

Standardized Commercial Instruments: New Solution to Commercial Instruments Market in China?

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Abstract: In order to solve the problem of poor liquidity of commercial instruments caused by credit default, the People's Bank of China (the central bank of PRC, hereinafter referred as "PBC") uses the principles of trust law to separate the beneficiary rights from the collective negotiable instruments assets under the premise of the state's control of Non-financial-institutional broker and investment on negotiable instrument (under the legal regime of PRC, the negotiable instruments such as commercial instruments only could be used as the payment instrument and brokers without government permit are forbidden), and the depository institution issues beneficiary certificate-Standardized commercial instruments to promote the circulation of commercial instruments with so called "demand-driven" methods. However, this new type of beneficiary certificate which directly created by government regulation conflicts with the principles of Law Trust, Law of Negotiable Instruments, and Securities Law and relevant regulation while Standardized commercial instruments removes the functions of payment and settlement and credit enhancement by endorsement. The root cause of the poor circulation of commercial instruments in market in PRC actually is the imperfect credit system, which should be resolved by improving the system of issuance, acceptance and exchange guarantees and allowing investment on commercial instruments.

1. Introduction

Standardized commercial instruments is a new type of beneficiary certificate created by the government regulation which named *Measures for the Administration of Standardized commercial instruments* in PRC (Measures for the Administration of Standardized Commercial Instruments issued by Instrumentalities of the State Council, All Banks, People's Bank of China with the effective date of July 28th 2020, hereinafter referred as "the Measures"). Standardized commercial instruments was described in the regulation as "the beneficiary certificates divided into equal shares which are created with the cash flow generated from the underlying asset pools formed by depository institutions by collecting commercial drafts with similar core credit elements and similar payment periods as the payment support".

The regulation "Notice on Direct Transaction Services for Foreign Institutional Investors in the Direct Investment Model" became effective September 1, 2020, foreign institutional investors will be able to participate in bond transactions in the inter-bank market in direct investment mode. In addition to common inter-bank varieties, standardized commercial instruments have been officially included. Therefore, to some extent, the Standardized commercial instruments are open to global investors.

It is clear that Standardized commercial instruments is beneficiary certificates, and it is considered as "Standardized Credit Assets". The regulation limited that only commercial banks or securities companies are qualified as depository institutions of Standardized commercial instruments.

The Standardized commercial instruments "strip" the beneficiary rights according to the principle of Trust, and issue the beneficiary certificates which were divided into "equal shares" and circulate in the debt trading market and negotiable instruments market as "Money Market Instrument"

Before the Measures issued, the In August 2019, one commercial bank (Baoshang Bank Limited) refused to pay the trade and commercial bills it accepted and this caused the suspension of the

re-discount of small and medium-sized banks. In order to help the outstanding commercial bills accepted by Baoshang Bank hold by small and medium-sized banks to keep circulate, with the approval of the central bank (PBC), the Shanghai Stock Exchange, as the creator, issued first batch of the Standardized commercial instruments. On July 27, 2020, with the Measure become effective, standardized commercial instruments formally entered the Chinese Bond Market.

Because commercial bills itself is the securitization of commercial credit, there shall be no "re securitization" on it. There is no theory of securitization of commercial bill nor relevant laws in PRC. If standardized commercial instruments are defined as securities derivatives, which are used to control the expected investment risk. As there is claim right based on commercial bills for determining amount (par value on commercial bills), and the payment is unconditional upon maturity, there shall be no need to establish Standardized commercial instruments.

There were also disputes when standard commercial instruments was created. Some considered it as new solution to commercial instruments market in China while some scholars insisted the Standardized commercial instruments are actually "Pseudo securitization" and conflict with current legal regime.

This paper analyzes the problems of the current structure of securitization of the beneficial right of negotiable instruments (the Standardized commercial instruments) and its conflict with current legal regime (relevant laws and regulations on trust, negotiable instruments and securities) and finally expounds the suggestions for promoting the circulation of commercial instruments market by improving the whole negotiable instruments system in PRC but not by "creating" the Standardized commercial instruments.

2. The process and problems of Standardized commercial instruments

In China, the circulation of commercial bills is not smooth and the pass rate is low. The fundamental reason for the difficulty in discounting and transferring commercial bills is credit default (risk of non-payment).

From the perspective of investment demand, due to financial restriction in PRC, which prevents private capital from legally investing in commercial bills, the low credit rating commercial bills held by enterprises cannot be circulated and financed normally and legally. From the perspective of former experience, commercial transactions, especially the innovation in financial markets, are produced under the pressure of regulation to break through legal barriers.

Some considered Standardized commercial instruments can not only solve the problem of bank credit assets statement, but also legalize private capital investment in commercial bill assets, which is undoubtedly a channel between market demand and legal restriction.

In August 2019, in order to increase the liquidity of small and medium-sized banks, the central bank (PBC) tried to issue Standardized commercial instruments of bill asset-backed securities. The first three issues were discounted bills and the fourth was undiscounted bills.

In July 2020, the PBC promulgated "the Measures", which defined Standardized commercial instruments and described the subject, content, issuing procedure and circulation scope of the legal relationship among the original holder (consignor), depositor, underwriter, etc. It has a certain practical significance to the poor liquidity of commercial bills, the difficulty of discount and discount, and the financing difficulty of small and medium-sized enterprise holders.

However, for the process of "Standardization" of commercial instruments, based on the value judgment of law, this paper held that it is inconsistent with the purposes of trust law to safeguard the interests of majority and the principal and negotiable instruments law to encourage transactions of the commercial bills, which makes the commercial instruments out of circulation in advance.

Although investment on Standardized commercial instruments can promote the circulation of commercial bills and indirectly support the financing of its holders in the short term. However, the commercial instruments shall have the function of payment and settlement. Standardized commercial instruments block the circulation of commercial instruments, which belongs to defunction and could be considered as functionally actual "anti-securitization".

Standardized commercial instrument is a typical securities derivative in form with the beneficiary right plus the right based on "Depository Agreement". Derivatives are generally only used to manage expected investment risks. The principle is that expected returns are a function of a variable, rarely can make an accurate judgment and need to offset its risk with a portfolio of securities with different probabilities. The holders of commercial instrument have the right of claim for a forward fixed amount, and bank acceptance is in principle a rigid payment, and there is no problem of rising or falling income.

In the collection of underlying asset pools of Standardized commercial instruments, the "similar core credit elements and similar payment periods" are required, and the securities portfolio with "different credit risk probability" is not available to offset the risk. Therefore, the Standardized commercial instruments also do not conform to the design principle of securities derivatives.

The underlying asset independence of Standardized commercial instruments is to realize "bankruptcy remote". However, the regulation required the depository institutions issue asset-backed securities to the public and use the cash generated from them to pay to the final holder lost the effect of bankruptcy remote.

In terms of function, bank acceptance bill is a bank credit, and its liquidity is better than Standardized commercial instruments. In addition, no one is allowed to issue Standardized commercial instruments by collecting commercial acceptance bills with low credit rating that have not been transferred.

The main function of commercial instrument is payment and settlement rather than financing. Due to the endorsement and credit enhancement function itself, with the enterprises with high credit rating participating in the transaction, accepting and endorsing the commercial bills, the commercial bills with low credit may be accepted by the relevant creditors and continue to circulate as a means of payment. It is better than using standardized commercial instrument.

The original intention of Standardized commercial instruments is to solve the poor liquidity and financing difficulties of negotiable instruments, but whether the funds can be financed depends on the investors rather than the financiers. From the perspective of investors, the decisive factors are income and security. If it can be bought directly through discount, why pay more for Standardized commercial instruments?

Standardized commercial instruments do not have credit enhancement function and may lead to credit reduction. The internal credit enhancement principle of securities derivatives is completed by combining securities with different credit levels and replacing and absorbing low-level equity with high-level securities equity. Due to the similarity of credit entities of underlying assets, Standardized commercial instruments does not have the basis of substitution and absorption of hierarchical rights and interests, and has no internal credit enhancement function; while Standardized commercial instruments also lost the "external credit enhancement" function of endorsement unique to the bill. The independence of the original holder of instruments from the trust assets, and the reduction of the number of callees also reduces credit.

The purpose of Standardized commercial instruments is to promote the circulation of commercial bills, but it conceals the nature of transfer risk of refuse-payment of acceptors. Standardized commercial instruments have the channel function of transferring liabilities to other banks and exporting credit assets. However, it is extremely unlikely that financial institutions in the debt and bill markets will purchase and hold maturity. If Standardized commercial instruments (or other financial products designed based on Standardized commercial instruments) are sold to investors of non-financial institutions, the commercial risk of notes will be transferred to public investors.

Therefore, commercial instrument market needs to improve the credit system to solve the problem of stagnant circulation of commercial bills but not a channel to transfer credit risk (the Standardized commercial instruments). It needs a payment and settlement method that supports the circulation of rigid cashing, and does not need investment arbitrage products with the carrier of bill beneficial right.

Standardized commercial instruments are not only related to the construction of the most important commercial bill credit system, transaction security and the interests of public investors in

the bill system, but also impact on the financial control concept of allowing private investment in negotiable instruments. It shall be pursued to discuss the legal principle and function of Standardized commercial instruments, to seek the root cause of poor circulation of commercial bills and to better support the economy.

3. Standardized commercial instruments conflicts with current legal regime of PRC

As mentioned above, the standardized commercial instrument as a new type of beneficiary certificate created by regulation in PRC, it conflicts with the current legal regime in PRC.

3.1 Conflict with Trust Law

Although the legal basis of Standardized commercial instruments is the trust law, its trading framework designed in accordance with the basic logic stipulated in the programmatic document "the Measures" to guide the project of credit asset securitization.

Firstly, the purpose of standardized commercial instrument is to support the liquidity of small and medium-sized financial institutions. From the perspective of investors, the depositor collects the bill assets and issues the beneficiary certificate. The beneficiary is the investor. However, the beneficiary stipulated in China's trust law is the trustor or the trustee, which should be established in accordance with the principle of self-benefit and the trustor's interests should be maximized. Standardized commercial instrument created in accordance with the principle of other beneficial trust conflicts with the principle of trust law.

Secondly, the legal nature of trust is "property entrustment" rather than property transferring, standardized commercial instrument adopts the concept of "depository", which can be interpreted as entrustment. However, S standardized commercial instrument is independent from the original holder after depository is made and transfers the beneficial right according to the fair consideration price, which deviates from the trust relationship stipulated in the trust law.

Thirdly, conflict of trust relationship and the independence of the underlying assets. To implement bankruptcy isolation of negotiable instrument assets, a special purpose carrier SPV is needed. However, from the perspective of trust law, countries of civil law system usually do not regard trust as an independent legal subject, but as a legal relationship between trustor, trustee and beneficiary. Therefore, trust cannot be the issuing subject of securities. And from the point of the realization of the aim of bankruptcy isolation, trust is unequal to the bankruptcy isolation, especially the cases as the discount interest is deducted and the shrink of expected returns of bills caused by anticipatory breach. It is difficult to determine whether "fair consideration price" has been achieved in the process of transferring assets from the original holder to the depository when the depository is repaid with cash flows from the asset-backed securities.

3.2 Conflict with the Law of Negotiable instruments

Firstly, the conflict between standardized commercial instrument and the record on negotiable instruments, which in principle are transferred by endorsement, and the rights are recorded on the negotiable instruments. Standardized commercial instrument does not stipulate the method of endorsement for bill depository, but it should make "transfer endorsement" for the purpose of pursuing complete transfer; However, according to the definition of depository, it seems more appropriate to record "entrusted collection".

The characteristically documental is the basic principle of a negotiable instrument, which cannot be interpreted in terms of a relationship other than the negotiable instrument. If the "negotiable" clause is recorded on the telegram after the endorsement is transferred, the endorsement shall continue for circulation; However, standardized commercial instrument requires that "during the duration of existence, there shall be no right burden such as transaction, embezzlement or pledge", which is in conflict with the content recorded in the endorsement of the commercial instrument.

The collection endorsement is closest to the meaning of depository, on which the phrase "collection by commission" is recorded. However, the depository agreement changed the recording

content. After the commercial instrument entered the SPV, the underlying asset was independent of the original holder and the cash flow generated by the bills supporting securities to repay the original holder before maturity, instead of collecting the full amount of the notes from the payer at maturity.

Secondly, the conflict between the principle of underlying asset independence and the principle of commercial instrument recourse standardized commercial instrument was created in accordance with the independence principle of trust property. However, the principle independent of the original holder and the principle of "The latter endorser shall have recourse to the former endorser" are mutually conflicted, especially as the credit body of collection paper assets is the discount one of former endorser and guarantor, it will be meaningless for the recourse of standardized commercial instrument as it fails to be made for recourse of original holder. After dishonor, standardized commercial instrument credit subject is exempted as bankruptcy remote.

3.3 Conflicts with Securities Law

Firstly, it runs against the principle of asset backed securitization. Negotiable instruments are securitizations of credit, and since the PBC requires that contracts and invoices are necessarily needed for negotiable instruments, which in fact, the creditor's right is also excluded as the reason for drawing a negotiable instrument. Commercial bills are receivables of securitization, which have the function of payment and settlement without be "re securitized".

In the United States, bills of exchange, promissory notes, and checks are collectively referred to as "negotiable instrument". The Geneva Unification Law fails to explicitly define the concept of bills. Securities have three characteristics: property rights are recorded on securities or in electronic systems, rights and securities are inseparable and can be fully circulated and transferred. Commercial bills conform to the above characteristics and have the function of payment and settlement. The principle of standardized commercial instrument is to withdraw bills from the payment and settlement, and its beneficial right of trust is securitized, and can only circulated in the bond market. From the point of view of shrinking circulation field, it belongs to "anti-capital circulation".

Secondly, it is inconsistent with the principle of financial derivatives to manage expected risks.

The legal structure of standardized commercial instrument is in line with the regulations on financial derivatives. The principle of derivative of option securities such as debt and stock is generated because there will be rise and fall in the future, its rise and fall are regarded as the trading object and design a trading rule, according to the total rise and fall of the market to indirectly earn the income of the original securities and the bid-ask spread. And "the risks of randomly distributed securities eventually tend to be mutually offset, so it produces a risk-free portfolio of securities."

As mentioned above, the holder of commercial instrument has the right to claim the certain amount at maturity, and there is no rise or fall of the expected income. The discount is also the certain amount calculated by deducting the maturity days and the discount rate. There is no problem that the forward interest rate changes affect the expected income. The risk of dishonor belongs to the category of negotiable instruments law. In the legal system of securities outside the territory, there is no financial derivative to manage negotiable instruments.

3.4 Unclear legal relationship between parties involved in standardized commercial instrument.

As standardized commercial instrument does not clearly define the legal relationship between the investor and the real debtor, once the commercial bills in the asset pool are refused to pay, it is difficult to determine the specific legal norms to resolve the dispute.

Standardized commercial instrument is established under the ideal condition that there is no refusal to pay the commercial bills when the commercial bills are due, and the clearinghouse can clear the commercial against payment. However, once the commercial bills in the underlying assets are refused to be paid, problems arise when litigation relief is required, but refusal cases exist in reality and a large number of cases. In 2019, there were 3906 cases of refusal to pay on commercial bills concluded by courts at all levels across PRC. The problem is that the "the Measures" for standardizing standardized commercial instrument is only a departmental regulation and can only be

"referenced." The trial of cases still needs to determine the status and nature of the parties' rights and obligations based on current legal regime, laws such as the law of negotiable instruments and Trust law. The legal norms for processing.

The investor of standardized commercial instrument is the last purchaser of the beneficiary securities, and the bills in the asset pool are rejected. Whether the plaintiff is the investor, depository institution or the original holder cannot be determined. Even if standardized commercial instrument cannot achieve bankruptcy isolation, the investor cannot exercise the right of recourse on behalf of the instrument.

Therefore, the creation of the standardized commercial instrument makes this special type of new beneficiary certificate conflict with current legal regime even contrary to many legal regulations.

4. Standardized commercial instrument could not achieve the interests of financiers, investors and social interest

4.1 Standardized commercial instrument shall be considered as the worst option for commercial instruments holders for financing

Commercial instruments actually are not suitable for depository, as a means of payment and settlement or the profits of face amount can be received at maturity, the discount interest and service charge is only deducted. Standardized commercial instrument holders has to pay trust fees and bear the interests surrendered to investors when the market is priced, so standardized commercial instrument is an option with low yield and high cost.

The "fair consideration price" for the cash received by the holder is not determined by itself, but formed by the depository according to the market pricing mechanism of the publicly issued securities, and this part of the interest can only be transferred by the original holder. Standardized commercial instrument is a depositor-initiated trust. In order to the successfully creation, it is theoretically possible to set the price lower at the expense of the trustee, so as to improve the competitiveness of standardized commercial instrument in the market.

In order to eliminate the scale of credit some bank may take standardized commercial instrument as the channel of transferring business out of the balance sheet, the banks holding the discounted commercial bills may have been punished for violating the rules and have no choice but to reduce the returns. However, standardized commercial instrument is also the option with the highest cost compared to other financing methods such as rediscount, custody and repurchase.

Adding credit to standardized commercial instrument can raise more capital, which is divided into internal credit and external credit enhancement. Internal credit enhancement is the basis of the principle of the assets of different credit rating paper and through the risk pricing of default rate to build different levels of equity structure including the underlying equity, mezzanine equity and priority rights and interests, rights and interests of the upper level rights. The credit subjects that standardized commercial instrument requires to collect bills are similar, and there are no commercial bills with different levels of equity, so it is impossible to improve the internal credit of commercial bills by optimizing the equity structure of different levels.

According to the principle of bill endorsement and transfer, the more endorsements, the more subjects to bear the responsibility, and the higher the credit is. Standardized commercial instrument culminates on circulation through SPV, participants were independent of the underlying assets, and the system of the transfer of standardized commercial instrument without commercial instrument has the function to increase credit of external endorsement.

4.2 Standardized commercial instrument cannot make sure the returns maximization of investor and trading security

From the perspective of the pursuit of yield rate, standardized commercial instrument also reduces the yield rate. Taking "Rong Yuan No. 1" (the first standardized commercial instrument appears in market) as an example, the interest rate of asset transfer into the pool is no less than 4%, and the

actual weighted average interest rate is 4.88%. Investors received only 3.64% of the expected earnings rights with the yield rate less than 1.24 percentage points.

For the standardized commercial instrument issued for four terms, the adjusted yield on five-year treasury bonds is 3%, the yield on local government bonds is 2.9%, and the yield on one-year certificates of deposit is 1.8%. The yield of standardized commercial instrument of the fourth stage were 3%, 2.8%, 2.1% and 1.7% respectively with the trend of continuous decline, which are lower than the yield of local government bonds, treasury bonds and certificates of deposit in the same period.

After “the Measures” come into effect, from July 27 to August 21, 2020, many institutions applied for the establishment of standardized commercial instruments. The number of instruments increased significantly, a total of 30 standardized commercial instruments were created, with a total issuance scale of 2658.1496 million yuan; the term was 39 days to 365 days; the price range was 2.5% to 4.4%. The subscription volume was 1:1, without oversubscription; the highest price was two coal mining enterprises and Hengtong group. However, it is still more likely to be cautious about the capital cost of banks.

Because there is no income or security reasons, if investors can directly purchase through the way of discounting commercial bills, they will not choose standardized commercial instrument to increase the trust fee. However, under the same rate of return, it is safer to invest in bonds market, local bonds or certificates of deposit, and there is no reason for investors to choose standardized commercial instruments with risks.

4.3 Standardized commercial instrument brings no social benefits

Firstly, the standardized commercial instrument removes the function of negotiable instruments in payment and settlement which restricting rather than encouraging transactions.

According to the utilitarian principle, it is the ultimate goal of commercial law to encourage transactions and create more social wealth and "the result of trade is wealth". The more links of negotiable instruments circulation, the longer the time, the more transactions completed, the more social wealth created, and vice versa. The creation of standardized commercial instrument stopped the payment and settlement of negotiable instruments and encouraged commercial bills to withdraw from the circulation of commodities and join the financial field, which was equivalent to restricting commodity trade.

Moreover, the standardized commercial instrument reducing the negotiable instruments liquidity. Encouraging the circulation is considered as a social responsibility rather than an individual responsibility, but from the perspective of encouraging and accelerating the circulation speed, the bank acceptance bill itself has better liquidity than the general standardizes commercial instruments due to its bank credit, Chinese current asset-backed securities have annual turnover rate of 9.4%. But practical experience shows that the turnover rate of negotiable instruments is certainly much higher than 10%.

Meanwhile, standardized commercial instrument provides no support for the economy but only the transferring of risk of dishonor. Standardized commercial instrument does not make sense for SMEs in financing. The commercial bills issued and accepted by the bank have no credit rating or with low credit rating, so no one can accept the transfer in the market and no financial institutions will create standardized commercial instrument.

However, the transferred acceptor is the commercial bills of large enterprises. If it can be directly transferred or discounted, there is no need for trust. If there is no transferee in the market, it cannot be circulated in the securitized bond market, and standardized commercial instrument cannot be created successfully.

If it is the transfer of risk between financial institutions, it can be realized through the pricing of default rate and the transferring of interest. It is based on the speculation after the evaluation of the yield and risk ratio, and it is not conducive to the real economy.

Therefore, as the conclusion of analysis above, it could be seen that standardized commercial instrument is not best solution for the best solution for the commercial instruments market in China.

5. Solution for the commercial instruments market in China shall focus on improving negotiable instruments system

Perfect the system of negotiable instrument broker and negotiable instrument exchange market and regulate non-financial-institutional discount market shall be considered as the actual solution for the negotiable instruments market in China

The non-financial-institutional negotiable instrument brokers are in the gray area in China, and its legal evaluation has gone through the process from innocence to guilt and then to innocence. Bank of China defines the broker as a financial institution. It is generally believed that excluding individuals from negotiable instrument activities does not conform to the current market.

In the United States, issuers include not only financial institutions, but also non-financial companies and companies holding by banks. In addition to the above three issuers, investors, investment companies, governments and funds can participate, allowing individual investors to join in the negotiable instrument exchange.

In China's negotiable instrument market, due to the fact that individuals and entities do not have the legal way to participate in negotiable instrument transaction, they can only choose non-financial-institution negotiable instrument discount. However, non-financial-institution brokers play an irreplaceable role in promoting negotiable instrument circulation, which requires regulation rather than banning.

There are hundreds of negotiable instruments of negotiable instrument transactions in the non-financial-institution discount market every day in China, with participants. What the broker provides is a kind of information or matching service, which is not the main creditor of negotiable instrument credit (the main creditor is acceptor), so it is not necessary to set up and manage according to the requirements of financial institutions. The Bank of China requires commercial banks to set up another negotiable instrument broker of financial institutions, which is not in line with the current situation of negotiable instrument market transactions in China.

In theory, the Cleaning House is a cooperative department between banks through which financial institutions exchange assets and some securities and vouchers in the name of their customers. Shanghai Cleaning House is still in its infancy and exploration stage and there are still some problems, such as incomplete functions (especially no negotiable instrument exchange function), narrow coverage, imperfect rules and regulations (no dishonest registration, delisting and exchange compensation and recovery system), poor operability, and poor implementation of the relative regulations (such as act as refuse payment on behalf, act as transfer on behalf in the transfer system), which should be solved as soon as possible.

The Cleaning House is the platform of exchange, while the broker is the link between the supply and demand. Only by improving the negotiable instrument exchange and broker system at the same time, can regulate the non-financial-institution discount from the system and bring it into legalization.

6. Conclusion

In order to solve the problem of poor liquidity of commercial bills, China has constructed a beneficial certificate of right of negotiable instruments, standardized commercial instruments, which has been securitized and circulated as a means of payment and settlement, under the condition that the regulation of private participation in commercial bill brokers and investment bill cannot be released. In terms of legal theory, it conflicts with the trust and negotiable instruments law principles on which it is established. In addition to the most valuable payment and settlement function of negotiable instruments, it increases the trust cost and lacks the basis for promoting circulation. The fundamental reason for the poor circulation of commercial bills is the lack of the effective whole legal system for negotiable instruments market, which should be solved by improving the whole negotiable instruments system rather than creating an investment product.

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