

ASSESSING CHINA'S TOP-DOWN SECURITIES MARKETS*

William T. Allen
New York University School of Law &
NYU Stern School of Business

Han Shen
Davis Polk & Wardwell, Hong Kong

China's mainland securities markets are unlike those of Amsterdam, London or New York, which evolved over centuries from myriad interactions between entrepreneurs or established businesses seeking finance and investors seeking both investment opportunities and a means for relatively easy and quick liquidation of such investments. Such spontaneous securities markets did emerge throughout China in the 1980s following the start of liberalization, but these spontaneous markets were closed by the government in 1992 in favor of new, tightly controlled, exchanges established in 1990 in Shenzhen and Shanghai. These new markets are different than those that had spontaneously evolved in the west or earlier in China. They have been designed to and largely limited to serve state purposes, that is to assist in the financing the state sector of the economy. This essay reviews as of late 2009 the development of these markets, the regulatory structure that controls and shapes them and the governance mechanisms – legal and otherwise -- that controls the management of the listed companies. These markets represent a signal accomplishment of the Chinese leadership in producing in less than twenty years modern, albeit not yet fully developed, securities markets. Whether they can be further developed to serve more basic economic role than they have been permitted to play is a question with which the essay concludes.

* For their helpful comments, the authors wish to thank the editors of this volume, Justice Jack B. Jacobs of the Delaware Supreme Court and Ms. Huang, Jie, a member of the Beijing Bar. The authors are responsible for remaining errors.

This essay seeks to assess the current Chinese securities markets, both in terms of their size and composition and in terms of their economic function and importance to the Chinese economy. In doing so, we also review and assess the regulatory regime within which these markets function and the corporate governance mechanisms that operate upon the firms that are listed on the Chinese stock exchanges. For reasons of space, we do not review the history of the evolution of these markets (see Greene 2003; Tan 2006), the corporatization program that created the firms that for the most part make up the listed firms on the two mainland exchanges or, except briefly, the original share segmentation system that restricted ownership of shares.

For the reasons set forth below, we conclude that the Shanghai and Shenzhen securities markets are not yet mature markets and do not yet play a substantial role in the finance of the Chinese economy. The finance of the Chinese economy is dominated, on large scale projects, primarily by bank finance and direct government support and, on entrepreneurial finance level, primarily by a range of less formal arrangements including friends and family, trade credit, business alliances and, importantly, local government support (Allen, Qian, Zhang and Zhao, 2010). Listing on the stock exchanges is tightly controlled by the government and is largely restricted to state affiliated firms. The resulting markets are comparatively quite small in terms of the size of the general economy. Prices of securities traded on them are volatile and do not appear to price securities very well. Because prices on these markets do not appear to be efficiently set and because, as we show, the legal system governance standards they incorporate are ineffective, the markets do not provide either a positive signaling function or a disciplinary function for the corporate management of listed firms. Finally, because they have not yet evolved futures markets or a large capacity to create derivative securities, the PRC securities markets do not provide adequate opportunities for the management of financial risk. For these reasons, the Chinese securities markets do not appear to deliver the principle economic advantages that a developed securities markets can provide.

If these markets do not provide the fundamental economic benefits that securities markets can provide, one needs to ask, why do they exist? Below, we suggest that they exist because they nevertheless do provide valuable benefits to both investors and to the Chinese state. Even without the benefits of substantial formal or legal system protection from exploitation, the markets do provide to investors a way to participate in the rapid growth of the PRC economy. In addition these markets provide the following real benefits: (1) they provide a channel through which can flow a limited amount of investment from the very large reservoir of domestic family savings in order to support large state-owned enterprises (“SOEs”); (2) to a greater extent, they facilitate the flow into China of international investment, for the same purpose; (3) they serve as means to induce improvements in the management and governance of large SOEs; and finally (4) they provide to the leadership a possible option for future expansion of the role of private sector in financing enterprise, including both the existing state sector and the entrepreneurial sector of the economy.

Despite the limited economic importance of Chinese securities markets to the nation's economy at this development stage, they continue to command great interest. In the extended effort to restructure the Chinese share segmentation system (touched on below in Section 1.1.), the country's senior leadership has demonstrated a continuing commitment to building out the infrastructure that might allow securities markets to play a different and greater role in the future. The following essay aims to assist interested readers in thinking about that future.

In Part I, we briefly provide a status report on the Chinese securities markets, discussing their current size and scope and their interesting relationship to the Hong Kong securities market. In Part II, we discuss the current regulatory environment of these markets, focusing on the structure and operation of the Chinese Securities Regulatory Commission (CSRC) which has a powerful role in controlling these markets, access to listing shares on them, and supervision of all the institutional actors on them. In Part III, we discuss Chinese corporate governance, including both the role of the Chinese Communist Party and the formal system of shareholders legal rights. In Part IV, we conclude with observations concerning the fundamental contradiction between the PRC securities markets top-down design and control on the one hand and their possible effectiveness in efficient capital allocation or disciplining under performing management teams of listed firms, on the other. We discuss the factors that may someday weigh on the perceived need of the leadership to address this contradiction.

PART I. THE CHARACTERISTICS OF THE CHINESE SECURITIES MARKETS TODAY

The Chinese securities markets are an important accomplishment. The technical, legal and human infrastructure supporting these markets has been created from almost nothing twenty-five years ago. Nevertheless they remain a work in progress. The bond market for commercial issuers is undeveloped as yet and the futures market (excepting some commodities) remains nascent.¹ But sitting as they do in one of the world's largest economies and its fastest growing one, these markets demand attention from investors around the world. In this part, we wish to briefly describe certain aspects of the Chinese securities markets. We note that any understanding of the scale and scope of these markets should be premised on an understanding of the on-going effects of the now reformed share segmentation system; therefore we begin our discussion of the markets with a brief description of that reform. Those familiar with the share segmentation system and its now largely completed reform, may safely move to Section 1.2.

1.1 Background: The Share Segmentation System and Its Reform

¹ The CSRC proposed to study the possibility of the introduction of China's first Stock Futures Index contracts could trade on the domestic stock exchange; if this will be implemented, this step will help improving the ability of domestic institutional investors to hedge investment risk. Previously the only futures contracts that traded in China were certain commodities futures; however, as of today, it is still not clear that the time table of the announcement of the Stock Futures Index.

Under the Chinese Company Law of 1993 (revised 1999, 2004 and 2005) all shares of common stock of an issuing company bear equal voting and cash flow rights (albeit until quite recently essentially no SOEs in fact paid dividends), but under the share segmentation scheme that governed the listing of shares on securities exchanges only a minority of the shares of SOEs could be issued to the public and tradable on those exchanges (“TS”).

The tradable shares themselves were broken down into A shares and B shares on the PRC exchanges. 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 originally could be purchased only by Chinese nationals or Chinese institutions. B shares 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 (now they can be purchased by Chinese nationals as well).² In addition to A and B shares, some larger Chinese firms, seeking access to foreign capital, have received (from the CSRC) 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 were distinguished by the nature of the holder. Shares could be either (1) pre-IPO shares issued in connection with the “corporitization” of the assets to (a) instrumentalities of the state – such as a Ministry, an Institute, the State-owned Assets Supervision and Administration Commission (“SASAC”) or a Provincial or Municipal governments; 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; or (2) shares issued in or after the IPO to Chinese nationals or institutions (and recently Qualified Foreign Institutional Investors, “QFIIs” also). 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 generally classified as “C shares” and were not tradable on the exchange. Non-tradable shares (“NTS”) could only be transferred to legal persons (including in recent years foreign strategic investors) in private placements with the prior approval of both SASAC and the CSRC.

Prior to the completion of share segmentation reform, significantly, with respect to every listed SOE — and, most of the firms listed on the Shanghai Exchange are SOEs, recent estimates varying between 70% and 80% (Chen, Firth and Xu, 2009) — non-tradable shares significantly outnumber the proportion of shares that are tradable. According to CSRC data, for example, 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, a fact of fundamental importance is that the trading market on the Chinese securities exchanges has represented only minority interests. Generally for most listed firms control exists in one

² 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 arbitrage then made possible eliminated the price differences.

or more state affiliated. For a relatively small minority of firms control exists in an individual, family or small group.

The non-tradability of control blocks has been deemed undesirable and the CSRC has attempted for several years to reform this structure. After several failed attempts to do so, the CSRC has now largely completed its program in which most non-tradable shares have been converted to tradable shares and gradually floated to the open market according to relevant rules.³ As of October 31, 2009, on the Shanghai Stock Exchange public float of tradable shares has been increased to 60.4%, compared to 33.2%, 23.9% and 22.9% as of December 31, 2008, 2007 and 2006, respectively (Shanghai Stock Exchange Monthly Statistics). On the Shenzhen Stock Exchange, public float of tradable shares has been increased to 66.1% as of October 31, 2009, compared to 58.8%, 54.3% and 49.5% as of December 31, 2008, 2007 and 2006, respectively (Shenzhen Stock Exchange Monthly Statistics).

Thus the share segmentation reform appears to be an unqualified success. With this reform, a significant inhibition to the efficiency of the Chinese securities markets has been gradually removed.

The 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 of NTSs? If so, the 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% which ordinarily would be deemed sufficient to thwart a market based change in corporate control.

Thus while the completion of the non-tradable share reform removes a formidable 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.

1.2 Growth in Market for Large Company (SOEs) Shares

By close of October 2009, the Shanghai and Shenzhen Stock Exchanges together listed 1,682 companies, a large majority of which were SOEs.⁴ Using the market capitaliza-

³ Article 27 of "The Administrative Measure of Share Segmentation Reform of Listed Companies" issued by the CSRC in September 2005 requires that (1) the NTSs cannot be publicly traded or transferred within 12 months after the implementation of the reform proposal of NTSs adopted by the listed company; (2) with regards to these NTSs shareholders who own more than 5% shares of a listed company, after the expiration of the above required 12-month period, they are not allowed to sell more than 5% of shares converted from NTSs on a stock exchange within 12 months and are not allowed to sell more than 10% of shares converted from NTSs within 24 months.

⁴ As of 2000, Tam (2002) put the number at 90%. Liu and Sun (2003) put the number at 84%. See Clark (2008): 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 Chen, Firth and Xu (2009):174. As of close of 2007, it appears that 65% of these listing were SOEs (and essentially all of the largest firms). In 2006 there were 14 new listings, all of which were SOEs.

tion metric, the two mainland Chinese exchanges would have together constituted the third largest exchange in the world at the close of October 2009. At that time, total market capitalization of both markets equaled US\$3,612.1 trillion, about one quarter of the size of the NYSE (which was US\$11,391.8 trillion) at that time (WFE Statistics). While in the context of the Chinese securities markets, market capitalization figures may mislead as much as inform, still the numbers are impressive. Daily trading volume on both markets averaged US\$30.1 billion for the ten-month as of October 31, 2009.⁵ Again, measured in total market capitalization, the comparative recent growth rates of these exchanges and their volatility appears remarkable. Recent comparative data for the periods of 2006 to 2008 is set forth in Table 1.

Table 1: Annual Changes of Domestic Market Capitalization (2006-2008)

Stock Exchange	At the end of			% Change 2008 vs. 2007	% Change 2007 vs. 2006
	2008	2007	2006		
	(USD millions, except for percentages)				
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

In terms of capital raising, the Shanghai and Shenzhen Exchanges were used to raise the equivalent of US\$17.1 billion in 2006, which increased to US\$65.1 billion in 2007, but fell to US\$14.9 billion in 2008 in initial public offerings (“IPO”) funds (WFE Statistics). The Shanghai Exchange itself was the venue for raising RMB223.8 billion (US\$33.4 billion equivalent) of new capital (IPO and secondary offerings) in 2008; and RMB670.1 billion (US\$100 billion equivalent) in 2007; and RMB211.2 billion (US\$31.5 billion equivalent) in 2006(WFE Statistics).

Despite their impressive size by some measures, and their impressive growth rates, the PRC exchanges 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 (CSRC Report, 2008: 237). While

⁵ More recently volumes and prices on the Chinese exchanges have fallen as elsewhere and then begun to rebound. 2008 average daily volume in dollars was 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 and fell and closed at 3580.63 as of November 26, 2009.

the proportion of securities of all financial assets in the PRC rose to 42% the end of 2008, compared to 77%, 78%, 56%, 64% in the U.S, U.K, Japan and emerging Asia markets (Mckinsey Global Institute, September 2009:27). The sophistication, regulation, strength of investor protection, and financing through local equity market of Chinese securities market and finance market are still weak in accordance with The Global Competitiveness Report 2009-2010, which was ranked No. 78, No. 91, No. 78 and No. 66, respectively, out of 133 (World Economic Forum, 2009).

1.3 Concentration, Liquidity and Pricing Efficiency of the Shanghai Exchange

The large SOEs dominate the Shanghai Stock Exchange. The two largest listed firms – Petrochina Company Limited (“PetroChina”) and Industrial and Commercial Bank of China (“ICBC”) – together account for more than 20% of the market capitalization of the entire exchange as of the end of October 2009.⁶ The ten largest firms make-up about 42.8% as of October 2009 of the total market capitalization of Shanghai Stock Exchange.⁷

As interesting as this market concentration data is, the data reflecting the very thin nature of the mainland trading markets in these shares may be more surprising to non-experts. Consider the case of ICBC Bank. In October 2006, ICBC, the state-owned bank, simultaneous listed and distributed a minority block of its shares on the Shanghai Stock Exchange and the Hong Kong Stock Exchange, in what proved to be the world largest IPO generating approximately US\$21.9 billion in proceeds. ICBC is the largest bank in China and it is the second largest listing by market capitalization on the Shanghai Stock Exchange as of October 2009. But how good is the Shanghai Exchange in fundamentally valuing these securities?

Note that ICBC Bank has (as of October 31, 2009) more than 334 trillion A shares and H shares outstanding, trading on the Shanghai Stock Exchange and Hong Kong Stock Exchange, among which, 75% of these shares trade on Shanghai Exchange and 25% trade in Hong Kong Stock Exchange, respectively. But how much of this equity is actually public floated and not controlled by non-state affiliate entities? Table 2 sets forth shareholding of the top five shareholders of ICBC as of October 31, 2009.⁸

Table 2: Top Five Shareholders of ICBC as of October 31, 2009

⁶ The equity market cap of PetroChina and ICBC accounted for 12.99% and 7.65%, respectively, of the market capitalization of the entire Shanghai Exchange as of October 30, 2009. (Shanghai Stock Exchange Statistics).

⁷ Hong Kong has a similar figure at 42.7% as of October 2009. By contrast, for the same period and by our calculation, the top ten listed companies on the NYSE equaled approximately 30% of the total market capitalization of the exchange.

⁸ Shareholding of top 6-10 shareholders of ICBC are between 0.1% to 1%.

<u>Name of Shareholder</u>	<u>Nature of Shareholder</u>	<u>Type of shares</u>	<u>Total number of shares held</u>	<u>Shareholding Percentage</u>
Central Huijin Investment Limited ⁽¹⁾	State-owned	A shares	118,316,716,139	35.4%
Ministry of Finance of PRC	State-owned	A shares	118,006,174,032	35.3%
HKSCC Nominees Limited ⁽²⁾	Foreign corporation	H shares	51,271,205,195	15.3%
National Council for Social Security Fund	State-owned	H shares	14,102,149,559	4.2%
The Goldman Sachs Group, Inc. ⁽³⁾	Foreign corporation	H shares	13,180,811,324	3.9%

(1) Central Huijin Investment Limited is a wholly-owned subsidiary of China Investment Corporation, the Chinese state sovereign investment company.

(2) Most retail and institutional investors hold their shares through a bank, broker or custodian who in turn hold them in an account with the Central Clearing and Automated Settlement System (CCASS) operated by Hong Kong Securities Clearing Co., Ltd. (HKSCC), a subsidiary of HKEx. HKSCC Nominees Ltd., a subsidiary of HKSCC, is the registered shareholder of listed companies and acts as nominee for the account holders of CCASS.

(3) Goldman Sachs has committed to a lock-up of 80% of its shares in ICBC no later than April 28, 2010.

From the table, we conclude the publicly owned shares traded in Shanghai constitute less than 4.3% of ICBC A shares tradable on Shanghai market and less than 3.2% of all outstanding ICBC shares. One must look to the Hong Kong Exchange to find more substantial private investment in ICBC shares.⁹ There we find listed ICBC H shares that constitute about 25% of all outstanding ICBC shares and about 21.1% of all ICBC shares are owned free of lock-ups (except Goldman-Sachs' shares in ICBC) can trade on the Hong Kong Exchange, compared to 4.3% available for possible trading in Shanghai Stock Exchange.

One obvious take-away: Not only is the Shanghai market thin, but in fact the Hong Kong market has been much more important than the Shanghai market for capital raising for ICBC bank.

ICBC's share trading structure is not unique among other of the largest SOEs. The proportion of shares publicly traded of the largest firms and not controlled by State on the Shanghai Exchange is typically quite small. For example, as of September 30, 2009, 67.53% A shares of Bank of China was owned by Central Huijin Investment Ltd. and less than 2.35% A shares were public floated and controlled by domestic non-state owned entities or individuals.¹⁰

In addition to the limited public traded A shares in Chinese securities market, the prices in most time is higher than in Hong Kong. The thinness of the Shanghai Exchange may account in part for the fact and the inefficient pricing of the mainland securities markets that results from restricted barriers to costless arbitrage between mainland markets and the Hong Kong market (and perhaps from greater volatility of mainland markets). There is

⁹ 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.

¹⁰ As of September 30, 2009, 70% of the issued shares of Bank of China are A Shares. 67.53% A shares of Bank of China was owned by Central Huijin Investment Ltd. China Southern Power Grid Co., Ltd., Aluminum Corporation of China and Shenhua Group Corporation Limited, each holding 0.04%.

a huge imbalance between supply and demand of high quality stocks in China. Moreover, high restrictions combined with high demand from newfound investible wealth, is pushing premiums up. The Hang Seng China A-H Premium Index, launched on July 9, 2007, tracks the average price difference between A shares and H shares for the largest and most liquid China enterprises with both A-share and H-share listings. As at November 26, 2009, the A-H Premium Index closed at 114.01, meaning A shares are trading at an average premium of 14.01% above H shares.

The upshot of the fact that the trading markets in Shanghai are very thin, highly concentrated and that Chinese investors have highly restricted alternative investment opportunities, is that there is good reason to suppose that the prices reflected on the mainland markets are not a good signal of fundamental value of the shares or the firms listed.

Chinese stock markets are frequently described as very volatile. Price movements are notably synchronous (e.g. Morck, Yeung and Yu, 2000; Xie, Dai and Xu, 2003), similar cash flow right trade at markedly different prices on Shanghai and Hong Kong, and when control of a listed firm is traded by private contract, it is on average at almost a 20% *discount* to market (Tuan, Zhang, Hsu and Zhang, 2007).

1.4 Mainland Exchanges Do Not Provide Substantial Access to “Private” Firms.

The development of SMEs has increasingly contributed to the growth of China’s economy; however, broadly speaking, formal sources of finance for these SMEs, growing firms has been difficult in China.

According to the State Administration for Industry and Commerce, over 99% of enterprises in China are SMEs at the end of 2008 (SAIC, March 2009); while over 98% SMEs have no access to formal financing (Shen, Shen, Xu and Bai, 2009). Due to the financing difficulties, around 40% of SMEs in China have faced bankruptcy in front of global financial crisis and economy slow down (CCTV 2009). It is an old problem in China. An early study by McKinsey studied private companies (most of them are SMEs) financing in China. The study shows private enterprises produced 52% of GDP in China in 2003, while they received only 27% of bank loans. In comparison SOEs reportedly produced 23% of GDP but absorbed 35% bank loans (McKinsey 2006).

More pointedly for this essay, securities markets have generally not been an available option for SME finance. Currently, there are about 570 private companies are listed on the two Chinese stock exchanges, presenting 34.8% of the total number of all listed companies and only 12.2% of the market capitalization (Shanghai Stock Exchange, August 10, 2009). In part, this may represent a reflection of the fact that these firms are perceived to be riskier than large established firms; the CSRC in its substantive regulation exhibits a strong bias in favor of listing only “safe” securities. Alternatively, the failure to approve listings for private firm issuances may either reflect an ideologically based disinclination to facilitate “private” wealth building or a general lack of heavy weight political connections of these smaller firms. SMEs have for the most part financed themselves through informal sources, such as family and friends, trade credit, informal support from local governments

and even underground lending institutions at very high interest rate (Allen, Qian and Qian, 2007). Given the fact that, as a class, SMEs represent the greatest prospect for substantial economic growth, the failure of the securities markets to provide finance to this segment must be deemed as a substantial current weakness.

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 approved the launch in May 2009 of a new Growth Enterprise Board (the “GEB”) for firms less mature than those contemplated by the SME Board to function as an exit channel for venture capital funded and other high growth enterprises. Access to the GEB market will be overseen by a special review committee, which committee will presumably be professionally familiar with the special character of entrepreneurial and venture financed backed firms. The first batch of 28 selected firms was listed on October 30, 2009.¹¹

The SME Board has met with some success. At the end of boom-year 2007, market capitalization reached US\$145.8 billion, a 464.5% increase from US\$25.8 billion in 2006 and ranked after London AIM, among all SME exchanges in this regard (WFE (2007): 126). Private enterprises have a very significant presence on the SME Board. They are said to represent approximately 76% listed companies as of October 2005 (Zhang 2005).

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 its 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 the 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.

1.5 Limited Market for Commercial Bonds and Futures.

From the perspective of more highly developed financial markets, a remarkable feature of the Chinese securities markets is the absence of a market for commercial bonds and indeed a very small bond market even when government bonds are included.

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%), the U.S. (188.5%), U.K. (140.5%), Korea (125.1%), and Germany (69.0%) (CSRC Report: 245). Moreover, such bond market

¹¹ According to Caijing (October 26, 2009), a total of 188 companies have applied to list on the GEB and about 70 percent of the applicants are from the electronics, new materials, alternative energy, biomedicine and other emerging sectors.

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 (CSRC Report: 246). 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%. Reportedly, only .05% of the bond market represents bonds issued by listed companies. When coupled with the very limited ability to hedge equity investments through derivative or futures trading, one can see the job of insurance company investment managers as very challenging in China.

PART II. THE REGULATORY ENVIRONMENT: THE CSRC.

Prior to 1992, China’s infant securities markets had been regulated by local government and the local branch offices of the People’s Bank of China (the “PBC”). In order to consolidate the complex, multilayered and fragmented institutional framework for securities trading, in fall 1992 the State Council formed the Securities Committee of the State Council (the “SCSC”) and the CSRC, as the SCSC’s executive arm. These new entities were charged to create a centralized supervisory framework for securities issuance and trading in China.

2.1 CSRC’s Dual Mandate: Advance State Policy While Also Protecting Investors.

As an executive arm of State Council, the CSRC has a primary obligation to advance 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.

Among Chinese regulatory bodies, the CSRC is regarded as among the most professional, staffed with highly trained lawyers, accountants and economists. It is also a powerful, but not always fully effective, regulator. Its functions are similar to, but more extensive than, 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 administer the securities markets and exercise the power of examination or verification;¹² (2) supervise and administer the issuance, offering, trading, registration, custody and settlement of securities (including granting or withholding permission to issuers to distribute shares); (3) supervise and administer securities activities of securities issuers, listed

¹² 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.

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; and (8) perform any other functions and duties in accordance with law or administrative rules.¹³

The CSRC has been an active regulator in attempting to improve market transparency and impose corporate governance standards.¹⁴ Importantly, 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. The wisdom of this gatekeeper role is discussed separately below.

2.2 Mandatory Information Disclosure.

Chinese statutory law mandates that issuers accurately disclose all material information and prohibits any material false statement or omission.¹⁵ Disclosure obligations are periodic and continuous.¹⁶

To be effective, a disclosure regime requires that the quality of information disclosed is good (truthful, timely and material) and that when it is not that some sanction be enforced. In fact, however, the creditability of information disclosed by Chinese listed companies is regarded as doubtful by investors and scholars (Aharony, Lee and Wong, 2000). Disclosure violations appear to constitute the most frequent type of securities law violation in China. A 2008 study by Shanghai Stock Exchange found that disclosure violations represented approximately 78% of all violations punished by CSRC and two stock exchanges for the period of 1996-2007 (Shanghai Stock Exchange, 2008). 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 (Shenzhen Stock Exchange, 2002). They represented 69.7% and 13.3%, respectively of all violations.

¹³ From the perspective of conventional legal analysis, it is quite unclear how far these statutory grants go to affording the CSRC with power to regulate the details of internal corporate affairs – such as are treated in the CSRC’s Code of Corporate Governance discussed below. In fact the CSRC may be of the view that its legitimate power in this area is very broad indeed. As a practical matter, since the CSRC does actively control access to the market and there is no effective judicial review of decisions to deny access, no issuer is likely to try to contest at this stage of development the CSRC’s legal power to propound binding governance or other rules affecting issuers.

¹⁴ See CSRC Report (2008) for a comprehensive review of its activity.

¹⁵ Article 62, the PRC Securities Law of 2006.

¹⁶ Periodic reports include annual reports, interim reports and quarterly reports. Ad hoc reports are primarily related to material events disclosure.

2.3. Enforcement

It is a common place for legal scholars to note the critical role of enforcement in effective securities regulation (e.g. Coffee, 2007). 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.¹⁷ 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, insider trading, market manipulation and professional (securities firm/accounting firm/law firm) misconduct in connection with the offer or sale of securities.¹⁸ 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,¹⁹ revocations of business licenses, orders of business suspension and internal correction, and warnings or censure. Fines,²⁰ an up-to a lifelong bar from the industry, and warnings are available against individuals, including directors and senior management in listed companies.

While it is empowered, it is difficult to say that the CSRC is as an effective enforcement body.²¹ For the most part, CSRC enforcement activities are limited and its penalties are mild. While the number of CSRC enforcement actions has grown as the markets has grown, the number of such actions 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, are small. It is suggestive, but little more than that, given the 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 enforce-

¹⁷ 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 Clark (2008), citing Zhou, Zheng and Hui (1998).

¹⁸ See "Interim Provisions on the Management of the Issuing and Trading of Stocks", issued by the 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.

¹⁹ 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.

²⁰ The amount ranges from RMB30,000 (US\$4,386 equivalent) to RMB100,000 (US\$14,622 equivalent).

²¹ It is suggestive that in a study of all voluntary tender offers, Tuan, Zhang, Hsu & Zhang (2007) found that an investor following a long arbitrage strategy on the date of announcement would not profit. 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.

ment actions (SEC 2008). In 2007, the SEC filed 656 enforcement actions (SEC 2007). In 2006, the total had dropped by about 9% to 574 enforcement actions compared to the prior year (SEC, 2006).²² There are grounds to believe that in China powerful SOEs are treated lightly by the CSRC; despite making up a small portion of listed companies in China's securities markets, private companies are more often sanctioned than SOEs.²³ But it is possible, of course, that the private firms may be less law abiding.

In all events, the result in most CSRC enforcement cases in which a listed company is accused of wrongdoing is censure; fines are quite rare (Firth, Chen, Gao and Rui, 2005). Yet Donald Clark wisely notes that where officers of SOEs are state officials, as may be the case in many large SOEs, a censure may be an effective remedy because it is likely to have serious career effects.

In recent years private actions by misled investors have been permitted. Enforcement of securities private litigation in the PRC courts is a recent phenomenon. The PRC courts have faced a similar puzzle like CSRC: they need provide access to shareholders to justice, while need consider state interests in front of massive private securities litigations.²⁴

2.4 Access to Listing: The Merits Based Regulatory Approach.

2.4.1 CSRC as Gatekeeper

Another way the CSRC is intended to protect state interests is in screening applicants for initial public offerings or secondary issuances on the PRC securities exchanges. In doing so, it exercises merits based discretionary judgment.²⁵ In this activity, the CSRC protects state policy interests both directly and less directly, by attempting to assure that high quality investment opportunities are offered to the investor community at appropriate prices.

²² In 2005, the SEC filed 629 enforcement actions. See SEC (2005).

²³ Liebman and Milhaupt (2008) posit that private firms may be less politically connected than state-owned firms, but they may also tend to have weaker governance.

²⁴ 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 million-900 million (US\$117.0 million-US\$131.6 million 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 (Shen, 2008).

²⁵ Article 12, Provisional Administrative Measures of Stock Issuance and Trading (1993); Article 10, the PRC Securities Law of 2006.

As an executory agency of the State Council, a primary responsibility of the CSRC is to advance the current policy goals of the State Council respecting the securities markets. Thus, for macro-economic reasons, the CSRC may reduce or even eliminate for a time the number of IPOs authorized without regard to the investment quality of any pending applicant for listing. 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 an effort 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 until late June 2009.

The merits based approach that the Chinese system deploys is often encountered in emerging markets, where retail investors may be thought to be somewhat unsophisticated. In such a context, there are possible benefits from such an approach, but the costs of this approach – in mistakenly denying securities market access to firms that may gain the most from the economic advantages of securities markets – are unobservable and may be significant. Also of course access to the market may be inefficiently allocated for reasons other than “mistake”. For example, in the earliest phase of the process of corporatization and issuance of shares in China, decisions concerning which companies would be permitted to distribute shares were heavily influenced by local politics. In this period, allocations were given to provincial governments to assign. Their allocation then would be reviewed by the CSRC, which would exercise final approval. Provincial governments tended to allot these allowances so as to raise money for those SOEs that were under their control and were most in need of capital. Thus, as it happened, underperforming SOEs were disproportionately selected for listing at the expense of dynamic entrepreneurial companies (Tao, 2006). During this period approximately 949 SOEs were listed on the domestic stock exchanges while only 30 private firms were permitted access to the securities markets (Zhang, 2000).

Currently, the CSRC deploys a process in which a committee -- the Public Offering Review Committee (the “Committee” or the “PORC”) makes or recommends access decisions. The 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.²⁶ The following table sets forth the review results of companies seeking to issue shares from 2004 to 2007.

Table 3: PORC Review Results (2004-2007)

Year	Number of Applications	Number of Approved 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%

²⁶ The CSRC also has set up a review committee for Merger & Acquisition and restructuring activities of listed companies in 2008 and a review committee for initial public offering on the Growth Enterprise Board in Shenzhen.

Source: Shenzhen Stock Exchange (2008)

In 2007, the PORC rejected 38 applications of initial public offerings and seventeen requests for secondary offerings. Among those rejected applications, sixteen were stated as being 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 the failure to meet qualification requirements such as material changes of management in the reporting period; and four rejections were primarily due to insufficient or false information disclosure.

2.4.2 IPO Pricing

IPO prices in China are constrained. The CSRC once set bounds on IPO offering prices 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). Within this range underwriters and issuers set an offering price.

On most exchanges globally incentives to push these initial offering prices to the low side exist. Underwriters want happy investors and issuers want share prices to rise initially too. Thus it is common to observe average price increases following an IPO.

But the volatile Chinese securities exchanges have, by a very large margin, recorded the largest average first day appreciation of any market 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 (Tan 2006):

Table 4: First Day Appreciation on IPOs

Country	Period	Average First Day Appreciation
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%

Perhaps responding to this apparent large systematic IPO under-pricing, 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.²⁷

2.4.3 Would a Disclosure Based IPO System Be Feasible for China and Beneficial?

A merits based securities regulatory system offers benefits; do those benefits justify the systems costs? Stated differently, would a system that permitted freer access to listing on the securities markets, conditioned upon full disclosure of reliable and relevant information and meeting objective listing standards be, feasible at this time and if so would it be more beneficial at this stage of market development than the current gatekeeper model?

An important benefit of a well administered merits based approach is the protection it offers to uninformed or unsophisticated investors. Such protection is most important when a large or dominant portion of investment decisions are made by unsophisticated individuals and when the market is not highly efficient in its pricing mechanism. If the market pricing mechanism is highly efficient, uninformed investors may rely upon the market price as a reasonable estimate of value. Both of these conditions – relatively unsophisticated investors and relative inefficient market prices – seem to have existed in Chinese markets in the 1990s.²⁸ That fact made the case for merits based regulation system comparatively strong. As institutional investors take a more prominent place in the function of Chinese securities markets the need for such protection is reduced.²⁹ From the CSRC perspective, a second benefit of merits based access is the ability it confers to affect overall conditions in the market by restricting or eliminating new issuances during a period of perceived market excess.

Against these benefits, policy makers must attempt to estimate costs. The most important source of such cost is the implied cost of erroneous merits judgments. The merit based system is in fact a 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 in general. The PRC members even if well informed and acting without political or other bias, can only weakly be counted on to admit good investment prospects and exclude poor ones from access to securities markets. A related cost of such a

²⁷ 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.

²⁸ Regarding the efficiency of share market prices, see text at 2.4.2.

²⁹ 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.

system is the opportunities it inescapably creates for official corruption.³⁰ The CSRC has unhappily been the recurring location of such misconduct in the past; recently, for example a high official of CSRC was charged with bribery in connection with providing IPO access to unqualified firms.³¹

A disclosure based system would have 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 an efficient market, and when investors gain with their share purchases a portfolio of enforceable governance rights.

Thus, while the CSRC has announced an intention to move towards a disclosure based system, as Hong Kong, Malaysia and Singapore are doing, until there is greater respect for the integrity of financial statements, and greater evidence that prices are fixed in an efficient secondary market³² we can expect movement towards disclosure based system to be unhurried.

PART III. LISTED COMPANIES: CORPORATE GOVERNANCE WITH CHINESE CHARACTERISTICS

It is generally thought that one of the institution preconditions necessary for the evolution of an efficient securities market is the existence of reasonable protections against *ex post* investor exploitation or management incompetence. A potential source of such protections is the system of legal rules, regulations and practices that define how power over the internal affairs of a business corporation is distributed, exercised and disciplined. This is the system of corporate governance. Of course, even systems with successful securities markets differ in the degree and manner in which this protection is provided. Indeed it is not essential that such protections come from a legal system, although the legal system is the formal source of such protection in “rule of law” systems. What is most important is that investors detect in a system a reliable set of practices that offers reasonable protections against *ex post* investor exploitation or management incompetence.

³⁰ 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 the “right” to form a corporation was made a universal right in the 19th century. See Allen, Kraakman and Subramanian (2007). The U.S. SEC was not given power to deny access to exchanges on the ground of “riskiness,” probably in recognition of a similar risk.

³¹ Mr. Wang Xiaoshi, an official of the CSRC, responsible for liaison with members of the PORC, was arrested for selling the list of names 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, according to the press. See Caijing (February 3, 2009).

³² We assert that the (relative) efficiency of secondary market prices is a condition for the optimal deployment of a disclosure based system because the overall character of price setting is what allows the IPO market to estimate value of new issues reasonably well.

3.1 Realism and the Governance of Internal Affairs in Chinese Corporations

Across the world, the topic of corporate governance receives attention from scholars, regulators and investors. China is not different in this respect; both its scholars³³ and law makers (e.g. State Counsel, 2004) appear deeply interested in this topic. The CSRC (e.g. CSRC, 2003) and the Stock Exchanges have addressed the topic of advisable corporate governance structures for listed companies. In this discussion, the very special features of “corporate governance with Chinese characteristics” are not always emphasized. Therefore, we begin by identifying the most significant aspect of these special characteristics.

3.1.1 Firm Level CCP Party Committees

With its legal system of “corporatized” joint stock companies, shareholder voting, takeover regulation and derivative law suits, China appears formally to be sufficiently similar to European or other western “rule of law” societies to justify discussing its economic control systems in these terms. As we discuss in this part, however, to treat these legal structures as representing the principal supports in the actual system of Chinese corporate governance would be a mistake. Chinese corporate governance – at least for the large majority of listed firms – is fundamentally different from that in the west. The formal system of board of directors, share-voting at meetings, of tender offers and of derivative law suits is of marginal importance in the actual system of power delegation, monitoring or discipline that exists for most listed Chinese firms.

That system is operated by the Chinese Communist Party and operates through several avenues, most directly, for all but the largest listed firms, through local, party designated committees that function in each large firm.³⁴ This committee which will be headed by a party secretary, who often will also sit as Chairman of the company’s supervisory board, will direct the voting of state controlled shares, will nominate both “independent” directors and insiders, and will in effect appoint or dismiss the CEO. As quoted by Howson (2009) from a 2006 interview in *Caijing Magazine*, Mr. Jiang Chaoliang, the CEO of China Bank of Communications discussed the roll of the Party in the operation of the bank as follows:

³³ See e.g., Li & Hovey(2008); Allen, Qian, and Qian (2005); and Clark (2008) for relevant scholarship.

³⁴ Concerning party activities, Article 17 of the Company Law of 1993 stated that the activities of the local party committees of the CCP in a firm shall be carried out in accordance with the constitution of the CCP. Article 19 of the 2005 revised Company Law provides that “ the organizations of CCP shall be established in companies in accordance with the constitution of the CCP so as to carry out their activities.” and it further adds “The companies shall provide party organization with conditions necessary to carry out their activities.” Article 31 of the constitution of the CCP assigns the implementation function of higher party decisions to local party committees within firms, while Section 7 assigns the right to supervise party cadres and any other personnel explicitly to local party committees. In effect, this provision gives local party committees a supervisory and monitoring role in shareholding firms. (Chang and Wong 2004)

What does the party committee govern? First, it is in charge of overseeing strategy. The government has a 65% [share interest in] Bank of Communications, and as the controlling shareholder, it has the power to propose strategic arrangements for the future development of the bank. Second, [the Party Committee] oversees human resources...The Party Committee recommends to the Board of Directors, senior management candidates with the Board of Directors making the final decision. Third, the Party Committee oversees corporate social responsibility such as lawfully paying taxes, operating the business in accordance with law, and not being lawless and chaotic. If the nation implements macroeconomic measures [the Bank] must abide by these measures [and by implication it is the Party Committee that sees that it does]. (Hu, Cheng and Fu, 2006)

While under the Constitution of the Chinese Communist Party (the “CCP”), local party committees are charged to “supervise the members of CCP in the firm” and “implement higher party policy” (Article 31), the Constitution provides that they “shall not be in charge of business operations of the firm.” (Article 32). Nevertheless often a member of the party committee sits on the board and often the party secretary serves as board chair. Chang and Wong (2004) found that in their large sample, 16.4% of firms had the party secretary serving as a senior officer of the company. In the largest firms, the governance role of the party is more formal and is directed from the central organs of the party. In December 2008, the Organization Department of CPC Central Committee and SASAC issued a notice that key positions in 53 major SOEs must be appointed by the Organization Department of CPC Central Committee. The list of affected SOEs included, among others, Industrial and Commercial Bank of China, China Construction Bank, Bank of China, China Life Insurance Co, China National Overseas Oil Company (“CNOOC”), China Telecom, China Oil & Foodstuff Co. (the “COFCO”) and China Coal Co. Key positions, generally includes Chairman of Party Committee, Chairman of Board of Directors and President or CEO of SOEs. In smaller enterprises the province level CCP designates local party committees.

The process by which senior officers are designated, paid, and promoted or demoted while formally a corporate process, is in reality strongly affected by party processes. Presumably the designation of officers is based on a blend of considerations including both competence in administration and on political reliability or connections. Relations between party committees in legal person shareholders and those in listed firms is an internal party matter which occurs behind a veil.

In fact, as the quotation of Jiang Chaoliang suggests, in China’s listed firms the formal board of directors has tended to play a secondary and formal role, responding to matters initiated by the Party Committee. While they may exercise great influence or control over corporate processes, technically, the Party Committee does not owe fiduciary duties to public shareholders. Each Party Committee fits into the CCP governance structure which establishes appointment, goal setting, reporting and disciplinary structures. (Howson, 2009 and Pistor, 2010).

3.1.2 Do Party Committees Benefit Public Shareholders?

The conventional scholarly view of this degree of political control of the internal affairs of a business corporation is that it will tend to be inefficient, diverting corporate resources away from activities designed to maximize market returns towards the achievement of political objectives, including unnecessary employment. (e.g. Blanchard and Aghion, 1996; and Hellman and Schankerman, 2000). The policy implication of this view is unambiguous: reductions in political control should be associated with more efficient firms.

Chinese scholars deploying the same theoretical framework have seen the question of CCP's role in the corporate governance of Chinese listed firms more subtly. They correctly point out that while party committees certainly involve the potential inefficiency of diversion of resources, or of excessive local employment, these committees may have other positive efficiency effects as well. They may assist management in securing limited resources and may limit both managerial agency costs and controlling shareholder expropriation. (Qian 1995, 1996). On this more textured view, the systemic effects of party committees on efficiency of listed firms presents a difficult empirical question. The studies done – based on accounting measures largely -- suggest that for their sample as a whole party committees add value in constraining agency costs of management but are associated with inefficient levels of employment. (Chang and Wang, 2004).

A deep difference between Chinese and modern western corporate governance is with respect to the generally accepted aim of corporate governance. In the west, while the question is contentious certainly in law and finance circles and also in much of the world of practice, the accepted goal of governance is the long-term advancement of shareholder financial interests. In China at least with respect to the corporatized SOEs, the leadership does not appear to seek in its management of the economy including governance of SOEs, simply to create higher current prices for shares. While both central and local Party leaders have an incentive to try efficiently to create wealth, their success in facilitating that outcome is not measured by security prices. Surely no one wants share prices to fall but they do not seek to maximize traded share price alone, regardless of time frame. As would any government, the government of China and the CCP behind it, has a multitude of social and economic aims respecting those firms.

Alongside its system of direct Communist Party control of most large firms, China has developed the legal infrastructure of liberal corporate governance. This formal structure, to which we now turn has several purposes as an adjunct to party control. Principally, we believe those purposes are to offer some assurance to foreign investors and to help in the modernization of management of listed SOEs. In the following sections of this part, we discuss the current status of formal governance system. In Section 3.2 we discuss the command and control type of governance that originates chiefly in the CSRC. In Section 3.3 we discuss formal legal governance rights of investors that will look familiar to those familiar to with western corporate governance mechanisms.

Before turning to formal governance however, we wish to note in passing the important fact that product markets can play an important governance role. In theory, there would be no problem of excessive agency costs of management were products fungible and markets perfectly competitive. In such a market any additional costs incurred by one producer,

whether it derived from an agency costs or from another source, would over time 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 a perfectly competitive product market corporate governance practices would not be very important. Product markets are of course rarely so competitive in fact. But directionally, it is clear that as product markets get more competitive the sources of inefficiency that governance practices can reduce should become less problematic. Many product markets are doubtlessly quite competitive in China and to the extent they are the need for effective internal governance is reduced.

3.2 Top Down Corporate Governance: The CSRC Governance Role

As we have indicated, governance power in listed firms in China is primarily located in a network of CCP committees, and with respect to listed firms other than the largest is probably coordinated through the local party committee. In addition however the CSRC exercises significant authority with respect to establishment of certain governance standards and practices for listed firms.

3.2.1 The Code of Corporate Governance for Listed Companies

In 2001 the CSRC issued its *Code of Corporate Governance for Listed Companies*.³⁵ In this code the CSRC, in ninety-five number paragraphs, 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 best management practices.

In fact, agencies of the State with large economic interests in residual earnings of listed SOEs would not be dependent on regulatory or judicial remedies for responding to mismanagement, self-dealing or even for poor corporate governance practices. If 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) or other agencies, learn of mismanagement, they can and presumably are expected to act through government or Communist Party channels for redress or discipline. Thus a plausible explanation of the 2001 CSRC Corporate Governance standards is that in it the CSRC in effect provides such state agen-

³⁵ English translation of this Code is available from <http://www.csrc.gov.cn/n575458/n4001948/n4002030/4062964.html>.

cies with expert guidance or standards respecting the topics it covers. Simultaneously, these standards and practices may serve to induce listed SOEs (and other listed firms coincidentally) to adopt more transparent and modern management and governance practices, in aid of future needs of the State to efficiently monetize parts of its economic interests.

3.2.2 Goals of CSRC's Formal Governance Activities

More fully we suggest that in promulgating the Corporate Governance Code or other governance type regulations the CSRC seeks to advance three main aims:

First, the promulgation of sensible governance standards and practices will offer some assurance to foreign institutional 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 raising capital for such firms than Shanghai and those shares enjoy special class voting rights.

The second 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 construct the infrastructure for a modern securities market — including statutory shareholder rights, fiduciary obligations and the modern standards of corporate governance — as an option for future finance of SOEs. The Share Segmentation Reform was an elaborate, time-consuming effort to make it possible to sell to public investors more of the State's share interest in large, listed SOEs. That effort must have been motivated by a desire to sell more stock to Chinese and to some extent overseas institutional investors. Time will tell to what extent these sales will occur and with respect to which firms. But, as with foreign investors in Hong Kong (as well as other overseas market), it is reasonable to expect that Chinese investors, especially institutional investors, will at that time be more likely to make further investments in SOEs at not-excessively discounted prices, if those firms appear to be governed by structures and "rights" consistent with those pertaining in other markets.

The third, and we suggest the most important reason that it makes sense for the leadership to authorize the 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 and to coordinate CCP governance of firms. Modernization of management of its state sector is important to China and the modern SOEs constitute a vital part of that sector. Listing standards on the exchanges and regulatory requirements by the CSRC can be seen both as a way to control undesirable management practices (such as self-dealing transactions) that hurt the State as a shareholder (and incidentally hurt public shareholders) and as a way to encourage the development of better management techniques, such as better financial re-

porting or incentive compensation programs.³⁶ The CSRC as a specialist organization will obviously be superior to decentralized Party Committees in establishing such things as transparent accounting standards or responsible management practices, in which the state and the party have an interest.

3.3. The Limited Role of “Internal” Corporate Governance in Chinese Securities Markets

We turn now to the formal legal system of investor rights that appear in many respects similar to shareholder rights in the U.S. or other western systems. We structure this discussion of the formal aspects of Chinese corporate governance around three primary investor governance mechanisms: the right to vote, to right to sell shares thus facilitating a change in control and the right to sue.

3.3.1 Public Shareholders’ Right to Vote

Turning first to the right to vote, we note that while all shares listed on Chinese securities exchanges formally carry one vote, voting rights with respect to PRC listed firms must be understood in the shadow of the fact that, in essentially all cases, block holders hold controlling blocks of shares. In SOEs, the controller is typically state affiliated; in the 20% or so of listed firms that are not SOEs, the controller is an individual, family or affiliated groups of investors. Thus, at first glance one would conclude that for public investors, corporate voting is almost wholly immaterial. This however is not entirely true.

Since one aim of the corporitization and listing process has been the attraction of capital – and as we show above, predominately foreign capital – to listed firms, it was seen as prudent, if not essential, to offer certain limited protections to such foreign investors against the risk that a simple majority vote of shares could alter the character of their investment once it was made. This protection was offered through a mandatory class voting right for H shares (and other overseas’ listing shares, if any) for the approval of transactions or charter amendments that would constitute an abrogation or variation in the rights of the H shares (or other overseas’ listed shares, if any).³⁷ The mandatory provisions identify the various types of corporate actions that require a class vote of H shares (or other overseas’ listed shares, if any) to be implemented.³⁸ The voting rule to determine such class votes is

³⁶ See e.g. See CSRC, “*Guidelines for Equity-based Compensation*” (2005 No. 151) (Restricted stock and options as compensation limited to 10% of outstanding shares).

³⁷ “*Mandatory Provisions for Articles of Association of Companies to Be Listed Overseas*” were issued in 1994 jointly by the Securities Commission of the State Council (then the parent organization to the CSRC) and the State Economic System Restructuring Commission.

³⁸ Art. 80 of Chapter 9 of the Mandatory Provisions provides the following situations shall be considered as a variation or abrogation of the rights of a certain class of shareholders: (1) the increase or reduction of the number of shares of that class of shares or the increase or reduction of the number of shares in another class which carry the same or more right to vote, right of distribution or other privileges; (2) the conversion of all or part of the shares of that class to another class, or the conversion of all or part of the shares of another class into the shares of that class or the granting of such right of conversion; (3) the cancellation or reduction of the rights of that class of shares to receive dividends declared or accrued; (4) the reduction or

set at two-thirds of issued and outstanding H shares (or other overseas' listed shares, if any). The class vote right can offer substantial protection to foreign investors in covered matters.

There exists another share voting protection of some significance which relates to related party transactions. Under "Guidelines for Articles of Association of Listed Companies" first issued by the CSRC in 1997 and revised in 2006, the authorization of any related party transactions that requires a shareholder vote, requires that only disinterested shareholders vote. In practice, listed companies have adopted this provision in their articles of association. Not all related party transactions do require a shareholder vote, however. According to the Listing Rules of the Shanghai Stock Exchange, a shareholders' vote is required in three cases: if the transaction is approved by fewer than three "independent" directors *or* the transaction is large (greater than 5% of net assets and in excess of RMB 30 million) *or* there is a guarantee issued by the company to a related party.

Shareholder voting might in future become more important in Chinese corporate governance, now that share segmentation reform is largely completed. But it remains to be seen whether and when some firms will in fact distribute their formerly non-tradable shares to the public and how many shares will be distributed in this way. Certainly these holders will have a substantial economic incentive to sell at market prices if, as has been the case in the past, the market prices are higher than the private market prices.

If and when control of some listed firms does become available in the securities markets, a number of very important corporate governance issues will be faced. Some of these are mentioned below in connection with tender offers for control, but others will relate directly to shareholder voting. Given the high cost of any shareholder initiated proxy contest, the most significant of these issues will be whether and on what terms shareholders might have access to the company's proxy statement, which has been a contentious issue in the U.S for some time, and whether successful proxy contestants can get reimbursement for some or all of the costs of the contest and under what circumstances.

3.3.2 Public Shareholder Inability to Participate in Disciplinary Tender Offers

In systems in which control over listed companies is in the market ("Contestable Control Systems"), the mechanism of hostile changes in corporate control has been treated both by scholars of law and of finance, as well as governance activists as the ultimate mar-

cancellation of the preferential rights of that class of shares to receive dividends or to receive distribution of assets upon the liquidation of the Company; (5) the increase, cancellation or reduction of the share conversion rights, options rights, voting rights, rights of transfer, preemptive rights and rights to acquire the securities of the Company of that class of shares; (6) the cancellation or reduction of the rights of that class of shares to receive payment payable by the Company in a particular currency; (7) to create a new class of shares which enjoys the same or more voting rights, distribution rights or other privileges than those enjoyed by that class of shares; (8) to restrict or increase the restriction on the transfer or ownership of that class of shares; (9) the granting of subscription rights or conversion rights in respect of that class or another class of shares; (10) the increase of the rights and privileges of another class of shares; (11) the reorganization of the Company as a result of which different classes of shareholders assume obligations otherwise than in proportion; and (12) the amendment or abrogation of the provisions in this Chapter 9.

ket corrective for inefficiency of management (Easterbrook and Fischel, 1991 and Bebchuk, 1987). The theory is well-known. The evolution of a disciplinary “market for corporate control” is often seen as a potentiality that can be useful in systems in which securities markets play a major financing role. But as neat as the theory of a market for corporate control appears to be, there are substantial grounds to believe that the types of costs and imperfections that affect the efficiency of securities markets generally (e.g. principally information problems, agent’s incentive misalignment problems and systematic limitations of human rationality) coupled with recurring periodic excess system liquidity, render this market far from perfect. (e.g. Schleifer and Summers, 1998 and Lipton, 1997). Thus, in the U.S. there has long been a debate concerning how “free” the market for corporate control should be. There are of course numerous techniques open to any legal system for moderating the market for corporate control when it is permitted to exist: approval of “takeovers” by substantive regulatory agencies where there is a strong public interest in the industry;³⁹ enactment of “constituency” statutes or regulations that give non-shareholder constituencies a legally cognizable interest in such transactions (Allen, Kraakman and Subramanian, 2009); authorization of “poison pill” securities which give boards of directors certain powers to defend against unwanted takeovers (Kahan and Rock, forthcoming); and less powerful company law devices, such as staggered election of the board of directors. (Bebchuk, Coates and Subramanian, 2002 and Bebchuk and Cohen, 2005). China need not address these secondary issues relating to a market in corporate control at this time because, while tender offers for control are legally possible, in fact there is virtually no market for corporate control.⁴⁰ “Takeovers” play no disciplinary role in China today.

Some “change in control” transactions do occasionally occur in China, but they are in the form of contracts in which an acquirer contracts with the holders of some or all non-tradable shares for transfer of controlling block of stock. The State – that is both CSRC and often SASAC – must consent to such a transfer of control where state controlled shares are involved. When these transfers involve listed companies, under CSRC regulations, the buyer is required to extend a tender offer to all public shares *at a price no less than that paid in the control transfer*⁴¹ (Such a rule is called a mandatory bid rule and is common in the E.U. and under some state law systems in the U.S.). While the beneficial effect of mandatory bid rules is controversial (Easterbrook and Fischel, 1989), what is notably is that in China such tender offers, when they occur, are merely formal and have no economic effect at all.

Professors Tuan, Zhang, Hsu and Zhang in a recent study of merger arbitrage in

³⁹ Thus most systems require governmental pre-approval of changes in corporate control of major financial institutions.

⁴⁰ In an apparent effort to aid public shareholders, the CSRC issued “Measures for the Administration of the Takeovers of Listed Companies” in 2003 and revised in 2008, which for the first time contemplated public tender offers for shares of listed companies in China.

⁴¹ More specifically whenever a holder acquires 30% or more of the traded shares of a listed company, the mandatory bid rules require a tender offer to the public shareholders. See Article 24 of Measures of Administration of Takeovers of Listed Companies.

China located just 24 instances of tender offers for shares of listed firms between June 2003 and December 2006. (Tuan, Zhang, Hsu and Zhang, 2007) Of these seventeen tender offers were “mandatory” in character and offered a price *below* the market price for the traded A shares! That is, in all these cases, the price per share of the control block was below market for the traded shares! Thus the public tender offer required by the CSRC mandatory bid rule could be and was at a below market price. The authors report that on average the discount from market price offered was 19.6%. Unsurprisingly, none of these offers closed. We might call these tender offers “phantom tender offers”, because they have the formal look of a tender offer, but have no economic substance. The remaining seven cases of tender offers were cash tender offers. All of these bids were in the petroleum & chemicals sector and all were initiated either by Petro China or by Sinopec, the giant SOEs in the petroleum business.

More interesting than the question why do buyers of control offer a price below market – having acquired control, they apparently saw no advantage in buying out the public shares – is the question why do holders of control agree to sell at substantial discount to market price? A standard answer, grounded in a belief in the fundamental efficiency of stock markets, would be that very large blocks often trade at a discount due to market illiquidity. An alternative possible account of this phenomena would posit that the market price for non-controlling A shares is recognized by both buyers and sellers of control to be irrationally high on the Shanghai or Shenzhen exchanges. That is, there may at times be a bubble premium reflected in the market that more informed and rational buyers are unwilling to pay.

In all events, we observe that at least as of the close of 2008, tender offers for corporate control have played little role in Chinese corporate governance. Whether disciplinary takeovers will be observed in the future, now that reform of the share segmentation system is almost complete, will turn on two factors. First, when the control of (some) listed firms will become available in the market and second whether the leadership is willing to permit the management of listed firms to be determined by market for corporate control processes. The second factor strikes us as quite unlikely for the immediate future, at least with respect to former SOEs, even if they are not in critical sectors of the economy. Moreover, given the likely inefficiency of the pricing of shares on the mainland exchanges, it would be difficult at this time to argue that this choice would necessarily be suboptimal policy.

3.4 Chinese Courts and Shareholders’ Right to Sue

3.4.1 The Institutional Contributions That Courts Can Provide.

While administrative agencies such as CSRC can act as powerful instruments in structuring and operating a scheme of market regulation, courts could supplement such activity in useful ways. Courts can give force and effect to abstract statements of law by determining contested facts and declaring and enforcing rights and duties of managers, shareholders or directors in those factual contexts. Among the institutional advantages of courts are the following: 1) well functioning courts offer a professional commitment to make decisions only in accordance with pre-existing law and to be unaffected by other matters; (2) they have expertise in the content of pre-existing law and in accepted professional tech-

niques of interpretation of it; (3) they make decisions grounded in the facts of a particular case, which are determined in an unbiased manner; and (4) they often or usually provide written justification for their results. In a judicial system in which courts function in this way, citizens know after a litigation has been determined that they have been heard by a disinterested judge with expertise who has ruled according to law. In this way well functioning courts can provide a form of satisfaction even to parties who lose their disputes. The reliable provision of these services can *ex ante* facilitate investment and more broadly contracting among strangers.

As an arbiter of disputes between shareholders and those controlling the management of the firm, courts could serve a corporate governance function either at the instance of government actors (e.g. administrative agencies) or at the instance of shareholders directly. In fact since the 2006 amendment of the Company Law, Chinese courts have been authorized to adjudicate claims of director wrongdoing in so-called “derivative” lawsuits – that is a suit brought by a shareholder in the name and for the benefit of the corporation itself.⁴² Such suits are brought against the corporate directors or officers who are alleged to have violated their duty and injured the company in some way.

Derivative lawsuits can be subject to abuse, but they can serve as an important constraint on corrupt behavior. Generally, these suits can be useful even if directors are not frequently required to pay damages for wrongs in such lawsuits. In the U.S., most such suits are settled through the payment of a relatively small payment from an insurance underwriter. Nevertheless, such suits are useful to investors because, *ex ante*, directors adjust their behavior knowing that in certain types of transactions they face a high probability that their conduct will be subject to derivative litigation and thus close judicial review. Thus the existence of this types of lawsuit and the legal infrastructure that permits them to be brought, can serve an important chilling effect on violations of the corporate directors fiduciary duties.

3.4.2 “Fiduciary Duties” and Shareholder Suits in China

Formally, the corporate board of directors, under Chinese company law and that of most western countries, holds power over corporate managers; it is responsible for overseeing the operation of the company. If those individuals wrongfully injure the corporation under most systems they can be held responsible and in most jurisdictions, including China, they may be held liable for such harm in a derivative suit brought by shareholders. Most such suits 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 corporatization movement, the first modern PRC Company Law of 1994 did expressly state that officers and directors of companies formed under its authority⁴³ shall be liable for damage caused to the company by their violation of law, administrative regulation or the company’s articles of

⁴² For a full description see Allen, Kraakman and Subramanian (2009), Chapter 10.

⁴³ E.g Articles 59, 60 and 61, the PRC Company Law of 1994.

association.⁴⁴ It did not mention any concept similar to the open-ended fiduciary duty of loyalty and, more importantly, did not authorize shareholders 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 corporation's behalf to redress injury caused by an alleged violation of law.⁴⁵ In 1997, a court in Fujian 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 were related to the debtor, and had refused to do so. The courts said:

“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 actionWhere the company does not take any action, the shareholder may in its stead bring a lawsuit.” (Clark, 2008, citing Xie and Chen ,2001).

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 (Shen, 2008 and Deng, 2005).⁴⁶

In its Corporate Governance Code, the CSRC seems clearly to have endorsed the concept of the derivative lawsuit when, it stated 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....”

But it is not free from doubt that the CSRC intended to try to advance derivative lawsuits by this provision. This translation of the language of Article 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 (Clarke 2008). More importantly, however, the authority of the CSRC to establish judicial rights of this kind is far from clear.

⁴⁴ See Article 63, the PRC Company Law of 1994.

⁴⁵ 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 Deng (2005).

⁴⁶ See, San Jiu Pharmaceutical Company, where the Shenzhen 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 (2005).

3.4.3. Derivative Suits and Shareholder Problems of Collective Action

Despite the shadowy legitimacy of shareholder derivative suits prior to the 2005 revision of the Company Law, the legitimacy of the shareholders derivative suits 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 investor protection tool at present. 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. That is instituting such a suit will be costly. For the holder of a relatively small proportion of total shares, unless there is a mechanism to allow these costs to be shared among all other shares, there will be a large and usually prohibitive impediment to bring such a suit, even if the claim to be litigated seems quite strong. Yet neither the statutory law nor judicial innovation recognizes a way to impose this cost sharing.

Thus, the few derivative cases that are found tend to be cases involving joint ventures in a corporate form. In those cases, the investors own large proportionate share of the firm (and of potential damages) and thus do not suffer to a disabling extent the collective action problem of the kind that often arises in publicly finance firms. Since neither the PRC Company Law , 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, 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 investor initiated derivative suit, at this time courts are not in fact a realistic source of constraint on management misbehavior in Chinese listed companies.

PART IV: THE NEAR AND NOT-SO-NEAR FUTURES OF CHINA’S “TOP DOWN” SECURITIES MARKETS

4.1 Assessing a Great Accomplishment

The creation in less than twenty years of the complex technological, financial and legal infrastructure necessary to operate the two mainland securities exchanges is unquestionably a great achievement. With these exchanges, and the corporatization effort that is their premise, the leadership of China has created one of the essential working parts of a world-class economy. It has successfully organized the former state and provincial production facilities into individual firms in which professional managers can direct activities with an eye to market-oriented production. It has created embryonic corporate governance structures and a structure of legal rights and duties that might be used to create more highly elaborated investor based corporate governance protections in the future. It has created a means for the corporatized firms to access domestic household savings and world global investment pools. It has created the option to institute some forms of stock or stock price related incentive compensation for professional senior managers. And it has made initiating some forms of capital markets based disciplinary methods such as takeovers a policy option for the future, as well.

Nevertheless in their present state these markets represent more potential value to China than realized value. They are not economically highly important yet. While the equity markets have grown rapidly in terms of market capitalization and in terms of listings, when compared to the securities markets in more developed financial systems, they appear as quite small relative to the Chinese economy. They lack deep liquidity and are excessively volatile; there is good evidence that they do not price equities very efficiently. An economically significant market for non-governmental bonds has not yet arisen in China and is important. Financial risk management is severely limited in part because hedging opportunities are constricted by a prohibition, now to be eased, on borrowing shares. Futures markets for securities are undeveloped. Quite significantly the public markets continue to offer little assistance in funding growth in the important non-governmental sector of the economy. And by most accounts there is significant level of managerial and other forms of corruption and virtually no investor corporate governance remedies available.

4.2 Future Development Steps

A more important role for these markets could include most importantly (1) broader access to the securities markets for the purpose of raising capital for the entrepreneurial sector of the economy, (2) the development of a substantial commercial bond market open to all corporate borrowers of requisite credit standing, (3) the development of an array of financial instruments capable of hedging of financial risk, (4) the gradual floatation into the market of a majority of outstanding voting stock in a significant number of former SOEs, and possibly, (5) the development of public shareholder protective institutions of corporate governance, as discussed above, including development of the infrastructure necessary for proxy voting, tender offers and shareholder law suits. More developed PRC securities markets might also involve, (6) easier access for foreign investors to Chinese markets and securities, and (7) easier access for domestic investors to foreign shares through the Hong Kong or Shanghai exchanges. Were the leadership to permit and direct this further development of the securities markets, we would expect those markets to more effectively provide to the

Chinese economy the three great benefits we identified at the outset of this essay: (relatively) efficient capital allocation, flexible financial risk management and useful techniques of financial market discipline.

Expansion of the use of securities markets would have distinct economic or development advantages for China, but it would raise two related issues. First, more significant securities markets would heighten political issues of Communist Party control that economic liberalization generally and securities markets particularly have raised from the beginning of reform. A market allocation of capital and market discipline of managers, if they are to be effective, would entail reduction in the ability of Communist Party committees to direct economic development, to appoint senior managers of firms and to direct operational outcomes on the firm level. While in the event of such liberalization, the sovereign power of the government could redirect its control to external tax and regulation of business to some extent, such a system would inevitably have less direct and immediate control over listed firms than the present systems offers. Thus these are effects that are unlikely to be eagerly embraced in the near future. Secondly, and more abstractly, fundamental growth in the securities markets (meaning a change in their structural limitations) raises the question: to what extent does or should China wish to expose its economy to the types of gyrations that the financial crisis of 2007-2008 has shown, again, that capital markets including securities markets are capable? The claim of some in the U.S. that its system, dominated by financial markets of ever greater complexity and shorter average holding periods, has become unduly short term oriented, is often dismissed by academic commentators. But it is unlikely that the near collapse of the U.S. financial system in the fall of 2008 leaves its model of finance in quite the same position as a role model. China's quick bounce-back from the global financial crisis of 2008-09, on the other hand, leaves its leadership in a position to question the value of such capital market liberalization.

Almost certainly the leadership will feel its way in assessing the risks and benefits of further expansion of the economic role that securities markets play in the Chinese economy. We do, however, have some evidence of an intention to foster further development of the Chinese securities markets. Despite its occurring before the global financial crisis, the elaborate effort of the Chinese government to remove the NTS designation, briefly outlined in this essay provides strong evidence that the leadership recently intended for the securities markets to have the capacity to grow into more powerful instrumentalities of finance.

Of course, it is very unlikely that the leadership will, for the foreseeable future (or ever), allow the most significant components of the economy – the large banks and insurance companies, natural resource companies, the national transport infrastructure and the telecom industries, for example – to be subject to the risk of investor “interference” that might potentially occur if a majority of voting shares of these firms were traded in the markets. But, we assume, that in the next period of development (whenever that may occur) the leadership will direct that a majority of the shares of at least some SOEs in non-strategic sectors of the Chinese economy be moved from government control into non-government, including market, control. Thus, we expect certain firms in consumer electronics and soft goods, textiles, footwear, recreation & leisure, home supplies and repair materials, health, beauty and hygiene products, and various other non-strategic products or activities to in-

crease the proportion of their shares that trade on securities markets. Furthermore, we expect that CSRC continuing current efforts to open the securities market to smaller entrepreneurial enterprises will meet with some success and we will in future observe greater use of securities markets by private entrepreneurial or foreign firms. Even these steps however will take time.

4.3 The Secondary Role of Legal Infrastructure in Chinese Securities Markets

Continued growth in Chinese securities markets, however, is not dependent on improvements in the legal infrastructure of those markets. While the attractiveness of those markets to investors would be increased if, e.g., the improvement in quality of financial statement disclosure, the reduction in insider trading, or improvements in corporate governance generally, such changes are not essential now. Chinese securities markets will continue to attract domestic and international investors without improvement in corporate governance protections for the immediate and indefinite future. Even substantial levels of investor exploitation by managers or by controlling shareholders – for example, insider trading, self-dealing transactions, or other forms of corruption – need not prevent the development of a large or growing securities market.

What is essential for these markets to continue to grow is only that the perceived expected returns available to investors, net of the expected cost of exploitation, is attractive when compared to all alternative opportunities to invest funds. Therefore, so long as the net returns expected to be generated on Chinese securities markets exceed risk adjusted expected returns offered by alternative investment opportunities, those markets will continue to attract investors. It is the growth of the Chinese economy, not the improvement of Chinese corporate governance that is the primary driver of the growth in the Chinese securities markets. While there has been some controversy about just how accurate the report growth rates for China have been, there is no doubt that real growth rates over the period 1990-2008 have been very high.⁴⁷ Indeed some informed views see this growth rate continuing for a substantial period (Fogel 2006).

4.4 Are Investor Initiated Protections and More Efficient Securities Markets Likely in Modern China?

The fact that we can expect continued growth in the Chinese stock markets even if we expect no improvement in legal infrastructure of those markets does not mean improvement in public investor protections is unimportant for China. The logic is compelling that, holding all other factors constant, an improvement in the quality of disclosure and a reduction in the amount of investor exploitation would reduce the costs at which capital would be committed to investment in China. Regardless of the period in which elevated growth rates can continue, in time these growth rates will reduce. Then the marginal improvement in

⁴⁷ While officially reported statistics on Chinese GDP growth rates have been controversial, see Thurow, Zhou and Wang (2003) (using data on electricity consumption to cast doubt on reliability of official GDP growth rate numbers). Official government sources reported the average real growth of GDP over the period 1999 to close of 2008 was 14.4% per year. See China Statistical Yearbook (2008).

costs of capital that investor protective governance can yield systemically will become relatively more important. The future need to further reduce corruption or management inefficiency could then be expected to be met with the China's traditional top-down style response – that is, with an increase in CCP campaigns to encourage right conduct and diligence. Should such campaigns fail, as one might expect, then we would expect greater or more effective official prosecution of private corruption. But there are reasons to think that that technique too would, alone, be ineffective. Public officials will inevitably have both very much weaker incentives to correct and much poorer quality information concerning breaches of fiduciary duty (or sub-par performance) than investors whose financial interests are adversely affected by managerial conduct. Therefore, at some point in time we expect the leadership of the country to experience increased pressure to improve the whole range of practices concerning internal corporate affairs. When this does occur the leadership will face again an old issue: how much can be decentralized, individually initiated actions be trusted?

Can fostering greater privately initiated governance mechanisms be consistent with the leadership role of the CCP in China's one party state? There seems to be no reason in logic why it cannot, but change always entails risks to the status quo. Much of the magnificent success that has occurred in the development of the Chinese economy over the last 30 years, despite being increasingly guided by free market prices, has occurred on a top-down, shaped or guided model of development.⁴⁸ Movement towards a more decentralized “bottom-up” mode of change, marked in the securities regulation area by investor empowerment and court adjudication under a “rule of law” approach, can be expected to be unwelcomed. Empowered investors would act through voting shares, or selling shares into tender offers or by initiating suit against insiders or other controllers of the firms in which they make investments. These means of action, however, involve instrumentalities (boards, courts, shareholder meetings) that, in a bottom up development regime, would not formally be a part of or agents of the Chinese Communist Party. Thus, it is reasonable to expect that substantial reform of the corporate governance of firms listed on Chinese securities markets, will not occur until there is a pressing development reason for the leadership to force such bittersweet change. Certainly those pressures are not sufficient at this time to occasion real change.

The existing limitations of the Chinese securities markets can be expected to be remedied over time – and the securities markets can be expected to play a more productive role in the Chinese economy – if, but only if, the leadership of the country wants Chinese securities markets to assume a more important role. This conclusion reflects the fundamental nature of these markets. Unlike securities markets in New York, London, Amsterdam or elsewhere, the Chinese markets were designed and created by government to mainly serve government purposes. Like their existence, their future depends upon the judgments to be made by the country's political leadership. Trying to predict choices those leaders may

⁴⁸ It is true that much growth at the beginning of liberalization appears to have been resulted from the spontaneous action of farmers and rural residence when simply allowed access to land and ability to contract. But certainly with respect to the SOEs and the stock markets post 1990, the whole story is one of designed top-down development.

make is fraught with risk of miscalculation. But it is clear that absent improvement in the practical ability of equity investors to protect their own economic interests, Chinese securities markets will continue to grow as the PRC economy grows and will continue to satisfy the limited economic role that those markets have thus far been permitted to play. But they will not serve the larger important functions of efficient capital allocation, nor the useful role of signaling, incenting or disciplining corporate management. But Rome, we have often been reminded was not built in a day; nor have the great Redwood trees of California reached their impressive size in just sixty years.

---- End ----

REFERENCES

Article 10, PRC Securities Law 2006.

Article 12, Provisional Administrative Measures of Stock Issuance and Trading 1993.

Article 62, PRC Securities Law, 2006.

Article 180, PRC Securities Law 2006.

Allen, Franklin, Qian, Jun, Zhang, Chenying and Zhao, Mengxin “China’s Financial System: Opportunities and Challenges” in the *Capitalizing China*, Morck, Randall and Fan, Joseph ed. (Chicago: University of Chicago Press, 2010).

Allen, Franklin, Qian, Jun and Qian, Meijun, “China’s Financial System: Past, Present, and Future” (March 28, 2007). Available at SSRN: <http://ssrn.com/abstract=978485>

Allen, Franklin, Qian, Jun and Qian, Meijun, “Law, Finance and Economic Growth in China, *Journal of Financial Economics*”, 77(2005):57-116.

Allen, William T., Kraakman, Reinier and Subramanian, Guhan, *Commentaries & Cases on Law of Business Organization*. Second Edition (Wolters Kluwer Law & Business Publishers, 2007):86-90

Agrawal, Ashwini K, “The Impact of Investor Protection Laws on Corporate Policy: Evidence From the Blue Sky Laws,” (2009)
http://pages.stern.nyu.edu/~sternfin/aagrawal/public_html/blue_sky.pdf

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

Anderson, R. & D. Reeb, Founding Family Ownership and Firm performance: Evidence From the S&P 500, *Journal of Finance* 58 (2003).

Bebchuk, Lucian, “The Pressure to Tender: An Analysis and a proposed Remedy,” *Delaware Journal of Corporate Law*, 12 (1987): 911-949.

Bebchuk, Lucian and Cohen, Alma, “The Costs of Entrenched Boards,” *Journal of Financial Economics* 78 (2005): 409-433.

Bebchuk, Lucian A., Coates, IV, John C. and Subramanian, Guhan, “The Powerful Anti-takeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants”. *Stanford Law Review*, 55 (2002):885-917.

Blanchard, O., and Aghion, P. “On insider privatization,” *European Economic Review*, 40 (1996).

Caijing Magazine (February 3, 2009), <http://english.caijing.com.cn/2009-02-03/110052333.html>.

Caijing Magazine (October 26, 2009), <http://english.caijing.com.cn/2009-10-26/110294620.html>.

CCTV, China opens more SME finance channels, (September 21, 2009), available from <http://english.cctv.com/program/bizchina/20090921/104343.shtml#>.

Chen, Gongmeng, Firth, Michael and Xu, Liping, “Does the Type of Ownership Control Matter? Evidence from China’s Listed Companies”, *Journal of Banking and Finance* 33(2009).

Clarke, Donald C., “The Ecology of Corporate Governance in China,” George Washington Law School Working Paper (2008), <http://ssrn.com/abstract=1245803>.

Coffee, John C., Jr., “Law and the Market: The Impact of Enforcement,” Columbia Law and Economics Working Paper No. 304 (March 7, 2007), <http://ssrn.com/abstract=967482>.

CSRC, Chinese Securities Regulatory Commission, Statistics of PRC Stock Market As of October 2009, available at <http://www.csrc.gov.cn/pub/zjhpublic/G00306204/zqscyb/200911/P020091117506564842958.xls>

CSRC, Chinese Securities Regulatory Commission. *China Capital Markets Development Report* (China Financial Publishing House, 2008).

CSRC, Chinese Securities Regulatory Commission, *Guidelines for Equity-based Compensation* (2005).

CSRC, Chinese Securities Regulatory Commission, *Principles of Corporate Governance for Listed Companies* (2003).

Deng, Jiong, “Building an Investor –Friendly Shareholder Derivative Lawsuit System in China,” *Harvard International Law Review* 46(2005):347, 365, note 108.

Easterbrook, Frank and Fischel, Daniel, “*The Economic Structure of Corporate Law*”, Harvard University Press (1991).

Easterbrook, Frank and Fischel, Daniel, “The Corporate Contract,” *Columbia Law Review*, 89 (1989).

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

Fogel, Robert W., Why China is Likely to Achieve its Growth Objectives (March 2006). NBER Working Paper Series, Vol. w12122, available at SSRN: <http://ssrn.com/abstract=893777>.

- Gao, Sheldon, *China Stock Market in a Global Perspective*, Dow Jones Indexes, 2002.
- Bebchuk, Lucian A. and Hamdani, Assaf, *The Elusive Quest for Global Governance Standards*, *University of Pennsylvania Law Review* 2009.
- Hellman, Joel and Schankerman, Mark, “Intervention Corruption and Capture: the Nexus between Enterprises and the State”, *Economics of Transition*, 8 (2000): 545-76.
- Howson, Nickolas, *China’s Restructured Commercial Banks: Nomenclature Accountability Serving Corporate Governance Reform?*, in Min, Zhu , Cai Jinqing & Martha Avery, *China’s Emerging Financial Markets* (2009).
- Hu, Runfeng, Cheng, Zhe and Fu, Tao, “Zhonghang Shenqiu Zhibang Zai Bao Piaoju An [Another Bank of China Shenqiu Branch Receipts Case Explodes], *Caijing Magazine*, 161 (2006) June 12: 40-1.
- Huang, Yasheng, *Capitalism with Chinese Characteristics*, (Cambridge University Press, 2008):57-65.
- Huang, Yasheng, *The Rural Roots of China’s Miracle*, *Financial Times* (October 21, 2007), <http://www.ftchinese.com/story.php?lang=en&storyid=001014907>.
- Jenson, Michael and Meckling, William, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, *Journal of Financial Economics* 3 (1976): 305
- Kahan, Marcel and Rock, Edward B., *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, *University of Chicago Law Review*, Forthcoming. Available at SSRN: <http://ssrn.com/abstract=310019> or DOI: 10.2139/ssrn.310019
- LaPorta, Rafael, Florencio Lopez-de-Salines, Andrei Schliefer & Robert Visney, “Investor Protection and Corporate Governance”, *Journal of Financial Economics* 58 (2000).
- La Porta, Rafael, Florencio Lopez-de-Silanes, Shleifer, Andrei and Vishny, Robert “Law and Finance,” *Journal of Political Economy* 106 (1998): 1113-55.
- LaPorta, Rafael, Florencio Lopez-de-Salines, Andrei Schliefer & Robert Visney, “Legal Determinants of External Finance”, *Journal of Finance*, 52 (1997): 1131-50.
- Li, Larry, Naughton, Tony, et al., *A Review of Corporate Governance in China*, <http://ssrn.com/abstract=1233070> (2008).
- Liebman, Benjamin and Curtis Milhaupt, “Reputational Sanctions in China’s Securities Market,” *Columbia Law Review* 108 (2008): 929, 958.
- Lipton, Martin, “Poison Pill Update”, *M&A Law.*, Jul./Aug. 1997, at 3.
- Lipton, Martin, “Pills, Polls, and Professors Redux”, *University of Chicago Law Review* 69 (2002).

Liu, Guy, and 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).

Pistor, Katherine, "The Governance of China's Finance", in the *Capitalizing China*, Morck, Randall and Fan, Joseph ed. (Chicago: University of Chicago Press, 2010).

Morck, Randall, Yeung, Bernard and Yu, Wayne "The Information Content of Stock Markets: Why Do Emerging Markets Have Synchronous Stock Price Movements," *Journal of Finance and Economy* 58(2000):215.

McKinsey Global Institute (September 2009), *Global Capital Markets: Entering a New Era*, available at http://www.mckinsey.com/locations/swiss/news_publications/pdf/Global_Capital_Markets_Sept_2009.pdf, at 27.

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.

North, Douglass and Weinglas, Barry "Constitutions and Commitment: The Evolution of Institutions of Public Choice in 17th Century England," *Journal of Economic History* 49 (1989).

SAIC, State Administration for Industry and Commerce (March 2009), "Annual Development Report on China's Entities", available at http://www.saic.gov.cn/zwgk/tjzl/200903/t20090320_50532.html

State Council, Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets, 2004.

Shleifer, Andrei & Robert W. Vishny, Large Shareholders & Corporate Control, *Journal of Political Economy* 94 (1986).

Schleifer, A. and L.Summers, "Breach of Trust in Hostile Takeovers", in Auerbach,A. (ed.) *Corporate Takeovers: Causes and Consequences*, London, University of Chicago Press (1998).

SEC, Annual Report of U.S Securities and Exchange Commission (2008):12, <http://www.sec.gov/about/secpar/secpar2008.pdf#sec1>

SEC, Annual Report of U.S Securities and Exchange Commission (2007):25, <http://www.sec.gov/about/secpar/secpar2007.pdf#sec1>.

SEC, Annual Report of U.S Securities and Exchange Commission (2006):8. <http://www.sec.gov/about/secpar/secpar2006.pdf#sec1>.

SEC, Annual Report of U.S Securities and Exchange Commission (2005):7,

<http://www.sec.gov/about/secpar/secpar2005.pdf#sec1>

Shanghai Stock Exchange, *Zhongguo Gongsì Zhìlì Bào gào (2008): Shangshì Gongsì Tòumíngdù yú Xìnxì Pílù (2008 PRC Corporate Governance Report: Transparency of Listed Companies and Information Disclosure)*,
<http://www.sse.com.cn/cs/zhs/xxfw/research/special/special20081120.pdf>.

Shanghai Stock Exchange, Monthly Statistic Report, available at
<http://www.sse.com.cn/sseportal/ps/zhs/yjcb/sztjyb.shtml>.

Shen, Han, “A Comparative Study of Insider Trading Regulation Enforcement in the U.S. and China,” *Journal of Business and Securities Law* 9 (2008):41-74

Shenzhen Stock Exchange, Key Issues relating to the Review of Public Offering Applications and An Analysis of Rejected Applications,
<http://www.szse.cn/main/images/2008/11/10/20081110152952164.pdf>, 2008.

Shenzhen Stock Exchange, Monthly Statistic Report, available at
http://www.szse.cn/main/marketdata/tjyb_front/.

Shenzhen Stock Exchange (2002), *Zhongwài Xìnxì Pílù Zhìdù Jì Shìjì Xiàoguó Bìjiào Yánjiù (Comparative Study of the Information Disclosure System and Effects)*,
<http://www.cninfo.com.cn/finalpage/2002-04-23/590499.PDF>.

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

Shen, Yan , Shen, Minggao, Xu, Zhong and Bai, Ying, “Bank Size and Small-and Meidium-sized Enterprise (SME) Lending: Evidence from China,” *World Development* 37(2009):800

Tam, Kit, “Ethical Issues in the Evolution of Corporate Governance in China,” *Journal of Business Ethics* 37 (2002): 305, 307.

Tan, Lay Hong, “The Legal & Regulatory Framework of Securities Markets in the PRC”,(1999), available at SSRN: <http://ssrn.com/abstract=325481>: 3-4.

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)

Thurow, Lester, Zhou, Ning and Wang, Yunshi “The PRC’s Real Economic Growth Rate”, available from www.oes.org/pdf/presentations/lesterthurow/pdf, (2003).

Tuan, Jason, Hsu, Jason C., et al., *Merger Arbitrage Profitability in China*, International Conference on Management Science and Engineering, Press of Harbin Institute of Technology 1995.

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

Villalong, B. & R. Amit, How Do Family Ownership, Control and Management Affect Firm Value, 62 *J. of Fin. Econ* 2001.

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

World Economic Forum (2009), *The Global Competitiveness Report 2009-2010*, available at <http://www.weforum.org/pdf/GCR09/GCR20092010fullreport.pdf>.

WFE, 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

Xie, Baishan, 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).

Xie, Zhihong and Chen, Mingtian, "Guhong Paisheng Susong Zai Sikao [Rethinking Shareholder Derivative Suits]," *Fujian ZhengFa Guanli Ganbu Xueyuan Xue bao [Journal of the Fujian Political-Legal Administrative Cadre Institute]* 4(2001): 24.

Xinxi, Zhongwai, Pilu Zhidu, Ji Shiji Xiaoguo and Bijiao Yanjiu Comparative Study of the Information Disclosure System and Effects, <http://www.cninfo.com.cn/finalpage/2002-04-23/590499.PDF>

Zhang Yujun, Developing the SME Board and Encourage the growth of SMEs, <http://www.sme.gov.cn/web/assembly/action/browsePage.do?channelID=1129097785944&contentID=1130306361557>, 2005.

Zhang, Wenkui, The Role of China's Securities Market in SOE Reform and Private Sector Development, http://www.tcf.or.jp/data/20020307-08_Wengkui_Zhang.pdf, 2002.

Zhang, Weiyong, The Reallocation of Entrepreneurial Talent and Economic Development in China (December 31, 2008) (copy with author)

Zhou, Weimin, Zheng, Zhongguo and Hui, Jian "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.