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

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Abstract

Having grown to one of the largest in the world in just over two decades, the stock market of China is cited as a counterexample to the significance of law for financial market development. A thorough examination of the development of China’s stock market however finds that law is actually critical to sustaining market growth and law did play a role in the growth of the market. On the other hand, the trajectory of development in China is growth first followed by law, and the improvement of law is caused by market growth. The experience of China hence suggests that law and market growth are in a bi- rather than unidirectional causal relation, and the course of development is “growth-law-further growth”. Nevertheless, this virtuous circulation is not a guarantee and market growth may not lead to stronger law in all instances, evidenced by the fact that, though now better protected from market abuse, Chinese investors remain vulnerable to serious managerial misconduct at listed SOEs. Political and ideological constraints are the root obstacle. Politics and ideologies in addition to economic growth seem to be fundamental to stock market development, for they not just explain the stagnation of law in China despite market growth, but also market growth or lack of it in the first place. On the other hand, the strength of law in a country might not have been predetermined by its legal origin, as law has improved in certain respects even in China, a country without the tradition of rule of law.

INTRODUCTION

Despite various peculiarities and once a “worse than a casino” reputation, the stock market of Mainland China has grown to a prominent stature since the opening of Shanghai and Shenzhen Stock Exchange in 1990. The total market capitalization of the two stock exchanges
has been more than that of the Japanese bourses for most of the time since 2007 and trailed only behind the United States,\(^1\) while the average daily trading value has been firmly in the second place.\(^2\) In terms of funds raised via IPOs (initial public offerings), Mainland China ranked first in 2007, 2010 and 2011, and second in 2008, 2009 and 2012.\(^3\) Since 2012 China boasts more than 170 million stock trading accounts and tens of millions of investors.\(^4\)

The rapid growth of China’s stock market seems to contradict the finding of the well-known law and finance research that legal protection of investors is essential for financial market

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\(^1\) The World Bank, *World Development Indicators* (various years), available at http://data.worldbank.org/data-catalog/world-development-indicators. It was argued that the official market capitalization data of the Chinese exchanges was a huge exaggeration, because the data was calculated based on the prices of shares that were traded on the stock exchanges, but shares of listed companies in China were divided into state, legal person and public shares (each accounting for about a third of the total), only public shares were tradable on the exchanges, and the prices recorded for off-exchange transactions of state or legal person shares were much lower than the trading prices of public shares. See CARL E. WALTER & FRASER J.T. HOWIE, PRIVATIZING CHINA: INSIDE CHINA’S STOCK MARKETS 121-122 (2006). For the classification of shares of listed companies in China, see STEPHEN GREEN, CHINA’S STOCK MARKET: A GUIDE TO ITS PROGRESS, PLAYERS AND PROSPECTS 15-18 (2003). However, in 2005 the Chinese government launched a reform to convert the non-tradable state and legal shares into tradable and by the end of 2009 the restriction on the tradability of state and legal shares had become a history.

\(^2\) Statistics including the trading value of major stock exchanges in the world are available from the website of the World Federation of Exchanges, http://www.world-exchanges.org/statistics. The daily trading value even exceeds the figure of the United States during the boom time of the first half of 2015.


\(^4\) 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. An investor needs to open an account at the CSDCC to trade shares 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.
development. It is commonly regarded that Chinese law in general and investor protection in particular are extraordinarily weak. According to the Worldwide Governance Indicators, between 1996 and 2012 China was within the range of 35.89th to 45.5th percentile rank in “rule of law” among all of the 213 economies under assessment (ranging from 0 to 100). In the World Bank’s “Doing Business” report, China ranked 93rd in 2010 and 97th in 2011 out of 183 economies in “protecting investors”. The Global Competitiveness Report 2013-2014 ranked China 75th among 148 economies in “protection of minority shareholders’ interests”, 80th in “strength of auditing and reporting standards” and 84th in “efficacy of corporate boards”. It seems that the stock market in China has been able to grow rapidly notwithstanding weak law for investor protection. Indeed, in examining the link among law, finance and economic growth in China, Allen et al. conclude that China is “an important counterexample” to the significance of law.

Is China indeed a counterexample? Is it true that investor protection has not played a role in China’s stock market development? These are intriguing and important questions. The connection among law, financial market development and economic growth has been widely accepted, evidenced by the fact that both the World Bank and the World Economic Forum use investor protection as an indicator of the business environment or competitiveness of economies

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5 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).


around the world. Nevertheless, if the answer to those questions is “yes”, the “law matters” thesis would be cast into serious doubt, considering that China has been able to develop a stock market that is now one of the world’s largest in such a short period of time. Moreover, as a live case of great magnitude, China’s experience could offer valuable insights into other law and finance issues, such as whether the positive correlation between investor protection and financial market development found by the law and finance research\(^\text{10}\) is due to the causation from investor protection to market growth or the opposite,\(^\text{11}\) whether the strength of investor protection in a country is predetermined by the legal origin\(^\text{12}\) or shaped by the modern politics,\(^\text{13}\) whether formal law for investor protection can be substituted by informal institutions,\(^\text{14}\) and why a market grows in the first place.

China’s stock market thus deserves more attention, and thorough and in-depth studies are warranted. To achieve this end, this Paper undertakes a detailed and comprehensive investigation of the history of China’s stock market development. It takes a qualitative approach in order to see what have really happened on the ground; it examines the whole history rather than the state of the market at a specific point of time in order to gain a full and holistic view. The findings are that, rather than being a counterexample, the case of China demonstrates that investor protection is critical to sustaining market growth and informal institutions cannot substitute for formal law. It is true that investor protection was hardly relevant to the rapid growth of the market before mid-2001. But weak law led to ubiquitous frauds (in particular, market manipulation, false

\(^\text{10}\) Rafael La Porta et al., supra note 5.
\(^\text{12}\) Rafael La Porta et al., supra note 5.
\(^\text{14}\) Franklin Allen et al, supra note 9.
information disclosure and misappropriation of corporate assets) towards the end of 1990s and early 2000s, bringing the market into a severe crisis even to the verge of complete collapse. The government took various measures to prop up the market, but to no avail. It was only after actions were taken to curb the frauds and a degree of law and order had been established that the stock market recovered in 2006. It is clear that when frauds were systemic, even a government as interventionist and powerful as the Chinese could not stop a market declining, and the market could survive only after a degree of law and order was established. Moreover, between 2010 and the end of 2014 the market was again in a prolonged bear and IPO had to be suspended for more than one year. The cause is the low profitability of listed companies, which is in turn partly attributable to the widespread managerial corruption, waste, overinvestment and mismanagement at listed SOEs (state-owned enterprises) that still dominate the exchanges. Although investors are now better protected from market frauds, they are still vulnerable to managerial misbehavior at listed SOEs. It is evident that when investor protection is weak and managerial misconduct unchecked, corporate profitability suffers, market is in the doldrums and growth capacity constrained.

Nonetheless, the experience of China shows that the scope of investor protection investigated by the law and finance research and assessed by the World Bank and World Economic Forum is too narrow. It focuses on shareholders’ rights versus their companies and managers. But the severe crisis China’s stock market encountered in the early 2000s was a result of market abuse by miscreant stock traders as well as of false disclosure by listed companies and asset appropriation by controlling shareholders. Investor protection in China in these areas has improved noticeably, but not captured by those assessments because of their narrower coverage.
The research that finds China is a counterexample also misses the improvement, not just because of its narrow coverage but also the static research approach, capturing only a snapshot of a time.

Second, it is found that, while law is critical to sustaining growth, the trajectory of development in China is growth first followed by law. China’s stock market emerged and experienced waves of “fever” even before a basic legal and regulatory framework was in place; while laws were quickly adopted from 1993 after the market regulator, China Securities Regulatory Commission (CSRC), was set up, they were largely unenforced throughout the 1990s, hence the pervasive frauds and the crisis. But by the early 2000s the number of investors had grown to tens of millions. They became a powerful political constituency whose complaints and discontent the government could no longer ignore; moreover, as the market grew to a substantial scale, it became significant to the national economy and strategic to the economic reform, motivating the government to crack down on the frauds in order to restore investors’ confidence and revive the market. The experience of China demonstrates that the causal relation between investor protection and market growth is bi- rather than unidirectional, and the course of development is growth first, followed by the improvement of law, which allows the market to grow further.

However, the virtuous circulation of “growth-law-further growth” is not a guarantee and market growth may not always lead to better investor protection, testified by the fact that serious managerial misconduct remains rampant among listed SOEs in China. Why has growth led to the reduction of market abuse but not managerial misconduct? The answer lies first in the dominance of state ownership in those listed SOEs. Because of the dominance, serious agency problems inherent with state ownership remain and managers’ incentive to “steal and shirk” is unchanged. On the other hand, currently the reduction of market frauds is achieved largely through public
enforcement of securities laws by the CSRC and the two exchanges under its control, but their remit to oversee the management of listed companies is limited and they have no authority to take legal actions against managerial corruption; in the meantime, private enforcement of laws is negligible and courts are useless for investors protection. Last, when corruption is endemic in the whole country, it is unrealistic to expect SOE managers to be any more honest. In a word, the dominance of state ownership, ineffectiveness of the judiciary and macro legal environment explain why managerial misconduct persists. Apparently, the dominance of state ownership is due to the remaining socialist ideology that favors public over private ownership and the Communist Party of China (CPC)’s political consideration to maintain its rule, a major reason for the impotence of the court is its weak position in the political structure of the state, and to ensure that the whole country is less corrupt, fundamental political changes have to be made. China’s experience thus indicates that, while investor protection may strengthen as a result of market growth, this is not always the case, and fundamental politics and ideologies are the root obstacle.

China’s experience thus reveals that the strength of investor protection in a country is not predetermined by its legal origin. Law is not static and investor protection can improve in response to political demands brought by market growth. This happened in China, a country even without the tradition of rule of law. It is true that market growth may not always lead to better investor protection, but the fundamental obstacle in China is politics and ideologies rather than the legal origin. China’s experience tells that no country is destined to be hopeless just because of their history.

Lastly, why did China’s stock market grow in the first place? First of all, the market grew in the course of liberalizing the ultra-leftist ideology that regarded capitalism as being evil and
the stock market the icon of capitalism, and the planned economic system that banned private ownership of production means. Without such liberalization, the shareholding system would not emerge and the stock exchanges would not be allowed to open and grow. Next, this is also because rapid economic growth as a result of liberalization generated huge financing demand and, in the meantime, household disposable income increased rapidly as a result of economic growth, providing sufficient finance to meet the demand. Finally, Chinese people in the 1990s did not have much choice but to invest in the stock market or leave their money in banks with low interest receipts.

On the other hand, the low corporate profitability that underscores the bear market and sluggish growth between 2010 and 2014 is also explained by the following reasons. First, despite liberalization, the current “socialist market” economic system still favors state ownership, allowing inefficient SOEs to dominate the stock market. It also allows them to monopolize the lucrative business sectors like finance and telecommunications, which ensures that even private listed companies, albeit more efficient, are in low profitability due to exclusion from those lucrative businesses. Such favoritism is again rooted in the socialist ideology that favors public ownership and CPC’s political consideration to maintain its rule. Second, corporate profitability is also undermined by excessive government bureaucracies and costs of doing business in China, for which the political system with unchecked government powers is to a degree responsible. Third, the low profitability of listed companies is further explained by their lack of technologies, brand names, managerial expertise, innovation, etc., which is not unusual for a developing country like China. Last, from the mid-2000s the booming real estate market provides Chinese people a highly profitable alternative investment opportunity and the emergence of shadow banking in the late 2000s offers investors even more options.
It can be seen that the growth of China’s stock market in the first place results from ideological and political liberalization as well as the consequent economic reform and growth, and ideologies, politics and economic development also limit the growth capacity of the market. All in all, China’s experience indicates that stock market development is ultimately determined by ideologies, politics as well as economic development. They not just explain market growth or lack of it in the first place, but are also fundamental to the strength of law for investor protection.

The next Part examines the growth history of China’s stock market. Part II reviews the development of the legal and regulatory frameworks and the evolution of investor protection in China. Part III analyzes the role of investor protection in different stages of the market development. Part IV assesses the causal relationship between investor protection and market growth, and explores why the stock market of China grows in the first place.

I. THE GROWTH OF CHINA’S STOCK MARKET

China’s experience with the stock market dates back more than a century and in the mid-1930s Shanghai was the financial center of the Far East. 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 informative, this Paper focuses on the stock market that has developed since 1978, when the CPC under the leadership of Deng Xiaoping decided to abandon far-left ideologies and shift the nation’s attention from political campaigns to economic development. Since then, the whole history of the stock market can be divided into 5 stages: before 1992 when the shareholding system emerged and the stock exchanges were

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opened; between 1992 and mid-2001 when the market was in rapid growth; between mid-2001 and 2005 when the stock market was in crisis; between 2006 and 2009 when the market recovered and experienced an enormous boom and crash; and between 2010 and 2014 when the market was in a prolonged bear.

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

China’s economic reform started from the countryside. Unsurprisingly, the first green shoots of the shareholding system emerged in rural areas.\textsuperscript{16} The system provided an alternative to government finance for the town and village enterprises (TVEs) that expanded rapidly after the agriculture sector was de-collectivized. It was also used to organize rural cooperatives to distribute returns to villagers. However, it was in urban China that later the shareholding system developed and stock markets emerged. As far-left ideologies and economic planning were relaxed, enterprises were allowed to produce beyond their plan quotas to fulfil market demand. But government finance was in severe shortage and the shareholding system was useful to raise money from other sources to fund production expansion.\textsuperscript{17} There was also the urgent need to create jobs, especially for those “sent-down youth” who returned to cities from the countryside after the Cultural Revolution ended.\textsuperscript{18} But at this early stage, most of the shares issued were in fact debts rather than equities, as they bore the right to returns at a fixed rate as well as the right of redemption at request.\textsuperscript{19} Invariably, shares were issued internally to employees or to other enterprises, and enterprises issuing shares were mostly collective rather than SOEs.

\textsuperscript{16} LIU HONGRU, TUPO—ZHONGGUO ZIBEN SHICHANG FAZHAN ZHI LU (BREAKING THROUGH—THE ROAD OF CHINA’S CAPITAL MARKET DEVELOPMENT) 139 (2008).

\textsuperscript{17} LI ZHANGZHE, ZHONGGUO GUSHI FENGYUN DANGAN (ACHIEVES OF TUMULT OF CHINA’S STOCK MARKET) 10-12 (2011).

\textsuperscript{18} Ibid, 13-22, for such an example.

\textsuperscript{19} STEPHEN GREEN, supra note 1, 9.
From 1984 the focus of China’s economic reform shifted to cities 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”. Some local governments went further to experiment with the shareholding system for reform. For example, in 1986 the Shenzhen government initiated a pilot scheme to transform SOEs into shareholding companies. A breakthrough came in 1987 when, in addition to legalizing private enterprises, the CPC proposed to separate the ownership and management of SOEs and endorsed the shareholding experiment. It was claimed that the system was not innately capitalist and that transforming SOEs into companies with a majority of state ownership would not lead to privatization and capitalism; rather, it could facilitate the separation of ownership and control, and help rationalize the management 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, the rapid accumulation of

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household savings as a result of economic growth ensured that these share issuances were possible.\textsuperscript{24}

Once having acquired shares, holders started to trade them. Markets for share trading emerged spontaneously at places like factory gates, street corners and open markets—so-called “kerb trading”.\textsuperscript{25} From 1986 state-owned banks in some cities started to provide the over-the-counter (OTC) service for stock trading, in addition for trading government bonds. The first OTC market for stock trading was commonly regarded as being opened in Shanghai in September 1986 by a local branch of ICBC.\textsuperscript{26} As more shares were issued in 1987 and 1988, local governments were active in setting up OTC markets.

It should be pointed out that the shareholding system and stock market were in their very early infancy during this period, and the miniscule amount of funds raised through issuing shares was dwarfed by the sum raised via government and enterprise bonds.\textsuperscript{27} It was only an “experiment” for SOE reform. The mainstream reform measure was the “responsibility system”, allowing SOEs to retain some profits and to have 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.\textsuperscript{28}

\textsuperscript{24} For example, household bank deposits increased almost tenfold between 1980 and 1988. See National Bureau of Statistics of China (NBSC), Statistical Communiqué of PRC (various years), available at http://data.stats.gov.cn/publish/index?m=.
\textsuperscript{25} Stephen Green, supra note 1, 9.
\textsuperscript{26} Li Zhangzhe, supra note 17, 52-60. ICBC is Industrial and Commercial Bank of China, one of the “big four” state-owned commercial banks of China.
\textsuperscript{28} Liu Hongru, supra note 16, 142-143.
Issuance was poorly received. For example, when *Shenzhen Development Bank*, the bellwether of China’s stock market development in the 1990s, offered shares to the public in 1987, less than 80% were subscribed even after the local government mobilized CPC cadres and government employees to buy. In the following year, *Vanke*, now the largest real estate developer in China, didn’t fare any better. 29 The trading market was lethargic. For instance, the turnover value on the OTC market in Shenzhen was only RMB4 million for the whole year of 1988. 30

But the situation changed dramatically after a wave of “share fever” broke out in Shenzhen in 1990. The “fever” was triggered just by *Shenzhen Development Bank*. In March 1989, the Bank declared a generous dividend. Subsequently, its share price rose steadily, only interrupted in June by the tragic ending of the Tiananmen Square student protest. 31 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 of 1990 the share price saw another jump of almost 600%. 32 The other 4 companies listed on the OTC market in Shenzhen performed equally well. Seeing fortunes gained overnight, more people rushed to the market and money from other parts of the country flooded in. The trading value on the OTC market increased more than 23 folds between January and May 1990. 33 The black

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29 Walter & Howie, supra note 1, 23.
30 Liu Hongru, supra note 16, 84.
32 Liu Hongru, supra note 16, 62.
33 *Ibid*, 63.
market is also flourishing and people congregated at street corners and in parks to trade shares.\textsuperscript{34} The whole city was in frenzy.

This speculation fever came to the attention of the central government. It warned against the danger of speculation and ordered to restrict 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 on daily price rise was further reduced to 5\%, 1\% and then 0.5\%; CPC and government officials were ordered to sell their shares.\textsuperscript{35} Eventually, the fever cooled off and share prices dropped from November 1990.

Although the 1990 “share fever” in Shenzhen was short-lived, it was a milestone in China’s stock market development. It educated the country that buying shares is not just to receive dividends, but big money could be made when prices go up. It ignited the enthusiasm of Mainland Chinese for stock investment. This enthusiasm underscored later the rapid growth of the stock market and explains why there have been so many individual investors in China.

After the “Tiananmen Incident”, Beijing was once more seized by political dogmas. Conservatives had the upper hand and economic reform stalled. It was a surprise that the Shanghai and Shenzhen Stock Exchange were allowed to open at the end of 1990, when reform was at low ebb and the stock exchange was still regarded as a symbol of capitalism. One explanation is that, fearful of social instability that “share fever” might cause, the central government decided to channel all trading activities to two localities (Shanghai and Shenzhen),

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

\textsuperscript{35} \textit{Liu Hongru}, supra note 16, 84-85.
thus limiting the scope for instability.\textsuperscript{36} Another is that by opening the stock exchanges the government intended to signal to the outside world that, despite the political retrenchment, it was still committed to economic reform.\textsuperscript{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.\textsuperscript{38}

Anyway, the Shanghai Stock Exchange was officially opened on November 26 and started to operate on December 19 1990, while the Shenzhen Stock Exchange began operation on December 1 1990, but was approved by Beijing only in July 1991.\textsuperscript{39} By then the Shenzhen market had already cooled and the Exchange was quiet. The Shenzhen Composite Index lost more than half between April 1991 and September 1991, and there was no transaction at all on April 22 1991.\textsuperscript{40} The market only rebounded briefly when the city government instructed government-affiliated institutions to buy shares on the exchange.\textsuperscript{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, ideology and politics in Beijing were unsettled and policy regarding the shareholding system and stock market was inhibitive. For the whole year of 1991, only 0.5

\textsuperscript{36} WALTER & HOWIE, supra note 1, 27.


\textsuperscript{38} STEPHEN GREEN, supra note 1, 11-12.

\textsuperscript{39} LIU HONGRU, supra note 16, 106-116.


billion shares were issued through IPO, raising RMB0.5 billion; the two exchanges were tiny with only 8 listed companies altogether; they were local rather than national markets, with only one listed company from outside the two cities and investors being local residents.

**B. Rapid Growth Between 1992 and Mid-2001**

1. **Explosion following Deng Xiaoping’s “Southern Tour” in 1992**

   At the age of 88, the “Southern Tour” was Deng Xiaoping’s last-ditch effort to push forward China’s economic reform. Pointing out that “development is the hard truth”, he tried to remind the leadership in Beijing to re-focus on economic development; commenting that market or planning is not the inherent nature of capitalism or socialism, he endeavored to draw a line under the divisive ideological debate about whether market should be allowed in socialist China. During his excursion Deng Xiaoping specially paid a visit to the Shenzhen Stock Exchange and appealed for pragmatism towards the stock market. Following his tour, the CPC held its 14th Congress in October 1992 and declare to build a “socialist market economy” as the goal of economic reform, which was later incorporated in the Constitution of the country. The market-oriented reform had then reached to a point of no-return. On the shareholding system and stock market, the CPC meeting reiterated their benefits for SOE reform and called for expanding

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42 CSRC, supra note 27.
43 CPC PARTY LITERATURE EDITING COMMITTEE, DENG XIAOPING WENXUAN (SELECTED WORKS OF DENG XIAOPING) (Vol. 3) 377 (1993).
44 Ibid, 373.
45 Supra note 43.
the shareholding experiment and developing the stock market. Stock market was formally legitimized.

Deng Xiaoping’s “Southern Tour” sparked an explosion of economic activities 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 changes 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 rushed to buy shares. Trading centers sponsored by local governments sprang up across the country, as did black markets. In this state of rage a serious social disturbance happened in Shenzhen on August 10, 1992. IPOs were so popular that investors were required to buy an application form to subscribe shares. After the Shenzhen government announced to issue 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{50} but in the evening they were told that application forms had been sold out and no more left for sale the next day. Suspecting corruption, people 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{51} 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 expressed support for its continuing development.\textsuperscript{52} The Shanghai government also instructed securities companies under its control


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

\textsuperscript{50} Liu Hongru, supra note 16, 196-203.

\textsuperscript{51} Li Zhangzhe, supra note 31, 233-236.

\textsuperscript{52} Ibid, 240-245
to buy shares on the exchange to prop up the market. Share prices thus rebounded sharply. As a result of the riot, the 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 rebound was short-lived. From January 1993 share prices started to drop, ushering in a bear market lasting almost 3 years. The bear market ensued due to changes in the macro economy. 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. The government was frightened, as high inflation was a cause for the Tiananmen protest in 1989. From late 1992 the State Council started to take action, beginning by ordering to halt unapproved share and bond issuance. As inflation rose quickly in 1993, more forceful actions were taken. Dissatisfied with the performance of the People’s Bank of China (PBOC), the central bank, the State Council took the rare action to sack the governor, and the then Vice Premier, Zhu Rongji, took over the job himself to reinstate order and control over credit provision. In the meantime, interest rates were raised twice in the year with one-year deposit rate reaching 10.98%. In this austere environment, it was no wonder that share prices declined. The Shanghai Index fell from 1536.82 in early January of 1993 to 323.92 on July 29

53 Walter & Howie, supra note 1, 265-266.
56 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.
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 notorious “327 government bond futures” scandal in early 1995.

With share prices on a roller coaster and a riot, the stock market was anything but dull during this period. The size of the market grew rapidly. Funds raised through IPO in 1992 were RMB5 billion, 10 times the amount in 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 trading 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.


The second wave of growth started from early 1996. By then share prices had become very cheap and the average price to earnings (P/E) ratio in Shenzhen was just above 9. The macro economy had also changed. The GDP growth rate dropped, but was still 10.2% in 1995.

57 CSRC, supra note 27
58 Li Zhangzhe, supra note 31, 350-355.
59 CSRC, supra note 27.
60 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.
61 CSRC, supra note 27.
62 Ibid.
and 9.7% in 1996;\textsuperscript{63} the consumer price index fell to 17.1% in 1995 and further to 8.3% in 1996.\textsuperscript{64} As inflation eased, the government cut interest rates twice in 1996. Moreover, the government’s attitude towards the stock market had changed. Back in 1992 and 1993 the shareholding system was only an “experiment” for SOE reform;\textsuperscript{65} the stock market was just too small to be significant for the reform. Zhu Rongji, despite his reform credentials and the fact that the Shanghai Stock Exchange was opened under his leadership as the mayor, was suspicious of the stock market, seeing it as being too speculative and of little economic utility.\textsuperscript{66} However, by 1996 the previous SOE reform policies had come to a dead end. The SOE sector as a whole recorded a net loss for the first time in the first quarter of 1996.\textsuperscript{67} As reform cut off funding from government budgets, SOEs were desperate for money. On the other hand, the stock market seemed to have grown big enough to play a role to quench SOEs’ thirst. Hence the government’s attitude became accommodative.\textsuperscript{68} Last, the Shanghai and Shenzhen government, which still controlled the stock exchanges, were locked in a fierce competition in 1996 to achieve the status of the “national financial center” for their city. Various financial incentives were offered to attract new listings and to lure securities companies to relocate; regulation was downplayed and fees for stock trading were cut to encourage more trading; the two governments even instructed

\textsuperscript{64} \textit{Ibid}.  
\textsuperscript{66} \textit{Stephen Green}, supra note 1, 21.  
\textsuperscript{67} Wu Jinglian et al., \textit{Shixian Guoyou Jingji De Zhanluexing Gaizu—Guoyou Qiye Gaige De Yizhong Silu} (Realizing Strategic Restructuring of State-Owned Economy—One Way of Thinking about SOE Reform), \textit{5 GAIGE (REFORM)} 13 (1997).  
\textsuperscript{68} Li Zhangzhe, supra note 31, 429-430.
securities companies under their control to manipulate share prices up in order to lure people into the markets and boost share trading, and the Shanghai Stock Exchange even used its own funds to buy shares to drive up share prices.69

With all these benign conditions, share prices rose and the stock indexes climbed steadily from January 1996. Investors rushed in and the number of trading accounts increased by more than 10 million in 1996. The value of trading in the year soared almost fivefold. By December, the Shanghai Composite Index had more than doubled and the Shenzhen Composite Index more than quadrupled.70 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,71 but the market forged ahead. Eventually the government decided to take drastic actions. On December 13, a 10% cap for daily price movement was reinstated. On December 16, People’s Daily, a newspaper run by the CPC Central Committee, published an editorial, warning in an exceptionally harsh tone against “excessive speculation” and vowing to bring the market under control.72 Investors reacted in panic and for two days share prices plunged almost to the 10% limit. The Shanghai Composite Index lost more than 31% and the Shenzhen Index more than 43% in two weeks.73


70 CSRC, supra note 27.

71 LI ZHANGZHE, supra note 31, 460-464.


73 LI ZHANGZHE, supra note 31, 478.
As share prices plummeted, the government seemed to feel that the market had overreacted and subsequently placated investors with some reassuring talks.\textsuperscript{74} The government also intervened to “stabilize” the market on February 20 1997 when the market reacted in panic to the news of Deng Xiaoping’s death.\textsuperscript{75} Moreover, stock analysts and media spun on the events of Hong Kong’s return to China and the holding of 15\textsuperscript{th} CPC congress, predicting that the government would let the market rise to create a festive atmosphere. The market did recover and by May 1997 the Shanghai index was more than 250 points above the high of 1996. This prompted the government to take new actions to rein in the market. The share issuance quota for 1997 was raised to RMB5 billion and further to RMB30 billion to increase supply; the stamp duty rate was raised; SOEs and listed companies were “strictly prohibited” from stock trading; banks were ordered to tighten control to prevent funds being channeled to the stock market; punishments were meted out and several prominent bankers lost their jobs;\textsuperscript{76} trading centers sponsored by local governments were closed, leaving the Shanghai and Shenzhen Stock Exchange the only venues for public share issue and trading.\textsuperscript{77}

Just as these measures started to take effect, the Asian Financial Crisis swept the region. Although the financial sector of Mainland China was not directly affected, its export, inward foreign direct investment (FDI) as well as GDP growth decelerated considerably.\textsuperscript{78} In this adverse economic environment, the stock market became quiet and share prices moved in a

\textsuperscript{74} Ibid, 475-480.
\textsuperscript{75} Ibid, 520-525.
\textsuperscript{76} Ibid, 528-530.
narrow range. Interest rates were cut on 4 occasions and the stamp duty rate was also cut, but the market remained sluggish until May 1999.

After this wave of growth, the stock market reached a new size. 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 highest figure achieved in 1993. The average daily trading value was RMB12.67 billion in 1997, almost a quadrupling of the previous high. The number of trading accounts reached 42.5988 million by the end of 1998.79

3. 1999-2001: The Third Wave of Growth

The third wave of growth 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 Composite Index reached a new record of 2245.80 This boom is fondly remembered by Chinese investors as the “519 Incident”.81 Both the Shanghai and Shenzhen Index more than doubled during this period. 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; the IPO funds reached a historical high of RMB81.237 billion in 2000.82

Underpinning this boom were again changes in the macro economy. By 1999 the Asian Financial Crisis had subsided and the economy of those affected countries stabilized, as did

79 CSRC, supra note 27.
80 Ibid.
81 Li ZHANGZHE, supra note 17, 625-627.
82 CSRC, supra note 27.
Chinese economy. Exports of the country picked up in 1999 and surged in 2000; inward FDI also accelerated.\textsuperscript{83} Moreover, responding to the change from inflation to deflation, interest rates were cut 7 times between 1996 and 1999\textsuperscript{84} and bank reserve ratio was also cut twice from 13\% in 1998 to 6\% in 1999.\textsuperscript{85}

Another reason was the favorable government policies. During this period the SOE reform strategy fundamentally changed and the stock market was no longer seen only as a source of funding, but also to offer a solution to the governance problems of SOEs. As SOEs’ condition continued to deteriorate, the CPC proposed “to grasp the big and let go the small” in 1995, which was confirmed by the 15\textsuperscript{th} congress of the CPC in 1997.\textsuperscript{86} But, while “letting go the small” could be achieved simply by selling-off, there was a question about how “the big” could be “grasped”. To this the CPC decided that the shareholding system was the answer. It reiterated the neutrality of the shareholding system and its benefits for SOEs.\textsuperscript{87} Large and medium SOEs were decreed to diversify their ownership, increase equity finance and undertake standardized corporatization.\textsuperscript{88} Corporatization and listing were thus established as the primary means for the reform of large and medium SOEs and the stock market became vital. The public promise made by the newly


\textsuperscript{85} 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{86} 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{87} \textit{Ibid}.

promoted Premier Zhu Rongji in 1998 to “relieve SOEs from their difficulties within three years” added urgency to the form.  

Against this backdrop of change, People’s Daily published another editorial on June 15, 1999, 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 claimed that a solid foundation had been laid for the market to have a “long-term and stable development”, and indicated that a series of supportive measures would be introduced. In the following days the ban on SOEs and listed companies for 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.

Lastly, the effect of frauds needs to be mentioned. Inspired by the “dot-com bubble” in the US, fraudsters in China fabricated various hi-tech stories and audaciously engaged in market manipulation. Outrageous scams of all sorts were widespread. 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 that SOE on the stock exchange to a level of 85% of the total. After control changed hands, the company was re-named as “Yi’an Keji” (Keji meaning “technology and science” in Chinese) and a succession of announcements made to start

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91 Ibid, 744, 747.

92 Li Jing, Shuizai Caocong 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.
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”. 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 scam and the share price crashed, but the fraudster had already made handsome profits and fled. As cases like this were common, the market boom was pretty much a bubble 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, marking the start of a bear market lasting for 4 and half years. Share indices lost more than half during this period and on June 6, 2005 the Shanghai Composite Index breached the symbolic low point of 1000. As stock prices slumped, investors withdrew from the market in droves. For example, for all the trading accounts in 2005 on the Shenzhen Stock Exchange, 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 during this period. The securities companies as a whole were in the red for 4 years from 2002 to 2005 and the loss

93 WALTER & HOWIE, supra note 1, 271.
97 Ibid, 63.
in 2002 was nearly RMB40 billion, while net assets of the whole sector were only RMB76.5 billion at the end of 2000.98 Throughout this period the market was gripped by bitter debates triggered by a prominent economist’s public denouncement of the stock market as being “worse than a casino”.99 The government was urged to “close down the market and start a new one from scratch”.100 The market slid to the brink of complete collapse.

The crisis occurred when the Chinese economy was at its best. Between 2001 and 2005 GDP accelerated and the growth rate increased from 7.3% to 9.9%.101 Exports skyrocketed after the WTO accession in 2001, as did the inward FDI.102 On the other hand, inflation stayed at a low level with the consumer price index being around 2%,103 and interest rates were thus kept low throughout the period. It is puzzling why the stock market drifted into crisis when the macro economy was in such a good shape. Many investors and commentators blamed the government’s


99 On January 14, 2001, Jinglian Wu, Senior Research Fellow at the Development Research Centre of the State Council, said in an interview on the CCTV (China Central Television) that the stock market was ‘worse than a casino’, because at least a casino had rules that were followed. His comments aroused uproar of debate and resonance among the public, and were extensively reported by other media. See Richard McGregor, “Crackdown on corruption splits Beijing”, FINANCIAL TIMES (February 13, 2001), 14; Anthony Kuhn, “Chinese Markets ‘Worse than a Casino’”, LOS ANGEL TIMES (March 29, 2001).


102 Ibid.

103 Ibid. Consumer price index was 3.9% in 2004.
decision in June 2001 to sell down state shares on the exchanges. The explanation is that investors feared the market would be overwhelmed by too much supply of shares. The evidence cited to support this claim was the drop in share prices after the decision was announced and the jump after the government suspended and finally abolished the policy. 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 a huge bubble and correction was inevitable. Moreover, the market was shaken repeatedly by scandals, including manipulation like the case of “Yi’an Keji” and market cornering, falsifying financial information, misappropriating listed companies’ funds by their controlling shareholders and investors’ funds and stocks by securities companies. It is also noticeable that, despite the robust macro economy, the number of listed companies making a loss increased significantly. In 2001, 150 companies, 12.9% of the total, made a loss. Among them, 20 had made a loss continuously for 3 years and could be delisted according to new regulations

104 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.

105 LU YI, supra note 41, 158-160.


introduced by the CSRC.\textsuperscript{108} The number of loss-making companies increased to 253 in 2005, 18.57\% of the total.\textsuperscript{109}

Whatever the causes, 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 exchanges. This however only produced a short-lived rally and the downward trend continued. The traditional supportive measures, such as cutting stamp duty rate, suspending IPO, and delivering positive talks by government officials, were tried. Even the ban on government officials and Party cadres to trade shares was lifted.\textsuperscript{110} But this time none of them worked and share prices kept falling. Even the CPC’s declaration in 2003 that the shareholding system should be the primary organizational form for SOEs, and the stock market should be greatly developed, did not stop the fall.\textsuperscript{111}

As the crisis intensified, the government realized that more needed to be done. Crackdown on market manipulation was carried out, and some notorious fraudsters were sent to prison; the third-party custody of investors’ funds was introduced to ensure that securities companies would no longer be able to misappropriate their clients’ money; a campaign was undertaken to force misappropriated funds of listed companies to be returned; special regulations were adopted to afford minority shareholders more say in important decisions of their

\textsuperscript{108} Li ZHANGZHE, supra note 17, 342.


\textsuperscript{110} Li ZHANGZHE, supra note 17, 331-333.

companies; the Company Law and Securities Law were revised to offer minority shareholders more protection, as was the Criminal Law to punish information falsification and misappropriating corporate assets; to ensure that only companies with good performance could be listed, the quota system for listing was replaced by a system of underwriters’ sponsoring; to foster institutional investment, the National Social Security Fund (NSSF), insurance companies and enterprise pension funds were allowed to invest in stocks, Qualified Foreign Institutional Investors (QFII) were introduced and the development of mutual funds was greatly encouraged; reform was implemented to allow state and legal person shares to become tradable on the exchanges; 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. All these efforts finally paid off and the market recovered eventually in 2006 and experienced an enormous boom in 2007.

D. 2006 to 2009: Boom, Bust and Rebound

Share prices started to rise 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 high achieved in 2001 and for the whole year recorded an increase of 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 between April 2006 and the end of 2007 interest rates were raised on 8 occasions, and the bank reserve ratio was also lifted. On May 30, 2007 stock indexes recorded

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112 CSRC, supra note 95, Chapter 2.
113 Li Zhangzhe, supra note 17, 454.
114 Ibid, 455-456.
a huge loss when stamp duty rate was raised. But the market shook this off later and surged ahead, peaking eventually on October 16 when the Shanghai Composite Index reached 6124, nearly 6 folds of the level when the bull started at the beginning of 2006. Shares prices then started to drop and, as the Global Financial Crisis intensified, embarked on a free fall. By October 28, 2008, the Shanghai Composite Index sank 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.117

During this round of boom, the market became one of the largest in the world. Funds raised through IPOs soared to RMB459 billion in 2007, by far the highest in the world and more than 5 times of the previous record in 2000. The government was able to list the major SOEs, the “national champions”, including the giant state-owned commercial banks. Market capitalization increased to RMB32.7 trillion by the end of 2007, 123% of the GDP and more than 6 times of the previous highest figure in 2000, while average daily trading value was more than RMB190 billion, nearly 4 times of the previous record in 2000. The number of trading accounts reached 143 million by the end of 2007.118

China was hard hit by the Global Financial Crisis. Export decreased by 27.2% year-on-year for the first 2 months of 2009.119 Inward FDI dropped 32.7% in January 2009.120 GDP

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116 CSRC, supra note 27.
117 LI ZHANGZHE, supra note 17, 483.
118 See CSRC, supra note 27.
decelerated from 11.9% in 2007 to 6.1% in the first quarter of 2009. 121 Thousands of factories were closed and tens of millions of migrant workers lost their jobs. 122 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. 123 The restrictive monetary policy was swiftly reversed. Interest rates and bank reserve ratio were cut 4 times in the last 4 months of 2008; 124 bank lending quotas were scrapped, 125 and new loans almost doubled in 2009 to RMB9.59 trillion, more than twice of the RMB4 trillion stimulation spending. 126

The stock market responded fiercely. The Shanghai Composite Index rose from the trough of 1664.93 in 2008 to 3478.01 on August 4 2009. As the market regained buoyancy in 2009, IPOs resumed and a large number of companies conducted IPO on the ChiNext, the new board opened in Shenzhen in early 2009 for listing growth companies. The remaining major

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SOEs were also listed. Funds raised from the stock market via IPOs in 2010 even surpassed the boom year of 2007.  

**E. 2010 to 2014: A Prolonged Bear Market**

But the rebound was again short lived. The market lost steam after August 2009 and jittered in 2010 with the Shanghai Index overall losing 16.04%. Concerned about the deluge of bank lending, the government raised the bank reserve ratio in early 2010. As inflation rate rose in late 2010, bank reserve ratio was raised further, as were interest rates. In the meantime, the effect of stimulation quickly tapered off and GDP growth rate fell from 10.3% in 2010 to 9.2% in 2011 and 7.8% in 2012. Profitability of listed companies also decreased and the average ROE (return over equity) dropped sharply. Moreover, the enormous amount of money raised from the market via IPOs is widely believed to have had a deleterious effect. For all these reasons, the downward trend started in 2010 continued and by July 2013 the Shanghai Index fell below 2000. As economic growth decelerated, the government loosened its monetary policy somewhat at the end of 2011 and early 2012, and in May 2012 quietly instigated a “stimulus 2.0”, but the impact on economic growth was negligible, like it was on the stock market.

As share prices decreased, the stock market seemed to drift into another crisis. The average daily trading value dropped from more than RMB225 billion in 2010 to less than

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127 CSRC, supra note 27.
128 Xinhua, supra note 85.
RMB80 billion in November 2012.\textsuperscript{131} Of all the trading accounts, less than 40\% held stocks at the end of 2012.\textsuperscript{132} IPO was suspended for more than one year from November 2012 to January 2014.\textsuperscript{133} Criticisms and debates about the future of the market raged again. The reform-minded CSRC chairman, Guo Shuqing, was removed in March 2013 after a stint of only 18 months.\textsuperscript{134}

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

The development of the legal and regulatory framework governing the stock market in China and the evolution of investor protection can be broadly divided into three stages. The first is the period before 1992, during which laws and regulations were few and rudimentary. The second is between 1992 and 2000, during which a legal framework was created and a centralized and unified regulatory system was finally established. The third stage started from 2001, when the government, driven by scandals and crisis, began to focus on investor protection and tighten up law enforcement.

A. The First Stage Before 1992

There were no laws governing company formation and operation when the shareholding system initially emerged in the country. The first such type of legislation did not come until 1984

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\begin{itemize}
  \item \textsuperscript{131} CSRC, \textit{Securities Market Monthly Report} (November 2012), available at \url{http://www.csrr.gov.cn/pub/newsite/sjtj/}.
  \item \textsuperscript{132} CSDCC, \textit{Monthly Report of Statistics} (June 2013), available at \url{http://www.chinaclear.cn/main/03/0304/0304_1.html}.
  \item \textsuperscript{134} \textit{Beijing to Sideline Top Securities Regulator}, \textit{Wall Street Journal}, Mar. 13, 2013, available at \url{http://online.wsj.com/article/SB10001424127887324392804578358303154198298.html}.
\end{itemize}
when the Shanghai government ratified a document drafted by the PBOC Shanghai Branch. It was of great brevity, comprising only 8 articles.\footnote{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}.} 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 requirements for it.\footnote{Gongsi Dengji Guanli Zanxing Guiding (Interim Provisions on the Administration of Company Registratin), issued by the State Administration for Industry and Commerce on Aug. 14, 1985, available at \url{http://www.law-lib.com/law/law_view.asp?id=46832}.} Throughout this period, the central government was hands-off and no company or securities legislation was adopted by the national legislature, the National People’s Congress (NPC) and its Standing Committee, or by the State Council. It was also unclear at the beginning which Ministry had the regulatory authority over the stock market. 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 stock and bond markets.\footnote{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 \url{chinalawinfo.com}.} But the PBOC in Beijing promulgated only one major piece of relevant legislation during this period.\footnote{Zhengquan Gongsi Guanli Zanxing Banfa (Interim Measures on the Administration of Securities Companies), promulgated by PBOC on Oct. 12, 1990, available at \url{chinalawinfo.com}.} The PBOC was also a decentralized system before 1998 in that local branches were effectively controlled by local governments rather than by the PBOC in Beijing.\footnote{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} Hence, at the national level laws and regulations on companies and stock markets virtually did not exist during this period.
From the very beginning local governments were the experimenters and promoters of the shareholding system. They became more enthusiastic after mid-1980s when leftist ideologies were further loosened. To guide experiments, rules were adopted by some local governments. For example, between 1985 and 1990 regulations on share issue and transfer were promulgated by provincial governments of Shaanxi, Guangdong, Fujian, Heilongjiang and by municipal governments of Beijing, Xiamen, Guangzhou, etc. In Shenzhen the government passed a regulation in 1986 to guide the 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 specifically for the corporatization reform of SOEs. In Shanghai the short document issued in 1984 was superseded by a longer one in 1987, but still had only 38 articles altogether.\footnote{Gupiao Guanli Zanxing Banfa (Interim Measures on the Administration of Shares), Art. 18, 19, 20 & 21, promulgated by the Shanghai Municipal Government on May 23, 1987, available at Chinalawinfo.com.} All these legislations were rudimentary at best. The purpose was to put in place some rules governing company formation and the major contents were the approval requirements and procedure for share issues. Investor protection was not yet on the agenda and shareholders’ rights were barely mentioned. Even the most sophisticated regulation of Shenzhen, which had the advantage to borrow from across the border Hong Kong, only vaguely stipulated shareholders’ rights to participate in management and supervision and to 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}.}
receive dividends and surplus. 142 It did not provide for what remedies were available to shareholders when their rights were infringed upon. Lastly, the constitutional legality of these local rules was questionable and the central government later actually refused to recognize some companies set up according to these rules. 143

On stock trading, the PBOC Shanghai Branch issued a document to regulate the OTC market in 1987. 144 In 1990 the government of Shanghai and in 1991 the Shenzhen government promulgated rules on the operation of the Stock Exchanges. 145 The PBOC Shanghai Branch also issued a separate document regulating securities listing and trading. 146 These rules stipulated the requirement for information disclosure and prohibited insider trading and market manipulation, but lacked details. Again investor protection was not yet a concern, illustrated by the requirement that listed companies were to disclose information to the government but not to investors. 147

B. The Second Stage Between 1992 and 2000

142 Supra note 140, Art. 7.
Following the “share fever” triggered by Deng’s “Southern Tour”, a number of legislations were enacted at the ministerial level. Among them, 3 documents issued by the State Commission for Restructuring the Economic System (SCRES) in May 1992 were most prominent. However, it was the riot in Shenzhen in August 1992 that prompted the leadership in Beijing to accelerate legislation and set up a regulatory system. The riot demonstrated that a chaotic market would not only be a risk to the financial system and economic order, but also pose a serious threat to social stability. The top leadership believed that the lack of laws was to blame for the mayhem and felt urgent to regulate the stock market to instill order. In October 1992 the State Council announced to establish a new regulatory system, consisting of the State Council Securities Committee (SCSC) and the CSRC. In December 1992, following the decision made by the 14th CPC Congress to expand the shareholding experiment and to develop the stock market, the State Council published a document, proclaiming that a sound legal system was the precondition for a healthy market and calling for speeding up legislation. It also clarified 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 the securities markets and intermediaries.

1. Creating a Legal Framework

148 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.
150 Ibid, Part V.
151 Ibid, Part I.
After the SCSC and CSRC were set up, legislation was passed at great pace. The first, the Interim Regulations on the Administration of Share Issuance and Trading, was adopted in April 1993.\textsuperscript{152} This was a 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 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 of developed economies.\textsuperscript{153} To implement this legislation, special rules on information disclosure and anti-securities frauds were issued by the SCSC and CSRC in 1993.\textsuperscript{154}

The SCSC and CSRC also promulgated a large number of regulations and rules to govern other issues, such as the organization and management of the stock exchanges, the regulation of securities companies and their businesses like underwriting, proprietary trading, investment

\textsuperscript{152} Zhengquan Faxing Yu Jiaoyi Guanli Zanxing Tiaoli (Interim Regulations on the Administration of Share Issuance and Trading), promulgated by the SCSC on Apr. 22, 1993, available at chinalawinfo.com.


\textsuperscript{154} Gongkai Faxing Gupiao Gongsi Xinxi Pilu 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.
consulting and fund management, the qualification and disqualification of securities practitioners. Special rules were passed to regulate B shares (domestically listed foreigners-invested shares) and overseas offerings and listings.¹⁵⁵ Last but not least, abundant numbers of normative documents, notices, etc. were issued, dealing with *ad hoc* issues, responding to changes or providing operational guidance. For example, by 1998 the CSRC had published 7 documents mandating the format and contents of IPO prospectus, annual and semi-annual report, prospectus 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 1998.¹⁵⁶

In December 1993 the Company Law was adopted by the Standing Committee of NPC, finally providing a solid legal footing for company formation and operation. However, this legislation was criticized for its conservatism left over from the era of planned economy.¹⁵⁷ At the start the law incongruously proclaimed that state assets of a company belong to the state.¹⁵⁸ 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 privilege to be organized as a limited liability


company with only one shareholder.\textsuperscript{159} In investor protection, the law was lamentable. For example, it did not provide for directors’ fiduciary duties; many common measures for minority shareholder protection, such as accumulative voting, shareholders’ right to access company information and the proposal and preemptive right, were absent;\textsuperscript{160} and shareholders did not have recourse to remedies such as the derivative action and appraisal right.\textsuperscript{161}

While other laws and regulations were passed with high efficiency, the adoption of the Securities Law was long delayed. Commencing as early as in July 1992, the NPC Standing Committee took charge of drafting the law—the first instance in China’s legislative history. But bitter disputes on some key issues and a turf war between two departments of the NPC Standing Committee soon broke out. The process of legislation stalled until top leadership intervened in the wake of the Asian Financial Crisis.\textsuperscript{162} The Law was eventually passed in December 1998 and took effect from July 1\textsuperscript{st} 1999. Basically, it was a codification of previous regulations and rules on public offerings, underwriting, listing, trading, information disclosure, anti-frauds, takeover and the regulation of stock exchanges, securities companies and securities businesses. Some provisions were made to confirm policy changes, like abolishing the quota system for share issue and establishing a unified market regulator. There were also technical improvements like in the area of takeover. Some controversial and unsettled issues like OTC market regulation were left

\textsuperscript{159} Ibid, Art. 64.
\textsuperscript{160} Nicholas C. Howson, supra note 157, 142-144 &148-150.
untouched. Overall, the law was rigid and restrictive, reflecting the government’s approach of heavy regulation and control in the face of wild speculation and lawlessness at the market. Nevertheless, the enactment of the Securities Law marked that a basic legal framework governing the stock market had been established.

On the front of criminal legislation, the first was a Decision passed by the NPC Standing Committee in 1995 to punish violations of the Company Law. The corporatization of SOEs created an 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 listed SOEs. 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 specified what the punishments were. Hence loopholes existed whereby miscreant managers might escape criminal punishment. To close them, the NPC adopted the Decision to specify punishments for those misconducts. In addition, the same Decision provided for punishments against fraudulent or unapproved public offerings and false disclosure of financial reports by listed companies. These provisions of the Decision 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

167 Decision 1995, Art. 9, 10 & 11.
information and manipulating share prices by way of trading. These misdeeds were
criminalized early in 1993 by the Interim Regulations on the Administration of Share Issuance
and Trading and the implementing rules on anti-securities frauds, but punishments were not
stipulated. After the 1997 amendment, legislative loopholes were closed. But new ones opened
after the enactment of the Securities Law 1998, which designated more misdemeanors as
criminally punishable without stipulating what punishments would be.

2. Establishing a centralized and unified regulatory system

Despite the establishment of the SCSC and CSRC in 1992 as the specialized regulators,
the regulatory system remained fragmented and locally-controlled. The SCSC and CSRC were
not the only regulators, but other ministries shared responsibilities and power. The State
Planning Commission had the mandate to formulate and distribute quotas for share issues; the
PBOC was responsible for licensing and supervising securities institutions and investment funds;
the Ministry of Finance was responsible for regulating the accounting sector. The CSRC was
overshadowed by other ministries and its authority to issue and enforce rules was questioned, as
it was designated as a non-governmental institution with only an administrative rank of vice-
ministry. In terms of resources, the number of its employees was limited to only 100 and its
funding was insecure. At the local level, the Shanghai and Shenzhen Stock Exchange were

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169 Zhonghua Renmin Gongheguo Xingfa (Criminal Law of PRC), Art. 180, 181 & 182, adopted at the 2nd Session of
the 5th NPC on July 1, 1979, revised at the 5th Session of the 8th NPC on Mar. 14, 1997.
170 Supra note 152 and 154.
171 See Gao Mingxuan & Wang Jianbo, Woguo zhengquan fanzui de bentuhua yu guojihua sibian (An Analysis of the
Localisation and Internationalization of Legislation on Securities Crimes in Our Country), 1 FAXUEJIA (JURIST) 125-133
172 See the State Council, supra note 149, Part I.
173 Ibid.
174 See LIU HONGRU, supra note 16, 212.
still under the control of their respective government.¹⁷⁵ Moreover, following the central government’s practice, Shanghai and Shenzhen set up their own specialized regulators in 1993 and governments in other provinces and cities later followed suit. But these regulators were under the control of local governments and the CSRC had no jurisdiction over them. To sum up, the CSRC was weak, isolated in Beijing and lacked authority. It even had trouble accessing information occurring at the stock exchanges, because it was not physically present at the exchanges and the requirement for the exchanges to report were regularly ignored.¹⁷⁶

It was a series of scandals that led to changes. The “327 government bond futures” scandal fully exposed the mismanagement at the Shanghai Stock Exchange and the lax attitude towards regulation and risk control. The competition between Shanghai and Shenzhen to boost stock trading by using local securities companies and bank money to manipulate share prices further revealed the danger of leaving local governments in control. Thus the first change made by the central government was stripping the two municipal governments the control of the stock exchanges. In August 1996, the provisional regulations on stock exchanges adopted in 1993 were amended and upgraded to a permanent status, which now stated that stock exchanges were under the administration of the CSRC and the CSRC had the power, in consultation with the local governments, to nominate the chairman and vice chairman of the board of directors for election and to appoint the general and vice general managers.¹⁷⁷ In July 1997 the General Office of the State Council gave notice that the two stock exchanges were to be under the “direct”

¹⁷⁵ See the State Council, supra note 149, Part I.
administration of the CSRC and the CSRC was to have the exclusive power over personnel issues. These changes were subsequently incorporated into the regulations. On August 14, 1997 the General Manager of the Shanghai Stock Exchange was replaced by an official from the CSRC, marking the end of local control over the stock exchanges.

The Asian Financial Crisis prompted further changes to the regulatory system. Witnessing the devastation a weak financial sector brought to the whole economy in other Asian economies, the leadership in China decided it was time to put its own unruly financial system in some order. In November 1997 the Central Committee of the 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 ordered to divest their non-deposit-taking and lending businesses. Specifically on the securities sector, it was announced to establish a unified and centralized regulatory system. In April 1998 the SCSC was abolished and the CSRC was upgraded to the rank of a full ministry. The PBOC’s power of licensing and supervising securities institutions and investment funds was transferred to the CSRC. The quota system for share issues was abolished so that the State Planning Commission was no longer involved in the regulation of the stock market. In the meantime, it was decide the CSRC to take over the existing local regulators and new ones to be set up across the country. By July 1999 all local regulators had been put under the control of


179 See the Central Committee of the CPC and the State Council, supra note 139.

180 Ibid, Part XII.
CSRC. A unified and centralized regulatory system had been established. The CSRC’s authority over the stock market was no longer disputed, and it was a physical presence all over the country.

C. The Stage Since 2000

After the new system was established, an urgent issue facing the CSRC was the deteriorated profit performance of listed companies. Despite the short history of the stock market, a large number of listed companies lost money by the end of 1990s. By 2001, 150 companies, 12.9% of the total, made a loss. Some of them had been losing continually for years. 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 continuously and in the following year the “PT” (Particular Treatment) for companies losing for 3 years. There were 26 “ST companies” in 1998 and by 2000 the number increased to 66. The number of “PT companies” increased from 4 in 1999 to 20 by 2001. It had become apparent that merely listing SOEs on the stock exchanges would not improve their performance and the governance of listed SOEs was in urgent need of improvement. 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 overseas markets.  

181 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.

market and identified it as a priority for CSRC to tackle.183 During his 34 months’ tenure, 2 corporate governance 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 directors of a listed company should be independent by mid-2003.184 The second was the issue in January 2002 of a corporate governance code for listed companies, inspired by the OECD Principles of Corporate Governance, but it was much more detailed and addressed problems that were particularly serious in Chinese companies, such as the dominance of controlling shareholder, prevalence of related-party transactions, dependence of listed companies on their controlling shareholder for business and operation, and so forth.185

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. 3 types of scandals were especially notorious. The first was market manipulation, including trade-based, information-based or both. Stock cornering was the most popular trade-based manipulation, whereby a manipulator secretly bought a large number of shares of a company using multiple trading accounts and sold down after innocent investors were lured in and the share price was high enough. In information-based manipulation, different ways were used 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 second type of fraud is information falsification by listed companies, whereby accounting documents like sale contracts, invoices and tax receipts could all be faked. The purposes could be for market manipulation or others, for example, to meet the minimum profit requirement for an IPO or secondary offering. The third was misappropriation, whereby a huge sum of money was channeled from a listed company to its controlling shareholder or other related parties in the name of “loan” or without any pretense.

In October 2000, Caijing, a respected business magazine, published an investigatory report on the shady fund management sector;\textsuperscript{186} December saw the debacle of the intricate and sprawling manipulation scheme of Zhongke Chuangye;\textsuperscript{187} the audacious manipulation of Yi’an Keji collapsed after the CSRC announced an investigation in April 2001;\textsuperscript{188} in August 2001 the CSRC issued a public criticism of Sanjiu Yiyao and its board of directors for not disclosing the misappropriation of billions of RMB by its controlling shareholder;\textsuperscript{189} in the same month the extraordinary story of a blue-chip, high-growth company, Yinguangxia, came to an abrupt end after Caijing discovered that its profits were completely fabricated.\textsuperscript{190} 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.


\textsuperscript{187} Hu Shuli \textit{et al.}, Zhuangjia Lu Liang (Market Manipulator Lu Liang), \textsc{Caijing}, Feb. 5, 2001.

\textsuperscript{188} Li Jing, supra note 92.


\textsuperscript{190} Ling Huawei & Wang Shuo, Yinguanxia Xianjing (The Trap of Yinguanxia), \textsc{Caijing}, Aug. 5, 2001.
Amid a public outcry, action was taken by the CSRC to investigate these scandals and punishments were meted out, helped by the revamped 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, as retail investors withdrew from the market, they could not sell down the shares that they had secretly accumulated. Instead, to maintain the high price of cornered stocks, 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 manipulations made huge losses and could not repay the funds they had appropriated from their clients or raised from other sources. The 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 bankrupt securities companies and clean up the mess that was left behind. 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’ 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 listed 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 “loans” borrowed by their controlling shareholders. But this was ignored and more funds of more 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 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. It was only after intervention by the State Council, amid the 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.

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 invested their real money in listed companies. Early in 2000 the new CSRC chairman proclaimed the importance of protecting minority investors and improving the quality of listed companies. 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-

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party transactions, use of 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 further develop the markets, calling for an improvement in the quality of listed companies and the protection of small investors.\textsuperscript{196} In October 2005 the State Council endorsed a document proposed by the CSRC specifically on improving 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{197} In December 2004, the CSRC issued a regulation specifically for protecting minority investors, giving them the right of veto on such important issues as new issues, rights issues and 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{198}

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,

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rules regarding related-party transactions and reorganization, and so forth. It also introduced the derivative action, offered minority shareholders the appraisal right, the right to propose resolutions to shareholders’ meetings and to have access to internal information; the shareholding threshold for calling an extraordinary shareholders’ meeting was reduced and the powers of the supervisory board augmented. The Securities Law, as amended, confirmed the requirement of underwriter sponsoring for share issues, the third-party custody of investors’ funds, and rules regarding risk control and personnel qualification of securities companies; it decreed to establish a fund for investor compensation in the event of securities companies bankruptcy, and offered investors the right to bring lawsuits against securities frauds; the CSRC’s investigative powers were also strengthened.

The Criminal Law was revised as well in 2006 to establish corporate managers’ personal liability for misappropriation and to close loopholes in criminal liability for information misrepresentation. Subsequently, rules previously adopted by the CSRC were updated in accordance with these revised statutes and more operational rules were issued by the CSRC.

Investor protection was hence improved considerably. Major deficiencies in the primary legislation were corrected and investors offered more legal rights. Regulations, rules and normative documents for investor protection were abundant and the total number exceeded

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201 Such as the guidance on recognition of insider trading and market manipulation, which was internally circulated but not publically available. See Nicholas C. Howson, Enforcement Without Foundation?—Insider Trading and China’s Administrative Law Crisis, 60 AM. J. COMP. L. 955 (2012).
Enforcement was also strengthened, witnessed by both the input of resources and output of CSRC enforcement activities. The era of the 1990s when laws were largely unenforced had gone. By 2006 a degree of order had been established and frauds that once plagued the market had been curtailed noticeably. The Chinese stock market can no longer be said being still in a state of lawlessness. Nevertheless, the decline of share prices since 2010 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{203}) becomes the focus of public indignation and the primary target of the CSRC’s enforcement action.\textsuperscript{204}

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

So far it is clear that investor protection was indeed hardly relevant in China’s stock market development before mid-2001. China experienced bouts of “share fever”, one of which caused a riot, even before a basic legal and regulatory framework was in place. Certainly, those people who frantically traded shares in 1990 and those queuing for days to buy a subscription form in 1992 in Shenzhen had not the least concern for investor protection. In fact, it can be safely assumed that few of them understood what the share is, how a company operates and what risks would be involved. What some of them might know was perhaps that their neighbors or


\textsuperscript{203}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{204}Insider trading accounts for more than half of the total number of cases investigated by CSRC in recent years. Xiao Gang, supra note 202.
friends had bought shares and made money. More might not even be aware of such examples. They just followed suit with only a faint idea that acquiring shares could make money.

Even after the CSRC was set up and major company and securities legislations were adopted, investor protection was still hardly relevant. There was no specific criminal legislation before 1995; the Securities Law was not enacted until 1998; the Company Law 1993 was defective and 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, as witnessed by the widespread and blatant frauds that took place. Even the Shanghai and Shenzhen government organized manipulation to boost stock trading and the two stock exchanges offered support. By the end of the 1990s and the early 2000s frauds (in particular, market manipulation, false disclosure and misappropriation) had become systemic. The magnitude of misappropriation has already been detailed. For false disclosure, one study estimated that 72% of listed companies engaged in such misconduct; for market manipulation, even staff from the CSRC openly admitted that at least 30% of stocks were being actively manipulated in 2000; another report revealed that the CSRC estimated 80% stocks were manipulated in 2001. 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”;

205 Supra note 160 & 161.
206 See text accompanying supra note 193.
207 STEPHEN GREEN, supra note 1, 137.
208 Ibid, 165.
210 STEPHEN GREEN, supra note 1, 164.
“insider trading and manipulation of the market have been conducted almost half-openly”\textsuperscript{211} and were “something of an open secret”\textsuperscript{212}.

The proposition that laws were largely unenforced is further supported by various empirical studies that found few enforcement activities in the 1990s. Table A indicates that the number of cases of CSRC’s administrative penalty and Shanghai and Shenzhen Stock Exchange’s disciplinary actions against listed companies was a single digit every year between 1994 and 2000, while Table B shows an increase from 1998 of the number of cases investigated by the CSRC. On specific frauds, both Table C and Table D display sporadic enforcement activities against market manipulation, insider trading and information misrepresentation by listed companies before 2001.

Table A. CSRC Administration Penalty and Stock Exchanges’ Disciplinary Action against Listed Companies and Managers

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\textsuperscript{211} Xian Chu Zhang, supra note 163, 989.

\textsuperscript{212} \textsc{Walter} & \textsc{Howie}, supra note 1, 64.
Source: GTA Information Technology Co., Ltd. (GTA), Zhongguo Shangshi Gongsi Weigui Chuli Yanjiu Shujuku (Research Database of Enforcement against Illegal Activities of Listed Companies in China) (2011)

Table B. Cases investigated by the CSRC

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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’s Penalty against Market Manipulation and Insider trading

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Table D. CSRC’s Penalty and Stock Exchanges’ Sanction against Information Misrepresentation by Listed Companies

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<th>Public criticism</th>
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<th>% of total listed companies</th>
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<td>108</td>
<td>9.36</td>
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<td>2002</td>
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<td>2003</td>
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Why were laws for investor protection not enforced during this period? In China where the rule of law has yet to be established, laws that have been promulgated 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 for SOE financing, the main concern was the danger that a bubble would cause to the financial system, to the economy and to social stability. This
concern underscored the decrees and warnings, the *People’s Daily* editorial in 1996, and the punishments of several prominent bankers for market manipulation in 1997. Enforcement was used to prick the bubble rather than for investor protection. On the other hand, while frauds were discovered in the earlier days, it was only from 2000 that series of shocking scandals were exposed to cause public outrage; the market ran into crisis only after 2001. In a word, the government lacked motivation to enforce laws, because the stock market was economically insignificant and the government faced no political pressure from investors.

The CSRC also lacked enforcement capacity during this period. There was no enforcement department in the CSRC until 1996; once established in 1996, the department had no more than 33 staff until 2001. The CSRC had no physical presence outside Beijing before 1999. The CSRC even could not access information at the stock exchanges, as they were controlled by the Shanghai and Shenzhen governments. But for the local governments, they were interested in expanding their exchanges and boosting trading rather than enforcing laws, because of the benefits of increased tax revenue, economic growth and political status brought by an enlarged exchange, while financial, economic and social disruption caused by a disorderly market being a concern for the central government. Thus it is not a surprise that before 1997 neither local governments nor the Shanghai and Shenzhen Stock Exchange entered any sanction against information misrepresentation.²¹³

2. *Why the Market Grew While Investor Protection Was Weak?*

Why did the market then grow rapidly while investor protection was weak? Clearly the behavior of those investors rushing to the market without the least concern for protection can be explained by the “herding” theory of behavioral finance. They jumped on the investment bandwagon, just because they saw other people buying shares. Such herd behavior is probably

²¹³ Luo Peixing et al., source for Table D.
more pronounced and pervasive in China, where in a highly collective society with tight-knit social fabrics information about peers’ behavior flows quickly and people feel more pressure to conform to collective norms. Behavioral finance also provides explanations for some other traits exhibited by Chinese investors. For example, some retail investors pursued an investment strategy, colloquially called “dancing with market manipulators”,\(^{214}\) signaling those investors’ overconfidence that they could beat the manipulators; there were numerous stories about investors holding 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 possible that Chinese investors’ rationality was “bounded”. The “bounded” rationality is further compounded by the fact that the market in the 1990s was dominated by individuals and institutional investors were few. These individuals were the first generation of investors with little experience. They paid little attention to a company’s fundamentals, but instead followed intuition, rumors, inside information and other people’s actions. They were especially prone to irrationality.

Second, 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 widespread frauds. During this period law may be indeed not relevant, but a conclusion based on the experience of this period that investor protection is unnecessary would be wrong.

Third, while “bounded” rationality and time lag could be common explanations for market growth, the growth of China’s stock market is further underpinned by a unique factor. Following the Shanghai and Shenzhen Stock Exchanges’ marking with the “ST” and “PT” label for companies losing for 2 and 3 years, the CSRC ruled in 2001 that trading of “PT” companies’ shares be suspended and such companies be delisted if their financial condition did not recovered within a year.\footnote{Kuisun Shangshi Gongsi Zanting Shangshi He Zhongzhi Shangshi Shishi Banfa (Implementation Measures for Suspending and Terminating the Listing of Loss-Making Listed Companies), promulgated by CSRC on Feb. 22 2001, available at Chinalawinfo.com.} Subsequently, local governments sponsored a wave of so-called “asset restructuring” to bail out companies in financial difficulties.\footnote{Stephen Green, The Privatization Two-Step at China’s Listed Firms, Chatham House Asia Programme China Project Working Paper No. 3, 2004, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=598277.} 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 instructed 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, if a controlling SOE did not have the ability to bail out their listed 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”, a popular choice in China. The reason is that private firms had little chance to become listed through an IPO, and “back door listing” was attractive because of 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. For local governments, their motivations to bail out a listed company were multiple. First, a listed company might be an important employer or source of tax revenues for a local
government; second, a listed company was an important vehicle for fund raising, which local
governments were reluctant 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”—
bailout in effect. Therefore, investors no longer needed to worry that a company might fail—the downside risk of stock investment was removed, which is another explanation for the growth despite weak investor protection.

A well-known study suggested that the quota system for share issue created incentives for local governments to select viable companies for listing, because, as the study found, future allocations of quotas to a local area were linked to the past performance of companies from there. 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 IPOs. One study found that of all CSRC’s penalties against accounting firms and accountants between 1994 and 2001, 62.5% were due to misconduct occurring in IPOs. Moreover, the quota system created ample opportunities for rent seeking by government officials in selecting and approving companies for listing. Therefore, even if quota allocation was meant to be merit-based, the system could not ensure only viable companies were listed—attested by the fact that so many companies had to be bailed out soon after being listed.

217 Ibid.
220 Ding Chen, supra note 214, 159.
It is also suggested that financial repression in China contributed to market growth during this period. Because interest rates set by the government were low and capital control restricted overseas investment, Chinese people had no choice but to invest in the domestic stock market. But the question is, when the risk of losing money in the market was high, why did people not leave their money in banks?—at least there it would not disappear. It is arguable that behind the financial repression lie deeper reasons, 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. However, these factors could not sustain a market to grow infinitely, as the history of China’s stock market development after mid-2001 demonstrates.

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

Why did the stock market run into a severe crisis between 2001 and 2005 when China’s macro economy was at its best? Many so-called “opinion leaders” blamed the State Council’s decision in June 2001 to sell down state shares on the exchanges, which was commonly accepted. However, in China there are too many “opinion leaders” whose words could 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 was in fact adopted in 1999, and a pilot experiment was undertaken in December 1999, but share prices rose continuously until June 2001. Second, the selling scheme adopted by the State Council was modest. Only companies undertaking an IPO were to sell, but not those that had already been listed; the number of state shares to be sold was limited to 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

221 Ibid, 172.
222 See text accompanying supra note 104 & 105.
223 CPC, supra note 88.
market. Third, share prices rose on June 13, 2001 when the details were publicized by Xinhua News Agency, and throughout June and July there was only a small drop 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 until the end of 2005. Lastly, it was also argued that selling state shares at market price was unfair to public investors, causing them to withdraw from the market. But the Hong Kong market, where many SOEs had been listed and the selling scheme did not stop, was not affected by such practice.

It can be seen the claim that selling down state shares was responsible for the crisis is not consistently supported by evidence. There must be other causes for the crisis. It is likely that the market fell in 2001 because the bubble became too big and a large number of companies made loss. Nevertheless, while statistically hard to prove, it is credible that securities frauds were also responsible for the crisis. First, the exposure of frauds caused sharp fall of the share price and market value of companies involved. For example, the price of Yi’an Keji plummeted from its highest point of RMB126.31 on February 17, 2000 to less than RMB10 in January 2002. The share price of Yinguangxia plunged from more than RMB33 in August 2001 to just over RMB2 at the end of January 2002 and reached the 10% daily limit for 15 days continuously. A company called Tuopu Software reported huge profits in 2001, but huge losses two years later. A subsequent investigation by the CSRC revealed that around RMB1.4 billion, more than the total of its net assets, had been misappropriated and that the company also offered free guarantee for

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224 State Council, supra note 104.
226 Xu Xiaonian, supra note 106.
227 Historical daily data of the price of individual stocks was available at http://finance.sina.com.cn/stock/.
bank loans of RMB886 million (63.81% of its net assets) borrowed by other companies.\(^{228}\) 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.\(^{229}\) The share price dropped from nearly RMB17 in October 2003 to just over RMB3 at the end of the year; in April 2004 *Delong Group*, a notorious private conglomerate which acquired a 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.\(^{230}\)

These cases showed that a scandal had a devastating effect on the share price and market value of a company. One study identified 212 corporate scandals (defined as an enforcement action taken by the securities regulators or courts) in the stock market between 1997 and 2005.\(^{231}\) Hence the total effect of scandals on the market performance is substantial. They were directly responsible for the fall of stock indices and loss of market capitalization during this period. Moreover, a scandal not only affected the involved stock, but might shake the whole market. For example, after the scandal of *Yinguangxia* was publicized, the Component Index of Shenzhen where the company was listed lost 4.38% on the following trading day, whereas the Index moved


\(^{229}\)Ibid.


narrowly during the previous trading week.\textsuperscript{232} It is very possible that the sudden plunge might be caused by the revelation of the scandal. Since there were so many similar cases, the market was rocked repeatedly and share prices were continually hit. Hence scandals were also responsible for the fall of the market indirectly. 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”.\textsuperscript{233} Faced with such high and dangerous risk, investors understandably withdrew from the market. Frauds thus eroded investors’ confidence in the market, causing them to leave. Lastly, one type of fraud, i.e. misappropriation, was a cause for the poor profitability of listed companies. In 2003, 70% “ST” companies had experienced misappropriation and misappropriation was an important reason for the failure of those delisted “PT” companies.\textsuperscript{234} So, if low profitability of listed companies was also a cause for the crisis, the fraud of misappropriation must be blamed.

To conclude, while there might be other explanations, the pervasive frauds were a crucial cause for the market crisis. Their exposure was not only responsible directly or indirectly for the fall of stock indices and loss of market value, but also damaged investors’ confidence in stock investment. Misappropriation was also a cause for the poor profit performance of listed companies. The experience of the Chinese stock market during this period thus demonstrates that investor protection is essential for sustaining the growth of a market. A market may grow initially, but would run into crisis and its survival eventually be in question, if investor protection

\textsuperscript{232} Data are available from \url{http://finance.sina.com.cn/stock/}.


\textsuperscript{234} Wang Hui, supra note 193.
is so weak that frauds prevail. China’s experience also demonstrates that investors are not just vulnerable to unscrupulous corporate managers, but also to miscreant stock traders. To develop a stock market, it is crucial to protect investors from abuse by stock traders.

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

The recovery of the market in 2006 developed into an enormous bubble and soon burst. Nevertheless, the Chinese stock market has since reached a new height and major state-owned “national champions” been listed. The revival was commonly attributed to the non-tradable share reform, but this view is logically flawed and inconsistent with facts. According to the same logic that the market collapsed in the previous period because of the fear of excessive share supply, the non-tradable share reform should have dampened rather than stimulated the market, because non-tradable shares could then be sold on the exchanges after they became tradable and the market would be flooded. Indeed, after the reform scheme was announced in April 2005, share prices dropped further until the end of 2005; during the 2008 crash and again between 2010 and 2014 when the market was in another bear, selling by owners of previously non-tradable shares was blamed.

Certainly, “bounded” rationality could again be an explanation. Perhaps the turnaround had also to do with the fact that shares had become very cheap after falling for 4 and half years. But the baffling question is, were investors no longer concerned about frauds? Why did investors become irrational after entering into 2006? It is noticeable that investor protection had improved considerably by 2006. Securities frauds that once plagued the market had been greatly curbed

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and a degree of law and order established in the market. It is plausible that the market resurfaced in 2006, also because of the improvement of investor protection. Without such improvement, the revival might not be possible. Also, how the market could survive the spectacular crash in 2008 and the bear market between 2010 and 2014 would be a question, if securities frauds were as widespread as they were in the late 1990s and early 2000s.

After the scandal of Kelon Group broke out in August 2005, major frauds had been exposed. The devastating effect of scandals 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 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 investors. As a result, minority shareholders’ legal rights had been greatly enhanced. Various indicators suggest that by 2006 shareholders’ rights in China were comparable to or even more generous than those of major developed economies. The original law and finance research of Rafael La Porta et al did not include China, but according to Allen et al, China’s “anti-director right index” would be 3 in 2000. While their interpretation of Chinese laws seemed inaccurate, the total score after error compensation would still be 3, falling in the middle among those countries studied by Rafael La

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236 See Long Xueqing et al., Gu Chujun Quan Diaocha (Gu Chujun: A Comprehensive Investigation), CAIJING, Sep. 5, 2005.

237 Supra note 9.
Porta et al. However, after the Company Law 2005 introduced the derivative action and cumulative voting, China’s score would increase to 5, among the highest of all countries. Second, in the “anti-self-dealing indices” compiled by Djankov et al, which were regarded as “better grounded in theory than the index of anti-director rights,” China scored 0.76, lower than the UK and Hong Kong, but comparable to Australia, Ireland and Israel and higher than the US and Canada. Third, in the shareholder protection index compiled by John Armour et al., which comprised of 10 variables and covered the period between 1995 and 2005, China ranked 6th among the 20 countries by 2005, only after the UK, US, France, Japan and Canada. This score of China might not reflect the improvements brought by the Company Law 2005 and Securities Law 2005, as the score did not change after 2003. Otherwise, China’s score would be among the highest after 2005.

Not only were investor offered more legal rights, changes made in other areas also enhanced their protection. For example, to prevent securities companies from misappropriating their clients’ funds, the CSRC decreed in 2004 that investors’ funds be deposited in commercial banks rather than with securities companies. The Securities Law 2005 formally stipulated this requirement. Since then securities companies misappropriating their clients’ funds has disappeared. The same law provided that one investor could only open one trading account and

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239 Simeon Djankov et al., The law and economics of self-dealing, 88 J. OF FIN. ECO. 430 (2008), 461.


the name of the trading account and the investor’s name should be identical.\textsuperscript{243} 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{244}—and banning market entry was provided for as well\textsuperscript{245}. These penalties would have a stronger deterrence effect than the administrative fine, which in most cases is a small amount of 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{246} SOE managers would thus have another thought when they decide to use funds of listed companies to support the ailing controlling SOEs.

On the other hand, enforcement was strengthened, which could be seen from both the input of resources and 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.\textsuperscript{247} 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 staff at the headquarter increased by 32 to nearly 60. The total

\textsuperscript{243} Ibid, Art. 166.
\textsuperscript{244} Author’s calculation.
\textsuperscript{245} Supra note 242, Art. 233.
\textsuperscript{246} 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.
\textsuperscript{247} WANG TING, source for Table B.
number of enforcement staff in the whole system 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 employees, nearly 3 times the previous figure, were added to the investigation departments in Beijing and 110 at the local level. The total number of staff for investigation increased to about 600, nearly 20 times the figure in 1999. In addition, the CSRC was offered more investigative power by the Securities Law 2005, including the power to inspect and freeze bank accounts and securities trading accounts, to seize assets, property and evidence, and to restrict securities trading. 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.

248 Ibid.
251 Supra note 242, Art. 180.
From the output perspective, various studies found that enforcement activities increased markedly from 2001. According to GTA’s database, the yearly figure of sanctions imposed by the CSRC and the two stock exchanges increased from a single digit before 2001 to 76 in 2001 and averaged 77 between 2001 and 2005.\textsuperscript{253} Other studies painted a similar picture. For example, data collected by Pistor & Xu\textsuperscript{254} indicated sanctions by the regulators and stock exchanges more than quadrupled in 2001 from the previous year’s figure; Luo Peixing \textit{et al}\textsuperscript{255} in their study of law enforcement against listed companies for information misrepresentation found that the sanctions by the CSRC and stock exchanges more than doubled in 2000 and doubled again 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,\textsuperscript{256} there is no doubt that enforcement intensified considerably after 2000. Enforcement activities increased further after 2005 and the total number of sanctions by the CSRC and the two stock exchanges has since exceeded 100 every year.\textsuperscript{257}

As a result of all these efforts to enhance investor protection, the scale and seriousness of market frauds have decreased significantly since 2006. First, the once-ubiquitous stock-cornering and the audacious fraud of acquiring listed companies for manipulation have largely disappeared, as has the misappropriation of clients’ funds and stocks by securities companies. There still exist two types of market manipulation. One is “pump and dump”, whereby manipulators make “buy” recommendations or disseminate false information to boost the share price of a company and

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{253} GTA, source for Table A.
\item \textsuperscript{254} Supra note 218.
\item \textsuperscript{255} Luo Peixing \textit{et al}, source for Table D. Also see Benjamin L. Liebman & Curtis J. Milhaupt, \textit{Reputational Sanctions in China’s Securities Market}, 108 Col. L. R. 951 (2008).
\item \textsuperscript{256} Pistor & Xu, supra note 218, 195; Donald C. Clarke, \textit{Law without Order in Chinese Corporate Governance Institutions}, 30 NW. J. INT’L L. & BUS. 131 (2010), 184.
\item \textsuperscript{257} GTA, source for Table A.
\end{itemize}
\end{footnotesize}
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 are severely punished. 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 license was revoked and the individual was banned for life from securities business.258 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.259 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 large number of sanctions handed out by the CSRC and stock exchanges. However, compared to the days when 72% of listed companies were estimated to have engaged in false disclosure,260 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.261 Fourth, insider trading has appeared to be rampant and

259 See text accompanying supra note 193.
260 See text accompanying supra note 207.
become a focus of public indignation. There has been a significant increase of enforcement actions against insider trading since 2008, accounting for more than half of the total sanctions imposed by the CSRC.\textsuperscript{262} However, rather than indicating a deteriorated situation, this increase should be seen as a result of better detection and greater determination to crack down on insider trading. Even a city mayor was sentenced to prison for insider trading.\textsuperscript{263} Arguably, insider trading has a less obvious and immediate effect on investors’ confidence and there are suggestions that insider trading is “victimless” and should be decriminalized. All in all, the scale and seriousness of market 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 Wu Zhipan, an authority on Chinese financial law and Vice President of Peking University, as being “the most transparent and efficient market with the highest degree of rule of law” in China.\textsuperscript{264}

To conclude, the stock market revived in 2006 after major scandals had been exposed and the effect on share prices tapered off. More importantly, by 2006 investor protection had greatly improved and the scale and seriousness of securities frauds had decreased significantly. It is after this improvement that the market recovered and boomed. Without it, it is reasonable to question whether the market could resurge in 2006 and survive the 2008 crash and the prolonged bear

\textsuperscript{262} Data are available on the website of CSRC, http://www.csrc.gov.cn/pub/zjhpublic/index.htm?channel=3300/3313.


\textsuperscript{264} Wu Zhipan, Gushi Shi Toumingdu Zuihao, Zuiyou Xiaolu He Fazihua Chengdu Zuigao De Shichang (The Stock Market is the Most Transparent and Efficient Market with the Highest Degree of Rule of Law), 4 ZHENGQUAN FAYUAN, 18 (2011).
market between 2010 and 2014. The experience of China’s stock market between 2006 and 2009 again testifies to the importance of investor protection for sustaining market growth.

D. Investor Protection and the Bear Market between 2010 and 2014

1. Corporate Profitability, Investment Return and the Bear Market

After the crash in 2008, the stock market experienced a brief rally following the “4 trillion RMB” economic stimulation. But from early 2010 share prices started to drop, heralding another bear market that lasted until the end of 2014. Because of the bear market, IPO was frozen and market growth stalled. As the value of stocks evaporated, investors again became very angry and “opinion leaders” increasingly vocal in their criticism of the market and the government. However, this time the public anger and criticism seemed to center on the market’s low investment return, especially the dismal amount of dividends paid out by listed companies.

In the wake of the bear market there was much media publicity about the poor performance of China’s stock markets in investment return. For example, it was reported in July 2013 that in 4 years the Mainland Chinese market had lost more money for investors than any other in the world;\textsuperscript{265} another report indicated that in 20 years since 1993 the MSCI China Index including dividend payments gained merely 14%, and investors earned less than 1% a year investing in Chinese stocks.\textsuperscript{266} However, China’s stock market is highly volatile and an assessment of market performance based on share prices at one point of time is not really meaningful. For instance, contrasting to the reported poor performance, the MSCI China Index


\textsuperscript{266} Wei\^i Lim & Kana Nishizawa, \textit{China Wealth Proves Elusive as Stocks Earn 1% in 20 Years}, BLOOMBERG, Jul. 15, 2013, available at \url{http://www.bloomberg.com/news/2013-07-14/china-wealth-eluding-foreigners-as-equitie earns-1-for-20-years.html}. 
returned 680% between November 2001 and October 2007. Nonetheless, measured by the amount of dividends, an important source of investment return, the performance of the Mainland Chinese market is indeed extraordinarily poor. In the 1990s few companies paid cash dividends. Even by 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 poor. Overall, it is 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 12 major markets from both emerging and developed economies. Following the CSRC’s effort to encourage companies to pay more dividends and the fall of share prices, there has been an increase in dividend yield over the last couple of years. The ratio increased to 1.04% in 2009, 1.14% in 2010 and 1.82% in 2011. It was announced by the CSRC in 2012 that the average dividend yield of top 300 blue-chip companies reached 2.34% in 2011, exceeding that of S&P500 stocks. The 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, much of the dividend was paid by dozens of big companies, primarily the 5 largest state-controlled banks. Indeed, the “big 5” banks contributed

267 Ibid.

268 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 dividend in 2012. Without excluding banks, the dividend yield of the market would be much lower. Yet, banks’ share prices are among the lowest, because their best time for profit making has passed and the prospect is dim: non-performing loans are increasing following years of binge lending and the guaranteed interest rate margin and oligopolistic market position will no longer be tenable, if the banking sector is liberalized as expected. On the other hand, risk-free rates of return are much higher in China. 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 interest rates in China are even higher than the official ones. The days when Chinese people could only deposit their money in banks or invest in stocks or bonds have gone. In addition to investing in the booming real estate market, they could 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” in China tripled between 2008 and 2012 to RMB20 trillion. Rates of return varied, but even the safest deposit-equivalent “wealth management products” originated by banks yielded around 5% annually. It is misleading to

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273 Historical interest rate data are available from CHINA STATISTICAL YEARBOOK and historical treasury yield data are available at [www.treasury.gov/](http://www.treasury.gov/).


compare dividend yields without considering the risk-free rates of return and the former is still considerably lower than the later in China. It is thus understandable why Chinese investors withdrew from the stock market and the market fell.

Capital gain is the other source of investment return. For growth companies with high profitability, retaining profits for business expansion 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, 72.77% made a loss at least in one year and 153 were “ST” companies with no profit to distribute. Second, the profitability of companies paying no dividend is much lower as a whole. 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%. Third, it is peculiar that in China 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%. This oddity is due to the CSRC’s effort to compel companies to pay dividends. Responding to public outcry, the CSRC introduced a rule in 2008 that only companies paying cash dividends of no less than 30% of their distributable profits continuously

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276 He Jibao, supra note 269.

277 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.

278 Ibid.

279 Ibid.
for 3 years 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, companies paying no dividends actually had poor operational and financial performance. These companies would not truly bring investors capital gains.

Ultimately, investment return of a stock market is determined by the profitability of the listed companies. Profitability determines not only the dividend yield, but also the size of capital gains. Without the support of profitability, high price of a company’s stocks would be an untenable bubble. How have Chinese companies fared in profitability? In the 1990s, a common saying about listed companies was “first year profit, second year even, and third year loss”. Listed companies were described as “a capital-destroying machine” and abundant capital raised from the market 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 ROE (WAROE) published by the CSRC was 7.63% in 2000, lower than that of non-listed companies and much lower than 19.1% of the largest 1000 listed companies from developed

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281 STEPHEN GREEN, supra note 1, 125.

282 Ibid.


284 CSRC, supra note 27.
countries and 14.62% of the largest 200 companies from emerging markets. 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%.

The WAROE gradually increased from 2003, exceeding 10% in 2006 and reaching the all-time high of 14.7% in 2007. It then crashed in 2008, recovered in 2009, but dropped again from 2011, staying at 13.35% in 2012. 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%. 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 WAROE figure; the median ROA was only 5.58% in 2012, again less than the official interest rate for one-year bank loans. Second, like dividend payments, the lion’s share of profits was made by a few large companies. The top

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286 Ibid, 177-178; CSRC, supra note 27.

287 CSRC, ibid.


289 He Jibao, supra note 269.

10 most profitable companies, including 7 banks, accounted for more than 70% of the profits made by all listed companies in the first half of 2009 and 50% in 2012.\footnote{Ye Jing, 10 Da Zui Zhuangqian 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/20090901/14256692033.shtml; Liu Yonggang & Zhu Ziye, Shida Zui Zhanqian Shangshi 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 Ziye, ibid.} Excluding the top 10, corporate profitability would be much lower. Third, in accompany with increased ROE, the leverage of listed companies surged since mid-2000s. 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 was partially caused by heightened leverage, which is no longer sustainable in the light of the current high level. Fourth, Chinese companies’ ability to sustain high profitability is weak 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 listed companies in the US.\footnote{He Jibao, supra note 269.}

It is now clear that for a long time corporate profitability was low and the stock market was in a bubble. This explains why the market was so speculative. Because of low corporate profitability, long-term investment was infeasible. The only chance for investor to make profits was to speculate on price movements. The bear market from 2001 to 2005 could be somehow seen as a major correction of the bubble. Although profitability increased 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 been declining. The economic stimulation in 2009 had only a short-term effect on corporate profitability, but hugely inflated share prices. Another bubble arose and the subsequent fall was a correction, sustained by declining corporate profitability. In the meantime, people now have more alternative investment opportunities with higher rates of return. Ultimately, the bear market since 2010 is underscored by the low and declining profitability of listed companies.

2. Reasons for the Low Corporate Profitability

The reasons why profitability of listed companies in China is low are multiple, but there is no doubt that weak investor protection is a major one. Certainly, the widespread misappropriation of listed companies’ assets by their controlling shareholders seriously hurt profitability. Although such misappropriation has been reduced since 2006, weak investor protection harms profitability in other ways. China’s stock market has long been dominated by SOEs. Although the number of listed SOEs had decreased to 47% of the total by the end of 2011, they still accounted for 90% of the total assets, 86% of the total revenues and profits, and 74% of the total market capitalization. Listing was supposed to improve SOEs’ governance, but serious problems remain. One is the endemic corruption in the forms of bribe taking and embezzlement 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

295 See infra discussion in Section B of Part IV.
corruption and scandals continue after their listing;\textsuperscript{298} serious corruption was also present in many other “national champions” such as China Mobile, Chalco (China Aluminum), and COSCO (China Ocean Shipping).\textsuperscript{299} These are only cases that have been exposed, and these companies, China’s strategic SOEs under the Central Committee of CPC and State Council’s close monitoring, are regarded as the best governed in the state sector. It is not an exaggeration to say that corruption is endemic in the SOE sector. The second problem is waste, in the forms of grandiose office buildings and opulent decoration, luxury limousines, incessant lavish banquets, wines and liquors, etc., which are routinely reported in the news media.\textsuperscript{300} The third is chronic overinvestment and overcapacity, the SOE-dominated steel industry being a prime example. Because of overcapacity, this sector as a whole made a loss for nearly two years up to August


The top 10 loss-making listed companies in 2012 were all SOEs and 5 of them were from the steel industry. Basically, SOE senior managers’ top priority is size 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 by a Singapore-listed Chinese SOE caused losses of $550 million and only after being bailed out by its controlling shareholder did it survive; 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 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 abated, abuse of power by corporate managers to benefit themselves and mismanagement remain serious at SOEs, suggesting that investor protection is still

301 Liu Xiruo, Gangtie Qiye Kuisun Jiazhong, Meidun Gang Yidu Zhi Zhan 0.43 Yuan (Losses at Steel and Iron Enterprises Deteriorating and One Ton Steel Once Producing only RMB0.43 Profits), XINJING BAO (BEIJING NEWS), Aug. 1, 2013, available at http://epaper.bjnews.com.cn/html/2013-08/01/content_454294.htm?div=-1.


extraordinarily weak in China. Corporate profitability suffers from these misdemeanors and market growth is constrained. This experience again gives evidence to the importance of law for stock market development.

IV. THE CAUSALITY BETWEEN LAW AND MARKET GROWTH AND MARKET GROWTH IN THE FIRST PLACE

A. The Causality between Law and Market Growth

If law for investor protection has to be strong for stock market development, there arises the question of why investor protection varies in different countries and how the law develops. Is it true that the enhancement of law is caused by market growth, as is suggested in the US and UK?\textsuperscript{306} Or is the strength of investor protection in a country predetermined by its legal origin, as is proposed by Rafael La Porta et al.,\textsuperscript{307} or dictated by modern politics?\textsuperscript{308}

China’s experience clearly indicates that, while law is important for sustaining market growth, the trajectory of development is market growth first followed by law. The shareholding system and the stock market emerged and grew in the 1980s when a basic legal and regulatory framework was absent and investor protection was none. While the CSRC was set up and laws were gradually put in place after 1992, they were rudimentary and laws for investor protection were basically unenforced until the severe crisis broke out in the early 2000s,\textsuperscript{309} but the market nevertheless grew rapidly. Investor protection improved only after the crisis happened and the market had grown to a significant scale.

\textsuperscript{306} Coffee, supra note 11.
\textsuperscript{307} Supra note 12.
\textsuperscript{308} Roe, supra note 13.
\textsuperscript{309} See discussion in III.A.1.
China’s experience thus supports the proposition that law strengthens as a result of market growth. Why did market growth lead to stronger law in China? Noticeably, the government’s decision in 1992 to establish a legal and regulatory system was prompted by the “riot” in Shenzhen, the market bubble and the excess of shares issues triggered by Deng Xiaoping’s “southern tour”. Leaders in Beijing clearly saw the danger that an uncontrolled stock market posed to the economy and society. Their motivation was to maintain economic order and social stability that a rapidly developing stock market might disrupt. In 1996 and 1997 the government clamped down on the market forcefully by even resorting to People’s Daily editorial, again because of the danger that an enormous bubble would cause to the economy and society. The bubble had been triggered partly by the competition between Shanghai and Shenzhen government to boost share trading and attract listings. It proved the danger of leaving the market under the control of local governments who were indifferent to regulation. It was no wonder that Beijing decided to centralize control and overhaul the regulatory system.

However, it was only after the crisis happened that investor protection really improved. The crisis started with the exposure of series of grotesque frauds. The media were at the forefront uncovering these frauds. Caijing in particular played a crucial role and took the lead to investigate and report them. These revelations ignited a public outcry and condemnations. 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. By the early 2000s the number of stock investors 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{310} As their number grew to tens of millions, this political constituency became very powerful, so powerful that even the Chinese government with no electoral pressure had to take heed and respond to their complaints. Moreover, as the number of investors grew, the demand for financial and stock market information increased. In response, financial media and news reports proliferated, helping inform investors and enabling them to express views with stronger collective voices. It can be seen that market growth created a constituency of stock investors whose political power increased as the market grew, which led to better investor protection.

The government was motivated by another consideration to tackle the frauds and enhance investor protection. 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 then suspended. The plan to use the stock market to reform SOEs was then derailed. While the stock market was a liability to the economy in the eyes of Beijing in the early 1990s, it became an important asset by the early 2000s after it had grown to a substantial scale. It was not only an important source of finance for SOEs, but also seen to offer a solution to their governance problems. Listing was established as the guiding policy for SOE reform and such a reform strategy seemed to be feasible after the stock market had grown to a significant size. The government 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{311} However, with the decline of the market, the reform of SOEs by listing had to be halted. To revive the market so that SOE reform could continue, it was plain that frauds had to be curtailed and investors offered more protections. Actually, after the stock market had


\textsuperscript{311} CPC, supra note 113.
grown to a substantial size, it was not just important for SOE reform but seen as strategic to the whole economy. It was said that the stock market could improve the efficiency of the national economy by allowing market to play a role in capital allocation, support innovation and development of the private sector that emerged to be critical to job creation and economic development, and enhance the safety of the financial system by allowing more equity finance to balance bank lending.\textsuperscript{312} These were motivations behind the government’s decision to open the Small and Medium-Sized Enterprise Board in 2004 and the ChiNext in 2009 at the Shenzhen Stock Exchange. However, to achieve these strategic goals, frauds had to be checked and investors protected to ensure that the market could revive and continue to grow.

China’s experience thus demonstrates that, while investor protection is critical to sustaining market growth, the improvement of investor protection is caused by market growth. Growth brought about stronger political demand for investor protection; growth also amplified the significance of the market to economic reform and the national economy, motivating the government to crack down on frauds in order to restore investors’ confidence and revive the market. The experience of China suggests that market growth and investor protection are in a bidirectional rather than unidirectional causal relation, and the trajectory of development is growth first followed by the strengthening of law, which allows the market to grow further.

Nevertheless, the virtuous circulation of “growth—law—further growth” is not a guarantee and market growth may not always lead to stronger investor protection, evidenced by the fact that serious corruption, waste, overinvestment and mismanagement are still rampant among listed SOEs. Why are investors in China still vulnerable to these managerial misbehaviors? Why has market growth led to the reduction of market frauds but not managerial misconducts? It is obvious that the continuing dominance of state ownership in listed SOEs is one explanation.\footnote{\textsuperscript{312} State Council, supra note 196.}
Because of the dominance, 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 persist and managers’ incentives to “steal and shirk” remain. Minority shareholders, who invest real money in listed companies, are powerless, despite CSRC’s corporate governance initiatives and increased legal rights. The introduction by the Company Law 2005 of cumulative voting and minority shareholders’ right to propose resolutions to shareholders’ meetings are useless, because of the overwhelming state ownership; independent directors are in fact not independent when the controlling shareholders are so powerful that they can decide the selection, appointment and remuneration of independent directors; performance-based remuneration is not workable when the stock market is volatile, companies enjoy monopoly, or the chances of managers being caught “stealing” are slim; the absence of hostile takeovers—the natural consequence of ownership dominance—and the monopolies enjoyed by many listed SOEs in 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 shareholders’ misappropriation, is ineffective in exposing and deterring managers from “stealing and shirking”. It can be seen that the dominance of state ownership provides explanation why market growth has not led to the reduction of managerial misbehaviors and CSRC’s corporate governance initiatives and increased shareholder rights are ineffective. As long as listed companies are state-controlled and the CPC and governments maintain their power to appoint senior managers, it is doubtful their governance can significantly improve. Apparently, the dominance of state ownership in listed companies is due to the remaining socialist ideology that favors public over private ownership, which is still enshrined in the constitution of both the CPC and the country, and the CPC’s
political consideration to maintain its rule over the country. Hence, the fundamental obstacle to the improvement of investor protection from market growth is ideology and politics.

Second, currently the reduction of market frauds is achieved through public enforcement of securities laws by the CSRC and the two exchanges under its control, but their remit to oversee the management of listed companies is limited. They have no authority to take legal actions and punish SOE managers for corruption, waste and mismanagement. In the meantime, private enforcement of laws is negligible and courts are useless for investor protection. Although the Company Law 2005 introduced the derivative action, shareholders faces various hurdles in bringing a derivative lawsuit and so far no action in connection with a listed company has ever been taken.313 For private securities litigation, investors were incapacitated in using such lawsuit to protect themselves, after the Supreme People’s Court imposed various restrictions and the class action was prohibited.314 The government is just not serious in empowering investors to call corporate managers to account by way of litigation, for fear of losing control. Another reason for the impotence of the court is its weak position in the political structure of the state315—courts are under the leadership of CPC and subordinate to the People’s Congresses. Such an arrangement is to ensure that the CPC’s power is unchallenged. As a result, courts are in a difficult position in adjudicating cases involving SOEs, because SOEs are the economic foundation of the CPC and a part of the state apparatus. Hence, politics again explains why market growth fails to reduce managerial misbehaviors at listed companies. Last, when corruption is endemic in the whole

313 Zhong Zhang, supra note 161.
315 Donald C. Clarke, supra note 256; Zhong Zhang, supra note 161.
country, it is unrealistic to expect SOE managers to be any more honest. To ensure that the whole country is less corrupt, fundamental political changes have to be made.

To conclude, the experience of China demonstrates that, while investor protection is necessary to sustain market growth, the improvement of investor protection is a result of market growth. However, market growth does not automatically result in better investor protection, and politics and ideologies are the fundamental hurdle.

China’s experience thus reveals that the strength of investor protection in a country is not predetermined by its legal origin. Law is not static and investor protection can improve in response to political demands brought about by market growth. This happened in China, a country even without the tradition of rule of law. It is true that market growth may not always lead to better investor protection, but the fundamental obstacle in China is politics and ideologies rather than the legal origin. China’s experience tells that no country is destined to be hopeless just because of its history.

**B. Market Growth in the First Place**

If the improvement of investor protection is caused by market growth, it is necessary to ask the fundamental question: why does a market grow in the first place? First of all, the stock market in China grew because of economic reform and development. After funding from government budgets was cut off since mid-1980s as a result of reform, SOEs were forced to seek alternative finances. A demand for financing via the stock market was created. As the reform scheme expanded, the demand increased. Later the stock market was not just a source of SOE financing, but also became a venue for reforming the governance of SOEs, adding more economic rationales for developing the market. Moreover, economic liberalization spurred the phenomenal growth of the private sector, generating a new demand for finance. By the early
2000s meeting the financing demand of private enterprises became an urgent issue, hence the opening of the Small and Medium-Sized Enterprise Board in 2004 and the ChiNext in 2009. By the end of 2011 more than half of the number of listed companies was private enterprises.\textsuperscript{316} Currently there are more than 600 companies queuing for an IPO and listing.\textsuperscript{317} China’s stock market has still a huge potential to grow on the demand side. On the other hand, as the economy grew rapidly, so did household disposable incomes and savings,\textsuperscript{318} providing sufficient supply to meet the demand. There is no doubt that, because China has maintained a steady growth of household savings since the start of economic reform in 1978, the stock market of China has been able to grow rapidly. Chinese households had RMB50 trillion bank savings at the end of 2014.\textsuperscript{319} Hence on the supply side the growth potential of China’s stock market could be met. The question is whether households will actually invest their money in the market.

Second, the market could emerge and grow, also because of ideological, political and the consequent economic liberalization. Such liberalizations not only brought about economic growth that underscored the growth of the stock market, but also directly allowed the market to develop. The shareholding system was allowed emerge and develop in the 1980s, because the ultra-leftist ideology that regarded capital as being exploitative and evil was gradually abandoned and the command economic system that banned private ownership of production means was relaxed. Speeches by Deng Xiaoping during his “Southern Tour” in 1992 further broke down the leftist dogmas that market and capital were incompatible with socialism. The political stigma attached to the shareholding system and the stock market was then removed and the ideological

\textsuperscript{316} China Association for Public Companies, supra note 296.


\textsuperscript{318} Supra note 14

and political obstacles for stock market development cleared. In 1997 the CCP further liberalized its ideology and policy towards the shareholding system and stock market\textsuperscript{320} and the government has since actively encouraged the development of the stock market. It is clear that without the liberalization, the shareholding system would not emerge and the stock exchanges would not be allowed to open and grow. Lastly, while household income and savings increased rapidly, the opportunities for investment were limited until the middle of 2000s. Chinese people did not have much choice but to invest in the stock market or leave their money in banks with low interest receipt. Hence the lack of alternative investment opportunities also contributed to the rapid growth of the stock market before the middle of 2000s.

On the other hand, while the bear market and sluggish growth between 2010 and 2014 was explained by low profitability of listed companies, the low profitability was not just caused by weak investor protection. First, the dominance over the market by inefficient SOEs surely reduced the profitability. Second, it is notable that private listed companies, while more efficient, 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 8.39\% for SOEs.\textsuperscript{321} By 2011 the WAROE for private companies was 12.12\%, still lower than SOEs’ figure of 14.51\%.\textsuperscript{322} One reason was that SOEs had a much higher level of debt leverage. Another was that private and state companies operate in different sectors with different levels of profitability.

\textsuperscript{320} Jiang Zemin, supra note 85.


As of the end of 2006, 62.47% of the private listed 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.\footnote{Chen Bing et al., supra note 321.} 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.\footnote{Ibid.} It is clear that, because private companies are barred from those lucrative sectors, their profitability is low and the profitability of listed companies as a whole suffers.

Third, low profitability is also caused by the unaccommodating business environment. Business in China faces endless and inhibiting bureaucracy and predatory financial burdens. 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; they paid nearly 10% of their revenues for tax and their social security contributions amounted to 40% of employees’ total salary.\footnote{Chen Qingtai & Zhang Yongwei, Xingzheng Shenpi Hegiduo (Administrative Approvals Endless), RENMIN RIBAO (PEOPLE’S DAILY), June 17, 1013, available at http://politics.people.com.cn/n/2013/0617/c1001-21856100.html.} 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.\footnote{The World Bank & IFC, Doing Business 2014, available at http://www.doingbusiness.org/data/exploreeconomies/china.} All these reduce the efficiency of business and eat into their profits.
Fourth, low profitability is also due to the fact that industrial and low-end service companies comprise the majority of listed companies in China.\textsuperscript{327} The profitability of these companies is much lower than their counterparts in developed economies, because they lack 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.\textsuperscript{328} Fifth, from the mid-2000s the booming real estate market provides Chinese people a highly profitable investment opportunity and the emergence of shadow banking in the late 2000s offers investors even more options than stock investment. Last, 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 as GDP growth decelerates, corporate profitability declines.

It can be seen the growth potential of China’s stock market was constrained by SOEs’ dominance over the stock market and the lucrative business sectors, the excessive bureaucracy and costs of doing business in China and listed companies’ limited technological, managerial and innovation capacity. Again, SOEs’ dominance is due to the ideology and politics that favor state ownership; the excessive bureaucracy and costs of doing business could be a result of the political system with unchecked government powers; and the limited capacity of listed companies can be partly explained by the fact that China is still a developing economy. All in all, China’s experience indicates that stock market development is ultimately determined by ideologies, politics as well as economic development. They not just explain why market growth does not lead to stronger law, but also why a market does or does not grow in the first place.

\textsuperscript{327} He Jibao, supra note 269.

CONCLUSION

Having grown to one of the largest in the world in just over two decades, China’s stock market deserves more attention in law and finance research. A thorough investigation of the development history of the market reveals that, instead of being a counterexample to the importance of law for financial market development, the case of China demonstrates that law is critical to sustaining market growth. Nevertheless, the trajectory of development in China is growth first followed by law. China’s experience thus suggests that law and market growth is in a bidirectional rather than unidirectional causal relation, and the course of development is growth first followed by law and then further growth. However, the virtuous circulation of “growth-law-further growth” is not a guarantee, as evidenced by the fact that, though now better protected from market abuse, Chinese investors remain vulnerable to serious managerial misconduct at listed SOEs. Political and ideological constraints are the root obstacle. Politics and ideologies in addition to economic growth are fundamental to stock market development, because they not only explain the stagnation of law in China despite market growth, but also market growth or lack of it in the first place. Lastly, China’s experience reveals that the strength of law is not predetermined by the legal origin of a country and no country is destined to be hopeless just because of their history. Law improves in certain respects even in China, a country even without the tradition of rule of law.

What lessons can be learned from the history of China’s stock market development? For China itself, further political and ideological liberalization is the key to fulfilling the growth potential of the market. They are essential to strengthening investor protection and improving corporate profitability and investment return of the market. For countries that want to develop their stock markets, although Chinese lessons may not be directly applicable, as actual situations
on the ground are different, the experience of China could nevertheless provide an analytical framework in policy development. Some critical questions should be answered. First, are the first-order conditions present? Is there enough demand for and supply of finance? Are the politics and ideologies favorable or hostile to equity financing and the stock market? Second, is the profitability of listed companies adequate? If not, what are the causes for the low profitability? Third, is investor protection strong enough? What are the fundamental obstacles that obstruct the improvement of investor protection?
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)

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