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THE CURIOUS CASE OF SECURITIES MARKETS IN MODERN CHINA

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THE CURIOUS CASE OF SECURITIES MARKETS IN MODERN CHINA

The securities markets of the People's Republic of China, located as they are in an economy with the greatest sustained growth rate on earth, command international attention. On the surface these markets appear rather similar to those in New York, London or Tokyo. They are governed by exchanges, which in turn are monitored by a strong securities regulator; they list shares in corporations (technically joint stock companies under Chinese law) that typically carry one vote per share; holders of shares can vote to elect company directors and approve fundamental corporate transactions; the exchange listing standards include familiar concepts of good corporate governance and disclosure; and directors of listed companies are said to bear fiduciary duties of care and loyalty in carrying out their duties. To the knowledgeable outsider who might travel halfway round the world to view these markets for the first time, all of this would look, we think, rather familiar. But a closer study of the Chinese securities markets would show to such a person that, as the markets presently function, these similarities to western securities markets are superficial and perhaps even misleading. The Chinese markets are fundamentally different. This is perhaps not surprising. Given the path along which they developed, it would be remarkable if these markets were not unique. In this essay, we review the development of securities market in modern China, outline their current condition and dilate upon some of their special characteristics.

PART I. INTRODUCTION

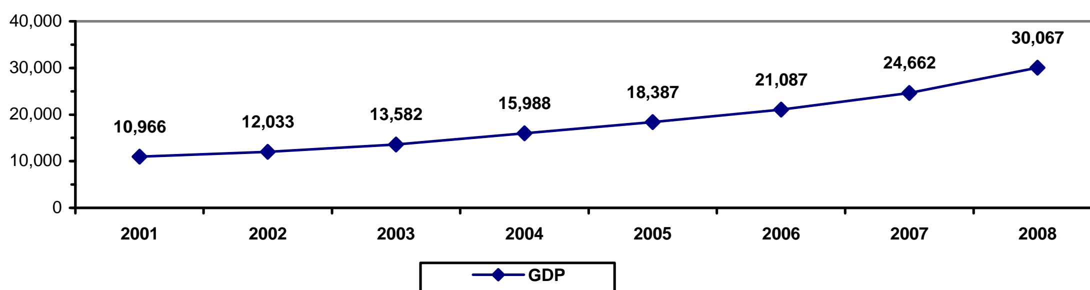
With the reforms of the Chinese economy initiated by the Third Plenary Session of the Eleventh National People's Congress in 1978, China embarked on an unprecedented effort to modernize its economy and gradually to introduce the legal and commercial infrastructure that such an economy is thought by many to require. It would be difficult to exaggerate both the scale and the difficulty of this undertaking. The legal and economic institutions of the old regime had been largely eradicated in the revolutionary enthusiasm that followed victory of the Peoples' Liberation Army in 1949. The history of the period following the establishment of New China need not be repeated here. It is well understood that by the mid-1970s the strong version of a centralized command and control economy that had been instituted, had failed very badly. Some leaders had early on seen the need for a different approach, but until Deng Xiaoping assumed leadership this view was powerless. The changes initiated under Deng's leadership in 1978 were experimental, pragmatic and gradual and that perhaps is part of the explanation for their marked success over time. Of course, these liberalizing moves were not intended to be counter-revolutionary. While designed to begin a pragmatic exploration of ways to allow the Chinese society to grow richer, a paramount objective of the country's leaders remained the maintenance of the leadership role of the Chinese State and of the Chinese Communist Party.

In its broadest aspect this reform effort required the limited and gradual liberalization of Chinese society and gradual opening up to the world. This effort fundamentally required some greater tolerance for decentralization of economic decision making; greater reliance on law as a technique for permitting decentralized actors to make and enforce bargains; and the development, not only of a host of fundamental legal institutions, such as property, contract and courts, but also corporations, commercial banks, insurance companies, stock exchanges, securities firms, mutual funds and other institutional investors. Finally, of course, reform required new forms of

human capital and thus an expansion of universities, including formation of law and business schools, played a part in this process.

The results of the 1978 initiative have of course been extraordinary. While officially reported statistics on Chinese GDP growth rates have been controversial,[1] there is no doubt that real growth over the period 1990-2008 has been very high. Official government sources estimate the average real growth of GDP over the period 2001 to close of 2008 to be 10.3% per year.[2] By official estimates China's total GDP amounted to RMB30.1 trillion (US$4.4 trillion equivalent), making its economy ranked the third largest in the world. Rarely if ever in human experience has so much be done in such a period of time to so significantly improve the condition of so many people. The following table sets forth the total and per capital GDP of China from 2001 to 2008.

Table 1: GDP and GDP per Capita in China (2001-2008)
(RMB in billions)



Source: National Bureau of Statistics of China

In this article we focus on the development of securities markets, as part of a larger project to assess the development of financial markets in modern China. These markets are large and command much attention around the world. Their existence can be judged a marvelous accomplishment. Yet they are somewhat mysterious when viewed from a western perspective. Legal underpinnings of the securities markets, deemed by some as essential, in China remain nascent. These markets themselves, while large, remain underutilized in the finance of the country. Finance of the Chinese economy continues to be dominated, on large scale projects, by bank finance and government support and, on entrepreneurial finance level, by informal (friends and family and loan sharks) lending. Insofar as the Chinese economy is concerned, the role of the securities markets has to date been largely to tap the large reservoir of family savings in China and to facilitate access to international investors for the purpose of relieving pressure on state-owned banks. Despite their limit economic effect to date, the country's leadership has demonstrated a continuing commitment to building out the infrastructure that might allow securities markets to play a substantially greater role in the future. That effort, in part, is recounted in this essay and the essay concludes with the question to which these efforts leads: what are the possible future roles for securities markets in financing further Chinese economic growth?

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[1] See Lester Thurow, Ning Zhou, & Yunshi Wang, The PRC's Real Economic Growth Rate (2003) www.oes.org/pdf/presentations/lesterthurow/pdf. (using data on electricity consumption to cast doubt on reliable of official GDP growth rate numbers).

[2] Source: China Statistical Yearbook (2008)

This article proceeds as follows. In Part II we briefly outline the development and growth of the institutions of the financial markets in modern China. In Part III we begin to focus on the special institutional features of the PRC securities markets. We discuss two strategies that the leadership deployed to protect against excessive change when securities exchanges were re-introduced to China. Those strategies include the shaping of a complex share regulatory plan, referred to generally as the Share Segmentation System, and the creation of a powerful securities regulator controlled directly by the State Council, known as China Securities Regulatory Committee (the "CSRC"). In Part IV we discuss reform of the Share Segmentation System, which appears now to be largely complete, and the implications of that reform for these markets. Part V addresses corporate governance in China, including rights of shareowners to sue on behalf of injured issuers. Part VI treats the role of the CSRC in acting as gatekeeper to the markets and the techniques it employs in the initial public offering (the "IPO") and secondary issuing process. Part VII concludes by asking what the future might hold for these markets and what their growth and condition might teach those interested in the relationship between law and finance.

Thus, this article looks largely at what might be considered corporate finance aspects of Chinese securities markets. We do not address several very important aspects of the general question presented. That is, we will not assess in any depth the state of the development of futures markets or hedging opportunities for Chinese shares; nor will we discuss the development of bond or commercial paper markets, the development of securities firms or institutional investors or the fundamental question of investor education. These important topics would require a monograph rather than an article of the length we attempt.

PART II. GROWTH OF THE INSTITUTIONS OF FINANCIAL MARKETS

2.1 The Dominance of Bank Finance

As an early step in the process of developing decentralized or "market-like" systems in China, in 1979, the state carved off from the People's Bank of China three large state-owned banks.[3] The People's Bank of China, which had been the sole bank permitted to exist in the immediate post revolution period, had joined the deposit taking and lending functions of a commercial bank with the monetary, administrative and governing functions of the state central bank. Creating free standing commercial banks was a significant initial step, but it was a cautious one. Not only were these new banks to be wholly state-owned and controlled, but they each were assigned a sector of the economy within which to lend. Thus, the creation of these banks, later joined in 1984 by the fourth large state-owned bank, the Industrial and Commercial Bank of China, did not introduce competition into the supply of credit. Rather we speculate that it was a step mainly taken (1) to begin the process of separating state functions from commercial functions administratively and (2) to develop the capacity to perform a core capital allocation skill: credit analysis and monitoring of risk. Creating commercial banks thus was a first step down the road towards a world in which more efficient capital allocation might be achieved. These banks were then designated with the task of supporting the productive capital needs of industries in

[3] These three banks included the Agricultural Bank of China, the Bank of China and China Construction Bank which were designated to specialize in agrarian financing; foreign exchange and trade financing and construction and infrastructure financing, respectively.

which state-owned enterprises functioned. The People's Bank of China was left with the monetary and regulatory functions of a state central bank.

Today bank finance continues to dominate capital allocation in China, at least in the formal economy. According to CSRC reported data as of 2006, 84.9% of all financing for non-financial firms was provided by bank loans, while only 3.9% was provided by share issuance, 10.1% by sale of bonds and 1.1% by asset backed securities.[4] Most of the bank finance was supplied by the four large state-owned banks. In 2004, these banks held RMB16.9 billion in assets and extended RMB10.1 billion in loans; while other commercial banks and credit cooperatives extended approximately RMB6 billion in loans.[5]

Yet the efficiency of a system in which state-owned banks are mandated to extend credit to state-owned enterprises is no greater than one in which a direct arm of the government providing this service. As is well understood, the state's natural interest in maintaining the large employment base of existing State-owned Enterprises (the "SOEs") (or at least allow this employment to shrink quite gradually) has led the state controlled banking sector to be operated inefficiently and for non-performing loans to be generated at seriously problematic levels.

2.2. A Theory of an Economic Role for Securities Markets in Modern China

From an economic point of view, the weaknesses of centrally planned and administered allocation of savings to investment as existed in 1978 in China have been well understood since the pioneering work of Ludwig Von Mises.[6] Assuming the goal of capital allocation is to facilitate the production of greater human welfare, then the weakness in the "planned economy" approach derives chiefly from (1) the lack of comparative productivity information concerning alternative uses of capital available to the officials required to make non-market allocations and (2) the difficulty of constructing socially useful economic incentives for enterprise managers who have no participation in any residual or profit that the enterprise may produce. That is, without market prices and investment return data that they yield, planners have few objective criteria for deciding which of many competing plausible uses of capital will best advance the general welfare. In the absence of good information, systems of administrative allocation of capital are susceptible to errors both because they lack good signals of comparative projected economic returns and because in the absence of such signals, non-economic factors of a variety of types (from corruption and favoritism to political expediency) may drive allocation decisions. Finally, administrative capital allocation can create only weak measures for judging the efficiency of individual enterprise management, and for incenting management's intelligent and energetic performance.

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[4] See Chinese Securities Regulatory Commission. *China Capital Markets Development Report* (China Financial Publishing House, 2008), 239. (Hereafter "CSRC Report"). For graphical portrayal of 15 years of this data, see CSRC Report,193.

[5] See China Finance and Banking Institution. *Almanac of China's Finance & Banking* (China Financial Publishing House, 2000-2005), 60.

[6] See Ludwig von Mises, *Socialism: An Economic and Sociological Analysis.* (1922), trans. J. Kahane (Indianapolis: Liberty Fund, 1981), 97-107.

A well constructed securities market can aid in the solution to these shortcomings. First equity investors, if provided with sufficient reliable information, can be expected to be rationally selective: they will try to fund investment opportunities with the highest expected returns. Second, secondary trading markets for a company's shares can produce securities prices that can guide future capital allocation *and* those same prices can act as a measure of and an incentive for high quality managerial performance. One might think this to be a particularly important aspect of securities markets if one were trying to imagine ways to push very large SOEs towards greater efficiency. Thus, it was to be expected that a securities market would be a significant part of the new legal and economic infrastructure that the PRC leadership would strive to put in place.

2.3 Legal Infrastructure of Securities Markets

A well-functioning securities market sits on a top of a great deal of legal infrastructure. While not requiring perfection — imperfections will give rise to risks and costs of a variety of types, but such costs need not be fatal. Non-legal social arrangements may sometimes be deployed to reduce these costs. The following set of legal rules or institutions may be (conventionally) thought to constitute a helpful institutional groundwork for the operation of securities markets:

1. Legal rules that establish the nature of the legal claims being traded on an exchange. For equity markets these rules include company law that specifies and legitimates the corporate form of ownership and creates the roles, rights and duties of management, the board of directors and securities holders. For bond markets, these rules include contract and creditor rights laws and bankruptcy or reorganization laws.

2. Rules that offer some level of protection to equity investors in publicly funded corporations against *ex post* expropriation of their rights or investment by those controlling the company. Such rules may cover a range of strategies including shareholder voting, and mandated good "corporate governance" practices; and imposition of open-ended "fiduciary duties" on corporate officers and directors.

3. Rules that facilitate the initial public offering and trading on a secondary market for shares by mandating disclosure of relevant, dependable information in uniform formats that will reduce the cost of estimating future cash flows and of "intrinsic" value of a security or a firm. Such rules will include uniform accounting, audit and disclosure standards.

4. Rules prohibiting fraud and manipulation on such securities markets, including regulation of trading on "inside information".

5. Regulation that offers assurance of the competence and integrity of financial market agents — brokers, underwriters, auditors etc.

6. Enforcement mechanism to assure reasonable compliance at reasonable cost with all of these necessary rules; such mechanisms may include regulatory or administrative actions or law suits (individual actions or class actions) by investors allegedly harmed by rule violations and must include mechanisms for public enforcement; and

7. A government regulatory agency with sufficient authority, staff and expertise to shape administrative regulations and grant required licenses and otherwise supervise the integrity of markets and disclosure.

2.4 Building the Legal Infrastructure

Among the challenge facing the Chinese leadership as it undertook to develop the modern institutions of finance was the interdependent nature of much of the legal infrastructure of modern finance. China in 1978, and even to a large extent in 1990, was essentially starting from ground zero in this respect. From property rights and the law of business organization and reorganization to the institutions of securities exchanges, regulators and courts, all had to be formed to interact successfully. Through a large series of enactments and re-enactments by the People's Congress, including among many others, the Company Law statutes of 1994 and as revised in 1999, 2004 and 2005, the Securities Law statutes of 1999 as revised in 2004 and 2005; through the establishment of the China Securities Regulatory Commission ("CSRC") in 1992, the Shanghai & Shenzhen Stock Exchanges (December 1990 and July 1991, respectively) and the Securities Association of China (August 1991) (the latter of which are "self-regulatory organizations," but are effectively controlled by the state) and through the detailed administrative work of the CSRC and the SROs much of the formal legal foundation for a modern securities market has now been laid. Indeed, as indicated earlier, on a formal level much of that infrastructure would look rather familiar to western eyes. The reality of Chinese economic institutions however lies beneath those formal institutions, embedded in an ancient culture and controlled by a command and control apparatus that has changed its levers and channels but not really atrophied during the course of thirty years of liberalization.

2.5 The Organization of Security Markets and the Risks They Might Pose to Status Quo

In 1990 the Chinese government permitted the cities of Shanghai and Shenzhen to reintroduce stock exchanges into Chinese economic life.[7] It is fair to infer that this step was seen by the leadership largely as a tool to help deal with the large task of making the state-owned enterprise system more efficient and reducing the burden placed on state-owned banks to fund their losses. The "corporitization" of SOEs — that is the process of carving out of existing state ministry or province production facilities sets of coordinated assets to be formed into "corporations"[8] — and the issuance of shares tradable on a securities market, while ideologically controversial at the time,[9] might help to modernize SOEs in several ways: first by attracting private savings, is-

[7] In the first phase of liberalization in the 1980s some local government ventures had, without benefit of any Company law, issued shares in pooled investments. The first was *Shanghai Fei Le* (1984) with a capitalization of RMB 500,000. Others followed and an informal OTC market evolved in Shanghai and other regional cities for trading these interests. This was permitted experimentally. But it was not until 1990 that the central government formally endorsed the idea of securities exchanges. See Tan Wentao, "History of China's Stock Markets," in *China's Financial Markets: An Insider's Guide to How the Markets Work*, ed. Salih N. Neftci and Michelle Yuan Menager-Xu(Academic Press, 2006).

[8] That is into organizations denominated under Chinese law as "companies limited by shares," which throughout this essay we simply refer to as corporations.

[9] See Jianfu Chen, "Securitization of State-owned Enterprises and the Ownership Controversy in the PRC," *Sydney Law Review* 15 (1993):59-69. For a report of the debates on the ideological justification for "corpora-

suing public shares would provide an additional source of capital for these enterprises; second, the market price of listed securities might serve as a more or less objective measure to evaluate management's work and thus be available as a disciplinary tool; third, through limited share grants or options, managers could one day be provided with strong incentives to make SOEs more efficient; fourth, listing on such an exchange may provide a way to facilitate the ultimate privatization of those parts of the state controlled economy not deemed part of some essential core that required indefinite state control (e.g. banking, national resources, transportation etc.). Lastly securities exchanges can provide listing standards and disclosure standards that could help to introduce modern corporate governance structures and make SOEs more transparent and better managed.

2.6 A Brief Review of the Dimensions of Securities Markets in China

2.6.1 Growth in Market for Large Company (SOEs) Shares

While the securities markets were re-introduced into China in 1990 are far from fully mature, they do represent a remarkable achievement. The most part companies listed on these exchanges are directly and indirectly state controlled companies and estimates vary between 70% and 90% at different times.[10]

Measured at the top of the late worldwide boom in shares prices (i.e. close of 2007) the size of these markets by some measures appears very impressive. The Shanghai and Shenzhen Stock Exchanges by close of 2007 together listed 1,550 companies with a total market capitalization of US$ 4.5 trillion, a bit less than one-third of the size of the NYSE at that time.[11] More remarkable than the market cap of these markets was the growth rate experienced in the preceding three years. Using the same measurement technique by the end of 2005 the market cap of these exchanges stood only at US$286.2 billion![12] According to World Federation of Exchanges, the percentage of changes from 2006 to 2007 in term of market capitalization of Shanghai Stock Exchange and Shenzhen Stock Exchange reached at 302.7% and 244.2%, respectively, much faster than any other exchanges in the world.[13] Market capitalization figures for Chinese securities markets however can be somewhat misleading given the ownership structure of most publicly

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tization" and shares ownership by investors, see "CRES Advocates Share-holding for State Enterprises", Joint Publications Research Service (JPRS)-*CAR-93-033* (May 18, 1993):22-23.

[10] As of 2000, one study put the number at 90%. See Kit Tam, "Ethical Issues in the Evolution of Corporate Governance in China," *Journal of Business Ethics* 37 (2002):305, 307. A study the following year put the number at 84%. See Guy Liu & Pei Sun, "Identifying Ultimate Controlling Shareholders in Chinese Public Corporations: An Empirical Survey," Royal Institute of International Affairs, Asia Program Working Paper No. 2 (2003). See Donald Clark, "The Ecology of Corporate Governance in China," http;//ssrn.com/abstract=1245803, at 8. A recent study studied a period of 1999-2004, consisting of 6,113 samples and it concluded state directly and indirectly acted as major controlling shareholder at 79.7%. See Gongmeng Chen, Michael Firth and Liping Xu, "Does the Type of Ownership Control Matter? Evidence from China's Listed Companies," *Journal of Banking and Finance* 33 (2009): 171, 174.

[11] Data from World Federation of Exchanges.

[12] Data from World Federation of Exchanges.

[13] See World Federation of Exchanges, *Annual Report and Statistics 2007*, http://www.world-exchanges.org/files/file/2007%20WFE%20Annual%20Report.pdf (accessed on April 1, 2009), at 74.

traded Chinese firms. As we explain immediately below, the shares trading on the mainland exchanges for the most important firms are very few (not infrequently less than 5% of outstanding shares). When large blocks of non-trading shares do change hands they appear to do so at very large discounts to market prices.[14]

At any rate, using this metric, these two Chinese exchanges would have together constituted the second largest exchange in the world at the close of 2007. The Shanghai Exchange was the sixth largest, roughly comparable in size to NASDAQ or the London Stock Exchange.[15] Daily trading volume on both markets averaged US$26.1 billion in 2007.[16] Throughout 2007 volumes and prices rose on these markets, as elsewhere, at rates that we now know were unsustainable. By the end of 2008, affected by global market meltdown, the total market capitalization of two stock exchanges were decreased to approximately US$1.8 trillion and a bit less than one-fifth of the size of the NYSE at that time.[17] The two stock exchanges dropped to be the sixth largest in the world at the close of 2008. Compared with major developed and emerging markets, two stock exchanges appeared more vulnerable in front of financial crises. The following table sets forth the changes of domestic market capitalization in major exchanges for the periods of 2006 to 2008.

Table 2: Changes of Domestic Market Capitalization (2006-2008)
(USD millions, except for percentages)

Exchange	End 2008	End 2007	End 2006	% Change 2008/2007	% Change 2007/2006
NYSE Group	9,208,934.1	15,650,832.5	15,421,167.9	-41.2	1.5
Nasdaq	2,396,344.3	4,013,650.3	3,865,003.6	-40.3	3.8
London SE	1,868,064.8	3,851,705.9	3,794,310.3	-51.5	1.5
Hong Kong SE	1,328,768.5	2,65,416.1	1,714,953.3	-49.9	54.8
Shanghai SE	1,425,354.0	3,694,348.0	917,507.5	**-61.4**	**302.7**
Shenzhen SE	353,430.0	784,518.6	227,947.3	**-54.9**	**244.2**
Singapore Exchange	264,974.4	539,176.6	384,286.4	-50.9	40.3
Korea Exchange	470,797.3	1,122,606.3	834,404.3	-58.1	34.5
Bombay SE	647,204.8	1,819,100.5	818,878.6	-64.4	122.1

Source: World Federation of Exchanges

The Shanghai and Shenzhen Exchanges were used to raise the equivalent of US$17.1 billion in 2006, which was increased to US$65.1 billion in 2007, but was decreased to US$14.9 billion in 2008 in IPO funds.[18] The Shanghai Exchange itself was the venue for raising RMB 223.8 billion (US$ 33.4 billion equivalent) of new capital (IPO and secondary offerings) in 2008; and

[14] See Zhiwu Chen and Xiong Peng, "The Illiquidity Discount in China," International Center for Financial Research Yale University (2002) (finding that non-circulating shares trade at a 70-90% average discount).

[15] Data from World Federation of Exchanges.

[16] More recently volumes and prices on the Chinese exchanges have fallen as elsewhere. 2008 average daily volume in dollars was estimated at approximately US$17.1 billion and the Shanghai & Shenzhen 300 Index, which had started 2006 at below 2000 and peaked at 6,124.04 in October 2007, fell to 1,990 in January 2009. Data from Shanghai Stock Exchange.

[17] Data from World Federation of Exchanges.

[18] Data from Zero2IPO Research Center.

RMB670.1 billion (US$ 100 billion equivalent) in 2007; and RMB211.2 billion(US$31.5 billion equivalent) in 2006.[19] In October 2006, ICBC, a state-owned bank, simultaneous distributed a minority block of its shares on the Shanghai and the Hong Kong markets, in what proved to be the world largest IPO generating approximately US$ 21.9 billion in proceeds.

Despite the significant growth in market capitalization of the mainland exchanges, three facts are especially notable about them. First, they are markedly smaller as a percentage of overall national economic activity than stock exchanges in developed financial systems. Reportedly, at the end of 2006, the total value of securities in PRC (equities and bonds, including treasury bonds) constituted just 22% of total financial assets, while in the U.S., U.K., Japan and Korea those percentages were 82%, 71 %, 62% and 75%, respectively.[20] While the proportion of securities of all financial assets in PRC rose to 37% at the end of September 2007,[21] reflecting in part the sharp increase in PRC equity prices in 2007, that percentage has no doubt fallen again with the remission of the Shanghai Shenzhen 300 Index that occurred throughout 2008.

2.6.2 Limited Access for Entrepreneurial Firms

A second notable feature about these stock markets is, as noted above, that for the most part they trade shares of large enterprises controlled by the state. Since control is unavailable on these markets the disciplinary role they can play is small. Moreover the exchanges have not been very useful for finance for private or new firms. It is a stated goal of the government, however, to develop a multi-level securities market system in which smaller enterprises can, under appropriate conditions, gain access to securities markets for raising finance. We address this subject below in section 7.1

2.6.3 Limited Bond Market

A third notable feature of the Chinese securities market is the absence of a substantial bond market. At the close of 2006, the PRC bond market was reported to equal just 35.3% of China's GDP. Comparable international bond market numbers demonstrate the underutilized nature of the Chinese bond market: Japan (201.0% of GDP), the U.S. (188.5%), U.K. (140.5%), Korea (125.1%), Germany (69.0%).[22] Moreover, such bond market as exists is heavily dominated by the issuance and trading of treasury bonds at 53.3% and bonds of government owned financial institutions at 37% at the end of 2007.[23] The CSRC reports that only 4.2% of the small PRC bond market represents what it classifies as "corporate bonds", and most of that amount represents the small commercial paper market at 3.7%.[24] Reportedly, only .05% of the bond

[19] Shanghai Stock Exchange Monthly Statistic Report December 2008, http://www.sse.com.cn/ps/zhs/yjcb/ybtj/sse_stat_monthly_200812.pdf (accessed on March 1, 2009).

[20] See CSRC Report at 237.

[21] See CSRC Report at 193.

[22] See CSRC Report at 245.

[23] See CSRC Report at 246.

[24] See Ibid.

market represents bonds issued by listed companies.[25] Thus if these numbers are accurate there is a very limited commercial paper or bond market for commercial or industrial firms in China.

Finally, we note in passing that China has not yet developed the advanced (and to some toxic) level of the securities market represented by asset securitization, or asset backed securities (ABS) products.

PART III TWO STRATEGIES TO MINIMIZE THREATS TO THE STATUS QUO THAT SECURITIES MARKETS MIGHT POSE

3.1 Possible Threats from Liberalized Financial Markets

The process by which Deng's vision of economic liberalization gradually moved forward in China was naturally one involving political and ideological controversy. These changes seemed necessary and wise, but risky as well. How they should be implemented, at what speed and in what order and how they should be rationalized with the commitment to Marxian ideology were difficult questions. The process of "corporatization" and the prospect of public trading in shares of these newly incorporated SOEs inevitably raised specific concerns.

Chief among those concerns were two, we think. First, by acquiring shares on an exchange, wealthy foreign interests could possibly once more gain power or influence over important Chinese institutions. Painful experience from the late 18th century until 1949 had made the risk of foreign domination of China powerfully salient to Chinese people, as it remains today. Thus, it appears to have been important from the beginning of the offering of equity interests in these newly restructured SOEs for sale that foreign interests be limited in their ability to own them. A second, related threat of publicly traded securities would naturally be seen to be a possible pre-mature weakening of the State's ability to direct the details of the operations of the largest industrial or financial enterprises in the most important sectors of the domestic economy.

Thus, a system was designed that attempted to permit the corporatization of large SOEs and the distribution and trading of their shares, while controlling for these threats. It contained two important features.

First, the securities markets themselves would be monitored and controlled by a strong, specialized state regulator (CSRC) that would have extensive power inspecting the securities exchanges; would control access to these markets both on the part of any firm seeking to distribute shares and on the part of investors (notably foreign investors) and would be empowered to monitor and control all the important players in the securities business.

The second protection was more unusual, the new system would entail a complex system regulating both types of shares that could be traded (or would be non-tradable) and the types of persons or entities that could own those shares. The upshot of this was a system in which only a minority of shares in firms that were allowed access to the market would be tradable and those would be held predominantly by Chinese nationals. The remaining shares would be held by gov-

[25] See Ibid.

ernment instrumentalities directly or indirectly. This resulting Share Segmentation System has been undergoing important change since 2004 (discussed below) but it is useful to understand it in order to understand where these markets are today. In the following sections we briefly address each of these sources of initial protection to State interests. We turn first to a brief description of the CSRC and then turn to a description of the Share Segmentation System and its recent reform.

3.2 Strategy One: The CSRC: Protector and Controller of Chinese Securities Markets

The first strategy we will discuss for dealing with risks that introduction of securities markets might create over time was the establishment of a powerful regulator by the State Council.

3.2.1 The Functions of the CSRC

Prior to 1992, China's infant securities markets were primarily regulated by local government and the local branch office of the People's Bank of China (the "PBC"). In order to consolidate the complex, multilayered and fragmented institutional framework, in fall 1992 the State Council formed the Securities Committee of the State Counsel (the "SCSC") and the CSRC, as the SCSC's executive arm. These new entitles were charged to create a centralized supervisory framework for securities issuance and trading in China. In November 1998, in response to the Asian financial crisis of that period, and largely to try to better protect Chinese financial institution from contagion, the State Council directed that, for both operating purposes and for regulation, the finance industry be segmented. Banking, securities, insurance and trust activities would thereafter be conducted in separate corporations and be regulated by separate regulators. Institutions formerly conducting securities business under the supervision of the PBC were then put under the centralized supervision of CSRC. It became the sole regulator of the securities markets.

As an executive functionary of the State Council, CSRC is a powerful regulator, whose functions are similar to those of the SEC in the U.S. As set forth in the PRC Securities Law of 2006, its main functions are broad indeed. They are to: (1) formulate relevant rules and regulations to supervise and administrate the securities markets and exercise the power of examination or verification; [26] (2) supervise and administrate the issuance, offering, trading, registration, custody and settlement of securities; (3) supervise and administrate securities activities of securities issuers, listed companies, securities firms, securities investment funds, securities trading service institutions, stock exchanges and securities registration and clearing institutions; (4) formulate the standards for securities practice qualification and code of conduct and carry on the supervision and implementation; (5) supervise and examine information disclosure relating to securities issuance, offering and trading; (6) offer guidance for and supervise activities of securities industries associations; (7) investigate and punish violations of any securities laws and administrative rules; (8) perform any other functions and duties in accordance with law or administrative rules.

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[26] Under the CSRC's direct supervision, the Shanghai Stock Exchange and the Shenzhen Stock Exchange are the major SROs in China. The CSRC holds the power to appoint and remove major officers of the exchanges. The stock exchanges themselves are not empowered with formal investigative and sanction authorities over frauds on the market; the CSRC is. But the CSRC's enforcement capacity is still restrained and the SROs may offer considerable depth and expertise regarding market operations and practices.

The CSRC has been an active and generally effective regulator.[27] Notably it has assumed the power to control access to the securities markets by all potential issuers of shares and adopted a substantive review procedure in allowing specific IPOs or secondary issuances to occur. (We discuss its role as gatekeeper in Part VI below). Generally, the CSRC has been the most active of China's financial regulators in attempting to improve market transparency and impose good corporate governance.

3.2.2 CSRC Mandate to Safeguard Investors While Advancing State Interests

As an executive arm of State Council, the CSRC has, as a primary obligation, the advancement of State policy and programs. Among its statutory obligations is the protection of investors —its English language website prominently proclaims, "Investor Protection is Our Top Priority." These dual obligations can sometimes create tension. For example, in its capacity as an agent of the State, the CSRC must advance state interests in the process of "corporatization" of SOEs and the distribution of their shares to the public. Thus, from its inception, the CSRC has sometimes found itself in something of a conflicted situation. As a result, its regulatory efforts or enforcement actions have sometimes been postponed or aborted when state assets and interests are involved.

But just what is the State's interest? At different phases of the development of the Chinese economy it may be seen differently. It is widely thought that the level of investor protection has a significant impact on the growth and performance of stock markets.[28] It seems clear that the remarkable growth of China's economy brings an increasing demand for a securities market of greater capacity and efficiency. The Share Segmentation Reform discusses below brings with it the possibility of sharply increasing number of secondary issuances holders of formerly NTS. Likewise, the banking sector restructuring will need efficient debt capital markets to be developed. Thus, we may be now observing a shift in regulatory focus of the CSRC from the protection of a group of investors' interests— here, the State as holder of non-tradable shares to investors in general, including the State as holder of tradable shares. (See below Part IV for discussion of the non-tradable share reform, and see section, 7.2.3 below for discussion of conclusions).

3.2.3 Mandatory Information Disclosure

Sunlight was famously said by Louis Brandeis to be the best disinfectant and electric light the most efficient policeman.[29] China adopts a similar regulatory approach to mandatory information disclosure. Chinese statutory law mandates disclosure regime that requires all issuers to make true, accurate and full information disclosure and prohibits any material false statement

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[27] See CSRC Report for a comprehensive review of its activity.

[28] For example, LaPorta, Lopez-de-Silanes, Shleifer and Vishny's empirical studies into a possible relationship between investor protection and capital market performance. conclude that countries with poorer investor protection had smaller and narrower capital markets, including both equity and debt markets. See LaPorta, Rafael, Lopez-De-Silanes, Florencio, Shleifer, Andrei and Vishny, Robert (1997), Legal Determinants of External Finance, 52 The Journal of Finance 1131.

[29] See Louis D Brandeis, *Other People's Money and How the Bankers Use it* (New York, NY: Stokes, 1914), 92.

or material omission.[30] Like many other markets, the information disclosure regime in China requires initial information disclosure and continuous information disclosure. The initial information disclosure includes public offering information, such as prospectus and listing announcement. The continuous information disclosure includes periodic reports and ad hoc reports. Periodic reports include annual reports, interim reports and quarterly reports. Ad hoc reports are primarily related to material events disclosure.

Sufficient and creditable information facilitates the rapid flow of capital to its high value users. In fact however, the creditability of information disclosed by Chinese listed companies is regarded as doubtful by investors and scholars.[31] There is evidence that disclosure violations constitutes the most frequent sort of securities law violation in China. A 2002 study by the Shenzhen Stock Exchange reviewed 218 violations of rules involving 171 listed companies from 1993 to 2001 and found that material omission and false disclosure were the two top categories of violations. [32] They represented 69.7% and 13.3%, respectively.[33]

3.2.4 Enforcement

It is commonplace for U.S. legal scholars to note the critical role of enforcement in effective securities regulation.[34] The difference between law as written on a page and law as implemented by active agents and courts can be great.

Securities law enforcement is one of the CSRC's major regulatory functions. It is widely accepted that the CSRC is empowered by the securities law to impose administrative penalties for violations of its rules or of the securities statute. [35] Market misconduct prescribed by existing laws and rules include the main securities market activities proscribed in the U.S.: illegal stock offerings, misrepresentation and omission in connection with the offer or sale of securities, in-

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[30] Article 62, the PRC Securities Law of 2006.

[31] See Joseph Aharony, Chi-Wen Jevons Lee and T J Wong "Financial Packaging of IPO Firms in China," 38 *Journal of Accounting Research* 38 (2000):103.

[32] See Shenzhen Stock Exchange, *Zhongwai Xinxi Pilu Zhidu Ji Shiji Xiaoguo Bijiao Yanjiu (Comparative Study of the Information Disclosure System and Effects)*, http://www.cninfo.com.cn/finalpage/2002-04-23/590499.PDF.

[33] See Ibid

[34] See John C. Coffee, "Law and the Market: The Impact of Enforcement," Columbia Law and Economics Working Paper No. 304 (March 7, 2007). http://ssrn.com/abstract=967482

[35] See Article 180 of PRC Securities Law of 2006. There is some controversy among Chinese academic commentators whether the CSRC as an institutional unit of the State Council (*shiye danwei*) not an administrative department of the State Council, is authorized under the Constitution to make rather apply rules. See Donald Clark, "The Ecology of Corporate Governance in China" George Washington Law School Working Paper (2008), http://ssrn.com/abstract=1245803, citing Weizin Zhou, Zhongguo Zheng and Jian Hui, "A Critique of the Shortcomings of the CSRC's Temporary Rules on Prohibiting Entry to the Securities Market," *FAXUE* [Legal Science] 4 (1998):60-61.

sider trading, market manipulation, securities firm/accounting firm/law firm misconduct in connection with the offer or sale of securities. [36]

Among the recurring matters that give rise to enforcement activities of the CSRC are disclosure violations, securities firm misconducts such as misappropriation of client funds and market manipulation. Authorized penalties against public companies or securities firms include disgorgement, fines,[37] revocations of business licenses, orders of business suspension and internal correction, and warnings or censure. Fines,[38] an up-to a lifelong bar from the industry, and warnings are available against individuals, including directors and officers in listed companies.

It is questionable how effective the CSRC is as an enforcement body. For example, while it proscribes trading on inside information, there is evidence that this regulation is ineffective. In an empirical study of all voluntary tender offers (see Section 7.2.2 below re tender offers) it appears that no investor following a long arbitrage strategy on the date of announcement would make money. The authors infer that information concerning the offers had fully been absorbed into prices before the announcement and that insider trading was the likely technique. [39] More generally, for the most part CSRC enforcement activities are limited and its penalties are mild. Of course, the number of CSRC enforcement actions has grown as the markets have grown, but the number does not seem large. In the early years fewer than 15 cases were investigated and adjudicated annually. In recent years, the number of administrative prosecutions has increased to more than 40. These numbers, however, seem small. It is suggestive, but little more than that, given the vast differences in the scale of U.S. financial markets, but in 2008 for example, it was reported that the U.S. S.E.C. "brought 671 enforcement actions. In contrast, in 2007 there were 636 enforcement actions filed. 2007 was the first time in years the number increased. In 2006 the total had dropped by about 9% compared to the prior year." [40] In recent years private actions by mislead investors have been permitted.[41]

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[36] Interim Provisions on the Management of the Issuing and Trading of Stocks, State Council, effective April 22, 1993; The PRC Securities Law of 2006, Standing Committee of the National People's Congress, effective January 1, 2006; The Regulation on the Administration of Futures Trading, State Council, effective April 15, 2007.

[37] The amount ranges from RMB100,000 (US$14,622 equivalent) to RMB600,000 (US$87,732 equivalent), 1% to 5% of or 1 to 5 times of illegal proceeds.

[38] The amount ranges from RMB30,000 (US$4,386 equivalent) to RMB100,000 (US$14,622 equivalent);

[39] See Jason Tuan, JinXin Zhang, Jason Hsu and Qiusheng Zhang, *Merger Arbitrage Profitability in China,* (2007), http://www.ssrn.com/abstract=992650.

[40] See http://www.secactions.com/?=570.

[41] As a supplement to CSRC enforcement, since 2002 CSRC enforcement has been augmented by possible private actions for misrepresentation. *Notice on Accepting Cases regarding Civil Tort Disputes Arising from Securities Market Misrepresentations, Supreme Court of People's Republic of China*, effective January 15, 2002 .In 2003 the Supreme Peoples Court indicated to lower courts that they could accept such actions if but only if the CSRC had imposed a sanction on the party defendant. According to a recent news article, by the end of 2008, approximately 10,000 investors brought suits against more than 20 public companies for claimed damages, totaling about RMB800,000,000-900,000,000 (US$116,971,035-US$131,592,414 equivalent). Most cases were settled and about 90% of the plaintiffs were compensated. http://finance.ifeng.com/stock/zqyw/20090401/499677.shtml. Additionally, in 2006, for the first time, the PRC Securities Law of 2006 established legal basis regarding civil liability for insider trading cases. See Han Shen, "A Comparative Study of Insider Trading Regulation Enforcement in the U.S. and China," *Journal of Business and Securities Law* 9 (2009).

The result in most CSRC enforcement cases in which a listed company is accused of wrongdoing is censure; fines are quite rare.[42] Donald Clark suggests that where officers of SOEs are state officials, as may be the case is many large SOEs, a censure may have serious career effects. If true, this mild sanction may be more useful than it might appear to western eyes. Perhaps not surprisingly some studies find that powerful SOEs are treated lightly by the CSRC; that is, despite making up a small portion of listed companies in China's securities markets, private companies are more often sanctioned than state-owned companies.[43]

While the indications are that in its formal enforcement actions the CSRC is not a powerful force, as controller of access by issuers to the market and administrative supervisor of the exchanges and other securities industry SROs, it certainly is the most powerful day to day force in the design and operation of the Chinese securities markets.

3.3 The Second Protection: Share Segmentation System 1992-2004

The second structural protection against threats of excessive change from the re-introduction of stock markets was the unique Shares Segmentation System. Under it all shares of common stock of an issuing company bear equal voting and cash flow rights, but only some of those shares were tradable on public securities exchanges ("TS") while others are non-tradable shares ("NTS"). The tradable shares themselves were broken down into A shares and B shares. The A shares constitute the vast majority of shares traded on the PRC exchanges, are traded in yuan on the Shanghai or Shenzhen exchanges and could be purchased only by Chinese nationals. B shares were (and are) traded on the same exchanges but were listed in US$ in Shanghai and HK$ in Shenzhen; they could be purchased originally only by foreign nationals or institutions.[44] The B share market has not grown; it is about the same size today as it was ten years ago and is not economically significant.

In addition to A and B shares, some larger Chinese firms, seeking access to foreign capital, have received permission to list on foreign exchanges. Stocks traded on these exchanges are denominated H shares (Hong Kong Exchange), N shares (NYSE), L shares (LSE) and S shares (Singapore Exchange) and carry the same voting and cash flow rights as A shares.

Importantly, in addition to the segmentation of shares into A and B shares; Chinese shares may be distinguished by the nature of the holder. A shares may be either (1) pre-IPO shares issued to (a) instrumentalities of the state – such as a Ministry or the State-owned Assets Supervision and Administration Commission ("SASAC") or a Provincial or Municipal governments (such shares called *Guojia gu*) or (b) to certain legal persons (principally the parent of the listed SOE, which itself will generally be controlled by a province or municipal body (*Faren Gu*)

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[42] See Michael Firth, Gong-meng Chen, Ning Daniel Gao and Oliver M. Rui, "Is China's Securities Regulatory Agency a Toothless Tiger? Evidence from Enforcement Actions" (January 2005). Available at SSRN: http://ssrn.com/abstract=711107.

[43] See Benjamin Liebman and Curtis Milhaupt, "Reputational Sanctions in China's Securities Market," *Columbia Law Review* 108 (2008): 929, 958. The authors posit that private firms may be less politically connected than state-owned firms, but they may also tend to have weaker governance.

[44] B share prices traded at prices below the same shares trading in A shares. But when Chinese nationals were given access to the B share market the arbitration then made possible eliminated the price differences.

or (2) shares issued in or after the IPO to Chinese nationals or institutions (and recently Qualified Foreign Institutional Investors "QFIIs" also) (*Geren Gu*). At least prior to the recent reform described below, the pre-IPO shares issued to state or municipal entities or to SOE management as part of the IPO process were not tradable on the exchange ('NTS") and could only be transferred to legal persons (including in recent years QFIIs[45]) in private placements with the prior approval of both SASAC and the CSRC.

Significantly, with respect to every listed SOE — and, as we noted earlier, most of the firms listed on the Shanghai Exchange are SOEs — these non-tradable shares significantly outnumber the proportion of shares that were tradable.[46] According to CSRC data, at the end of 2004 there were 714.9 billion shares outstanding of all listed Chinese companies of which 454.3 billion or 64% were non-tradable.

Thus, this Share Segmentation System offered several types of apparent benefits: (1) to investors — that their investment would not be massively diluted by a flood of state securities of the same type onto the market; (2) to the state — that the entire economic interest of the state would not be monetized too quickly with risk to the fairness that the state would realize from the exchange; and (3) to the state — by assuring stability to the SOEs during a period of transition state control.[47]

It should perhaps be noted that the fact that more than 50% (sometimes much more) of issued shares of listed SOEs were not tradable and have been controlled directly or indirectly by the state did not mean that control over each of these enterprises has been exercised by a central state agency holding the NTS. Legal person shares, which again accounted for roughly one third of shares, tended to be held by parent companies of the SOE (often controlled by provincial or municipal governments) and labor groups associated with the company. While these groups may be (almost certainly would be) susceptible of influence from a central authority, they are nevertheless decentralized. The other one third of shares generally is held by a state instrumentality, most often SASAC. But since its creation in 2004, SASAC has also operated in a decentralized way with province level administrative offices exercises monitoring and decision making responsibilities respecting their portfolio firms. Thus, this element of state ownership is somewhat decentralized in operation, as well. In most instances it is believed that actual control of listed SOE firms lies with the SOE parent company, which in turn is often controlled by a municipal or provincial government.[48] Thus as Donald Clark puts it with respect to "state" control, "If we

[45] Qualified foreign institutional investors were permitted limited access to the market for A shares in 2004. These investors now appear to account for about 2.2% of that market.

[46] See CSRC Report, at 204.

[47] Consider a typical venture capital backed IPO in the U.S. A not uncommon pattern is the creation of a market with an issuance of less than 50% -- sometimes less than 20% -- of the company's shares.

[48] This arrangement of local governmental units "owning" SOEs (or now their shares) dates from the mid 1990s when the leadership adopted a policy know as "grasping the large and letting go the small" as a program of industrial reorganization. This policy contemplated the transfer to provincial and municipal governments from the central government of most industrial activity that did not have national strategic importance. These activities were then "corporitized" under the PRC Company Law of 1994. See Barry Naughton, *The Chinese Economy: Transitions and Growth*. (Cambridge, MA: MIT Press, 2007):301-302.

insist on speaking of “state” ownership or “state” control of enterprises, we must conceptualize the state as an entity that is capable of pursuing contradictory and inconsistent policies.”[49]

The Share Segmentation System was effective in assuring the state that important SOEs remain outside the control of securities markets participants. This benefit came with costs. One obvious cost was a limitation on the ability of the state to finance SOE’s riskiest tranche of capital from investor funds. Another apparent cost was the restrictions on liquidity of the Chinese securities markets and on the efficiency of the prices set in those markets.

For some of the large SOEs what is available to trade on securities markets is a very small slice of the company’s equity indeed. Consider the case of ICBC Bank. It is the biggest bank in China by all measures and its 2006 IPO on Shanghai and Honk Kong Exchanges was the largest IPO ever. In 2007 it was said to be the largest bank in the world in terms of market capitalization. ICBC Bank has (as of April 2009) more than 334 million A shares and H shares outstanding, trading in Shanghai and Hong Kong. If we consider just the shares traded on the Shanghai exchange (or both exchanges) we find that 47.02% of outstanding shares (35.3292% of shares traded on both exchanges) are held by the Chinese Ministry of Finance; 47.02% (35.329%) are held by a Central Huijin Investment Company Limited, a wholly-owned subsidiary of China Investment Corporation, the Chinese state sovereign investment company. The publicly owned shares tradable on the Shanghai constitute only 3.65% of ICBC A shares (2.74% of shares total shares listed on both exchanges). We must go the Hong Kong Exchange to find more substantial private investment in ICBC shares. There we find most of the tradable shares are listed; H shares constitute about 25% of all outstanding ICBC shares. Of those, about half are owned (subject to lock-ups) by foreign financial institutions (e.g. Goldman-Sachs; Allianz); and about half (or 12-13% of total outstanding shares) are currently tradable on that Exchange. Thus the public owns free of lock-ups about 41% of H shares but only 10.4% of all outstanding shares.[50] One obvious take-away from this review: the Hong Kong market has in fact been much more important than the Shanghai market for capital raising for ICBC bank.

ICBC’s share trading structure is not unique. The proportion of shares available for trading of the largest firms on the Shanghai Exchange is typically quite small. As reported in January 2008 by CSRC, the top ten traded firms on PRC exchanges and their percentage of tradable A shares were as follows: Petro China (1.6%); ICBC Bank (3.6%); China Life Insurance (9.8%); Sinopec (3.2%); Bank of China (2.1%); China Shenhua Energy (6.3%); Ping An Insurance (11.0%); China Merchants Bank (32.0%); Bank of Communication (4.6%); and China Pacific Insurance (9.1%).[51]

Shares traded on the Shanghai Exchange tend to trade at higher multiples than those on the HK exchange. Expressed in terms of P/E multiples the following chart shows that A shares command a substantial premium where there is a dual listing.

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[49] See Clark, Chinese Corporate Governance note __ above, at p 9.

[50] The share ownership structure of ICBC is available on the bank’s website www.icbc.com.cn.

[51] See CSRC Report at 241

Table 3: A and H Share Prices of Selected Companies

	Company Name	A share price	H share price	Premiums
1.	ICBC	5.6	4.1	36.7
2.	China Life Insurance	37.8	24.2	56.3
3.	Bank of China	5.8	3.8	52.7
4.	Ping An Insurance	62.2	45.3	37.4
5.	Sinopec	14.2	5.2	176

Source: [Bloomberg, companies websites, figures as of [May 13, 2007].

The source of this premium is not clear, but we take it as some evidence of inefficient pricing of the mainland securities markets that results from restricted liquidity in mainland markets and the impediments to access of Chinese investors to the Hong Kong market (and perhaps from greater volatility of mainland markets).

3.4 The Costs of Success

Thus the perceived risks that the re-introduction of securities markets into the finance of the country might occasion were originally limited by two major sources of protection. These protective devices – the Share Segmentation System and the CSRC – effectively prevented harmful disruption and facilitate orderly re-introduction of securities markets in the finance of the country. Additionally, since share segmentation assured continuing state control of SOEs, these two strategies made the ideological acceptance of "market socialism" easier. At the same time while securities markets in China have grown very substantially since introduced less than twenty years ago, these sources of protection have also in some respects retarded what might be expected to be social utility of securities markets to the Chinese economy.

PART IV. SHARE SEGMENTATION REFORM

4.1 The Elimination of the NTS Category

The limitations on the utility of securities markets and on the ability of the State to monetize its ownership interests in SOEs that the segmentation of share ownership creates were quite obvious. It must be concluded therefore that that system was seen from the outset as either a necessary political compromise, or as a prudent interim measure to allow the market to mature before the state's largest share interest were monetized (or both). Certainly the goal of raising capital for struggling SOEs through share issuance would be seriously constrained if a large majority of shares may not be sold. Thus, there were several important reasons to try to convert NTS into TS once a market for shares had been seasoned.

If we attribute to the Chinese state the simple business motivations of any property owner, we would posit that an important aspect of any program to reform the NTS structure would be that it not drive down share prices of traded securities too greatly. In fact, all IPOs in China had been made with a standard representation that NTS would remain non-tradable, and because holders of TS thought that that conversion of NTS into TS would drive down the price

of TS, the holders of TS resisted later attempts at such conversions. What such resistance meant in practice was widespread sale of shares at the first hint of such a program. In fact the negative market impacts that greeted the first effort to make state shares tradable engulfed the program. Trial efforts were made by officials in 1999 and in 2001 without success. For example, in 1999 China Jialing Company and Guizhou Tire Company were selected for an experiment in which each firm was to sell state-owned shares to holders of tradable shares, thus making these shares tradable.[52] The market did not receive this early effort well. Beltratti & Bortolotti report that within fifteen days both companies shares had fallen 40%. [53]

In June 2001 a more systematic effort was made. The State Council ordered that on any occasion in which a listed firm with NTS either issued shares in an IPO or otherwise sold shares over the exchange, it must sell an additional 10% of NTS and pay the proceeds of such sale to the National Social Security Fund. This effort was interpreted by the market as opening the floodgates of NTS and lead to (or was closely followed by) a substantial bear market in stocks. This effort was abandoned in June 2002.

In January 2004 the State Council issued its *Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets*. This document has been interpreted as a strong endorsement at the highest levels of the further development of Chinese "market socialism" including further improvements in corporate governance and securities markets. Among the principles and directions contained in this document was a direction to continue the gradual opening of the capital markets. The specifics included instructions to proceed with elimination of NTS according to "market principles" and "the rule of law." Pursuant to this directive in April 2005 the CSRC initiated a pilot program to eliminate the category of NTS in four firms. That program required each firm with NTS to receive a proposal from the holders of NTS for the compensation to be paid to TS holders in order to compensate them for the affect that the change may have upon the TS market value. The compensation could be in any form and the government (i.e CSRC) was to take no role in fixing it. The usual form of compensation in fact that has been used has been a distribution of some part of the converted NTS to the holders of TS. This proposal is then was to be "negotiated" with the holders of TS, although it is not clear in practice how much negotiation occurs or who does the negotiating party for the holders of TS. In any case the holders of TS are protected by a vote requirement in which two-thirds of the TS must approve the proposal.

The initial program was successful, allowing three of the four companies to eliminate NTS. A further pilot program of 42 firms was initiated by CSRC in June 2005 and in August guidelines were issued extending the program to the rest of the market. The CSRC encouraged companies to join this program by stating that compliant firms would be given priority for raising new capital on the market. The new program has been highly successful. By the end of 2007, 1,298 companies listed on the Shanghai and Shenzhen stock exchanges had initiated or

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[52] See CSRC Report at 204.

[53] See Andrea Beltratti and Bernardo Bortolotti, "The Non-Tradable Share Reform in the Chinese Stock Market,"(November 2006). FEEM Working Paper No. 131.06. Available at SSRN: http://ssrn.com/abstract=944412, at 3.

completed the program and only 33 companies had not completed the reform.[54] Early indications is that this reform, which is no doubt a highly beneficial effect in the long-term, has been beneficial to holders of TS in the short run as well. Beltratti & Bortolotti report that the on average the announcement of NTS reform generated statistically significant 8 percent positive abnormal returns over a twenty day window, net of compensation received from the holders of NTS.[55]

Thus the share segmentation reform appears to be an unqualified success. With this reform the greatest potential inhibition to the efficiency of the Chinese securities markets is potentially removed. Completion of this reform raises a new series of economically interesting questions however: Will the state in fact dissolve its control blocks through secondary market sales? [56] If so, control of which firms will be put on the market and when? It seems highly unlikely that the state will allow control over key elements of the economy – e.g., finance, transportation, energy, communications, and natural resources – to pass into the market. And with respect to less vital SOEs, the state may raise capital by sale of state-owned shares while retaining blocks of 20%—25%, blocks which ordinarily would be deemed sufficient to thwart a market based change in corporate control. Thus while completion of the non-tradable share reform removes a huge impediment to the development of an effective securities market, it remains to be seen if, when and respect to which firms the reform will be operationalized.

PART V. INVESTOR RIGHTS: CORPORATE GOVERNANCE AND JUDICIAL ENFORCEMENT

At the outset of this essay we identified the existence of reasonable protections against *ex post* investor exploitation as one of the institution preconditions generally thought necessary for the evolution of an efficient securities market. The system of such protections is generally characterized as "corporate governance."

5.1 "Corporate Governance" as a Source of Constrain of Excessive Agency Costs

Worldwide the topic of corporate governance receives great attention from scholars, regulators and investors. China is no different in this respect; both its scholars[57] and law makers[58] appear deeply interested in this topic. The CSRC[59] and the Stock Exchanges have ad-

[54] See CSRC Report at 208.

[55] See Andrea Beltratti and Bernardo Bortolotti, "The Non-Tradable Share Reform in the Chinese Stock Market,"(November 2006). FEEM Working Paper No. 131.06. Available at SSRN: http://ssrn.com/abstract=944412,

[56] As of first quarter of 2008 the CSRC web site reports that about 30% of the value of all shares were represented by "negotiable shares". See, http://www.csrc.gov.cn/n575458/n4001948/n4002090/n10188507/n10193901/10224788.html

[57] See Allen, Franklin, Qian, Jun and Qian, Meijun, 2005. "Law, Finance and Economic Growth in China," Journal of Financial Economics 77; 57-116 and see Donald Clark, "The Ecology of Corporate Governance in China," http;//ssrn.com/abstract=1245803

[58] See State Council, *Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets (2004).*

[59] See CSRC, *Principles of Corporate Governance for Listed Companies* (2003).

dressed the topic of advisable corporate governance structures for listed companies. And the tone of official statements is often one in which it appears that modern corporate governance standards evolving elsewhere are being deployed effectively in China as well.[60]

Most fundamentally "corporate governance" refers to the systems by which power is conferred, distributed, and exercised with respect to the internal controls over a corporation. For most finance or legal scholars a somewhat narrower notion of corporate governance is preferred. For them, corporate governance is the network of legally enforceable rights and duties adopted by the participants or imposed by law in an attempt to offer protection to long-term investors from *ex-post* exploitation or sub-optimal deployment of their investment. Typically in the literature such a definition focuses more particularly on means to protect equity investors as they are required to commit their funds to the enterprise for an indefinite period, with no legal right to a return and, especially in stock market centered systems such as the U.S. and Britain, often suffer from sever collective action disabilities. Corporate governance therefore is seen as a set of protections offered to such investors to encourage their investment.

Threats of exploitation with which corporate governance deals comes from those controlling the enterprise.[61] In a typical U.S. public firm, that control resides in management of the firm, but in China, and often elsewhere, control lies in a controlling shareholder. The main sources of corporate governance protections that an investor in common stock receive in either event are the following [62]:

First, is assurance that there has been disclosure of all relevant information by the issuer at the time of an IPO and periodically thereafter through public filings.

Second, is the right of all holders of voting shares to elect the board of directors who will have ultimate responsibility for overseeing the firm and who will select and monitor the chief management officers. In addition to electing the board of directors, shareholders may, under Delaware corporate law at least,[63] remove the directors without cause at anytime.[64] In addition

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[60] For example a report of a July 2006 Conference at the Shanghai Stock Exchange includes the following:"[A high CSRC official] put forward that the equity division reform has profound influence on the perfection of corporate governance. On the one hand, the interests of controlling shareholder, institutional investors and small and medium-sized investors will become more closely related; on the other hand, the interests of the senior management are also related to that of listed companies and small and medium-sized investors. Under such circumstances, the corporate governance and listed companies' quality have become the hot topics among investors. From current situation in China, the legal system of corporate governance is being further perfected… . " See Shanghai Stock Exchange, "Introduce Corporate Governance Index of Listed Companies" (2006-07-17) http://www.sse.com.cn/en_us/cs/about/news_20060717a.html.

[61] Of course equity investors can fear threats of exploitation that comes from other sources – government confiscation, for example – but corporate governance mechanisms have little or nothing to do with reducing any such threat.

[62] This package may be modified in a great many ways under U.S. corporate law; most statutes governing corporate governance being of an "enabling" and not a prescriptive type.

[63] Delaware is the jurisdictional choice for incorporation in more than one-half of the NYSE firms and thus its corporation law is the governing law for the internal affairs of these companies. As a result of this prominence Delaware corporation law serves as the prototype for discussions of issues of corporate governance in the U.S. and is sometimes influential in non-U.S. jurisdictions as well.

certain "fundamental" corporate actions, such as amendment to the charter (or articles of incorporation), most large mergers, and any dissolution of the company, may be undertaken only when approved by a shareholder vote. This governance right to vote may then be supported both by a right to vote by proxy and regulation of proxy solicitation materials to assure that they are truthful and complete. Both proxy voting and regulation of proxy solicitation are aimed at reducing shareholder collective costs disabilities. Finally there are, in the U.S. at least, judicial principles that are aimed at remedying manipulation by managers of shareholder voting process (the so-called Blasius principle[65]).

Third, as a general default, there exists a right of shareholders to sell their shares at any time and for any reason. This "walk away" right is thought to constrain agency costs of management in the obvious way: if in response to sub-optimal performance, sales of the company's shares grow great, it may drive down the stock price of the firms' securities on their market. At a certain point a low stock price will excite interest from an alternative potential controller who may then initiate a proxy solicitation campaign or, more likely, a tender offer, in order to wrest control away from the current managers. Again this source of governance constraint is supported in the U.S. by extensive S.E.C. regulations respecting disclosure and manipulation during tender offers and a well developed fiduciary law restricting "defensive" actions that board of directors may take to defeat a tender offer.[66]

Fourth, while the right of shareholders to "walk away" from a disappointing investment adds a systemic constraint on agency costs of management, (and *ex ante* serve as an incentive for good managerial performance), in any individual case sub-optimal performance may cause individual investors to suffer substantial stock price loss before a takeover becomes attractive to a third party. Thus, when such losses can be said to come from wrongful action – as opposed to poor business judgment -- another remedy seems warranted. At least in common-law jurisdictions, shareholders may initiate suit on behalf of the corporation itself charging breach of the directors' fiduciary duties of care or loyalty.[67]

These fundamental corporate governance mechanisms – the right with others to elect the board and to concur in fundamental decisions; the right to sell shares and to receive tender offers; and the right to sue for breach of fiduciary duty – together with the disclosure obligations that helps make these basic rights effective, provide the framework of corporate governance in the U.S. Much of what the practice community and some scholars write about under the heading corporate governance deals with the implementing detail of these three mechanisms.[68] That is,

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[64] See D.G.C.L. Section 141(k). In the event the company has a "staggered" board of directors, that is one that is broken into cohorts that are elected separately over several years, directors may be removed only for "cause" unless the charter of the corporation provides for unrestricted removal rights in that setting also.

[65] Blasius Industries, Inc. v. Atlas Corp. 564 A.2d 651 (Del. Ch. 1988).

[66] See generally, Arthur Fleischer, Alexander Sussman and Henry Lesser. *Takeover Defense*. Sixth Edition (Aspen Law & Business, 2005).

[67] See generally William T Allen, Reinier Kraakman, Guhan Subramanian, *Commentaries & Cases on Law of Business Organization*. Second Edition (Wolters Klur Law & Business Publishers, 2007), chapter 10, (derivative law suits).

[68]E.g., Should shares with uneven voting rights be allowed? How large is the best size for the board the shareholders elect? Should shareholder vote be extended to vote on CEO compensation also? Should all of the

most of what is conventionally discussed under the rubric of corporate governance relates to one of these three fundamental shareholders powers: the right to vote, the right to receive tender offers and the right to sue for breach of fiduciary duty.

5.2 A Note on External Constraints on Excess Agency Costs

Whenever one discusses the effects of various corporate governance mechanisms on constraining agency costs of management, it is well to begin by placing the subject in a larger frame by noting the connections between product markets and internal governance. In theory there would be no problem of excessive agency costs were products fungible and markets perfectly competitive. In such a theoretical market any additional costs incurred by one producer, whether it derived from an agency costs or from another source, would more or less immediately either drive its price up, in which case its revenues would disappear, or should it leave its price at the market price, would cause it to begin to erode its capital. In either event any significant agency costs in such a market would over time lead to failure of the firm. In such a market corporate governance practices would not be very important. But product markets are rarely if ever so competitive in fact. Indeed, much of what modern corporations do in product design, advertising and distribution is designed to try to make their products seem unique. Thus, in highly competitive product markets the product market itself will impose limits on agency costs and in such situations corporate governance will be less important to investors.

5.3 The Limited Role of Corporate Governance in Chinese Securities Markets

5.3.1 The Shareholders Right to Vote or Accept Tender Offers

We now turn to a brief discussion of the corporate governance rights and duties as they affect investors on Chinese securities exchanges. Specifically in this section we address the constraint on agency costs provided by the rights that buyers of shares on Chinese exchanges to vote those shares and the right that such a shareholder has to sell those shares into a tender offer if the opportunity arises. In western systems these two sources of constraint are considered to be fundamentally important. But investors in Chinese securities markets are offered little protection by their right to vote or their right to sell shares.[69] This condition will remain at least until the share segmentation reform is operationalized by the state and related legal persons selling their control positions to disaggregated shareholders. The right of public shareholders to vote is unimportant if state controlled agencies and/or related legal persons hold 65% of voting shares, at least if these holders vote in sympathetic way. The right to sell your shares into a tender offer is unimportant, as well, if there are virtually no tender offers, as is the case, because control over most listed companies is not available on the market. Thus, with respect to most of the companies listed on

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elected members of the board of directors be elected annually or may some firms adopt a staggered system? Should designated committees of the board be mandated or should there be freedom to operate the board as seems best in each case? Should there be a separation between the chair of the board and the CEO? Should there be many, few or no senior officers on the board? What standards should be employed to determine if a director is “independent” and independent of whom or what? etc and so forth.

[69] An exception to this general statement relates to the authorization of related party transaction by shareholder vote. CSRC rules direct that such transactions must be approved by a vote of disinterested shareholders. CITE The effect of this directive in practice remains to be explored.

Chinese exchanges, such potential as exists for effective shareholder legal protection as it is understood in the west, rests upon the possibility of *ex post* suits against officer, directors or control shareholders for violation of law or breach of fiduciary duty.

5.3.2 Shareholders Right to Sue

It is common around the world to encounter nations in which the dominant form of business ownership structure involves a single dominant owner or a small number of shareholders affiliated through common control or some informal or family relation. In such situations the formal levers of corporate governance are ineffective to protect minority investors. In these situations the possibility of *ex post* judicial protection is especially important.

Such suits can charge violation of positive law, but more likely would charge a violation of a general duty to try in good faith to undertake transactions only in a good faith effort to advance corporate purposes. Such a duty is generally characterized as the fiduciary duty of loyalty. As part of the early corporitization movement, the first modern PRC Company Law of 1994 did expressly state that officers and directors of companies formed under its authority[70] shall be liable for damage caused to the company by their violation of law, administrative regulation or the company's articles of association. [71] It did not mention any concept similar to the fiduciary duty of loyalty and more importantly did not authorize shareholder's to initiate any action upon an allegation of such unauthorized conduct nor was it interpreted by courts to do so.

Nevertheless, some PRC courts did from time to time signal receptivity to the idea of a shareholder suing on the corporations behalf to redress injury cased by such an alleged violation of law.[72] Notably, in 1997 a court in Fuijian Province upheld the right of a minority shareholder (in a joint venture corporation) to sue on the corporation's behalf on a debt where the majority of the board, related to the debtor, refused to do so. The courts saying:

> "If the infringement suffered by the shareholders is to the right of the company, then the shareholders should first present a written application to the organ of power of the company requesting that the company take action ….Where the company does not take any action, the shareholder may in its stead bring a lawsuit."[73]

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[70] E.g Articles 59, 60 and 61, the PRC Company Law of 1994.

[71] See Article 63, the PRC Company Law of 1994.

[72] An early example, dealing with a foreign joint venture involved the Zhangjiagang Fiber Company in which the Supreme People's Court allowed a Chinese joint venture partner to sue on behalf of the joint venture when the managing partner had refused to do so allegedly because it had inappropriate motivations. See Jiong Deng, "Building an Invetsor –Friendly Shareholder Derivative Lawsuit System in China," *Harvard International Law Review* 46(2005):347, 365, note 108.

[73] Quoted in Donald Clark, supra note __ , citing Zhihong Xie and Mingtian Chen, "Guhong Paisheng Susong Zai Sikoa [Rethinking Shareholder Derivative Suits]," *Fuijian ZhengFa Guanli Ganbu Xueyuan Xue bao [Journal of the Fuijian Politcal-Leghal Administrative Cadre Institute*] 4(2001): 24

This is a clear statement of the derivative theory and its articulation by a Chinese provincial court in 1997 evidences the strong appeal of the logic of the form of action. Nevertheless, other Provincial courts during this period rejected the theory.[74]

In its 2002 Corporate Governance Code seems clearly to endorse the concept of the derivative lawsuit when, its state that:

> " Shareholders shall have the right to protect their interests and rights through civil litigation or other legal means in accordance with law and administrative regulation. In the event the resolutions of the shareholders meeting or the resolutions of the board of directors are in breach of laws or administrative regulation, or infringe shareholders legal interests or rights, the shareholders shall have the right to initiate litigation…."

It is not free from doubt that the CSRC did intend to try to advance derivative lawsuits by this provision however. This translation of the language of Art 4 of the Corporate Governance Code appears on the CSRC website. Some authoritative scholars, however, translate the provisions as giving shareholders only the right to demand the company initiate lawsuits. [75] More importantly, however, the authority of the CSRC to establish judicial rights of this kind is far from clear.

Despite the shadowy legitimacy of shareholder derivative suits prior to the 2005 revision of the Company Law, the legitimacy of the shareholders derivative suit in China was made clear in Article 152 of the PRC Company Law of 2005. That enactment specifically acknowledged corporate directors owe fiduciary duties of loyalty and care (Art. 146) and also authorized derivative suits by shareholders. The pre-conditions to such suits are first, plaintiffs must represent more than one percent of the shares of the company for more than 180 consecutive days, alone or jointly. Second, demand to sue must be made upon the board of directors and suit may be filed only after thirty days following such a demand. The latter prerequisite is designed to allow the corporate board an opportunity to study the matter and take action with respect to it. It is a conventional precondition to such suits in the U.S. The first requirement appears to be an attempt to limit so-called "strike suits" brought by persons with insignificant equity investment merely for the purpose of extract a nuisance settlement. It may however serve as an impediment to meritorious claims also

It is early to judge whether this new statutory authorization may in time provide a remedy that is useful to shareholders, but there is, in the short term, little hope for a strong good governance tool here. The problem stems from the fact that there appears to be little willingness to innovate a solution to the collective action problem that potential shareholder plaintiffs face.

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[74] See, San Jiu Pharmaceutical Company, where the Shenzh Basic Level People's Court rejected a derivative suit unless unanimous shareholder action was taken (an obviously impossible pre-condition to such suits). See Deng, note 13 at note 271.

[75] See Donald Clark, "The Ecology of Corporate Governance in China," http;//ssrn.com/abstract=1245803

The few derivative cases that are found tend to be cases involving joint ventures in a corporate form. In those cases the investors do not suffer a collective action problem of the kind that often arises in publicly finance firms. Where plaintiff is a stockholder who bought shares on an exchange, it is unreasonable to expect such person to act as plaintiff in a derivative suit, unless there is a reasonable expectation that, at least if the suit is meritorious, he will be compensated for the costs of acting as champion for the other shareholders. Yet neither the PRC Company Law of 2005, nor the few courts who have discussed derivative suits, have suggested that costs of this litigation, including attorney's fees, might be awarded to a successful derivative plaintiff. In the absence of such assurance it is not to be expected that shareholders who acquire shares on the exchange will undertake to fund such litigation, where they own only a minor percentage of the company's securities.

Thus despite the fact that formally Chinese law has adopted the derivative suit, for the moment, courts are not a realistic source of constraint on agency costs of management or of controlling shareholders and thus add little or nothing to the store of investor protections that constitute corporate governance.

5.4 The CSRC and Top Down Corporate Governance in China

To say that the main sources of shareholder protection available in the U.S. do not exist in China is, of course, not to say that corporate governance in its deeper sense does not exist in China. Generally we think of corporate governance – however else it may be characterizes – as *a shareholder triggered* protection or corrective available against a directors of officers abuse or incompetence. But when we discuss corporate governance as it exist in China at the moment we discuss not a shareholder initiated set of protections but a top down system directed by CSRC that regulates some aspects of internal corporate affairs.

The creator of corporate governance rules or mandated practices in China is principally the CSRC and to a lesser extent the Exchanges. There has been a significant amount of work by the CSRC and the Exchanges to promulgate corporate governance rules and principles addressing the secondary sorts of corporate governance questions referred to in note __ above. This appears to represent an effort to improve the transparency and integrity of the management of listed firms. But as we noted above, until state persons dissolve their control through sale of their controlling stakes, the principal tools of corporate governance – the vote, the law suit and the tender offer – will not be of much use to public shareholders, except indirectly. So why all the sincere effort? The answers, we suggest, are three.

First, the promulgation of sensible governance standards and practices may offer some assurance to investors on the Hong Kong or New York exchanges that investment in the large PRC SOEs listed on those exchanges constitutes an investment in a sensibly governed modern commercial enterprise. Currently, as we indicated above, Hong Kong appears to be more important for capital raising for such firms than Shanghai.

The second reason it makes sense for CSRC to promulgate (and care about) corporate governance practices even though shareholders have virtually no way to enforce such standards, is that these standards may also be thought of as attempts to modernize management practices of

SOEs. This modernization of management is important and will incidentally benefit public shareholders, but not less importantly it will benefit, non-controlling elements of the state shareholders.

The CSRC corporate governance rules can be seen as techniques to control the legal person shareholders who tend to be in operating control of the SOE listed firms. Thus, for example, in its 2001 *Code of Corporate Governance for Listed Companies* [76] the CSRC in ninety-five number paragraph establishes standards for corporate governance. They include three paragraphs on related party transactions (12-14), seven paragraphs on Behavior Rules for Controlling Stockholders, six paragraphs (22-27) on the Independence of the Listed Company, and three paragraphs on disclosure of Controlling Shareholder's Interests (92-94). These rules of corporate governance plausibly seem directed towards protecting holders of state (formerly) NTS (and public shareholder incidentally) by forcing disclosure by legal person shareholders. In addition the CSRC establishes rules for board procedure (44-48), for specialized committees of the board (52-58) and for Performance Assessments and Incentive and Disciplinary Systems (69-72). These rules seem directed to instructing management (and controlling holders of legal person shares) about required good management techniques.

Of course SASAC as the body holding the residential state interest in many publicly listed SOEs (or the Ministry of Finance in the case of the largest banks) is not really limited to judicial enforcement remedies, if it learns (through better disclosure) that legal person controllers abuse investors' rights. SASAC presumably can act through governmental or CCP channels to trigger discipline for abuse or prosecution. The 2001 CSRC Corporate Governance standards may serve to provide SASAC with benchmarks or standards that it should expect from management of its SOE firms. In addition the Code seems designed to encourage adoption of modern management in SOEs.

The third reason we suppose that CSRC engages in serious corporate governance activity, even though public shareholders have virtually no ability to enforce such standards, involves the apparent aim of the leadership to carefully construct the infrastructure for a modern securities market — including statutory shareholder rights, and the standards of corporate governance — as an option for future construction of the finance infrastructure of the country.

PART VI. GOVERNING ISSUER ACCESS TO SECURITIES EXCHANGES BY CHINESE FIRMS

6.1 Introduction to IPO Access

We have identified the social benefits of securities markets to be (1) relatively efficient allocation of capital among competing users of capital and (2) signaling through stock price of the comparative performance of management. In addition, in some cases we might expect (3) that the costs of capital available on a securities exchange would be lower than that supplied by other means since the exchange allows for cheap diversification of risk. Of course securities

[76] Full English translation of this Code is available from CSRC website, http://www.csrc.gov.cn/n575458/n4001948/n4002030/4062964.html

markets are not riskless. They can go through periods of excessive enthusiasm or the reverse and in those moments allocations of capital may be distorted by them. On balance, however, we believe that access to securities markets by issuers of securities is, under sensible regulatory oversight, a good thing in most settings. We turn in this part to discuss the existing system in China for granting access to IPOs or secondary issuance and the limited access available to the entrepreneurial sector.

6.2 The Merits Based Regulatory Approach of the CSRC

China has established a merits based regulatory approach for those seeking to list shares on one of its two securities exchanges or to issue new shares in a secondary offering. This approach requires share issuance be reviewed and approved by the CSRC or a government agency delegated by the State Council.[77] An approach to access to securities markets that requires a state regulatory agency to act as a gatekeeper, is often encountered in emerging markets, since such markets often lack a body of experienced or sophisticated investors. Thus, in theory, in these situations, the state regulator will deploy its greater expertise to protect ill-informed investors from the consequences of their inexperience. There are possible benefits from such an approach, but the cost of such an approach – in mistakenly denying securities market access to firms that may gain the most from the economic advantages of securities markets – may be significant. How great this cost may be is, of course, a function of the standards the regulator in fact uses in granting or denying access and its skill in applying those standards. Notably, in China, the regulator does not apply a standard related solely to the qualities of the proposed investment, but also seeks to advance state interests in the securities market and its development.

6.2.1 Quantitative Control Over Market Access

From the outset of modern securities markets in China, the government limited the number of shares to be offered on its exchanges. Initially, it used a quota system to achieve this end. Under that system, the State Council decided each year's quota and allocated it among provincial or municipal governments. Recall that from the time of the 1990s' reform ("grasp the large and let go of the small") these provincial and municipal governments had come to act as "owners" of the many SOEs deemed not essential for the national government to directly control . These provincial governments tended to allot these allowances to raise money by issuing shares to those SOEs that were under their control and urgently needed capital injection, or that were otherwise socially or economically important. Thus, as it happened, underperforming SOEs were disproportionately selected for listing at the expense of dynamic entrepreneurial companies.

Firms granted quotas, then, upon the completion of their "corporatization" and successful audit, would apply to the CSRC for permission to issue some portion of their A shares to the Chinese public.[78] The CSRC would then approve some and disapprove other applications (this is discussed below) and establish a range of prices (also discussed below) at which an approved

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[77] Article 12, Provisional Administrative Measures of Stock Issuance and Trading (1993); Article 10, the PRC Securities Law of 2006.

[78] See Tan Wentao, "History of China's Stock Markets," in *China's Financial Markets: An Insider's Guide to How the Markets Work*, ed. Salih N. Neftci and Michelle Yuan Menager-Xu(Academic Press, 2006), at__.

firm could offer its shares on the market. One of the principal goals of the quota system was to "nurse" the development of securities markets and protect them from a tsunami of share offerings, which it was feared would drive down prices of existing traded shares and impair the capacity for the exchanges to attract investors in future.

During the period when this quota system was used approximately 949 SOEs were listed on the domestic stock exchanges while only 30 private firms were permitted access to the securities markets.[79]

The quota system was abandoned in March 2000. The CSRC then launched a modified technique for distributing limited rights to sell shares publicly. In the modified plan the CSRC allocated these rights to regulated securities firms who would act as underwriters. The thought, probably was to remove some of the local influence that provincial governments brought to the distribution process and make the process more commercial in practice. One feature of this new mechanism was that the CSRC would accept for processing new IPO application only from a securities firm whose previous IPO recommendation had been approved. Under that approach, a qualified securities firm could obtain up to eight "channels" (or IPO approvals) a year. Given the limited number of "channels" that a securities firm could be awarded under this system, and the relative size of SOEs compared to private companies, the incentive, once again, was to allocate access to large SOE firms.

In February 2004, the CSRC introduced a further modified process for selecting IPO candidates. This "sponsor system" eventually replaced the channel control system. Under this system, each IPO application must carry the endorsement of a qualified sponsor securities firm, that meets minimum capital and other qualifications. The new system has placed additional responsibilities and potential liabilities on sponsors and their representatives with respect to the quality of offerings, including possible personal liability of a sponsor representative for false or misleading statements in offering documents. Currently, there is an insufficient number of sponsors to meet the needs of the development of China's stock markets. Thus expanding this number responsibly is one of the regulatory tasks that CSRC intends to pursue.

6.2.2 Qualitative Assessment of Applicants

In a system that chooses to confer on a regulator power to make qualitative judgments respecting issuer access to securities markets, a critical question will relate to the regulators' ability to make such determinations wisely. In the CSRC, such determinations are made by the Public Offering Review Committee (the "Committee" or the "PORC").

The PORC was established in 1999. As established initially, the Committee contained 80 part-time members and their identities were kept confidential. For each application, nine members of the Committee were convened and at least 2/3 anonymous votes were required to approve an application. This process lacked transparency and critics expressed doubts that part-time members had the time necessary and the incentives to observe professional standards, including

[79] See Wenkui Zhang, "The Role of China's Securities Market in SOE Reform and Private Sector Development" (2002), available from http://www.tcf.or.jp/data/20020307-08_Wengkui_Zhang.pdf.

confidentiality. Of course any process in which access to a valuable benefit is granted or denied is subject to the risk of corruption and the CSRC process has not be perfect in this respect.[80] Intending to enhance the accountability and transparency of the IPO review process, in December 2003, the CSRC announced changes.. The Committee was reduced in size (to 25). Some full-time members were added and their roles expanded. For instance, in year 2004 there were thirteen full time members, seventeen in 2007 and twenty in 2008. External experts constitute a majority of the Committee.[81] The CSRC seeks public input into the process of appointment of PORC members.[82]

Seven members of PORC will attend each committee meeting and five votes are required for passing the review. Prior to the meeting, CSRC will disclose to the public the meeting schedule, the list of attending members and the list of companies under review. The members generally commenced the review of two to four applications five work days before the hearing and are required to prepare a written opinion on the merits of these applications. Members have in large exercised their own judgment respecting the merits of an application.

Decisions of PORC may take into account all relevant considerations including the issuer's qualifications, use of proceeds, legitimacy of business operation, competitive strength, assets' quality, profit generating ability, independence, information disclosure and corporate governance.[83] In 2007, the PORC rejected 38 applications, among which, sixteen rejections were primarily due to PORC's view of risky or impracticable plans of use of proceeds; fourteen rejections were primarily due to perceived over-reliance on business with the controlling shareholders or major clients and the lack of competitiveness or independence; eleven rejections were primarily due to poor accounting practices, such as inconsistent accounting policies, non-compliance in revenue recognition, insufficient provisions and significant contingency issues; eight rejections were primarily due to failure to meet qualification requirements such as material changes of management in the reporting period; and four rejections were primarily due to insufficient or

[80] For example, there was the noted case in which Mr. Wang Xiaoshi, an official of the CSRC, responsible for liaison with members of the Committee, was arrested for selling the name lists of the listing approval panel to issuers and profited approximately RMB10 million. Because of Wang's help, at least one company with severe internal control problems successfully passed the IPO review. Wang's case significantly tarnished the credibility of the CSRC. See, Caijing Magazine http://english.caijing.com.cn/2009-02-03/110052333.htlm

[81] For instance, the members of the tenth Committee for the year 2008 include five persons from the CSRC, nine from accounting firms, five from law firms and one from an asset appraisal company. Five part-time members include two from the CSRC, one from a university and two from fund management companies.

[82] CSRC seeks nominations from a number of sources. For example, in 2004, the CSRC request the China Bar Association to recommend 12 candidates. In meeting this request the Bar Association allocated this number to bar associations in Beijing, Shanghai, Zhejiang, Xinjiang and Guangdong and required them recommend candidates who worked at a law firm with revenue from securities business no less than RMB30 million in recent two years and who had lead no less than 20 IPOs. This geographic assignment obviously precluded the professionals in other provinces. Even such, the responses from lawyers in these selected cities were very different, with oversubscription of applications in Beijing, and not enough interests in Guangdong, partly because the position requires frequent meetings and self-sacrifice to take a full-time job at the CSRC with a much lower salary than a partnership in a law firm.

[83] See Shenzhen Stock Exchange, "Key Issues relating to the Review of Public Offering Applications and An Analysis of Rejected Applications" (2008), available from http://www.szse.cn/main/images/2008/11/10/20081110152952164.pdf, at 8.

false information disclosure.[84] All above establish that the PORC processes are deeply substantive in character. PORC has, in recent years, rejected a significant number of applicants. The following table sets forth the review results of companies seeking to issue shares from 2004 to 2007.[85]

Table 4: PORC Review Results (2004-2007)

Year	Number of Applications	Number of Successful Applications	Number of Rejected Applications	Rejection rate
2007	354	298	55	15.54%
2006	181	159	22	13.84
2005	16	9	6	37.5%
2004	177	119	58	32.77%

Source: Shenzhen Stock Exchange (2008)

6.2.3 Policy Considerations in Granting Access to Securities Markets

In considering whether and when to permit a firm to issue securities on either of the two Chinese exchanges, the CSRC exercises not only an investor protection role but also gives consideration to policy or market concerns. Thus, even at the end of a lengthy process, a firm that gains CSRC approval may find itself stuck in a line awaiting final approval to distribute shares because the CSRC, with concern for market conditions, may hold up new issuances. For example, in order to accommodate the non-tradable shares reform, all IPO activities were held in abeyance from October 2004 to January 2005 and July 2005 to May 2006. Also in reaction to the world-wide financial crisis of 2008, in order to slow the descent of prices on the Shanghai and Shenzhen Exchanges, all CSRC work on new IPO quietly came to a halt in mid-September 2008.

6.2.4 IPO Pricing

In an initial offering of shares it is, of course, necessary to fix a price at which the shares will be offered to the market. In China, prices of domestic stocks in IPO are set without any formal consultation with investors. The CSRC must approve this price. In doing so, it establishes a range of prices at which the issuer and underwriter may offer the securities to the market. This range is created by a formula in which average firm earnings over the last three years are multiplied by a floor rate (15 usually) and a ceiling rate (usually 20). Under this formula, some quality companies have to be undervalued while less-promising companies were overpriced.

As in the west, there are certain incentives that tend to push these initial offering prices to the low side of the permitted range. Moreover, since there is a huge reservoir of family savings in China anxious to earn a return greater than the low return on savings at commercial banks, the

[84] See Shenzhen Stock Exchange (2008), Key Issues relating to the Review of Public Offering Applications and An Analysis of Rejected Applications, available from http://www.szse.cn/main/images/2008/11/10/20081110152952164.pdf, at 21.

[85] See Ibid, at 19.

supply of securities is limited and strict capital controls limit external investment possibilities, the China securities markets have gone through periods of great investor excitement. The effect of these three factors in China has been a remarkable history of first day trading appreciation. IPOs on Chinese securities exchanges have, by a very large margin, recorded the largest average first day appreciation of any markets in the world in the modern era. One source cites average first day appreciation on Chinese IPOs as an order of magnitude greater than any those of other countries. E.g. France (1983-1992): 4.2%; Germany (1978-1992): 10.9%; England (1959-1990): (12.0%); United States (1960-1996): 15.8%; China (1990-2001): 127%.[86]

Perhaps responding to this apparent large systematic IPO underpricing, at the close of 2004, the CSRC began to experiment with the introduction of a price inquiry mechanism and book-building process, which seeks to move towards an IPO price more reflective of market sentiment. In accordance with these new initiatives, IPO issuers, after receiving CSRC's green light for share issuance, must initially inquire about appropriate IPO prices from at least twenty institutional investors (more if the issuance is planned at 400 million shares or more). Presumably the range of P/E ratios that the CSRC will use setting IPO price ranges in specific cases will take these opinions into account.

With the introduction of this system, it was found that some institutional investors "conspired" with underwriters during the initial consultation process to drive up initial offering prices, but thereafter withdrawing from the process to allow retail investors to invest at what the CSRC concludes may be artificially high prices. The Regulator is now considering new measures to build up a more reliable IPO pricing process.

6.3 Is a Disclosure Based IPO System Feasible and Would it be Beneficial for Chinese Markets?

Merits based regulatory system do offer potential benefits to China, but those benefits come at some cost. The question for State Council of China is whether a disclosure based system, which would result in a different set of tradeoffs might be more beneficial at this stage of market development. This question is of course not simple.

The primary benefit of a merits based approach is increased protection of uninformed or unsophisticated investors. Certainly in principle a governmental gatekeeper could prevent unsophisticated investors from investing in securities in which the risk reward calculus is egregiously out of balance. Such protection is most important when most investors in the market are individuals and the market is not highly efficient in its pricing mechanism. These conditions certainly obtained throughout the 1990s in the Chinese markets. During this period, the absence of large number of institutional investors and the relative inefficiency of market pricing mechanism[87] made the case for merits based regulation system comparatively stronger. As institutional

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[86] Source: Hong Yuan Securities cited in Tan Wentao, "History of China's Stock Markets," in *China's Financial Markets: An Insider's Guide to How the Markets Work*, ed. Salih N. Neftci and Michelle Yuan Menager-Xu(Academic Press, 2006), n ___above at 222.

[87] There are a lot of reasons to think Chinese markets are not especially good at efficiently pricing shares. See e.g. Randal Morck, Berhard Yeung and Wayne Yu, "The Information Content of Stock Markets: Why Do Emerging Markets Have Synchronous Stock Price Movements," *Journal of Finance and Economy* 58(2000):215.

investors take a more prominent place in the function of Chinese securities markets the need for such protection is reduced.[88]

But the merits based approach to market access also risks substantial costs. The merits based approach is, in fact, a diluted or weak form of centralized, administrative capital allocation and as such it is subject to the same type of information based criticisms that Von Mises leveled at socialist capital allocations. PORC members can only weakly be counted on to admit good investment prospects and exclude poor ones from access to securities markets. And also as Von Mises warned such systems create opportunities for corruption.[89] The CSRC has unhappily be the recurring location of such misconduct. Recently, for example, Mr. Wang Yi, former Vice Chair of CSRC was charged with bribery in connection with providing IPO access to unqualified firms.

A disclosure based system has the obverse costs and benefits. When it works well such a system has the great benefit of providing access to markets in a way that short cuts opportunity for bias, mistake or corruption on the part of gatekeepers. Such a system works best when investors are relatively well informed and sophisticated, when issuer disclosures are of high quality, when share prices are set in a liquid market, and when investors gain with their share purchases a portfolio of enforceable rights. As we suggest in early parts of this essay, at least until the important share-segmentation reform is completed and governance rights in voting and takeovers are real in China, these conditions will not effectively exist in China, even if institutional investor activity grows, as its has.

Thus while the CSRC has an announced intention to move towards a disclosure based system as Hong Kong, Malaysia and Singapore are doing, we can expect movement towards disclosure based system to be unhurried.

6.4 Regulating Post-IPO Offerings

Post-IPO offerings are an important part of the Chinese securities markets. In 2007, for

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Information available to the market is often limited or questionable; markets have been relatively illiquid and finally investors have no practical rights effectively to vote, no prospect of a takeover and often no current dividends. Thus equity investing seems akin to speculation on the future rather than an attempt to arrive at fundamental value form DCF type analysis. Perhaps for these reasons, prices of shares on the Chinese markets appear to be much more volatile than the underlying economy or profitability of firms. See Sheldon Gao, "China Stock Market in a Global Perspective",(2002) Dow Jones Indexes. When prices are set in an efficient market even uninformed investors may depend to some extent on the market price of a stock as a more or less fair evaluation of its intrinsic value.

[88] As of today, institutional investors in China primarily include securities investment funds, insurance companies, pension funds, securities companies, commercial banks, trust and investment companies and qualified foreign institutional investors (the "QFII"). However, these institutional investors remain small, simple model of business and limited products and low efficiency in operation.

[89] The risk that government approvals would be granted either for political rather than merits based reasons or would be induced by corrupt payments was precisely why in the U.S in corporation was made a general right through "general incorporation laws" in the 19th century and probably why SEC was not given power to deny access to exchanges on basis of riskiness. See William T Allen, Reinier Kraakman, Guhan Subramanian, *Commentaries & Cases on Law of Business Organization*. Second Edition (Wolters Klur Law & Business Publishers, 2007):86-90.

example, new capital raised through secondary pubic offering from domestic stock markets increased to US$36.8 billion from US$8.7 billion in 2006.[90] During the same period, new capital raised from IPOs increased to US$63.4 billion from US$13.8 billion.[91]

As with merits based IPOs, Chinese regulators have strictly regulate the supply and size of post-IPO offerings on domestic stock markets. There are two ways to access post-IPO stock financing in China. The first is the secondary offering of new shares and the second is rights offering to existing shareholders. Regulation of the secondary offering is usually stricter than that of rights offering. Indeed secondary offerings were prohibited from 1992 to 1997 in order to preclude threats to state control through dilution of state-owned shares.

Chinese regulators have implemented strict approval process and threshold requirements for rights offering. One criteria was imposed in 1996 was a profit requirement. It requires that listed companies have earned a return on equity of at least 10 percent in each of the last three years. The focus on this ROE measure of performance greatly restricts the number of listed companies that can raise their funds through rights offering. Paradoxically, it also created a strong incentive to listed companies to manipulate their earnings so as to meet thresholds requirement. In 1996, only 97 out of 510 listed companies' ROE were over 10%.[92]

The CSRC is now conducting research and drafting new measures regulating post-IPO offering measures. Whether the approval from the CSRC is required and Chinese regulator is able to allow a full disclosure-based regulatory approach to post-IPO offerings, the practice elsewhere, is still a key pending issue.

6.5 The Dual Listing Phenomenon

In recent years, a dual-listing trend has emerged in the Hong Kong Stock Exchange and Shanghai Stock Exchange for large SOEs, such as Petro China, China Construction Bank and Shenhua Coal. While in theory the decision where to list a firm's securities is the decision of the firm's management and board, it is we think naïve to imagine that some aspects of the government (most notably the CSRC) do not affect decisions of who will list locally and who will carry on a dual-listing. It is speculated that those who do list on a "foreign" exchange do so for one or more of several possible reasons. First, while Chinese families on average save at a staggering rate of 40% of income, the practice of investing in stock is not widespread. Thus the amount of investable capital available on the Chinese exchanges is not yet very large by international standards. Foreign markets are more liquid and larger than the Chinese markets. Large PRC firms therefore do list overseas when feasible in order to get access to deeper capital markets.

A second reason PRC firms list on foreign exchanges may be that in doing so they signal a willingness to meet the different corporate governance standards required on these exchanges.

[90] See World Federal of Exchanges, Annual Report and Statistics 2007, at 91.

[91] See World Federal of Exchanges, Annual Report and Statistics 2007, at 91.

[92] See Sonia Wong, "China's stock market: a marriage of capitalism and socialism," *Cato Journal* 26(2006):389, 407.

In doing so a Chinese firm may help create an international reputation, since relatively few Chinese firms are able to list on such exchanges.

Dual listed shares of large SOEs form a substantial part of the market capitalization of the Hong Kong Exchange. As reported by the Hong Kong Stock Exchange, by the end of 2008, only approximately 10.1% Chinese companies listed in Hong Kong Stock Exchange, but their market capitalization reached 54.6% of the market capitalization.[93] It is supposed that China would like to see the Shanghai Exchange grow by calling for a return to China of H shares of the largest SOEs. Elsewhere in this essay we report market price differences between comparable shares of the same firms; H shares tend to demand a lower price than identical Shanghai A shares. See p ___ above.

The impact of the return of H-shares on A share market is significant. The increasing dual-listing of SOEs significantly increased the market capitalization of domestic markets. By the end of 2007, market capitalization of listed companies in domestic markets reached RMB 32,714 billion, ranking the highest among emerging markets, equivalent to 132.6% of China's GDP; As a comparison, by the end of 2005, market capitalization was RMB3,243 billion, equivalent to 17.6% of China's GDP.[94]

Usually, of course, dual-listing are pursued because domestic markets are not deep enough to offer issuers funds at comparable cost of capital. To what extent are large SOEs driven to Hong Kong market by these costs of capital considerations? A comparison of H share issuance to A share issuance for some large SOEs may be illuminating. The ratio of outstanding A shares to total outstanding shares and the corresponding ratio of outstanding H shares to total outstanding shares for some large SOEs is as follows: ICBC (2.7%:24.9%); China Life Insurance (3.2%: 26.3%); Bank of China (2.1%: 29.9%), Ping An Insurance (7.8%: 31.8%) and Sinopec (10.0%: 34.3%).[95] These figures illustrated that these companies do not rely much on raising capital from domestic market. Thus without deepening liquidity in the Chinese markets, we expect the governments effort to return H shares to Shanghai market will be an uphill struggle.

6.6 Would it Benefit China to Broaden Access to Domestic Securities Markets For Entrepreneurial Firms?

From their modern re-appearance, Chinese security markets have been designed to support the modernization of the formerly wholly state-owned sector. Consequently, they have played little role in financing of the fully private sector, a sector that represents a large proportion of the economic growth that has propelled China's new wealth. In western countries, as in China, entrepreneurial activity is often a key component of long term growth. Microsoft, Cisco, Dell, FedEx, are prominent examples of entrepreneurial firms that have evolved in very large firms financed largely through securities markets. The life cycle of the finance of such firms as they evolved in the U.S., at any rate, has taken a customary pattern — from informal friends and

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[93] See Hong Kong Stock Exchange, available from http://www.hkex.com.hk/data/chidimen/CD_MC.htm

[94] For market capitalization data, see CSRC 2007 Annual Report, at 69; For GDP data, see China Statistical Yearbook 2008.

[95] Source: Bloomberg; companies' websites; Data as of [May 2007].

family finance, followed by bank finance, which may later be replaced with venture capital finance, and lastly if the firm grows and succeeds, and is not sold to a larger enterprise, venture capital will be replaced by securities market finance in an IPO. Thus security markets act as an exit mechanism, and thus an inducement to venture capital finance and entrepreneurial activity. .

This pattern or life-cycle has not yet evolved in PRC. Indeed in our experience, even offshore IPOs for PRC incorporated companies require government approval which are very hard to obtain in practice. Private companies when they achieve a certain scale do attempt to list overseas. In this they usually have private equity firm(s) as a pre-IPO investor. See section 7.1 below for brief discussion of efforts to establish a board for entrepreneurial firms.

PART VII. FUTURE PATHWAYS FOR SECURITIES MARKETS DEVELOPMENT IN CHINA

As the CSRC understands, extending the utility of the securities markets for the Chinese economy will require simultaneous construction along several different pathways. Among the topics addressed in this essay, it is well recognized that the institutions of Chinese corporate governance must continue to mature and the rights created must be provided with effective avenues for enforcement. In this section we briefly address three other areas of interest to those who wish to see the institutions of the securities markets contribute to an even more productive Chinese economy: the broadening of access to the securities markets to private or entrepreneurial firms (Section 7.1), the possible use of these markets to build managerial incentive contracts (Section 7.2.1) and the possibility of a disciplinary market for corporate control (Section 7.2.2)

7.1 The Future for Securities Market Funding for Fully Private Firms

Broadly speaking, formal sources of finance for smaller, growing firms has been difficult in China. According to a 2006 McKinsey report, private enterprises produced 52% of GDP in China in 2003, while it only received only 27% of bank loans. In comparison SOEs reportedly produced 23% of GDP but absorbed 35% bank loans.[96] More pointedly for this essay, securities markets have generally not been an available option for small and medium sized firm ("SMEs") finance. In part, this may represent a reflection of the fact that these firms are perceived to be more risky enterprises than large established firms; the CSRC in its substantive regulation may exhibit a strong bias in favor of listing only "safe" securities. Thus, SMEs largely have financed themselves through informal sources, such as family and friends, and even underground lending institutions at very high interest rate.

The CSRC public statements, however, state that it seeks to develop "multi-level stock market" to improve market access for smaller enterprises. It has two initiatives in that respect. In 2004 a Small and Medium Enterprises Board (the "SME Board") was opened in Shenzhen. Secondly, the CSRC has approved very recently the launch of a new Growth Enterprise Board (the "GEB") for firms less mature than those contemplated by the SME Board in May 2009 to function exit channel for these venture capital and high growth enterprises. The CSRC will establish

[96] See McKinsey Global Institute (May 2006), *Putting China's Capital to Work: The Value of Financial System Reform*, available at http://www.mckinsey.com/mgi/publications/china_capital/index.asp, at 62.

a special review committee for access to this new GEB market, which committee will presumably be professionally familiar with the special character of entrepreneurial and venture financed backed firms.

The SME Board has met with some success. At the end of 2007, market capitalization reached US$145.8 billion in 2007, a 464.5% increase from US$25.8 billion in 2006 and ranked after London AIM, among all SME exchanges in this regard.[97] Private enterprises have a very significant presence on the SME Board. They are said to represent approximately 76% listed companies as of October 2005.[98]

However, in many respects the listing standards for the SME board are similar to those of the bigger boards. The SME Board requires companies to have a minimum RMB30 million of accumulated net profits in the three years prior to listing. This rather importantly limits it's utility to smaller entrepreneurial firms. The standards for listing on the GEB however will be lower: a minimum RMB10 million in retained earnings. Nevertheless, in contrast to similar markets in other countries, companies that apply for listing on the GEB must already be profitable, a test that neither Amazon nor EBay would have been able to satisfy. Thus even these innovative small company boards may reflect a strong regulatory bias against more risky enterprises.

7.2 Can We Expect PRC Securities Markets to Evolve into Disciplinary Markets?

Securities markets can provide economic benefits to the PRC economy in addition to providing a source of finance to lumbering former SOEs. One utility that they can provide is an exit for venture capital investments that would support the entrepreneurial sector of the economy, as we discuss briefly above. In this section we briefly address another potential benefit: the incentive to high quality corporate management that can be provided by a securities market. As we discussed in Part V this incentive can be positive – for example stock option compensation for an effective manager– or negative – management replacement by shareholder vote for ineffective management teams.

7.2.1 Option Based Compensation: A Positive Stock Market Based Incentive

In theory, incentive compensation tied to the performance of the company's stock is one means for reducing the agency problem and aligning managers and shareholder incentives. If shareholder wealth is taken as a proxy for social welfare maximization, well designed stock option compensation contracts could advance the general or public interest. But such theoretically useful contracts are complicated to design. Moreover for even well designed option-based incentive compensation plans to be tied to increasing social welfare requires that share prices to be a more or less sound signal of fundamental value.

Design of incentive compensation contracts is difficult. To be socially desirable a stock

[97] See World Federal of Exchanges, Annual Report and Statistics 2007, p126.

[98] See http://www.sme.gov.cn/web/assembly/action/browsePage.do?channelID=1129097785944&contentID=1130306361557

option based employment contract must be tied closely to what the plan wishes to encourage: contribution that the employee makes to the firm's marginal productivity. Since most people work in teams, the measurement of individual contribution is difficult to observe or estimate. Moreover most production teams contribute only indirectly and opaquely to firm total performance. And finally firm performance is not the only factor affecting stock price in the short run. Therefore stock option based compensation is a very crude device for the great majority of firm employees. Even for senior officers, whose effect on firm performance is greatest, it may be a very imperfect incentive. Nevertheless, these contracts are widely (if imperfectly) deployed in U.S. firms. While in theory such contracts are privileged as a favored way to align interests, whether in fact, as generally deployed they increase investor returns would is an open question.

Even if an executive compensation contract is designed correctly to somehow measure the marginal productivity of the executive to corporate productivity, the account by which such contracts are seen as an effective means to align management and investor interests with social interest requires that the firm's share price is set on an efficient market. If share price are shaped by irrational sentiments, such as momentum investing, then the significance of manger incentives measured by share price would be reduced.

It is lawful in China for listed companies to write option based incentive contracts.[99] We find no studies disclosing the extent to which they are presently employed, however. [100]

Given the presumed relative inefficiency of the mainland exchanges in setting prices, the technical difficulty in writing optimal option-based incentive contracts, and the absence of effective investor-based corporate governance protections, we would not suppose that widespread adoption of option based compensation would be beneficial for China at this stage of security market and corporate governance development. If greater corporate governance rights and more liquid markets were to render prices presumably more efficient, we might observe a stronger claim for their use in China. Even then, the model of contract dominant in the U.S. (which generally do not adjust for example for industry performance) would require significant redesign to be effective in China.

7.2.2 Tender Offers: A Goad to Better Managerial Performance

Public tender offers for corporate control, despite being technically possible, appear today to play no disciplinary role in China. Law and finance scholars generally believe these

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[99] See CSRC, *"Guidelines for Equity-based Compensation"* (2005 No. 151) (Restricted stock and options as compensation limited to 10% of outstanding shares).

[100] There is some indication that such contracts are widely used by "red chip" firms (Hong Kong incorporated firms doing business in mainland china) but oddly the authors find the options very often are not exercised. .See Zhihong Chen, Yuyan Guan and Bin Ke, "Stock Option Compensation with Chinese Characteristics: The Case of Hong Kong-Listed Red Chip Firms," http://ssrn.com/abstract=1249526 (2008). See also Michel Magnan and Tiemei Li, "Equity-based Compensation: An Important determinant of Chinese Cross Listed Firms," (2008) http://ssrn.com/abstract=1082888 (purporting to show for period before options permitted that option based compensation for Chinese "significantly increases shareholder wealth" of "red chip" firms when compared to comparable Shanghai listed firms, even though no affect on ROA observed).

transactions can have a net beneficial social effect. If and when they may make such a contribution to efficiency of the Chinese economy is the topic touched upon in this subpart.

The theory by which securities markets can act as a painful incentive to better managerial performance is well known. Under-performance by managers for whatever reason will cause the shares of the enterprise to trade at a price below their potential trading price under better managers. Once this discount reaches an attractive level, other management teams will attract capital to themselves in aid of buying control of the firm on the market. Once control has been achieved through a premium over market tender offer, the under-performers may be replaced with the new superior managers. Whether such activity will really result in displacement of underperformers by better performers is controversial. But it seems almost universally agreed that some level of hostile tender offer activity should aid in the social pursuit of efficiency. In part this is because the prospect of this painful replacement experience acts as an incentive for all management teams, ex ante, to perform well.

Historically, most of the change-in-control transactions in China have taken the form of contracts, in which an acquirer reaches an agreement with the holders of some or all non-tradable shares, such that control would be passed. These transactions were inevitably at prices below the market price of tradable shares – often large discounts – even though they carried control. The standard explanation for this is a "liquidity discount" (alternatively one might think of a bubble premium from time to time in the public market that an acquirer would be unwilling to pay). In either event, any such contract withholders of the non-tradable shares required, before it may be closed, the consent or approval by CSRC and SASAC. In these transaction the holders of tradable A shares were left unaffected in terms of their ownership.

In an apparent effort to aid public shareholders the CSRC established in 2003 a regulation *(Administrative Measures on the Acquisition of Listed Companies*) which for the first time contemplated public tender offers for shares of listed companies. Moreover, that pronouncement provided that if any person acquired thirty percent or more of the shares of a listed company, that person would be required to make a no less generous offer to all shareholders of the company (a "mandatory offer"). This regulation, however, was with effect. Since the voluntary transaction with holders of NTS always were at a price that was below market value of the tradable shares, an acquirer could (and did) satisfy the regulation by making an offer to public shareholders that was at a price below market. There is no incentive to accept such a discount price and few did.

Professors Tuan, Zhang, Hsu and Zhang in a study of merger arbitrage in China[101] located just twenty four instances of tender offers for shares of listed firms between June 2003 and December 2006. Of these seventeen tender offers were "mandatory" in character and offered a price lower than market price for the traded A shares. The authors report that on average the discount from market price offered was 19.6%. None of the offers closed. We might call these phantom tender offers, because they have the formal look of a tender offer, but have no economic substance. The remaining seven cases were cash offers. All of these bids were in petro-

[101] Tuan Jason, Zhang JinXin, Hsu Jason, & Zhang Qiusheng, *Merger Arbitrage Profitability in China,* (2007) http://www.ssrn.com/abstract=992650.

leum & chemicals sector and all were initiated either by PetroChina or by Sinopec, the giant SOEs in the petroleum business.

Thus we conclude that at least as of the close of 2006, tender offers for corporate control have not played a role in Chinese finance and have no disciplinary function.

Hostile corporate control transactions are controversial where they exist. While highly favored in law & finance theory, some have claimed that markets in corporate control have at times lead to excessive hostile takeovers in the U.S. with adverse consequences for firms[102]. We need not take a position on the question "Precisely how much hostile takeover activity is optimal? " to be confident that zero as in China is almost certainly too low for efficiency purposes.

We regard the absence of any possibility for hostile corporate control transactions in China as a cost of the share segmentation system. Now we wait for the effects of the just concluded share restructuring program to become manifest. If control of substantial numbers of firms is permitted to flow into the market through secondary offerings or private placements, we may expect that the costs and benefits of a more lively corporate control market may evolve. But, for such a market to operate with high assurance that public welfare is likely to be enhanced by such transactions, it is necessary that share prices fairly represent fundamental value. Thus market liquidity and corporate governance should be enhanced simultaneously.

PART VIII CONCLUSIONS

The construction of Chinese securities markets and the infrastructure that supports them has been a top-down activity pursued very steadily and with great prudence for almost twenty years. That effort has been a notable success for the leadership of the country. The job is not yet complete, as is well understood.

Despite the great gains made, the Chinese economy is not yet fully realizing the benefits that these securities markets can provide. Existing equity markets have grown rapidly in terms of market capitalization and in terms of listings, but when compared to the securities markets in more developed financial systems, they appear small relative Chinese economy. There are reasons to believe they do not price equities very efficiently. Those prices are more volatile than the Chinese economy as a whole and price movements are notably synchronous.[103] An economically significant market for non-governmental bonds has not yet arisen in China and is important. Financial risk management is limited in part because hedging opportunities are constricted by a prohibition, now to be eased, on borrowing shares.

More importantly perhaps, the discipline that an equity market can supply to corporate management is largely absent from the Chinese economy because of the absence of any effective

[102] See e.g. work of Marty Lipton (cites to come)

[103] See e.g., Baishan Xie, Xuelai Dai and Lan Xu. "Comparative Study of US and Chinese Securities Markets," in *International Comparison of Securities Markets 3-4*, edited by Baisan Xie (Qinghua University Press 2003).

investor corporate governance levers (that is the essential absence of proxy contests, tender offers or derivative lawsuits). Finally, and importantly the securities market at this time provides little support for the growing entrepreneurial sector of the Chinese economy.

Deng Xiaoping said of the liberalization and opening-up of China's economy that the country would proceed as a man crossing a stream, finding one rock to safely place his foot before searching for the next. This image continues to describe the rapid yet paradoxically cautious step by step development of these markets. Even now the largest unknown questions relate not to technical steps in this process that are next required, but to the political and ideological issues that must still be discussed at senior leadership levels, concerning how much faith it is save to place on the decentralized and loosely controlled capital markets. One can only surmise that the financial crisis in global financial markets and institutions that emerged in 2008 will enhance a natural caution in this respect. But surely the share restructuring program reflects a commitment to continue moving, quickly or more slowly, towards public securities markets with greater functionality.

4.8.09