment Bank.<sup>51</sup> In addition to the problems presented the transition of non-commercial banking interests from the PBOC, these newly established financial institutions also suffer from a high default rate on loans granted. This problem remains an area of concern. To protect state-owned banks from defaulted loans, the PBOC created a finance management company in April of 1999. This company is similar to the Restructure Trust Company, which accepts the bad loans of state-owned banks.<sup>52</sup>

Furthermore, China's dynamic economic development over the past two decades provided incentives for opening its markets to foreign financial institutions.<sup>53</sup> Following increased capital inflows, new technological improvements, and foreign banks' market-oriented approach, China's banking sector faces increasing competition.

The success of open-economic development has also promoted China's extremely active but unsophisticated securities markets, and therefore requires greater regulation than currently exists. On December 29, 1998, China passed the Securities Law, which the National People's Congress Standing Committee adopted, and will take effect on July 1, 1999. While application of uniform securities regulations exists, China's securities markets remain segmented not only by the types of the securities traded, but also by geographic area. Foreign brokers are allowed to deal only in "B" shares,<sup>54</sup> which do not enjoy many of the benefits common to normal Chinese securities. In addition, the liquidity of "B" shares is severely restricted; "B" shares cannot be traded with the same immediacy or volume as

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<sup>51</sup> See Huang Yang Xin, *REVAMPING THE LEGAL FRAMEWORK FOR THE CHINESE BANKING CRITICAL EXAMINATION SYSTEM* 10 (1996).

<sup>52</sup> See *PBOC Will Establish The First Finance Management Company*, *WORLD J.*, March 27, 1999, at D4 (Chin.).

<sup>53</sup> See Toney Walker, *Chinese Growth 'under Threat'*, *FIN. TIMES* at 4 (repeating that the World Bank's report that China's vibrant economic led foreign institution to establish office in China).

<sup>54</sup> "B" shares are one kind of Chinese domestic security that can only be purchased by foreign investors with foreign currencies rather than with *renminbi*. See I.A. Tokley & Tina Ravn, *COMPANY AND SECURITIES LAW* 71 (1998).

regular "A" shares.<sup>55</sup> Further amending regulations to loosen restrictions on foreign investors is required to develop a more efficient and consistent securities market in China.

Compared to China's closed and state-owned financial system, Hong Kong is synonymous with the free and open market. On July 1, 1997, Hong Kong was transferred to China as a Special Administrative Region ("SAR").<sup>56</sup> The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China<sup>57</sup> is specified in China's "One country; Two systems" framework<sup>58</sup> as the equivalent of Hong Kong's constitution. It includes specific provisions designed to preserve Hong Kong as a world-class financial center.<sup>59</sup> Under the Banking Ordinance<sup>60</sup> amended on June 28, 1995, the Hong Kong Monetary Authority ("HKMA") functions as the central bank of Hong Kong monitoring banking operations and dictating monetary policy. In addition, the main purpose of the HKMA is to promote the financial and economic growth of the SAR. Recently, the HKMA created a mortgage corporation, one of several measures enacted to ensure the future success of Hong Kong as a financial center.<sup>61</sup>

The Securities and Futures Commission ("SFC") is in charge of ensuring the integrity of the stock and futures markets and protecting investors. In order to increase the stability of, and worldwide investors' confidence in the Stock Exchange of Hong Kong ("SEHK"),<sup>62</sup> Hong Kong instituted reforms in its securities and exchange systems in 1987.<sup>63</sup> Despite

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<sup>55</sup>"A" shares were designed for the Chinese domestic investors by trading with only *renminbi*. *Id.*

<sup>56</sup>For background analysis of the Special Administrative Region, see Ian Dobinson & Derek Roebuck, *INTRODUCTION TO LAW IN THE HONG KONG SAR* (1996).

<sup>57</sup>*See generally* Basic Law, *supra* note 2. The Basic Law, which is the constitutional law of Hong Kong, is probably the only document enumerating the commitment to maintain Hong Kong's status as an international financial center.

<sup>58</sup>In 1987, China introduced the "One Country: Two systems" framework to resolve the difference between China's socialist legal system and Hong Kong's colonial democratic and liberal government. *See* Xianglong, Dai, *One State, Two Currencies*, *BANKER*, Nov. 1996, at 100-01. The "One Country: Two systems" approach refers to the operation of a capitalist system in Hong Kong separate from China's socialist system. *Id.* This arrangement is China's first experimentation with federalism. If successful, China is likely to attempt to reunite Taiwan by offering a similar proposal to Taiwan.

<sup>59</sup>*See* Roda Mushkat, *ONE COUNTRY, TWO INTERNATIONAL LEGAL PERSONALITIES: THE CASE OF HONG KONG* 33 (1997).

<sup>60</sup>The Banking Ordinance, the title of Hong Kong banking law, was enacted in 1948 and amended in 1964, 1986, and 1995.

<sup>61</sup>*See* Hong Kong Monetary Authority, *Hong Kong's Monetary Arrangements through 1997*, 60 (1998).

<sup>62</sup>The Stock Exchange of Hong Kong [hereinafter "SEHK"] ranked ninth largest in the world in market capitalization in 1997, however, down from sixth largest in 1993 partly because of regional financial turmoil in late 1997.

<sup>63</sup>In line with wide-ranging recommendations made by a Securities Review Committee appointed in the wake of the 1987 market crash, Hong Kong considerably strengthened op-

these reforms, Hong Kong's securities market has experienced a change of focus from private companies to "red chip" companies.<sup>64</sup>

This shift reflects an eroding public confidence in private companies and indicates that investors will hedge, given the new Chinese sovereignty of Hong Kong.<sup>65</sup> Although the Hong Kong market is widely considered one of the most liberal securities systems in the world, a stable relationship between Hong Kong and China is very important to ensure the vitality of the Hong Kong securities market.

The financial approach adopted in Taiwan is different from both China's state-owned system and Hong Kong's free market system. Taiwan chose the unique approach of solidly conservative financial policies for the organization of its financial system in response to the 1946-49 Chinese banking collapse. The Chinese collapse was a result of the Communist Party's manipulation of a number of private financial institutions.<sup>66</sup> A financial disaster undermined the people's confidence and constituted one of the major factors forcing the Kuomintang ("KMT") regime to leave China.<sup>67</sup> The KMT relocated to Taiwan and formed a state-owned financial system in an attempt to avoid future financial problems similar to the 1946-49 banking collapse. Accordingly, banks dominated Taiwan's financial system until early 1992, when Taiwan granted licenses to fifteen private banks, more than doubling the number in existence.<sup>68</sup>

Taiwan recently promoted the privatization of state-owned banks in 1997. Taiwan hopes that transferring governmental activities to the private sector may increase management efficiency and operational competitiveness.<sup>69</sup> Acknowledging that onerous government regulations decreased the

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eration and regulation of Hong Kong's stock and futures markets. See *The Securities and Futures Commission of Hong Kong* [hereinafter SFC], *Historical Background to the SFC* <<http://www.hksfc.org.hk/eng/index.htm>>.

<sup>64</sup> "Red Chip" stocks refer to shares of Chinese companies registered in Hong Kong in which Chinese corporations hold at least 30 percent interest and were estimated to account for 12 percent of the SEHK's market capitalization as of April 30, 1998. See also *infra* note 189.

<sup>65</sup> See Moody's Investors Service, *Banking System Outlook: Hong Kong, A New Operating Environment is the Key Challenge for Hong Kong's Banks*, 5 (1997).

<sup>66</sup> See *In Defense of Taiwan*, TIME, Oct. 18, 1997, at 72 (stating that to maintain financial stability, Taiwan's government frequently adopts extreme caution in monitoring financial market activities, which is primarily attributed to Taiwan's apprehension over national security).

<sup>67</sup> See Jia-Don Shea, *Taiwan: Development and Structural Change of the Financial System*, in *THE FINANCIAL DEVELOPMENT OF JAPAN, KOREA, AND TAIWAN*, 222, 230 (Hugh T. Patrick & Yung Chul Park eds., 1994).

<sup>68</sup> See Brian Wallace Semkow, *TAIWAN'S CAPITAL MARKET REFORM: THE FINANCIAL AND LEGAL ISSUES* 30 (1994).

<sup>69</sup> See Deborah Shen, *Standard & Poor's Rates Financial Condition AA+*, FREE CHINA J. Nov. 14, 1997, at 3 (reporting that without the legislature's strict screening and onerous ad-



productivity of state-owned banks, Taiwan gathered the National Development Conference in December 1996. This conference examined attempts to privatize state-run banks by reducing state-owned shares to under forty percent.<sup>70</sup> The continuing effort to privatize state-owned banks is intended to ensure their survival in a newly liberalized and globalized atmosphere.<sup>71</sup>

Financial supervision in Taiwan is currently handled by three agencies: the Central Bank of China, the Ministry of Finance, and the Central Deposit Insurance Corporation.<sup>72</sup> Since the current multi-agency system results in overlapping duties and unclear lines of responsibility, Taiwan's financial reforms must ultimately also include the clear designation of a new financial supervisory agency that mixes insurance, banking, and securities.

Taiwan needs a sophisticated financial system in order to establish a regional financial center<sup>73</sup> and gain WTO approval. Although Taiwan has *de facto* self-determination,<sup>74</sup> Taiwan does not receive *de jure* recognition<sup>75</sup> from the international community due to China's boycott.<sup>76</sup> By participating in international organizations, Taiwan will be able to receive more benefits and greater exposure to the international community.

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ministrative approval procedure, privatization of state-owned banks will boost efficiency and competitiveness).

<sup>70</sup>Taiwan reduced the shareholding rate to privatize state-owned banks. The provincial government's shareholdings in Chang Hwa Commercial Bank, First Commercial Bank, and Hua Nan Commercial Bank have been cut to 30.72 percent, 21.05 percent, and 41.26 percent, respectively. See Deborah Shen, *Three Provincial Government Banks Privatized*, FREE CHINA J., Feb. 6, 1996.

<sup>71</sup>See *Waiting is over for 'Big Three'*, BANKER, July 1997, at 68. (reporting that a growth of domestic private banks and competition from foreign banks promoted the privatization of Taiwan's three major state-owned banks).

<sup>72</sup>This Deposit Insurance Act [hereinafter "DIA"], passed on January 9, 1985 and amended on January 20, 1999, created the Central Deposit Insurance Company [hereinafter "CDIC"]. In addition to supervising the Basic-Level Financial Institutions (credit co-operatives, credit departments of the farmers' association and the fisherman's associations), the CDIC took over the Cooperative Bank of Taiwan in June 1996. Art. 21 of the DIA empowers the CDIC with the right to examine any bank that is under the umbrella of CDIC insurance.

<sup>73</sup>See Laura Tyson, *Growing Demands for Diverse Products*, FIN. TIMES, October 7, 1997, at III.

<sup>74</sup>*De facto* self-determination means the ability of a people to determine their own fate in a democratic way.

<sup>75</sup>*De jure* recognition is legitimate or lawful. See BLACKS LAW DICTIONARY 425 (6th ed. 1990).

<sup>76</sup>While a clear national identity may be psychologically attractive to certain political movements in Taiwan, there is clearly greater security for the Taiwanese people in political ambiguity. According to "one country; two systems," Taiwan is part of China through having a different political or economic system; China is the only representative of entire China, which also includes Hong Kong and Macao. China will not agree with any country who has diplomatic relations with Taiwan. Deng Xioping, *Deng Xioping's Talk with Yang Liyu*, in DENG XIOPING WENSUAN [Selected Works of Deng Xioping] 230 (1993).

Taiwan's securities market, including a stock exchange and an over-the-counter market, is extremely prosperous. However, the securities markets are over-dependent on governmental interference for their stability.<sup>77</sup> Rampant manipulation of Taiwan's securities markets accentuates the need for a neutral regulator.<sup>78</sup> Governmental influence would be more beneficial in regulating the dissemination of financial information to ensure greater accuracy and assessment of financial functions. Further, governmental regulation of insider information and disclosure policies is needed to curb the trend toward corruption.

### III. TAIWAN: A VIBRANT ECONOMY FORCES FINANCIAL LIBERALIZATION

The growth of Taiwan's financial market has evolved from Taiwan's stable economic environment during the past decades. In terms of the relationship between economic and financial development, Taiwan's impressive economic performance<sup>79</sup> stimulated the development of its financial sectors. Taiwan's securities market is lively in terms of daily trading value, but it suffers from a lack of information transparency. Although Taiwan also has twenty of the largest banks in the world,<sup>80</sup> the Taiwanese government's oversight of Taiwan's financial sector has gradually restricted growth in order to maintain greater stability.

Taiwan changed the character of its financial policies from conservative to prudential by the gradual removal of financial regulations. In order to liberalize its financial system, Taiwan began deregulating interest rates to establish the money market in 1976.<sup>81</sup> In the securities market, Taiwan amended its Securities Exchange Law to deregulate restrictions on investment to the securities market in 1988.<sup>82</sup> Subsequently, Taiwan amended its Banking Law<sup>83</sup> in 1989, 1992, and 1995.<sup>84</sup> These amendments chartered

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<sup>77</sup> See Shea, *supra* note 67, at 248-249.

<sup>78</sup> *Id.* at 232.

<sup>79</sup> Taiwan's economy has grown at an average annual rate of 8.5 percent between 1952 and 1997. Even during the worldwide economic downturn, Taiwan managed a 5.87 percent growth rate in 1993. In 1997, Taiwan was the fourteenth largest trading nation with a trading volume of \$236.5 billion (unless otherwise indicated, the currency unit appearing in this paper is in US\$). Taiwan's Gross National Product ("GNP") of \$84.8 billion was the twentieth 20th largest in the world, and per capita GNP was the twenty-fifth highest in the world in 1993. See MINISTRY OF ECONOMIC AFFAIRS OF TAIWAN, *Current Status of Economic Development* <[http://www.moea.gov.tw/~meco/Intro\\_e/xmoel.htm](http://www.moea.gov.tw/~meco/Intro_e/xmoel.htm)>.

<sup>80</sup> See Michael Blanden, *Top 1000 Banks: Big is Beautiful*, BANKER, July 1997, at 96.

<sup>81</sup> See Kuo-Shu Liang, *The Banking System and Financial Reform*, in INT'L CONF. ON DEREGULATION AND REGS. 16, 30 (Jeremy P. Moyes ed. 1994).

<sup>82</sup> Taiwan Securities Exchange Law [hereinafter "SEL"] was enacted in 1968 with 168 articles divided into nine chapters. The SEL has already been amended four times in 1970, 1972, 1977, and 1997.

<sup>83</sup> The Banking Law of the Republic of China (1995) [hereinafter Taiwan's Banking Law], with seven chapters and 140 articles, is the primary banking statute in Taiwan. Taiwan's Banking Law describes the powers and duties of all banks in Taiwan, both domestic

banking licenses to private applicants and confirmed the need for international banking and deregulation. Other amendments to the Banking Law in 1992 and 1995 enlarged the scope of banking operations.<sup>85</sup>

To promote its entry into the WTO, Taiwan organized a Financial Reform Task Force in February 1997. The Financial Reform Task Force is designed to accelerate the liberalization of financial services and create financial market discipline under comprehensive supervision.<sup>86</sup> In January 1998, the Financial Reform Task force presented a new financial blueprint for further financial reform to the government.<sup>87</sup>

Taiwan aspires to become a regional operations center for multinational corporations operating in the Asian-Pacific region by implementation of the Plan for Developing Taiwan as an Asia-Pacific Region Operation Center.<sup>88</sup> An integral part of Taiwan's plan is to become another financial

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and foreign, through regulations governing their operations. To date, Taiwan has had fourteen amendments to the Banking Law. Except the 1947 amendment proclaimed in mainland China, the other thirteen amendments were made in Taiwan after the KMT's withdrawal to Taiwan in 1949. The promulgation of the fourteen amendments to the Banking Law were passed on September 1, 1947; June 16, 1950; November 11, 1968; July 4, 1975; December 29, 1977; July 19, 1978; December 5, 1979; December 5, 1980; July 17, 1981; May 20, 1985; July 17, 1989; October 30, 1992; June 29, 1995, and 1997. For a background in the Banking Law of the ROC, see Li-Chung Lee, *What Next for Banking in Taiwan*, AM. U. LL.M. INT'L BULL., 11-14 (Sum. 1994); and Jann Kaufman Winn, *Banking and Finance in Taiwan: The Prospect for Internationalization in the 1990s*, 25 INT'L LAW. 907-952 (1991).

<sup>84</sup> On July 17, 1989, Taiwan amended its Banking Law mainly to abolish the control over interest rates, which allows banks to freely trade and determine the rate of interest. Winn, *supra* note 83.

<sup>85</sup> On October 30, 1992, Taiwan promulgated an amendment of the Banking Law primarily to relax restrictions on the number of bank branches and the establishment of new private banks. In addition, foreign banks received national treatment. *Id.*

<sup>86</sup> The Financial Reform Task Force ("Reform Force") is an *ad hoc* committee consisting of representatives from the Ministry of Finance and the Central Bank of China, academics, and industrial participants. By the end of March 1998, this Reform Force will propose a package of financial sector reforms similar to Japan's "big bang," which is aimed at abolishing the control of foreign-exchange rules in April 1998. See Laura Tyson, *Growing Demands for Diverse Products*, FIN. TIMES, Oct. 7, 1997, Survey at III.

<sup>87</sup> *Id.*

<sup>88</sup> In order to finish economic liberalization and the completion of infrastructure projects to enhance economic prowess, Taiwan proposed the Plan for Developing Taiwan as an Asia-Pacific Region Operation Center [hereinafter APROC Plan] on January 5, 1995. See Lawrence S. Liu, *Aspiring to Excel --The Uneasy Case of Implementing Taiwan's Asia-Pacific Regional Operations Center Plan*, 10 COLUM. J. ASIAN. L. 199, 201 (1996). The seven components of the APROC Plan include a (1) macroeconomic adjustment program under CEPD; (2) regional manufacturing center program under MDEA; (3) regional sea transportation center program under the Ministry of Transportation and Communications ("MOTC"); (4) regional air transportation center program; (5) regional financial center program under MOTC; (6) regional telecommunications center program under MOTC; and (7) regional media center program under the Government Information Office (GIO). Taiwan is scheduled to fully complete the APROC Plan by 2005. See *id.*

center in the Western Pacific.<sup>89</sup> However, to be successful, Taiwan must move toward further financial liberalization. One area of concern for the task force is the status of financial supervision in Taiwan.

A. Banking: Proposed Financial Reform towards More Liberalization, Privatization, and Internationalization

Taiwan's banking system needs liberalization<sup>90</sup> and an improved system of banking supervision. Taiwan made major strides toward liberalization in 1989 after repealing barriers for the licensing of private commercial banks.<sup>91</sup> Nonetheless, Taiwan still maintains conservative financial policies, and financial supervision is provided through multiple agencies. The banking sector's conservative characteristics hinder Taiwan's attempts to evolve into a major financial center. This conservative approach also hinders the development of other financial institutions. Nevertheless, Taiwan did benefit from its conservative policies while its financial sectors suffered little from the "financial firestorm"<sup>92</sup> that engulfed so many other Asian countries in 1997.<sup>93</sup>

Taiwan's conservative financial policies were initially created in response to the financial instability of Chinese banks before the 1949 Chinese Civil War.<sup>94</sup> During the period of 1945 to 1949, Mainland China suffered from hyperinflation.<sup>95</sup> Thus, Taiwanese experts and authorities designed Taiwan's macroeconomic policies and financial structures to prevent un-

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<sup>89</sup> See Lawrence S. Liu, *Creating an International Financial Center: The Case of Taiwan, ROC*, in INTERNATIONAL BANKING OPERATIONS AND PRACTICES: CURRENT DEVELOPMENTS 71, 76-77 (J. J. Norton et al., 1994).

<sup>90</sup> See Financial Liberalization, *supra* note 11.

<sup>91</sup> See Brian Wallace Semkow, TAIWAN'S FINANCIAL MARKETS AND INSTITUTIONS: THE LEGAL AND FINANCIAL ISSUES OF DEREGULATION AND INTERNATIONALIZATION 90-93 (1992) (describing the establishment of private banks in Taiwan based on the substantive amendments to the Banking Law of the Republic of China on July 19, 1989).

<sup>92</sup> While 1997's financial firestorm has blitzed many Asian countries, Taiwan has remained relatively unscathed. Indeed, South Korea's sudden descent into the "abyss" of financial difficulties was a wake-up call for Taiwan, which had been complacent about the wider impact of currency woes sweeping across Asia. See *Asia and the Abyss*, ECONOMIST, Dec. 20, 1997, at 15.

<sup>93</sup> See S. P. Seth, *Taiwan Least Affected by Asia's Meltdown*, FREE CHINA J. Dec. 27, 1997, at 7; *The Flexible Tiger*, ECONOMIST, Jan. 3, 1998, at 73 (stating that Taiwan escaped Asia's 1997 financial turmoil with a small currency devaluation and a relatively modest decline in stock market prices based on three factors: a light foreign-debt burden; banking regulation accomplishments; and a more flexible response to market fluctuations); Laura Tyson, *Taiwan Keeps Markets Beast at Bay*, FIN. TIMES, December 24, 1997, at 3.

<sup>94</sup> See Cynthia Owens, *Taiwan: Official's Dreams of Creating Financial Center Slowed by Regulatory Barriers, Taipei Stigma*, ASIAN WALL ST. J. WKLY., July 15, 1991, at 25.

<sup>95</sup> See Shea, *supra* note 67.

controlled inflation.<sup>96</sup> Taiwan's financial institutions were controlled by governmental agencies in light of these guidelines. Until 1992 with the emergence of the first private bank established in Taiwan, state-owned banks, though privatized since 1997, still dominated Taiwan's banking system. Additionally, Taiwan paid attention to interest rates and exchange rates to keep its market prices stabilized and reassure investors.<sup>97</sup>

Taiwan's banking system is complicated.<sup>98</sup> The development of Taiwan's banking system was heavily influenced by Japanese banking concepts.<sup>99</sup> Remnants of the Japanese financial system remained following the Japanese occupation between 1895 and 1945.<sup>100</sup> In addition, Japan's geographic proximity to Taiwan and its sophisticated financial industry also help to explain the similarity between the two systems.

Taiwanese banks are organized and registered in accordance with its Banking Law.<sup>101</sup> Taiwan's banks are classified into four categories: commercial banks, saving banks, specialized banks,<sup>102</sup> and trust and investment

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<sup>96</sup> See Hung T. Patrick & Yung Chul Park, *THE FINANCIAL DEVELOPMENT OF JAPAN, KOREA, AND TAIWAN: GROWTH, REPRESSION, AND LIBERALIZATION* 230-31 (1994).

<sup>97</sup> In the trends of Globalization of financial services, Taiwan has been pushed to switch from conservative to prudential policies to govern banking operations. The lesson from the failure of Chile's financial reform encouraged Taiwan to restructure its financial system incrementally rather than in one comprehensive reform. Taiwan started deregulation of financial markets in accordance with the market need and the stability of economic development from the late of 1980s. See Lawrence S. Liu, *Brave New World of Financial Reform in Taiwan, The Republic of China -- Three Waves of International and Liberalization and Beyond*, CHINESE YEARBOOK, 134, 135 (1996).

<sup>98</sup> Taiwan's banks are divided into three categories according to the year of establishment. Coincidentally, the development of the banking industry in Taiwan has also undergone three major phases. Banks under each category are not only similar in the general functions performed, but also in the developmental phase during which they were established. These three categories are (1) banks established during the Japanese occupation of Taiwan from 1895-1945; (2) banks founded in Mainland China and subsequently re-established in Taiwan after 1949; and (3) banks founded and established in Taiwan after 1949. See Kuo-Shu-Liang & Takeshi Ohta, *Banking Models and Operation Realities in Japan and Taiwan*, in *INTERNATIONAL BANKING REGULATION AND SUPERVISION: CHANGE AND TRANSFORMATION IN THE 1990s* 105-117 (J.J. Norton ed. al. 1994).

<sup>99</sup> See Lawrence L. C. Lee, *Banking Supervisory Structure: The Japanese influence on Taiwan Financial Market Development* (unpublished manuscript, on file with author).

<sup>100</sup> For example, Taiwan's postal saving networks and local credit unions continue to operate like those in Japan. See Lawrence S. Liu, *Taiwan: A Roadmap for Financial Reform in the Nineties?*, EUR. INT'L FIN. L., Aug. 3, 1991.

<sup>101</sup> Art. 2 of Taiwan Banking Law, *supra* note 83 (ruling that the term "bank" means an institution organized and registered under Taiwan Banking Law hereunder to conduct banking business).

<sup>102</sup> Taiwan Banking Law defines specified banks and the scope of business delegated to the specified banks. According to Art. 87 of Taiwan's Banking Law, "to facilitate the availability of special credit for enterprises, the central competence, the Ministry of Finance, authorizes the establishment of special banks or may designate an existing bank to extend such credit." Moreover, Art. 88 of the Banking Law, indicates that the special credit referred

companies. Other financial institutions such bill finance companies, credit cooperatives,<sup>103</sup> securities firms, the postal saving system,<sup>104</sup> insurance companies, and leasing companies are established in accordance with different laws.

Most Taiwanese banks operate under a similar universal banking model,<sup>105</sup> and a multi-office-banking system<sup>106</sup> has branches throughout the island. A few specialized banks engage in multiple banking operations that include providing industries with medium- and long-term credit. These specialized banks are intended to accelerate the development of certain industries designated by governmental authorities.<sup>107</sup> In 1999, Taiwan licensed two industrial bank applicants, who will begin operation for specified customers of advanced industries by the end of 1999.

Due to this myriad of banking institutions,<sup>108</sup> restructuring the banking supervision system is crucial to ensuring a sound multiple banking system

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to in the Art. 87 is divided into 6 categories: (1) industrial credit; (2) agricultural credit; (3) export-import credit; (4) medium and small-size enterprise credit; (5) mortgage credit; and (6) local credit. Pursuant to the Banking Law, Taiwan has a number of specialized banks that provide specialized credit for certain important financial market segments. These specialized banks provide medium and long-term industrial, agricultural, trade, real-estate, and medium and small business credit. In some cases, a non-specialist bank has undertaken these specialized functions, or a specialized bank has undertaken two or more specialized functions. See Semkow, *supra* note 68 at 39.

<sup>103</sup>Farming and fishing associations throughout Taiwan Island also have credit departments. Credit departments handle limited banking activities and credit extension services for their members. See Wallace Wen-Yen Wang & James Ting-Yeh Yang, *Financial Institutions in Taiwan: An Analysis of the Regularity Scheme*, 4 J. CHINESE L. 1, 11 (1990).

<sup>104</sup>The postal saving system was designed to encourage domestic consumer savings. Taiwan's postal saving system has proven very popular largely as a result of the greater convenience offered by the large number of locations and longer working hours, ten hours from Monday to Friday, and four hours on Saturday every other week in accordance with the new working days policy in Taiwan since 1998.

<sup>105</sup>The universal banking model, an opposition to specific banking, refers to a banking institution which can perform a wide variety of financial services including taking deposits, making loans, underwriting securities issues, dealing in precious metals and collectible coins, and brokering real estate. See Theodor Baums & Michael Gruson, *The German Banking System--System of the Future?*, 19 BROOK. J. INT'L L. 101, 106-07 (1993).

<sup>106</sup>Taiwan Banking Law, art. 57 (permitting a bank to establish its branch with an approval and issuance of a business license issued by the central competent authority).

<sup>107</sup>Taiwan Banking Law, art. 86.

<sup>108</sup>Banks have a total of over 5,791 offices and branches throughout Taiwan. As of December 1998, Taiwan had 48 domestic banks, including 16 new private commercial banks established in 1992, 8 medium business banks, and two of which were restructured from trust and investment companies, as well as one which was permitted to convert from the status of a national local credit union to a commercial bank. There were also 4 trust and investment companies, 378 credit unions, 31 domestic and foreign life insurance companies, 16 bill and finance companies, 4 securities finance company, 46 branches of foreign banks with 75 outlets, and 26 representative offices of foreign banks from 19 countries in Taiwan. In addition, savings deposits can be made at 1,539 Post Office outlets, established in 1930,

in Taiwan. The current system involving multiple agencies has stunted the development of banking supervisory techniques. Under Taiwan's Banking Law, the Ministry of Finance ("MOF") is the central authority that ultimately supervises banking activities.<sup>109</sup>

However, because human resources are limited and the histories developed, the MOF also coordinates supervision with two agencies: the Central Bank of China ("CBC")<sup>110</sup> and the Central Deposit Insurance Company ("CDIC").<sup>111</sup> Under the principle of supervising financial institutions by these three agencies, the CDIC is not responsible for examining those financial institutions for which other supervisory agencies such as the MOF or CBC are responsible, in accordance with the principle of "Designated Task Assignment Guidelines of Bank examination." The CBC is responsible for older banks, those established before 1992. The MOF is responsible for all new banks established after 1992.

Pursuant to the "Designated Task Assignment Guidelines of Bank examination," the Ministry of Finance established the "Financial Examination Business Review Committee," which is in charge of communications and coordination of bank supervision operations. In order to improve the efficiency of supervision and human resources, the committee also arranged to exchange the audit reports produced by the three supervisory agencies.

Nevertheless, this multi-agency supervisory framework inhibits the ability of the government to cope quickly and efficiently with financial problems. Thus, reform should clearly delineate the responsibilities of each agency. Learning from the experience of British financial supervision reform,<sup>112</sup> consolidation of Taiwan's current multiple supervision system as a

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and operated by the Director General of Postal Remittances and Savings Banks. See Ministry of Finance, Statistics on Number of Domestic Financial Institutions on Taiwan (1998).

<sup>109</sup>Taiwan Banking Law, art. 19 (1995), as amended 1995 ruling that the Ministry of Finance is responsible for all new banks established after 1992.

<sup>110</sup>Central Bank of China Act [hereinafter the CBCA] art. 38 (guiding the Central Bank of China to undertake the supervision of the operation of all financial institutions in coordination with the Ministry of Finance). The Central Bank of China is responsible for the older banks, those established before 1992. The CBCA was enacted on May 23, 1935, and amended in 1979 and 1997. Art. 38 of the CBCA, as amended in 1979

<sup>111</sup>See Deposit Insurance Act ("DIA"), art.21, *supra* note 72. Pursuant to Article 21 of the Deposit Insurance Act and the "Designated Task Assignment Guidelines Of Bank Examination" promulgated by the cabinet, the CDIC shall examine the insured financial institutions, provide them with formal recommendations for improvement, and assist them in running sound businesses.

<sup>112</sup>In response to the trend of financial diversity, most industrial countries, such as the United States, Japan, and England, proposed to centralize current multi-agency financial supervision. For example, in 1999, England organized the Financial Services Authority [hereinafter FSA] which has clear responsibilities and a close relationship with the Bank of England and the Treasury. In addition to banking supervisors, the FSA also encompasses the regulators of securities, investment management, personal investment products, building societies (Britain's savings and loan industry), and insurers. The purpose of creating the FSA,

single regulatory supervisory agency will empower Taiwan financial authority with comprehensive power to monitor financial services.<sup>113</sup>

By creating a single financial supervisory agency, Taiwan would eliminate conflicting supervisory regulations and comply with the standards of the Basle Accords. Amendments to the current financial supervisory scheme will require the development of new regulations and the cooperation of several related agencies. Further, collaboration will be necessary to avoid the costly process of modifying each agency's rules.

Financial liberalization also fuels Taiwan to reform obsolete banking regulations. Through a 1989 amendment to the Banking Law, Taiwan granted licenses to sixteen new private banks.<sup>114</sup> To facilitate open-market competition, Taiwan amended its Constitution to privatize government-owned banks on July 21, 1997.<sup>115</sup> In January 1998, the Taiwan provincial government's "big three" commercial banks, First Commercial Bank, Hua Nan Commercial Bank, and Chang Hwa Commercial Bank, were privatized along with several other state-owned banks.<sup>116</sup> The privatization of state-run banks increases their efficiency, competition, and customer response.

Taiwan plans to promote Taipei as a regional financial center by pressing ahead with the liberalization effort and by improving the financial system.<sup>117</sup> Taiwan's strategy for becoming a regional financial center includes keeping the off-shore and on-shore markets separate. Off-shore markets enjoy full liberalization, while on-shore or domestic markets will

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effective in the middle of 1998, is to ensure stability, avoid duplication, and enhance England's banking competitiveness. See Howard Davies, *A Policeman's Lot is not a National One*, in *THE WORLD IN 1998* 122 (Economist ed. 1997).

<sup>113</sup>Taiwan drafted legislation which simplified multi-agency responsibilities to strengthen banking supervision. Once the drafted legislation is approved by the legislative Yuan (Taiwan's equivalency of the US Congress), the CDIC will compel supervision of the management of financial institutions. This draft legislation raises the penalties to banks who are negligent in monitoring internal control. See Laura Tyson, *Growing Demands for Diverse Products*, *FINANCIAL TIMES*, Oct. 7, 1997, at surv. III.

<sup>114</sup>See *Taiwan: New Banks Urged to Exercise Self-Discipline*, China Eco. News Service, July 8, 1993 (available in *LEXIS*, *ASIAPC Library*, *TAIWAN File*).

<sup>115</sup>On July 18, 1997, Taiwan's third National Assembly at its 32nd plenary session passed the fourth amendment to the Constitution, which was promulgated by Taiwan's president on July 21, 1997, and took effect immediately. See Michael Y.M. Kau, *Crafting Constitutional Reform under President Lee Teng-hui*, *FREE CHINA J.*, Aug. 23, 1997. The amended Constitution starts the privatization of state-owned banks. See *Constitutional Reform: Adjusting the System*, *FREE CHINA REV.* Oct. 1997, at 49.

<sup>116</sup>The three banks together accounted for twenty percent of total domestic deposits and 18.4 percent of total domestic loans by the end of 1996. In addition to these three banks, the other Taiwan provincial banks also include the Taiwan Business Bank, the Bank of Taiwan, the Land Bank of Taiwan, and the Taiwan Cooperative Bank. See United World Chinese Commercial Bank, *Major Economic Indicators on Taiwan*, *R.O.C.*, Oct. 20, 1999, at 76-79.

<sup>117</sup>See Lawrence S. Liu, *supra* note 89 at 78-79.



gradually liberalize.<sup>118</sup> The separation of off-shore and on-shore banking systems reflects Taiwan's conservative policy of protecting the domestic banking system from the negative effects of off-shore volatility, such as the high fluctuation in interest rates, systemic risk, and exchange rates.

In addition, Taiwan has made systematic regulatory efforts to modernize its financial sector. These changes, however, are merely the beginning of what is needed. Taiwan still faces many challenges to achieve financial liberalization.<sup>119</sup> These challenges include the need to implement better regulations, supervision, capital and foreign exchange controls, market access, and national treatment of foreign investors and financial institutions.<sup>120</sup>

In connection with increasing financial globalization, Taiwan should focus on preventing rather than responding to financial collapses by improving the supervision of banking activities. Adoption of international financial supervisory standards is likely to provide Taiwan with an international level of financial supervision. Taiwan's Banking Law already requires that the risk-based capital ratios of a bank be no less than eight percent, as recommended by the Basle Accord on the International Convergence of Capital Measurement to Capital Standards.<sup>121</sup>

Further adoption of the Basle Accords by the Taiwanese government in the banking sector would be a significant step toward establishing Taipei as a financial center. One popular method for improving the supervision of complicated financial institutions is to create a single agency to monitor financial services.<sup>122</sup> The concept of the Basle Accords corresponds to Tai-

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<sup>118</sup>See Ya-Huei, *Legal Aspects of Off-Shore Banking in Taiwan*, 8 MD. J. INT'L L. & TRADE. 237, 238 (1984) (noting that establishing an off-shore banking system could attract foreign banks and achieve the goal of becoming a financial center with low cost and risk to Taiwan's domestic financial system).

<sup>119</sup>For example, in 1995, problems at a major credit cooperative, a leading commercial paper financing company, and several agricultural cooperatives exacerbated weaknesses in the Taiwanese banking system. These financial scandals partially accounted for a twenty-seven percent decline in the stock market in 1995 and highlighted the need for Taiwan to revamp its system for the oversight of financial institutions. See *Recent Developments in Banking and Finance in the People's Republic of China, Hong Kong, and Taiwan: Hearing Before the Comm. on Banking and Fin. Services*, 104 Cong., 2d Sess. 20 (1996).

<sup>120</sup>See Liang, *supra* note 81, at 117, 131.

<sup>121</sup>Taiwan's Banking Law, art. 44.

<sup>122</sup>The establishment of a single, integrated regulator for financial services has become the norm in many advanced countries around the world. For example, under the pressure of a developing financial conglomerate which combined banking, securities, insurance, and non-financial business, Britain designed the Financial Service Authority [hereinafter FSA] to merge nine financial regulatory bodies into one effective on October 28, 1997. These nine financial agencies were the Securities and Investment Board, the Personal Investment Authority, the Investment Management Regulatory Organization, the Securities and Futures Authority, the Supervision and Surveillance Division of the Bank of England, the Building Societies Commission, the Insurance Directorate of the Department of Trade and Industry, the Friendly Societies Commission, and the Registrar of Friendly Societies. See Clive Briault, *The Rationale for a Single National Financial Services Regulator*, (Financial Services

wan's requirements which avoid banking fraud, money laundering, and frame a sound and safe banking system with compliance ensured by banking supervision.<sup>123</sup>

B. Securities: The Demand for Efficient Policing and Alleviation of Government Interference

Taiwan's securities market is one of the most active securities markets in the world. Economic growth and financial deregulation fuel the continued growth of Taiwan's securities market. The Taiwan Stock Exchange ("TSE") began operating in 1962 and is governed by the Securities and Exchange Commission ("SEC") under the supervision of the Ministry of Finance.<sup>124</sup> In addition, the Over-the-Counter markets ("OTC") were operated by securities brokers and traders before the establishment of the TSE in 1962. Because the number of traded companies and the level of transactions were minimal in the OTC, Taiwan prohibited OTC transactions until the end of 1989. The reopening of the OTC did not become an investing target of investors until 1995, when the Ministry of Finance restructured the OTC to conform with market liberalization.

Stocks traded on the TSE market are divided into three categories based on the listed companies' paid-in capital. Category "A" includes companies with a minimum paid-in capital of 600 million New Taiwan dollars.<sup>125</sup> Category "B" includes corporations with a paid-in capital of 300 to 600 million New Taiwan dollars. Category "C" includes high-tech businesses and companies with a paid-in capital of 200 million to 300 million New Taiwan dollars. The criteria for inclusion in each category also include duration of incorporation, minimum level of profitability, and diversification of shareholding requirements with descending stringency.

Following international standards, Taiwan allows foreign investors to invest in the TSE through indirect investment, direct investment by quali-

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Authority) May 1999. The FSA will eliminate disputes about responsibilities between regulators and results in simpler regulation for Britain's financial industry. See Global Survey, *supra* note 20, at 169.

<sup>123</sup> See Michael Blanden, *Can the Risks be Seen?*, THE BANKER, May 1997, at 35.

<sup>124</sup> In addition, establishing the Taiwan Stock Exchange was part of Taiwan's land reform program, which re-allocated land by giving former landowners government securities as compensation for land transferred to tenant farmers. See Jane Kaufman Winn, *Banking and Finance in Taiwan: The Prospects for Internationalization in the 1990s*, 25 INT'L LAW. 907, 915 (1991).

<sup>125</sup> As of November 17, 1999, the currency exchange rate is NT\$ 31.70 to US\$1. See *Emerging-Market Indicators*, THE ECONOMIST, July 29, 1999, at 100.

In Taiwan, the currency rate of the US dollar against the NT dollar is based on the daily basis of the weighted average of inter-bank transaction rates on the previous business day. Daily adjustment of the currency rate is limited to 2.25 percent of the central rate on the previous business day.

fied foreign institutional investors,<sup>126</sup> and direct investment by all foreign investors. Unless otherwise specified by regulation or law, the scope of foreign investment is not limited. At the end of 1996, Taiwan listed 382 companies on the TSE.<sup>127</sup> The TSE has a large margin for growth because most Taiwanese firms currently raise capital through bank loans. Therefore, shifting from rigid bank-loan financing to more freely and more accessible stock-based financing will likely result in phenomenal growth for the TSE.

To enlarge Taiwan's stock market, Taiwan has made a number of adjustments. For example, in 1988, Taiwan first allowed new domestic securities firms to do business in the TSE. By 1995, Taiwan had restructured the over-the-counter stock market and permitted foreign securities firms to access the market. These changes led to an influx of capital which enlarged Taiwan's securities market.<sup>128</sup> To prevent potential and uncertain dramatic fluctuations, daily changes in TSE share prices are capped at plus or minus seven percent.

Before the Securities Exchange Law ("SEL") was amended in 1988, securities firms were classified as underwriters, brokers, or dealers.<sup>129</sup> Each securities firm was limited exclusively to one approved function. As of 1988, Taiwan had only twenty-two underwriters (only five or six of whom were active), ten dealers, and twenty-eight brokers (fourteen brokers were private companies and the other fourteen were state-owned trust or savings departments of financial institutions).

Since many securities firms were inactive due to the small number of listed companies and inadequate depth in the market until the mid-1980s, the securities business in Taiwan was unprofitable before 1980. Trading increased in Taiwan's equities between 1986 and 1989, funded by underground investment companies ("UICs").<sup>130</sup> Due to the limited investment

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<sup>126</sup> Subject to the Regulations for Investments in Securities by Overseas and Foreign National [hereinafter QFII Regulations], Qualified Foreign Institutional Investors [hereinafter QFII] are defined as banks, insurance companies, fund management institutions, securities firms, brokerages, and other institutional investors, which meet the qualifications set by the SEC.

<sup>127</sup> See THE CENTRAL BANK OF CHINA, 1996 ANNUAL REPORT 105 (1996) (reporting according to TSE statistics, as of the end of 1996, a total 382 listed companies, an increase of thirty-five companies over the number in 1995. The total booking capital in 1996 amounted to NT\$1,661.3 billion, an increase of 23.4 percent over 1995).

<sup>128</sup> See Dennis Engbarth, *Heat for the New Kids*, THE BANKER, Feb. 1997, at 55.

<sup>129</sup> Taiwan's Securities and Exchange Law [hereinafter Taiwan's SEL] was promulgated on April 30, 1968. Taiwan's SEL has been enacted five times, on November 13, 1968, May 11, 1981, May 11, 1983, January 29, 1988, and May 7, 1997. Taiwan's SEL consists of eight chapters and 183 articles that primarily govern the securities market, maintain securities market order, promulgates the scope of official duties delegated to the Securities and Futures Commission.

<sup>130</sup> The UICs rose to prominence in 1986 and 1987, creating major economic and financial problems for Taiwanese authorities and investors. The UICs mushroomed to colossal

channels under Taiwan's conservative policies, the UICs, which are unlicensed, non-banking financial institutions, received large deposits from Taiwanese investors, who in turn received interest rates ten to twenty-five percent higher than those of banks. The UICs manipulated stock prices, by investing in specific companies' shares and illegal insider trading, to pay off high short-term interest rates to its investors.<sup>131</sup> The UICs threaten Taiwan's financial system and cause a loss of confidence in the government. Additionally, the bankruptcy of a number of UICs in 1987 caused a financial crisis from which investors could not recover lost capital. The market crash and defaults on loan payments prevented other companies from raising capital.

The UICs scandals pushed open Taiwanese investing channels by catalyzing the amendment of financial regulations. Taiwan amended the Banking Law in 1989 to punish illegal financial institutions with criminal penalties and to grant licenses to new private banks. In addition, the 1988 SEL amendment also removed the barrier to entry which had been in force since 1949. The number of newly established securities firms in the Taiwan securities market exploded. By the end of 1991, 332 new firms had appeared in Taiwan, of which forty-five were integrated securities houses,<sup>132</sup> and 287 were brokerages.

To accomplish the long-term goal of a sound securities market, Taiwan should efficiently distribute information to investors and prohibit the use of borrowed-name accounts<sup>133</sup> to solidify the TSE. The Securities and Exchange Commission has not clearly defined insider trading and market manipulation. Vague regulations create inconsistent viewpoints and have caused the Securities and Exchange Commission and the Ministry of Justice to reach different definitions of insider trading. In addition, the divergent views of the two agencies give investors no guidance, and thus created a legal loophole for the enforcement of the Securities Exchange Law. In order to avoid limiting majority shareholders' responsibilities regulated by the SEL,<sup>134</sup> it is necessary to eliminate the widespread use of borrowed-name accounts which hinders effective implementation of the SEL and effective collection of capital gains taxes caused by this deception.

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proportions within only a few years by offering returns to investors of four percent or more per month. For example, Hung Yuan, the largest UIC, together with 170 small UICs, was estimated to have taken the equivalent of US \$8 billion from more than a million investors in Taiwan. See James McGregor, *Fate of a Gray-Market Behemoth in Taiwan Could Cause Financial and Political Tremors*, ASIAN WALL ST. J. WKLY, Nov. 20, 1989, at 1.

<sup>131</sup> *Id.*

<sup>132</sup> Art. 22 of Taiwan's SEL, *supra* note 130 (allowing securities firms to engage in a complete range of securities business).

<sup>133</sup> Borrowed-name accounts are securities accounts opened in the name of a real person, but controlled and owned by another person or entity.

<sup>134</sup> Art. 22(2) of Taiwan's SEL, *supra* note 129, (requiring a report or approval once shareholders, who own more than ten percent of a company, transfer their stock shares).

The lack of efficient oversight contributes to instability in the securities market of Taiwan. Since one-third of Taiwan's population invests in the TSE and because the market overreacts to political events, Taiwan's government should endeavor to create a stable stock market in order to avoid adverse political implications. Without a competent regulatory system to govern securities markets, the Taiwanese stock market is like a casino with its lax disclosure regulations, insider trading, and the use of borrowed-name accounts. As a consequence, Taiwan needs market discipline to establish an efficient market-oriented system for its securities markets.<sup>135</sup>

#### IV. CHINA: BURGEONING FINANCIAL SERVICES DEVELOPMENT

China's financial system plays a role in supporting open-economic development. China's banking sector is contributing to China's ongoing economic development by switching from state-owned policy banks<sup>136</sup> to state-owned commercial banks.<sup>137</sup> Separating state banks from state-controlled commercial banks is the most immediate and important task for China in regard to banking reform.<sup>138</sup> Since many state-owned enterprises are inefficient, state-owned banks endure inordinate amounts of bad debt. To resolve its bad debt problem, China is considering financing state-owned enterprises through the securities market rather than via banking loans.<sup>139</sup> In addition to spreading the risk, raising funds from the securities market will put Chinese state-owned enterprises in a better position to face market competition.

After seven years of the legislative drafting process, on December 29, 1998 China enacted the Securities Law on the national level, which became effective on July 1, 1999.<sup>140</sup> The Securities Law terminated the divergence in domestic securities regulations and accorded with the expectations of

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<sup>135</sup> See Jeffrey H. Chen & Jack J. T. Huang, *Taiwan's Evolving Stock Market: Policy and Regulatory Trends*, 12 UCLA PAC. BASIN L. J. 35, 36-37 (1993).

<sup>136</sup> A Chinese state-owned policy bank refers to a state-owned bank which, unlike a commercial bank, prioritizes and reflects government policy. See WORLD BANK, CHINA: FINANCIAL SECTOR POLICIES AND INSTITUTIONAL DEVELOPMENT 9 (1990).

<sup>137</sup> See Haiqun Yang, BANKING AND FINANCIAL CONTROL IN REFORMING PLANNED ECONOMIES 77 (1997).

<sup>138</sup> See Tony Walker, *Chinese Growth 'under Threat'*, FIN. TIMES, Sept. 19, 1997, at P.6.

<sup>139</sup> See James Harding, *China Moves Towards Allowing Mutual Funds*, FIN. TIMES, Oct. 10, 1997, at 6 (stating that China approved regulations for establishing mutual investment funds which is the first step to establish a second capital market).

<sup>140</sup> The People's Republic of China Securities Law [hereinafter China's Securities Law] was promulgated on December 29, 1998 and came into enforce on July 1, 1999. See The People's Republic of China Securities Law, CHINA LAW PRACTICE, Feb. 1999, at 25-66. China's Securities Law comprises 214 articles grouped under twelve chapters, dealing with a wide variety of matters including the issuance of securities, trading of securities, takeover of listed companies, stock exchange, securities firms, securities intermediaries and regulatory authorities.

domestic and foreign investors. The amendment of China's securities law may enable China to create efficient securities markets. To further reform the financial system, one proposal for China's securities market is to consolidate the classification of shares and unification of securities issues. Consequently, in order to participate in this internationalization and join the WTO, China must increasingly liberalize and apply the rule of law on its financial system.<sup>141</sup>

#### A. Banking: A Crucial Aspect of China's Ongoing Economic Reform

As early as 1978, China implemented market-oriented reforms for its banking system.<sup>142</sup> In spite of passing laws to improve banking supervision, such as the Central Banking Law,<sup>143</sup> the Chinese banking supervision system remains underdeveloped and disorganized. The primary risks to the pursuit of China's banking reforms are the continued burdens of state-enterprise debt, rising unemployment, and a weakening of the government's fiscal position.<sup>144</sup>

China's state-owned banking system has numerous problems. Its primary drawbacks are insufficient capital reserves, and a misallocation of credit.<sup>145</sup> For example, normal international standards require minimum capital reserves of eight percent.<sup>146</sup> China's banks are not even close to meeting these minimum international standards.<sup>147</sup> In addition, misallocation of credit is common because all of China's banks are state-controlled, which forces many banks are forced to offer loans to unproductive state-enterprises rather than to the private sector. Political interference and mismanagement are also common in China's banking system.<sup>148</sup>

China's politicians manipulate banks for quasi-political reasons; specifically, to sustain non-profit state-owned enterprises and prevent further

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<sup>141</sup> See *Beijing's Blueprint for Reform*, FIN. TIMES. Nov. 13, 1995, at 21 (reporting China's plans to make its currency convertible in accordance with the requirement for the entry into the WTO).

<sup>142</sup> See UNITED STATES GENERAL ACCOUNTING OFFICE [hereinafter GAO], INTERNATIONAL TRADE, U.S. GOVERNMENT POLICY ISSUES AFFECTING U.S. BUSINESS ACTIVITIES IN CHINA 19 (May 1994).

<sup>143</sup> See Andrew Xuefeng Qian, *Transforming China's Traditional Banking Systems under The New National Banking Laws*, 25 GA. J. INT'L & COMP. L. 479 (1996).

<sup>144</sup> See WORLD BANK, *supra* note 136, at 70-79.

<sup>145</sup> See Gary Klintworth, *China's State Owned Enterprises*, in PRC POLITICAL ECONOMY: PROSPECTS UNDER JIANG ZEMIN 73, 76 (Hsin-hsing We eds. 1999).

<sup>146</sup> See BASLE COMMITTEE, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS 16 (July 1988) (suggesting that a minimum standard of capital of international bank to weighted risk assets should be set at eight percent).

<sup>147</sup> See Tokley & Ravn, *supra* note 49, at 86.

<sup>148</sup> See David Eu, Note, *Financial Reforms and Corporate Governance in China*, 34 COLUMBIA J. TRAN. L. 469, 484 (1996).

unemployment.<sup>149</sup> Under constant political pressure, China's banking authorities focus on political factors instead of credit analysis in making lending decisions.<sup>150</sup> Inefficient operation of and frequent losses by China's state-owned enterprises exacerbate this problem. Loans to inefficient governmental enterprises indirectly burden China's banking system, as banks are forced to accept a large number of bad loans.<sup>151</sup>

These bad loans have required China to proceed with a series of banking reforms. From 1994 to 1995, China's solution for uncollectable debt was to create three new "policy banks" whose purpose was to attempt to establish commercial banks in China.<sup>152</sup> China transferred policy-lending operations to the three newly created policy banks: the State Development Bank of China, the Agricultural Development Bank, and the Import/Export Bank of China.

These new policy banks allowed the four commercial banks<sup>153</sup> to take on normal commercial functions upon the release of the bad debt owed by state-owned enterprises, and learning to apply commercial criteria to lending practices. China wanted the new policy banks to be the sole policy-based lenders, thereby relieving the commercial banks of this responsibility.

Subsequently, China's banking authorities have made numerous efforts to reform both the state and commercial banking sectors. China enacted the Law of the People's Bank of China ("Central Banking Law") on March 18, 1995,<sup>154</sup> which increased the authority and responsibilities of the People's Bank of China ("PBOC"), as a central bank.<sup>155</sup> The PBOC was the only

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<sup>149</sup> A banking failure, in political terms, may encourage the government to bail out rather than sell or liquidate a bank. Further, a substantial number of countries involve the courts in the decision to close a bank or in the disposition of the assets of a failed bank. The resulting delays are frequently counter-productive and may result in the authorities' unwillingness to close an insolvent bank, which will either continue to operate and provide hampered competition or will be later rescued, detracting from market discipline under either scenario. Given the lending relationship and general dependence between state-owned enterprise and state-owned banks in China, a banking failure would have drastic social, political, and economic effects. See George G. Kaufman, *Bank Failures, Systemic Risk, and Bank Regulations*, 16 CATO J. 17, 19 (Spring/Summer 1996).

<sup>150</sup> See *Dinosaurs Lumbering towards the Real World*, ASIAMONEY, Dec. 1997/Jan. 1998, at 20.

<sup>151</sup> See Xin, *supra* note 51, at 36.

<sup>152</sup> See *Dinosaurs Lumbering towards the Real World*, *supra* note 150.

<sup>153</sup> China's banking system is dominated by the four major commercial banks: the Bank of China, the Industrial and Commercial Bank of China, the Agriculture Bank of China, and the People's Construction Bank of China. See D. K. Srivastava & Wang Chenguang, *The Role of the Central Bank of China*, in LEGAL DEVELOPMENTS IN CHINA: MARKET ECONOMY AND LAW, 217, 225 (Wang Guiguo & Wei Zhenying eds. 1996).

<sup>154</sup> The Law of the People's Bank of China [hereinafter China's Central Banking Law], promulgated on March 18, 1995, has eight chapters, fifty-one articles, and was adopted by the Third Session of the Eighth National People's Congress.

<sup>155</sup> Founded in December 1948 on the eve of the establishment of the government of the People's Republic of China, the People's Bank of China had been a government agency un-

bank in China to perform the myriad functions of a quasi-central bank, a commercial bank, and a merchant bank until the establishment of the special banks in January 1986.

The People's Bank of China has three major responsibilities: making and implementing national monetary policies; supervising and administering financial institutions; and maintaining the stability of the official currency.<sup>156</sup> In order to govern commercial banking activities, China passed the Commercial Banking Law<sup>157</sup> on July 1, 1995, which sets standards for evaluating and granting loans.

The enactment of China's Central Banking Law and Commercial Banking Law has moved China closer to meeting the international banking and financial standards. However, the Central Banking Law fails to identify the agencies responsible for enforcement.<sup>158</sup> China also needs additional provisions to enhance the implementation of banking supervision. Finally, the susceptibility of China's banking industry to political and governmental interference<sup>159</sup> requires the establishment of an efficient and independent banking system.

Such a system could be achieved through the adoption of the Basle Accords. As the Basle Accords are soft laws of international banking supervision standards, application of the Basle Accords into China's system of banking regulation will allow China to adopt internationally recognized standards. In turn, the adoption of the Basle Accords will entice foreign banks to conduct business in China.

With its recent economic growth, China's financial system appears diversified. China has non-banking financial institutions such as rural credit cooperatives and trust and investment companies ("TIC").<sup>160</sup> TICs provide

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der the state Council. Its main responsibilities were stabilizing the value of *renminbi* (China's official currency) and attracting and allocating funds for "socialist construction." See Liu Hongru, *Developments in the Reform of China's Banking and Financial Systems*, 2 J. CHINESE L. 323, 326 (1988).

<sup>156</sup> See China's Central Banking Law, art 4.

<sup>157</sup> China's Commercial Banking Law [hereinafter China's Banking Law] was adopted at the 13th Session of the Standing Committee of the 8th National People's Congress on May 10, 1995 and became effective as of July 1, 1995. China's Commercial Banking Law has nine chapters and ninety-one articles, and clarifies the role of commercial banks in China. Additionally, China's Commercial Banking Law standardizes the commercial behavior of the banks.

<sup>158</sup> *PBOC will Enforce Its Supervision over the Non-Bank Financial Institutions*, WORLD J., May 3, 1995, at B15 (noting that the People's Bank of China plans to issue rules in the next two or three years regarding insurance, securities, lottery and investment funds).

<sup>159</sup> See Henry Sender, *Black-Box Bankers*, FAR E. ECO. REV., Feb. 9, 1995, at 48-49 (noting the strange phenomenon in China that central banking is little known and aspires to obscurity rather than prominence).

<sup>160</sup> Trust and investment companies primarily undertake deposit-taking and the provision of guarantee or letter of credit; investment in industrial companies; brokerage activities; and



credit and service to customers in rural areas where banks are reluctant to enter. Most TICs are affiliated with banks or closely linked to local governments. TICs provide China's economy with valuable flexibility in areas of new financial growth.

However, the Commercial Banking Law's separation of banking and non-banking activities decreases the TIC's value in China's financial system.<sup>161</sup> Moreover, TIC's high risks and reduced macroeconomic control pose a challenge to changing the character of China's financial system.<sup>162</sup> As a result, the merger of the TIC into the local banking system will be an appropriate method in accordance with the Commercial Banking Law.

China's banking reform was structured to prevent banking failure and to increase the competitiveness of China's banks against foreign banks, which are increasingly present in China. China's banking reform is likely to benefit from China's ongoing need for economic development.<sup>163</sup> In reviewing China's banking reforms, establishing agencies responsible for banking supervision can prevent banking failures. After becoming a WTO member, China's implementation of its promise for additional openness will allow more foreign institutions into China's market. This banking reform through comprehensive banking supervisory regulations also can increase China's banks' competitiveness with foreign banks.

#### B. Securities: Demanding Enhancement to Unify Securities Activities

China's securities market is an emerging market and needs enhancement and transparency in its securities regulations. China's securities market started in two cities in the 1990s, Shanghai and Shenzhen.<sup>164</sup> After being closed since 1949, the Shanghai Securities Exchange re-opened on December 19, 1990, and the Shenzhen Stock Exchange reopened on July 3, 1991.<sup>165</sup> By the end of 1991, the total value of stocks approved by the state and publicly issued in Shanghai and Shenzhen had reached 3.3 billion ren-

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securities dealing and underwriting. See Anjali Kumar et al., WORLD BANK, CHINA'S NON-BANK FINANCIAL INSTITUTIONS, TRUST AND INVESTMENT COMPANIES 6 (1997).

<sup>161</sup> Art. 43 II of China's Commercial Banking Law prohibits commercial banks from investing in non-banking financial institutions or enterprises within the People's Republic of China. The State Council shall formulate separate implementation procedures for commercial banks which invest in non-banking financial institutions or enterprises prior to the implementation of the [commercial banking] law.

<sup>162</sup> See KUMAR, *supra* note 160, at 19.

<sup>163</sup> See *China's Reforms*, FIN. TIMES, March 1998, at 19 (analyzing China's need to reform its banking system to avoid bankruptcy caused by bad loans).

<sup>164</sup> Mei Xia et al., THE RE-EMERGING SECURITIES MARKET IN CHINA 103 (1992).

<sup>165</sup> For an overview of the history and development of China's stock market, see Benjamin R. Tarbutton, *China--A National Regulatory Framework for the PRCs Stock Markets Begins to Emerge*, 24 GA. J. INT'L & COMP. 411, 412 (1994).

*minbi* (equivalent to 412 million U.S. dollars), of which 84.8 percent were public stocks and 15.1 percent were individual stocks.<sup>166</sup>

Prior to July 1, 1999, during the time before the Securities Law passed on December 29, 1998, local rather than national securities regulations governed both securities markets. In addition to these two officially recognized exchanges, China has also instituted "securities exchange centers" in eighteen of China's larger cities as well as two electronic trading systems, the National Electronic Trading system and the Securities Trading Automated Quotation system.

In cooperation with the People's Bank of China,<sup>167</sup> Shanghai and Shenzhen's municipal governments promulgated China's securities regulations.<sup>168</sup> Both the Provisional Measures of Shanghai Municipality for Administration of the Trading of Securities<sup>169</sup> and the Provisional Measures of Shenzhen Municipality for Administration of the Issue and Trading of Shares<sup>170</sup> demonstrated a distinctly regional attitude. Due to inconsistent local administrative orders and guidance, however, China's capital markets often present low liquidity, and high volatility.<sup>171</sup> In addition, agencies with over-lapping and ill-defined responsibilities make the regulatory process unclear.

As a result, China needs comprehensive securities regulations to provide adequate shareholder protection and promote the internationalization of China's securities market. For this reason, in 1992, the State Council organized the State Council Securities Regulatory Commission and China Securities Regulatory Commission to develop China's national securities regulations and regulators.<sup>172</sup>

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<sup>166</sup> See Hassanali Mehran et al., *MONETARY AND EXCHANGE SYSTEM REFORM IN CHINA: AN EXPERIMENT IN GRADUALISM* 32-33 (1996).

<sup>167</sup> Under Article 4 of the China's Central Banking Law, the People's Bank of China has authority to regulate stock, bonds, and negotiable instruments, and to administer China's financial markets. See Huang, *supra* note 51, at 18.

<sup>168</sup> The regulation promulgated by the municipal governments of Shanghai and Shenzhen include provisions governing stock registration, disclosure, trading, insider information, broker dealers, and administration of the stock exchanges. See Xia, *supra* note 164, at 112.

<sup>169</sup> On November 27, 1990, the Shanghai Municipality promulgated the Provisional Measures of Shanghai Municipality for Administration of the Trading of Securities. *Id.* at 113.

<sup>170</sup> On May 15, 1991, the City Government of Shenzhen declared the Provisional Measures of Shanghai Municipality for Administration of the Trading of Securities. *Id.* at 115.

<sup>171</sup> In 1993 and 1994, China's market for "A" shares has remained volatile. Shanghai's "A" share index tumbled twenty percent in September and early October 1994, with analysts attributing the fall to profit-taking and concerns about rising inflation. Shanghai's "A" share index fell to a low of 328.85 at the end of July 1994.

<sup>172</sup> Since 1993, China drafted the Securities Law and proposed the China Securities Regulatory Commission to supervise the trading activities of securities firms. See Lay Hong Tan, *The Legal and Regulatory Framework of Securities Markets in the PRC*, 7 ASIA PACIFIC L. REV. 69, 79 (1999).

China's equity market has grown rapidly since re-opening with eighty-nine listed enterprises in 1990-1991.<sup>173</sup> At the end of September 1997, a total of 708 enterprises were listed on China's securities market.<sup>174</sup> Over US\$159.7 billion in equity shares were available for trading.<sup>175</sup> The listed companies had a paid-in capital of 164 billion *renminbi* equivalent to twenty-four percent of China's GDP.<sup>176</sup>

The Chinese economic reform, which began in December 1979,<sup>177</sup> created an urgent need to build China's capital market.<sup>178</sup> Low capital requirements to invest in industry and infrastructure construction are indications of the limited financial resources of the State. Both private and state-owned enterprises in China suffer from a deficiency of capital. As a result of an unbalanced allocation of capital, private sector entities rarely borrow from state-owned banks.<sup>179</sup>

Since state-owned enterprises receive subsidies from the government, they have very few incentives for efficiency and profitability. By establishing a stock exchange system, China could change the corporate structure of state-owned enterprises and create market competition, improve capital deficiency, and improve the allocation of capital.<sup>180</sup>

A top priority for China's securities authorities is the simplification of stock categories based on the principle of "same share, same right." Under the present securities regulatory system, stocks are divided into three categories: state shares, legal-person shares, and individual shares.<sup>181</sup> In addition, these shares are further classified depending on corporate ownership and the nature of the listing and the issuing places.<sup>182</sup>

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<sup>173</sup> On December 9, 1990, the Shanghai Stock Exchange was established; and on July 3, 1991, the Shenzhen Stock Exchange was established. By the end of 1991, the total value of stocks approved by the state and publicly issued in Shanghai and Shenzhen had reached 3.3 billion *renminbi* (equivalent to 412 million U.S. dollars), of which 84.8 percent were public stocks and 15.1 percent were individual stocks. See MEHRAN, *supra* note 166.

<sup>174</sup> *Id.*

<sup>175</sup> *Id.*

<sup>176</sup> See *Sleight of Hand*, THE ECONOMIST, Mar. 7, 1998, at 78 (indicating that the some estimates was as high as seventy percent).

<sup>177</sup> China began its remarkable economic reform starting in 1979 by welcoming foreign capital and technology to promote China's economic development. See Standly B. Lubnman, *Investment and Export Contracts in the People's Republic of China: Perspectives of Evolving Pattern*, BRIGHAM YOUNG U.L.REV. 543, 544-45 (1988).

<sup>178</sup> See *Capital Markets*, CHINA'S TOP 2000, 1998, at 140.

<sup>179</sup> In 1996, nearly one-third of large and medium-sized state-owned enterprises were unprofitable and survived on government subsidies. In 1993, China spent \$3.5 billion to subsidize inefficient state-owned enterprises, an amount equal to 150 percent of the central government's total budget deficit. The subsidies were the main force driving inflation in China's economy.

<sup>180</sup> See WORLD BANK, *supra* note 136.

<sup>181</sup> See MEHRAN, *supra* note 166, at 33.

<sup>182</sup> See Tokley & Ravn, *supra* note 49, at 71.

China divides stock shares into six categories.<sup>183</sup> "A" shares are issued by Chinese companies exclusively to Chinese individuals and Chinese legal persons.<sup>184</sup> "B" shares are issued by Chinese companies and sold exclusively to non-Chinese persons or foreign legal entities.<sup>185</sup> "B" shares are denominated in *renminbi*, but must be purchased with foreign currency.<sup>186</sup> In addition to the two major categories of shares ("A" and "B"), "C" shares are issued to legal-persons, such as enterprises that hold shares in another enterprise.<sup>187</sup> "H" shares, also known as "red chip" shares, are stocks of China's state-owned companies issued and traded in Hong Kong.<sup>188</sup> "N" shares are American Depositary Receipts traded on the New York Stock Exchange.<sup>189</sup> Also, "L" shares are listed on the London Stock Exchange as of October 7, 1996.

Generally, individual "A" and "B" shares are traded in the domestic stock markets in large volumes. Both "A" and "B" shares are traded in the two stock exchanges in Shanghai and Shenzhen.<sup>190</sup> As of June 1998, 890 "A" shares were registered (456 in Shanghai and 434 in Shenzhen).<sup>191</sup> Only a total of 104 "B" shares were listed in Shanghai and Shenzhen during the same period. The smaller amount of "B" shares demonstrates the limited opportunities for foreign portfolio equity investment in China compared to the opportunities for domestic investors. In addition, a small volume of "C" shares, known as legal person shares, were created to designated holdings in State enterprises by official bodies which were traded within domestic markets.<sup>192</sup>

"H" and "N" shares have opened a new channel of fund-raising for China's big companies.<sup>193</sup> By listing and issuing shares overseas, China's

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<sup>183</sup> See Tan, *supra* note 172, at 70.

<sup>184</sup> *Id.* at 72.

<sup>185</sup> *Id.*

<sup>186</sup> *Id.*

<sup>187</sup> *Id.*

<sup>188</sup> In July 1993, China's government permitted nine state-owned enterprises to issue and list their shares on the Stock Exchange of Hong Kong [hereinafter SEHK]. These shares are known as "H" shares or "red chips." The first issuing group issued 5.6 billion shares, raising total funds of over 11.56 billion Hong Kong dollars. In September 1996, thirty-one of China's state-owned enterprises have listed H shares on the SEHK. See Nicholas R. Lardy, CHINA'S UNFINISHED ECONOMIC REVOLUTION 153-4 (1998).

<sup>189</sup> In September 1994, Shongdong Huaneng Energy International began offering "N" shares, also known as American Depositary Receipts, on the New York Stock Exchange. *Id.*

<sup>190</sup> See Li Kui-Wai, FINANCIAL REPRESSION AND ECONOMIC REFORM IN CHINA 85 (1994); Xia, *supra* note 164, at 103-16.

<sup>191</sup> See *A Growing Stock Market in China*, CHINA DAILY, July 7, 1998.

<sup>192</sup> See Tan, *supra* note 172, at 70.

<sup>193</sup> See Lay Hong Tan, *Capitalism in the People's Republic of China? A Survey of the Re-emerging Securities and Financial Markets*, 16 COMPANY LAWYER 72, 79 (1996) (mentioning that one of the reasons commonly offered for the poor performance of "B" shares is the competition from issuing the "N" and "H" shares).

state-owned companies can raise capital and restructure in accordance with international corporate standards, regulated by the US, UK, and Hong Kong. These reforms set an example for China's overall corporate restructuring.<sup>194</sup>

Increased participation in China's stock markets requires adjustments in the shareholding system to provide investors with additional investment information. For example, China should broaden the structure of shareholding to encourage individual investment and decrease the presence of shareholding companies. A general lack of regulation and an indifference towards the purposes of current regulation cause further instability in the securities market. In addition, the different regulations of the Shanghai and Shenzhen markets create confusion. Thus, to remedy these problems, China needs national securities regulations to prevent market manipulation and to create a disciplined framework.

#### V. HONG KONG: HOPE FOR ECONOMIC PROGRESS AFTER THE TRANSITION TO CHINA'S SOVEREIGNTY

With Hong Kong's "hand-over" to China, the future of Hong Kong's economic development will depend on the continuing progress of Hong Kong's financial system. Compared with the banking systems in Taiwan and China, Hong Kong has a liberal international banking system that was previously overseen by the British government.<sup>195</sup> At the end of February 1997, Hong Kong granted licenses to 61 restricted banks and 123 deposit-taking companies, which was comprised of 366 authorized institutions.<sup>196</sup> Thirty foreign countries established banks and placed 333 authorized institutions and 159 representative offices in Hong Kong.

Hong Kong is an enormous player in the international securities market. For example, the "Asian Flu," which started in Hong Kong, indicates the increasing international importance of the Hong Kong securities mar-

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<sup>194</sup> *Id.*

<sup>195</sup> See generally Elizabeth A. R. Yee, *Hong Kong and China in 1997: An Examination of Possible Legal and Economic Implications for United States Business*, 36 SANTA CLARA L. REV. 595 n.1 (1996) (discussing the idea that Hong Kong may be the best example of free trade).

<sup>196</sup> Hong Kong maintains a three-tier system of deposit-taking institutions, comprised of licensed banks, restricted license banks, and deposit-taking companies. They are collectively known as authorized institutions. Only licensed banks may operate savings accounts, and accept deposits of any size and maturity. Restricted license banks are only permitted to accept deposits of HK\$500,000 or more, while deposit-taking companies are only permitted to accept a minimum deposits of HK\$100,000 with an original maturity of not less than three months. Restricted license banks and deposit-taking companies are two categories of institutions which provide an opportunity for overseas banks not qualified for a full banking license to set up establishments in Hong Kong and conduct wholesale and investment banking business. See Berry F. C. Hsu, *Laws of Banking and Finance in the Hong Kong SAR* 175-78 (1998).

ket.<sup>197</sup> To promote stability, China should strengthen its relationship with Hong Kong. By supporting Hong Kong, China would establish confidence in Hong Kong's securities market and insulate itself against further financial crises.

Under the Basic Law policy of "One country, Two systems,"<sup>198</sup> Hong Kong's people should enjoy a high degree of autonomy. With the change from British to Chinese rule, however, Hong Kong may have to alter its existing financial system. The major challenge in Hong Kong is to maintain deregulation and trade liberalization and to retain its status as a major financial center.

#### A. Banking: Maintaining Hong Kong's Financial Autonomy

Hong Kong reverted to China's control on July 1, 1997, after over a century of rule by the United Kingdom.<sup>199</sup> China and the United Kingdom agreed to the terms of Hong Kong's reversion in the 1984 Joint Declaration (the "Joint Declaration").<sup>200</sup> The Basic Law,<sup>201</sup> enacted subject to the Joint Declaration, provides Hong Kong with a high degree of autonomy except in the matters of defense and foreign affairs.<sup>202</sup> China drafted the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China mainly to facilitate the transfer of political authority.

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<sup>197</sup>"Asian Flu" refers to the period during which "Asian Stock markets from Tokyo to Singapore" tumbled after "Hong Kong's upheaval." The turmoil spread rapidly through European markets and to the US. See *HK Upheaval Caused Global Shockwaves*, FIN. TIMES, Oct. 24, 1997, at 1.

<sup>198</sup> See Basic Law, *supra* note 2.

<sup>199</sup> See John H. Henderson, *Notes, The Reintegration of Hong Kong into the People's Republic of China: What It Means to Hong Kong's Future Prosperity*, 28 VAND. J. TRANSNAT'L L. 503, 514 (1995).

<sup>200</sup> See Joint Declaration of the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Question of Hong Kong, December 19, 1984, PRC-U.K., 1984 Gr. Brit. T.S.No.26 (Cmd. 9543).

<sup>201</sup> Article 109 of the Basic Law provides that the post-1997 government shall "provide an appropriate economic and legal environment for the maintenance of Hong Kong as an international financial center." Article 110 of the Basic Law provides that the local Hong Kong government shall "on its own, formulate monetary and financial policies, safeguard the free operation of financial business and financial markets, and regulate and supervise them in accordance with law." Article 111 of the Basic Law provides that the Hong Kong dollar shall continue to circulate and that the authority to issue Hong Kong dollars must continue to be backed by a 100 percent reserve. Article 112 of the Basic Law prohibits any foreign exchange control policies whatsoever, directs that the Hong Kong dollar shall remain freely convertible, and requires free flow of capital. Additionally, Article 113 of the Basic Law provides that the Hong Kong government, not the Chinese central government, shall control the Exchange Fund, the currency reserve maintained to regulate the value of the Hong Kong dollar. For further discussion of the interpretation of the Basic Law, see Albert H. Y. Chen, *The Basic Law and the Protection of Property Rights*, 23 HONG KONG L. J. 55-62 (1993).

<sup>202</sup> For a detailed discussion of Hong Kong's SAR, see Dobinson & Roebuck, *supra* note 56.

Hong Kong and China will maintain two separate currencies and two monetary systems in a mutually independent manner.<sup>203</sup> To prepare for the transfer to China, Hong Kong enacted new banking regulations to establish independence for the new Hong Kong Special Administrative Region Government. By establishing a quasi-central bank, the Hong Kong Monetary Authority ("HKMA"), in 1993,<sup>204</sup> Hong Kong actually increased the level of government supervision of banks.<sup>205</sup> The HKMA not only formulates and implements monetary policy and manages foreign reserves and government debts, it also maintains the stability and integrity of the monetary and financial systems.<sup>206</sup> The HKMA exercises adequate supervision of financial institutions and ensures appropriate liquidity to support the banks in Hong Kong.

Under the "One country, Two systems" formulation, Hong Kong will remain separate in several ways. It will remain a separate customs territory, maintain separate currency and monetary systems, and retain its status as a free port and financial center in the Asian area for at least fifty years. The Hong Kong government retains sole control of the HKMA. As the master of Hong Kong, the People's Bank of China will support the stability of Hong Kong's currency. However, the Basic Law prevents China from drawing on or resorting to Hong Kong's Exchange Fund or other assets in order to keep HKMA an independent financial authority.

China realizes that ensuring Hong Kong's stability and prosperity will be mutually beneficial to both Hong Kong and China. Under this philosophy, China is likely to keep Hong Kong in its traditional role as China's outlet to the world. Even prior to the turnover, most of China's capital was transacted through the Hong Kong market. Hong Kong is likely to remain

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<sup>203</sup> See Dai Xianglong, *One State, Two Currencies*, BANKER, Nov. 1996, at 100 (stating that in order to maintain Hong Kong's prosperity, China adopted the "one state, two currencies" system which allows Hong Kong to continue to have its existing currency system under China's sovereignty).

<sup>204</sup> The HKMA was established on April 1, 1993 by merging Hong Kong's Office of the Commissioner of Banking and the Office of the Exchange Fund. The HKMA is established within the framework of the Hong Kong executive-led government and is accountable to the Financial Secretary. The Exchange Fund Advisory Committee will continue to advise the Financial Secretary on the control and management of the Exchange Fund and will serve as a management board of the HKMA. See Hsu, *supra* note 196, at 221-29.

<sup>205</sup> See Henny Sender, *Bank on Us*, FAR E. ECON. REV., Nov. 17, 1994, at 66, 67 (reporting that government regulation of banking in Hong Kong, however, is still relatively lax).

<sup>206</sup> The HKMA explicitly pegs the HK dollar against the US dollar. By enforcing the peg to the US Dollar, the HKMA guarantees the price of the HK Dollar by trading through the three commercial banks which are allowed to print money in Hong Kong. In return, the banks receive certificates of indebtedness with which they can print the equivalent amount of Hong Kong dollars at the official rate of HK\$7.8 to the US\$1. The process also works in reverse. If the banks have a surplus of Hong Kong notes, they can use them to redeem their certificates of indebtedness, again at the official rate. See Dustsche Morgan Grenfell, *Hong Kong Banks and HighBOR*, 47-50 (Nov. 1997).

the gateway to China, and it is in China's best interest to observe the Joint Declaration to its very letter.

Hong Kong's financial stability before and after July 1, 1997 is a critical international concern, as well as a local and regional one.<sup>207</sup> As Hong Kong is an international financial center, international traders have important economic and financial interests at stake in a smooth and successful transition to Chinese sovereignty.<sup>208</sup>

Hong Kong is economically successful in large part because of its service-based economy and liberalized financial system.<sup>209</sup> Aside from Japan, Hong Kong is the main financial center in Asia. Not only does Hong Kong's Basic Law contain specific commitments designed to maintain Hong Kong's world-class financial status,<sup>210</sup> Hong Kong also continues to concentrate on maintaining its status as an international financial center to ensure its future prosperity.<sup>211</sup>

Hong Kong faces a number of challenges in the future. One of the HKMA's main objectives is to ensure the safety and stability of Hong Kong's banking system. The HKMA regulates the banking business and the business of taking deposits through the supervision of authorized institutions. The HKMA employs the "continuous supervision" approach to financial institutions. A wide variety of techniques are utilized to detect problems at an early stage and ensure that banks have adequate internal control systems to manage risks.

In supervising banks, the HKMA follows international practices as recommended by the Basle Committee. For example, since late 1989, the HKMA has applied the Basle Accords' capital adequacy framework and the minimum standards for supervision of international financial groups. The collapse of the Bank of Credit and Commercial Hong Kong in July 1991<sup>212</sup> taught the HKMA that capital adequacy is a better criterion than any criteria

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<sup>207</sup> See Julia Charlton, *A Guide to the Financial Markets in Hong Kong*, at THE ASIANLAW GUIDE TO FINANCIAL MARKETS, 65-70 (1998).

<sup>208</sup> See *Issuing Securities: A Guide to Securities Regulation around the World*, INT'L FIN. L. REV. 24, 24-32 (Mar. 1993).

<sup>209</sup> As a result of Hong Kong's liberalized financial policy, eighty-five of the world's largest one hundred banks have a presence in the Hong Kong banking market, which is Asia's second largest stock market after Japan. See Aasim M. Husain, *Hong Kong, China in Transition*, FIN. & DEV., Sept. 1997, at 4.

<sup>210</sup> See Article 109 of the Basic Law, *supra* note 2.

<sup>211</sup> China anticipates that Hong Kong will continue to conduct business in all convertible currencies, while Shanghai will be a domestic financial center with business transacted in *renminbi*. Because China views Hong Kong as a viable economic asset, China will likely enshrine Hong Kong's extraordinary economic values by preserving the existing system.

<sup>212</sup> In July 1991, the close of the Bank of Credit and Commercial Hong Kong [hereinafter BCCHK] astonished Hong Kong's banking supervisory system. The revelation of widespread fraudulent activities by the Bank of Credit of Commerce International, the parent company of the BCCHK, resulted in the closing of the BCCHK. See Derek Roebuck et al., LAW RELATION TO BANKING IN HONG KONG 307-319 (2nd. ed. 1994).



it had used before. This capital adequacy approach to supervision monitors both the total of a bank's capital base and its relationship to the amount of risk on the balance sheet.<sup>213</sup> While the Basle Committee recommends a minimum capital adequacy ratio of eight percent, the HKMA requires fifteen percent, far exceeding the Basle Committee's recommendation.<sup>214</sup> The high capital adequacy ratio requirement ensures Hong Kong's prudent supervision and increased financial competition with large financial institutions.

Following an amendment to the Banking Ordinance,<sup>215</sup> HKMA's 1995 reforms focused on the efficiency and transparency of the banking system. The HKMA introduced a revised policy on liquidity with provisions designed to assure the quality of liquid assets held by banks. Additionally, the HKMA required all authorized institutions to submit written statements on their liquidity management policies. The HKMA also developed disclosure requirements for bank balance sheets, including notification of transfers to and from internal reserves. The HKMA also instituted a new policy for bilateral netting arrangements. This policy was intended to lower the capital required to insure transactions between banks.

Hong Kong has made significant progress in stabilizing its banking system. Further, the HKMA continues to integrate the Basle Accords in its development of capital adequacy ratios and in the promotion of prudential supervision. Hong Kong should continue to adopt measures consistent with the amendments of the Basle Accords so as to promote stability and investors confidence.

#### B. Securities: The Gradual Shift of Confidence in the Securities Markets

Hong Kong's stock market is one of the four largest securities markets in the world. Established in 1891,<sup>216</sup> the Hong Kong securities market is

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<sup>213</sup> See David Carse, *Banking Supervision in the Practice of Central Banking in Hong Kong*, Development 68, 70-75 (Hong Kong Monetary Authority 1994).

<sup>214</sup> See *Recent Developments in Banking and Finance in the People's Republic of China, Hong Kong, and Taiwan: Hearing Before the House Committee on Banking and Financial Service*, H.R. Rep. No. 104-51, at 7 (1996); David Carse, *THE FRAMEWORK OF BANKING SUPERVISION: THE HONG KONG PERSPECTIVE* 7 (March 1996) (reprinted in HKMA Quarterly Bulletin Issue No. 7).

<sup>215</sup> See Roebuck, *supra* note 202, at 279.

<sup>216</sup> Records of securities trading in Hong Kong date back to 1866, but the first formal stock market, the Association of Stockbrokers in Hong Kong, was established in 1891. It was renamed the Hong Kong Stock Exchange in 1914. In 1921, a second exchange, the Hong Kong Association, was incorporated. The two exchanges merged to form the Hong Kong Stock Exchange in 1947. The rapid growth of the Hong Kong economy led to the establishment of three other exchanges in the late 1960s and early 1970s, including the Far East Exchange (1969), the Kam Ngan Stock Exchange (1971) and the Kowloon Stock Exchange (1972). However, prompted by the 1973 market crash and the need to strengthen market surveillance, the Hong Kong government set up a working party to consider the unification of the four stock exchanges. As a result, a unified exchange, the Stock Exchange of

also the world's eighth largest trading market. Despite the enormous amount of trade between China and Hong Kong, Hong Kong must maintain its own securities system in order to retain its position as a regional financial center. Hong Kong maintains a *laissez-faire* approach to investment while exercising prudent market supervision. The combination of a convenient foreign capital exchange, duty-free trading, flat taxation on income, and a solid legal foundation has spawned one of the most liberal economies in the world.

The size of Hong Kong's securities market increased from the fifteenth-largest market in 1990 to the sixth-largest in terms of market capitalization in 1993. The SEHK is currently the eighth-largest securities exchange in the world and the second-largest stock market in Asia.<sup>217</sup>

In addition to benefiting from geographic advantages,<sup>218</sup> Hong Kong established itself as a liberal yet disciplined market for investors following the market crash in October 1987. The SEHK underwent a complete reorganization which led to the formation of a new Securities and Futures Commission ("SFC")<sup>219</sup> and a professional executive management team.<sup>220</sup> The SFC protects the interests of stockholders by encouraging development and by establishing safeguards for the SEHK.<sup>221</sup> Minor protests were raised regarding new classifications for initial public offerings that are based on capital requirements, increased disclosure requirements for securities, and new rules governing the use of derivatives.<sup>222</sup> In spite of the protests, however, Hong Kong continued to be a disciplined financial market and its regulatory framework remained in accordance with international standards.<sup>223</sup>

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Hong Kong, was incorporated on July 7, 1980. The four exchanges ceased trading after the close of business on March 27, 1986. A new era began with the commencement of trading via a computerized system on the unified exchange on April 2, 1986. See Hsu, *supra* note 196, at 235-37.

<sup>217</sup>See Anthony Neoh, QC, *Securities and Future Legislation in Hong Kong*, CHINA L. 107 (July 1, 1997).

<sup>218</sup>Hong Kong serves as an intermediary between London and New York, completing a twenty-four-hour stock loop throughout the world. The Hong Kong time zone enables foreign market participants to bridge the gap between New York and London.

<sup>219</sup>The Securities and Futures Commission of Hong Kong [hereinafter SFC] was established on May 1, 1989 as an independent statutory body outside the Civil Service but still forming part of the wider machinery of the Hong Kong government. The function of the SFC is to administer the regulations relating to the trading of securities, futures, and leveraged foreign exchange contracts in Hong Kong. These regulations are designed to ensure that the financial community operates with integrity so that the interests of investors are protected. The SFC is also charged with facilitating and encouraging the development of Hong Kong's markets. See SFC at <<http://www.hksfc.org.hk/eng/index.htm>>.

<sup>220</sup>See Richard Yan-Ki Ho et al., *THE HONG KONG FINANCIAL SYSTEM* 28 (1991).

<sup>221</sup>See SFC, *supra* note 219.

<sup>222</sup>*Id.*

<sup>223</sup>See Hsu, *supra* note 196, at 243-45.

The SEHK serves as an important link between China and international capital markets. The SEHK is China's primary channel for raising equity capital for Chinese state enterprises. Included on the SEHK's listing are some seventeen Chinese companies, whose shares are classified as "H" shares. "H" shares, commonly referred to as "red chips," accounted for one-tenth of the SEHK's trading volume during their peak in 1993. Since maintaining Hong Kong's prosperity will benefit China,<sup>224</sup> coordination between the two regions will instill confidence in investors throughout both Hong Kong and China.

Although the SEHK currently serves as the "gateway" into China, the rapid development of the Shanghai and Shenzhen securities markets may hinder the future growth of the SEHK. The Shanghai Stock Exchange served as the largest regional securities market prior to the 1949 Chinese Civil War. Shanghai will probably regain that status as China integrates with the international market. Despite these problems, Hong Kong can retain a prominent role in the development of the southern provinces and continue to serve as China's link to Southeast Asia's developing countries.<sup>225</sup>

As an international financial center, the development of Hong Kong's securities market depends on international capital. Hong Kong is an integrated financial center and the movement of capital is not restricted. Freedom of capital has both advantages and disadvantages for Hong Kong as an international financial center. One disadvantage is that with no capital restrictions, an exodus of capital is just as likely as an influx of capital, making it a particularly volatile market.

Because of its open market status and geographic location, the Hong Kong securities market is extremely sensitive to international affairs and to the ebb and flow of foreign capital. For example, the SEHK is extremely sensitive to U.S. interest rates and local property prices.<sup>226</sup> Similarly, economic and political developments in China and Taiwan, inevitably have an impact on the SEHK.<sup>227</sup> When the Hang Seng Index, the exponent of the SEHK, dropped seven percent in March 1996, this was seen as a reaction to both military tensions between China and Taiwan and a drop in the US stock market.<sup>228</sup>

In sum, it is clear that Hong Kong plays an integral role in the world trading market. Certainly, international affairs will continue to have sig-

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<sup>224</sup> See Yun-Wing Sun, *THE CHINA-HONG KONG CONNECTION: THE KEY TO CHINA'S OPEN-DOOR POLICY* 16 (1991) (stating that Hong Kong served as an important financial intermediary for China).

<sup>225</sup> Christopher Langley, *Benefiting from the Liberalization of China's Financial Markets*, CHINA 1998, 1, 2 (1998).

<sup>226</sup> See H.R. Rep. No. 104-5 *supra* note 214, at 61 (statement of William H. Overholt).

<sup>227</sup> *Id.*

<sup>228</sup> *Id.*

nificant effects on Hong Kong's continued economic development. These effects will determine the extent of Hong Kong's influences on the international economy.

VI. FOREIGN FINANCIAL INSTITUTIONS' OPERATION WITHIN THE CHINESE ECONOMIC AREA AS EVALUATED BY THE PRINCIPLE OF NATIONAL TREATMENT

Given the proliferation of financial institutions from countries around the world, the concept of national treatment has been proposed to deal with multinational financial regulation. National treatment is equal opportunity in an international trade regime.<sup>229</sup> National treatment is intended to provide a level playing field for foreign and domestic financial institutions.<sup>230</sup> A country will adopt a national treatment policy if it believes competition in financial services is healthy and beneficial.<sup>231</sup>

Foreign financial institutions in Hong Kong, China, and Taiwan are catalogued into a two-tiered system. Treatment varies according to the region in which a corporation operates. In Hong Kong, foreign financial institutions are treated in a manner similar to domestic institutions. China is considering reforming regulations to encourage further international participation in the banking industry. The new regulations may ease the geographic restrictions which currently limit the locations where foreign institutions can establish offices.

National treatment in financial services is also emphasized by the WTO under GATS.<sup>232</sup> GATS recommends full market access and national treatment for WTO members.<sup>233</sup> The WTO applies an impartial dispute-settlement mechanism to ensure the implementation of national treatment. Consequently, all CEA members must conform to national treatment standards in order to receive WTO approval.

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<sup>229</sup> See Tycho H.E. Stahl, *Liberalization International Trade in Services: The Case for Sidestepping the GATT*, 19 YALE J. INT'L L. 405, 418 (1994).

<sup>230</sup> GATS, *supra* note 31, art. XVII (stating that national treatment entitles foreign firms to the same business opportunities and treatment as domestic firms, thereby establishing a basic standard of equality between foreign and domestic products sold within a country).

<sup>231</sup> See Stahl, *supra* note 229, at 451.

<sup>232</sup> See Frances Williams & Guy Jonquieres, *WTO Pact Will Open Financial Services Sector*, FIN. TIMES, Dec. 15, 1997, at 1 (reporting that the WTO will open financial services markets to an unprecedented degree and provide lasting benefits to WTO members because foreign financial institutions will enjoy the same treatment as domestic financial institutions).

<sup>233</sup> See *Financial Services Talks Resume*, WTO FOCUS, May 1997, at 1, 8.

A. Hong Kong: Accommodating National Treatment to Foreign  
Institutions

Hong Kong offers no barriers to foreign bank branch operations and securities firms registered on the SEHK.<sup>234</sup> Although overseas banks that were granted licenses after 1978 may maintain branch offices in only one building, this limitation on location was modified in 1994 to permit foreign banks to establish regional offices and other offices in buildings separate from the branch office.

Foreign banks may also acquire a controlling interest in a local bank that has unlimited branching rights. In 1996, 154 international banks operated in Hong Kong and over 1,600 firms and over 16,000 individuals were registered on Hong Kong's securities market.<sup>235</sup>

1. *Banking Sector*

Hong Kong's use of national treatment has made it generally regarded as one of the most open and favorable regulatory environments in Asia for foreign financial institutions, and as a result it has a large foreign bank presence.<sup>236</sup> With its transparent banking regulations, Hong Kong does not place restrictions on cross-border capital flows. Foreign banking institutions operating in Hong Kong are treated in a manner similar to domestic institutions, though the reporting and capital adequacy standards applied to all banks are somewhat demanding.

Hong Kong's position as an international financial center is a result of the free flow of capital, independent monetary and taxation systems, a regulatory environment conducive to international transactions, and national treatment for foreign financial institutions. In terms of applying comprehensive banking supervision, Hong Kong supervises foreign and domestic banking institutions equally by creating a level playing field for banking activities. As a result of implementing the concept of national treatment, Hong Kong attracts more foreign banks to Hong Kong, and this enriches the Hong Kong financial market.

2. *Securities Sector*

By its efforts to organize a free market, Hong Kong has become a proponent of national treatment. The dynamism of Hong Kong's economy derives from its unique capitalistic economy and free society. Hong Kong has placed no discriminatory legal constraints on foreign securities firms that do their business in Hong Kong via branching, acquisition, or by establishing subsidiaries. In practice, foreign firms typically establish themselves in

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<sup>234</sup> See Anthony Neoh, Q.C., *Financial Legal Institutions in Hong Kong's Transition*, 18 U. PA. J. INT'L ECON. L. 31, 34 (1997).

<sup>235</sup> *Id.*, at 36.

<sup>236</sup> See National Treatment, *supra* note 32, at 218.

Hong Kong using subsidiaries. Rules governing their operations are the same, however, irrespective of ownership.

After China assumed control in July 1997, Hong Kong was expected to become China's international financial center. Hong Kong's financial market is expected to be interdependent with China's developing financial centers in Shanghai and Shenzhen.<sup>237</sup> In addition, Hong Kong's free stock market provides China's state-owned enterprises with a means for raising capital. Under the Basic Law, Hong Kong treats China's enterprises as foreign companies. As China controls Hong Kong, Hong Kong's stock market gives Chinese companies greater weight in the Hang Seng index.<sup>238</sup> China's state-controlled companies, known as "H"-Shares and Hong Kong-based window companies of Chinese provinces, cities, and ministries are listed on HKSE to raise capital. China's participation in Hong Kong is also expected to expand the Hong Kong Stock Exchange.<sup>239</sup>

In general, Hong Kong is poised to play a critical role in the international financial market. In preparation for this role, and in order to compete with other international financial centers, Hong Kong has adopted flexible measures to attract foreign financial institutions. For example, in 1984, the HKSE decided to allow foreign-domiciled companies to be listed instead of listing only domestic corporations.<sup>240</sup>

#### B. China: Adjusting Treatment of Foreign Financial Institutions

China's past stringent regulations means China is only now considering national treatment policies. At present, foreign financial institutions face geographic limitations on the location of their commercial establishments in China.<sup>241</sup> Severe restrictions are also imposed on foreign financial institutions, limiting the scope of their business operations in China.<sup>242</sup> To garner consideration for WTO membership, China should meet the WTO's

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<sup>237</sup> See Henderson, *supra* note 199, at 540.

<sup>238</sup> See Louise Lucas, *Hang Seng to Give Chinese More Weight*, FIN. TIMES., December 17, 1997, at 28.

<sup>239</sup> See Donna Deese Skeen, *Can Capitalism Survive under Communist Rule? The Effect of Hong Kong's Reversion to the People's Republic of China in 1997*, 29 INT'L LAW. 175, 190 (1995).

<sup>240</sup> In 1984, Hong Kong amended its securities regulations for foreign companies which were unsatisfied by their inability to be listed on the HKSE. The Jardines group, after nearly 140 years on HKSE, proposed registering in Bermuda because Hong Kong would not list the group on the HKSE. By 1996, after the new securities regulations were promulgated, nearly sixty percent of the 567 companies listed on the HKSE were foreign companies. See Neoh, *supra* note 234, at 34.

<sup>241</sup> See I. A. Tokley & Tina Ravn, *BANKING LAW IN CHINA* 263 (1997).

<sup>242</sup> See Geng Xiao, *China's Money and Banking in 1990s*, in *PRC POLITICAL ECONOMY: PROSPECTS UNDER JIANG ZEMIN* 207, 214-22 (Hsin-hsing We eds. 1999).

trade standards by opening China's financial markets to other WTO members with MFN and national treatment.<sup>243</sup>

### 1. Banking Sector

All aspects of the Chinese banking system are heavily regulated. The People's Bank of China sets interest and deposit rates and overall bank lending is administratively controlled through the government's credit plan.<sup>244</sup> The establishment of a foreign bank in China is subject to China's Regulation for the Administration of Foreign Funded Financial Institutions.<sup>245</sup> Foreign banks are also very limited in the range of operations allowed under the Commercial Banking Law.<sup>246</sup> Foreign banks may only participate in wholesale banking, which includes areas such as letters of credit, export credits, and commercial loan syndication.

Foreign banks need to apply for permission to conduct *renminbi* business. Currently, China permits nine foreign banks to use *renminbi*.<sup>247</sup> However, these foreign banks are restricted to trading *renminbi* only with foreign-invested enterprises and foreigners. The foreign banks are still prohibited from doing *renminbi* business with China's domestic enterprises.<sup>248</sup> Between March and June 1997, Chinese customers deposited 215 million *renminbi* into foreign banks.<sup>249</sup> The nine foreign banks also transacted 103 million *renminbi* in loans and overdrafts during the same period.<sup>250</sup>

Foreign banks should be able to open branches, export credits, and offer commercial loan syndication.<sup>251</sup> They are allowed to open branches and subsidiaries (joint ventures and wholly foreign-owned entities) in only thirteen selected cities and special economic zones. Outside these specified areas, banks are restricted to opening representative offices that may not engage in profit-making activities. Despite these restrictions, the number of foreign banks in China has steadily increased over the last several years.

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<sup>243</sup> See Nancy Dunne, *Congress Seeks to End China's Trade Status Battle, Attempt to Nudge Beijing to Enter the WTO on US Terms*, Fin. Times, Nov. 5, 1997, at 1.

<sup>244</sup> See Survey China: *The Death of Gradualism*, THE ECONOMIST, March 8, 1997, at 16.

<sup>245</sup> See Lardy, *supra* note 188, at 166 (stating the Regulation for the Administration of Foreign Funded Financial Institutions confirm the long-standing, two-stage process for a foreign financial institution to register for business in China).

<sup>246</sup> *Id.*

<sup>247</sup> See *China Temporarily Stops Inviting Foreigners to Trade in Local Currency*, WORLD J., Sept. 27, 1997, at B6 (reporting that in March 1997, China chose nine foreign banks to conduct *renminbi* business in Shanghai as an experiment. However, in September 1997 China decided not to issue permission to new applicants until further notice).

<sup>248</sup> See *China Invited Foreigners to Trade in Local Currency*, BANKER, February 1997, at 58.

<sup>249</sup> *Id.*

<sup>250</sup> *Id.*

<sup>251</sup> See Survey China, *supra* note 244.

Because of greater pressure from foreign banks, increased internationalization of financial services, and to gain WTO membership, China began to change the banking system for foreign institutions.<sup>252</sup> In the early 1990s, China began reforming its foreign exchange control system. China instituted a uniform dual-exchange rate system for *renminbi* aimed at making *renminbi* a fully convertible free currency by the year 2000.<sup>253</sup> In addition, China has opened major cities (in addition to Shanghai) to foreign financial institutions in March 1999, and China also has permitted foreign banks to participate in some local banking and non-banking financial business.

Even though China is not immediately ready to completely liberalize its financial sector, China is likely to reform its financial system gradually. As China participates more fully in the global economy,<sup>254</sup> developed countries will likely pressure China to reform its financial sector to allow their banks into in China.<sup>255</sup> Such pressure will likely hasten China's reform schedule. For example, China has promised to open five more special economic zones where foreign banks may freely trade *renminbi* two years after it enrolls in the WTO.<sup>256</sup>

## 2. Securities Sector

National treatment has not been used in China partly because its equity market is so new, and is still in flux. The lack of clarity in regulations poses a significant problem to both domestic and foreign securities firms. Foreign securities firms may establish representative offices, but are not permitted to establish either local branches or local subsidiaries.<sup>257</sup> Representative offices are limited to brokering selected equity shares.

China breaches the principle of national treatment when it classifies shares as "A" and "B" and when it restricts foreign investors' trade in stock. Foreign investors may not trade in "A" shares. They may only invest in

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<sup>252</sup> See Nancy Dunne, *Congress Seeks to End China Trade Status Battle, Attempt to Nudge Beijing to Enter the WTO on US Terms*, FIN. TIMES, Nov. 5, 1997, at 1.

<sup>253</sup> See James Harding, *Jitter in Beijing: China May Not Be Able to Remain Aloof from the Crisis in South-East Asia That it Helped Set in Train*, FIN. TIMES, Nov. 10, 1997, at 19 (stating that China adopts a step-by-step process to achieve full financial liberalization including currency convertibility by 2000).

<sup>254</sup> Asia's financial turmoil reverberated recognition in China of the country's role and responsibilities within the global economy. For the first time, China has participated in a regional bailout committing \$1 billion to the International Monetary Fund-led fund to support the Thailand financial crisis. See Harding, *id.*

<sup>255</sup> See Rachel Mararjee, *A Long March Ahead*, Banker July 1997, at 6.

<sup>256</sup> See *Foreign Banks Allowed to Trade Renminbi in Five More Locations in China*, (Dec. 15, 1997) <<http://w3.tnn.com/cna/971215/b10.html>> (reporting that under the pressure of the WTO, China agreed to open five more locations for foreign banks to trade *renminbi*).

<sup>257</sup> An exception to this policy is that in October 1994, a joint venture investment bank was authorized which included U.S. participation.



corporations offering governmentally approved and listed "B" shares.<sup>258</sup> These selected "B" shares are sold exclusively to foreigners and must be purchased with foreign currencies.

In addition, national treatment is frustrated since foreign firms are required to hire local Chinese staff through an approved labor supplier. Foreign firms in China mainly underwrite offshore equity and bond issues for domestic Chinese companies. However, each new issue must receive prior approval from the Chinese government.<sup>259</sup> China has offered to relax restrictions on foreign securities firms but only for foreign firms engaged in non-profit activities.

China has political incentives to promote the transfer of capital and technologies from Taiwan to China. Therefore, China treats Taiwanese firms more preferentially than other foreign firms. Although Taiwan does not currently allow Chinese companies to list their shares on the Taiwan Stock Exchange, China does allow Taiwanese-invested firms to list on China's equity markets.<sup>260</sup> Thus, it is clear that China generously contributes to Taiwan's activity in China's financial market.

### C. Taiwan: Lacking Reciprocal Treatment of Chinese Financial Institutions

The liberalization and deregulation of Taiwan's banking system provides most foreign financial institutions, including banks and securities firms, with treatment similar to their domestic counterparts. However, due to national security considerations and memories of the painful Chinese Financial Crisis in 1946-1949, Taiwan prohibits China's financial institutions from operating in Taiwan.

#### 1. Banking Sector

In 1953, when the Dai-Ichi Kangyo Bank of Japan established itself as the first foreign bank in Taiwan, these banks occupied merely a peripheral position in Taiwan's financial system. At that time, foreign banks provided only four percent of the lending that domestic banks provided. As of October 1996, foreign banks represented only five percent of the total assets held by all financial institutions in Taiwan.<sup>261</sup> By the end of June 1997, forty-four foreign banks from nineteen countries established seventy branches in

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<sup>258</sup> See Jia Zhao, *Trading Stocks in China: Development, Regulations, Issues and Prospectus*, E. ASIAN EXEC. REP., June 15, 1992, available in LEXIS, NEWS LIBRARY, EASIAN FILE.

<sup>259</sup> Under the 1982 Constitution of the People's Republic of China, which socially authorizes each regional Congress or its standing committee to enact regional laws and regulations effective within their jurisdiction, an issue of securities must receive approval from the department-in-charge prior to submission to the People's Bank of China. See Tan, *supra* note 172, at 77.

<sup>260</sup> See Heda Bayron, *Even Hong Kong's Blue Chips Turn Red*, ASIAMONEY, June 1997.

<sup>261</sup> See *Asia's Economic Crisis, How Far is Down*, THE ECONOMIST, Nov. 15, 1997, at 20.

Taiwan.<sup>262</sup> Additionally, twenty-eight foreign banks had representative offices in Taiwan.<sup>263</sup>

Taiwan anticipates that foreign banks will play a more active role in the domestic market.<sup>264</sup> Thus, Taiwan has made a number of improvements in its treatment of foreign banks. A ban on foreign investments in local banks was lifted in June 1994, although the individual investor limit is capped at five percent of the bank's equity. Also, restrictions on the geographic location of banks and the number of bank branches were eliminated in August 1994, when the MOF decreased the restrictions on the entry of foreign bank branches.<sup>265</sup> Waiting periods for sub-branching were reduced from five to two years. However, this remains discriminatory since domestic banks are not subject to the same delay.

While Taiwan envisions greater foreign bank involvement, the activities of these bank branches continue to be restricted by the amount of their local capital as compared to their parent company's global capital. In addition, access to local funding continues to pose a problem. Foreign banks are forced to rely heavily on a continually illiquid inter-bank market because of restrictions on the terms of foreign exchange liabilities and position-taking.<sup>266</sup> Foreign banking institutions are also subject to limitations on guarantees of commercial paper that do not apply to their domestic competitors.<sup>267</sup> Thus far, Taiwan has modeled its financial system to reduce substantial barriers to market access and to provide national treatment for foreign financial institutions.<sup>268</sup>

Due to the financial separation after 1949, Taiwan does not give national treatment to Chinese financial institutions. Taiwan instead designed a system of national security that prevents China from manipulating Taiwan's economy.<sup>269</sup> Taiwan prohibits any direct banking connections with

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<sup>262</sup>The Ministry of Finance [hereinafter MOF], Basic Financial Statistics (Jun. 1997).

<sup>263</sup>*Id.*

<sup>264</sup>See Liu, *supra* note 88, 207 (1996).

<sup>265</sup>The MOF abolished the restriction on location of branches of foreign banks since late 1996.

<sup>266</sup>See the MOF. Guidelines for Screening and Approval of Establishing of Branches and Representative Offices by Foreign Banks.

<sup>267</sup>See Art. 4 of Trust Company Regulations, recognizing foreign banking as a trust company which is partly regulated by the Trust Company Regulations.

<sup>268</sup>See Ya-Hwei Yang, *Development and Structure Change of the Banking System, in THE FINANCIAL DEVELOPMENT OF JAPAN, KOREA, AND TAIWAN: GROWTH, REPRESSION, AND LIBERALIZATION* 228, 259 (Hung T. Patrick & Yung Chiu Park ed. 1994).

<sup>269</sup>In 1992, Taiwan enacted Statute Governing Relations between Peoples of the Taiwan Area and Mainland Area. In terms of this Statute, Taiwan reserves the right to refuse investments by companies from any territory, including Hong Kong, with over twenty percent Mainland Chinese shareholding. See *New Emphasis on Old Rules*, *BANKER*, July 1997, at 73.

financial institutions from China. Nonetheless, Taiwan allows its banks to have direct connections with China's banks through overseas branches.<sup>270</sup>

Although Taiwan prohibits the entry of Chinese banking operations, Taiwan has a much more amiable relationship with Hong Kong. However, Taiwanese banks have reservations about entering the Hong Kong financial markets due to Hong Kong's recent transfer to China. Taiwanese banks are also reluctant to open operations in China due to the dim prospects for quick liberalization in China. Because of these difficulties, Taiwanese banks seek other markets besides those of Hong Kong and China.<sup>271</sup> One way to establish business in other international financial centers, such as the United States and Singapore, would be to offer reciprocal treatment to banks from those countries.

## 2. Securities Sector

To create a capital market for private enterprise, Taiwan intensified its efforts to liberalize and internationalize its securities market by allowing participation of foreign investors beginning in 1982.<sup>272</sup> Under the Regulations for Investments in Securities by Overseas and Foreign Nationals and Their Exchange Settlement,<sup>273</sup> foreign investors are provided with three ways to access Taiwan's securities market. First, any foreign investors may invest in a securities operation through a joint venture with Taiwanese partners.<sup>274</sup> Second, foreign securities firms may establish branch operations. Third, foreign banks with branches in Taiwan may also establish a securities operation.

Before July 1993, only three foreign securities firms could establish branches in Taiwan, and each could only establish one branch. From July 1993 to February 1994, restrictions on branching in Taiwan were eased. For example, foreign firms that establish Taiwan-based securities branches are no longer required to be one of the ten largest brokers, in terms of assets, in their home countries. Similarly, foreign firms no longer face discriminatory capital requirements. In January 1994, all foreign ownership

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<sup>270</sup> See Deborah Shen, *Three-way Hong Kong Bank Plan*, FREE CHINA J. Dec. 27, 1996, at 8 (mentioning that Taiwan allows banks to connect with Chinese banks indirectly rather than directly).

<sup>271</sup> For example, the presence of an estimated \$3 billion in Taiwanese manufacturers' investment in Vietnam has made Ho Chi Minh City a more feasible option for new and old Taiwanese banks.

<sup>272</sup> See Chen & Huang, *supra* note 135, at 37 & n 37.

<sup>273</sup> See QFII Regulations, *supra* note 126.

<sup>274</sup> Foreign nationals are allowed to invest in a securities company to engage in securities operations, but a prior approval of the Securities Exchange Commission is required. Such investments have to go through the review process pursuant to the Statute of Investment by Foreign Nationals. The total amount of foreign ownership in a securities business entity, however, may not exceed forty percent of its paid-in capital. Furthermore, each foreign investor may only invest up to ten percent of the total paid-in capital of the entity.

restrictions were abolished. Thus, U.S. firms may now create one hundred percent-owned subsidiaries and participate freely in joint ventures.

Foreign and domestic firms are able to provide essentially the same securities services, which include brokering, dealing, underwriting, and securities financing.<sup>275</sup> Foreign securities firms may provide brokerage services for local investors wanting to purchase shares listed in New York, London, and Tokyo, but firms from Taiwan are currently unable to offer similar services.<sup>276</sup>

Although Taiwan liberalized foreign investment in the Taipei stock market in 1995, some restrictions still apply to foreign institutional investors. Foreign institutional investors are subject to a US\$400 million individual investment limit and a US\$7.5 billion aggregate investment limit.<sup>277</sup> In addition, foreign institutional investors are subject to restrictions for the repatriation of capital and earnings.<sup>278</sup> Further, there is a twenty percent foreign ownership limit for individual institutional investors and a ten percent foreign aggregate limit.<sup>279</sup> Since 1996, natural persons from foreign nations have been able to trade directly on the Taipei stock exchange or hold equity and debt instruments listed on the exchange.<sup>280</sup> Loosening the restrictions on foreign investors increases a potentially large component of the prospective brokerage business of foreign firms. Further liberalization will expand the Taiwanese securities market and may attract more foreign investors.

## VII. PROSPECTS FOR FUTURE FINANCIAL DEVELOPMENT IN THE CHINESE ECONOMIC AREA

The considerable integration of international financial relationships in recent decades contrasts sharply with the sluggishness of the CEA's progress in this area.<sup>281</sup> However, the primary reason for the lethargic progress of the CEA in financial sectors is the fact that the CEA is not a formally integrated financial area.<sup>282</sup>

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<sup>275</sup> See Chen & Huang, *supra* note 135, at 43.

<sup>276</sup> See Brian W. Semkow, *A Synopsis of Current Financial Deregulation and International of Financial Markets and Institutions in Taiwan*, 6 J. INT'L BANKING L. 353, 357 (1991).

<sup>277</sup> See Liu, *supra* note 97, at 169.

<sup>278</sup> *Id.*

<sup>279</sup> *Id.*

<sup>280</sup> *Id.*

<sup>281</sup> As discussed previously, the success of the CEA is dependent on its members' efforts to reform their financial markets to conform to the standards of the international financial system. The soundness and safety of financial markets are the policies' driving future adjustments and developments in the CEA's banking sectors. See pages 5-8.

<sup>282</sup> See Jones, *supra* note 3, at 14.

As a result, to establish a sound financial system, a satisfactory CEA framework for banking regulation would require that CEA entities adopt the principles of the Basle Accords. However, political controversies between Taiwan and China may retard this formal adoption and application of the Basle Accords. In achieving the purpose of a sound financial system within the CEA, each CEA member should accept the mandates of the Basle Accords individually and thus utilize the Basle Accords as "soft law."<sup>283</sup>

Soft laws may overcome deadlocks in international relations that result from economic or political differences.<sup>284</sup> International banking regulators have recognized the benefits of soft law and established a global banking supervisory regime, the Basle Committee on Banking Supervision.

As a soft law of international banking supervisory standards, the Basle Accords continue to strengthen the supervisory and regulatory infrastructure by reformulating both capital adequacy requirements<sup>285</sup> and the internal risk management controls of banks.<sup>286</sup> Until recently, capital adequacy requirements have served as the most important tool of bank supervisors and regulators. The CEA financial regulators should design a new, more stringent set of regulatory capital requirements for banks that operate in high-risk and fast-changing environments.

Since adoption of the Basle Accords will be informal, the CEA may use alternative approaches to harmonize its banking supervisory standards. The European Union ("EU") presents an appropriate model of convergence in fundamental supervisory standards which could be emulated by the CEA.<sup>287</sup> In January 1993, the EU achieved a single market for financial services through three measures.<sup>288</sup> First, it harmonized the essential standards for prudential supervision of banking and for the protection of investors, depositors, and consumers.<sup>289</sup> Second, it required mutual recognition

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<sup>283</sup> See discussion of soft law, *supra* note 39.

<sup>284</sup> See Joseph Gold, INTERPRETATION: THE IMF AND INTERNATIONAL LAW 301-02 (1996).

<sup>285</sup> See Peter C. Hayward, *Prospects for International Cooperation by Bank Supervision*, 24 INT'L L. 787 (1990).

<sup>286</sup> See David Folkerts-Landau & Takatoshi Ito, INTERNATIONAL CAPITAL MARKET DEVELOPMENTS, PROSPECTS AND POLICY ISSUES 141 (1995) (noting that the Basle Committee devised new approaches to using internal risk-management models for the calculation of capital requirements).

<sup>287</sup> See Michael Gruson & Wolfgang Feuring, *A European Union Banking Law: The Second Banking and Related Directives*, in THE SINGLE MARKET AND THE LAW OF BANKING 25, 35 (Ross Cranston 2d ed. 1995) (noting that the EU's Second Directive standardized the banking law of the Member States by harmonizing minimum capital for authorization and continuing business; granting supervisory control of banks' participation in the non-bank sector and supervisory control of major shareholders).

<sup>288</sup> *Id.* at 25.

<sup>289</sup> The Second Council Directive on the Co-ordination of Law, Regulations and Administrative Provisions Relating to the Taking-up and Pursuit of the Business of Credit Institutions and Amending Directive 77/88/EEC [hereinafter Second Directive] (emphasizing that

of the way each Member State applied those essential standards.<sup>290</sup> Third, it emphasized home country control and supervision of financial institutions operating in other Member States.<sup>291</sup> As a result, all banks in the EU are subject to common minimum standards of banking supervision. Using this EU model, the CEA could successfully incorporate the international banking standards of the Basle Accords.

As it evolves into an integrated financial market, the CEA should reconsider private internal risk management as a foundation for ensuring individual financial institutions' stability and reduction in systemic risk. One possibility would be for the CEA to develop new regulatory capital requirements. Such a new set of requirements could allow banks to use their own modes of international risk-management to estimate "value-at-risk," an important component for determining their regulatory capital requirements.<sup>292</sup> As a consequence, the CEA regulators and financial institutions should encourage banks to actively participate in the design of the framework for establishing capital requirements.<sup>293</sup>

In addition, the CEA's policy in the banking sector should consider three fundamental features to converge national banking regulations: the harmonization of banking regulations, the mutual recognition of financial standards, and the home country control principle. One of the long-term efforts of the CEA's financial community has been to implement the first of these features in the CEA. However, meticulous harmonization efforts in the EU banking sector have proven to be impractical and cumbersome.<sup>294</sup> Given the example of the EU's harmonization, efforts by the CEA might achieve the same result; however, harmonization of the essential regulatory

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the Member States of the EU must harmonize their national banking laws and practices and the required results to be achieved by January 1, 1993).

<sup>290</sup> *Id.*

<sup>291</sup> See Brealey & Quigley, *COMPLETING THE INTERNAL MARKET OF THE EUROPEAN COMMUNITY — 1992 HANDBOOK* 126 (G. Hufbauer ed. 1990).

<sup>292</sup> See Folkerts-Landau & Ito, *supra* note 286, at 141 (defining "value-at-risk" as an estimate of the "maximum" loss in the value of a portfolio or financial position over a given time period with a certain level of confidence).

<sup>293</sup> The 1995 failure of Barings, a well-capitalized institution, suggests that markets, operation risk, and internal management controls are extremely important elements of risk management. See Sheila C. Bair, *Lessons from the Barings Collapse*, 64 *FORDHAM L. REV.* 1, 4-5 (1995).

<sup>294</sup> This experience, coupled with the urgency of completing the common banking market by 1992, has prompted the European Commission to shift its policy emphasis. The European Commission has adopted the harmonization of banking legislation and the mutual recognition of supervisory standards as its main tools for integration in the financial field. See U. H. Schneider, *The Harmonization of EC Banking Laws: the Euro-Passport to Profitability and International Competitiveness of Financial Institutions*, 22 *LAW & POLICY IN INT'L BUS.*, 261, 267-76 (1991).

elements for EU Member States includes the prudential principles of maintaining sound and stable banks and other financial institutions.<sup>295</sup>

The CEA can employ the EU single banking model to harmonize banking standards. Convergence of the CEA's banking standards will allow the banks of one CEA member to establish branches within other CEA members. The concept of "mutual recognition"<sup>296</sup> means that bank approval by one member country's banking authorities will open the market to all member countries.<sup>297</sup> The CEA's application of the EU's "mutual recognition" concept would be a crucial step towards the harmonization of the CEA's banking supervisory system.

Under the concept of mutual recognition, each CEA member will maintain home country control over banking regulations.<sup>298</sup> In contrast, the host country will only have the authority to supervise branch liquidity or marketing-related activities. If a home country's rules are more liberal than those in the host country, the home country's financial firms will be able to offer a wider range of services and will not be subject to the same regulatory costs as the host country's own financial firms. The expected result under these competitive circumstances will be that the regulations "will all eventually converge to the same minimum essential standards and the widest range of permissible powers."<sup>299</sup> This process is known as "regulatory convergence."<sup>300</sup>

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<sup>295</sup> Even though the White Paper (the proposal of EU Financial Integration) refers to "minimum harmonization" of prudential standards, it is not to be construed as an endorsement of the lowest common denominator or an alignment with the most relaxed supervisory standards of any Member State. See George S. Zavvos, *The Banking Perspective of 1992*, EUR. AFF., Jan. 1988, at 100.

<sup>296</sup> Mutual recognition is consistent with the EU's open market philosophy. Under this philosophy, the EU stresses that its power should be activated only when it can deliver a "public good" that cannot be effectively provided at a national level (e.g., the protection of a depositor or investor, or the safety and stability of the financial system). See Christos Hadjiemmanuil, *THE EUROPEAN CENTRAL BANK AND BANKING SUPERVISION*, 12-9 (1996).

<sup>297</sup> The mutual recognition endorsed in the EU's White Paper in 1985 constitutes a major integration technique in the financial field. Since the White Paper is incorporated in the EC Treaty provisions concerning professional qualifications, this concept was already known in Community law. See George S. Zavvos, *Towards a European Banking Act*, 25 COMMON MKT. L. REV. 263 (1988). In addition, prior to the adoption of the White Paper, the Commission had proposed a mortgage credit directive based entirely on this approach. *Id.*

<sup>298</sup> See Second Derivative, *supra* note 289.

<sup>299</sup> See GAO, *European Community: U.S. Financial Services' Competitiveness under the Single Market Program* 59, 60 (1990) (indicating that the EU should improve its banking supervisory framework by converging the banking law and practices of the national Member States).

<sup>300</sup> See Joseph Norton, *EU Banking Law in the International Context*, in *THE SINGLE MARKET AND THE LAW OF BANKING* (Ross Cranston 2d ed. 1995).

Regulatory convergence in the CEA will promote shared responsibility, as recommended by the Basle Accords.<sup>301</sup> All the activities of banks and other financial institutions, provided by branching or cross-border provision of services, will be supervised by coordination between host and home authorities.<sup>302</sup>

Certain exceptions should be made for the three general policies. The potential coordination of economic and monetary policies in the CEA requires that the host authority be responsible for the supervision of liquidity. Similarly, the host authority should monitor the monetary provisions regarding the market risk related to securities. Finally, the framework should ensure the cooperation of the home country's authorities in the field of banking supervision.<sup>303</sup>

### VIII. CONCLUSIONS

China, Hong Kong, and Taiwan constitute one of the world's most vibrant economic regions.<sup>304</sup> Each entity has supported continued economic development using different methods. However, increased internationalization within the region suggests the development of sophisticated banking and securities markets for all participants' countries.<sup>305</sup>

The members of the CEA currently retain their own banking systems and supervisory regulations which inhibit and render ineffective the supervision of financial institutions conducting inter-entity business within the CEA. The different banking systems that exist in China, Hong Kong, and Taiwan have been shaped by history, politics, and cultural traditions. The financial systems of China, Hong Kong, and Taiwan have evolved in different fashions according to Marxist principles,<sup>306</sup> market competition, and concerns for national security, respectively. Each of the three banking systems has different features and drawbacks and present alternative methods of financial development.

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<sup>301</sup> See Susan M. Phillips, *International Competitions: Should We Harmonize Our National Regulatory Systems?*, in *BANKING SOUNDNESS AND MONETARY POLICY, ISSUE AND EXPERIENCES IN THE GLOBAL ECONOMY* 527, 533 (Charles Enoch & John H. Green ed. 1997) (finding that in order to improve banking supervision, the BIS and EU started harmonization of banking laws, regulations, and operating standing).

<sup>302</sup> See Nancy Louise Kessler, *Banking on Europe: 1992 and EMU*, 60 *FORDHAM L. REV.* 395, 404 (1992).

<sup>303</sup> See Folkerts-Landau and Ito, *supra* note 286, at 17.

<sup>304</sup> See Barry Naughton, *The Future in the China Circle*, in *THE CHINA CIRCLE: ECONOMICS AND ELECTRONICS IN THE PRC, TAIWAN, AND HONG KONG* 289 (Barry Naughton ed., 1997).

<sup>305</sup> See *A Survey of International Banking*, *THE ECONOMIST*, Apr. 17, 1999, at 24.

<sup>306</sup> See Alan S. Greenspan, *Thoughts about the Transitioning Market Economies of Eastern Europe and the Former Soviet Union*, 6 *DEPAUL BUS. L. J.* 1, 13 (1994) (indicating that Marxist ideology presumed competition to be destructive and that the centrally planned economies of the Soviet bloc organized their production around state monopolies).



In the past, Taiwan and China utilized banks to stimulate economic growth whereas Hong Kong used financial development to promote economic prosperity. Along with continuing economic integration, a stable financial system will continue to play an integral role in the economic development of the CEA. Taiwan should implement reforms which guarantee greater privatization, liberalization, and internationalization, while China should separate its state-owned enterprises from commercial banks.<sup>307</sup> Additionally, China should impose strict loan restrictions on state-owned enterprises in order to reduce the amount of bad debts.<sup>308</sup> To ensure Hong Kong's future financial success, China must cultivate its relationship with Hong Kong and sustain Hong Kong's financial autonomy and stability.

Energetic securities markets provide an additional influx of capital that expands businesses and broadens the economy. However, Taiwan's securities market requires stringent regulations to prevent manipulation of the market. Although enacting a consistent national framework for securities transactions, China should make an effort to simplify the classification of share types. Hong Kong should provide assurances of financial autonomy in order to instill confidence in investors.

The CEA should consider the implications of the internationalization of the securities business. Further, the October 1997 Asian stock market crash exemplifies the increased integration of the worldwide securities industry.<sup>309</sup> Problems from Southeast Asia gradually influenced the currency rates and stock markets of both Taiwan and Hong Kong.<sup>310</sup> Therefore, greater internationalization not only facilitates economic growth but also requires controls to avoid potential global financial crises.

National treatment provides a level playing field for all foreign and domestic financial institutions. While all domestic and foreign financial institutions operating in Hong Kong receive equal treatment, China does not accord national treatment to foreign financial firms who wish to operate there. Taiwan accords national treatment to all firms excluding those from China. Providing national treatment to all firms will permit Taiwan and

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<sup>307</sup> See Che-Ning Liu, *From Cashiers to Banks: Banking Reform in the People's Republic of China and the Emergence of Banks as Financial Intermediaries*, 6 CHINA L. REP. 103, 121 (1990).

<sup>308</sup> See Eric Girardin, BANKING SECTOR REFORM AND CREDIT CONTROL IN CHINA 30 (1997).

<sup>309</sup> See *Will the World Slump?* THE ECONOMIST, Nov. 15, 1997, at 15 (stating that globalization and technological advances promote the international securities market; as a result, the Asian stock markets' tumble spread worldwide).

<sup>310</sup> See the "Asian Flu" *supra* note 197. Following other South-East Asian countries, Taiwan's stock market dropped 380 points on October 20, 1997. The SEHK had record losses during the same period. On October 27, 1997, the Asian crisis spread to the New York Stock Exchange which fell a record 554.26 points, or 7.18 percent of the Dow Jones industrial average. See Daniel Kadlec, *Still on A Roll*, TIME, Nov. 10, 1997, at 37-43.

China to join Hong Kong as members of the WTO. In addition, the CEA's adoption of a national treatment policy confirms that competition in financial services is mutually healthy and beneficial.

The financial integration of the CEA is critical to its financial growth and prosperity at both the regional and international levels. The Mexican financial crisis in 1994-1995<sup>311</sup> demonstrated that an unstable financial system is likely to encumber the development of the economy. In order to achieve a stable banking system, the CEA needs to maintain stable macroeconomic policies<sup>312</sup> and prudent supervision as the core values of its banking regulations. The Basle Accords provide a reputable and reliable framework of standards for financial supervision while providing the flexibility of soft law. By adopting and applying the Basle Accords, the CEA would move significantly closer to establishing a functioning regional financial supervisory regime.<sup>313</sup>

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<sup>311</sup> The Mexican financial crisis of 1994-95 dealt a serious blow to the Mexican economy. The ensuing ripple effect, also called the "Tequila Effect," upset other developing and emerging markets. The same phenomenon explains in part the most recent turbulence in the international capital markets. Clearly, one of the major actors in the Mexican crisis, the portfolio or institutional investor, continues to wield tremendous power over economic policy in developing countries. See *Mexican Banks*, FIN. TIMES, July 22, 1999, at 11.

<sup>312</sup> See *Highlighting the Link between Bank Soundness and Macroeconomic Policy*, IMF SURVEY, May 20, 1996, at 165-69 (highlighting the influence of macroeconomic and structured policies on the soundness of the banking system).

<sup>313</sup> See GAO, *International Banking, Strengthening the Framework for Supervision International Banks* 4 (1994) (emphasizing that cross-border banking activities need greater adherence to the Basle Accords by countries who adopt and implement the Basle Accords).

