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Law and Finance: The Case of Stock Market Development in China

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In just over 2 decades China has developed a stock market that is now one of the biggest in the world. This is puzzling, considering that law in general and investor protection in particular in China is widely regarded as weak. However, a thorough examination reveals that, far from being a counterexample, the case of China lends strong support to the “law matters” thesis. Granted, investor protection counted for little during the rapid growth of the market before mid-2001. But by the early 2000s, outrageous securities frauds had become endemic, bringing the market to a serious crisis. Faced with a constituency of angry investors and the prospect that the market might collapse, the government was forced to crack down on frauds and strengthen investor protection. It was only after frauds had been considerably curbed and a degree of order established that the market recovered in 2006 and experienced an enormous boom in 2007. Nevertheless, since August 2009 the market has run into another prolonged bear and crisis. This time the principal cause is low corporate profitability, which has roots in both weak investor protection, in the forms of managerial corruption, waste and mismanagement, and defects in areas not related to investor protection.

The experience of China indicates that a precondition for a stock market to emerge and grow is a demand for and enough supply of capital in the economy. It demonstrates the critical role of investor protection in sustaining market growth and attests the sequence of growth first, followed by law. However, such a virtuous circle of “growth-law-further growth” is not a guarantee. While securities frauds have been greatly curtailed in China, managerial misconduct has not. Fundamentally, political and economic reasons explain why market growth has led to improvement of investor protection in one area but not in another. The facts that market growth preceded law and that it was political and economic

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factors that drove or hindered investor protection improvement in China seem to contradict the proposition that legal origins determine the strength of investor protection. Moreover, China’s experience indicates that the scope of investor protection assessment undertaken by “law and finance” research and certain international organizations is too narrow to capture China’s improvement in the area of securities frauds. Furthermore, a stock market’s growth capacity is ultimately determined by its performance in investment return and investor protection is only one factor that affects that performance. An obsession with investor protection and law may risk that other important issues are neglected.

Looking ahead, while securities frauds would no longer seem to be a serious threat, the Chinese stock market still faces a serious challenge of how to increase corporate profitability, which will not only need enhanced investor protection but also changes in other areas. The difficulties the stock market faces are also facing the whole economy, and whether they can be overcome determines not only the future of the stock market, but also China’s whole economic development.

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INTRODUCTION
Despite various peculiarities and a reputation of being “worse than a casino”, the stock market in China has grown to a prominent stature in just over two decades. Since the end of 2007 the market capitalization of the two stock exchanges in Shanghai and Shenzhen has been comparable to that of Japan for most of the time and smaller only than that of the United States. In terms of share trading, the Mainland Chinese stock exchanges are very active and the total trading value has firmly ranked second in the world since the end of 2007. In terms of funds raised through IPOs, Mainland China ranked first in 2007, 2010 and 2011, and second in 2008.

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1 In the late 1990s and early 2000s, securities frauds were rampant in China. Wu Jinglian, a preeminent economist and Senior Research Fellow at the Development Research Centre of the State Council, said in an CCTV (China Central Television) interview in January 2001 that the stock market was “worse than a casino”, because “at least a casino had rules that were followed”. His comment roused an uproar and resonance among the public, and was extensively reported by other media. Since then “worse than a casino” has been widely used to refer to China’s fraud-ridden stock market. See Richard McGregor, Crackdown on corruption splits Beijing, FINANCIAL TIMES, Feb. 13, 2001, at 14; Anthony Kuhn, Chinese Markets “Worse than a Casino”, LOS ANGELE TIMES, Mar. 29, 2001, available at http://articles.latimes.com/2001/mar/29/business/fi-44137; STEPHEN GREEN, CHINA’S STOCK MARKET: A GUIDE TO ITS PROGRESS, PLAYERS AND PROSPECTS 165-166 (2003).

2 Statistics for the major stock exchanges in the world are available on the website of the World Federation of Exchanges, http://www.world-exchanges.org/statistics. Originally in China only shares issued to the public on the stock exchanges were freely tradable, but shares owned by governments or acquired by legal persons before an IPO (initial public offering) could be sold and bought only privately off the exchanges. See STEPHEN GREEN, ibid, 15-18; CARL E. WALTER & FRASER J.T. HOWIE, PRIVATIZING CHINA: INSIDE CHINA’S STOCK MARKETS 67-84 (2006). Since the price recorded in a private transaction of state or legal person shares was much lower than the trading price of public shares and public shares only accounted for about 1/3 of the total number of shares, it was argued that the market capitalization calculated based on the trading price of public shares was a huge exaggeration. See WALTER & HOWIE, ibid, 121-122. However, in 2005 the Chinese government launched a reform to convert those non-tradable shares into tradable and by the end of 2009 the restriction on the tradability of state and legal shares had become a history. For the non-tradable reform, see text accompanying note 118.
2009 and 2012.\textsuperscript{3} China now boasts more than 170 million share trading accounts and tens of millions of investors.\textsuperscript{4} It is no exaggeration to say that the growth of the Chinese stock market is exponential.

The growth is even more astonishing and perplexing when we consider that law in general and investor protection in particular in China are widely regarded as very weak. According to the Worldwide Governance Indicators, between 1996 and 2012 China was within the range of 35.89\textsuperscript{th} and 45.5\textsuperscript{th} percentile rank in “rule of law” among all the 213 assessed economies (ranging from 0 to 100).\textsuperscript{5} In the World Bank’s “Doing Business” report, out of all the 183 economies under assessment, China ranked 93\textsuperscript{rd} in 2010 and 97\textsuperscript{th} in 2011 in “protecting investors”.\textsuperscript{6} The Global Competitiveness Report 2008-2009 ranked China 94\textsuperscript{th} among all the 134 economies in “protection of minority shareholders’ interests”, 90\textsuperscript{th} in “strength of auditing and reporting standards” and 86\textsuperscript{th} in “efficacy of corporate boards”.\textsuperscript{7}

It seems that the stock market in China has been able to grow rapidly notwithstanding weak investor protection. This is contrary to the influential “law and finance” literature, which


\textsuperscript{4} China Securities Depository and Clearing Corporation (CSDCC), China Securities Registration and Settlement Statistical Yearbook 2012, available at http://www.chinaclear.cn/zdjs/editor_file/20130906103133909.pdf. A Chinese investor needs to open an account with the CSDCC to trade stocks listed in Shanghai or Shenzhen. The actual number of investors is smaller than the total number of trading accounts, because an investor needs to open a trading account separately to trade shares in Shanghai or Shenzhen.


suggests that strong investor protection by law is essential for financial market development. The “law matters” thesis has been widely accepted. It is evident that both the World Bank and the World Economic Forum have used the strength of investor protection to assess the business environment or competitiveness of economies around the world. The World Bank even adopts the methodology used by the “law and finance” research to compile the investor protection index. Nevertheless, there have been various critiques of and challenges to the “law matters” thesis for both its methodological approaches and theoretical reasoning. The Chinese experience seems to provide live ammunition for such charges. Indeed, in examining the link between law, finance and economic growth, Allen et al. (2005) conclude that China is “an important counterexample” to the existing literature on the significance of law.

Is it true that China is a counterexample? Has investor protection really not played a role in the growth of China’s stock market? Were Chinese investors not concerned that their investments might be lost? Would the growth be sustainable if investor protection remains weak? These questions are fascinating and important. Having developed such a sizeable market right under our noses in so short a period, the case of China would be powerful evidence to cast doubt on the “law matters” thesis, if it were true that legal protection for investors did not play a role in the growth, and vice versa. An investigation of these questions might also shed new light and offer lessons on how to develop a stock market. Moreover, an answer to the question of whether

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8 Rafael La Porta et al., Legal Determinants of External Finance, 52 J. OF FINANCE 1131 (1997); Rafael La Porta et al., Law and Finance, 106 J. OF POLITICAL ECONOMY 1113 (1998); Rafael La Porta et al., Corporate Ownership around the World, 54 J. OF FINANCE 471 (1999); Simeon Djankov et al., The Law and Economics of Self-Dealing, 88 J. OF FINANCIAL ECONOMICS 430 (2008).

9 The literature is vast. For a useful review and summery, see John Armour, et al., Law and Financial Development: What we are Learning from Time-Series Evidence, BYU L. REV. 1435 (2009).

the growth of the stock market in China is sustainable would not just furnish a view of the future of the market, but also give insight into the issue that is attracting the world’s attention—the sustainability of China’s economic growth.\(^\text{11}\)

After a thorough examination of the history of the growth of the market and the evolution of investor protection, this paper finds that, far from being a counterexample, the case of China lends strong support to the “law matters” thesis. Granted, investor protection was not very relevant in the rapid growth of the market before mid-2001. This growth can be explained by investors’ inexperience and bounded rationality, a time lag between the establishment of the market and the prevalence of securities frauds, lack of alternative investment opportunities and the bailing out of failed companies by governments. However, by the end of the 1990s and early 2000s, securities frauds had become endemic and outrageous. Funds of listed companies were routinely and openly misappropriated by their controlling shareholders; few stocks were spared from manipulation and fraudsters even dared to acquire listed companies and use them as a tool for market manipulation; false disclosure by listed companies was the rule and the falsification of accounting records and profits was standard practice; even investors’ funds deposited with securities companies for stock trading were regularly misappropriated. Led by a financial magazine, *Caijing*, the media started to investigate and report securities frauds from 2000. After a scandal was revealed, the share price of the company involved plummeted and investors suffered huge losses. As more and more shocking scandals were revealed, the market reversed the upward trend from mid-2001 and share prices dropped sharply. The fall in share price sealed the fate of many manipulation schemes and exposed even more scandals. Investors became very angry, frustrated and started to withdraw from the market, sending the share price into a

\(^{11}\) For a discussion of whether Chinese economy can continue to grow without the support of rule of law, see KENNETH W. DAM, *THE LAW-GROWTH NEXUS: THE RULE OF LAW AND ECONOMIC DEVELOPMENT* (2006), Chapter 10.
downward spiral. Between mid-2001 and the end of 2005, while the macro economy of China was at its strongest, following accession to the WTO, both price indices and market capitalization of the two exchanges were more than halved. The whole securities industry was in the red continuously for 4 years. IPO had to be halted 3 times and the plan to use the stock market for SOE (state-owned enterprise) reform was derailed. The market was in a serious crisis and the government tried various measures to prop it up, but to no avail. Indeed, the public, commentators and policy advisors engaged in a serious debate about whether the existing market should be closed down and a new one started from scratch.

Facing a constituency of angry investors and the prospect that the market might collapse, the government was under huge pressure to take action. It was plain that the market needed to be cleaned up and investors offered more protection to restore their confidence in share investment. A campaign was launched to force misappropriated funds to be returned; a large number of fraudsters were sent to prison; the Criminal Law was revised to make managers personally liable for controlling shareholders’ misappropriation, and to tighten criminal liability for information misrepresentation; action was taken to rehabilitate the securities industry; the trading account registration system was enhanced to make manipulation and hiding more difficult; a new rule requiring investors’ funds for stock trading to be deposited with a third-party bank meant that securities companies could no longer misappropriate these funds; numerous laws, regulations, rules, orders, and codes, were issued, in an effort to enhance corporate governance and increase shareholders’ rights; law enforcement improved significantly, evidenced by both the input of resources and output of activities. By 2006 the once-ubiquitous stock cornering had disappeared, blatant information misrepresentation been curbed and most of the misappropriated funds returned. A degree of order had been established and the market was no longer in a wild state of
lawlessness. Indeed, the Vice President of Peking University, an authority of Chinese financial law, even extolled the stock market as being “the most transparent and efficient market with the highest degree of rule of law” in China. It was only after this change that the stock market recovered in 2006 and experienced an enormous boom in 2007. Although crashing shortly afterwards in 2008, the boom elevated the market to another level of magnitude and enabled many “national champions”, the strategic SOEs, including the “big 4” state-owned commercial banks, to be listed.

Nevertheless, since August 2009 the stock exchanges have run into another prolonged bear market. The Shanghai Composite Index fell from the 2009 high of 3478.01 to less than 2000 in July 2013. As share prices dropped, the stock market seemed to have drifted into another crisis. A majority of investors sold off and left. The exchanges become much quieter in trading. IPO was suspended once again in November 2012. Criticisms and debates about the future of the market raged all over again. The bear market was underlined by listed companies’ poor profitability. For a long time the profitability was very poor and increased only after 2003. After reaching an all-time high in 2007, it decreased sharply after the Global Financial Crisis. The economic stimulation introduced by the government in late 2008 had a short-term effect on profitability, but greatly inflated share prices. The market in 2009 was again in a bubble, unsupported by corporate profitability. The prolonged bear market was a result of the correction of this bubble, and decreasing corporate profitability. Clearly, deceleration of the macro economy affected profitability, but weak investor protection, albeit in a different form, also contributed to the poor performance. Although the number of private listed companies has increased, the stock market is still overwhelmed by SOEs in terms of market capitalization, total assets, revenues and profits of listed companies. The misconduct of managers in the forms of
corruption, waste and mismanagement are still rampant among listed SOEs. Investors are vulnerable and corporate profitability suffers. In addition, this low profitability is also explained by factors that are not related to investor protection, such as the stifling red tape and exorbitant cost of doing business, SOE monopoly or oligopoly and limited access to the market by private companies, low level of technological and managerial sophistication, and a low capacity for innovation.

The history of China’s stock market development shows that a precondition for a market to emerge and grow is sufficient demand for and supply of capital in the economy. As a result of economic reform and the policy of encouraging people “to get rich”, by the time the stock market emerged, many households in China had already had money to spare; as the economy grew rapidly, so did people’s disposable income and savings. On the demand side, after the agricultural sector was liberalized, rural industry flourished, demanding investment; SOE reform in the early 1990s tightened the soft budget and SEOs became desperate to find new sources of funding; by the early 2000s a new demand for capital had been created as a result of the growth of private enterprises.

Second, China’s experience demonstrates concretely that investor protection is critical to sustaining market growth. When frauds are systemic, even a government as powerful and interventionist as the Chinese could not stop the market declining, and a market can only flourish when a degree of law and order is established. Moreover, when investor protection is weak and managerial misbehavior is unchecked, corporate profitability suffers, the market stagnates and growth capacity is constrained. However, it seems that the scope of investor protection assessed by the “law and finance” research and the World Bank and World Economic Forum is too narrow. It focuses on corporate governance and information disclosure. But the first crisis that
China’s stock market met was caused by securities frauds, particularly in the form of misappropriation by controlling shareholders, market manipulation by stock traders and false disclosure by listed companies. In this area of investor protection China has achieved much, which does not register with those international assessments because of their narrow coverage.

Third, China’s experience indicates that the sequence of development is market growth first followed by law but not the other way around. China’s stock market emerged and experienced waves of “fever” even before a basic legal and regulatory framework was in place. The curbing of securities fraud and the establishment of a degree of law and order happened only after the market had already grown to a considerable size. It seems that market growth led to the improvement of investor protection. However, the virtuous circle of “growth-law-further growth” is not a guarantee and market growth may not lead to better investor protection in all cases, as illustrated by the widespread managerial corruption, waste and mismanagement that continue in the stock market of China.

Why has market growth led to an improvement in investor protection in one area but not another? Fundamentally, the political and economic factors provide an answer. It was out of concern about social stability and economic order that the legal and regulatory frameworks were established in the 1990s; by the early 2000s, the number of investors had increased to tens of millions. Because of their common interest, these investors formed a political constituency even though not formally organized. The proliferation of financial media in response to market demand for stock market information helped to inform investors and enabled them to speak in stronger collective voices. Investors had become so powerful that even the Chinese government, with no electoral pressure, had to heed their complaints and take action. The government was further motivated by its wish to use the stock market for SOE reform. As the market grew to a
considerable size, the Chinese government happily found that it was very useful and big enough for transforming the whole state sector. By the time the bear market started in 2001, corporatization and listing had been established as the primary policy and the stock market had become the workhorse for SOE reform. But as the market ran into crisis, the reform was derailed. To put it back on track, it was obvious that securities frauds had to be tackled and investor protection strengthened. On the other hand, the widespread managerial misconduct has roots in the dominance of state ownership in listed companies. Despite corporate governance initiatives and increased shareholder rights promoted by the CSRC (China Securities Regulatory commission, the market regulator), serious agency problems still exist and the incentives for managers to “steal and shirk” remain in listed SOEs. It is also unrealistic to expect those managers to be honest, while corruption is endemic to the whole country. However, to reduce this widespread corruption, the whole political and legal system needs to be reformed. Basically, the political and economic factors resulting from market growth have worked to curb securities frauds, but failed to reduce managerial misbehavior because of fundamental political and economic considerations.

The fact that market growth preceded law and investor protection, and that it was political and economic factors that drove or hindered the improvement of investor protection in China would seem to contradict the proposition that legal origins determine the strength of investor protection and consequently the financial market development.\(^\text{12}\)

Lastly, the experience of China suggests that investor protection and law are not the whole story. Ultimately, the capacity for growth of a stock market is determined by its performance in investment return, the foundation of which is corporate profitability, but investor

\(^{12}\) Rafael La Porta et al., supra note 8.
protection is only one factor that affects corporate profitability. In China, the business environment and the cost of doing business, the SOE monopolies or oligopolies and the limited access to the market for private companies, as well as the backward technologies, poor managerial skills and limited innovation capability, all affect corporate profits. Moreover, even in investor protection, it is political and economic factors that work behind law. An obsession with investor protection and law may risk that other important issues are neglected.

Looking ahead, China will have no shortage of demand for and supply of capital in the foreseeable future. While there is a limit on how far they can be reduced further, securities frauds should not pose a serious threat to market growth, because the political and economic factors that curbed them will still be in place. Indeed, the stock market has now been given even more strategic roles in China’s economic and social development, in so far as the government hopes that the market can promote indigenous innovation, technological advancement and industrial upgrading, as well as helping to restructure the economy, reduce risk in the financial sector and develop China’s pension system. An optimistic sign is that the government recently announced a doubling in the number of law enforcement personnel. On the other hand, the market faces the challenge of how to increase corporate profitability. The dominance of state ownership in listed companies needs to be changed; sectors with SOEs in positions of monopoly or oligopoly should be opened up to competition, and more private companies should be allowed into the stock market; red tape and the cost of doing business need to be reduced; barriers that hinder innovation and technological development have to be removed. These challenges also face the whole economy. Whether they can be overcome will determine not just the future of China’s stock market, but also China’s whole economic development.
The next Part examines the growth history of China’s stock market. Part II reviews the evolution of the legal and regulatory frameworks and the enforcement of law that are relevant to investor protection. Part III analyzes the role of investor protection in different stages of the market’s growth. Part IV assesses the prospect of China’s stock market for further growth and discusses the challenges it faces.

**I. THE GROWTH OF CHINA’S STOCK MARKET**

China’s experience with stock markets dates back more than a century, and in the mid-1930s Shanghai was the financial center of the Far East and stock exchanges also operated in Beijing and Tianjin before the People’s Republic of China (PRC) was established in 1949. However, while the turbulent pre-PRC history is also informative, this Paper focuses on the stock market that has developed since the introduction of economic reform in 1978. The emergence of the stock market was made possible after the Communist Party of China (CPC) under the leadership of Deng Xiaoping abandoned the far-left ideologies and liberalized the economy. Since then, the market has evolved and grown in tandem with ideological and economic liberalization and growth in the country, and government policies played a crucial role in shaping the course and pace of its development.

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A. The Emergence of the Shareholding System and Establishment of the Stock Exchanges

China’s economic reform started in the countryside. Unsurprisingly, the first green shoots of a shareholding economy emerged in rural areas.\(^\text{14}\) It provided a way other than from the government to finance the fledgling town and village enterprises (TVEs). It was also useful for organizing rural cooperatives and distributing returns to villagers. Subsequently, elements of shareholding practice emerged spontaneously at grass-roots levels in the urban areas. As far-left ideologies and economic planning were relaxed, enterprises were allowed to produce beyond plan scopes and quotas to fulfil market demand for consumer goods that were in short supply. But government funding was in severely short supply and the shareholding system was useful to raise finance from new sources. The share issuance by a red brick factory in a city of Liaoning Province was a pioneering example.\(^\text{15}\) There was also a need to create jobs for young people, especially for those returned “sent-down youth”.\(^\text{16}\) However, shares issued by many of these enterprises were actually debts rather than equities, as they bore the right to returns at a fixed rate as well as the right of redemption at request.\(^\text{17}\) Invariably, shares were issued internally to employees or to other enterprises, and almost all enterprises issuing shares were collective enterprises rather than SOEs.

From 1984 the focus of China’s economic reform shifted to urban areas and the central task was to revitalize ailing SOEs. Inspired by the success of the “household responsibility system” in the rural area, the government encouraged SOEs to establish responsibility systems as

\(^\text{14}\) LIU HONGRU, TUPO—ZHONGGUO ZIBEN SHICHANG FAZHAN ZHI LU (BREAKING THROUGH—THE ROAD OF CHINA’S CAPITAL MARKET DEVELOPMENT) 139 (2008).

\(^\text{15}\) For an example of enterprises LI ZHANGZHE, ZHONGGUO GUSHI FENGYUN DANGAN (ACHIEVES OF TUMULT OF CHINA’S STOCK MARKET) 10-12 (2011).

\(^\text{16}\) See Ibid, 13-22, for such an example.

\(^\text{17}\) Stephen Green, supra note 1, 9.
a way of reform. Some local governments took the initiative to try the shareholding system as a means for reform. For example, in 1986 the Shenzhen Municipal Government set up a pilot scheme for transforming SOEs into shareholding companies. Another ideological breakthrough came in 1987 when, in addition to legalizing private enterprises with more than 7 employees, the CPC proposed separating the ownership and management of SOEs and endorsed the shareholding system experiment. It was claimed that the system was not innately capitalist and that transforming SOEs into companies with a majority of public ownership would not lead to privatization; rather, it could facilitate the separation of ownership and control, and help rationalize the management mechanism of SOEs. Subsequently, a flurry of share issuances swept over the country. It was reported that 6000 shareholding enterprises had been set up across the country by the end of 1987 and 3800 were added in 1988. Certainly, these share issuances

18 Shenzhen was designated as a special economic zone in 1980 and enjoying more freedom in economic reform.


22 CARL E. WALTER & FRASER J.T. HOWIE, ‘TO GET RICH IS GLORIOUS!’: CHINA’S STOCK MARKETS IN THE 80S AND 90s (2001).
were possible only because of the rapid accumulation of household savings, which increased almost tenfold between 1980 (RMB39.9 billion) and 1988 (380.7 billion). 23

Once having acquired shares, people started to trade them. Markets for trading emerged spontaneously with people congregating in places such as factory gates, street corners and open markets—so-called ‘kerb trading’. 24 From 1986 state-owned banks in some cities started to provide an over-the-counter (OTC) service for stock trading. The first OTC market is commonly regarded as being opened in Shanghai in September 1986, when a local branch of ICBC 25 started to list shares, in addition to government bonds, for trading. 26 As more shares were issued in 1987 and 1988, local governments were active in setting up OTC markets.

However, it should be pointed out that the shareholding system and stock market were still in their very early infancy, and the miniscule amount of funds raised through issuing shares was dwarfed by the sum raised through issuing government and enterprise bonds. 27 It was only an “experiment” and a sideshow for SOE reform. The mainstream reform was the “contract responsibility system”, which allowed SOEs to retain some profits and more managerial autonomy. Enterprises adopting the shareholding system were collective or small SOEs. Among them, issuing shares internally was the norm and the number of enterprises issuing shares publicly was less than 90.28 Share issuance was poorly received. For example, when Shenzhen

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24 STEPHEN GREEN, supra note 1, 9.
25 Industrial and Commercial Bank of China, one of the “big four” state-owned commercial banks.
26 LI ZHANGZHE, supra note 15, 52-60.
28 LIU HONGRU, supra note 14, 142-143.
Development Bank, the bellwether of China’s stock market development in the 1990s, offered shares to the public in 1987, less than 80% were issued even after the local government mobilized party officials and government employees to buy. In the following year, Vanke, which later became the largest real estate developer in China, didn’t fare much better. The market for share trading was lethargic as well. For instance, the turnover value for the whole year of 1988 in Shenzhen was only RMB4 million.

The situation changed dramatically and a wave of “share fever” broke out in Shenzhen in 1990, later spreading to other cities. The “fever” was triggered just by Shenzhen Development Bank. In March 1989, the Bank declared a generous cash dividend of RMB7 per share plus one bonus share per two shares. Subsequently, the share price rose steadily, only interrupted in June by the tragic ending of the Tiananmen Square student protest. Expecting generous dividends again, the share price of the bank started to pick up in January 1990 and by March had nearly tripled. The expectation turned out to be true and between March and June 1990 the share price saw another jump of almost 600%. The other 4 companies listed on the OTC market performed equally well. Seeing fortunes gained overnight from share investment, more people rushed to the market and money from all over the country flooded in. The trading value in the OTC market increased more than 23 folds between January and May 1990.

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29 WALTER & HOWIE, supra note 2, 23.
30 LIU HONGRU, supra note 14, 84.
31 LI ZHANGZHE, ZHONGYU CHENGGONG: ZHONGGUO GUSHI FAZHAN BAOGAO (SUCCEEDING EVENTUALLY: CHINA’S STOCK MARKET DEVELOPMENT REPORT) 120-121 (2000).
32 LIU HONGRU, supra note 14, 62.
33 Ibid, 63.
even more and people congregated on street corners and in parks to trade shares.\textsuperscript{34} The whole city was in a frenzy.

This fever for speculation came to the attention of the central government, which had at that time been taken hold by conservatism after the “Tiananmen Incident”. It warned against the danger of such a situation and ordered the restriction of the shareholding experiment in the country. The Shenzhen government took heed and tried to bring the market under control. A 10% limit for daily price movements was introduced and then stamp duty and capital gains tax were imposed; the limit for daily price rises was further reduced to 5%, 1% and then 0.5%; CPC members and government officials were ordered to sell their shares.\textsuperscript{35} As a result, share prices started to drop from November 1990 and the fever eventually cooled off.

Although the 1990 “share fever” in Shenzhen was short-lived, it was a milestone in China’s stock market development. It educated the country about share investment and people learned that buying shares was not just about receiving dividends; money is made when prices go up and big money could be made quickly. It effectively ignited the enthusiasm of the country for share investment. This enthusiasm underpinned the rapid growth of the stock market in its early stages and explains why there have been so many individual investors in China.

After the “Tiananmen Incident”, Beijing was seized once more by political dogmas. Conservatives had the upper hand and economic reform stalled. It was a surprise that the central government approved the opening of the Shanghai and Shenzhen Stock Exchanges, when reform was at a low ebb and the stock exchange was still regarded as an icon of capitalism. One explanation is that, fearful of social instability that “share fever” might cause, the central government

\textsuperscript{34} A Kui, Xuanhua Yu Sandong—Xinzhongguo Gushi Ershinian (Tumult and Ferment—Twenty Years of China’s Stock Market) 26 (2008).

\textsuperscript{35} Liu Hongru, supra note 14, 84-85.
government decided to channel all trading activities to two localities (Shanghai and Shenzhen), so limiting the scope for instability. 36 Another is that, despite the “Tiananmen Incident” interruption, by opening the stock exchanges, the government intended to signal its commitment to economic reform. 37 It is also possible that the paramount leader Deng Xiaoping, who had officially retired but still enjoyed an overriding authority, lent support to government officials in Shanghai and Shenzhen who pushed for setting up the stock exchanges. 38

Anyway, the Shanghai Stock Exchange was officially opened on November 26 and started operating on December 19 1990, while the Shenzhen Stock Exchange began operation on December 1 1990, but was approved only later in July 1991. 39 However, by then the market in Shenzhen had already cooled and the Exchange was quiet with infrequent trading. There were no transactions at all on April 22 1991 and the Shenzhen Composite Index lost more than half between April 1991 and September 1991. 40 The market rebounded only after the city government instructed government-controlled institutions to buy shares on the exchange. 41 The Shanghai market was initially different as a result of infection by the “share fever” from Shenzhen, but was tamed in the second half of 1991 after similar restrictive measures were imposed. Although the stock exchanges were opened, politics in Beijing was unsettled and policy regarding the

36 WALTER & HOWIE, supra note 2, 27.  
38 See STEPHEN GREEN, supra note 1, 11-12.  
39 LIU HONGRU, supra note 14, 106-116.  
shareholding system and stock market was inhibitive. For the whole year of 1991 only 0.5 billion shares were issued through IPO, raising RMB0.5 billion.\textsuperscript{42} Before 1992 the two exchanges were tiny with only 8 companies listed in Shanghai and 5 in Shenzhen. They were local rather than national markets with only one company from outside the two cities, and investors being local residents.

\textbf{B. Growth Before Mid-2001}

\textit{1. Explosion following Deng Xiaoping’s “Southern Tour”}

At the age of 88, the “Southern Tour” was Deng Xiaoping’s last-ditch campaign to push forward China’s economic reform. Pointing out that “development is the hard truth”,\textsuperscript{43} he tried to remind leadership in Beijing to re-focus on economic development; commenting that market or planning is not the inherent nature of capitalism or socialism,\textsuperscript{44} he endeavored to draw a line under the divisive ideological debate that had raged for too long. Following his speech, the CPC at its 14\textsuperscript{th} Congress in October 1992 declared to build a “socialist market economy” as the goal of economic reform.\textsuperscript{45} This was later enshrined in the revised constitution of the country.\textsuperscript{46} The market-oriented reform had then reached to a point of no-return. To back the stock market in particular, Deng Xiaoping paid a visit to the Shenzhen Stock Exchange during his excursion and spoke favorably of the shareholding system and stock market.\textsuperscript{47}

\textsuperscript{42} CSRC, supra note 27.
\textsuperscript{43} CPC PARTY LITERATURE EDITING COMMITTEE, DENG XIAOPING WENXUAN (SELECTED WORKS OF DENG XIAOPING) (Vol. 3) 377 (1993).
\textsuperscript{44} Ibid, 373.
\textsuperscript{46} See Amendment to the Constitution of PRC, Art. 7, adopted by the 1\textsuperscript{st} plenary Session of the 8\textsuperscript{th} National People’s Congress on Mar. 29, 1993, available at http://www.lawinfochina.com/display.aspx?lib=law&id=6188&CGid=.
\textsuperscript{47} Supra note 43.
Deng Xiaoping’s “Southern Tour” sparked an explosion of economic activity all over the country. GDP grew by 12.8% in 1992 and 13.4% in 1993.\textsuperscript{48} In the stock market, another wave of “share fever” quickly broke out. On May 21, 1992, when limits on price movement were removed, the Shanghai Composite Index more than doubled in one day.\textsuperscript{49} A round of mass share issuance was triggered throughout the country and people were desperate to get hold of shares. The Securities Trading Automated Quotation System (STAQS) and the National Electronic Trading System (NETS), established respectively in 1990 and 1991 originally for trading government bonds, started to list legal person shares for trading.\textsuperscript{50} Trading centers sponsored by local governments and black markets sprang up across the country. In this state of frenzy a serious social disturbance happened in Shenzhen on August 10, 1992. IPOs were so popular that investors were required to buy an application form before they could subscribe shares. After the Shenzhen government announced an issue of shares on August 9 and 10, people flocked to the city. On August 9 more than one million people queued in the streets of Shenzhen to buy an application form,\textsuperscript{51} but in the evening they were told that application forms had sold out and no more would be available the next day. Suspecting corruption, people who had not been able to buy an application form went to the government in protest, which soon turned violent. People’s Armed Police had to be called in to put down the riot.\textsuperscript{52} The conservatives in Beijing seized this opportunity to condemn the stock market and push for its closure. Investors were alarmed and share prices plummeted. Nevertheless, the top leaders in Beijing decided to save the market and


\textsuperscript{49} Li Zhangzhe, supra note 31, 221.

\textsuperscript{50} Walter & Howie, supra note 2, 35-39.

\textsuperscript{51} Liu Hongru, supra note 14, 196-203.

\textsuperscript{52} Li Zhangzhe, supra note 31, 233-236.
expressed support for its continuing development,\textsuperscript{53} which was later confirmed by the CPC at its 14\textsuperscript{th} Congress.\textsuperscript{54} The Shanghai government also instructed securities companies under its control to buy shares on the exchange to prop up the market.\textsuperscript{55} Share prices thus rebounded sharply. As a result of the riot, the central government decided in late 1992 to set up the CSRC. An annualized quota for share issuance was introduced. Local governments were ordered to close down black markets in their areas.

But the recovery was short-lived. After reaching the high of 1536.82 in January 1993, the Shanghai index started to drop, ushering in a bear market lasting almost 3 years. This bear market was the result of changes in the macro-economic environment. The wild excess let loose by Deng’s campaign soon had its effect. The national credit plan was thrown into chaos by mass share issuance and flood of bank lending. Inflation rose rapidly and the consumer price index climbed from 3.4\% in 1991 to a dangerous level of 24.1\% in 1994.\textsuperscript{56} The government was frightened, as high inflation was a cause of the Tiananmen protest in 1989. From late 1992, the State Council started to take action, beginning by halting unapproved share and bond issuance.\textsuperscript{57}

As the inflation rate rose quickly in 1993, more forceful action was taken. Dissatisfied with the performance of the People’s Bank (PBOC), the central bank of China, the government took the rare action to sack the governor, and the then Vice Premier, Zhu Rongji, the “economic czar” of China, took over the job himself to reinstate order and control credit provision. In the meantime,

\textsuperscript{53} Ibid, 240-245
\textsuperscript{54} Jiang Zemin, supra note 45.
\textsuperscript{55} WALTER & HOWIE, supra note 2, 265-266.
interest rates were raised twice in the year with one-year deposit rate rising to 10.98%. In this austere environment, it was no wonder that share prices declined. The Shanghai Index fell to 323.92 on July 29 1994. Later it regained some lost ground as a result of various measures taken by the government to prop up the market, but it fell back to 516.46 by January 22 1996 (see Appendices, Figure 1). On top of this, the market was rocked by the “327 treasury bond futures” scandal in early 1995.

With share prices on a roller coaster and people rioting, the stock market was anything but dull during this period. The size of the market increased rapidly. Funds raised through IPO in 1992 were RMB5 billion, 10 times the amount for 1991. The figure rose to RMB19.483 billion in 1993, but decreased to RMB4.962 billion in 1994 and RMB2.268 billion in 1995 (see Appendices, Figure 5). The number of listed companies increased to 323 by the end of 1995 (see Appendices, Figure 3). 5.614 million investment accounts were opened in 1993, up by 67.22% from the previous year and by the end of 1995 the total number reached almost 13 million (see Appendices, Figure 4). The stock exchanges became national in that they were opened to companies for listing and investors for trading from outside Shanghai and Shenzhen.

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58 Renmin Yinhang Jueding Tigao Renminbi Cundaikuan Lilu (PBOC Decided to Raise RMB Deposit and Lending Interest Rate), RENMIN RIBAO (PEOPLE’S DAILY), May 15, 1993, 1; Renmin Yinhang Jueding Zaici Tigao Cundaikuan Lilu (PBOC to Raise Deposit and Lending Interest Rate Again), RENMIN RIBAO (PEOPLE’S DAILY), July 11, 1993, 1.

59 See CSRC, supra note 27.

60 Li ZHANGZHE, supra note 31, 350-355.

61 See CSRC, supra note 27.

62 It is a scandal of trading on inside information and manipulating prices of treasury bond futures, which led to the bankruptcy of Wanguo, then the most prominent securities company, and the closure of the market for treasury bond futures for 18 years. See STEPHEN GREEN, supra note 1, 19-21.

63 See CSRC, supra note 27.

The second wave of growth started in early 1996. By then share prices had become very cheap in terms of the price to earnings (P/E) ratio and the average P/E for Shenzhen was just above 9 in 1995. The macroeconomic conditions had also changed. The GDP growth rate dropped, but was still 10.2% in 1995 and 9.7% in 1996, the consumer price index fell to 17.1% in 1995 and further to 8.3% in 1996. As inflation eased, the government cut interest rates twice in 1996. In the meantime, the government’s attitude towards the stock market had also changed. Back in 1992 and 1993 the shareholding system was only an “experiment” for SOE reform and the number of listed companies limited. The stock market was just too small to play a significant role in the reform. In addition, despite his reform credentials and the fact that the Shanghai Stock Exchange was opened under his leadership as the mayor of the city, Zhu Rongji was suspicious of the market, seeing it as being too speculative and of little economic utility. However, by 1996, the previous SOE reform policies had come to a dead end. The SOE sector as a whole recorded a net loss in the first quarter of 1996. SOEs were in desperate need of money, as funding from government budgets was cut off. On the other hand, the stock market seemed to have grown big enough to play a role to quench SOEs’ thirst for funding. Hence the government

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64 Ibid.
66 Ibid.
68 STEPHEN GREEN, supra note 1, 21.
became accommodative and signaled to accelerate the development of the market. Another cause for the rise was that the Shanghai and Shenzhen governments, which still had control over the stock exchanges, were locked in fierce competition to achieve the status of “national financial center” for their city. Various financial incentives were offered to attract new listings and lure securities companies to relocate; regulation was downplayed and fees for share trading were cut to encourage more trading; the governments even instructed securities companies under their control to manipulate up share prices in order to lure people into the markets and boost share trading, and the Shanghai Stock Exchange also used its funds to buy shares to boost share prices.

With these benign conditions, share prices rose and the Shanghai Composite Index climbed steadily from January 22 1996. Investors rushed in and the number of trading accounts increased by more than 10 million in 1996. The value of shares traded on the two exchanges in the year soared almost fivefold. By December, the Shanghai Index had more than doubled and the Shenzhen Composite Index more than quadrupled. As the market rocketed and investors were in ecstasy, the central government became concerned. From October, a series of warnings, decrees, regulations, and official speeches were issued to try to cool down the market, but they had no effect and the market forged ahead. Eventually the government decided to take drastic action. On December 13, a 10% cap for daily price movement was reinstated. On December 16, People’s Daily, the newspaper run by the CPC Central Committee, published an editorial, warning in an exceptionally harsh tone against “excessive speculation” and vowing to bring the

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70 Li ZHANGZHE, supra note 31, 429-430.
72 CSRC, supra note 27.
73 Li ZHANGZHE, supra note 31, 460-464.
market under control. The market reacted in panic and for two days share prices plunged almost to the 10% limit. By December 25 the Shanghai Index had lost more than 31% and the Shenzhen Index more than 43% from the high point of two weeks previously.

As share prices plummeted, the government seemed to feel that the market had overreacted and subsequently placated investors with some reassuring talk. The government also intervened directly to “stabilize” the market on February 20 1997 when the market reacted in panic to the news of Deng Xiaoping’s death. Moreover, stock analysts and media spun the events of Hong Kong’s return to China and the holding of 15th CPC congress, predicting that the government would let the market rise in order to create a festive atmosphere. The market did recover shortly after the crash and by May 1997 the Shanghai index was more than 250 points above the high of 1996. This prompted the government to take new action to rein in the market. The quota for share issuance was raised to RMB5 billion and then to RMB 30 billion for the year; the stamp duty rate was raised; SOEs and listed companies were “strictly prohibited” from share trading; banks were ordered to enhance internal controls to prevent funds being channeled to the stock market; punishments were meted out and several prominent bankers lost their jobs; stock trading centers sponsored by local governments as well as the STAQs and NETS were ordered to close, leaving the Shanghai and Shenzhen Stock Exchange the only venues for stock trading.

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75 Li ZHANGZHE, supra note 31, 478.
76 Ibid, 475-480.
77 Ibid, 520-525.
78 Ibid, 528-530.
Just as these measures had gradually taken effect and share prices cooled, the Asian Financial Crisis swept the region. The financial sectors of those countries affected were hard hit, and their real economies suffered greatly.\textsuperscript{80} Hong Kong, the largest source of foreign direct investment and a major trading partner of Mainland China, suffered a deep economic recession.\textsuperscript{81} While the financial sector of Mainland China escaped unscathed, export, inward foreign direct investment as well as GDP growth decelerated considerably.\textsuperscript{82} In this adverse economic environment, the stock market became dull and share prices moved in a narrow range. The market became much quieter. Interest rates were cut on 4 occasions and the stamp duty rate was also cut, but despite these measures the market remained sluggish until May 1999.

After this wave of growth, the size of the stock market reached a new level. The number of listed companies increased by more than 500 to 851 by the end of 1998 and the market capitalization increased more than fivefold between 1995 and 1998 to nearly RMB2 trillion. The amount of funds raised through IPOs was RMB65.5 billion in 1997, 3 times of the previous highest figure achieved in 1993. The average daily trading value was RMB12.67 billion in 1997, almost a quadrupling of the previous highest figure. The number of trading accounts reached 42.5988 million by the end of 1998.\textsuperscript{83}

3. 1999-2001: The Third Wave of Growth


\textsuperscript{81} Historical data on economic indicators of countries around the world can be found from IMF, \textit{International Financial Statistics}, available on the website of ESDS (Economic and Social Data Service), \url{http://esds80.mcc.ac.uk/wds_ifs/ReportFolders/reportFolders.aspx}.


\textsuperscript{83} CSRC, supra note 27.
The third wave of growth was caused by the boom started from May 19, 1999. Within 40 days the Shanghai Composite Index jumped more than 65%. After some adjustment in the second half of 1999, the market regained its momentum and the upward trend lasted until June 14, 2001 when the Shanghai Index reached a new peak of 2245.\textsuperscript{84} Overall, both the Shanghai and Shenzhen Index more than doubled during this period. This boom is fondly remembered by Chinese investors as the “519 Incident”.\textsuperscript{85} After this new round of growth, the number of listed companies increased to 1160 and the number of trading accounts to nearly 70 million by the end of 2001; market capitalization was over RMB4.8 trillion by the end of 2000, an increase of approximately 150% from the end of 1998; funds raised through IPOs reached a historical high in 2000 of RMB81.237 billion and the average daily trading value was almost RMB20 billion in 2000, an increase of approximately 70% from the previous peak in 1997.\textsuperscript{86}

Underpinning this market boom were again changes in the macro economy and the government’s attitude and policy towards the market. By 1999 the Asian Financial Crisis had subsided and the economy of those countries affected stabilized. The same for the Chinese economy, which saw exports picking up in 1999 and surging in 2000. Inward foreign direct investment also accelerated significantly, as did the GDP.\textsuperscript{87} Moreover, the monetary policy changed dramatically in response to the change from hyperinflation to deflation in 1998 and 1999. Interest rates were cut 7 times between 1996 and 1999, and the one-year deposit interest

\textsuperscript{84} Ibid.

\textsuperscript{85} Li ZHANGZHE, supra note 15, 625-627.

\textsuperscript{86} CSRC, supra note 27.

rate dropped to 2.25% by June 1999.\textsuperscript{88} The bank reserve ratio was also cut twice from 13% in 1998 to 6% in 1999.\textsuperscript{89}

With regard to the change of attitude and policy towards the stock market, the underlying cause was the fundamental shift in SOE reform strategy, which saw the stock market not just a source of funding, but also offering a solution to the intrinsic governance problems of SOEs. As the condition of the SOEs continued to deteriorate, the CPC proposed “to grasp the big and let go the small” in 1995, this being confirmed at the 15\textsuperscript{th} congress of the CPC in 1997.\textsuperscript{90} But, while “letting go the small” was straightforward, there was a question about how “the big” could be “grasped”. To this the CPC decided that the shareholding system was the answer. It claimed that the shareholding system is a neutral form of modern business organization that could be used by socialist countries as well; it could facilitate the separation of management from ownership and help improve the management of SOEs; and corporatization, rather than leading to privatization, would enhance the State’s control over the economy.\textsuperscript{91} It decreed that large and medium SOEs introduce multiple investors, increase equity finance and undertake standardized corporatization reform.\textsuperscript{92} This meant that the stock market had to play an important role in the new reform. The shareholding system and listing on the stock market were thus established as the primary means for the reform of large and medium SOEs. The public announcement by the newly promoted

\textsuperscript{89} Xinhua, Cunkuan Zhunbeijin Lu Lici Tiaozheng (A Chronicle of Adjustment of Bank Deposit Reserve Ratio), available at \url{http://news.xinhuanet.com/ziliao/2009-05/22/content_11420181.htm}.
\textsuperscript{90} Jiang Zemin, \textit{Report to the 15\textsuperscript{th} Congress of CPC}, Sep, 12, 1997, available at \url{http://cpc.people.com.cn/GB/64162/64168/64568/65445/4526285.html}.
\textsuperscript{91} \textit{Ibid}.
premier Zhu Rongji in 1998 to “relieve SOEs from their difficulties within three years” added urgency, and the stock market was critical to the fulfillment of his goal.

Hence it is understandable that the government became very positive towards the stock market. On June 15, 1999, People’s Daily published another editorial, commenting on the recent surge of share prices as being “recovering” and “normal”, in stark contrast in tone to the editorial published in December 1996. It further claimed that a solid foundation had been laid for the stock market to have a “long-term and stable development”, and indicated that a series of supportive measures would be implemented. In the following days the ban on SOEs and listed companies from share trading was lifted; securities companies were allowed to borrow money from banks as well as to access the interbank money market for liquidity; the quota for insurance companies to buy shares on the stock exchanges was raised. All these measures surely contributed to the market boom.

Lastly, the role of frauds needs to be mentioned. Inspired by the “dot-com bubble” in developed economies, fraudsters in China fabricated various hi-tech stories and audaciously engaged in market manipulation, driving up the share prices. Scams of all sorts were widespread and outrageous. The following is just one example. A business man from Hong Kong acquired the state-owned non-tradable shares and therefore control of a listed SOE in Shenzhen. In the meantime 4 companies set up by him with concealed identities secretly bought tradable shares of

95 Ibid, 744, 747.
96 Li Jing, Shuizai Caogong Yi’an Keji? (Who is Manipulating Yi’an Keji?), and Shu Li, Yi’an Keji Hai Meiyou wan (The Yi An Keji case still isn’t over), CAIJING, June 5, 2001.
that SOE on the exchange to a level of 85% of the total. After control changed hands, the listed SOE was re-named as “Yi’an Keji” (Keji meaning “technology and science” in Chinese) and a succession of announcements made promised the start of various hi-tech businesses, such as electric cars, new energy, digital communication, nanotechnology, etc. “It is almost as if Yi’an management had picked up the latest hi-tech weekly and listed out likely products”. Consequently, the share price rose from RMB6.39 to RMB126.31 and the company had the “honor” to be the first listed company in China whose share price surpassed RMB100. Before long all this turned out to be a fiction and the share price crashed, but the fraudster had already made handsome profits. Because cases like this were common, it could be said that the boom was pretty much a Chinese version of the “dot-com bubble”, but driven by frauds.

C. 2001-2005: The Stock Market in Crisis

After reaching the historical high on June 14, 2001, Shanghai and Shenzhen market closed the day at a loss. This marked the start of a bear market lasting for 4 and a half years. Share prices lost more than half during this period and on June 6, 2005 the Shanghai Composite Index breached the symbolic low point of 1000. As share prices slumped, investors sold out and withdrew from the market in droves. For example, in 2005 on the Shenzhen Stock Exchange, for all the trading accounts, only 33% held stocks. The market shrank considerably. Between 2000 and 2005 market capitalization decreased from more than RMB4.8 trillion to less than RMB 3.25 trillion and the ratio to GDP from 48% to 18%. Funds raised through IPO declined from RMB81.24 billion in 2000 to RMB5.67 billion in 2005, and IPO was suspended 3 times

97 WALTER & HOWIE, supra note 2, 271.


during this period. The securities companies as a whole were in the red for 4 years from 2002 to 2005 and the loss in 2002 was nearly RMB40 billion, while net assets of the whole sector were only RMB76.5 billion at the end of 2000. Throughout the period the market was gripped by bitter debates triggered by a prominent economist’s public denouncement of the stock market as “worse than a casino”, and the suggestion that the market should be “closed down and a new one started from scratch”.

The crisis of the market happened when the Chinese economy was in its best shape. Between 2001 and 2005 GDP growth accelerated from 7.3% to 9.9% and the average growth rate was 9.1% between 2002 and 2005. Exports skyrocketed after entry into the WTO in 2001, as did the inward FDI. On the other hand, inflation stayed at a low level with the consumer price index below 2% except for all but one year, and so interest rates were kept low throughout the period. It is puzzling why the stock market drifted into a crisis when the macro

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101 Ibid, 63.


103 See supra note 1.


106 Ibid.

107 Ibid. Consumer price index was 3.9% in 2004.
economy was in such good form. Many investors and commentators blamed the government’s decision in June 2001 to sell down state shares on the market. The explanation is that investors feared there would be an oversupply of shares and the market would be overwhelmed. The evidence cited to support this explanation was the drop in share prices after the decision was announced and the jump after the government suspended and finally reversed the decision. But there was the view that, with an average P/E ratio at 58.22 in Shanghai and 56.04 in Shenzhen in 2000, the market was in fact in a huge bubble and that a correction was inevitable. Moreover, the market was shaken repeatedly by a series of frauds. These included market manipulation like the case of “Yi’an Keji”, stock cornering, falsifying the financial information of listed companies, the misappropriation of their funds by controlling shareholders, and of stock traders’ funds by securities companies. It is also noticeable that, despite the good macroeconomic conditions, the number of companies making loss increased significantly. In 2001, 150 listed companies, 12.9% of the total, made a loss. Among them, 20 had made a loss continuously for 3 years and thus

108 The State Council decided in June 2001 that, when a SOE issues shares through IPO or secondary issue on stock exchanges, existing state shares should also be sold to raise funds for the National Social Security Fund. The number of state shares to be sold should be 10% of the new shares to be issued. See State Council, Interim Measures on the Management of Reducing State Shares and Raising Social Security Funds, June 12, 2001, available at www.chinalawinfo.com.

109 See LU YI, supra note 41, 158-160.


could be delisted according to new regulations introduced by the CSRC.\textsuperscript{112} The number of loss-making companies increased to 253 in 2005, 18.57\% of the total.\textsuperscript{113}

Whatever the causes for the crisis, the government decided to “save” the market rather than close it down. Responding to heavy criticism and a sharp fall in share prices, the government caved in and abandoned the plan to sell state shares on the domestic exchanges. This however only produced a short-lived rally and the downward trend continued. The traditional supportive measures were tried such as cutting stamp duty, suspending IPO, and giving positive talks given by government officials. Even the ban on government officials and party cadres trading shares was lifted.\textsuperscript{114} But this time none of these worked and share prices kept falling. Even the CPC’s declaration in 2003 that the shareholding system should be the major organizational form for SOEs, and that enterprises with diversified ownership should be greatly developed, did not stop the fall.\textsuperscript{115}

As the crisis intensified, the government realized that fundamental changes were needed. So crackdowns on market manipulation were carried out, and some notorious fraudsters were sent to prison; the third-party custody of client’s funds was implemented to ensure that they could no longer be misappropriated by securities companies; a campaign was undertaken to force misappropriated funds to be returned; special regulations were adopted to afford minority

\begin{itemize}
\item \textsuperscript{112} Li ZHANGZHE, supra note 15, 342.
\item \textsuperscript{113} Zhang Xiyu, Nianbao Pilu Wanbi, Shangshi Gongsi Jing Lilun Wunian Lai Shoudu Huiluo (The Publication Annual Reports has Completed, Net Profits of Listed Companies Fall for the First Time Since 5 Years Ago), SHANGHAI ZHENGQUAN BAO (SHANGHAI SECURITIES NEWS), May 8, 2006, available at \url{http://finance.sina.com.cn/stock/t/20060508/0000677860.shtml}.
\item \textsuperscript{114} Li ZHANGZHE, supra note 15, 331-333.
\end{itemize}
shareholders more say in governing their companies; the Company Law, Securities Law and Criminal Law were revised to offer minority shareholders more protection and to punish information falsification and misappropriation of corporate assets; to ensure that only companies with good performance could be listed, the quota system for listing was replaced by a system of underwriter recommendation, which was replaced again by the system of underwriter sponsoring; to develop institutional investment, the National Social Security Fund (NSSF), insurance companies and enterprise pension funds were allowed to buy stocks, Qualified Foreign Institutional Investors (QFII) were introduced and the development of mutual funds was greatly encouraged; non-tradable share reform was implemented to allow state and legal person shares to be tradable; a new board was set up at the Shenzhen Stock Exchange in May 2004 to allow small and medium-sized enterprises to access the stock market and support the development of hi-tech industry.  

D. 2006 to Date: An Enormous Bubble, Spectacular Crash and Prolonged Bear Market

After the failure of the plan to sell state shares, how state and legal person shares could be converted into tradable shares and reduced on the market became a heatedly debated issue. It was said that the non-tradability of state and legal person shares was the biggest problem facing the stock market and resolving this was fundamental to its revival. As the market faced a looming collapse, the government was under huge pressure to tackle the issue. In April 2005 the CSRC

116 CSRC, supra note 99, Chapter 2.

launched a pilot reform scheme, which was later extended to all companies. The essence of the scheme was that owners of non-tradable shares were required to pay owners of tradable shares “consideration” in order for their shares to be tradable, but the form and amount of the “considerations” were determined case by case through negotiation with tradable share owners having the right to approve or reject; even after becoming tradable, non-tradable shares were subject to lock-up over a phased period of 3 years. The reform went quickly and by the end of 2006 had largely been completed.

The reform was said to be very successful and credited with triggering the revival of the market, which turned into an enormous bubble. Share prices rose steadily from the beginning of 2006. In the second half of the year the market picked up momentum and rose sharply. On December 14 the Shanghai Composite Index surpassed the previous record high achieved in 2001 and by the end of the year rose more than 130%. The market entered 2007 with a choppy start but then continued its upsurge. As share prices shot up and investors rushed in, the government became increasingly concerned that a bubble was being formed and warnings were given. The economy had also become overheated, and after mid-2006 interest rates were raised four times, and the bank deposit reserve ratio seven times. On May 30, 2007 stamp duty was raised and stock indices recorded a huge loss. But the market later shook this off and surged

118 CSRC, Measures for the Administration of the Reform of Non-Tradable Shares, Art. 5, 10, 16 and 27, adopted on Sep. 4, 2005.
120 CSRC, supra note 99, 53.
121 Li ZHANGZHE, supra note 15, 454.
122 Ibid, 455-456.
ahead, eventually peaking on October 16 when the Shanghai Composite Index reached 6124, more than 5 times its level at the beginning of 2006. Subsequently, as the Global Financial Crisis intensified, the market embarked on a free fall. In the year to October 28, 2008, the Shanghai Composite Index dropped almost 75% to 1664.93. The government took a series of actions to prop up the market. Stamp duty was cut twice, IPO was again suspended and state-affiliated controlling shareholders as well as listed companies were ordered to buy shares on the market.

During this round of boom, the market grew to become one of the biggest in the world. Funds raised through IPOs soared to RMB459 billion in 2007, by far the largest amount in the world and more than 5 times the previous high in 2000. The government was able to list major SOEs including the gigantic state-owned commercial banks on the domestic exchanges. Market capitalization increased to RMB32.7 trillion in 2007, 123% of the total GDP and more than 6 times the previous peak in 2000. Average Daily trading value was more than RMB190 billion, nearly 4 times the previous high in 2000. The number of trading accounts reached 143 million by the end of 2007, increasing by almost 70 million.

From September 2008 the magnitude of the Global Financial Crisis surfaced. China was hard hit. Export grew by 25.7% in 2007 and 17.2% in 2008, but decreased by 27.2% for the first 2 months of 2009. Inward FDI decreased by 32.7% in January 2009. GDP decelerated

124 CSRC, supra note 27.
125 LI ZHANGZHE, supra note 15, 483.
126 See CSRC, supra note 27.
rapidly from a growth rate of 11.9% in 2007 to 6.1% in the first quarter of 2009.129 Thousands of factories were closed and tens of millions of migrant workers lost their jobs.130 Facing a looming economic crisis, the Chinese leadership made a dramatic change of economic policy. In November 2008, the State Council announced to spend RMB4 trillion to stimulate the economy—the so-called “4 trillion Yuan stimulus program”.131 The restrictive monetary policy was swiftly reversed. Interest rates and bank deposit reserve ratio were cut 4 times in the last 4 months of 2008;132 bank lending quotas were scrapped,133 and new bank lending almost doubled in 2009 to RMB9.59 trillion, more than twice of the RMB4 trillion stimulation spending.134

The stock market responded fiercely with a sharp rebound from late 2008. The Shanghai Composite Index rose from the trough of 1664.93 in 2008 to 3478.01 on August 4 2009. But the rally lasted less than one year. The market lost steam after August 2009 and share prices tumbled in 2010 with the Shanghai Index losing 16.04%. Concerned about the deluge of bank lending, the government raised the bank deposit reserve in early 2010. As inflation emerged in late 2010,

bank reserve was further raised several times, as were the interest rates.\(^{135}\) In the meantime, the
effect of the stimulation quickly tapered off and GDP growth dropped from 10.3% in 2010 to 9.2%
in 2011 and 7.8% in 2012.\(^{136}\) Moreover, as the market regained buoyancy in 2009, IPO resumed
and a large number of companies conducted IPO on the ChiNext, a new board opened in
Shenzhen in early 2009 to list growth companies. Funds raised from the stock market in 2010
even surpassed the boom year of 2007.\(^{137}\) For all these reasons, the market continued its
downward trend throughout 2011, 2012 and 2013. The Shanghai Index dropped from the high
point of 3478 in 2009 to below 2000 in early July 2013. As GDP growth fell below 8%, the
government loosened its monetary policy somewhat at the end of 2011 and early 2012 and
quietly instituted a “stimulus 2.0” in May 2012,\(^{138}\) but the impact on economic growth was
negligible, like it was on the stock market.

As share prices decreased, the stock market seemed to have drifted into another crisis.
The average daily trading value dropped from more than RMB225 billion in 2010 to less than
RMB80 billion in November 2012.\(^{139}\) Of all the trading accounts, less than 40% held stock at the
end of 2012.\(^{140}\) Under huge pressure from stock traders, the CSRC suspended IPO once again in

\(^{135}\) Xinhua, supra note 89.


\(^{137}\) CSRC, supra note 27.

\(^{138}\) Ed Zhang & Huang Ying, ‘Stimulus 2.0’ Aims to Reboot Growth, *China Daily*, June 1, 2012, available at
http://www.chinadaily.com.cn/bizchina/2012-06/01/content_15445847.htm.


http://www.chinaclear.cn/main/03/0304/0304_1.html.
November 2012 and has not resumed it to this writing.\textsuperscript{141} Criticisms and debates about the future of the market raged again. The reform-minded CSRC chairman, Guo Shuqing, was removed after a stint of only 18 months.\textsuperscript{142}

**II. THE DEVELOPMENT OF LEGAL AND REGULATORY FRAMEWORK AND INVESTOR PROTECTION**

The development of legal and regulatory framework governing the stock market in China can be broadly divided into three stages. The first is the period before 1993, during which laws and regulations were minimal, rudimentary and local governments were in the driver’s seat in managing the market. The second is the period between 1993 and 2000, during which legislation was rapidly adopted, a legal framework was created and the central government eventually took full control over the market. The third stage started from 2001, when the government, driven by scandals and crises in the market, began to tighten up and improve the enforcement of laws relevant to investor protection.

**A. The First Stage Before 1993**

Since China’s stock market emerged spontaneously from bottom-up, there was no law governing company formation, share issuance and transfer, shareholders’ liability, etc. at the very beginning. It seems the first such type of legislation in the country was a 1984 document drafted by the PBOC Shanghai Branch and ratified by the Shanghai Municipal Government,


which comprised only 8 articles.\textsuperscript{143} At the national level, the first was a 1985 document issued by the State Administration for Industry and Commerce permitting company registration and stipulating some basic criteria for it.\textsuperscript{144} Apart from this, the central government remained hands-off and there was no more company legislation until May 1992 when two documents were published by one of the ministries.\textsuperscript{145} Throughout this period no such laws were made by the legislature, the National People’s Congress (NPC) or its Standing Committee, nor by the State Council, except several decrees to allow or restrict the experimentation of the shareholding system.\textsuperscript{146} It was also unclear at the beginning which ministry had the regulatory authority. Only in 1986 by a regulation on the banking sector did the PBOC incidentally acquire the mandate to license non-bank financial institutions and to regulate stocks and bonds.\textsuperscript{147} But the PBOC system was decentralized before 1998 in that local branches were effectively controlled by local governments rather than by the PBOC in Beijing, and the same regulation actually offered

\begin{itemize}
\item \textsuperscript{143} Guanyu Faxing Gupiao De Zanxing Guanli Banfa (Interim Measures on the Administration of Share Issuance), promulgated by the Shanghai Municipal Government on Aug. 10, 1984, available at \url{http://www.law-lib.com/law/law_view.asp?id=46101}.
\item \textsuperscript{145} See infra note 156.
\item \textsuperscript{146} For example, see Guanyu Jiaqiang Gupiao Zhaiquan Guanli De Tongzhi (Notice on Strengthening the Administration of Stocks and Bonds), issued by the State Council on Mar. 28, 1987; Guanyu Xiang Shehui Gongkai Faxing Gupiao De Gufenzhi Shidian Wenti De Tongzhi (Notice on Issues Related to the Experimentation of Shareholding System with Shares being Publicly Issued), issued by the State Council General Office on Dec. 26, 1990, available at chinalawinfo.com.
\item \textsuperscript{147} Zhonghua Renmin Gongheguo Yinhang Guanli Zanxing Tiaoli (Interim Regulations of the People’s Republic China on Bank Administration), Art. 5, 22 & 25, promulgated by the State Council on Jan. 7, 1986, available at chinalawinfo.com.
\end{itemize}
provincial PBOC branches significant power in licensing financial institutions.\footnote{Ibid, Art. 25. Originally local governments controlled the personnel administration and were responsible for funding local PBOC branches. Following a decision made by the CPC and State Council in 1998, provincial PBOC branches were abolished and 9 cross-province regional branches were set up in an aim to cut off the control of local governments over PBOC branches. See Guanyu Shenhua Jinrong Gaige, Zhengdun Jinrong Zhixu, Fangfan He Huajie Jinrong Fengxian De Tongzhi (Notice on Deepening Financial Reform, Rectifying Financial Order, Preventing and Defusing Financial Risk), issued by the Central Committee of CPC and the State Council on Dec. 6, 1997, available at \url{http://cpc.people.com.cn/GB/64184/64186/66688/4494459.html}.} Therefore, before the CSRC was set up in 1993, local governments, especially those in Shanghai and Shenzhen, ran the show in managing stock markets. Despite being the ministry having the regulatory responsibility and power, the PBOC in Beijing during this period adopted only one major piece of relevant legislation, a regulation regarding securities companies.\footnote{Zhengquan Gongsi Guanli Zanxing Banfa (Interim Measures on the Administration of Securities Companies), promulgated by PBOC on Oct. 12, 1990, available at chinalawinfo.com.}

From the very beginning local governments were the experimenters and promoters of the shareholding system. Their attitude became more enthusiastic after mid-1980s when the far-left ideology was further loosened. Rules were promulgated by governments in different areas to guide experimentation. For example, between 1985 and 1990 rules concerning share issuance and transfer were adopted by provincial governments of Shaanxi, Guangdong, Fujian, Heirongjiang and by municipal governments in Beijing, Xiamen, Guangzhou, etc. In Shenzhen the municipal government passed a legislation to guide the experimentation of transforming SOEs into shareholding companies.\footnote{Shenzhen Jingji Tequ Guoying Qiye Gufenhua Shidian Zanxing Guiding (Interim Provisions of Shenzhen Special Economic Zone on the Experimentation of Shareholding System by SOEs), promulgated by Shenzhen Municipal Government on Oct. 15, 1986, in JIANG PING, supra note 19, 2815-18.} This was the first company legislation in the country adopted to guide the corporatization reform of SOEs. In Shanghai the document issued in 1984 was superseded by a longer one and rules regarding OTC stock trading were issued by the PBOC.
Shanghai Branch in 1987. However, when these rules were adopted, investor protection was not yet on the agenda. The purpose was to lay down some rules for share issuance and the major contents concerned the criteria and approval procedure for enterprises to issue shares. All this legislation was rudimentary at best. For example, the 1987 document of Shanghai supplanting the 1984 one had only 4 articles on share transfer. Shareholders’ rights were not mentioned in much of this legislation, and even the most sophisticated laws of Shenzhen, which had the advantage of borrowing from across the border in Hong Kong, only stipulated shareholders’ rights vaguely to participate in management and supervision and to receive dividends and surplus. It was unclear what remedies were available to shareholders if their interests were damaged. Lastly, the constitutional foundation of these local laws was feeble, as demonstrated by the fact that the central government later refused to recognize some companies set up according to them.

To lay down operational rules for the Stock Exchanges, the government of Shanghai and Shenzhen in 1990 and 1991 promulgated more detailed rules for securities issuance, listing and trading. In Shanghai the PBOC branch also ratified a lengthy document governing securities

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153 Supra note 150, Art. 7.


155 Zhengquan Jiaoyi Guanli Banfa (Measures for Administration of Securities Trading), promulgated by Shanghai Municipal Government on Nov. 27, 1990, available at chinalawinfo.com; Gupiao Faxing Yu Jiaoyi Guanli Zanxing
listing and trading.\footnote{Shanghai Zhengquan Jiaoyisuo Jiaoyi Shichang Yewu Shixing Guize (Trial Rules of the Shanghai Securities Exchange on Market Trading Operation), promulgated by the Board of Directors, Shanghai Securities Exchange, and ratified by the Shanghai Branch of PBOC on Nov. 26, 1990, available at chinalawinfo.com.} These rules stipulated some requirements for information disclosure and prohibition against insider trading and market manipulation, but it is questionable that investor protection was a serious consideration, as information was required to be disclosed only to the government but not to investors, and there was little elaboration on the prohibition of insider trading and market manipulation.\footnote{See Pitman B. Potter, \textit{The Legal Framework for Securities Markets in China: The Challenge of Maintaining State Control and Inducing Investor Confidence}, \textit{7 China L. Rep.} 61-94 (1992), 86-87.} Anyway, the two stock exchanges were tiny and in the doldrums before Deng Xiaoping’s “Southern Tour” triggered the explosion of 1992. Following this, a large number of legislation was enacted and the 3 rules issued in May 1992 by the State Commission for Restructuring the Economic System (SCRES) were the most prominent and authoritative.\footnote{Gufenzhi Qiye Shidian Banfa (Measures on Experimenting with the Shareholding Enterprise), Gufen Youxian Gongsi Guifan Yijian (Opinion on Standards for Companies Limited by Shares), and Youxian Zeren Gongsi Guifan Yijian (Opinion on Standards for Limited Liability Companies), available on chinalawinfo.com.} However, they soon became obsolete after the Company Law and other regulations on the stock market were adopted in 1993.

\textbf{B. The Second Stage Between 1993 and 2000}

The explosion of share issuance ignited by Deng’s “Southern Tour” threw the financial and economic plan into disarray. The riot in Shenzhen further demonstrated that a chaotic market would not only be a risk to the financial system and economic order, but would also pose a serious threat to social stability, a major concern for the leadership in Beijing after the “Tiananmen Incident”. The riot highlighted the urgency to control the stock market and instill

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\textbf{Shanghai Zhengquan Jiaoyisuo Jiaoyi Shichang Yewu Shixing Guize (Trial Rules of the Shanghai Securities Exchange on Market Trading Operation), promulgated by the Board of Directors, Shanghai Securities Exchange, and ratified by the Shanghai Branch of PBOC on Nov. 26, 1990, available at chinalawinfo.com.}


\textbf{Gufenzhi Qiye Shidian Banfa (Measures on Experimenting with the Shareholding Enterprise), Gufen Youxian Gongsi Guifan Yijian (Opinion on Standards for Companies Limited by Shares), and Youxian Zeren Gongsi Guifan Yijian (Opinion on Standards for Limited Liability Companies), available on chinalawinfo.com.}
order. The top leadership believed that the incomplete laws on the one hand and the fragmented and decentralized regulatory system on the other were to blame for the mayhem. In October 1992 the State Council announced the establishment of a specialized regulatory system, consisting of the State Council Securities Committee (SCSC) and the China Securities Regulatory Commission (CSRC). At the end of 1992, the State Council published a document, clarifying the responsibility and power of the SCSC and CSRC. The SCSC would be a meeting system of senior government officials, responsible for, policy formulation, coordination and organizing laws and regulations drafting, while the CSRC would be the executive of the SCSC, responsible for enacting regulatory rules and supervising share issuance and trading and securities intermediaries. The same document proclaimed that a sound legal system was the precondition for a healthy market and ordered to speed up legislation. Specific laws, regulations and the respective governmental departments responsible for drafting were listed. In addition, a quota system for share issuance was adopted and rules on distributing the quota and procedure for approving issuance were specified.

1. Creating a Legal Framework

After the new system came into operation, great efforts were put into legislation, which soon bore fruits. In April 1993, the Interim Regulations on the Administration of Share Issuance

160 Ibid, Part I.
161 Ibid, Part V.
162 Ibid, Part II & III.
and Trading was promulgated.\textsuperscript{163} This formed the pillar of the legal system until the Securities Law was enacted in 1998. It was comprehensive, covering a wide range of issues, such as the conditions and approval procedure for companies to make public offerings, the documents that are required for approval and compulsory contents of prospectus, underwriting and subscription, conditions and procedure for listing, and depository and clearing rules. Listed companies were required to publish both annual and semi-annual reports and disclose material price-sensitive information. Based on the City Code of the UK, rules on hostile takeovers were laid down. Insider trading, information misrepresentation and manipulating share prices were prohibited and penalties against such frauds were spelt out. The CSRC was authorized to investigate violations. On paper these provisions were “thorough and demanding”, comparable to securities regulations from developed economies in the area of investor protection.\textsuperscript{164} Following this legislation, detailed rules were issued by the SCSC and CSRC in 1993 to implement the provisions on information disclosure and anti-securities frauds.\textsuperscript{165}

Regulations and rules were adopted later by SCSC and CSRC to govern other relevant issues, such as organizing and managing stock exchanges, regulating securities companies and securities business like underwriting, proprietary trading, investment consulting and fund management, qualification and disqualification of securities practitioners, etc. Special rules were


\textsuperscript{165} Gongkai Faxing Gupiao Gongsi Xinxi Pili Shishi Xize (Shixing) (Detailed Implementing Rules on Information Disclosure by Publicly Issuing Companies (Trail Implementation)), promulgated by the CSRC on June 12, 1993; Jinzhi Zhengquan Qizha Xingwei Zanxing Banfa (Interim Measures on Preventing Securities Frauds), promulgated by the SCSC on Sep. 2, 1993, available at chinalawinfo.com.
passed to regulate issuing and listing domestically listed foreign-invested shares (B shares) and overseas offerings and listings.\textsuperscript{166} Last but not least, abundant numbers of normative documents, \textit{ad hoc} notices, etc. were issued, dealing with specific issues, responding to changes or providing operational guidance. For example, by 1998 the CSRC had published 7 documents mandating the contents and format for prospectuses, annual and semi-annual reports, prospectuses for rights issues, report for changes of shareholding, lawyers work reports and so on. The total number of relevant laws, regulations and rules had exceeded 250 by 1998.\textsuperscript{167}

In December 1993 the Company Law was adopted by the Standing Committee of NPC, finally providing a solid legal footing for corporatization reform and developing the stock market. However, this legislation was criticized for its conservatism left over from the era of planned economy as well as multiple legal flaws.\textsuperscript{168} At the beginning the law incongruously proclaimed that state assets of a company belong to the state.\textsuperscript{169} Moreover, while two types of company, limited liability company (similar to close or private company) and company limited by shares (equivalent to joint stock or public company), were allowed in general, only SOEs enjoyed the

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\textsuperscript{169} Zhonghuo Renmin Gongheguo Gongsi Fa (Company Law of PRC), Art. 4, adopted by the 5\textsuperscript{th} Session of the Standing Committee of the 8\textsuperscript{th} NPC on Dec. 29, 1993 and effective July 1, 1994, available at chinalawinfo.com.
\end{flushleft}
privilege to be organized as a limited liability company with only one shareholder. In terms of investor protection, the law did not provide for directors’ fiduciary duties; some important shareholders’ rights, such as the right to propose resolution and the preemptive right of shareholders of company limited by shares, were absent; and shareholders did not have recourse to remedies such as the derivative action.

In contrast to the swift pace in enacting these laws and regulations, the adoption of the Securities Law was long delayed, even though its drafting started quite early in July 1992. It was the first time in China’s legislative history that the NPC Standing Committee took charge of drafting a law. But bitter disputes on some key issues and a turf war between two departments of the NPC Standing Committee soon broke out. The drafting was stalled until top leadership intervened in the wake of the Asian Financial Crisis. The Law was eventually passed in December 1998 and took effect from July 1st 1999. Basically, it was a codification of previous regulations and rules regarding public issuance of securities, underwriting, listing, trading, information disclosure, anti-securities frauds, hostile takeover, regulating stock exchanges, securities companies, clearing and settlement, investment consulting, penalties, etc. Some provisions were made to confirm policy changes, such as abolishing the quota system for share issuance and establishing a unified regulator. There were also some technical changes and improvements, like in the area of hostile takeover. Some controversial and unsettled issues like

170 Ibid, Art. 64.

171 Nicholas C. Howson, supra note 168, 142-144 &148-150.


the OTC market were left untouched. Overall, the law was rigid and restrictive, reflecting the government’s approach of control and heavy regulation, which could be partly explained by the fact that the market was then in a state of wild speculation and lawlessness. Nevertheless, the enactment of the Securities Law marked that a basic legal framework for the governance of the stock market had been established.

On the criminal legislation front, the first action taken by the government was a decision passed by the NPC Standing Committee in 1995 to punish violations of the Company Law. The corporatization reform created uncertainty as to whether the criminal liabilities stipulated in the Criminal Law 1979 against graft and bribe-taking by state personnel and SOE managers were applicable to managers of companies with mixed state and private ownership. In the meantime, although the Company Law stated that embezzlement, misappropriation and bribe-taking by company managers were criminally punishable, neither the Company Law nor the Criminal Law 1979 specified what the punishments would be. This created a potential loophole whereby miscreant company managers might escape criminal punishment. To fill the gap, the NPC adopted the decision to provide for punishments for those misconducts. In addition, the same decision provided for punishments for fraudulent or unapproved public offerings as well as misrepresentation in the form of supplying false financial reports, which were criminalized by

175 Ibid, 1008-1009.
178 Decision 1995, Art. 9, 10 & 11.
179 Ibid, art. 3, 4 & 7.
the Company Law similarly but punishments were not specified. These provisions were codified when the Criminal Law 1979 was amended in 1997. The 1997 amendment also added punishments for insider trading, divulging inside information, fabricating and spreading false securities information and manipulating share prices by way of trading. These misdeeds were criminalized by the Interim Regulations on the Administration of Share Issuance and Trading and the implementing rules on anti- securities frauds issued by the CSRC in 1993, but punishments were not specified. After the 1997 amendment, legislative loopholes were closed. But new ones opened after the enactment of the 1998 Securities Law, which designated more misdemeanors as criminally punishable, without stipulating punishments.

2. Establishing a unified and centralized regulatory system

The problem of a fragmented and locally-controlled regulatory system was far from being solved with the establishment of SCSC and CSRC in 1992. Although SCSC and CSRC were designated as the market regulators, other ministries shared responsibility and power. The State Planning Commission had a say in formulating and distributing quotas for share issuance; the PBOC was responsible for licensing and supervising securities institutions and investment funds; the Ministry of Finance was responsible for supervising the accounting industry. In the meantime, CSRC was overshadowed by other ministries in that its administrative ranking was lower, and its authority to issue and enforce rules was questioned, as it was designated as a non-

181 See supra note 163 and 165.
183 See the State Council, supra note 159, Part I.
governmental entity.\textsuperscript{184} In terms of resources, it was limited to only 100 staff and funding was insecure.\textsuperscript{185} At the local level, the Shanghai and Shenzhen Stock Exchange were still under the control of Shanghai and Shenzhen government.\textsuperscript{186} Following the central practice, the Shanghai and Shenzhen government also set up their own specialized regulators in 1993 and governments in other provinces and cities later followed suit. But these local regulators were under the command of respective local governments and CSRC had no jurisdiction. To sum up, CSRC was weak, isolated and lacking authority. It had trouble accessing information on the ground, as it did not have physical presence at the two exchanges until late 1997 and the reporting requirements laid out in a SCSC notice were regularly ignored.\textsuperscript{187}

It was a series of scandals that led to changes. The “327 treasury bond futures” scandal plainly exposed the mismanagement and lax attitude towards regulation and risk control at the Shanghai Stock Exchange. The competition between the two municipal governments to boost stock trading and using local securities companies and bank money to manipulate shares prices further revealed the danger of leaving local government in control. The first step taken by central government was to remove the two municipal governments from the control of the stock exchanges. In August 1996 SCSC issued Measures for the Administration of Stock Exchanges,\textsuperscript{188} replacing the provisional 1993 predecessor. Significant changes were made to Article 4, which now stated that stock exchanges were under the administration of CSRC, and

\textsuperscript{184} Ibid.
\textsuperscript{185} See LIU HONGRU, supra note 14, 212.
\textsuperscript{186} See the State Council, supra note 159, Part I.
\textsuperscript{188} Zhengquan Jiaoyisuo Guanli Banfa, issued by the SCSC on Aug. 21, 1996, available at chinalawinfo.com.
Article 22 and 24, which gave CSRC the power, in deliberation with the local governments, to nominate the chairman and vice chairman of the board of directors for election and to appoint general and vice general managers of stock exchanges. In July 1997 the General Office of the State Council gave notice that the two stock exchanges were to be under the “direct” administration of CSRC and CSRC was to have the exclusive power over personnel management. The Measures were subsequently amended to accommodate this change. On August 14, 1997 the General Manager of the Shanghai Stock Exchange was replaced by an official from CSRC, marking the end of local control of stock exchanges.

The Asian Financial Crisis prompted further changes. Witnessing the devastating effects a weak financial sector had on the whole economy in those crisis-hit countries, top Chinese leadership decided it was time to put its own unruly financial sector in some order. In November 1997 the Central Committee of CPC and the State Council held a national financial conference in Beijing and decided, first, to centralize the administration and personnel management of the PBOC, state-owned commercial banks and other financial institutions, and second, to enforce the principle of separated businesses so that commercial banks were required to divest their securities and other non-banking businesses. Regarding securities regulation, the establishment was announced of a unified regulator with local regulators put under CSRC’s control. To implement these decisions, SCSC was abolished and CSRC was upgraded to the

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191 See the Central Committee of the CPC and the State Council, supra note 148.
192 Ibid, Part XII.
ranking of a full ministry in April 1998. The power of licensing and supervising securities institutions and investment funds was transferred from PBOC to CSRC. In the meantime, CSRC took over existing local regulators and established new ones in economically important cities. By July 1999 this process was complete and all local regulators were under the jurisdiction of CSRC. A unified and centralized regulatory system was thus established. CSRC’s authority over the stock market was no longer disputed, and it was a physical presence all over the country.

C. The Stage From 2000 to Date

After the unified system was established, an urgent issue that CRSC needed to tackle was the poor corporate governance of listed companies. Early in 1994 the Chinese government issued a document to regulate companies’ articles of association, but it was only applicable to companies issuing and listing shares on overseas stock exchanges and the purpose was to ensure those companies meet the corporate governance standards of those overseas markets. In 1997 a similar document was adopted by CSRC for companies listed on the domestic stock exchanges. But by the end of 1990s the problem of poor quality of listed companies had fully surfaced. A large number of listed companies lost money and some of them had been losing continually for years, despite the short history of the stock market. In 1998 the Shanghai and Shenzhen Stock Exchange came up with the “ST” (Special Treatment) label to mark companies having made a loss for 2 years and in the following year the “PT” (Particular Treatment) for companies losing for 3 years. 26 companies were marked with “ST” in 1998 and this number

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193 Dao Jingwai Shangshi Gongsi Zhangcheng Bibei Tiaokuan (Mandatory Articles of Association for Overseas Listed Companies), promulgated by the SCSC and SCRES on Aug. 27, 1994, available at chinalawinfo.com.
194 Shangshi Gongsi Zhangcheng Zhiyin (Guiding Articles of Association for Listed Companies), Issued by the CSRC on Dec. 16, 1997, available at chinalawinfo.com.
increased to 66 by 2000. The number of “PT companies” increased from 4 in 1999 to 20 by 2001 and 150 companies, 12.9% of the total, made a loss in that year. It had become apparent that corporate governance of listed companies was in need of improvement. The change of leadership at the CSRC in early 2000 also facilitated a shift of focus on corporate governance in that the new chairman, Zhou Xiaochuan, who was regarded as capable, reform-minded and experienced in international finance, identified corporate governance as critical to a healthy market. During his 34 months’ tenure, 2 initiatives were implemented. The first was introducing an independent director system. A document issued by the CSRC in August 2001 decreed that at least one third of board directors of listed companies should be independent by mid-2003. The second was the issuing in January 2002 of a corporate governance code for listed companies, inspired by the OECD Principles of Corporate Governance, but much more detailed, and addressing governance problems that were particularly serious in Chinese companies, such as the prevalence of related-party transactions, dominance of controlling shareholder, dependence of listed companies on their controlling shareholder for business and operation, and so forth.

196 Li Zhangzhe, Ibid, 342-346.
Zhou Xiaochuan also emphasized the importance of law enforcement. But the sharp increase in enforcement activities from 2000 was driven more by scandals. 2000 and 2001 are remembered in the history of China’s stock market for the revelation of a series of outrageous scandals. Following are a few examples: In October 2000, Caijing published an investigatory report on the shady investment fund sector;\(^2\) December saw the debacle of the intricate and sprawling manipulation scheme of Zhongke Chuangye;\(^3\) the crude but audacious manipulation of Yi’an Keji collapsed after the CSRC announced an investigation in April 2001;\(^4\) in August 2001 the CSRC announced a public criticism of Sanjiu Yiyao and its board of directors for not disclosing the misappropriation of billions of RMB by its controlling shareholder;\(^5\) in the same month the extraordinary story of a blue-chip, high-growth company, Yinguangxia, came to an abrupt end after Caijing discovered that it was all a total fiction and its profits were completely fabricated.\(^6\) It was because of these scandals that the preeminent economist, Wu Jinglian, condemned the market as “worse than a Casino”, a statement resonating strongly with investors. Amid a public outcry, action was taken by the CSRC to investigate these scandals and punishments were meted out, a process helped by the newly established and expanded regulatory system. With share prices dropping further after 2001, more scandals were exposed. Market manipulators found they were now in an unenviable position in that they could not sell down the


\(^3\) Hu Shuli et al., Zhuangjia Lu Liang (Market Manipulator Lu Liang), CAIJING, Feb. 5, 2001.

\(^4\) See Li Jing, supra note 96.


shares that they had secretly accumulated, as retail investors withdrew from the market. Instead, to maintain high prices more money was needed, which they now found difficult to access. In the end a large number of manipulation schemes failed and share prices collapsed. Securities companies and other fraudsters that had engaged in these crimes made huge losses and could not repay the funds they had stolen from their clients or raised from other sources. The central government had to step in to plug the hole. The CSRC acted like a firefighter. They not only needed to investigate the scams and punish the culprits, but also to close down or restructure the miscreant securities companies and clean up the mess that had been left. In the process, various rules were adopted to better control the securities companies.

Another problem that needed to be tackled urgently was the misappropriation of corporate funds by controlling shareholders and listed companies offering guarantees for loans borrowed by their controlling shareholders or affiliates. The seriousness of the problem was highlighted by the scandal of Sanjiu Yiyao. More than RMB2.5 billion, equivalent to 96% of its total net assets, was channeled from the company to its controlling shareholder and more than RMB1.1 billion was “lent” to one of its sister companies. In 2001 the CSRC instructed listed companies to recover these “loans” from their controlling shareholders. But this was ignored and more funds of more listed companies went missing. In 2003, the CSRC, with the newly established State-Owned Assets Supervision and Administration, tried to regulate inter-corporate loans, guarantees and other financial transactions between listed companies and their controlling shareholders or affiliates, demanding that existing loans and guarantees be reduced by 30% every year, but again these measures were ineffective. By the end of 2003, misappropriation

206 Guanyu Guifan Shangshi Gongsi Yu Guanlianfang Zijin Wanglai Ji Shangshi Gongsi Duiwai Danbao Ruogan Wenti De Tongzhi (Notice Regarding Certain Issues Relating to the Regularization of Listed Companies’ financial
happened to 737 listed companies out of a total of 1287, and the total amount of misappropriated funds reached RMB113.2 billion, while the total profits of listed companies in that year were RMB178.2 billion.\textsuperscript{207} It was only after intervention by the State Council, amid a serious crisis in the stock market, that progress was made. It took 3 more years for most of the misappropriated funds to be returned. In the process criminal actions were taken against senior managers of controlling shareholders.\textsuperscript{208}

The misappropriation problem illustrated the inherent defects of Chinese listed companies. It exposed the scale of power abuse by controlling shareholders at the expense of public investors who supplied real money to listed companies. Early in 2000 the new CSRC chairman proclaimed the importance of protecting minority investors and improving the quality of listed companies.\textsuperscript{209} As scandals continued and the stock market faced a looming collapse, better protection for investors and curing the ills of listed companies became urgent. Copious numbers of rules, documents and ad hoc notices were issued to address such issues as related-party transactions, use of raised funds by listed companies, takeover and asset restructuring, independence of listed companies from their controlling shareholder, and so on. 2 high level documents and one enactment by the CSRC were most important. In January 2004 the State Council published a document on how to resolve the problems in the securities markets and transactions with Related Parties and External Guarantees by Listed Companies), promulgated by CSRC & SASAC on Aug. 28, 2003, available at chinalawinfo.com.

\textsuperscript{207} Wang Hui, *Dagudong Guanlian Zhankuan Falu Duice Yanjiu (Research on Legal Countermeasures to Misappropriation by Related Parties of Large Shareholders)*, *GONGSI FALU PINGLUN (COMPANY LAW REVIEW)* 88 (2005).


further develop the market, calling for an improvement in the quality of listed companies and the protection of small investors.\textsuperscript{210} In October 2005 the State Council endorsed a document proposed by the CSRC specifically on how to improve the quality of listed companies. Among the issues it covered were corporate governance, internal control, transparency, related-party transactions, independence and supervision of listed companies.\textsuperscript{211} In December 2004, the CSRC issued rules aimed specifically at protecting minority investors, giving them the right of veto on a company’s important issues, such as issuing new shares, rights issues and material asset reorganization, and the right of cumulative and proxy voting; the power of independent directors was strengthened and fiduciary duties towards the company and minority shareholders were imposed on controlling shareholders.\textsuperscript{212}

To further strengthen the protection of minority shareholders and reinforce the authority of existing rules issued by the CSRC, the Company Law and Securities Law were extensively amended in 2005. The revised Company Law confirmed the independent director system, the fiduciary duties of directors and controlling shareholders, the cumulative and proxy voting right, rules regarding related-party transactions and material asset reorganization, and so forth. It also introduced the derivative action, offered minority shareholders the appraisal right, the right to propose shareholder meeting resolutions and to have access to such information as board of


directors’ decisions and accounting books; it reduced the shareholding threshold for calling an extraordinary shareholders’ meeting and augmented the powers of the supervisory board.\textsuperscript{213} The Securities Law, as amended, confirmed the underwriter sponsoring system, the third-party custody of investors’ deposits and securities, and rules regarding risk control and personnel qualification of securities companies; it provided for the establishment of a fund for compensating investors’ losses in the event of securities companies bankruptcies, and explicitly stated that investors had the right to bring lawsuits against securities frauds; the CSRC’s investigative powers were also strengthened.\textsuperscript{214} Also, the Criminal Law was revised in 2006 to provide for personal liability for misappropriation and to close loopholes in criminal liability for misrepresentation of information. Subsequently, rules previously adopted by the CSRC were updated in accordance with these revised statutes and more operational rules were also issued by the CSRC.\textsuperscript{215}

For all these activities investor protection has since improved considerably. Although there are still unsatisfactory aspects,\textsuperscript{216} loopholes in the primary legislation have been closed, major deficiencies corrected and investors offered more legal rights. Regulations, rules and

\textsuperscript{213} Cao Kangtai, \textit{Guanyu Zhonghua Renmin Gongheguo Gongsifa (Xiuding Caoan) De Shuoming (Explanations Regarding the Draft Revision of Company Law of PRC)}, Quanguo Renda Changweihui Gongbao (Gazette of the Standing Committee of NPC), No. 7, 2005.


\textsuperscript{215} Such as the guidance on recognition of insider trading and market manipulation, which was internally circulated but not publically available. See Nicholas C. Howson, \textit{Enforcement Without Foundation?—Insider Trading and China’s Administrative Law Crisis}, 60 \textit{Am. J. COMP. L.} 955 (2012).

\textsuperscript{216} E.g., the Company Law’s requirement for a minimum of 1% shareholdings to take a derivative action by shareholders of companies limited by shares ensues there has been no derivative action against listed companies in China. See Zhong Zhang, supra note 172.
normative documents for investor protection are abundant and the total number of securities laws has now exceeded 1200.\textsuperscript{217} On the other hand, enforcement has improved and the era of the 1990s when laws were largely unenforced has gone. A degree of order has been established and the securities frauds that plagued the market at the end of the 1990s and in the early 2000s have been curtailed noticeably. It is no longer true that the Chinese stock market is still in a wild state of lawlessness. Nevertheless, the decline of share prices since 2009 provoked a new public outcry over the dismal amount of dividends paid out by listed companies. In terms of securities frauds, insider trading (including so-called “rat trading”\textsuperscript{218}) has become the focus of public indignation and the primary target of the CSRC’s enforcement activities.\textsuperscript{219}

III. INVESTOR PROTECTION AND THE GROWTH OF CHINA’S STOCK MARKET

A. The Role of Investor Protection in the Growth of the Market Before Mid-2001

1. The Irrelevance of Investor Protection

Having examined the history of growth and the development of investor protection, we can see that the role of investor protection was indeed negligible until mid-2001. China experienced bouts of “share fever”, one of which caused a riot, before even a basic legal and regulatory framework was in place. Certainly, those people who frantically traded shares in the streets of Shenzhen in 1990 and those queuing for days to buy a subscription form in 1992 had not the least concern for investor protection. In fact, it can be safely assumed that few of them


\textsuperscript{218} It is a type of “front running”, whereby an investment fund manager buys or sells a stock for their personal account before the fund that they manage buys or sells.

\textsuperscript{219} Insider trading accounts for more than half of the total number of cases investigated by CSRC in recent years. Xiao Gang, supra note 217.
knew or understood what a share is, how a company operates and what risks would be involved. What some of them might have known perhaps was that their neighbors or friends had bought shares and made big money quickly. More might not even be aware of any such example. They just followed suit with only a faint idea that acquiring shares could make money.

Even after the national regulatory system was set up and the major legislation, like the Company Law and Interim Regulations on the Administration of Share Issuance and Trading, were adopted in 1993, investor protection was still not very relevant. There was no specific criminal legislation before 1995; the Securities Law was not enacted until 1998 and did not take effect until 1999; the Company Law 1993 was defective and some legal rights and remedies that are critical for shareholder protection were glaringly absent. More importantly, all the laws and rules for investor protection were largely unenforced. This was shown by the widespread and blatant securities frauds that took place. Before 1997, even the governments in Shanghai and Shenzhen organized manipulation to boost stock trading with the involvement of the two stock exchanges. By the end of the 1990s and the early 2000s securities frauds of all sorts had become systemic. The magnitude of misappropriation has already been mentioned. Other types of frauds are not less widespread. One study estimated that 72% listed companies engaged in false disclosure. In respect of market manipulation, even staff from CSRC admitted in 2000 that at least 30% of stocks were being actively manipulated. Another report

220 See text accompanying supra note 176.
221 See text accompanying supra note 171 & 172.
222 See text accompanying supra note 71.
223 See text accompanying supra note 207.
224 STEPHEN GREEN, supra note 1, 137.
225 Ibid, 165.
revealed that the CSRC estimated in 2001 80% stocks were manipulated.\textsuperscript{226} Observers of the market summarized that “China’s stock market is a notoriously corrupt place. Securities firms, investment funds, finance companies and rich individuals all manipulate prices and spread prodigious amounts of false information”;\textsuperscript{227} “insider trading and manipulation of the market have been conducted almost half-openly”\textsuperscript{228} and were “something of an open secret”\textsuperscript{229}. It is thus understandable why the stock market was condemned as “worse than a casino”. In a word, frauds were systemic and laws for investor protection ineffectual during this period.

In China where the rule of law has yet to be established, laws that have been proclaimed to be effective are not necessarily so in reality. Much depends on whether senior leaders are serious about them, which is in turn largely determined by the particular political, economic and social circumstances of the time. In earlier days, the stock market was seen as a liability rather than an asset to the economy. Even after the market was given the job of SOE financing, investor protection was not a priority. On the one hand, the main concern was the danger that a bubble would cause to the financial system, to the whole economy and to social stability. This concern was behind the decrees and warnings, the \textit{People’s Daily} editorial at the end of 1996, and the punishments for market manipulation announced in 1997.\textsuperscript{230} Basically, enforcement was used to prick the bubble rather than protect investors. On the other hand, while frauds were discovered in the earlier days,\textsuperscript{231} it was only from 2000 that series of shocking scandals were exposed, to

\textsuperscript{226} Wang Xiaolu, \textit{Zhengjian Xin Qiju (CSRC’s New Chess Game)}, \textsc{China}, July 16, 2012.
\textsuperscript{227} \textit{Ibid}, 164.
\textsuperscript{228} Xian Chu Zhang, supra note 174, 989.
\textsuperscript{229} \textsc{Walter & Howie}, supra note 2, 64.
\textsuperscript{230} See text accompanying supra note 73, 74 & 78.
\textsuperscript{231} Two cases of frauds were well known in the early history of China’s stock market. The first is the asset misappropriation happened to a listed company, \textit{Shenzhen Yuanye}, in 1990 and the second is financial information
public outrage, and the crisis only grew. So it is understandable that, while multiple laws and rules had been issued, they were not very relevant and unenforced, and because the government did not take investor protection seriously and a crisis had not developed.

The CSRC’s lack of enforcement capacity also meant that investor protection laws were ineffective. There was no enforcement department until 1996; once established, the department had no more than 33 staff until 2001. The CSRC did not have a presence outside Beijing before 1999. The stock exchanges were controlled by the Shanghai and Shenzhen governments and the CSRC had no access to information there, but the local governments’ interest was in enlarging their exchanges and boosting trading, rather than enforcing laws, because, while they enjoyed the benefits of increased tax revenue, economic growth and political status, the costs of economic disruption and social instability that resulted from a disorderly market were largely a concern for the central government. As a result, local governments rarely enforced laws to protect investors. For example, before 1997 neither local governments nor the Shanghai and Shenzhen Stock Exchange entered any sanction for misrepresentation of information.

The ineffectiveness of the laws is demonstrated by empirical data of enforcement output. Table A shows the number of CSRC administrative penalties imposed and Shanghai and falsification by a listed company, Qiong Minyuan, in 1996. As for the market manipulation organized by Shanghai and Shenzhen government in 1996, investors were happy because share prices rose as a result of the manipulation.


233 See Stephen Green, supra note 187.

Shenzhen Stock Exchange’s disciplinary actions against listed companies, as well as the number of managers sanctioned between 1994 and 2010. Table B shows the number of all cases investigated by the CSRC from 1993 to 2008. Table A indicates only few instances before 2001, while Table B shows an increase from 1998. Specific studies of penalties for securities frauds found a similar result. Table C displays the findings of one study of CSRC penalties for market manipulation and insider trading, and Table D those of another of CSRC penalties and Shanghai and Shenzhen Stock Exchange’s disciplinary actions against information misrepresentation by listed companies. Both show only sporadic enforcement activities before 2001.

Table A. CSRC Administration Penalties and Disciplinary Actions by Shanghai and Shenzhen Stock Exchange against Listed Companies and Managers

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<td>8</td>
<td>76</td>
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<td>Managers sanctioned</td>
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<td>2</td>
<td>0</td>
<td>46</td>
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<td>19</td>
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<tr>
<td>Managers sanctioned</td>
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<td>225</td>
<td>922</td>
<td>613</td>
<td>367</td>
<td>250</td>
<td>253</td>
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Source: GTA, Zhongguo Shangshi Gongsi Weigui Chuli Yanjiu Shujuku (Research Database of Enforcement against Illegal Activities of Listed Companies in China) (2011)
Table B. All Cases of CSRC Investigation

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Source: WANG TING, ZHONGGUO ZHENGQUAN JICHA ZHIFA ZHIDU BIANQIAN YU SHIZHENG YANJU (THE EVOLUTION OF THE INSPECTION AND ENFORCEMENT INSTITUTION IN CHINA’S SECURITIES MARKET: AN EMPIRICAL STUDY), PhD Dissertation (Wuhan University, 2009)

Table C Cases of CSRC Penalty against Market Manipulation and Insider trading

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Table D Cases of CSRC Penalty and Stock Exchange Sanction against Information Misrepresentation by Listed Companies

66
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<th>Public censure</th>
<th>Public criticism</th>
<th>Warning</th>
<th>Fines</th>
<th>Warning + Fines</th>
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<td>12</td>
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<td>21</td>
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</table>

Source: Luo Peixing et al., supra note 234.

2. *Explanations for Growth with Weak Investor Protection*

Why did the market then grow rapidly while investor protection was weak? Clearly those investors rushing to the market without the least concern for protection contributed to the growth. Their behavior can be best explained by the concept of “herding”. They jumped on the investment bandwagon, just because they saw other people buying shares. Such herd behavior is probably more pronounced and pervasive in China, as the people are seen as highly collectivist with tight-knit social fabrics where information on peers’ behavior flows quickly and people feel more pressure to conform to the norms. In fact, behavioral finance provides explanations for some other traits exhibited by Chinese investors. For example, there was an investment strategy
pursued by some retail investors in China, colloquially called “dancing with market manipulators”,\textsuperscript{235} which signaled those investors’ overconfidence that they could beat these manipulators; there were numerous stories about investors who held on to losing stocks for years, explicable perhaps by the “prospect theory” that investors have a tendency to avoid the negative utility of a prospective loss. It is therefore evident that Chinese investors’ rationality could be “bounded” and that this “bounded rationality” means they may not be concerned about the lack of protection when making investment decisions. Moreover, in the 1990s there were few institutional investors and most were individuals who were novices, with little experience; the investment industry was primitive, with little importance being attached to fundamentals but intuition, rumors, inside information and trend following being the norm. All this meant that the first generation of Chinese investors in the 1990s was especially prone to irrationality, which explains why the market grew despite weak protection. Besides, it is possible that time is needed for fraudsters to learn their trade and for their skills to spread, causing a lag between the opening of the stock market and the prevalence of frauds. The fact that widespread frauds were discovered only from 2000 supports this supposition. A stock market therefore always has a grace period to grow before investors’ confidence is shaken by frauds. During this period, law is not really relevant and a conclusion that investor protection is unnecessary should not be drawn from the experience of that period.

While “bounded rationality” and time lag could be common explanations for market growth, a unique factor underpins the growth of China’s stock market. Following the labeling of companies losing for 2 and 3 years with “ST” and “PT” by the Shanghai and Shenzhen Stock Exchanges, the CSRC in 2001 ruled that trading of “PT” companies’ shares be suspended and

such companies be delisted if their financial situation had not recovered within a year.\(^{236}\)

Subsequently, local governments sponsored a wave of so-called “asset restructuring” to bail out companies in financial difficulties.\(^{237}\) First, direct subsidies in different names were provided to listed companies and tax or other liabilities were waived. Second, the controlling SOE shareholder of a listed company was directed by local governments to waive debts owed to them by their subsidiary or to take over debt liabilities owed by their subsidiary to others; loss-making assets were removed and new assets were inserted. Third, where a controlling SOE did not have the ability to bail out their subsidiary, shares owned by the SOE were sold to a private firm at a nominal price on the condition that the private firm inserted new assets into the listed company. This is the so-called “back door listing”. Because of the quota system, private firms had little chance to become listed through an IPO and the attractions of “back door listing” were the potential opportunities to raise funds from the market or simply the status and reputation as a listed company. Some companies were also acquired by fraudsters and used as a tool for market manipulation, as the notorious scandals of Yi’an Keji and Zhongke Chuangye illustrated. As far as local governments were concerned, their motivations to bail out listed companies were several. First, a listed company might be an important employer in a local area or source of tax revenues for a local government; second, a listed company was an important vehicle for fund raising, which local governments would not want to lose; third, local governments simply did not want to lose ‘face’, as “ST”, “PT” and delisting showed them in a bad light. Anyway, by 2001 around 680 listed companies, more than half of the total, had undergone some form of “asset


restructuring”,\textsuperscript{238} that is, bailouts funded by governments and SOEs under their control. As a result of bailout, the downside risk from investing in a listed company was taken away. Investors no longer needed to worry that the companies they invested in might fail and their investment might lose. This is another explanation of why the market can grow with weak protection.

One study suggested that the quota system for share issuance created incentives for local governments to select viable companies for listing, because, as the study claimed to have found, future allocations of quotas to a region were related to the past performance of companies from there.\textsuperscript{239} However, considering the widespread frauds and corruption in the IPO process, this explanation for market growth is doubtful. Falsification of information was especially serious in the IPO process. One study found that in all the cases of CSRC penalties against accounting firms and accountants between 1994 and 2001, 62.5\% were due to misconduct occurring in IPOs.\textsuperscript{240} On the other hand, the quota system created a fertile ground for rent seeking and corruption in selecting and approving companies for listing.\textsuperscript{241} Therefore, even if quota allocation was meant to be merit-based, the system failed to ensure only viable companies were listed—attested by the fact that so many companies had to be bailed out soon after being listed. It is also suggested that financial repression in China contributed to market growth—Chinese people had no alternatives but to invest in the stock market, because interest rates set by the

\textsuperscript{238}\textit{Ibid.}


\textsuperscript{241}Ding Chen, supra note 235, 159.
government were low and capital control restricted them investing abroad. But the deeper question is, if the risk of losing money in the stock market was real, why did people not leave their money in banks?—at least there it would not disappear. Either the risk must have been low, or investors miscalculated the risk, or they acted irrationally. It is arguable that behind the financial repression lie deeper roots, and bounded rationality, inexperience, bailouts by governments and a time lag between the opening of the stock market and the prevalence of frauds might be fundamental.

**B. Investor Protection and the Stock Market Crisis Between 2001 and 2005**

Why did the stock market run into a crisis between 2001 and 2005 when China’s macro economy was in its best condition? Many so-called “opinion leaders” blamed the State Council’s decision in June 2001 to sell down state shares on the market. This seems to be the view commonly accepted. However, in China there are too many such “opinion leaders” whose words should not be taken too seriously and the claim that the crisis was caused by the decision to sell down state shares is questionable. First, the policy to sell down state shares was in fact adopted in 1999, and an experimental scheme was undertaken in December of that year. But share prices rose continuously from 2000 to June 2001. Second, the selling scheme adopted by the State Council in June 2001 was modest. Only companies undertaking an IPO were to sell, but not companies that had already been listed; the number of state shares to be sold was only 10% of the number of new shares to be issued; funds raised were to be transferred to the National Social Security Fund, parts of which would be re-invested in the market. Third, share prices rose on

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243 See text accompanying supra note 108 & 117.

244 CPC, supra note 92.

245 State Council, supra note 108.
June 13, 2001 when the scheme was publicized by Xinhua News Agency, and throughout June and July there was only a small drop overall with occasional rises. Fourth, although share prices rose sharply following the government’s announcement in October 2001 to suspend and in June 2002 to terminate the scheme, the rallies were short-lived and the downward trend continued. Fifth, the revival in 2006 was commonly attributed to the non-tradable share reform, but according to the same logic that the market collapsed because of the fear of excessive share supply, the non-tradable share reform should have dampened rather than stimulated the market, because it could be flooded by non-tradable shares, which were to become tradable after the reform. Indeed, during the 2008 crash and again from late 2009 when the market entered another bear, people blamed owners of previously non-tradable shares selling their shares. In fact, after the reform scheme was first announced on April 29, 2005, prices dropped further and on June 6 the symbolic 1000 points of Shanghai Composite Index was breached. Lastly, it was also argued that selling state shares at market price was unfair to public investors and that this caused the market to decline. But the Hong Kong market, where many SOEs had been listed and the selling scheme was not suspended, was not affected by such practice.

It can be seen that selling down state shares did not consistently cause share prices to drop and the claim that the selling was responsible for the crisis is flawed. There must have been other causes for the crisis. It is likely that the market fell in 2001 because the bubble became too big; it is also possible that investors as a whole became more mature and realized the true value of investing in such a market with a large number of loss-making companies. Nevertheless, while statistically it is hard to prove, there is ample strong evidence that securities frauds were

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247 Ibid.

248 Xu Xiaonian, supra note 110.
also responsible for the crisis. 3 kinds of frauds had the greatest effect. The first was misappropriation, exemplified by Sanjiu Yiyao where billions of RMB were channeled out of the listed company. The second was market manipulation, which was either trade-based, information-based or both. Stock cornering was the most popular trade-based manipulation, whereby one or more manipulators secretly bought a large number of shares of a company using multiple trading accounts and sold down after innocent investors had been lured in and the share price was high enough. In information-based manipulation, different ways were undertaken to propagate false information. A manipulator might procure the collusion of the top managers of a company or buy control of a company in order to disclose false information, or spread rumors privately or through public media. The scandal of Yi’an Keji could be classified as information-based while Zhongke Chuangye was both information and trade based. The third kind of fraud is information falsification and the purposes could be for market manipulation or others, for example, to meet the minimum financial requirements for an IPO, or secondary offering. Yinguangxia was an example where sale contracts, invoices, tax receipts, and such like were all fake.

These 3 types of frauds severely damaged investor interests and their exposure led to sharp fall in share prices. For example, the share price of Yi’an Keji plummeted from its highest point of RMB 126.31 on February 17, 2000 to less than RMB 10 in January 2002; the share price of Yinguangxia plunged from more than RMB 33 in August 2001 to just over RMB 2 at the end of January 2002 and reached the 10% daily price movement limit for 15 days continuously; a company called Tuopu Software reported huge profits in 2001, but huge losses two years later. A

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249 CSRC, supra note 205.

250 Ling Huawei & Wang Shuo, supra note 204.

251 Historical daily data of the price of individual stocks was available at http://finance.sina.com.cn/stock/.
subsequent investigation by the CSRC revealed that around RMB1.4 billion of the company, more than the total of its net assets, had been misappropriated and that the company also offered free guarantee for RMB886 million (63.81% of its net assets) of bank loans borrowed by other companies. The share price of the company was more than RMB40 in May 2001, but less than RMB1 in May 2005; another company called *Pijiu Hua* announced in November 2003 that its chairman had disappeared and subsequently the company disclosed that it had offered to guarantee RMB1.787 billion of bank loans. The share price dropped from nearly RMB17 in October 2003 to just over RMB3 at the end of the year; in April 2004 the empire of *Delong Group*, which acquired a complex web of financial institutions and bought control of 3 listed companies for manipulation, finally crumbled, wiping out RMB20 billions of market value in 10 trading days.

These cases showed that a scandal had a marked effect on the share price of a company. With so many frauds, the total effect on market performance must necessarily be significant. One study identified 212 corporate scandals (defined as an enforcement action taken by the courts or securities regulators) in the stock market between 1997 and 2005. These were divided into ‘relationship scandals’, exemplified by bribing government officials or tax evasion, ‘market scandals’, in other words misrepresentation of financial information and misappropriating corporate assets, and ‘mixed scandals’, involving both of the above. Even counting only the

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253 *Ibid*.


latter two, they totaled 186. The scale of fraud is thus clear and its weight on the price movement of the market can be imagined. Moreover, a scandal did not affect only an individual stock, but might shake the whole market. For example, after the scandal of Yinguangxia was publicized on August 5, 2001, the Component Index of Shenzhen where the company was listed lost 4.38% on the following trading day, whereas the Index moved narrowly and the average daily loss was only 0.207% during the previous trading week. It is very possible that the sudden plunge might have been caused by the revelation of the scandal. Since there were so many similar cases, the market was repeatedly rocked and share prices were continually hit, in turn exposing even more frauds. Eventually, investors found share investment was too risky and decided to leave the market. The Chinese stock market was not just “worse than a casino”, but also had a reputation as “a minefield full of traps”—one trip, and an investor would be “blasted to pieces”. Faced with such high and dangerous risk, understandably investors would withdraw from the market. Lastly, one type of fraud, i.e. misappropriation, was also responsible for the poor profitability of listed companies. In 2003, 70% “ST” companies had experienced misappropriation and it was an important reason for the failure of those delisted “PT” companies. So, if low profitability of listed companies was also a cause for the crisis, the fraud of misappropriation must be blamed.

In conclusion, while there might be other reasons, the endemic frauds, especially misappropriation by controlling shareholders, market manipulation and information falsification, were a crucial cause for the market crisis. Their exposure weighed down share prices and

256 Ibid.
259 Wang Hui, supra note 207.
shattered investors’ confidence, causing them to leave the market. Misappropriation was also responsible for the poor profitability performance of listed companies, which might have been another cause for the crisis. The experience of the Chinese stock market during this period demonstrates that, far from being unimportant, investor protection is essential for the sustainable growth of a market. A market may grow initially, but will run into crisis and its survival will eventually be in question, if investor protection is so weak that frauds prevail. China’s experience also indicates that securities frauds, especially the aforementioned 3 types, are a serious threat to a market and the first crisis that it might experience might be caused by these frauds. To develop a stock market, it is crucial that these frauds are prevented.

C. Investor Protection and the Revival and Survival of the Market Since 2006

The enormous boom in 2006 and 2007 turned out to be a spectacular bubble and soon burst. But because of it, the Chinese stock market reached a new height and major state-owned ‘national champions’ were listed. It is widely believed that the resurgence was attributable to the non-tradable share reform. As aforementioned, this view is logically flawed and inconsistent with the facts. Perhaps the turnaround had more to do with the fact that share prices had become very low after falling for more than four years. But the baffling question is, were investors no longer concerned about securities frauds? Could irrationality again be an explanation? Or had the circumstances of the market actually changed? It is the view of this author that the market resurgence in 2006 was also because the securities frauds that once plagued it had been greatly curbed and investor protection considerably improved. This strengthened protection also enabled the market to survive the spectacular crash in 2008 and the bear market from late 2009.
After the *Kelon* scandal broke out in August 2005, most major frauds had been exposed. The devastating effect of scandals on share prices had tapered off. In the end, most of the companies affected by frauds were bailed out and saved from being delisted, so avoiding the fatal consequence for investors. By the end of 2005, many of those companies had been “restructured” or a restructuring plan had been put in place. A large number of criminals were sent to prison. Securities companies were also saved from bankruptcy and investors were compensated by governments for their misappropriated funds and stocks. The campaign to force misappropriated funds of listed companies to be returned was well underway after the State Council’s intervention and the threat to use criminal sanctions. Meanwhile, multiple laws, regulations and rules were adopted to provide more protection for vulnerable minority investors, and enforcement was enhanced.

After all the legislative activities throughout the crisis, shareholders’ rights had greatly improved. By 2006, various indicators suggest that shareholders’ rights in China were comparable to or even more generous than those in major developed economies. LLSV’s original “anti-director right index” did not include China, but according to Allen *et al.*, China would score 3 in 2000. But their interpretation of Chinese laws seems incorrect. On the one hand, the derivative action was not actually allowed in China before 2005 and only shareholders of limited liability companies (but not companies limited by shares) had the pre-emptive right to new offerings of shares. Hence China should score zero rather than 1 in both “oppressed

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261 Supra note 10.

262 Zhong zhang, supra note 172.

"minority" and “pre-emptive right” categories. On the other hand, the percentage of shares needed to call an extraordinary shareholder meeting was 10% and shares were not blocked before a shareholder’s meeting.\textsuperscript{264} Hence China should score 2 rather than zero in these two aspects. In total China would still score 3, falling in the middle among those countries studied. However, after the Company Law 2005 introduced the derivative action and cumulative voting,\textsuperscript{265} China’s score would increase to 5, among the highest of all countries. Second, in the “anti-self-dealing indices” compiled by Djankov \textit{et al}, which were regarded as “better grounded in theory than the index of anti-director rights”,\textsuperscript{266} China scored 0.76 overall, lower than the UK and Hong Kong, but comparable to Australia, Ireland and Israel and higher than the US and Canada.\textsuperscript{267} Even this score is an underestimation. For example, China scored zero in “rescission”, but the Contract Law 1999 of China clearly provides that one party to a contract may apply to the court to annul the contract where the transaction is unfair.\textsuperscript{268} Accordingly China should score 1 in “rescission” and the total score should be 0.82. Third, in a shareholder protection index compiled by John Armour \textit{et al}., which comprised of 10 variables and covered the period of 1995-2005, China ranked 6\textsuperscript{th} among the 20 countries by 2005, only after the UK, US, France, Japan and Canada.\textsuperscript{269} This score of China might not reflect the improvements brought by the Company Law 2005 and

\textsuperscript{264} \textit{Ibid}, Art. 104. In China shareholders owning shares in a company on the registration day have the right to vote in a shareholders’ meeting, even if they sell their shares before the meeting, which becomes a controversy.

\textsuperscript{265} Zhonghua Renmin Gongheguo Gongsi Fa (Company Law of PRC), Art. 106 & 152, adopted at the 18\textsuperscript{th} meeting of the Standing Committee of 10\textsuperscript{th} NPC on Oct. 27, 2005, available at chinalawinfo.com.

\textsuperscript{266} Simeon Djankov \textit{et al}., \textit{The law and economics of self-dealing}, 88 J. OF FIN. ECO. 430 (2008), 461.

\textsuperscript{267} \textit{Ibid}. The dataset is available at \url{http://scholar.harvard.edu/shleifer/publications?page=1}.

\textsuperscript{268} Zhonghua Renmin Gongheguo Hetong Fa, (Contract Law of PRC), Art. 54, adopted at the 2\textsuperscript{nd} meeting of the Standing Committee of 9\textsuperscript{th} NPC on Mar. 15, 1999, available at chinalawinfo.com.

Securities Law 2005, as the score did not change after 2003. If this is true, China’s score would be among the highest after 2005.

Not only were shareholders offered more legal rights, changes made in other areas also enhanced investor protection. For example, to prevent securities companies from misappropriating clients’ funds, the CSRC decreed in 2004 that they should not take deposit of their clients’ funds and those funds should be deposited in commercial banks. The Securities Law 2005 formally recognized this requirement.\textsuperscript{270} Since then the problem of misappropriating investors’ funds has disappeared. The same law required that an investor could only open one trading account and the name of the trading account should be identical to the investor’ name.\textsuperscript{271} As a result, it is much more difficult for manipulators to corner a stock by using multiple trading accounts and hide the fraud. The Securities Law 2005 also greatly increased the use of the penalties of disqualification and suspending or revoking business licenses—the number of circumstances under which such penalties could be used increased from 5 to 27\textsuperscript{272}—and provided a legal foundation for banning market entry\textsuperscript{273}. These penalties would have a stronger deterrence effect than the administrative fine, which in most circumstances is RMB300000 for individuals and RMB600000 for legal persons at most. The revision of the Criminal Law in 2006 made directors and other senior managers of listed companies or the controlling shareholders criminally liable for misappropriation even if they gained no personal benefit.\textsuperscript{274} SOE managers

\begin{footnotesize}
\textsuperscript{270} Zhonghua Renmin Gongheguo Zhengquan Fa (Securities Law of PRC), Art. 139, adopted at the 18th meeting of the Standing Committee of 10th NPC on Oct. 27, 2005, available at chinalawinfo.com.

\textsuperscript{271} Ibid, Art. 166.

\textsuperscript{272} Author’s calculation.

\textsuperscript{273} Supra note 270, Art. 233.

\textsuperscript{274} Zhonghua Renmin Gongheguo Xingfa Xiuzhengan (Liu) (Amendments (6) to the Criminal Law of PRC), Art. 9, adopted at the 22\textsuperscript{nd} meeting of the Standing Committee of 10\textsuperscript{th} NPC on June 29, 2006.
\end{footnotesize}
would thus rethink their decisions to use funds of listed companies to save the controlling SOE from financial difficulties.

Law enforcement, on the other hand, had been strengthened since 2001, which can be demonstrated from both the input of resources and the output of enforcement activities. As for resources, first, the CSRC’s enforcement department branched out of Beijing after taking over local regulators in 1999. In 2001, the enforcement unit of 9 major local regulators was upgraded to become a bureau directly under the CSRC’s control. In the same year a specialized enforcement bureau for investigating insider trading and market manipulation was set up at the CSRC’s headquarter in Beijing and the total number of enforcement personnel at the headquarter increased by 32 to nearly 60. The total number of enforcement personnel in the whole system of the CSRC increased to more than 270. A specialized bureau for investigating securities crimes with 6 local divisions was established in 2002 by the Ministry of Public Security. In 2007, the CSRC’s enforcement system was overhauled again. Investigation and adjudication were separated and a new department was set up solely for trials and making penalty decisions. 170 enforcement personnel, nearly 3 times the previous figure, were added in Beijing and 110 at the local level. In total the number of personnel for investigation increased to about 600, nearly 20 times the number in 1999. In addition, the CSRC was offered more investigative power by

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275 WANG TING, source of Table B, 65.
276 Ibid.
the Securities Law 2005, including, first, the right to check bank accounts as well as securities trading accounts; second, the right to freeze trading accounts and bank accounts and seize assets, property and evidence; and third, the right to restrict securities trading.\textsuperscript{279} Furthermore, CSRC’s capacity to detect frauds was also enhanced. For example, local regulators were required to undertake regular inspection of listed companies and securities institutions; both Shanghai and Shenzhen Exchange set up a surveillance department and sophisticated computer software was installed to monitor abnormal trading and price movements in real time. This surveillance system is now a key instrument for detecting insider trading and market manipulation.\textsuperscript{280}

From the output perspective, various studies have found that enforcement activities increased markedly from 2001. According to GTA’s database, the yearly figure of enforcement actions taken by the CSRC and the two stock exchanges increased from a single figure number before 2001 to 76 in 2001 and averaged 77 between 2001 and 2005.\textsuperscript{281} Other studies painted a similar picture. For example, data collected by \textit{Pistor & Xu}\textsuperscript{282} indicated enforcement actions taken by governments and the stock exchanges more than quadrupled in 2001 compared to the previous year, and \textit{Luo Peixing et al}\textsuperscript{283} in their study of law enforcement against listed companies for information misrepresentation found that the actions taken by CSRC and the stock exchanges more than doubled in 2001. The number of sanctions by the two stock exchanges in the form of

\begin{thebibliography}{99}
\item \textsuperscript{279} Supra note 270, Art. 233.
\item \textsuperscript{280} CSRC, \textit{Zhengjianhui Zhuoli Qianghua Jicha Zhiba Jiace Yujing Jizhi Jianshe} (CSRC Enhancing Surveillance and Early Warning System to Strengthen Inspection and Enforcement), CSRC \textit{NEWS}, Apr. 12, 2013, available at \url{http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201304/t20130412_227098.htm}.
\item \textsuperscript{281} GTA, source of Table A.
\item \textsuperscript{282} Supra note 239.
\item \textsuperscript{283} Supra not 232.
\end{thebibliography}
public criticism increased to 48 in 2001. While it was argued that the number of enforcement actions was still too low in light of the total number of listed companies, there is no doubt that enforcement intensified considerably after 2000. Enforcement activities have increased further after 2005 and the total number of actions undertaken by the CSRC and the two stock exchanges has exceeded 100 since then.

As a result of all these efforts to enhance investor protection, the scale and seriousness of securities frauds have decreased significantly since 2006. First, the once-ubiquitous stock-cornering and the unashamed fraud of acquiring listed companies for manipulation have disappeared, as has the misappropriation of clients’ funds by securities companies. There are still two types of manipulation. One is “pump and dump” whereby manipulators make “buy” recommendations or disseminate false information to boost the share price of a company and then secretly sell the shares that they have previously bought. The other is the so-called “short swing manipulation” whereby manipulators create false trading activities and rig price movements by placing false orders or using other tactics. But, judging from media reports, even these types of manipulation have decreased significantly and the culprits have been severely punished. For example, in a “pump and dump” case, the owner of an investment advising company was sentenced to 7 years in prison, profits of RMB0.125 billion were confiscated and the same amount of fines was imposed, the company’s licence to conduct securities business was

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286 GTA, supra note 281.
revoked and the individual was banned for life from securities business. Second, although there are still occasional news reports about controlling shareholders stealing listed companies’ funds, the days when this happened to 737 companies out of a total of 1287 have gone. Third, information misrepresentation is still a serious problem. Companies still invent profits and a large number still engage in other types of misrepresentation, indicated by the number of sanctions handed out by the CSRC and the stock exchanges. However, compared to the days when 72% of listed companies were estimated to have engaged in false disclosure, it is reasonable to believe that the situation has improved. Indeed, the chief accountant of the CSRC even claims that more than 90% financial information disclosed by listed companies is essentially credible. Fourth, insider trading has appeared to be rampant and become a focus of public indignation. There has been a significant increase of enforcement action against insider trading since 2008, accounting now for more than half of all enforcements taken by the CSRC. However, rather than indicating a deteriorated situation, this increase should be seen as a result of better detection capacity and the government’s greater determination to crack down insider trading.

288 See text accompanying supra note 207.
trading. Even a city mayor was sentenced to prison in 2011 for insider trading.\textsuperscript{290} Arguably, insider trading has a less obvious and immediate effect on investors’ interests and there are suggestions in China that insider trading is “victimless” and should be decriminalized. Overall, the scale and seriousness of securities frauds have decreased considerably since 2006 and it is now no longer true that the stock market is lawless. Indeed, in contrast to its denunciation in 2001 as “worse than a casino”, the stock market was extolled in 2010 by the Vice President of Peking University, an authority on Chinese financial law, as being “the most transparent and efficient market with the highest degree of rule of law” in China.\textsuperscript{291}

In conclusion, the stock market revived in 2006 after major scandals had been exposed, the effect on share prices diminished and the mess was cleared up. More importantly, by 2006 investor protection had greatly improved and the scale and seriousness of securities frauds had decreased significantly. Better protection for investors not only helped the market recover, but also helped it survive the 2008 crash and the prolonged bear market that followed from late 2009. It is unimaginable what the situation would be if fraud was still as widespread as it was in the late 1990s and early 2000s. The experience of China’s stock market after 2006 again testifies to the importance of investor protection in market growth. The scope of the assessment undertaken by the “law and finance” research and the World Bank and World Economic Forum is too narrow to capture the improvement of investor protection in China in the area of securities frauds.

\textbf{D. Investor Protection and the Bear Market since Late 2009}

\textsuperscript{290} Yuan Guangdong Zhongshan Shizhang Li Qihong Bei Pan 11 Nian, Fajin 2 Qianwan (Former Mayor of Zhongshang City, Guangdong Province, Sentenced to 11 Years and Fined RMB20 Million), \textsc{Nanfang Ribao (Southern Daily)}, Oct. 27, 2011, available at \url{http://news.xinhuanet.com/legal/2011-10/27/c_122205252.htm}.

\textsuperscript{291} Wu Zhipan, \textit{Gushi Shi Toumingdu Zuihao, Zuiyou Xiaolu He Fazhihua Chengdu Zuigao De Shichang (The Stock Market is the Most Transparent and Efficient Market with the Highest Degree of Rule of Law)}, 4 \textsc{Zhengquan Fayuan}, 18 (2011).
1. Corporate Profitability, Investor Return and the Bear Market

After the crash in 2008, the stock market experienced a brief rally following the “4 trillion RMB stimulation”. But from late 2009 share prices started to drop, heralding another bear market that is still on-going. As the value of stocks evaporated, investors again became very angry and “opinion leaders” increasingly vocal in criticizing government policies and the CSRC’s performance in managing the market. Under huge pressure from the public the government called off IPOs once again and there have been none since November 2012. Nevertheless, this time the anger and criticism seemed to center on the market’s low return on investments, especially the dismal amount of dividends paid out by listed companies.

There has been much media publicity about the poor performance of China’s stock markets in investment return in the wake of the bear market. For example, in July 2013 it was reported that in 4 years the mainland Chinese market had lost more money for investors than any other in the world; another report indicated that in 20 years since 1993 the MSCI China Index had gained merely 14%, including dividends, and investors earned less than 1% a year investing in Chinese stocks. However, Chinese stock markets are highly volatile and an assessment of the market’s performance based on share prices is not really meaningful. For instance, in contrast to the reported poor performance, the MSCI China Index returned 680% between November 2001 and October 2007. Nonetheless, measured by the amount of dividends, an important

294 Ibid.
source of investment return, the performance of the mainland Chinese market is indeed extraordinarily poor. In the 1990s few companies paid cash dividends. In 1999 59% companies did not pay any kind of dividends (cash or bonus shares). The proportion of companies paying dividends increased in the 2000s, but performance was still very poor. One study found the average annual dividend/price ratio of the mainland Chinese market was just over 0.75% between 1990 and 2010, the worst by a long way of the markets of the 12 emerging and developed economies under study. With such a low dividend yield, Chinese investors could only make profits by speculating on price movements. As a result of CSRC’s policy to encourage companies to pay more dividends and the slumping of share prices, there has been an increase in dividend yield over the last couple of years. For example, the ratio increased to 1.04% in 2009, 1.14% in 2010 and 1.82% in 2011. It was announced by CSRC in 2012 that the average dividend yield of the 300 blue-chip companies covered by the SHSZ300 Index reached 2.34% in 2011, exceeding that of S&P500 Stocks. CSRC thus encouraged people to buy shares, proclaiming that China’s stock market then had a value for long-term investment.

But this claim is misleading. First, many of the dividends were paid by dozens of big companies, including the 5 largest state-controlled banks. Indeed, the “big 5” banks contributed

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295 Stephen Green, supra note 1, 131. Most of the companies paid bonus shares rather than cash dividends, but paying bonus shares is only a change in book-keeping and shareholders receive no real benefit.


48% of the total dividends in 2012 and the dividend yield of all of them exceeded 5%. Without contributions from these banks, the dividend yield of the stock market would be much lower. Yet, banks’ share prices are among the lowest, largely because their best time has passed and the prospects are dim: non-performing loans are increasing following years of binge lending and the guaranteed interest rate margin and oligopolistic profits will no longer be possible if the banking sector is liberalized. More significantly, risk-free rates of return in China are much higher. Even the government-set one-year deposit interest rate has been above 3% since April 2011, while the yield of one-year treasury bills in the US has never exceeded 0.5% since 2010. The market rates in China are even higher than the official interest rates. The days when Chinese people could only deposit their money in banks or invest in stocks or bonds have gone. In addition to real estate investment, they can now buy various “wealth management products” originated by banks, invest in different types of funds sponsored by non-bank financial institutions and even lend their money to private financiers. The size of the so-called “shadow banking” sector in China tripled between 2008 and 2012 to RMB20 trillion, roughly the total capitalization of the stock market. Rates of return vary, but even the safest deposit-equivalent


300 Historical interest rate data are available from CHINA STATISTICAL YEARBOOK and historical treasury yield data are available at www.treasury.gov/.

“wealth management products” originated by banks produce around 5% annual return.\textsuperscript{302} It is misleading to compare dividend yield without considering the risk-free rates of return, and the dividend yield of Chinese stocks is still considerably lower than these.

Capital gain is the other source of investment return. For growth companies with high profitability, retaining profits for business development is a better way to reward shareholders. So if the low dividend yield of the Chinese market were due to growth companies retaining profits for efficient use, this would actually have benefited investors. Unfortunately, this was not in fact the case. First, a large number of companies paid no dividend, simply because they made no or little profit. Between 2008 and 2010, 710 companies paid dividends every year, while 516 companies paid no dividend at all in any of these years. Of these 516 companies, 153 were “ST” companies which were loss-making and had no profit to distribute,\textsuperscript{303} and 72.77\% made a loss at least in one year.\textsuperscript{304} Second, the profitability of companies paying no dividend is much lower as a whole. For example, in 2010 the median ROA (return over assets) and ROE (return over equity) for companies paying dividends was 4.87\% and 8.67\%, while the figure for companies paying no dividend was 2.10\% and 5.22\%.\textsuperscript{305} Third, it is a particularity of China that growth companies tend to pay dividends and companies paying no dividends do not record much growth. In 2010 the average sale and net asset growth rate for companies paying dividends was 20.16\% and 13.33\%, while the figure for companies paying no dividend was 9.41\% and 2.63\%.\textsuperscript{306} This oddity is due to the CSRC’s policy to compel companies to pay dividends.

\textsuperscript{302} Ibid, 116.\
\textsuperscript{303} Yang Yang, 56 Zhi A Gu Pingjun Sannian Guxilu Chao 2\% (56 A Stocks’ Dividend Yield Exceeding 2%), GUSHI DONGTAI FENXI (STOCK MARKET TREND ANALYSIS WEEKLY), 45 (2011), 85.\
\textsuperscript{304} He Jibao, supra note 296.\
\textsuperscript{305} Ibid.\
\textsuperscript{306} Ibid.
introduced a coercive rule requiring companies to pay cash dividends of no less than 30% of their distributable profits continuously for 3 years, before they could raise new capital on the market. Nevertheless, only growth companies have profits to distribute. It is clear that, far from being in high growth with high profitability, most of the companies paying no dividends actually had poor operational performance with difficult financial conditions. These companies would not truly bring investors capital gains.

Ultimately, the performance of a stock market in investment return is determined by the profitability of the companies listed. Profitability determines not only the dividend yield, but also the size of capital gains that investors can earn. Higher profitability means more profits, better growth potential and accordingly a higher value for a company and its share price. Without the support of profitability, the high price of a company would be an untenable bubble. How has been Chinese companies’ profitability? In the 1990s, a common saying about listed companies was “first year profit, second year even, third year losses”. Listed companies were described as “a capital-destroying machine” and abundant capital raised through IPOs, new and rights issues were wasted or simply disappeared. One study found that some 70% of listed companies were actually destroying value, in the sense that profits created by these companies were lower than the opportunity cost of the equity capital they owned. The weighted average

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308 STEPHEN GREEN, supra note 1, 125.

309 Ibid.

ROE (WAROE) published by CSRC was 7.63% in 2000,\textsuperscript{311} lower than the figure of non-listed companies and much lower than the 19.1% of the largest 1000 listed companies in developed countries, and the 14.62%, figure of the largest 200 companies from emerging markets.\textsuperscript{312} The WAROE decreased further to 5.35% and the ROA was only 3.02% in 2001, while the official interest rate for one-year bank loans was 5.85%.\textsuperscript{313}

The WAROE gradually increased from 2003. It passed 10% in 2006 and reached the all-time high of 14.7% in 2007.\textsuperscript{314} But, just like share prices, the WAROE crashed in 2008, recovered in 2009 and then dropped again from 2011, standing at 13.35% in 2012.\textsuperscript{315} Admittedly, this figure is much better than in the 1990s and early 2000s, but corporate profitability is still not encouraging. First, other research suggests that the average ROE of listed companies is actually much lower than the official WAROE. One study found that the average ROE of Chinese companies was only 7.83% in 2010, while the figure of listed companies in the US was 10.71%.\textsuperscript{316} A study by the All-China Federation of Industries and Commerce (ACFIC) indicated that, excluding “ST” companies and companies listed on the ChiNext, the average ROE was 11.14% in 2010, 9.85% in 2011 and 7.6% in 2012, confirming the downward trend suggested by the official figure; the median ROA was only 5.58% in 2012, again less than the official interest rate.

\textsuperscript{311} CSRC, supra note 27.
\textsuperscript{313} Ibid., 177-178; CSRC, supra note 27.
\textsuperscript{314} CSRC, ibid.
\textsuperscript{316} He Jibao, supra note 296.
rate for one-year bank loans.\footnote{ACFIC, 2012 Niandu Zhonghua Gongshang Shangshi Gongsi Caiwu Zhibiao Zhishu (2012 ACFIC Index of Financial Indicators of Listed Companies), June 28, 2013, available at http://www.acfic.org.cn/Web/c_000000010003000100050005/d_12217.htm.} Second, like dividend payments, the lion’s share of profits was made by a few large companies. For instance, the top 10 most profitable companies, including 7 banks, accounted for more than 70\% of the total profits made by listed companies in the first half of 2009 and 50\% in 2012.\footnote{Ye Jing, 10 Da Zui Zhuanqian Gongsi Shixian Jingli 3078 Yi, Zhan A Gu Lirun 70\% (RMB307.8 Billion Profits Made by Top 10 Most Profitable Companies, 70\% of the total by A Share Companies), XINGXI SHIBAO (INFORMATION TIMES), Sep. 1, 2009, available at http://finance.sina.com.cn/stock/s/20090901/1425669203.shtml; Liu Yonggang & Zhu Ziyi, Shida Zui Zhuanqian Shangsi Gongsi 7 Jia wei Yinhang, Baijiu Ye Yiran Zui ‘Baoli’ (7 Banks Among the Top 10 Most Profitable Listed Companies and Liquor Business Remaining to Have an Exorbitant Rate of Return), ZHONGGUO JINGJI ZHOUKAN (CHINA ECONOMIC WEEKLY), May 21, 2013, available at http://finance.people.com.cn/n/2013/0521/c1004-21549060.html.} The average ROE of the 7 banks was almost 22\% in 2012.\footnote{Liu Yonggang & Zhu Ziyi, ibid.} Without these banks, companies’ profitability would be much lower. Third, while the profits of listed companies increased, their leverage surged. The average liability/asset ratio was less than 50\% in 1998, but increased to 86.76\% in 2010 and 84.24\% in 2011.\footnote{CSRC, supra note 27.} The increase of ROE might have been caused partly by heightened leverage, which is no longer sustainable in the light of the current high level of debt. Fourth, Chinese companies’ ability to sustain high profitability is low and the number of companies with ROE above 10\% continuously for 5 years was only 6.66\% of the total in 2010, less than half of the percentage of the US listed companies.\footnote{He Jibao, supra note 296.}

It is now clear that for a long time corporate profitability was low and the stock market was in a bubble unmatched by the profitability and dividends. The bear market from 2001 to 2005, set off by a rash of securities scandals, could be seen as a major correction. Although
profitability increased considerably in 2006 and 2007, the enormous surge of share prices outgrew the increased profits by a massive scale, hence the subsequent crash. Since then the profitability of listed companies has entered a decline. The economic stimulation in the wake of the global financial crisis had only a short-term effect on corporate profitability, but inflated share prices greatly. Another bubble arose in 2009 and the subsequent fall was a correction, sustained by declining corporate profits. On the other hand, people now have more alternative investment opportunities with higher rates of return, and this further explains the prolonged bear market. Ultimately however, the market’s decline is underscored by the poor profitability performance of listed companies.

It is clear that this low profitability has restrained the market’s growth. Because of low profitability, China’s stock market has been in a bear since 2001 and the eruption of 2007 and rebound of 2009 were ephemeral. Every time that share prices dropped, the CSRC had to slow down or even suspend IPOs, because of the pressure from investors who complained that the oversupply of shares depressed share prices. Indeed, since 2001 IPO has been suspended 5 times.\textsuperscript{322} As a result, companies, even the well-known ones like Sina, Baidu and Tencent, representatives of China’s new economy, and China Mobile, one of the most profitable SOEs, had to list overseas. Alibaba, the Chinese e-commerce giant, is planning an IPO, but not in the domestic market, simply because IPO is currently frozen.\textsuperscript{323} In 2007 when the market was high, the government proposed to open an “international board” in Shanghai to list foreign companies.

\textsuperscript{322} Cheng Zhenjiang, supra note 100.


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But this plan has now been shelved because of the bear market.\textsuperscript{324} Indeed, the low profitability of listed companies underlines many other anomalies of China’s stock market. It explains why the market is so speculative. Because of low corporate profitability, long-term investment does not make sense. Dividend payments are negligible and capital appreciation is not supported by corporate profitability. The only chance to make profits is to speculate on price movements and constantly buy and sell.

\textit{2. Reasons for Low Corporate Profitability}

There are multiple reasons why the profitability of listed companies in China is low. A comprehensive examination is beyond the scope of this article and only some brief observations can be made. Certainly the widespread theft by controlling shareholders seriously hurt profitability and the crime is a sign and result of weak investor protection. Although such misappropriation has now been greatly reduced, weak investor protection harms profitability in other ways. China’s stock market has long been dominated by SOEs. While the number of listed SOEs had decreased to 47\% of the total by September 30, 2011, they still accounted for 90\% of the total assets, 86\% of the total revenues and profits, and 74\% of the total market capitalization.\textsuperscript{325} An important motive for the government to list these SOEs on the stock market was to improve their governance and management, but fatal problems remain. One is the endemic corruption among corporate managers. Of the 3 SOEs monopolizing the oil and gas production sector, 2 had their senior managers arrested for corruption and the chairman of


Sinopec was sentenced to death with reprieve; the “big 4” state-owned banks were riddled with corruption and scandals of this kind have continued to be revealed after their listing; serious corruption was also present in other “national champions” such as China Mobile, Chalco, and COSCO. These are only cases that have been exposed, and these companies, China’s strategic SOEs under the CPC and central government’s close monitoring, are commonly regarded as the best governed in the state sector. The scale of corruption in the whole sector is not difficult to imagine. The predominant forms of corruption are bribe taking and embezzlement, the effect of which on companies’ profits is clear. The second is the problem of waste, in the form of opulent office buildings and decoration, luxury limousines, incessant lavish banquets and expensive wines and liquors, etc., which are routinely reported in the news media. The third is chronic overinvestment and overcapacity, the SOE-dominated steel industry being a prime example.

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Because of overcapacity, this sector as a whole made a loss for nearly two years up to August 2013. The top 10 loss-making listed companies in 2012 were all SOEs and 5 of them were from the steel industry. Basically, for senior managers of SOEs the top priority in management is growth, or empire-building, rather than returns for shareholders. Fourth, there are too many cases of mismanagement, the cost of which is enormous. One scandal involving gambling in oil derivatives trading by a Singapore-listed Chinese SOE caused losses of $550 million, leading it to collapse, until revived by its controlling shareholder; another Hong Kong-listed SOE engaging in foreign exchange gambling lost $2 billion and again had to be bailed out by its controlling shareholder. COSCO, or China Ocean Shipping, recorded the biggest loss in the mainland stock market in both 2011 and 2012 totaling RMB20 billion, the most important reasons for the loss being mismanagement and corruption.

It can be seen that, while the abuse of power by controlling shareholders to plunder listed companies has been reduced, abuse and misuse of power by corporate managers is still a serious

331 Huang Quan, Yangqi Baolan Nianbao Qiansixi, Gangtieye Cheng Zhongzaiqiu (Central SOEs are the Top 4 Loss-Making Companies and the Steel and Iron Industry is a Severe Disaster), SHANGHAI ZHENGQUAN BAO (SHANGHAI SECURITIES NEWS), April 26, 2013, available at http://finance.sina.com.cn/stock/s/20130426/085715288926.shtml.
problem, suggesting that investor protection is still very weak in China. Corporate profitability suffers from these misdemeanors and the market suffers.

Low profitability is also caused by factors unrelated to investor protection in the usual sense. It is notable that private listed companies fare no better in profitability. One study found that between 2002 and 2006 the ROE of private companies was lower than that of listed SOEs, in 2005 being -1.4%, as against the figure for listed SOEs of 8.39%. 335 By 2011 the profitability of private companies with a WAROE being 12.12% was still lower than the WAROE of state companies at 14.51%. 336 One reason was the much higher level of debt leverage of state companies. Another was that private and state companies occupy different sectors with different levels profitability. As of the end of 2006, 62.47% of private companies were from the manufacturing sector, with tight profit margins, while SOEs dominated the lucrative sectors such as finance, communications, utilities, infrastructure and natural resource exploitation. 337 Indeed, only two listed banks are privately controlled, and all the telecommunication network operators and most of the oil, gas, coal and metal production companies are state-controlled. In those sectors where entry barriers do not exist, private companies are much more profitable than state companies. 338 It is clear that, because private companies are restricted from entering those lucrative sectors, their profitability is lower and the profitability of listed companies as a whole suffers. Secondly, low profitability is also caused by the unaccommodating business

337 Chen Bing et al., supra note 335.
338 Ibid.
environment. Business in China faces endless and inhibiting bureaucracy and predatory costs. A 2013 survey found that on average every business sought 17.67 government approvals, received 19.06 government inspections and assessments, and their senior managers attended 24.5 government meetings every year; they paid nearly 10% of their revenues for tax and 40% of employees’ total salary for social security contributions. The World Bank’s *Doing Business 2014* finds that China ranks 96th overall among all 189 economies under assessment and that it takes 33 days to start a business, 270 days to secure a construction permit, and that tax and other mandatory contributions account for 63.7% of a business’ total profits, ranking 158th, 185th and 120th respectively. All these reduce the efficiency of business and eat into their profits. Third, low profitability is also caused by the fact of industrial and low-end service companies comprising the majority of listed companies in China. The profitability of these companies is much lower than their counterparts from developed economies, because they lack of technologies, brand names, managerial expertise, innovation, and so on. The case of Apple and its Chinese supplier, Foxconn, whose profit margins were respectively over 30% and 1.5%, is a stark example. Lastly, the profitability of listed companies is linked to the macro economy. GDP and profitability simultaneously surged in 2007, and recovered in 2009 and 2010. After 2010, GDP decelerated, and with it, corporate profitability.

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341 He Jibao, supra note 296.

To conclude, the prolonged bear market since late 2009 is underlined by the low profitability of listed companies. The reasons why listed companies have had a poor profitability performance are two: weak investor protection and problems in the areas not commonly regarded as investor protection.

IV. INVESTOR PROTECTION AND THE FUTURE OF CHINA’S STOCK MARKET

The history of China’s stock market to date has clearly shown the importance of investor protection in the growth of the market. Therefore, to assess the market’s prospect for further growth, the first question to be asked is whether investor protection can be improved, to support that growth. Specifically, first, it is necessary to ask whether securities frauds can be kept under control, or even reduced further. There is a legitimate concern that those frauds that have been suppressed may spread once more, because many of their root causes still exist. For example, the domination of listed companies by their controlling shareholders, which enabled widespread misappropriation, remains unchanged. Moreover, information misrepresentation is still common, false accounting continues and insider trading is rampant. Although it was supposed to be victimless and seemed not to be a primary concern during the 2001-2005 crisis, insider trading damages the integrity of the market and corrupts the whole system. If allowed to flourish, these frauds will surely undermine investors’ confidence in the market. Secondly, to support market growth, investor protection has to be improved in order to fight managerial misconduct like corruption, waste and mismanagement. If not, corporate profitability will remain depressed, the bear market will carry on, and the growth capacity of the market inhibited.

A. Securities Frauds as a Threat to Market Growth

To answer the question of securities frauds, it is useful to reflect how they have been able to be reduced since the crisis of 2001-2005. Although in the 1990’s China’s stock market was
lawless, the legal and regulatory frameworks were already in place, providing the foundation for future action. Noticeably, the establishment of these frameworks was prompted by the “riot” in Shenzhen, the wildly excessive issues of shares, and the market bubble triggered by Deng Xiaoping’s “southern tour”. Leaders in Beijing clearly saw the danger that an uncontrolled stock market posed to the whole economy and to society. Their concern was to maintain social stability and economic order, and it was this that prompted them to act. In 1996 and 1997 the government clamped down on the market forcefully by even resorting to a People’s Daily editorial, again because of the danger that an enormous bubble would cause to the economy and society. The bubble had been caused partly by the Shanghai and Shenzhen governments’ competition to boost share trading at their local exchanges and attract more listings. It proved not just the impotence of local regulations, but the danger of leaving the market under local control. It was no wonder that Beijing decided to centralize regulations and strip local governments’ power of control. The desire for economic and social stability was the stimulus for the overhaul of the legal and regulatory system.

The crisis of 2001-2005 started with the exposure of series of grotesque frauds. The media were at the forefront in uncovering these frauds. Caijing especially played an important role and took the lead in investigating and reporting them. These revelations ignited a public outcry and condemnations by “opinion leaders” further inflamed investors. As share prices plunged and the market declined, investors became even angrier. The newly emerged internet was used by investors to exchange views, share their sentiment of frustration and voice anger. The government was under huge pressure to take action to crack down on frauds. The change of leadership at the CSRC also brought changes in policy and the new CSRC chairman, Zhou
Xiaochuan, put investor protection and corporate governance in priority.\textsuperscript{343} It can be seen that politics played a critical role here. Stock investors had formed an informal constituency, so powerful that the government had to take heed and respond to their complaints. By the early 2000s their numbers had increased to tens of millions. These investors shared the common experience of making tangible losses as a result of securities frauds. They could easily identify with each other. This meant that stock investors were a natural political constituency in China even though they are not allowed to formally organize themselves.\textsuperscript{344} Moreover, as the number of investors grew, the demand for information on the market and listed companies grew. In response, financial media and news reports proliferated, helping inform investors and enabling them to express themselves with stronger collective voices.

Another factor that drove the government to tackle frauds and enhance investor protection was economic. Falling share prices revealed yet more scandals, driving share prices down further. Investors began to lose confidence and withdraw from the market. Listing had to be slowed down and later suspended 3 times, and the plan to use the stock market to reform the SOEs was derailed. The stock market that in the eyes of Beijing was a liability to the economy in the early 1990s became, by the early 2000s, an important asset. It was not only a convenient source of new capital for SOEs, but also seen as a solution to the inherent governance problems of them. It seemed that the government had finally found a way to transform and revitalize the state sector, calling the shareholding system “the primary form of organization for the state economy” and encouraging SOEs to be listed.\textsuperscript{345} However, with the decline of the market, the reform of SOEs by listing had to be halted. The market at this point faced a looming collapse.

\textsuperscript{343} See text accompanying supra note 197.


\textsuperscript{345} CPC, supra note 115.
prevent this and bring the market to a state where SOE reform could continue, it was plain and urgent to curtail securities frauds and provide investors with more protection.

Will the political and economic factors continue to exist whereby securities frauds can be controlled or even reduced further in the future? Regarding the political factor, the key question is whether the market can maintain a large number of investors. Previous experience shows that many investors will sell off during a bear market, but a bull market will lure them back and even bring new investors into the market. Barring long and sustained bear markets, it is likely that the number of investors, if not increasing, will not decrease significantly. Hence we could expect that the political constituency of stock investors will continue to play a critical role in pushing for the improvement of investor protection. On the economic side, as well as supporting SOE reform, the stock market has now in fact been given a more strategic role in China’s economic development. By opening the ChiNext in Shenzhen, the government hopes that, like the NASDAQ, the stock market will facilitate indigenous innovation, technological advancement and industrial upgrading. It is also hoped that the stock market can help restructure the economy by providing a platform for M&A, develop China’s pension system by providing a venue for long term investment, and balance the commercial banks’ dominant role to make the financial system safer and more efficient.346 The stock market has become more important in China’s future economic and social development. Therefore, since both the factors that have worked to improve investor protection would remain, we can speculate that securities frauds will not get worse, but be reduced further. Indeed, the CSRC recently announced a doubling of the number of

enforcement personnel in order to further strengthen law enforcement.\textsuperscript{347} This is a sign of optimism and is explained exactly by the pressure from investors, increasingly unhappy in a prolonged bear market, and by the government’s desire to revive the market for economic and social reform. Nevertheless, there is a limit on how much further the current system can reduce securities frauds. At present, law is enforced almost singlehandedly by the CSRC and the two exchanges under its control. Private enforcement of law through the courts is negligible and the initial excitement about private enforcement turns out to be much ado about nothing.\textsuperscript{348} Various defects in the judicial system explain the impotence of the court and political weakness is fundamental.\textsuperscript{349} As long as the political system remains unchanged, it is unrealistic to expect private enforcement of law to be of any significance. The fact that SOEs dominate the market ensures that insider trading is especially difficult to tackle, because SOEs have a long chain of control from top government officials down to SOE managers and the number of insiders is excessive. Indeed, the fact that China is a highly collective society with close-knit social groups and pervasive guanxi networks makes insider trading even more difficult to tackle. In conclusion, securities frauds may continue to lessen, but only up to a point. However, they should no longer pose a serious threat to the further growth of the market.

\textbf{B. Investor Protection, Corporate Profitability and Market Growth}

In considering the prospects for market growth, another question that must be asked is whether investor protection can improve so that managerial misconduct in the forms of

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\textsuperscript{349} Ibid.
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corruption, waste and mismanagement can be reduced significantly. To answer this question, it is again useful to look at the history to find why the CSRC’s efforts to improve corporate governance and increase shareholder rights have been unsuccessful in curbing those misdeeds. It is obvious that the central reason is the continuing dominance of state ownership in listed companies. Despite the introduction of cumulative voting by the Company Law 2005, and minority shareholders being allowed to propose resolutions to shareholders’ meetings, the CPC and governments still enjoy a monopoly in staffing the senior managerial positions of listed SOEs. The serious agency problems inherent with traditional SOEs remain, as do managers’ incentives to “steal and shirk”. These managers are not accountable to public investors, because their minority shareholdings mean they are powerless to call them to account; independent directors are not in fact independent when their selection, appointment and remuneration are determined by the controlling shareholders; performance-based remuneration is unworkable when the stock market is so volatile, companies operate with monopoly, and the chances of being caught “stealing” are slim; the absence of hostile takeovers and the monopolies enjoyed by many listed SOEs in their product markets means market discipline is an illusion, or simply does not work when staffing is based on political considerations, personal connections or bribes; enhanced disclosure, while perhaps a “pesticide” for controlling shareholder misappropriation, is ineffective in exposing and deterring managerial “stealing and shirking”. It can be seen that the CSRC’s corporate governance initiatives and increased shareholder rights are undermined by the dominance of state ownership. As long as a listed company is state-controlled and the CPC and governments hold the power to appoint senior managers, these managers will always have the

perverse incentive to “steal and shirk”, and it is doubtful that further actions to improve corporate governance and increase shareholders’ rights would be successful.

Secondly, as regards corruption, company and securities laws are unimportant and the CSRC irrelevant. In fact, when corruption is endemic to the whole country, it is unrealistic to expect managers of listed SOEs to be any more honest. But to make the country less corrupt, it is obvious that the whole economic, political and legal systems need reforming, so that the government controls fewer resources, officials’ power is checked and they become more accountable to people. Finally, if the judicial system were strong and effective, the threat of private law enforcement could play a role in deterring managerial misbehaviors. But, as aforementioned, the judiciary is politically weak. To change this situation and ensure the courts are effective, political and legal reform is needed.

It is thus clear that the stock market faces a daunting challenge to improve investor protection so as to curb the corruption, waste and poor decision-making of managers. It is doubtful how effective it would be to introduce more corporate governance schemes and further increase legal rights of minority shareholders. The stranglehold of state ownership in listed companies has to be ended and the whole political and legal systems reformed.

Moreover, investor protection is not the only factor that affects corporate profitability. To increase the profitability of listed companies, sectors where SOEs are in monopoly or oligopoly need to be opened up to private companies, and more private companies should be allowed to access the stock market; the business environment has to be improved and cost of doing business reduced; businesses must be more innovative, must develop their own technologies, build their own brand names, attract talent and acquire managerial expertise.

**CONCLUSION**
In just over 20 years China has developed one of the biggest stock markets in the world. As such, the case of China could be very relevant to the “law and finance” debate. As has been demonstrated, China is less exceptional than one might imagine, and its experience could offer useful lessons for countries wishing to develop their own stock markets. In addition, an examination of the market’ development history could not only shed light on the challenges facing the stock market, but also give an insight into the future of China’s economic development.

The history of China’s stock market development shows that a preconditions for a market to emerge and grow is the presence of sufficient demand and supply of capital in the economy. As a result of economic reform and the policy of encouraging people “to get rich”, by the time the stock market emerged, many households in China already had “spare money”; as the economy grew rapidly, so did people’s disposable income and savings. On the demand side, after the agricultural sector was liberalized, rural industry flourished, creating a demand for finance; SOE reform in the early 1990s tightened the soft budget and SEOs became desperate for new sources of funding; by the early 2000s a new demand for capital had been generated by the growth of private enterprises. So, China’s experience suggests that, in asking why a country has or has not developed a large stock market, the first question is whether there is a enough demand for and supply of capital in the economy.

Second, China’s experience demonstrates concretely that investor protection is critical to sustaining market growth. When frauds are systemic, not even a government as powerful and interventionist as China’s could stop the market declining, and a market can only survive when a degree of law and order is established. Moreover, when investor protection is weak and managerial misbehaviors are unchecked, corporate profitability suffers, the market stalls and its
capacity for growth is stifled. However, it seems that the scope of investor protection assessment undertaken by the “law and finance” research, the World Bank and the World Economic Forum is too narrow. It focuses on corporate governance and information disclosure. But the first crisis China’s stock market encountered was caused by securities frauds, especially by controlling shareholder misappropriation, market manipulation and false information disclosure. In this area of investor protection China has achieved much that is not captured by these international assessments because of their narrow scope.

Thirdly, China’s experience indicates that the sequence of development is market growth first followed by law but not the other way around. China’s stock market emerged and experienced waves of “fever” even before even a basic legal and regulatory framework was in place. The curbing of securities fraud and establishing a degree of law and order happened only after the market had already grown to a considerable size. It seems therefore that market growth caused investor protection to be improved. However, the virtuous circle of “growth-law-further growth” is not a guarantee and market growth may not lead to stronger investor protection in all areas, demonstrated by the still rampant managerial corruption, waste and mismanagement among listed companies in China.

Why has market growth led to an improvement in investor protection in one area but not another? Fundamentally, the answer lies in political and economic factors. It was out of concern for social stability and economic order that the legal and regulatory frameworks were established in the 1990s; by the early 2000s, the number of investors had increased to tens of millions. Because of their common interests, these investors formed a political constituency even though not formally organized. The proliferation of financial media that responded to the market demand for stock market information helped inform investors and enabled them to speak with a
stronger collective voice. Investors had become powerful enough to force the Chinese government to heed their complaints and take action. The government was also moved by its desire to use the stock market for SOE reform. As the stock market grew bigger, the government happily found that it was usefully big enough to transform the whole SOE sector. By the time the bear market started in 2001, corporatization and listing had been established as the primary policy and the stock market had become the workhorse for SOE reform. But the reform was halted when the market ran into crisis. To revive the market, it was obvious that securities frauds had to be tackled and investor protection strengthened. On the other hand, the widespread managerial misconduct has roots in the dominant position of state ownership in listed companies. Despite the CSRC’s corporate governance initiatives and increased shareholder rights, serious agency problems and managers’ incentives to “steal and shirk” remain. It is also unrealistic to expect those managers to be honest and clean, while corruption is endemic to the whole country. But to cure this ill, wholesale political and legal reform is needed. Basically, political and economic factors resulting from market growth have succeeded in improving investor protection in the area of securities frauds, but failed to reduce managerial misbehaviors because of more fundamental politic and economic factors.

The fact that market growth preceded law and investor protection, and the fact that it was political and economic factors that drove or hindered the improvement of investor protection seems to contradict the proposition that legal origins determine the strength of investor protection, and the financial market development consequently. The case of China suggests that, instead of looking at the legal origins, an investigation of the political and economic situation may offer more fruitful findings and convincing explanations for the relative strength or weakness of investor protection and the development of the stock market in a country.
Lastly, the experience of China shows us that investor protection and law are not the whole story. Ultimately, the capacity for growth of a stock market is determined by its performance in investment return and corporate profitability is the foundation of investment return, but investor protection is only one factor that affects corporate profitability. In China, the business environment and cost of doing business, the prevalent SOE monopolies or oligopolies and limited access to the market for private companies, backward technologies and managerial skills, and limited innovation capability, etc. all explain the low profitability. Moreover, even in investor protection, it is political and economic factors that work behind the law. An obsession with investor protection and law may risk that other important issues are neglected. When seeking an answer why a country has or has not been able to develop a strong stock market, we should not limit our investigation only to these two areas.

Looking ahead, China shall not have a shortage of demand for and supply of capital in the foreseeable future. While there is a limit on how far the current system can reduce securities frauds further, they shall no longer pose a serious threat to market growth, because the political and economic factors that have worked to curb frauds will remain. Indeed, the stock market has now been given even more strategic roles in China’s economic and social development, the government hoping that the stock market can facilitate indigenous innovation, technological advancement and industrial upgrading, while helping to restructure the economy, reduce risk in the financial sector and develop China’s pension system. A sign of optimism is that the government recently announced a doubling of the personnel for law enforcement. On the other hand, the stock market faces the daunting challenge of how to increase corporate profitability. The dominance of state ownership in listed companies has to change; fundamental political and legal reform needs to be carried out to curb managerial misconduct; sectors with SOEs in
monopoly or oligopoly should be opened up to private companies and more private companies allowed into the stock market; red tape and cost of doing business need to be reduced; and barriers that hinder innovation and technological development have to be removed. These are challenges that face the whole economy. Whether they can be overcome determines not just the future of China’s stock market, but also China’s whole economic development.
APPENDICES

Figure 1, Shanghai Stock Exchange Composite Index (1991-2010)

Source: GTA CSMAR China Securities Market Index Research Database
Figure 2, Shenzhen Stock Exchange Component Index (1991-2010)

Source: GTA CSMAR China Securities Market Index Research Database
Figure 3, Numbers of Companies listed in Shanghai and Shenzhen

Figure 4, Number of Trading Accounts (including trading accounts for A share, B share and Investment Funds trading)

Number of Trading Accounts
Unit: 10000

Figure 5, Funds Raised Via IPOs

Figure 6, Market Capitalization and Market Capitalization to GDP Ratio

Figure 7, Annual Turnover Rate and Average Daily Trading Value