

Stock Market in China's Modernization Process

---- Its past, present and future prospects

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China's stock market today is of a sizable scale. It has 1377 listed companies, with a total market capitalization of RMB 3.5 trillion (two thirds of which is not yet tradable) and a monthly trading volume of RMB 364 billion.¹ There are over 300 securities and trust companies that are licensed to provide stock brokerage services through more than 2500 branch offices in cities, large and small. This extensive network of brokers has attracted more than 73 million stock trading accounts. The 53 fund management companies offer hundreds of mutual funds that are distributed through the vast retail network of thousands of commercial bank branch offices. Together with the advanced electronic trading systems at both the Shanghai Stock Exchange and the Shenzhen Stock Exchange, China today has among the most robust securities market infrastructures in the world, when measured in terms of both trading capacity afforded by the advanced electronic systems and potential investor reach facilitated by the vast physical distribution network. The physical infrastructure and distribution network present the Chinese economy with a great financing potential.

The gap between potential and reality is, however, still quite large. While China's physical infrastructure for a stock market is impressive by many measures, the institutional

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¹ The statistics cited in this paragraph are all as of February 2006. Source: The Chinese Securities Regulatory Commission, www.csrc.gov.cn.

infrastructure necessary for financial market development is largely missing or not functioning in its intended way. As a result, for example, the Chinese stock market from October 2002 to March 2006 went down by 15% (the only down stock market around the globe over this period, as measured in U.S. dollar returns),² even though China's GDP managed to grow by more than 9% year over year. To highlight the declining investor confidence in China's stock market, note that in 2005 each month brought in fewer than 100,000 new stock accounts, whereas in 2001 the monthly increase in investor accounts was more than 800,000.³

Further deepening of China's stock market requires the development of a more acceptable institutional infrastructure, so that investors can be confident that the separation between ownership and control --- the heart of a public equity market --- will not mean the lack of protection for their hard-earned money. Such an infrastructure contains three key components: (i) reliable and independent legal institutions, (ii) an independent regulatory body, and (iii) uninhibited informational institutions. The former two ensure that investors' assets will be protected and that their interest will be maximized to the extent possible by management insiders (Black 2001 and Coffee 2001). At the center of these two sets of institutions is the rule of law. The last component serves to provide investors with unbiased, useful and substantial information so that they can reliably assess the value of each stock as an investment opportunity.

As is known in the literature, such impersonal external and checked-and-balanced institutions are what China has traditionally lacked and still lacks. In this sense, the search for a deep and liquid stock market is synonymous with China's process of modernization. Until the rule of law is a basic characteristic of the Chinese society, it is hard to imagine that China will have a well developed stock market. A functioning constitutional system is a pre-condition for a prosperous public equity market.

Over the last 150 years, China has engaged in a long march towards a modern society. Scholars and policy makers in China have often identified modernity with the modernization of industry, of agriculture, of national defense, and of science and technology, that is, the so

² See Norris (2006).

³ Source: The Chinese Securities Regulatory Commission, www.csrc.gov.cn.

called “Four Modernizations”. These Four Modernizations have been a defining theme of social and political movements by generations of Chinese since the 1850’s. As such, the development of impersonal legal institutions has often not been thought to be a crucial part of the modernization process. Consequently, not as much efforts have been spent on modernizing China’s institutional infrastructure.

In this chapter, our purpose is to review the history of China’s stock market development from the 1860’s to the present and then make projections on its future path. In the discussions to follow, a central question that we attempt to answer is: absent of the necessary impersonal legal and regulatory institutions, what functionally substitutive arrangements did China come up with to induce public investors to join stock trading? That is, what was done to overcome the confidence and trust barriers? How well have such functional substitutes worked in promoting capital market development? What we will see is a constant struggle between the traditional Chinese preferences for informal or relationship-based rules of business transactions and the stock market’s dependence on formal structures of contracting and governance. This struggle in the capital market place mirrors closely the struggle by the larger Chinese society with the process of modernization. It has led to frequent disruptions and crashes in stock trading. China’s stock market history thus reflects its modern social and political history. In the same sense, its future will also mirror the social and political future of China.

1. The origin of China’s stock market: 1860’s to 1911

The word for “securities”, *ZhengQuan*, came into the Chinese language in the 19th century when trading in stocks and bonds was first brought to Shanghai by foreigners in the 1860’s. Initially, stocks were issued by foreign registered companies and traded mostly by non-Chinese residents in the treaty ports. Examples include the Shanghai Steam Navigation Company (started in 1862 by Russell and Company) and HSBC (1865 by the British). It was in the early 1870’s when the first indigenous joint-stock company --- The China Merchants’ Steam Navigation Company (CMC, in short) --- was established and its shares were later traded informally on the Shanghai streets. Other domestic enterprises of the modern

corporate form followed suit, including the *Jiangnan Arsenal*, the *Shanghai Cotton and Textile Co.*, and the *Kaiping Coal Mines*, ventures that formed the original foundation of China's modern manufacturing and mining industries.

Stock trading was thus introduced into China around the same time period as stock exchanges were established in many other countries, including Switzerland (1850), Spain (1860), Hungary (1864), Turkey (1866), Australia (1871), Czechoslovakia (1871), Argentina (1872), New Zealand (1872), Canada (1874), Brazil (1877), India (1877), Norway (1881), South Africa (1887), Egypt (1890), Chile (1892), Greece (1892), Mexico (1894), and Singapore (1911).⁴ It coincided with the major stock market craze --- the railroad stock bubble --- in the 1860's and 1870's in the U.S. and England. China is known to be the first country that invented paper money dating back to the Song dynasty (960 – 1279).⁵ But, it did not venture into innovations in securities trading until the late 19th century. Still, globally speaking, China was not far behind in adopting this financial technology: tradable ownership shares. The question is then: what led to the adoption of the modern corporate form and its twin --- stock trading --- in China? How did this western financial innovation fit in China's political, legal and social traditions?

China's venture into the stock market and its associated corporate form was largely a consequence of the Self-Strengthening Movement following the defeat in both Opium Wars (1839-42 and 1858-60) to Britain and France (in the second Opium War). The wars taught the Chinese elite a lesson that China was far behind in military technology and that in order to win over the West and regain national pride, China must catch up with western military and industrial technologies. But, adopting such technologies and developing the necessary manufacturing infrastructure required much capital, large sums of capital. Yet, at the time the Qing government was financially constrained. The state would not have the needed resources to take on the projects directly. The financing challenge was therefore daunting.

Note that after losing the first Opium War in 1842, China signed the historical *Nanking Treaty* with Britain. As part of the agreement, China agreed to open five port cities

⁴ See Table 1 of Goetzmann and Jorion (1999) for a more complete list of stock exchange starting times around the globe.

⁵ See von Glahn (2005).

for foreign trade, including Shanghai, Guangzhou, Xiamen, Fuzhou and Ningbo. In the following two decades, British merchants and other nationals moved into the different foreign settlements or concessions in Shanghai. As noted above, in the 1860's, founders of several foreign-registered joint-stock corporations (such as HSBC, the Union Steam Navigation Co., the Shanghai Steam Navigation Co., and Trautmann & Co.) were able to raise capital by issuing publicly tradable shares to private investors. These examples of stock trading brought to Shanghai by westerners provided a timely idea to the on-going post-war debate in China, that is, you can raise funds through issuing public shares to a large number of investors. It made many Chinese intellectuals and policy advisors conclude that industrial technology and financial technology are what allowed the West to be more powerful.

As one of the leading voices at the time, XUE Fucheng (1838-1894), commented, "The essence of the joint-stock corporation is to make a nation rich and powerful ... If a country does not pursue joint-stock companies, its industry cannot prosper nor can its commerce; If China's industry and commerce do not prosper, China will not be rich nor powerful." "Where foreign firms are present, there are corporations raising capital from hundreds or even thousands of shareholders. Backed by plenty of financial resources, no wonder they are so powerful and hard to compete with ... This is truly an unprecedented historical change in business." ⁶ In 1868, an 1854 Yale College graduate (also the first Chinese student who ever graduated from an American university), Yung Wing, proposed to the then governor-general of Liangjiang, ZENG Guofan, to adopt the joint-stock corporate form and start a Chinese-owned navigation company. That idea was well received by the Qing mandarins. China was thus on its way to experiment with the modern corporation and make its shares tradable. But, how could this be done?

The modern corporation has three defining characters. First, it is a "legal person", with the same ability to do business and engage in contracting as a real person. Second, it can issue tradable shares to any number of investors. Third, the investors face limited liability (i.e., they could lose no more than their initial investment). At the heart of the modern corporation is the separation between ownership and control, that is, thousands of outside

⁶ Quoted from page 271 in Li (2002).

investors (owners) entrust their capital with the management who has actual and full control over the use of shareholder assets. To provide outside shareholders with the needed confidence, this separation has to be supported by a corresponding set of legal institutions, including investor-friendly substantive laws, an independent judiciary and a reliable enforcement infrastructure (Black 2001 and Coffee 2001). In addition, as what is exchanged between the outside shareholders and the corporation is a financial contract (instead of tangible physical goods), there need to be informational institutions, such as a free press and other mass media, to facilitate the uninhibited and fast flow of information. Substantial and truthful information about the stock-issuing corporation is essential for the accurate pricing of its traded shares and for the keeping of investors' trust.

Business organizations and economic transactions in China had relied on personal relationships for centuries. Relationships served as a signaling and commitment framework, or as informal bedrocks for trust and a basis for enforcement of contracts (implicit or explicit). Partnerships of unlimited liability were the typical form of joint ownership, with partners from a single family, a lineage, a small number of lineages, or the same locality, usually not going beyond township boundaries. Before the railroad network was built in the late 19th century and afterwards, the lack of mass transportation means prevented for centuries the inland local economies from expanding across regions, generating no pressure for business organizational changes. The waterways in south-east China (Jiangnan) and along the coast could have pressured the unlimited-liability partnership structure and called for more impersonal forms of business organization. However, the emperors' orders forbidding overseas trading since the 13th century and the general anti-commercial Chinese culture stifled the possibility of inter-regional market expansion afforded by the waterways.

There had nonetheless been a few successful partnership cases in which there were not only clear separation between ownership and control, but also the ability to sustain growth for more than a century. According to Pomeranz (1997), the Yutang Pickle Factory was founded as a family business in 1779 and sold in 1807 to a partnership owned by several partners, of which the two main partners were from the Bing and the Sun lineages. From 1807 to 1905, the Bing and Sun families remained the controlling partners. After 1905, the Sun lineage bought out the Bing and other outside partners and became the sole owner of the

company until 1956 when it was nationalized after the communist revolution. Throughout the 19th century, the Bing and Sun families hired a professional manager for Yutang and kept the two controlling families at arm's length distance from the daily management of the business. This separation between ownership and control worked for almost a century from 1807 to 1905.

As remarkable as it was, the Yutang Pickle Factory studied by Pomeranz (1997) was a rare exception, of course. However, this unique case was possible because the high political/official positions held by the Sun and Bing families provided a functionally substitutive protection structure for property and contracts. For example, the Sun lineage had to send its children to study and take national exams, in order to become powerful officials. Indeed, when Sun Yuting and Sun Shanbao joined the partnership to purchase the company in 1807, the former was already a *Jinshi* and a provincial governor-general, while the latter a *Juren*, which afforded him the opportunity to select among many official positions. In 1821, Sun Shanbao passed the exams to become a *Jinshi*, which resulted in his taking a high position in the Qing empire's bureaucracy as well. Several descendants of these two brothers also made it to high official positions in the late 19th century. In the absence of formal legal institutions run by the state and equally available to all citizens, such official positions held by members of the lineage served as effective functional substitutes to secure property, contracts, and opportunities of business growth. Such an informal framework for property protection and contract enforcement was not based on a notion of rights, but on official power and brute force. This type of protection framework was not friendly to market development of a large scale or a wide scope. Neither was it conducive to the development of impersonal market-friendly legal institutions. Nonetheless, with such high official positions in the partners' families, Yutang's separation between ownership and control did not lead to the firm's demise. The informal "gentlemen's agreement" among the partners and the manager was then possible to work and last for a century, because no one dared to "mess up" with the

families of official power. --- But, unfortunately, not everyone was so lucky to have official power in the family, which is why cases like Yutang's were rather rare in Chinese history.⁷

According to Jensen and Meckling (1976) and Easterbrook and Fischel (1989), the modern corporation is simply a "nexus of contracts" or a legal creation. For this "nexus of contracts" to work, there have to be supportive laws and impartial enforcement institutions with enough force. But, as of the late 19th century, China did not have the necessary legal nor informational institutions for arm's-length or impersonal financial contracting, let alone an institutional infrastructure for public trading in financial contracts. First, in China's legal tradition, the legal system is never separated from, or independent of, the administrative system (e.g., Jones (2003) for an excellent overview). At least since the Tang dynasty (618-906 A.D.) and until the end of the Qing in 1911, the system of government consisted of a strong central authority headed by the emperor, who ruled through a bureaucracy and with absolute power. The lowest ranking officials at the county level represented the central government and in effect exercised all of the power of the state, even deciding lawsuit cases. Adjudication was simply one of the many administrative duties. In addition, China's legal tradition put its emphasis on administrative and criminal sanctions, with a lack of formal development in contract, civil liability and procedural laws. For example, the Great Qing Code was a collection of rules that were predominantly concerned with the official activities and functions of the bureaucracy, not with contractual disputes and relationships between and among private citizens. The imperial law touched upon private matters only as the matters were thought to affect imperial policies. Thus, the code was primarily of an administrative nature, and it tended to rely only on administrative and criminal penalties. This is in sharp contrast with the Roman law tradition, from which western laws are derived. As Jones commented, "In China, the subject matter of Roman civil law was considered only when it affected the interests of the Emperor" (Jones, 2003, p. 13). Rules and practices did not

⁷ To contrast with the Yutang Pickle Factory case, Goetzmann and Koll (2004) provide an interesting, but more typical, case of Dasheng cotton mills, a family of modern enterprises initially founded by Zhang Jian (1853-1926). They conduct a careful study of how the Dasheng cotton mills were governed even after Zhang Jian took advantage of the first Company Law of 1904 and obtained limited-liability corporation status for his enterprises. Their study shows that even after the turn of the century living and working with the modern corporate form had not become a second nature.

develop to enforce impersonal contracts or commercial transactions, nor to protect property rights, across regions and beyond local circles.

A related barrier to China's adoption of the modern corporation was its traditional practice of unlimited liability. Chinese literature classics are often full of stories in which children were held responsible for their parents' or even grand parents' unpaid debt, stories of debt being passed down generation after generation. This culture of unlimited liability is even dominant in today's Chinese society. But, limited liability is a fundamental character of the modern corporation, without which passive outside shareholders would not be willing to part with the control of their corporate assets and without which the inside managers would not want to engage in the control because they would not be willing to risk the future of their children and children's children. This is why a sage of the Progressive Era, Nicholas Murray Butler, proclaimed that "The limited liability corporation is the greatest single discovery of modern times" (Micklethwait and Wooldridge 2003, p. xxi). Therefore, the modern corporation would imply a direct clash with one of the defining features of the Chinese tradition.

Newspapers, commercial or otherwise, did not occur in China until 1861 when British merchants started the weekly in English, *The Chinese Shipping List & Advertiser*. In 1872, the first major newspaper in Chinese, *ShenBao*, came into existence and had since played a fundamental role in nurturing a substantial readership in the following years. Thus, before the late 19th century, China did not have a sizable public media to facilitate the free flow of business information and hence reduce the level of informational asymmetry in the market place. According to Akerlof (1970) and Chen (2005), the level of information asymmetry between buyers and sellers cannot be too high especially when what is being traded is an intangible financial contract; Otherwise, trading in such markets would be difficult to last and a market shut-down would eventually occur.

Without the legal and informational institutions to support the separation between ownership and control, investors found it, not surprisingly, hard to have confidence in stock shares or to trust joint-stock corporations. As a high-ranking official and a key reformer, SHENG Xunhuai, informed the emperor in 1898, "The Imperial Railway Administration originally intended to depend on raising private capital. But Chinese merchants will only

come forward when the construction is completed and profits are visible ... It is rarely heard that private merchants and common people buy stock. They may be attracted by a completed enterprise, but it is impossible to depend on them for new undertakings” (Feuerwerker 1958, p. 237).

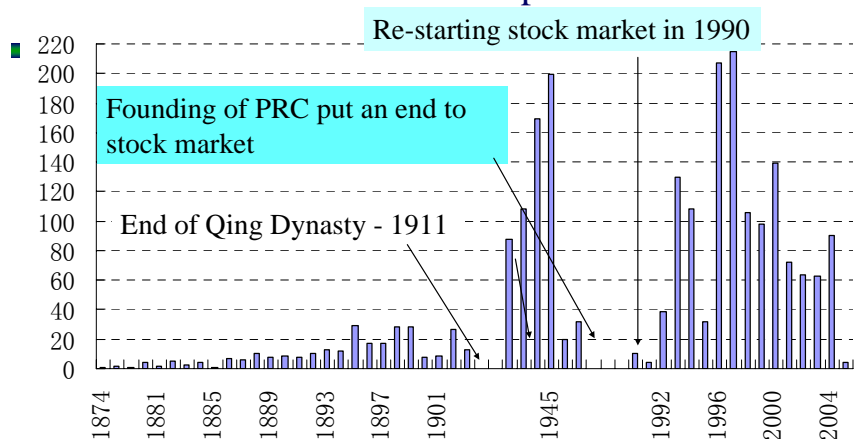
Developing the necessary legal and informational institutions would by no means be a short-term task, even if the elite at the time had known how to do it. Given the urgency of China’s modernization movement, the state had to come in and sponsor the new enterprises. In the absence of a corporate law and a bankruptcy law, the government’s sponsorship had to include implicit guarantees, limiting the liabilities for outside shareholders and for the corporation. This also marked the beginning of the state’s role in corporate management and/or direct corporate ownership in modern Chinese history. Of course, other factors were important as well in the government’s decision to become involved in the early experiment with joint-stock companies, including its traditional distrust in private merchants’ motives (so the government had to be in, lest the businessmen would exploit the public). Also, the reformer officials were personally interested in ensuring the experiment’s success by providing the new enterprises with privileged trade monopolies and protection from expropriation.

Take the CMC – the first modern corporation --- as an example. It was founded in 1872 by LI Hongzhang in his official capacity as the governor-general of Zhili province and a key reformer official in the Qing court. In explaining his motive, Li stressed in a letter that “The use of steamships for the transport of tribute rice by sea route is but a minor consideration. The project will open up new prospects for the dignity of the state, for commerce, for revenue, and for military strength of China for hundreds of years to come” (Lai 1991, p. 142). In October 1872, he appointed ZHU Qi’ang to be in charge of the CMC project and appropriated 135,000 taels of Zhili military funds as a government loan to the CMC. But, despite the government’s sponsorship and assurance that outside shareholders would receive a 10% government-guaranteed dividend yield, private merchants pledged share capital of more than 100,000 taels but actually paid up only 10,000 in cash. Between 1873 and 1883, the government provided to the CMC annual loan amounts between 80,000 and

1,000,000 taels (Lai 1991). The total of these government loans was 2.2 times the maximum paid-up share capital during this period.

In the CMC and other joint-stock cases under the “government supervision and merchant management” model in late Qing, “government supervision” meant that officials appointed and replaced key managers and dictated operational and financial policies sometimes on a daily basis. In the case of the CMC alone, for example, there were more than 400 instructions on file by LI Hongzhang on the daily operations of the company. With the official support, the CMC was able to become profitable by the early 1880’s, which then led to the call by other Qing officials to nationalize the CMC. It was LI Hongzhang who protected the private shareholders’ interest and prevented the state from taking control of the CMC. In this sense, the officials’ involvement in early joint-stock experiments did provide both shareholder and property protection, so that the state and others would not easily expropriate corporate and other properties. Absent of an independent judiciary, private property, corporate or not, would otherwise be at the mercy of the state and powerful officials.

Figure 1: Number of New Chinese Stocks Issued from 1873 to the present



Data sources: Goetzmann, Ukhov and Zhu (2001) for the late Qing, Zhu (2005) for the 1940’s, and CSRC website for post-1990.

Overall, the first decade after the founding of the CMC brought 15 joint-stock companies to the market (see Figure 1 for the evolution of new joint-stock companies), from mining, manufacturing and transportation industries. Their stock shares were traded on the streets and teahouses in Shanghai. With the lack of disclosure and accounting rules and the resulting absence of useful information about the corporations, the investors had no basis to

distinguish between good and bad companies. Consequently, the stocks provided a natural environment for speculation. As commented by the *ShengBao* newspaper on September 2, 1882, “Investors in China today just buy stocks without even asking whether the issuing company is good or bad, profitable or not. Whenever a new stock is issued, they rush to buy a few shares, 10s of shares or even hundreds of shares as if they would otherwise miss the opportunity to purchase the shares. ... when there is a stock that some people were not able to purchase and now the stock is suddenly going up, you will then hear them say ‘if I had purchased the stock earlier, I would have made so and so much money’, hating themselves for missing the opportunity” (Li 2002, p. 22).

The speculative fever led to the first Chinese stock market bubble in 1882. In that year, many stock prices went up by more than 100% (Li 2002). At the height of the bubble, the first stock trading company, Shanghai Pingzhun Stock Company, was founded in September 1882. This moved trading in Chinese stocks from the streets and teahouses to a central location with some basic rules for settlement and cash requirements. It was considered to be the first Chinese stock exchange of a sort.

The 1882 boom was followed by a crash in 1883. The average stock price decline was more than 70% for the 1883-84 period (Goetzmann, Ukhov and Zhu 2001). Such blue-chip names as the CMC, Kaiping Coal Mines, and Pingquan Copper Company all had their stock prices cut by over 80% from their 1882 high to the end of 1883.⁸ That crash was so severe that many native banks that provided margin lending to stock speculators went bankrupt, leading to a major financial crisis in Shanghai and other port cities.

Following the crash of 1883, the Chinese stock market and the modern corporation movement went through a relatively slow period, though the westernization process was still on. First, after the crash, “stock shares” became a not-so-favorite name for people to be reminded of. There was a shortage of appetite for stocks. Second, the strongest official supporting the movement, Li Hongzhang, was increasingly criticized for his favoritism towards the joint-stock companies, weakening his political position. The protection he provided to the new enterprises became gradually compromised. Finally, the increasing

⁸ Li (2002), Appendix Table 1.

defense needs of China reversed the government's policy from giving financial support to extracting resources from the corporations. The semi-official nature of the modern enterprises turned itself from an advantage to a major liability, which served to slow down the growth of the new industries. Top managers in these joint-stock companies were mostly of official background, often accustomed to corruption. The "government supervision and merchant management" enterprise model, which was a result of adapting the western corporate form to the Chinese social-legal-political context, no longer worked.

The next major stage of development was right after China lost in the 1894-95 Sino-Japanese naval war. That loss was a major blow to China's national pride, starting a new round of soul searching and national debate on China's future. This time the government had no more resources to sponsor new joint-stock corporations, as it could not even have enough funding to satisfy its defense needs or pay for the war indemnity. The Qing court was too busy worrying about its own future than minding the business firms. For the first time, the government allowed private initiatives to lead new industrial ventures. Pure private joint-stock companies started to appear, with shares offered to merchants. During this period, a new business form also emerged: joint ownership between the state and merchants (*GuanShan HeBan*) in which the state took a direct equity stake instead of making loans. This joint-stock form was adopted first in 1898 with the Hubu Bank (later renamed to the Great Qing Bank in 1908) and later, between 1903-1907, with several railway companies. Figure 1 shows that 29 new corporations were formed in 1895, followed by 28 in each of 1898 and 1899. The development momentum was halted after the Boxer Rebellion of 1899-1900.

In the soul-searching intellectual debate after the Sino-Japanese naval war and especially after the Boxer Rebellion, a key question was asked: why couldn't China develop joint-stock corporations and a stock market to provide an abundant supply of capital for new industry projects and military modernization? It was finally recognized at the time that there had to be a supportive legal infrastructure, including a company law and a bankruptcy law putting substance into "limited liability". A key reformer official and governor-general of Lianghu, Zhang Zhidong, wrote during the time that "A business cannot be big if it does not adopt the corporation form; There cannot be many corporations if there is no commercial law. In China, even after a stock issuer has committed fraud, there is rarely any penalty or

accountability. Thus, it is no surprise that Chinese corporations find it so difficult to raise capital. In the West, not only there are good commercial and corporate laws, but also citizens, official or otherwise, each follow the laws, which is why their corporations can easily raise much capital.” (Li 2002, p. 101).

As a result of the debate and the Qing court’s determination to reform, China introduced its first ever “Company Law” in 1904. Subsequently, between 1904-10 a total of 197 limited-liability corporations were registered across China, with their shares floated.⁹ As found by Feuerwerker (1958), Goetzmann and Koll (2004) and Kirby (1995), that law had quite a mixed impact on Chinese business practice as not many businessmen rushed to acquire the formal protection provided by the new law. Instead, the law was looked upon with more suspicion than relief. Nonetheless, it was a first attempt in the right direction, in a country that had no formal legal profession or a formal legal doctrine based on the separation of power and on the notion of rights.

By the end of the Qing dynasty in 1911, China had had more than 40 years of experimentation with joint-stock corporations and a stock market. More than 480 stocks had been issued for public trading, with many more businesses indirectly benefiting from the stock market. These modern corporations represented a cross section of industries from manufacturing, electrical power, mining, textile, railway, steamship transportation, to banking and financial services. This period of trial and errors made the country’s elite recognize the necessity for a government structure that separates the officialdom from the judiciary and from business. In the words of another scholar-official and governor-general of Liangjiang, Zhen Guanyin, “The essence of corporate and commercial laws is to protect business and commerce from the threat of political power”.¹⁰ At the beginning of the 20th century, China started to accept the notion of government powers checked and balanced by a constitutional structure.

2. Stock Market during the Republican Period

⁹ Li (2002), Appendix Table 3.

¹⁰ Li (2002), p. 100.

The founding of the Republic of China (ROC) in 1911 put an end to the legal-political reforms, including the introduction of a constitutional system, pursued by the Qing after about 1901. The Republican government sought to adopt a power structure based on the principle of checks and balances among functional branches and with independent institutions such as the executive (*XinZhenYuan*), the legislative (*LiFaYuan*) and the judiciary (*FaYuan*). It marked a new beginning in China's modernization process. However, the reality after 1911 was that the president and his office were in Beijing while the parliament and the judiciary branch were in Nanjing. In the mean time, the provinces were each ruled by one or more warlords. Until the end of the Northern Expedition to rein in all the warlords and the establishment of Nanjing as the nation's capital in 1927, China was in a *laze faire* state. Public goods such as contract enforcement and property protection were up to the private organizations to provide. In some ways, the weak government was not much of a threat to private properties and businesses, so private enterprises were given ample room to grow and prosper.

By 1911, stock trading had converged to one central location --- the Beneficent Fragrance Tea House (*HuiFang CaLou*), on Fuzhou Road in Shanghai. Several stock broker/dealer companies were functioning as settlement service providers. In 1914, the Shanghai Securities Dealers Association was founded, making its headquarter as a central location for stock trading. It set guidelines and rules such as trading hours and commission rates, and the association introduced membership standards and disciplines. At the end of that year, the ROC government put forward China's first "Securities Exchange Law" (*ZhenQuan JiaoYiSuo Fa*). On June 5, 1918, the first formal Chinese securities exchange, the Peking Stock Exchange, was started in Beijing. In September 1919, the Shanghai Securities and Commodities Exchange was founded. In November 1920 the Shanghai Securities and Commodities Exchange was renamed the Shanghai Chinese Stock Exchange (as opposed to the Shanghai Stock Exchange organized and managed by foreign businessmen and for foreign registered corporations). That was immediately followed by a wave of new securities exchanges set up in and outside Shanghai. By the end of 1921, there were more than 140 securities exchanges in Shanghai, and 52 exchanges together in Hankou, Tianjin, Guangzhou,

Nanjing and Suzhou.¹¹ This marked the second major speculative bubble in China's stock market history.

When founded, most of these exchanges did not have much to trade on as the number of available securities was small relative to the number of exchanges. This made the new exchanges starting their services by first trading the stock of the exchange itself. Some of them were simply single-stock exchanges (Zhang 2001). It was indeed a period of truly free markets.

Trust companies represented another favorite business of the time. In Shanghai more than 12 trust companies were attracting capital and savings from individuals and institutions, by the end of 1921. These companies would often team up with the securities exchanges to manipulate targeted stocks, adding to speculative fever. Native banks were standing ready to lend to speculators on margin. 1921 was a year of stock market bubble in Shanghai.

Why are stock markets perfectly vulnerable to excessive speculation and bubbles? The key lies in the fact that a stock represents a financial contract whose value depends on an uncertain future. The intangibility and uncertainty about the issuer's future presents ample space for manipulation and irrational exuberance. It can equally likely lead to extreme pessimism. Thus, excessive financial speculation and bubbles can be especially common and extensive in the absence of protective legal and informational institutions for the informationally disadvantaged outside investors. The Republican period China offered one such social-legal environment.

Towards the end of 1921, native banks and other financial institutions that were extended in margin lending became increasingly more nervous and began to make margin calls. This caused sharp declines in stock prices, which in turn led to the bankruptcy of multiple banks, trust companies and securities exchanges. By the end of 1922, there were fewer than 10 securities exchanges and a couple of trust companies left all across China, ending a golden period in China's stock market history.

During the remaining years of the 1920's, securities trading was concentrated in government bonds and far less on stocks while corporate bonds were issued for the first time.

¹¹ Zhang (2001).

In this sense, the bursting of the 1921 stock bubble paved a way for the bond market to develop in China. For this line of financial market history in China, see Zhu (2006) in this volume.

Despite the above, the 1912-28 period was a golden age for China's securities market development. According to an estimate by Xu and Chen (1995), during this period, more than 1984 modern industrial and mining enterprises were established each with a capital base of more than 10,000 yuan, with a total investment of 45.89 million yuan; 311 modern joint-stock banks were founded, with a total share capital of 119.43 million. These developments together lifted China's industrial structure to a new level in terms of both scale and scope, covering manufacturing, textile, mining, transportation and financial services. Precisely because of the weak or non-functioning ROC government during this period, free enterprise was the dominating theme of business practice. Strong self-regulating professional organizations emerged, such as the Shanghai Native Bankers Association, the Shanghai Securities Broker/Dealers Association, and various other industry associations. These professional organizations served as important functional substitutes for non-existing government institutions in the areas of contract enforcement, market conduct and property rights. As a result, a sizable network of financial intermediation emerged with fund-raising capabilities extending beyond geographical boundaries (Zhang 2001). It was perhaps the most dynamic development period in modern Chinese history.

In 1927, the ROC government moved its headquarters to Nanjing and consolidated much of its power there. For the first few years, fighting was still continuing to rein in the few remaining provincial warlords. By this time, while the stock market was still recovering from the burst bubble of 1921, the Republican government was in severe financial difficulty and was forced to issue bonds to finance the on-going war efforts. In 1931, the Japanese troops moved into China and started their long occupation of the Manchurian provinces. The Japanese invasion and occupation pushed the ROC to further increase its defense spending, escalating the government's financial burden to another level. More government bonds were then issued. Between 1927-36 the ROC issued 2.6 billion yuan government bonds in China and \$60 million sovereign bonds outside China (Zhang 2001). As a result, the 1930's was marked by bond trading, not by stock market development.

In 1929, the Republican government revised the *Company Law* and the *Securities Exchange Law*, refining the protective articles for shareholders of joint-stock corporations. A specific regulatory body for securities markets was set up as a joint agency between the Ministry of Finance and the Ministry of Industry and Commerce. The judiciary system also experienced significant development during this time, forming a better legal infrastructure for securities trading. In 1933, the securities trading division of the Shanghai Securities and Commodity Exchange was merged into the Shanghai Chinese Stock Exchange. In the following year the construction of the famous “Shanghai Securities Building” on Hankou Road was completed, making it the best equipped and largest securities exchange center in the Far East at the time. However, the 1929 stock market crash in the United States and its following Great Depression in the 1930’s did not help, as these events in the West only served to dampen potential stock-market growth in Asia. In 1933, local Shanghai companies issued more than 100 million yuan worth of stocks. The total stock trading volume for 1934 was 477 million yuan in Shanghai (Zhang 2001).

Outside Shanghai, there were the Peking Stock Exchange, the Simin Stock Exchange in Ningbo, the Hankou Stock Exchange in Wuhan, the Chongqing Stock Exchange, and the Tsingtao Stock Exchange. In the 1930’s these exchanges traded mostly local government bonds, in addition to the central government bonds and the stocks of a few well-known national corporations.

In 1937 the Japanese occupation troops marched south from Manchuria and China was forced into the 8-year anti-Japanese war (1937-45). Trading in Chinese stocks was soon halted by the government, to focus efforts on the war. Between 1937-40 stock trading was confined to the foreign settlement areas in Shanghai and only foreign-registered company stocks were traded. Given the lack of Chinese stocks and other securities during this time, foreign stocks were the only game in town, attracting all the speculative capital in and around Shanghai.

In 1940, a group of Chinese broker/dealers formed the Chinese Stock Promotion Society, with a mission “to promote the liquidity of Chinese stocks, to encourage investments, and to enhance enterprise development”. The formation of this society during the war period put some structure and organization on stock trading again, with more formal rules of trading

and settlement. When trading in Chinese domestic stocks resumed in 1940, the society applied its own listing requirements and admitted 88 company stocks. See Figure 1 for the year-by-year numbers of new stocks issued during this period, where the data are from Zhu (2005). The pre-war Shanghai Chinese Stock Exchange was re-opened for trading in September 1943.

After the Japanese troops withdrew from China at the end of World War II, the Shanghai Chinese Stock Exchange was closed again in August 1945 and then to re-open in September 1946, this time with just 20 stocks listed. When it re-opened, 225 broker/dealers were admitted. To encourage trading during the ensuing intensified civil war in China, the exchange introduced stock futures and allowed arbitrage trading by the end of 1946. Consequently, daily trading volume rocketed up to 800 million shares. By the end of 1947, there were 32 stocks listed with a total market capitalization of 70 billion yuan (Zhang 2001).

The good time however did not last long, as the stock exchanges in Shanghai and Tianjin were once more halted by the Republican government in August 1948. This time the reason was to give the government enough time to reform its monetary system. After that, the Tianjin Stock Exchange was never re-opened as the Communist troops moved into the city in January 1949. The Shanghai Chinese Stock Exchange resumed operation in March 1949 but was closed in May when the Communist troops marched into Shanghai.

The post-1927 Republican years were therefore punctuated with wars and political-financial crises. As a result, the Chinese stock market went through rounds of stop and go cycles, making it difficult to develop any sustainable equity culture or a functioning institutional infrastructure that is stable enough for reliable shareholder protection.

3. China's Stock Market after 1949

The People's Republic of China (PRC) was founded on October 1, 1949. A new economic philosophy of public ownership was to replace centuries-old private ownership. Nonetheless, the PRC re-established a Tianjin Stock Exchange in 1949 and a Beijing Stock Exchange in 1950, with 10 and 6 stocks traded, respectively. At that time there was some uncertainty remaining among the public as to whether private properties would be all or

partially nationalized, so some individuals were willing to speculate in stocks. But, trading was overall inactive. It was soon realized by the authorities that these investors liked market volatility, that is, when stock price volatility was low there was not much enthusiasm among investors, whereas investor interest would rise fast when the volatility was high. It was concluded that the market was too speculative, something that diametrically contradicts the Marxist economic principles. Both stock exchanges were shut down in 1952, and the expropriation of private properties entered its high tide thereafter. By 1958, China was under state ownership, with the private sector making up less than 3% of national output.

Economic reform started in 1978, soon after the end of the disastrous Cultural Revolution (1966-76). However, until the mid 1980's the focus of the reform efforts was on the agricultural sector, allowing peasant families to each have a plot of land to grow grain crops and retain whatever profits the peasant was able to generate after sending to the government the required production quota. As a result, there was a large increase in income and living standard among peasants.

The success in agriculture then started to affect the debate on how to reform the industrial sector where state ownership dominated. The first industrial-reform experiment in the mid 1980's was to apply the individual-responsibility model of farming to state-owned enterprises (SOE). But, this responsibility model did not work out, since it promoted mostly short-term behavior by management. It was then realized that without clearly defined private ownership, there would not be an incentive structure to induce managers to take a long-term view.¹²

3.1. Re-inventing the Stock Market

¹² In some sense, state ownership represents an extreme form of diverse ownership as each citizen in the country is supposed to own an equal piece of the firm. Thus, the separation between ownership and control is also extreme. But, there has been no corporate governance structure in place to ensure the functioning of this extreme separation. Since the state controls the management of each SOE and since the government is not democratically elected, there is no institutional infrastructure to ensure that the agents at the various levels will work in the best interest of the ultimate shareholders -- the citizens. Therefore, it is not surprising that the management responsibility model did not work.

In the late 1980's, joint-stock limited-liability corporations became the new experiment, with some SOEs converted into joint-share corporations. These shares were traded on unofficial street markets in Shanghai and elsewhere, much like in the late Qing years. More formally, the new Shanghai Stock Exchange emerged in December 1990, followed by the Shenzhen Stock Exchange two months later. Both then and today, the ownership structure for a typical public company is broken into several share classes: state shares, legal-person shares (only ownable by legal-person corporations), and floating common shares (A-shares for domestic citizens only and B-shares for foreign investors). In particular, the state shares and legal-person shares are not publicly tradable.¹³ Regardless of share type, the holder of a share is entitled to the same cashflow and voting rights. Today, a typical public corporation has about one third of its shares in each category of state, legal-person and floating common shares.¹⁴

Shown in Figure 2 is the post-1990 history of the Shanghai Stock Exchange Composite Index. The peak valuation was reached in June 2001, when the index reached 2218. Since then, it had come down steadily until the bottom near 1000 in July 2005. The Chinese stock market has become the third largest in Asia based on market capitalization (after Japan and Hong Kong). The combined market capitalization of the companies is over RMB 3.5 trillion (about \$500 billion) at the end of February 2006,¹⁵ where the tradable shares are priced at RMB 1.2 trillion. Trading is active with a monthly turnover rate of

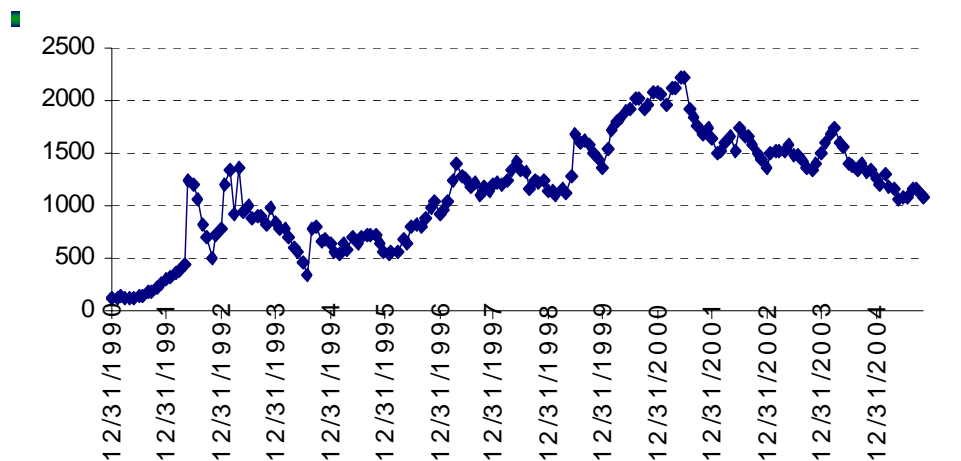
¹³ A reform policy started in 2005 allowing the listed companies to convert their state and legal-person shares into tradable ones (hence identical to A-shares). By March 2006, about 40% of the 1377 public corporations have completed the conversion. The government's plan is to have the conversion completed for all the companies by the end of 2006.

¹⁴ See Chen and Xiong (2001) for a study on the underpricing structure of legal-person shares. They show that because these shares are not tradable, they are priced at an average discount of 86% to the otherwise identical floating common A-shares. This pricing and liquidity distortion is also a source for corporate governance problems.

¹⁵ The exact market capitalization value for all listed companies combined is a mystery because the state and legal-person shares are not publicly traded and hence no reliable price information can be used to value them. The RMB 3.5 trillion given here is based on the official estimate published on the CSRC website, in which they simply multiply the total number of shares outstanding by the floating A-share price. From Chen and Xiong (2001), this is clearly an over estimate, because the legal-person and state shares are sold at an average discount of 86%. See also Walter and Howie (2003) for another discussion on this market capitalization issue of China's listed firms.

18.2%. About 20% of the 1377 companies are private firms without the state being the largest shareholder.

Figure 2: Shanghai Stock Exchange Composite Index



Data source: www.SinoFin.com.cn

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Table 1 shows the total amount of capital raised in each year, together with the annual number of IPOs (see also Figure 1). In Table 2, we see that the amount of capital raised on China's stock market is, when measured as a fraction of GDP, lower than the U.S. but higher than Japan's and Germany's, in the 1990's. It should be recognized that this period marked the beginning of China's stock market (hence one would expect some level of exuberance).

3.2. Political and Legal Background

Having reviewed the overall picture of the stock market since 1990, we now seek to understand its political and institutional context from which the stock market re-emerged in China. Such an analysis allows us to see whether 150 years later China has finally gotten the stock market "right". Recall that when the Qing reformers started experimenting with joint-stock companies and the stock market, they went from an economy in which business enterprises were almost all privately owned. During the late Qing, the state's sponsorship was to promote new industries that might otherwise be difficult to launch because of the lack of

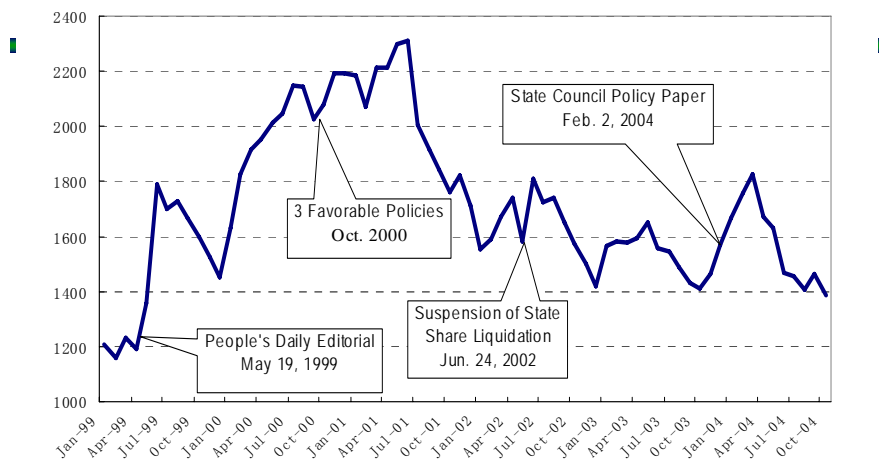
trust-enhancing legal institutions. In contrast, when stock trading and joint-stock corporations re-started in the late 1980's, almost all enterprises converted into this corporate form were 100% SOEs. The re-emergence of stock shares was because the SOEs had accumulated large financial losses. So the government's intention was to solve the SOEs' financial problems through raising funds from, and selling equity shares to, the investing public. It was not meant to offer the general public a way to participate in wealth creation, diversify investment portfolios or hedge future consumption/income risks.¹⁶ The PRC state was effectively the stock issuer and controlling shareholder. Shareholder rights were more of an afterthought, which became a concern several years after stock trading was widespread.

As an example to illustrate the inherent conflict of interest (that has greatly compromised the state's regulatory and law enforcement roles), note that from 1990 to 2000, the government practiced a quota system on the number of IPOs for each year, so as to ensure a planned and orderly sequence with no supply shocks. The planning was to make the IPO flow low enough so that IPO prices would be high, setting a perfect environment for more SOEs to issue shares. To achieve this, the government has also needed to maintain a positive and encouraging market through policy announcements and newspaper editorials. Figure 3 illustrates the recent history of central government interventions to boost stock prices. Since 1999, four intervention events occurred to push the stock index higher. First, on May 19, 1999, the Communist Party newspaper, People's Daily, published an editorial effectively calling upon the people to buy stocks as a way to invest in the future of China. Second, after a brief dip in stock prices, in October 2000 the China Securities Regulatory Commission (CSRC) issued three favorable policies. The third and fourth events occurred respectively on June 24, 2002 and February 2, 2004. Each time the market got the message and went up, though the boosts were short-lived. The fact that the stock market was designed to promote the state's interest in the SOEs means that the regulator's and even the court's roles are to maintain a high stock price level, instead of ensuring a level playing field for every market

¹⁶ Walter and Howie (2003) argue extensively that the Chinese government's determined interest has really been, and will continue to be, to use the equity capital markets as a tool of enterprise reform, while other by-products of the capital markets have been more of a side purpose.

participant. In China, neither the court nor the regulators are independent from either the government or the Communist Party. Thus, market regulation is equated with the management of the stock market index.

Figure 3: Regulations of market index?



Source: Goldman Sachs Gaohua Securities Inc.

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Note that when the late Qing began its stock market experiment in the 1870's, there was no institutional structure that separated the judiciary from the executive branch and from the legislative branch (judicial independence and regulatory independence would have been foreign concepts back then). Against that background, the Qing government almost had to come in to provide implicit guarantees to the investing public, but the Qing state did not have a direct equity stake in the new enterprises. In contrast, by the late 1980's China appeared to have in place all the modern political institutions from the legislative (the National People's Congress) to the executive branch (the State Council), to the judiciary (the People's Court system), and to the newly adopted Constitution of the PRC. Thus, one would expect the PRC to be much more ready to develop the modern corporation and a stock market in the 1980's. But, as discussed above, the state's stock-issuer role has greatly compromised the functioning of the PRC institutional structure for contract enforcement and shareholder rights protection.

The political philosophy and government structure of the PRC have impaired market development in other ways. Back in the late 1980's, preparation was under way to re-introduce an official stock exchange. But, while stock trading was already taking place on the

streets, private ownership and privatization was still political taboo. Against that background, the reformers had to settle for a political compromise, that is, each publicly traded corporation would have several classes of share: state shares, legal-person shares, and floating common shares (A- and B-shares). Making the state and legal-person shares not publicly tradable was supposed to serve two purposes: that no loss of state ownership would occur and that investors in such shares would not engage in speculation (something the communist ideology is totally against). Given that most legal-persons are state-owned or state-controlled, about two thirds of most corporations' shares are owned by the state, directly or indirectly. This ownership structure has not only mis-aligned the interest of different shareholder types (e.g., holders of floating shares can benefit from stock price gains whereas holders of non-tradable shares cannot), but also made it difficult for private securities litigation to proceed independently, because granting damage awards in private litigation would amount to the loss of state assets (to the extent that the state owns a majority of the shares outstanding), which puts the court in a conflicted situation. We will return to this topic shortly.

Another ideological obstacle to corporate governance in the PRC is the traditional communist value principle that only income through labor is rightly acceptable. Though stock trading appeared in the 1980's, this official line on justifiable income remained in the Communist Party charter until November 2002, when the 16th Party Congress changed the charter to formerly acknowledge that acceptable income can be earned through both labor and capital (i.e., monetary capital, intellectual capital and managerial capital). Therefore, until late 2002, Communist Party members were not supposed to buy or trade stocks; Otherwise, any income from holding shares would not be legitimate. This ideology is of course contrary to the notion of shareholder rights and the protection thereof, which has been partly responsible for the slow implementation of the Securities Law and the Company Law of the PRC. It has been detrimental to the growth of confidence in the stock market.

The government structure has also played a role in distorting market development, as can be illustrated by the IPO quota allocation process. At the beginning of each year prior to 2000, the national IPO quota was approximately equally divided among the 32 provinces and province-level municipalities. Table 1 shows that since 1990 the annual number of IPOs has

been between 4 and 206. This implies that in a typical year each province would get a quota of about 3 IPOs. This limited supply clearly made the value of each IPO permit very high, and created a lucrative opportunity for rent-seeking and bribing. Consequently, each provincial government set up a dedicated Securities Listing Office to both lobby the CSRC for a higher quota and to assist local firms to prepare for an IPO.

For provincial and lower governments, how many local firms are publicly listed has become a major metric of performance, on which future promotion of local officials depends. As a result, provincial and lower-level officials have been quite willing to help local firms manipulate financial numbers or commit fraud, in order to have more local stocks traded nationally. Or, even when local firms are caught by the media for committing financial fraud or earnings manipulation, local governments would be happy to assist in covering up the fraud.

Both of the central government's bias in helping the SOEs and the local government's desire for political performance have worked against outside shareholders' interest. Therefore, the SOE origin, the continuing dominance of the state as the majority shareholder, and the political-legal infrastructure have made China's stock market inevitably biased against shareholders. At the heart of this is the lack of both judicial and regulatory independence.

As in the late Qing, China today still does not have an independent legal infrastructure to support capital market development. This is partly due to the fact that in the early 1950's the PRC completely abandoned the experience, institutional learning and legal development accumulated between the 1860's and 1949. One hundred years of knowledge and experience was thrown away. Thus, in 1990, China re-entered the process of stock market development without a clear idea of what institutional framework would be needed. Fortunately, as discussed below, the increasingly larger number of investors has created a powerful constituency in China. This constituency has generated much pressure for institutional change and led to a sequence of legal development.¹⁷ In other words, consistent with the "crash-then-

¹⁷ See Hutchens (2003) for an excellent account and analysis of the development history of private securities litigation in China. He summarizes the various factors (positive and negative) that have each contributed to legal development in a country whose tradition has de-emphasized civil law.

law" hypothesis of Coffee (2001), as long as the stock market experiment continues, a reliable legal infrastructure may eventually emerge in China.

3.3. The Stock Market as a Force for Legal Development

China's stock market was started top-down, with the CSRC and other agencies controlling every step in both the overall development and a firm's public equity financing process. The stock exchanges are state-owned and managed by government-appointed officials, while the securities firms, fund management and trust companies are state-owned (or majority-controlled) either directly or indirectly. Since the market's re-emergence in 1990, it has been a well known secret that every public company had been "nurtured financially" and re-packaged just for the sake of IPO, with widespread practice of making up the numbers so as to meet the listing requirements (e.g., profitability in each of the recent three years).

As discussed earlier, the state's multiple roles as the stock issuer, legislature/rule-maker and law enforcer have compromised its willingness to protect outside shareholders' rights. Even though it had been known for years that accounting fraud and market manipulation were wide spread, private securities litigation and corporate governance issues did not become policy topics of much concern until 2001. It took a sequence of events in which a large number of shareholders suffered losses that pushed the government to become more serious about shareholder rights and corporate governance. Therefore, China's recent development process in investor-friendly institutions has been driven largely by the financially injured individual investors, not by government initiatives. As expected based on our preceding discussions, the government and the court have been reluctant in enforcing the laws and regulations.

Though the market started in late 1990, suing management and directors and/or other parties for damages was not much on investors' mind until after a sustained market downturn in 1993. As Figure 2 shows, the Shanghai Stock Exchange Composite Index (hereafter SSE Composite) went straight up from 100 in 1990 to 1266 by May 21, 1992. In particular, the index rose from 617 to 1266 in a single day on May 21, 1992. It was then followed by five months of decline. But, that decline did not last long enough to motivate a substantial number

of investors to call for private litigation against manipulators. In late 1992, the government stepped in to officially encourage stock trading, creating a new upward movement.

In the early 1990's, even if any private investor had wanted to sue for damages, the court would not have accepted such private actions. The only law that shareholders would be able to rely on up until July 1, 1994 was the PRC General Principles of Civil Law, which provides that victims of torts are entitled to civil recovery. However, the PRC judiciary had little experience with tort law in general and securities law in particular, which remains true today. Legal training was all but stopped during the Cultural Revolution, and resumed only after 1980.

Furthermore, the current legal system was modeled by the late Qing reformers after the Japanese civil-law system, which in turn was adapted from German law during the Meiji reform period of the 19th century. A dominant theme of Chinese law is that “wei jin pizhun bu ke”, that is, without a formal written rule in the law or a legal interpretation by the Supreme People's Court (SPC), judges cannot on their own interpret and apply a legal principle to decide specific cases. Given that at the time when the PRC General Principles of Civil Law was enacted in 1986 there was not a stock market, it is not surprising that the general PRC Civil Law did not include securities related provisions until revisions in the late 1990's.

In principle, before judges can accept a new type of private legal action, the National People's Congress has to first pass a law for the specific area and then the SPC has to issue one or more detailed legal interpretations. This process can last for five years or longer.

Nonetheless, while there was no securities law until July 1, 1999, administrative regulations were introduced to fill in the gap. The Provisional Rules on Stock Issuance and Trading of 1993 issued by the CSRC proscribed various miscreant practices and provided for civil compensation for those who were financially injured as a result (Hutchens, 2003). But, the court was not ready for private securities litigation, and hence these administrative provisions would not amount to anything for investors. Penalties based on the Provisional Rules of 1993 could only be determined and enforced either administratively by the CSRC,

or through criminal litigation by the Public Security Department. The following are three representative cases of this nature:¹⁸

1. The first administrative case on insider trading was announced on January 28, 1994, in which the violator, the Shanghai brokerage office of the XiangFan Trust and Investment Company, was fined by the CSRC. The violator was accused of (1) insider trading and market manipulation and (2) trading stocks using customer account capital. The brokerage branch was ordered to turn in all the trading profits of 16,711,808 yuan (about \$2 million), and pay a fine of 2 million yuan (about \$240,000) . The brokerage firm was also suspended from trading for two months. But, no manager or other individual was personally penalized in any way.
2. The first administrative case against false disclosure and misleading statements in connection with securities trading was decided on June 7, 1996. In this case, the named violators were the DaMing Group, its underwriter firm, accounting and auditing firm, and law firm that each provided service to facilitate the IPO of the DaMing Group. The CSRC's charges included misrepresentation of the listed company's outstanding share structure, omitting material facts, and false statements in its IPO Prospectus. The administrative penalty included a fine of 2 million yuan for the listed company and a warning to its board of directors. The named underwriter firm, accounting and law firms were respectively fined 400,000, 200,000, and 100,000 yuan. Again, no individual manager or other person was fined or named in the administrative action.
3. In December 1999, the Prosecutory Office of Chengdu City formally filed a criminal action against the chairman and key executives of HongGuang Enterprise (a listed company) for accounting fraud. On November 26, 1998, the company was fined, while its directors and executives were warned, in an administrative action by the CSRC. The company was found to have overstated its 1996 and 1997 earnings respectively by 157 million and 31.52 million yuan. On December 14, 2000, the court ruled against the defendants in the criminal case.

¹⁸ For details of these and other administrative cases, visit the CSRC website: <http://www.csrc.gov.cn>.

These and other administrative and criminal cases were taking place at a somewhat accelerated pace after 1995. It was happening against the following background. When the Shanghai Stock Exchange opened in December 1990, there were 45,000 individual stock accounts and most of the investors were Shanghai locals. As the stock market rose unstoppably in 1991 and 1992, the easy money generated much excitement, attracting more and more investors from all over the country. Occasional encouraging and possibly misleading editorials by the People's Daily and remarks by top leaders have also played a significant role in mobilizing the public to buy stocks.

By the end of 1999, there were 44 million stock accounts (this number went up to over 70 million by April 2003).¹⁹ As noted above, the wave of administrative actions against violators of securities rules started in early 1996, which coincided with the last phase of the 3-year long bear market that began in mid 1993. During this long bear market, many investors were stuck with losses, which motivated them to seek recovery. The investors were joined by professional and academic commentators to call for better enforcement of rules and ultimately for a "better" market. This wave of public pressure forced the CSRC to take more aggressive administrative actions in 1996 and afterwards. Thus, it is the first bear market, together with the fast-growing investor constituency, that led to public enforcement ("crash then administrative enforcement").

However, from the administrative actions, the public learned that first of all, managers and intermediaries responsible for misleading or cheating investors were not fined personally (but only given a verbal warning). It is usually the listed companies that were fined. That is, the shareholders, not the responsible violators, ultimately were paying for the fines. Secondly, shareholders who suffered losses were not given any piece of the

¹⁹ The number of investors is vastly different from the number of stock accounts. First, the same investor has to have one account with the Shanghai Stock Exchange and one with the Shenzhen Stock Exchange, if he or she is to trade stocks listed on both exchanges. So, the same investor is counted twice, implying the 70 million accounts must be divided at least by two. Second, investors often own multiple accounts to hide their identity by opening accounts using borrowed ID cards from others. This is a common practice especially among market manipulators, who have to hide their trades to evade regulators' attention. Some believe a realistic number of investors is more like 10 million or less. See Walter and Howie (2003) for more discussion.

administrative fines (the fines went to the Ministry of Finance). Thirdly, as in the later securities criminal cases, defendants may have been jailed, but that again did not help injured investors recover any financial loss.

Unable to benefit from administrative or criminal sanctions, investors learned about the limitations of the traditional emphasis on administrative and criminal penalties by the Chinese legal system. Not surprisingly, investors care more about recovering losses than about whether a violator is fined administratively or jailed. The public debate on private securities litigation soon gained momentum. Fortunately, in a country with a generally restricted press, the financial media have enjoyed increasingly more freedom, so investors, professionals and academics can openly discuss shareholder rights and civil litigation issues. The common economic interest led to the formation of a significant constituency, though for political reasons the government forbids any formal shareholder organization.

The Company Law of 1994 does provide ambiguous support for certain shareholder rights, including the right to seek compensation for damages due to financial fraud, misleading statements, market manipulation and so on. But, for the reasons mentioned above (e.g., the lack of operational guidance or legal interpretation from the SPC), the court refused to accept private securities litigation until years later.

In April 1999, a shareholder in Shanghai filed a civil suit against HongGuang Enterprise for damages due to accounting fraud (see the description of the first criminal case referred to above). But, for many months, the Shanghai court gave no answer as to whether the case would be accepted. Then, in early 2000, the court decided not to take on the case at all, refusing to enforce the law.

On December 29, 1998, the National People's Congress passed the PRC Securities Law, to be effective on July 1, 1999. Together with the Company Law of 1994, this marked the completion of the "laws on the books" concerning corporation formation, public offering and securities trading in China. However, it does not mean that injured investors could rush to court to seek damage recovery or to force a corporation's board and/or management to take shareholders' interest seriously.

The PRC Securities Law became effective in the midst of a stock-market bull run that started in January 1999 and ended in June 2001 (when the SSE Composite Index reached a

peak of 2218). During that period, accounting fraud, market manipulation and insider trading were rampant. The CSRC took 92 administrative actions against perpetrators (including 104 corporate entities and 270 individuals).²⁰ The media also reported on fraud cases. But, the bull market made the new law almost unnoticed for two years.

Within the first two years after the PRC Securities Law, investors made few attempts to seek damage recovery through litigation, and the judiciary was not in any hurry to draft a legal interpretation or procedural rules for the new law. When only some investors were suffering losses from fraud, the pressure for fast legal change could not be high. The court was reluctant to protect investors.

In its July 2001 issue, *Caijing* magazine's cover story featured a detailed account of the fraud scheme of Yorkpoint's stock. In its August issue, *Caijing* published an extensive investigative report on another high-profile corporation, YinGuangXia Enterprise.²¹ It was found that from 1998 to 2001, YinGuangXia fabricated sales receipts (with hundreds of millions yuan worth of exports to Germany) and lied to the market about various production facilities that actually never existed. The total amount of faked sales was over 1 billion yuan (about \$120 million). This scandal was a shock to not only the investor community but also the larger society in general. Many expected accounting fraud to be rampant but of a lesser nature, not so egregious. The YinGuangXia scandal was dubbed the "Enron of China". ----- These stories came out just as the stock market was suffering a major downturn from the June high of 2218 for the SSE Composite Index to around 1700 by the end of September (see Figure 2).

These events provided the needed crash for legal change. Disappointed investors started to demonstrate in front of the CSRC building. Key officials from the CSRC initiated meetings with the Supreme People's Court, urging the court to assume a more significant role in regulating securities markets through adjudicating cases. However, a typical Chinese official (whether in a bureaucratic position or in a judicial position) thinks in terms of territories of responsibility. In this case, matters related to stock trading were considered to be the sole responsibility of the CSRC, not that of the judicial system. Thus, even after the

²⁰ Visit the CSRC website for data on administrative actions: <http://www.csrc.gov.cn>.

²¹ See *Caijing's* website for current and past articles: www.caijing.com.cn.

CSRC's efforts to convince the court of its role, the judiciary showed much reluctance to join in.²²

On September 20, 2001, investors filed suits against the company and management of Yorkpoint Science & Technology, simultaneously in the No. 1 Intermediate Court of Beijing, the Intermediate Court of Guangzhou, and the Intermediate Court of Shanghai. Some investors in Jiangsu province were preparing to do so as well. Lawyers were also filing paperwork in different courts to sue the management and directors of YinGuangXia Enterprise and other responsible parties.

In the mean time, newspapers and TV were full of stories of angry investors, with articles detailing legal rules and remedies concerning securities litigation. A wave of lawsuits was in formation, challenging the Supreme People's Court and the entire PRC judicial system. To the Communist Party, this appeared to be too dangerous politically.

On September 21, 2001, the Supreme People's Court issued a notice directing all lower courts temporarily not to accept private securities lawsuits. Just as a private litigation storm was about to begin, such an announcement was a shock to everyone with a stake in the market or concerned about capital markets and legal development in China. It prompted an immediate outcry from various professions and interest groups. It fueled much further heated debate on not just market development, but also the rule of law in general and judicial roles in particular. That notice put the Supreme People's Court on the spotlight.

From several interviews given by the then Vice President of the Supreme People's Court, Mr. LI Guoguang, it became clear that the Court had the following concerns. First, as suits were filed against the same defendants and for the same cause but by different plaintiffs and in different lower courts, it became possible that there would be different rulings, the occurrence of which would jeopardize the reputation and credibility of the legal system. In the history of the PRC, there had never been such an instance in which numerous plaintiffs would simultaneously file separate lawsuits in different provinces but against the same

²² Private conversations with participants in these discussions between the CSRC and the Supreme People's Court suggest that senior officials from the Court were blaming the CSRC for all the securities trading related troubles and that the judiciary did not want to get involved. Protection of shareholder rights was not exactly the first thing on the Court's priority list.

defendants and for the same cause. How should the court system respond to this possible crisis? Could there be chaos, both legal and political? Second, if financially injured investors would each file an individual suit, the entire court system would be more than overwhelmed with securities litigation. Are there efficient ways to handle such mass litigation? Third, given the lack of prior experience in this area, the lower court judges had no uniform standards yet with regard to who has a standing to sue, what type of evidence is required, how damages are calculated, and so on. Finally, if there would be numerous lawsuits against all these listed firms and if the private plaintiffs would be awarded rightfully deserved relieves, it would lead to major losses of state assets (since the listed companies are majority state-owned). In such civil litigation, the defendant's interest is in fact the state's interest. This is precisely where the plaintiff's rights and state interest collide. Is there a compromise between the two? How can there be judicial independence? ----- These questions and reasons were sufficient to cause the Court to pause.

The extensive debate by legal experts in the media following the notice served as one of the best legal education opportunities for the public. It was during this period that even individuals with no legal training learned about what "class action" litigation means, why class action may be the best mechanism for securities litigation, why there should be more emphasis on civil liability than administrative or criminal liability, who should bear the burden of proof in securities litigation, why the court should accept private action suits, and so on. As a result, a large number of investors and readers can now comment on "class action" and the "burden of proof". Observing these developments from a "crash-then-law" perspective, one can see how a legal culture is developed in such a process.

On January 15, 2002, the Supreme People's Court issued a second notice dictating that lower courts may accept private securities litigation based on false disclosure and material misrepresentation, subject to the condition that administrative penalty has been imposed on the alleged fraud. However, the ban remains in place for private litigation based on other types of cause, such as insider trading and market manipulation.

While the second notice opened the door for private litigation in a limited way, the required pre-condition of an existing enabling government action was troubling and led to a new round of debate. The requirement was against the principle of judicial independence, and

it substantially compromised shareholder rights. It was also a fundamental re-write of the PRC Securities Law. The Supreme People's Court's justification was that the lower courts had no prior experience with securities litigation.

Nonetheless, within a week and on January 24, three investors went ahead in Harbin with separate actions against DaQing LianYi, a listed company, and its management for false disclosure and accounting fraud. Soon afterwards, 767 other investors sued the same defendants for the same claim. Since class action litigation is forbidden by the second notice, these separate cases had to be resolved individually. The Intermediate Court of Harbin conducted individual case hearings for two months from August to October 2002, but managed to go through only 94 out of the 770 suits.

In 2002, nine other listed companies and their respective managers, directors and other responsible parties were sued in different courts. Among them, YinGuangXia was named as a defendant in 1100 individual suits, again all for the same cause.

The PRC Private Securities Litigation Rules (hereafter, PSL Rules) were issued by the Supreme People's Court on January 9, 2003. The PSL Rules is the most detailed legal interpretation yet of the PRC Securities Law (with 37 articles), and it is a result of extensive consultation with legal and finance experts and scholars. This new interpretation still limits private securities litigation to false disclosure causes, and it still requires an enabling government action as a pre-condition for the court to accept a private suit, except that now the condition can be met by either an administrative penalty or a criminal court ruling. New restrictions are added as well. Among other things, Article 9 states that all PSL lawsuits must be filed with the intermediate court of the jurisdiction in which the listed firm is headquartered. The official justification for this rule is judicial convenience. This restriction is inconsistent with the PRC Civil Litigation Procedure Law, which gives the plaintiff a choice of jurisdiction between the plaintiff's local court and the defendant's. As noted earlier, local governments have a strong incentive to protect listed companies from their jurisdiction, and lower courts are known to favor local defendants. Thus, this restriction comes at the expense of shareholder rights and in favor of fraudulent listed firms.

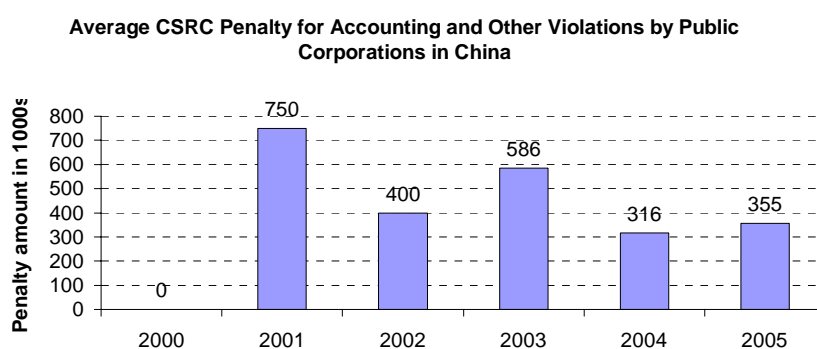
It has been almost six years since the PRC Securities Law became effective. Judicial rulings on earlier cases have yielded nominal recoveries that have disappointed

not only investors but also experts who were initially hopeful of legal protection for shareholders. The Securities Law which many people were counting on turned out to be not “biting” at all. The distance between the “law on the books” and the law in practice is thus not short. The court has been reluctant to deliver the investor protection as promised by the law.

3.4. Recent Trends

On the administrative enforcement front, the CSRC’s punitive actions against public corporations have been in decline since 2003. In Figure 4, the average penalty on public corporations for accounting fraud and other violations was RMB 750,000 in 2001, RMB 586,000 in 2003, and RMB 355,000 in 2005. This declining trend may have been in response to the government’s desire to push the stock indices higher. That is, as the thought among officials is usually that uncovering and penalizing “too many” fraudulent corporations may give too negative a picture, being more positive is often considered to be better for maintaining a good market environment.

Figure 4: As the stock indices have declined, so has CSRC enforcement of rules



Source: CSRC website www.csrc.gov.cn

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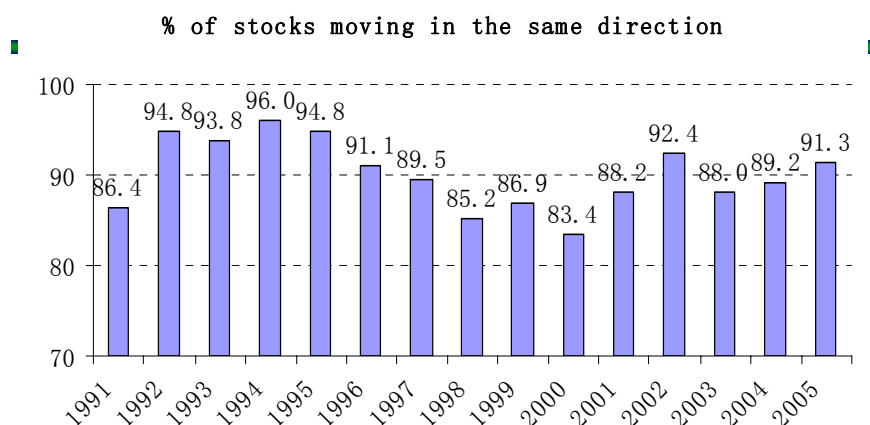
Another noticeable pattern is that since the stock market’s peak in mid 2001, the government has tried hard to rejuvenate investor sentiment, but failed to create any sustainable recovery. In this process, the CSRC has tightly controlled IPO admissions and

seasoned equity offerings. Even though many firms have been approved to go public, they all have to wait in an IPO queue before actually issuing public shares. The waiting time is uncertain, depending on when the regulators consider the market to be positive enough to let go a few IPOs. This is why even though there have been more qualified companies to go public in recent years the number of IPOs was only 71 in 2002, 67 in 2003, 100 in 2004 but only 15 in 2005 (see Table 1). Share supply management has been one of the key policy tools for the CSRC.

Much like in the late Qing, the PRC government has played an active role in sponsoring and managing the stock market. Have the government's "nurturing" and index management efforts improved the quality of the market? One way to measure the market's quality is to look at the degree of comovement among individual stock prices, that is, the average fraction of stocks that move in the same direction (up or down) in a given week. In a transparent stock market where reliable firm-specific information is abundant and legal enforcement of shareholder-friendly rules is secure, investors should be able to tell "good" from "bad" stocks so that stocks tend to move in their own ways.²³ On the other hand, the more opaque the stock market's informational and legal environment, the lower the investors' ability to distinguish among different types of companies and hence the more closely the individual stocks move. Figure 5 shows how this measure for China's stock market has evolved from 1991 to the present. It is clear from the chart that the market quality was in steady improvement between 1994 and 2000. But, since then, the government's interventions have made it more and more difficult for investors to tell the good from the bad companies. Market quality has not improved since then.

²³ See Akerlof (1970) for a classic model that can be extended to yield the conclusion here. This measure of comovement was first introduced by Morck, Yeung and Yu (2000). Chen (2005) examines this hypothesis in more detail using informational institutions such as the freedom of the press.

Figure 5: Has China's stock market improved?

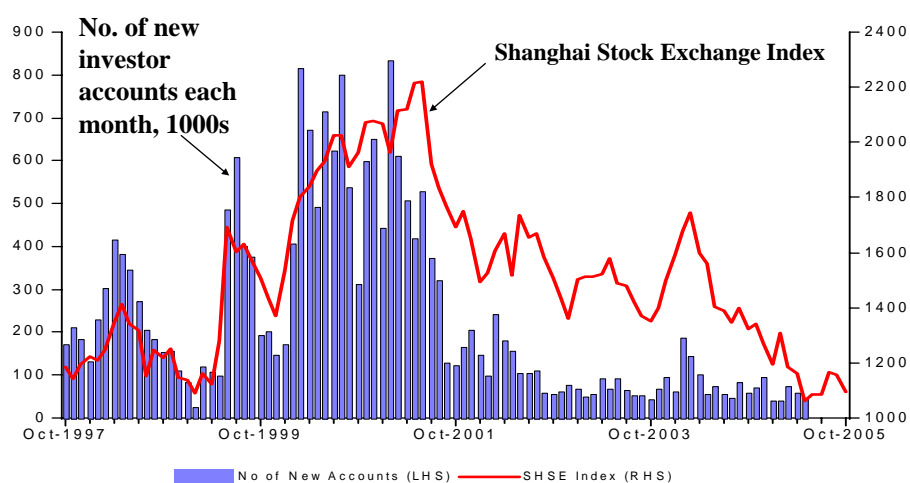


The higher (than 50%) the comovement level, the more opaque the market and hence the lower the market's quality. Data source: www.SinoFin.com.cn

As a comparison, in 1996, the U.S. had on average 57% of the stocks moving in the same direction, whereas Poland had the highest comovement level of 82%, according to Morck, Yeung and Yu (2000). In Figure 5, China in 2005 still had 91.3% of the stocks moving in the same direction, implying that China's stock market is the most opaque.

As a measure of investor confidence in the stock market, we can look at the number of newly opened accounts each month in Figure 6. Clearly, from the chart, this confidence measure has moved closely with the Shanghai Stock Exchange Composite Index: as the market moves lower, so does investors' interest. But, as seen in the chart, after the end of 2001 the sensitivity of the number of new accounts to stock market run-ups has been much lower than before, indicating a declining willingness on the part of the public to jump into the market. Thus, the government's frequent policy efforts to boost the market have increasingly played to deaf ears.

Figure 6: Evolution of Investor Confidence



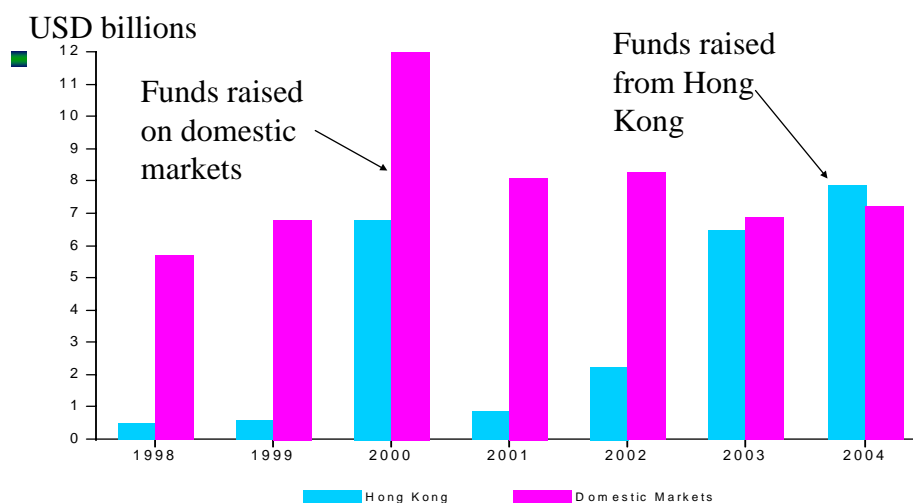
Source: CEIC

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3.5. Future Prospects

The administrative or “planned” nature of China’s stock market has stifled the market’s internal innovative energy, leaving little room for spontaneous institutional development afforded by the high growth pace of China’s economy. While access to the limited fund-raising capacity of the domestic stock market has been largely exclusively reserved for the SOEs, the demand for capital by Chinese companies and entrepreneurs has been growing fast. Consequently, a trend has been developing in which more Chinese companies go overseas to issue their stocks on the Hong Kong, New York and other markets. As Figure 6 illustrates, funds raised through the Hong Kong Stock Exchange alone surpassed the total raised on the mainland stock exchanges for the first time in 2004. While the data is not available in this chart for 2005, the IPO of the China Construction Bank in November 2005 alone raised about \$8 billion in Hong Kong. Equity capital raised in Hong Kong easily exceeded that raised domestically in 2005. Thus, overseas stock markets in Hong Kong, New York and elsewhere are playing a more important role for corporate China than the Chinese stock market itself.

Figure 7: Equity Funds Raised on Domestic Exchanges vs Hong Kong



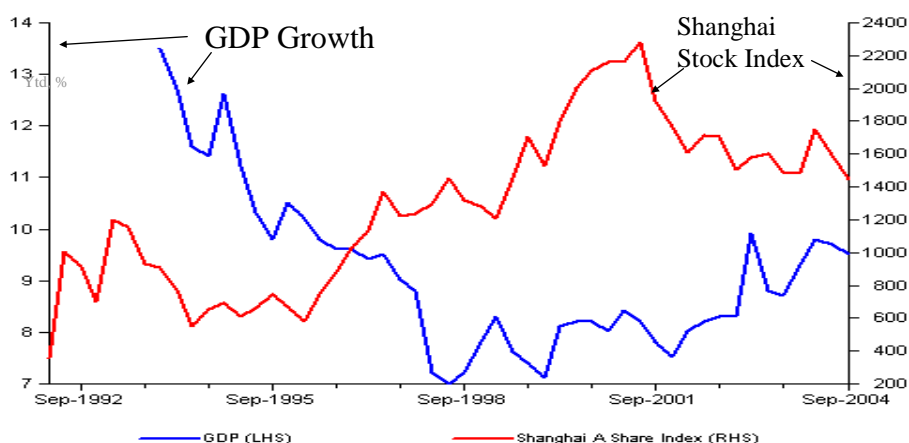
Source: CEIC

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To underscore the dominating importance of the Hong Kong Stock Exchange for China's economy, note that in recent years H-share prices (i.e., shares of mainland companies traded in Hong Kong) are far more closely correlated with China's GDP growth than the stock indices of Shanghai and Shenzhen. In Figure 8, we plot the Shanghai Stock Exchange Composite Index (right-hand scale) against the annual GDP growth of China (left-hand scale). Between 1994 and 1999, as the GDP growth rate declined, the stock index kept going higher. Between mid 2001 and 2005, the opposite occurred: the stock market went steadily down as the GDP growth rate increased. Therefore, the Chinese stock market as a whole has acted to determine stock prices in a way totally detached from the economic growth process. This can be due to several reasons. First, the public companies may be inefficiently managed so that even though their revenues may be growing (in relation to the higher GDP growth), their costs may be increasing faster, resulting in more losses instead of bigger profits. If this is the case, it means that the stock market has not imposed the right or enough discipline on the management of Chinese corporations, implying something is wrong with the functioning of the stock market. That is, the market may not have priced the good and the bad company stocks accordingly, sending the wrong or mixed signals to corporate managers. This in turn does not encourage corporations to become more efficient or more competitive. Second, the revenue and profit numbers disclosed by the companies are so unreliable and untrustworthy

that investors choose to simply ignore them and treat every stock the same: they are almost as good, or as bad, as others and they are indistinguishable. This leads to the high level of comovement among stocks as reported in Figure 5. In this case, the stock market as a whole is totally subject to speculative craze, moving up and down with the human emotions, instead of with economic fundamentals.

**Figure 8: China's Stock Market
as the Wrong Pricing Mechanism of its Assets?**



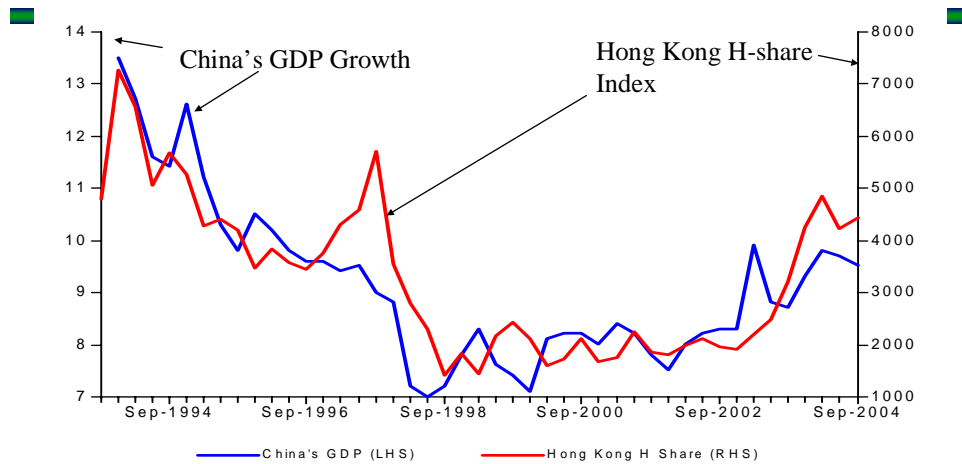
Source: CEIC

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Regardless of which reason of the above two is true, the mainland stock market is the wrong mechanism whose pricing outcome is detached from economics.

In contrast, the Hong Kong capital market functions to price Chinese stocks more in relation to the underlying economic values. We now plot in Figure 9 the H-share price index from Hong Kong (right-hand scale) together with China's GDP growth rate (left-hand scale). It is clear that the mainland H-share prices in Hong Kong move closely with China's GDP growth rate. This means the Hong Kong market is far less driven by emotions and fads than by economic fundamentals.

Figure 9: The Hong Kong H-Share Index vs. China's GDP Growth



Source: CEIC

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This trend of Hong Kong's capital market replacing the mainland's is likely to continue for the years to come, while China moves reluctantly into political and legal reforms. Even if China starts such reforms right away (which is not likely), it will, as the late Qing experience demonstrated, take many years for an acceptable degree of judicial and regulatory independence to be established. As shown in Chen (2005), freedom of the press is another necessary institution for a well-functioning capital market, but that can also take years to achieve in China.

The dependence of Chinese corporations on overseas stock markets will nonetheless present significant competitive pressure on the domestic markets. The rising nationalism in China will perhaps not let this trend continue forever, which can in turn pressure the government and the judiciary to take more serious steps towards developing a more reliable institutional infrastructure for capital markets.

4. Concluding Remarks

Stock markets are easy to set up: one can have some ownership claims issued and traded on a street or in a central physical or virtual location. But, developing a deep and liquid stock market is a totally different matter as it requires all sorts of legal, regulatory and

informational institutions. They serve to put meanings and substance to notions such as “fiduciary duty”, “fair disclosure”, “contracts”, “property rights”, and “fair value”. Since not so many countries have succeeded in putting all these institutions in a reasonable order, there are only a few liquid and deep stock markets around the world, including the U.S., the U.K., Germany and Hong Kong. In light of this basic fact, one should not be surprised that as a society in transition from a traditional to a modern nation, China has struggled for almost 150 years to get the public capital market and its associated modern corporate form right.

When China started its experimentation with the modern corporation in the late 19th century, it is understandable that the government had to come in to sponsor such ventures, providing implicit and explicit guarantees and assurances. Without a formal law of limited liability and fiduciary duty, the government’s or officials’ sponsorship served as a quick, short-term functional substitute. But, that sponsorship in the end stifled the market’s ability to grow endogenously, as the government’s sponsorship was transformed into officially sanctioned monopolies and “grabbing hands” instead of “helping hands”.

A century later in 1990, China’s new reformers faced a different challenge than their late Qing sympathizers. Now the state has too many hats: it is the largest shareholder in most of the public companies; it is the rule/law maker; it is the law enforcer; it is the market regulator; and it is the judiciary. All of these roles taken by various state organs that are all absolutely controlled by the Communist Party Central Committee have made it impossible for the judiciary, the market regulator and the law enforcer to be independent. For example, since the state is the largest shareholder in most public corporations, it is hard for the judges and the CSRC to be impartial in adjudication or regulations, respectively. Therefore, privatizing the state-owned shares and the SOEs is a first necessary step to afford the possibility of judicial and regulatory independence in China. Otherwise, China’s public capital markets would be difficult to develop. Fortunately, this step has been started and is continuing as the recent tradability reforms for state and legal-person shares have indicated.

In the near term, the Hong Kong public capital markets and the mainland private equity market are realistically the main ways for Chinese businesses to raise financing and for investors, domestic and foreign, to profit from China’s on-going growth story.

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Table 1: IPO Listings and Capital Raising on China's Stock Market

Data used in this table are graciously provided by www.SinoFin.com.cn.

	No. of New Listings in Each Year	Total Amount Raised through IPO and SEO (Million Yuan)
1991	13	500
1992	38	9,409
1993	113	31,454
1994	106	13,805
1995	23	11,886
1996	185	34,152
1997	200	93,382
1998	101	80,357
1999	97	89,739
2000	136	154,086
2001	79	118,214
2002	71	96,175
2003	67	65,974
2004	100	61,057
2005	15	33,621

Table 2: Raising Capital through the Stock Market Across Countries

Note: The total amount of capital raised includes both IPO and seasoned equity offerings on the stock market. The ratio reported below is the total capital raised divided by the country's GDP in the same year. This table was originally published in Chen (2003).

	China	US	Japan	Germany	France
1991	0.02%			0.23%	
1992	0.36%	0.90%		0.06%	
1993	0.91%	1.64%	0.16%	0.11%	
1994	0.30%	1.64%	0.08%	0.03%	0.18%
1995	0.20%	1.08%	0.20%	0.27%	0.29%
1996	0.50%	1.26%	0.54%	0.56%	1.94%
1997	1.25%	1.72%	0.27%	0.29%	0.08%
1998	1.02%	2.35%	0.74%	2.74%	0.88%
1999	1.09%	1.34%	0.93%	1.04%	0.85%
2000	1.72%	2.03%	0.90%	1.44%	1.44%
2001	1.20%	2.33%	0.49%	0.29%	1.56%
2002	0.94%	1.26%	0.34%	0.20%	0.85%
Average	0.79%	1.60%	0.47%	0.61%	0.90%
Std Deviation	0.65%	0.25%	0.13%	0.02%	0.47%