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To: Members of the Executive Board

From: The Secretary

Subject: **People's Republic of China—Selected Issues**

The following correction has been made in SM/99/167, Supplement 1 (8/9/99):

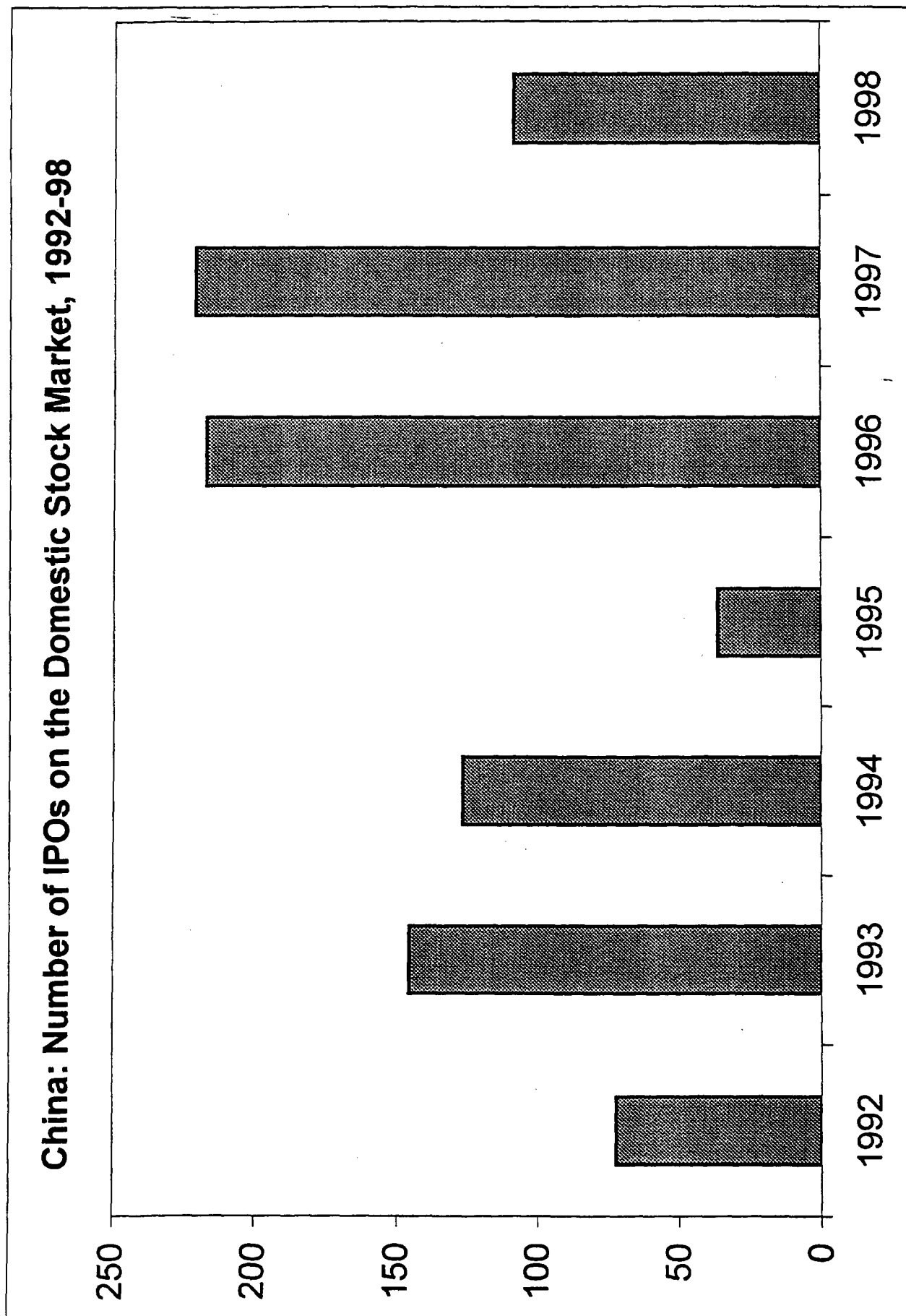
Page 158, Box VII.1: revised

A corrected page is attached.

Att: (1)

Other Distribution:
Department Heads

Chart VII.4



Source: China Securities Regulatory Commission.

Box VII.1. The Origins of China's Shareholding System

The emergence of the shareholding system

The initial impetus for shareholding reform originated in the rural sector. To alleviate capital shortages in the villages, the central government in 1979 allowed brigades to withdraw accumulation funds to form joint-stock enterprises. In 1983, capital and labor were both deemed "legitimate bases" for distributing returns in cooperative production units. This resulted in a rapid expansion of joint-stock township and village enterprises (TVEs), and in 1984 it became official policy to encourage farmers to invest in various kinds of enterprises. In the same year, the concept of "socialist joint-stock" ownership also emerged, and the country's first shareholding company, the Beijing Tianqiao Department Store Company, was established. The following year, the Fushan First Radio Factory in Guangzhou became the first industrial shareholding enterprise in China. This was followed by the selection of a small number of SOEs in Beijing, Shanghai, and Guangzhou as experimental units of the shareholding system.

In December 1986, the shareholding system experiment was expanded. It was noted at the 13th Party Congress the following October that since China was still at an "initial stage of socialism", other forms of ownership should supplement the dominant public sector. Specifically, the shareholding system was recognized as "a form of organizing assets of socialist enterprises", and hence the experiment "could continue". Further, official support was given in the 1988 Report of the 3rd Plenum of the 13th Central Committee, which defended the shareholding system as not being privatization but rather a means to rationalize property rights relations.

Against this background, the scale of the shareholding system experiment was expanded. In March 1988, there were some 6,000 enterprises with shareholding characteristics. They fell under four major categories of enterprises issuing shares to employees, other legal persons (i.e., enterprises or institutions), the public, or enterprises owned by workers on the basis of the capital they had contributed. Shareholding enterprises came under the first three categories. In 1988, there were about 3,800 such enterprises. Enterprises in the first two categories were known as private placement enterprises, as the shares were privately issued to specific employees and/or legal persons. The third category were known as public placement enterprises, while those in the fourth category were a mixture of shareholding enterprises and cooperatives, and as such were called cooperative shareholding cooperative enterprises, distinct from shareholding enterprises.

The early attempts at developing a shareholding system, which was a spontaneous process, took place in the absence of a legal framework. The experiment was attempted mainly by small-sized collective enterprises. Shares were issued primarily to raise capital rather than to establish a new form of corporate governance. Most of the shares received guaranteed interest plus dividends. They could be redeemed when mature, and investors bore little risk. As such, the shares were more like bonds in nature, and only a small handful were traded over-the-counter in Shanghai, Shenyang, Wuhan, and Chongqing.

Later setbacks

The recognition in 1987-88 of the shareholding system as an official reform experiment was misinterpreted by some as a signal for national promotion. Capital shortages also caused many enterprises to switch to the shareholding system as a means to raise funds. As a result, shareholding expanded rapidly in early 1989. However, the contract responsibility system was still the mainstream reform scheme at the time, and the State Council issued a Notice reminding enterprises that shareholding system reform should focus on consolidating existing shareholding enterprises rather than establishing new experimental units. The Notice added that the reform was intended to improve overall enterprise efficiency, rather than just to raise funds and distribute returns; that the leading role of state ownership should be retained; and that the value of state assets should be protected.

From 1989, the spread of shareholding in China slowed. According to the limited statistics available (there are no official statistics kept), by the end of 1989 there were some 3,800 shareholding units in the country, which was about the same as the previous year. It was the intention to restrict the shareholding system reform to inter-enterprise investment (i.e., the second category noted above), as this involved no sale of state assets to private individuals. In 1990, the State Council issued a document allowing further experimentation with the second shareholding category, but freezing enterprises in the first and third categories. The idea of shareholding reform still appeared in the Party's proposal for the 8th Five Year Plan, but the theme was restricted to the second category option.

New momentum

The momentum for enlarging the target of share issues from legal persons and employees to the general public, however, continued. Accordingly, the Shanghai stock exchange was opened in December 1990 and the Shenzhen exchange in mid-1991, which provided official markets for the trading of shares. The impetus for revamping the shareholder system along these lines gained additional momentum after Deng Xiaoping called for further reform during his high profile Southern Tour in January 1992, and the basic precept of share issuance has since been a focus of reform efforts.