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LAW AND FINANCE: THE CASE OF STOCK MARKET DEVELOPMENT IN CHINA

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Abstract: Having grown to one of the largest in the world in just over two decades, China's stock market is cited as a counterexample to the significance of law for financial market development. A thorough examination of the development of China's stock market, however, finds that law is actually critical to sustaining growth. On the other hand, the trajectory of development in China is growth first followed by law, and the improvement of law is caused by market growth. The experience of China suggests that law and market growth exhibit a bidirectional rather than unidirectional causal relationship, and the course of development is "growth-law-further growth." Nevertheless, this virtuous cycle is not a guarantee and market growth may not lead to stronger law in all instances, as evidenced by the fact that, although now better protected from market abuse, Chinese investors remain vulnerable to serious managerial misconduct at listed state-owned enterprises. Political and ideological constraints are the key obstacle. Politics and ideologies seem to be fundamental to stock market development, for they not only explain the stagnation of law in China despite market growth, but also, together with economic development, determine market growth, or lack thereof, in the first place. Furthermore, the strength of law in a country might not be predetermined by its legal origin, as law has improved in certain respects even in China—a country without the tradition of rule of law.

INTRODUCTION

Despite various peculiarities and having the reputation of being "worse than a casino," the stock market of mainland China has grown to prominent stature since the opening of the Shanghai and Shenzhen Stock Exchanges in 1990.[1] Since 2007, the total market capitalization of these two stock ex-

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[1] Anthony Kuhn, *Chinese Markets 'Worse Than a Casino,'* L.A. TIMES (Mar. 29, 2001), http://articles.latimes.com/2001/mar/29/business/fi-44137 [https://perma.cc/X3WW-TWQX]; Richard McGregor, *Crackdown on Corruption Splits Beijing*, FIN. TIMES, Feb. 13, 2001, at A14.

changes has been greater than almost all stock markets, trailing only the United States' New York Stock Exchange and NASDAQ.[2] In addition, average daily trading value is second only to the U.S. exchanges.[3] In terms of funds raised via initial public offerings (IPOs), mainland China ranked first in 2007, 2010, and 2011, and second in 2008, 2009, and 2012.[4] Since 2012, China boasts more than 170 million stock trading accounts and tens of millions of investors.[5]

This rapid growth in China's stock market contradicts the findings of well-known law and finance research that concludes that legal protection of investors is essential for financial market development.[6] It is commonly regarded that Chinese law, in general, and investor protection, in particular,

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[2] *See Market Capitalization of Listed Domestic Companies (Current $US) (2011–2015)*, WORLD BANK, http://data.worldbank.org/indicator/CM.MKT.LCAP.CD [https://perma.cc/M43P-KUHY] (last visited May 19, 2016); *Market Capitalization of Listed Domestic Companies (Current US$) (2006–2010)*, WORLD BANK, http://data.worldbank.org/indicator/CM.MKT.LCAP.CD?page=1 [https://perma.cc/3Z4F-TUS4] (last visited May 19, 2016). It has been argued that the official market capitalization data of the Chinese exchanges was a huge exaggeration because the data was calculated based on the prices of shares traded on the stock exchanges, but shares of listed companies in China were divided into state, legal person, and public shares (each accounting for about a third of the total). Only public shares were tradable on the exchanges, and the prices recorded for off-exchange transactions of state or legal person shares were much lower than the trading prices of public shares. *See* CARL E. WALTER & FRASER J.T. HOWIE, PRIVATIZING CHINA: INSIDE CHINA'S STOCK MARKETS 121–24 (2d ed. 2006). For the classification of shares of listed companies in China, see STEPHEN GREEN, CHINA'S STOCK MARKET: A GUIDE TO ITS PROGRESS, PLAYERS AND PROSPECTS 15–18 (2003). In 2005, however, the Chinese government launched a reform to convert the non-tradable state and legal shares into tradable shares, and by the end of 2009, the restriction on the tradability of state and legal shares was history. *See* WALTER & HOWIE, *supra*, at 121–24.

[3] *See, e.g.*, WORLD FED'N OF EXCH., MONTHLY REPORT: EQUITY: VALUE OF SHARE TRADING (2015) (on file with author). The daily trading value sometimes exceeded the figure of the United States during the boom time of the first half of 2015. Laura He, *China's Equity Mania Intensifies—Daily Trading Volume Now 4x NYSE*, DAVID STOCKMAN'S CONTRA CORNER (Mar. 27, 2015), http://davidstockmanscontracorner.com/chinas-equity-mania-intensifies-daily-trading-volume-now-4x-nyse/ [https://perma.cc/7ABY-NF5S].

[4] *See Greater China IPO Watch 2009*, PRICEWATERHOUSECOOPERS 12 (2009), http://www.lefigaro.fr/assets/pdf/Etude%20IPO%20Chine.pdf [https://perma.cc/UG2B-2U3M]; *Greater China IPO Watch 2012*, PRICEWATERHOUSECOOPERS 20 (2012), http://www.pwchk.com/webmedia/doc/635025856837447502_gc_ipo_survey_rpt_apr2013.pdf [https://perma.cc/FU2R-UG2Z].

[5] *China Securities Registration and Settlement Statistical Yearbook*, CHINA SECURITIES DEPOSITORY AND CLEARING CORP. LTD. 4 (2012), http://www.chinaclear.cn/zdjs/editor_file/20130906103133909.pdf [https://perma.cc/XW3G-MB9B]. An investor needs to open an account at the China Securities Depository and Clearing Corporation (CSDCC) to trade shares listed in Shanghai or Shenzhen. The actual number of investors is smaller than the total number of trading accounts, because an investor needs to open a trading account separately to trade shares in Shanghai or Shenzhen. *See id.* at 9.

[6] *See* Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430, 463 (2008); Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 474 (1999); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1151–52 (1998); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1149 (1997).

are extraordinarily weak. According to the Worldwide Governance Indicators, between 1996 and 2012, China was within the range of 36.36th to 38.86th percentile rank in rule of law among all of the 215 economies under assessment.[7] In the World Bank's "Doing Business" report, China ranked 93rd in 2010 and 97th in 2011 out of 183 economies in "protecting investors."[8] The 2013–14 Global Competitiveness Report ranked China 75th among 148 economies in "[p]rotection of minority shareholders' interests," 80th in "[s]trength of auditing and reporting standards," and 84th in "[e]fficacy of corporate boards."[9] It seems that the stock market in China has been able to grow rapidly notwithstanding the perceived weak investor-protection law. Indeed, in examining the links between law, finance, and economic growth in China, Franklin Allen concluded that China is "an important counterexample" to the significance of law.[10]

Is China indeed a counterexample? Is it true that investor protection has not played a role in China's stock market development? These are intriguing and important questions. The connection among law, financial market development, and economic growth has been widely accepted, as evidenced by the fact that both the World Bank and the World Economic Forum use investor protection as an indicator of the business environment or competitiveness of economies around the world.[11] Nevertheless, if the answer to those questions is "yes," the "law matters" thesis would be cast into serious doubt, considering that China has been able to rapidly develop its stock market into one of the world's largest. Moreover, as a live case of great magnitude, China's experience could offer valuable insights into other law and finance issues, such as whether the positive correlation between investor protection and financial market development found by the law and fi-

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[7] *Worldwide Governance Indicators (1996–2014)*, WORLD BANK, http://info.worldbank.org/governance/wgi/index.aspx#home (select "Download Full Data Set (Excel)"; open Excel file; and choose "Rule of Law" tab) [https://perma.cc/33FF-LY9Q].

[8] WORLD BANK & INT'L FIN. CORP., DOING BUSINESS IN A MORE TRANSPARENT WORLD 88 (2012), http://www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB12-FullReport [https://perma.cc/QK3N-2DPE] [hereinafter DOING BUSINESS 2012]; WORLD BANK & INT'L FIN. CORP., DOING BUSINESS 2011: MAKING A DIFFERENCE FOR ENTREPRENEURS 156 (2011), http://www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB11-FullReport.pdf [https://perma.cc/7V36-F8J3] [hereinafter DOING BUSINESS 2011].

[9] WORLD ECON. FORUM, THE GLOBAL COMPETITIVENESS REPORT 2013–2014, at 156–57 (Klaus Schwab ed., 2013), http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2013-14.pdf [https://perma.cc/TRU5-D9GH].

[10] Franklin Allen et al., *Law, Finance, and Economic Growth in China* 36 (Wharton Fin. Inst. Ctr. Working Paper No. 02-44, 2002).

[11] *See* DOING BUSINESS 2012, *supra* note 8, at 88; DOING BUSINESS 2011, *supra* note 8, at 156; WORLD ECONOMIC FORUM, *supra* note 9, at 157.

nance research[12] is due to a causal relationship from investor protection to market growth or the opposite;[13] whether the strength of investor protection in a country is predetermined by the legal origin[14] or shaped by the modern politics;[15] whether formal law for investor protection can be substituted by informal institutions;[16] and why a market grows in the first place.

China's stock market thus deserves more attention and a thorough and in-depth analysis. To achieve this end, this Article undertakes a detailed and comprehensive investigation into the history of China's stock market development. It takes a qualitative approach to examine on-the-ground developments and examines the whole history, rather than the state of the market at a specific point of time, in order to gain a full and holistic view. The Article finds that, rather than being a counterexample, the case of China demonstrates that investor protection is critical to sustaining market growth and informal institutions cannot substitute for formal law. It is true that investor protection was hardly relevant to the rapid growth of the market before mid-2001, but weak law led to ubiquitous frauds (in particular, market manipulation, false information disclosure, and misappropriation of corporate assets) towards the end of the 1990s and early 2000s, bringing the market into severe crisis and even to the verge of complete collapse.[17]

To no avail, the government was forced to take various measures to prop up the market. It was only after actions were taken to curb fraud and a degree of law and order had been established that the stock market recovered in 2006.[18] When fraud was systemic, even a government as interventionist and powerful as the Chinese could not stop the market from declining, and the market could only survive after a degree of law and order was established. Moreover, between 2010 and the end of 2014, the market was again in a prolonged bear state, resulting in a suspension of IPOs for more than one year.[19] The cause was the low profitability of listed companies, which was in turn partly attributable to widespread managerial corruption, waste, overinvestment, and mismanagement at listed state-owned enterprises (SOEs) that still dominate Chinese exchanges.[20] Although investors are

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[12] *See* La Porta et al., *Law and Finance*, *supra* note 6, at 1152; La Porta et al., *Legal Determinants of External Finance*, *supra* note 6, at 1149.

[13] *See* John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 80–81 (2001).

[14] *See* La Porta et al., *Law and Finance*, *supra* note 6, at 1116; La Porta et al., *Legal Determinants of External Finance*, *supra* note 6, at 1149–50.

[15] *See* Mark J. Roe, *Legal Origins, Politics, and Modern Stock Markets*, 120 HARV. L. REV. 460, 516–17 (2006).

[16] *See* Allen et al., *supra* note 10, at 2.

[17] *See infra* Part I.B.

[18] *See infra* Part I.C.

[19] *See infra* Parts I.D. and I.E.

[20] *See id.*

now better protected from market fraud, they are still vulnerable to managerial misbehavior at listed SOEs. It is evident that when investor protection is weak and managerial misconduct unchecked, corporate profitability suffers, market volatility reigns, and growth capacity shrinks.

Nonetheless, the experience of China shows that the scope of investor protection investigated by the law and finance research and assessed by the World Bank and World Economic Forum is too narrow. It focuses on shareholders' rights against their companies and managers. But the severe crisis China's stock market encountered in the early 2000s was a result of market abuse by miscreant stock traders as well as false disclosure by listed companies and asset appropriation by controlling shareholders.[21] Investor protection in China in these areas has improved noticeably, but this has not been captured by those assessments because of their narrow coverage. The research that finds China is a counterexample also misses the improvement, not just because of its narrow coverage but also because of its static research approach, capturing only a snapshot at a time.

Second, this Article finds that, although law is critical to sustaining growth, the trajectory of development in China is growth first followed by law. China's stock market emerged and experienced waves of "fever" even before a basic legal and regulatory framework was in place; although laws were quickly adopted in 1993 after the market regulator, the China Securities Regulatory Commission (CSRC), was set up, they were largely unenforced throughout the 1990s, resulting in pervasive fraud and sustained market volatility.[22] But by the early 2000s, the number of investors had grown to tens of millions.[23] They became a powerful political constituency whose complaints and discontent the government could no longer ignore; moreover, as the market grew to a substantial scale, it became significant to the national economy and strategic for economic reform, motivating the government to crack down on fraud in order to restore investor confidence and revive the market.[24] The experience of China demonstrates that the causal relationship between investor protection and market growth is bidirectional rather than unidirectional. The course of development is growth first, followed by the improvement of law, which allows the market to grow further.

The virtuous cycle of "growth-law-further growth," however, is not a guarantee, and market growth may not always lead to better investor protection, as evidenced by the fact that serious managerial misconduct remains rampant among listed SOEs in China. So why has growth led to the reduc-

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[21] *See infra* Part I.C.

[22] *See infra* Part II.B.

[23] *See* Zhiwu Chen, *Capital Markets and Legal Development: The China Case*, 14 CHINA ECON. REV. 451, 462 (2003) [hereinafter Chen, *Capital Markets*].

[24] *See id.*

tion of market abuse but not managerial misconduct? The answer lies first in the dominance of state ownership in those listed SOEs. Because of such dominance, serious agency problems inherent with state ownership remain, and the incentives for managers to steal and shirk remain unchanged.[25] On the other hand, the reduction of market fraud is currently achieved largely through public enforcement of securities laws by the CSRC and the two exchanges under its control, but the agency's remit to oversee the management of listed companies is limited and it has no authority to take legal action against managerial corruption.[26] In the meantime, private enforcement of the law is negligible and Chinese courts have proven useless for investor protection.[27] Lastly, when corruption is endemic in the whole country, it is unrealistic to expect SOE managers to be any more honest. Apparently, the dominance of state ownership, the ineffectiveness of the judiciary, and the macro legal environment explain why managerial misconduct persists. Apparently, the dominance of state ownership is due to the remaining socialist ideology that favors public over private ownership as well as the Communist Party of China (CPC)'s political consideration to maintain its rule, which also explains the impotence of the court system.[28] This shows that, although investor protection may strengthen as a result of market growth, this is not always the case, and fundamental politics and ideologies are the root obstacle.

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

Lastly, why did China's stock market grow in the first place? Its market growth was the natural progression and outcome of liberalizing the ultra-leftist ideology, which regarded capitalism as being evil and the stock market the icon of capitalism, and the planned economic system, which banned private ownership of the means of production.[29] Without such liber-

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[25] *See* Alvaro Cuervo-Cazurra et al., *Governments as Owners: State-Owned Multinational Companies*, 45 J. INT'L BUS. STUDIES 919, 931 (2014), http://www.palgrave-journals.com/jibs/journal/v45/n8/pdf/jibs201443a.pdf [https://perma.cc/Z8NT-5642].

[26] *See infra* Part IV.A.

[27] *See id.*

[28] *See id.*

[29] WAYNE MORRISON, CONG. RESEARCH SERV., RL33534, CHINA'S ECONOMIC RISE: HISTORY, TRENDS, CHALLENGES, AND IMPLICATIONS FOR THE UNITED STATES 4, 28 (Oct. 21, 2015), https://www.fas.org/sgp/crs/row/RL33534.pdf [https://perma.cc/87PD-L22Y].

alization, the shareholding system could not emerge and the stock exchanges would not be allowed to open and grow. Next, this is also because rapid economic growth as a result of liberalization generated huge financing demand and, in the meantime, household disposable income increased rapidly as a result of economic growth, providing sufficient finance to meet demand.[30] Finally, Chinese people in the 1990s did not have much choice but to invest in the stock market or leave their money in banks with low interest rates.[31]

On the other hand, there are several other reasons that explain the low corporate profitability that underscores the bear market and sluggish growth between 2010 and 2014. First, despite liberalization, the current socialist market economic system still favors state ownership, allowing inefficient SOEs to dominate the stock market. It also allows them to monopolize the lucrative business sectors like finance and telecommunications, which ensures that even private listed companies, albeit more efficient, have low profitability due to exclusion from those lucrative industries.[32] Such favoritism is again rooted in the socialist ideology that favors public ownership and the CPC's political consideration to maintain its rule.[33] Second, corporate profitability is also undermined by excessive government bureaucracies that increase the cost of doing business in China, for which the political system with unchecked government powers is responsible to a degree. Third, the low profitability of listed companies is further explained by their lack of technologies, brand names, managerial expertise, innovation, etc., which is not unusual for a developing country like China.[34] Last, from the mid-2000s, the booming real estate market has provided Chinese people a highly profitable alternative investment opportunity, and the emergence of shadow banking in the late 2000s offered investors even more options.[35]

Part I of this Article examines the growth history of China's stock market. Part II reviews the development of the legal and regulatory frameworks and the evolution of investor protection in China. Part III analyzes the role of investor protection in different stages of market development. Part IV assesses the causal relationship between investor protection and market growth and explores why the stock market of China grew in the first place.

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[30] *See* Allen et al., *supra* note 10, at 4.

[31] *See* Ding Chen, *Developing a Stock Market Without Institutions—The China Puzzle*, 13 J. CORP. L. STUD. 151, 172–74 (2013) [hereinafter Chen, *The China Puzzle*].

[32] *See infra* Part IV.B.

[33] *See* Nan Lin, *Capitalism in China: A Centrally Managed Capitalism (CMC) and Its Future*, 7 MGMT. & ORG. REV. 63, 63 (2011).

[34] *See* Scott Cendrowski, *China's Global 500 Companies Are Bigger Than Ever—And Mostly State-Owned*, FORTUNE (July 22, 2015), http://fortune.com/2015/07/22/china-global-500-government-owned/ [https://perma.cc/BH8T-HARZ].

[35] *See infra* Part IV.B.

I. The Growth of China's Stock Market

China's experience with the stock market dates back more than a century. In the mid-1930s, Shanghai was the financial center of the Far East. Stock exchanges also operated in Beijing and Tianjin before the People's Republic of China (PRC) was established in 1949.[36] Although the turbulent pre-PRC history is informative, this Article focuses on the stock market that has developed since 1978, when the CPC, under the leadership of Deng Xiaoping, decided to abandon far-left ideologies and shift the nation's attention from political and ideological campaigns to economic development. Since then, the whole history of the stock market can be divided into five stages: (1) pre-1992, when the shareholder system emerged and the stock exchanges were opened; (2) between 1992 and mid-2001, when the market experienced rapid growth; (3) between mid-2001 and 2005, when the stock market was in crisis; (4) between 2006 and 2009, when the market recovered and experienced an enormous boom and crash; and (5) between 2010 and 2014, when the market exhibited sharpened contraction.

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

The first green shoots of the shareholding system emerged in rural areas.[37] The shareholding system began as an alternative to government finance for town and village enterprises, which expanded rapidly after the agriculture sector was de-collectivized. It was also used to organize rural cooperatives to distribute returns to villagers. It was in urban China, however, that the shareholding system developed rapidly and the stock market emerged. As far-left ideologies and economic planning were relaxed through China's great awakening, enterprises were allowed to produce beyond their plan quotas to fulfill market demand. But government finance was in severe shortage, making the shareholding system particularly useful to raise money from other sources and fund the expansion of production. [38] There was also the urgent need to

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[36] *See* William N. Goetzmann et al., *China and the World Financial Markets 1870–1939: Modern Lessons from Historical Globalization*, 60 ECON. HIST. REV. 267, 273 (2007); William C. Kirby, *China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China*, 54 J. ASIAN STUD. 43, 47 (1995). For the pre-PRC history of the Shanghai Stock Exchange, see W.A. THOMAS, WESTERN CAPITALISM IN CHINA: A HISTORY OF THE SHANGHAI STOCK EXCHANGE (2001).

[37] *See* HONGRU LIU, TUPO—ZHONGGUO ZIBEN SHICHANG FAZHAN ZHI LU (突破一中国资本市场发展之路）［BREAKING THROUGH—THE ROAD OF CHINA'S CAPITAL MARKET DEVELOPMENT] 1, 139 (2008).

[38] ZHANGZHE LI, ZHONGGUO GUSHI FENGYUN DANGAN (中国股市风云档案）［CHINESE STOCK MARKET SITUATION FILES] 1, 10–12 (2011) [hereinafter LI, CHINESE STOCK MARKET].

create jobs, especially for those "sent-down youth" who returned to cities from the countryside after the Cultural Revolution ended.[39] At this early stage, most of the shares that were issued were in fact debts rather than equities, as they bore the right to returns at a fixed rate as well as the right of redemption at request.[40] Invariably, shares were issued internally to employees or to other connected enterprises, and enterprises issuing shares were mostly collective rather than SOEs.[41]

From 1984, the focus of China's economic reform shifted to cities, and the central task was to revitalize ailing SOEs. Inspired by the success of the "household responsibility system" in rural areas, the government encouraged SOEs to establish "responsibility systems."[42] Some local governments went further to experiment with the shareholding system. For example, in 1986, the Shenzhen government initiated a pilot scheme to transform SOEs into shareholding companies.[43] A breakthrough came in 1987 when, in addition to legalizing private enterprises, the CPC proposed to separate the ownership and management of SOEs and endorsed the shareholding experiment.[44] It was claimed that the system was not innately capitalist and that transforming SOEs into companies with a majority of state ownership would not lead to privatization and capitalism; instead, it could facilitate the separation of ownership and control, helping rationalize the management of SOEs.[45] Subsequently, a flurry of share issuances swept over the country. More than 6000 shareholding enterprises were set up across the country by the end of 1987, and 3800 were added in 1988.[46] Certainly, the rapid accu-

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[39] *See, e.g.*, *id.* at 13–22; Kathrin Hille, *China's 'Sent-Down' Youth*, FIN. TIMES MAG. (Sept. 20, 2013), http://www.ft.com/intl/cms/s/2/3d2ba75c-1fdf-11e3-8861-00144feab7de.html [https://perma.cc/23XT-H4XT].

[40] GREEN, *supra* note 2, at 9.

[41] *Id.*

[42] *See id.* at 10; CARL E. WALTER & FRASER J.T. HOWIE, 'TO GET RICH IS GLORIOUS!': CHINA'S STOCK MARKETS IN THE '80S AND '90S, 21 (2001).

[43] Shenzhen Jingji Tequ Guoying Qiye Gufenhua Shidian Zanxing Guiding (深圳经济特区国营企业股份化试点暂行规定) [Provisional Regulations on the Pilot Program for the Transformation of State-Owned Enterprises of Shenzhen Special Economic Zone into Shareholding Companies] (promulgated by the Shenzhen Mun. People's Gov't, Oct. 1987) [hereinafter Provisional Regulations on the Pilot Program], *in* JINRONG FALU FAGUI QUANSHU (金融法律全書) [A WHOLE COLLECTION OF FINANCIAL LAWS AND REGULATIONS], Vol. 3, 2815–18 (1997).

[44] Ziyang Zhao, *Yanzhe You Zhongguo Tese de Shehuizhuyi Daolu Qianjin: Zai Zhongguo Gongchandang Di Shisanci Quanguo Daibiao Dahui Shangde Baogao* (*March Along the Road to Socialism with Chinese Characters: Report to the 13th Congress of CPC*), RENMIN RIBAO (PEOPLE'S DAILY) (Oct. 25, 1987).

[45] *See* Ziyang Zhao, *Zai Zhongguo Gongchandang Di Shisanjie Zhongyang Weiyuanhui Di Sanci Quanti Huiyi Shangde Baogao* (*Report to the 3rd Plenum of the 13th Central Committee of CPC*), PEOPLE (Sept. 26, 1988), http://cpc.people.com.cn/GB/64162/64168/64566/65385/4441840.html [https://perma.cc/64DU-6M72].

[46] *See* WALTER & HOWIE, TO GET RICH IS GLORIOUS!, *supra* note 42, at 6.

mulation of household savings as a result of economic growth ensured that these share issuances were possible.[47]

Once having acquired shares, holders started to trade them. Markets for trading shares emerged spontaneously at places like factory gates, street corners, and open markets—so-called "kerb trading."[48] From 1986, state-owned banks in some cities started to provide over-the-counter (OTC) service for stock trading, in addition to trading government bonds. The first OTC market for trading stocks was opened in Shanghai in September 1986 by a local branch of the Industrial and Commercial Bank of China (ICBC).[49] As more shares were issued in 1987 and 1988, local governments were active in setting up OTC markets.

During this period, the shareholding system and stock market were in their very early infancy, and the miniscule amount of funds raised through issuing shares was dwarfed by the amount raised via government and enterprise bonds.[50] It was only an experiment for SOE reform. The mainstream reform measure was the "responsibility system," which allowed SOEs to retain some profits and to have more managerial autonomy.[51] Enterprises adopting the shareholding system were collective or small SOEs. Among them, the norm was to issue shares internally, and the number of enterprises issuing shares publicly was fewer than ninety.[52] Issuance was poorly received. For example, when the Shenzhen Development Bank, the bellwether of China's stock market development in the 1990s, offered shares to the public in 1987, only 50% were subscribed even after the local government mobilized CPC cadres and government employees to buy.[53] In the following year, *Vanke*, now the largest real estate developer in China, did not fare any better.[54] The trading market was lethargic. For instance, the turnover value on the OTC market in Shenzhen was only RMB 4 million for all of 1988.[55]

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[47] *See* Sonia Wong Man Lai & Yong Yang, *From Scorned to Loved? The Political Economy of the Development of the Stock Market in China*, 38 GLOB. ECON. REV. 409–29 (2009). For example, household bank deposits increased almost tenfold between 1980 and 1988. *See* NAT'L BUREAU OF STAT. OF CHINA, STATISTICAL COMMUNIQUÉ OF THE PEOPLE'S REPUBLIC OF CHINA 7 (1988).

[48] GREEN, *supra* note 2, at 9.

[49] LI, CHINESE STOCK MARKET, *supra* note 38, at 52–60. The Industrial and Commercial Bank of China is one of the "big four" state-owned commercial banks of China. *Id.*

[50] *See* CHINA SEC. REG. COMM'N, CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, 6–9 (2012).

[51] *See Reform of State-Owned Enterprises in China*, CHINA LABOR BULLETIN (Dec. 19, 2007), http://www.clb.org.hk/en/content/reform-state-owned-enterprises-china [https://perma.cc/26ZM-9Q34].

[52] *See* LIU, *supra* note 37, at 142–43.

[53] *See* WALTER & HOWIE, *supra* note 2, at 23.

[54] *See* LI, CHINESE STOCK MARKET, *supra* note 38, at 78.

[55] LIU, *supra* note 37, at 84.

But the situation changed dramatically after a wave of "share fever" broke out in Shenzhen in 1990, which was singlehandedly triggered by the Shenzhen Development Bank.[56] In March 1989, the Bank declared a generous dividend. Subsequently, its share price rose steadily, only interrupted in June by the tragic ending of the Tiananmen Square student protest.[57] Expecting generous dividends again, the share price of the bank started to pick up in January 1990, and by March, it had nearly tripled.[58] The expectation turned out to be true, and subsequently between March and June of 1990, the share price saw another jump of almost 600%.[59] The other four companies listed on the OTC market in Shenzhen performed equally well. Seeing fortunes gained overnight, more people rushed to the market and money from other parts of the country flooded in. The trading value on the OTC market increased more than twenty-three fold between January and May 1990.[60] The black market trading schemes also flourished, and people congregated at street corners and in parks to trade shares.[61] The whole city was in frenzy.

This speculation fever came to the attention of the central government. It warned against the danger of speculation and ordered the restriction of the shareholding experiment in the country.[62] The Shenzhen government took heed and tried to bring the market under control: a 10% limit for daily price movements was introduced; a stamp duty and capital gains tax were imposed; the limit on daily price increases were further reduced to 5%, 1%, and then 0.5%; and CPC and government officials were ordered to sell their shares.[63] Eventually, the fever cooled and share prices began to drop in November 1990.[64]

Although the 1990 "share fever" in Shenzhen was short-lived, it was a milestone in China's stock market development. It educated the country that the purpose of buying shares is not just to receive dividends, but also that

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[56] *See* WALTER & HOWIE, TO GET RICH IS GLORIOUS!, *supra* note 42, at 7.

[57] ZHANGZHE LI, ZHONGYU CHENGGONG: ZHONGGUO GUSHI FAZHAN BAOGAO (终于成功：中国股市发展报告）［FINALLY SUCCEEDED: THE DEVELOPMENT OF CHINA'S STOCK MARKET REPORT] 120–21 (2000) [hereinafter LI, FINALLY SUCCEEDED].

[58] ROSS GARNAUT & LIGANG SONG, THE CHINA BOOM AND ITS DISCONTENTS 177 (2005).

[59] LIU, *supra* note 37, at 62.

[60] *Id.* at 63.

[61] KUI A, XUANHUA YU SAODONG—XINZHONGGUO GUSHI ERSHINIAN (喧哗与骚动：新中国股市二十年）［TUMULT AND FERMENT—TWENTY YEARS OF CHINA'S STOCK MARKET]) 26 (2008).

[62] Guanyu Xiang Shehui Gongkai Faxing Gupiao De Gufenzhi Shidian Wenti De Tongzhi (国务院办公厅关于向社会公开发行股票的股份制试点问题的通知) [Notice on Issues Regarding Shareholding Experimentation with Public Issuance of Shares] (promulgated by the General Office of the State Council, Dec. 26, 1990), http://pkulaw.com/fulltext_form.aspx?Db=chl&Gid=4921 [https://perma.cc/QZ6P-T8HU].

[63] LIU, *supra* note 37, at 84–85.

[64] WALTER & HOWIE, *supra* note 2, at 25.

big money could be made when share prices increased. For the first time, it ignited the enthusiasm of mainland Chinese for stock investment. This enthusiasm underscored the resulting rapid growth of the stock market and explains why there have been so many individual investors in China.[65]

After the Tiananmen Incident in 1989, Beijing was once more seized by political dogma. Conservatives had the upper hand and economic reform stalled.[66] It was a surprise that the Shanghai and Shenzhen Stock Exchanges were even allowed to open at the end of 1990, when economic liberalization stalled and the stock exchange was still regarded as a symbol of capitalism.[67] One explanation for the opening of these exchanges despite the political reality is that, because it was fearful of the social instability that "share fever" might cause, the central government decided to channel all trading activities to two localities (Shanghai and Shenzhen), thus limiting the scope for instability.[68] Another is that by opening the stock exchanges, the government intended to signal to the outside world that, despite the political retrenchment, it was still committed to economic reform.[69] It is also possible that the paramount leader Deng Xiaoping, who had officially retired but still enjoyed an overriding authority, lent support to government officials in Shanghai and Shenzhen who pushed for setting up the stock exchanges.[70]

Nevertheless, the Shanghai Stock Exchange was officially opened on November 26, 1990 and started to operate on December 19, 1990, while the Shenzhen Stock Exchange began operation on December 1, 1990, but was approved by Beijing only in July 1991.[71] By then, the Shenzhen market had already cooled and the Exchange was quiet. The Shenzhen Composite Index lost more than half its value between April 1991 and September 1991, and there were no transactions at all on April 22, 1991.[72] The market only rebounded briefly when the city government instructed government-affiliated institutions to buy shares on the exchange.[73] The Shanghai market was ini-

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[65] *See id.* at 23–25.

[66] *See id.* at 25.

[67] *See id.*

[68] *See id.* at 27.

[69] *See* Wenyuan Wei, *Gushi Zuowei Zaochaner De Feifan Licheng (The Extraordinary History of the Stock Market Born as a Premature Baby)*, SINA: FINANCE (Oct. 27, 2010), http://finance.sina.com.cn/stock/stocktalk/20101022/07108823891.shtml [https://perma.cc/VLG6-DRJV].

[70] *See* GREEN, *supra* note 2, at 11–13.

[71] LIU, *supra* note 37, at 106–16.

[72] SHENZHEN STOCK EXCHANGE, SHENZHEN ZHENGQUAN JIAOYISUO DASHI JI: 1991 (1991深圳证券交易所大事记)［THE CHRONICLE OF SHENZHEN STOCK EXCHANGE: 1991], http://www.szse.cn/main/aboutus/dsj/9989.shtml [https://perma.cc/RP9H-PGFH] (last visited May 19, 2016).

[73] YI LU, XIANBUZHU DE SHOU—ZHONGGUO GUSHI TIZHI JIYIN YANHUASHI (闲不住的手－中国股市体制基因演化史)［RESTLESS HANDS—THE GENE EVOLUTION OF CHINA'S STOCK MARKET SYSTEM] 36–39 (2008).

tially different as a result of infection by the "share fever" from Shenzhen, but was tamed in the second half of 1991 after similar restrictive measures were imposed. Although the stock exchanges were open, ideology and politics in Beijing were unsettled and policy regarding the shareholding system and stock market was restrictive.[74] For all of 1991, only 0.5 billion shares were issued through IPOs, raising RMB 0.5 billion.[75] The two exchanges were tiny with only eight listed companies altogether; they were local rather than national markets, with only one listed company from outside the two cities, and consisted of local investors.[76]

B. Rapid Growth Between 1992 and Mid-2001

1. Explosion Following Deng Xiaoping's "Southern Tour" in 1992

At the age of eighty-eight, Deng Xiaoping engaged in his "Southern Tour" as a last-ditch effort to push forward China's economic reform.[77] Pointing out that "development is the hard truth,"[78] he tried to remind the leadership in Beijing to re-focus on economic development. He commented that markets or planning were not the inherent nature of capitalism or socialism,[79] and he endeavored to draw a line under the divisive ideological debate about whether markets should be allowed in socialist China. During this tour, Deng Xiaoping paid a special visit to the Shenzhen Stock Exchange and appealed for pragmatism towards the stock market.[80] Following his tour, the CPC held its 14th Congress in October 1992, where the CPC declared that building a "socialist market economy" was the goal of economic reform,[81] which was later incorporated in the Constitution of the country.[82] The market-oriented reform had then reached the point of no return. The CPC meeting reiterated the benefits of the shareholding system and stock market for SOE reform and called for expanding the shareholding experiment and developing the stock market.[83] Thus, the stock market was formally legitimized.

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[74] *See* LIU, *supra* note 37, at 125–38.

[75] CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 6–9.

[76] *See id.*

[77] GREEN, *supra* note 2, at 13–14.

[78] XIAOPING DENG, DENG XIAOPING WENXUAN DISANJUAN (邓小平文选第三卷) [SELECTED WORKS OF DENG XIAOPING: VOLUME THREE] 377 (1993).

[79] *Id.* at 373.

[80] *Id.* at 377.

[81] Zemin Jiang, *Report to the 14th Congress of CPC*, RENMIN RIBAO (PEOPLE'S DAILY) (Oct. 12, 1992), http://cpc.people.com.cn/GB/64162/64168/64567/65446/4526308.html [https://perma.cc/5426-PQQL] [hereinafter Jiang, *14th Congress*].

[82] XIANFA [CONSTITUTION] Mar. 14, 2004, art. 7 (China).

[83] *See* Jiang, *14th Congress*, *supra* note 81.

Deng Xiaoping's "Southern Tour" sparked an explosion of economic activities all over the country. GDP grew by 12.8% in 1992 and 13.4% in 1993.[84] In the stock market, another wave of "share fever" quickly broke out. On May 21, 1992, when limits on price changes were removed, the Shanghai Composite Index more than doubled in one day.[85] A round of mass share issuance was triggered throughout the country and people rushed to buy shares.[86] Trading centers sponsored by local governments sprang up across the country, as did black markets. In this state of rage, a serious social disturbance happened in Shenzhen on August 10, 1992. IPOs were so popular that investors were required to buy an application form to subscribe shares. After the Shenzhen government announced approval of share issuance on August 9 and 10, people flocked to the city. On August 9, more than one million people queued in the streets of Shenzhen to buy an application form,[87] but in the evening they were told that application forms had been sold out for the next day. Suspecting corruption, people went to the government in protest, which soon turned violent. The People's Armed Police had to be called in to put down the riot.[88] The conservatives in Beijing seized this opportunity to condemn the stock market and push for its closure. Investors were alarmed and share prices plummeted. Nevertheless, the top leaders in Beijing decided to save the market and expressed support for its continuing development.[89] The Shanghai government also instructed securities companies under its control to buy shares on the exchange to prop up the market.[90] Share prices thus rebounded sharply. As a result of the riot, the government decided in late 1992 to establish the CSRC.[91] An annualized quota for share issuance was introduced, and local governments were ordered to close down black markets in their areas.[92]

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[84] NAT'L BUREAU OF STAT. OF CHINA, STATISTICAL COMMUNIQUÉ OF THE PEOPLE'S REPUBLIC OF CHINA 16, 26 (1992, 1993).

[85] LI, CHINESE STOCK MARKET, *supra* note 38, at 221.

[86] *See Timeline: China's Intervention in the Stock Market*, REUTERS (July 8, 2010), http://www.reuters.com/article/us-markets-china-stocks-timeline-idUSTRE6670PO20100708 [https://perma.cc/GVB8-FPNG].

[87] LIU, *supra* note 37, at 196–203.

[88] LI, FINALLY SUCCEEDED, *supra* note 57, at 233–36.

[89] *Id.* at 240–45.

[90] *See* WALTER & HOWIE, *supra* note 2, at 265–66.

[91] Stephen Green, *Equity Politics and Market Institutions: The Development of Stock Exchange Governance in China, 1984–2003*, 1, 5 (Royal Inst. of Int'l Aff., Asia Programme Working Paper No. 12, Mar. 2004), http://www.chathamhouse.org/sites/default/files/public/Research/Asia/wpmar04.pdf [https://perma.cc/CS3C-3F9Y] [hereinafter Green, *Equity Politics*].

[92] *See* Sonia M.L. Wong, *China's Stock Market: A Marriage of Capitalism and Socialism*, 26 CATO J. 389, 402–03 (2006), http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2006/11/cj26n3-1.pdf [https://perma.cc/97UK-WW4H].

But the rebound was short-lived. From January 1993, share prices started to drop, ushering in a bear market lasting almost three years.[93] The bear market ensued due to changes in the macro economy. The wild excess let loose by Deng's campaign soon had its effect. The national credit plan was thrown into chaos by mass share issuance and a flood of bank lending.[94] Inflation rose rapidly and the consumer price index (CPI) climbed from 3.4% in 1991 to a dangerous 24.1% in 1994.[95] Fearing political and social unrest, the government was frightened, as high inflation was one of the causes for the Tiananmen protest in 1989.[96] From late 1992, the State Council started to take action, beginning by halting unapproved share and bond issuance.[97] As inflation rose quickly in 1993, more forceful actions were taken. Dissatisfied with the performance of the People's Bank of China (PBOC), China's central bank, the State Council took the rare action to sack the governor. The then Vice Premier, Zhu Rongji, took over the job himself to reinstate order and control over credit provisions.[98] In the meantime, interest rates were raised twice in the year, with the one-year deposit rate reaching 10.98%.[99] In this austere environment, it was no wonder that share prices declined. The Shanghai Index fell from 1,536.82 in early January of 1993 to 323.92 on July 29, 1994.[100] It later regained some lost ground as a result of various measures taken by the government to prop up the market,[101] but it fell back to 516.46 by January 22, 1996.[102] On top of this, the

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[93] *See* YAHOO! FINANCE, https://finance.yahoo.com (enter "SSE Composite Index" in the "Enter Symbol" field; then follow "Historical Prices" hyperlink; then enter "Jan. 1, 2003" in the "Start Date" field; then enter "Dec. 31, 2006" in the "End Date" field; then follow "Get Prices" hyperlink) (last visited July 5, 2016).

[94] *See* Green, *supra* note 2, at 13.

[95] NAT'L BUREAU OF STAT. OF CHINA, STATISTICAL COMMUNIQUÉ OF THE PEOPLE'S REPUBLIC OF CHINA 41, 50 (1991, 1994).

[96] *See* Maria Reis, *The Origins of the Tiananmen Protests: A Comparison of the May Fourth and June Fourth Movements in China*, U. ST. ANDREWS HIST. SOC. (Nov. 25, 2014), http://standrews historysociety.co.uk/2014/11/the-origins-of-the-tiananmen-protests-a-comparison-of-the-may-fourth-and-june-fourth-movements-in-china/ [https://perma.cc/TM9P-5R44].

[97] Guanyu Jinyibu Jiaqiang Zhengquan Shichang Hongguan Guanli De Tongzhi (關於進一步加強證券市場宏觀管理的通知) [Notice on Further Strengthening Macro Administration of Securities Markets] (promulgated by the State Council, Dec. 17, 1992), pmbl., (Lawinfochina) [hereinafter Notice on Further Strengthening].

[98] *See* GREEN, *supra* note 2, at 14–15.

[99] PEOPLE'S BANK OF CHINA, RENMIN YINHANG JUEDING ZAICI TIGAO CUNDAIKUAN LILU (人民銀行決定再次提高人民幣存貸款利率) [PBOC TO RAISE DEPOSIT AND LENDING INTEREST RATE AGAIN], July 11, 1993 (Lawinfochina); PEOPLE'S BANK OF CHINA, RENMIN YINHANG JUEDING TIGAO RENMINBI CUNDAIKUAN LILU (人民銀行決定提高人民幣存貸款利率) [PEOPLE'S BANK OF CHINA DECIDED TO RAISE RMB DEPOSIT AND LENDING INTEREST RATE], May 15, 1993 (Lawinfochina).

[100] *See* CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 22.

[101] LI, FINALLY SUCCEEDED, *supra* note 57, at 350–55.

[102] *See* CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 22.

market was rocked by the notorious "327 government bond futures" scandal in early 1995, where the speculation of government securities resulted in the fall of the then largest brokerage and an indefinite suspension of government bond futures.[103]

With share prices on a roller coaster and significant social unrest, the stock market was anything but dull during this period. The size of the market grew rapidly. Funds raised through IPOs in 1992 were RMB 5 billion.[104] The figure rose to RMB 19.48 billion in 1993, but decreased to RMB 4.96 billion in 1994 and RMB 2.27 billion in 1995.[105] The number of listed companies increased to 323 by the end of 1995.[106] In 1993, 5.614 million trading accounts were opened, up by 67.22% from the previous year, and by the end of 1995, the total number reached almost thirteen million.[107] The stock exchanges became national, opened to companies for listing and investors for trading from outside Shanghai and Shenzhen.[108]

2. 1996–98: The Second Wave of Growth

The second wave of growth started in early 1996. By then share prices had become very cheap and the average price to earnings (P/E) ratio in Shenzhen was just above nine.[109] The macro economy had also changed. The GDP growth rate slowed, but was still 10.2% in 1995 and 9.7% in 1996;[110] the CPI fell to 17.1% in 1995 and further to 8.3% in 1996.[111] As inflation eased, the government cut interest rates twice in 1996.[112] Moreover, the government's attitude towards the stock market had changed. Back in 1992 and 1993, the shareholding system was only an experiment for SOE reform;[113] the stock market was just too small to be significant for economic reform. Zhu Rongji, despite his reform credentials and the fact that the

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[103] *See* GREEN, *supra* note 2, at 19–21. It was the scandals of insider trading and the manipulation of prices of treasury bond futures that led to the bankruptcy of *Wanguo*, then a prominent securities company, and the closure of the market for treasury bond futures for eighteen years. *See id.*

[104] Wong, *China's Stock Market: A Marriage of Capitalism and Socialism*, *supra* note 92, at 408.

[105] *Id.*

[106] *See* CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 6–9.

[107] *See id.*

[108] *See id.*

[109] *See id.*

[110] NAT'L BUREAU OF STAT. OF CHINA, STATISTICAL COMMUNIQUÉ OF THE PEOPLE'S REPUBLIC OF CHINA 54 (1996, 1997).

[111] *Id.*

[112] *Id.*

[113] *See Decision of the Central Committee on Certain Questions Regarding the Construction of a Socialist Market Economic System*, CHINA (Nov. 14, 1993), http://www.china.com.cn/chinese/archive/131747.htm [https://perma.cc/DD4P-W2FX]; Jiang, *14th Congress*, *supra* note 81.

Shanghai Stock Exchange opened under his leadership as the mayor, was suspicious of the stock market, seeing it as being too speculative and of little economic utility.[114] By 1996, however, the previous SOE reform policies had come to a dead end. The SOE sector as a whole recorded a net loss for the first time in the first quarter of 1996.[115] As reform cut off funding from government budgets, SOEs were desperate for money. On the other hand, the stock market seemed to have grown big enough to play a role to quench the thirst of SOEs. Hence the government's attitude became accommodative.[116] Last, in 1996, the Shanghai and Shenzhen governments, which still controlled the stock exchanges, were locked in fierce competition to achieve the status of the "national financial center" for their city: various financial incentives were offered to attract new listings and to lure securities companies to relocate; regulation was downplayed and fees for stock trading were cut to encourage more trading; the two governments even instructed securities companies under their control to manipulate share prices up in order to lure people into the markets and boost share trading; and the Shanghai Stock Exchange even used its own funds to buy shares to drive up share prices.[117]

With all these benign conditions, share prices rose and the stock indexes climbed steadily from January 1996.[118] Investors rushed in and the number of trading accounts increased by more than ten million in 1996.[119] The volume of trading in the year soared almost fivefold.[120] By December, the Shanghai Composite Index had more than doubled and the Shenzhen Composite Index more than quadrupled.[121] As the market rocketed and investors were in ecstasy, the central government became concerned. From October, a series of warnings, decrees, regulations, and official speeches were issued to try to cool down the market,[122] but the market forged ahead. Eventually the government decided to take drastic actions. On December 13, a 10% cap for daily price movement was reinstated.[123] On December 16, *People's Daily*, a newspaper run by the CPC Central Committee, published an editorial, warning—in an exceptionally harsh tone—against "excessive speculation" and

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[114] GREEN, *supra* note 2, at 21.
[115] *See* JOINT ECONOMIC COMM., CHINA'S ECONOMIC FUTURE: CHALLENGES TO U.S. POLICY 196 (1997).
[116] LI, FINALLY SUCCEEDED, *supra* note 57, at 429–30.
[117] ZHIDONG KAN, RONGRU ERSHI NIAN: WO DE GUSHI RENSHENG (榮辱二十年：我的股市人生) [UPS AND DOWNS: THE KAN ZHIDONG STORY] 1, 155–72 (2010).
[118] *See* CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 6–9.
[119] Wong, *China's Stock Market: A Marriage of Capitalism and Socialism*, *supra* note 92, at 390.
[120] *Id.*
[121] *See* CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 6–9.
[122] LI, FINALLY SUCCEEDED, *supra* note 57, at 460–64.
[123] DONGWEI SU, CHINESE STOCKMARKETS: A RESEARCH HANDBOOK 86 (2003).

vowing to bring the market under control.[124] Investors reacted in panic, and for two days share prices plunged almost to the 10% limit.[125] The Shanghai Composite Index and the Shenzhen Index lost more than 31% and 43%, respectively, in two weeks.[126]

As share prices plummeted, the government felt that the market had overreacted and subsequently placated investors with reassuring words.[127] The government also intervened to stabilize the market on February 20, 1997, when the market reacted in panic to the news of Deng Xiaoping's death.[128] Moreover, stock analysts and media spun the events of Hong Kong's return to China and the holding of the 15th CPC congress, predicting that the government would let the market rise to create a festive atmosphere.[129] The market recovered, and by May 1997, the Shanghai index was more than 250 points above its high in 1996.[130] This prompted the government to take new actions to rein in the market: the share issuance quota for 1997 was raised to RMB 5 billion and further to RMB 30 billion to increase supply; the stamp duty rate was raised; SOEs and listed companies were "strictly prohibited" from stock trading; banks were ordered to tighten control to prevent funds being channeled to the stock market; punishments were meted out and several prominent bankers lost their jobs;[131] and trading centers sponsored by local governments were closed, leaving the Shanghai and Shenzhen Stock Exchange the only venues for public share issue and trading.[132]

Just as these measures began to take effect, the Asian Financial Crisis of 1997 swept the region. Although the financial sector of Mainland China was not directly affected, its export, inward foreign direct investment (FDI), as well as GDP growth decelerated considerably.[133] In this adverse economic environment, the stock market became quiet and share prices moved in a

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[124] *Zhengque Renshi Dangqian Gupiao Shichang (正确认识当前股票市场) [Correctly Understanding the Current State of the Stock Market]*, RENMIN RIBAO (PEOPLE'S DAILY) (Dec. 16, 1996), http://www.people.com.cn/GB/historic/1216/4301.html [https://perma.cc/87YQ-XBKR].

[125] *See* LI, FINALLY SUCCEEDED, *supra* note 57, at 474, 477.

[126] *Id.* at 478.

[127] *Id.* at 475–80.

[128] *Id.* at 520–25.

[129] *Id.* at 530.

[130] *Id.* at 528.

[131] LI, FINALLY SUCCEEDED, *supra* note 57, at 528–30.

[132] Zhuanfa Zhengjianhui Guanyu "Qingli Zhengdun Changwai Feifa Gupiao Jiaoyi Fangan" De Tongzhi (轉發證監會關於"清理整頓場外非法股票交易方案"的通知) [Notice on Forwarding Scheme Proposed by CSRC to Close Down and Clean up Illegal Off-Exchange Stock Trading] (promulgated by State Council General Office, Mar. 25, 1998) (Lawinfochina).

[133] *See* NAT'L BUREAU OF STAT. OF CHINA, STATISTICAL COMMUNIQUÉ OF THE PEOPLE'S REPUBLIC OF CHINA ON THE 1998 ECONOMIC AND SOCIAL DEVELOPMENT, Part VII (1998), http://www.stats.gov.cn/english/NewsEvents/200203/t20020331_25979.html [https://perma.cc/2CNR-PCHV].

narrow range.[134] Interest rates were cut on four occasions and the stamp duty rate was also cut, but the market remained sluggish until May 1999.[135]

After this wave of growth, the stock market had reached a new size. The number of listed companies increased by more than 500 to 851 by the end of 1998 and the market capitalization increased more than fivefold between 1995 and 1998 to nearly RMB 2 trillion.[136] The amount of funds raised through IPOs was RMB 65.5 billion in 1997, three times the highest figure achieved in 1993.[137] The average daily trading value was RMB 12.67 billion in 1997, almost a quadrupling of the previous high.[138] The number of trading accounts reached 42.6 million by the end of 1998.[139]

3. 1999–2001: The Third Wave of Growth

The third wave of growth started in May 1999. Within forty days, the Shanghai Composite Index jumped more than 65%.[140] After some adjustment in the second half of 1999, the market regained its momentum and the upward trend lasted until June 14, 2001, when the Shanghai Composite Index reached a new record of 2245.[141] Chinese investors fondly remember this boom as the "519 Incident."[142] Both the Shanghai and Shenzhen Index more than doubled during this period. The number of listed companies increased to 1160 and the number of trading accounts to nearly seventy million by the end of 2001; market capitalization was over RMB 4.8 trillion by the end of 2000, an increase of approximately 150% from the end of 1998; and IPO funds reached a historical high of RMB 81.237 billion in 2000.[143]

Underpinning this boom were again changes in the macro economy. By 1999, the Asian Financial Crisis had subsided and the economy of those affected countries stabilized, as did the Chinese economy.[144] Exports of the country picked up in 1999 and surged in 2000 and inward FDI also acceler-

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[134] *See* YAHOO! FINANCE, https://finance.yahoo.com (enter "SSE Composite Index" in the "Enter Symbol" field; then follow "Historical Prices" hyperlink; then enter "Jan. 1, 2007" in the "Start Date" field; then enter "Dec. 31, 2009" in the "End Date" field; then follow "Get Prices" hyperlink) (last visited July 5, 2016).

[135] *See* LI, FINALLY SUCCEEDED, *supra* note 57, at 577–79.

[136] Wong, *China's Stock Market: A Marriage of Capitalism and Socialism*, *supra* note 92, at 390.

[137] *Id.* at 408.

[138] CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 6–9.

[139] *Id.*

[140] Wong, *China's Stock Market: A Marriage of Capitalism and Socialism*, *supra* note 92, at 390.

[141] CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 22.

[142] LI, CHINESE STOCK MARKET, *supra* note 38, at 625–27.

[143] CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 6–9.

[144] Timothy Lane, *The Asian Financial Crisis: What Have We Learned?*, 36 FIN. & DEV. 44, 44 (1999), http://www.imf.org/external/pubs/ft/fandd/1999/09/pdf/lane.pdf [https://perma.cc/ZPP2-2XWS].

ated.[145] Moreover, responding to the switch from inflation to deflation, interest rates were cut seven times between 1996 and 1999 [146] and the bank reserve ratio was also cut twice from 13% in 1998 to 6% in 1999.[147]

Another reason for the intense growth exhibited in the stock markets was the government's favorable policies. During this period, the SOE reform strategy fundamentally changed and the stock market was no longer seen only as a source of funding, but also as a solution to the governance problems of SOEs. As the performance and condition of SOEs continued to deteriorate, the CPC proposed "to grasp the big and let go the small" in 1995, which was confirmed by the 15th Congress of the CPC in 1997.[148] But, although "letting go the small" could be achieved simply by selling-off small SOEs, there was a question about how "the big" could be "grasped."[149] The CPC decided that the shareholding system was the answer. It reiterated the neutrality of the shareholding system and its benefits for SOEs. [150] Large and medium SOEs were decreed to diversify their ownership, increase equity finance, and undertake standardized corporatization.[151] Corporatization and share listing were thus established as the primary means for the reform of large and medium SOEs, making the stock market vital. The public promise made by the newly promoted Premier Zhu Rongji in 1998 to "relieve SOEs from their difficulties within three years" added urgency to the reform.[152]

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[145] *See* NAT'L BUREAU OF STAT. OF CHINA, STATISTICAL COMMUNIQUÉ OF THE PEOPLE'S REPUBLIC OF CHINA ON THE 2000 NATIONAL ECONOMIC AND SOCIAL DEVELOPMENT, Part VIII (2000), http://www.stats.gov.cn/english/NewsEvents/200203/t20020329_25981.html [https://perma.cc/8XDE-NJWM]; NAT'L BUREAU OF STAT. OF CHINA, STATISTICAL COMMUNIQUÉ OF THE PEOPLE'S REPUBLIC OF CHINA ON THE 1999 NATIONAL ECONOMIC AND SOCIAL DEVELOPMENT, Part VIII (1999), http://www.stats.gov.cn/english/NewsEvents/200203/t20020329_25980.html [https://perma.cc/785F-P43Y].

[146] *See* Peter Chiu, *From Inflation to Deflation: A Novel Experience for Hong Kong*, 50 CHINA PERSP. 1, 5 (2003), https://chinaperspectives.revues.org/pdf/774 [https://perma.cc/T89D-GU37].

[147] *Cunkuan Zhunbeijin Lu Lici Tiaozheng (存款准备金率历次调整) [A Chronicle of Adjustment of Bank Deposit Reserve Ratio]*, XINHUA NEWS (May 22, 2009), http://news.xinhuanet.com/ziliao/2009-05/22/content_11420181.htm [https://perma.cc/6UWM-5DKF].

[148] Zemin Jiang, *Report to the 15th Congress of CPC*, RENMIN RIBAO (PEOPLE'S DAILY) (Sept. 12, 1997), http://cpc.people.com.cn/GB/64162/64168/64568/65445/4526285.html [https://perma.cc/2AHA-HQKF] [hereinafter Jiang, *15th Congress*].

[149] *See* Yongnian Zheng & Minjia Chen, *China's State-Owned Enterprise Reform and Its Discontents*, 56 PROBS. OF POST-COMMUNISM 36, 36–42 (2009).

[150] Jiang, *15th Congress*, *supra* note 148.

[151] *Zhongguo Zhongyang Guangyu Guoyou Qiye Gaige He FaZhan Ruogan Zhongda Wenti de Jueding, （中共中央关于国有企业改革和发展若干重大问题的决定）[Decision of the Central Committee on Certain Important Questions Regarding SOE Reform and Development]*, RENMIN RIBAO (PEOPLE'S DAILY) (Sept. 22, 1999), http://cpc.people.com.cn/GB/64162/71380/71382/71386/4837883.html [https://perma.cc/JL2U-ZTHR].

[152] *Jiujie Quanguo Renda Yici Huiyi Juxing Jizhe Zhaodaihui, Zhu Rongji Zongli Deng Da Zhongwai Jizhe Wen (九届全国人大一次会议举行记者招待会，朱镕基总理等答中外记者问) [The 1st Meeting of the 9th National People's Congress Holds Press Conference and Premier Zhu*

Against this backdrop of change, *People's Daily* published another editorial on June 15, 1999, commenting on the recent surge of share prices as "recovering" and "normal," which was in stark contrast in tone to the editorial published in December 1996.[153] It claimed that a solid foundation had been laid for the market to have a "long-term and stable development," and indicated that a series of supportive measures would be introduced.[154] In the following days, a number of supportive measures were enacted: the ban on SOEs and listed companies for share trading was lifted; securities companies were allowed to borrow money from banks as well as to access the interbank money market for liquidity; and the quota for insurance companies to buy shares on the stock exchanges was raised.[155]

Lastly, the effect of fraud needs to be mentioned. Inspired by the "dot-com bubble" in the United States in 2000 and 2001, fraudsters in China fabricated various hi-tech stories and audaciously engaged in market manipulation. Outrageous scams of all sorts were widespread. The following is just one example.[156] A businessman from Hong Kong acquired state-owned, non-tradable shares, and therefore control, of a listed SOE in Shenzhen.[157] In the meantime, he secretly set up four companies with concealed identities and bought 85% of the total tradable shares of that SOE on the exchange.[158] After control changed hands, the company was re-named "*Yi'an Keji*" (*Keji* meaning "technology and science" in Chinese) and a succession of announcements were made to start various hi-tech businesses, such as electric cars, new energy, digital communication, nanotechnology, etc.[159] "It is almost as if [*Yi'an*] management had picked up the latest hi-tech weekly and listed out likely products."[160] The share price rose from RMB 6.39 to RMB 126.31 and the company had the "honor" to be the first listed company in China whose share price surpassed RMB 100.[161] Before long, all this turned out to be a scam and the share price crashed, but the fraudster had already

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Rongji Answers Questions from Chinese and Foreign Correspondents], RENMIN RIBAO (PEOPLE'S DAILY) (Mar. 20, 1998).

[153] Jianding Xinxin, Guifan Fazhan (坚定信心，规范发展) [Strengthening Determination, Regularizing Development], RENMIN RIBAO (PEOPLE'S DAILY) (June 15, 1999).

[154] *Id.*

[155] *See* Wong, *China's Stock Market: A Marriage of Capitalism and Socialism*, *supra* note 92, at 398–99.

[156] Jing Li, *Shuizai Caozong Yi'an Keji? (谁在操纵亿安科技) [Who Is Manipulating Yi'an Keji?]*, CAIJING (June 6, 2001), http://www.360doc.com/content/10/1105/16/142_66872069.shtml [https://perma.cc/5S4L-C9QU]; Shu Li, *Yi'an Keji Hai Meiyou Wan (亿安科技还没有完) [The Yi'an Keji Case Still Isn't Over]*, CAIJING (June 5, 2001), http://magazine.caixin.com/2001-06-05/100082957.html [https://perma.cc/E24L-SRUA].

[157] *Li*, *Who Is Manipulating Yi'an Keji?*, *supra* note 156.

[158] *Id.*

[159] *Id.*

[160] WALTER & HOWIE, *supra* note 2, at 271.

[161] *See id.*

made handsome profits and fled.[162] As cases like this were common, the market boom was pretty much a bubble driven by fraud.

C. 2001–05: The Stock Market in Crisis

After reaching an historic high on June 14, 2001, Shanghai and Shenzhen markets closed the day at a loss, marking the start of a bear market lasting for four and half years.[163] Share indices lost more than half their value during this period, and on June 6, 2005, the Shanghai Composite Index breached the symbolic low point of 1000.[164] As stock prices slumped, investors withdrew from the market in droves. For example, for all the trading accounts in 2005 on the Shenzhen Stock Exchange, only 33% held stocks.[165] The market shrank considerably. Between 2000 and 2005, market capitalization decreased from more than RMB 4.8 trillion to less than RMB 3.25 trillion and the ratio of market capitalization to GDP from 48% to 18%.[166] Funds raised through IPOs declined from RMB 81.24 billion in 2000 to RMB 5.67 billion in 2005, and IPOs were suspended three times during this period.[167] Securities companies as a whole were in the red for four years from 2002 to 2005.[168] The loss in 2002 was nearly RMB 40 billion, while net assets of the whole sector were only RMB 76.5 billion by the end of 2000.[169] Throughout this period, the market was gripped by bitter debates triggered by a prominent economist's public denouncement of the stock market as being "worse than a casino."[170] The government was urged

[162] *See id.*

[163] *See* Wong, *China's Stock Market: A Marriage of Capitalism and Socialism*, *supra* note 92, at 394.

[164] *See* CHINA DAILY, *China's Stock Markets Slumping to 8-Year Lows*, http://www.chinadaily.com.cn/english/doc/2005-06/06/content_448880.htm [https://perma.cc/A69A-52KL] (June 6, 2005).

[165] *See* CHINA SEC. REG. COMM'N, CHINA CAPITAL MARKET DEVELOPMENT REPORT 2008, at 153, 269, http://www.csrc.gov.cn/pub/csrc_en/Informations/publication/200911/P020091103520222505841.pdf [https://perma.cc/ATN2-CEZX].

[166] *See* CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 6–9.

[167] Zhenjiang Cheng, *Pandian Lici IPO Zanting Chongqi Dui Erci Shichang De Yingxiang (盘点历次 IPO 暂停，重启对二次市场的影响) [Stocktaking the Impacts of IPO Suspensions and Resumptions on the Secondary Market]*, ZHENGQUAN DAOKAN (SECURITIES GUIDE) (May 21, 2013), http://finance.ifeng.com/ipo/xgyw/20130521/8057561.shtml [https://perma.cc/6J3T-2KSK].

[168] *See* LIU, *supra* note 37, at 63.

[169] Ke He & Hongchao Guo, *Zhongguo Zhengquanye Qunian Zhengti Kuisun 400 Yi, Quanshang Jidai Tuwei (中国证券业去年整体亏损 400 亿券商亟待突围) [China's Securities Industry Lost RMB 40 Billion, Securities Companies Need to Sally Forth]*, JINGJI GUANCHA BAO (THE ECONOMIC OBSERVER) (Jan. 18, 2003), http://news.xinhuanet.com/fortune/2003-01/18/content_695538.htm [https://perma.cc/V7YT-RRWC]; Fan Shu, *Quanshang Weiji (券商危机) [Securities Companies in Crisis]*, CAIJING (Nov. 5, 2001), http://magazine.caixin.com/2001-11-05/100076890.html [https://perma.cc/8LFY-7ALU].

[170] *See* Kuhn, *supra* note 1; McGregor, *supra* note 1. On January 14, 2001, Jinglian Wu, Senior Research Fellow at the Development Research Centre of the State Council, said in an interview on China Central Television (CCTV) that the stock market was "worse than a casino" because at

to "close down the market and start a new one from scratch."[171] The market slid to the brink of complete collapse.

This stock market crisis occurred when the Chinese economy was at its best. Between 2001 and 2005, GDP growth accelerated from 8.3% to 9.9%.[172] Exports skyrocketed after China acceded to the World Trade Organization in 2001, as did inward FDI.[173] On the other hand, inflation stayed at a low level with the CPI being around 2%,[174] and interest rates were consequently kept low throughout the period. It is puzzling why the stock market drifted into crisis when the macro economy was in such a good shape. Many investors and commentators blamed the government's decision in June 2001 to sell down state shares on the exchanges.[175] Investors feared the market would be overwhelmed by too much supply. In support of this claim, commentators pointed to the share price drop after the government announced its decision and the share price jump after the government suspended and finally abolished the policy.[176] But there was the view that, with an average price to earnings ratio of 58.22 in Shanghai and 56.04 in Shenzhen in 2000, the market was in a huge bubble and market correction was inevitable.[177] Moreover, the market was repeatedly shaken by scandals, including manipulation, like the case of *Yi'an Keji*, and market cornering, falsifying financial information, and misappropriation of listed companies'

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least a casino had rules that were followed. *See* Kuhn, *supra* note 1. His comments caused an uproar of debate and resonance among the public and were extensively reported by other media. *See id.*; McGregor, *supra* note 1.

[171] Yuan Pan, *Da Bianlun: Gushi Shifou Yao Tuidao Chonglai, Nao Chang Geming Fengbao? (大辩论：股市是否要推到重来，闹场革命风暴?) [Great Debate: Should the Stock Market Be Revolutionized by Closing It Down and Starting All Again?]*, ZHONGGUO QINGNIAN BAO (CHINA YOUTH DAILY) (Nov. 26, 2001), http://finance.sina.com.cn/t/20011126/148328.html [https://perma.cc/U78S-QX5W].

[172] NAT'L BUREAU OF STAT., STATISTICAL COMMUNIQUÉ OF THE PEOPLE'S REPUBLIC OF CHINA ON THE 2005 NATIONAL ECONOMIC AND SOCIAL DEVELOPMENT, Part I (Mar. 3, 2006), http://www.stats.gov.cn/english/NewsEvents/200603/t20060302_25737.html [https://perma.cc/WZA7-47KE].

[173] *Id.* at Part VI.

[174] *Id.* at Part I. The consumer price index was 3.9% in 2004. *See* NAT'L BUREAU OF STAT. OF CHINA, CHINA STATISTICAL YEARBOOK 2005, at 9-1, http://www.stats.gov.cn/tjsj/ndsj/2005/indexeh.htm [https://perma.cc/UX33-5UMP].

[175] *See* LU, *supra* note 73, at 158–60. The State Council decided in June 2001 that when a SOE issues shares through an IPO or secondary issue on stock exchanges, existing state shares should also be sold to raise funds for the National Social Security Fund. The number of state shares to be sold should be 10% of the new shares to be issued. *See* Guowuyuan Guanyu Jian Chi Guoyougu Chouji Shehui Baozhang Zijin Guanli Zhanxing Banfa (国务院关于减持国有股筹集社会保障资金管理暂行办法) [Interim Measures on the Management of Reducing State Shares and Raising Social Security Funds] (promulgated by the Standing Comm. Nat'l People's Cong., June 12, 2001) (Lawinfochina).

[176] *See* LU, *supra* note 73, at 158–60.

[177] Xiaonian Xu, *Gushi Tiaozheng Lakai Xumu (股市调整拉开序幕) [The Prelude to a Stock Market Adjustment Has Started]*, CAIJING (Oct. 5, 2001), http://magazine.caixin.com/2001-10-05/100085738.html [https://perma.cc/W6G6-RVTS].

funds by their controlling shareholders, and misappropriation of investors' funds and stocks by securities companies.[178] Furthermore, despite the robust macro economy, the number of listed companies suffering losses increased significantly. In 2001, 150 companies, 12.9% of the total, made a loss.[179] Among them, twenty had experienced losses continuously for three years and could be delisted according to the CSRC's new regulations.[180] The number of loss-making companies increased to 253 in 2005, constituting 18.57% of the total.[181]

Whatever the cause, the government decided to save the market rather than close it down. Responding to heavy criticism and a sharp fall in share prices, the government caved and abandoned the plan to sell state shares on the exchanges.[182] This, however, only produced a short-lived rally, and the downward trend continued. The traditional supportive measures, such as cutting the stamp duty rate, suspending IPOs, and delivering positive talks by government officials, were tried. Even the ban on government officials and Party cadres trading shares was lifted.[183] But this time none of the measures worked and share prices kept falling.[184] Even the CPC's declaration in 2003 that the shareholding system should be the primary organizational form for SOEs and that the stock market should be greatly developed did not stop the fall.[185]

As the crisis intensified, the government realized that more needed to be done. The government cracked down on market manipulation and some notorious fraudsters were sent to prison; it introduced third-party custody of investors' funds to ensure that securities companies would no longer be able

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[178] *See infra* Part III.B.

[179] *2001 Nian Nianbao Pilu Jiben Jieshu, Shangshi Gongsi Zhengti Yeji Tan Xingdi (2001 年年报披露基本结束， 上市公司整体业绩探新低）［The Publication of 2001 Annual Reports Has Largely Completed, the Overall Financial Performance of Listed Companies Has Come to a New Bottom]*, SHANGHAI ZHENGQUAN BAO (SHANGHAI SECURITIES NEWS) (Apr. 30, 2002), http://news.xinhuanet.com/fortune/2002-04/30/content_378663.htm [https://perma.cc/7GRQ-3WDA].

[180] LI, CHINESE STOCK MARKET, *supra* note 38, at 342.

[181] Xiyu Zhang, *Nianbao Pilu Wanbi, Shangshi Gongsi Jing Lilun Wunian Lai Shoudu Huiluo (年报披露完毕上市公司净利润五年来首度回落）［The Publication of Annual Reports Has Completed, Net Profits of Listed Companies Fall for the First Time Since 5 Years Ago]*, SHANGHAI ZHENGQUAN BAO (SHANGHAI SECURITIES NEWS) (May 8, 2006), http://finance.sina.com.cn/stock/t/20060508/0000677860.shtml [https://perma.cc/SZ2C-RP23].

[182] *See* Wong, *China's Stock Market: A Marriage of Capitalism and Socialism*, *supra* note 92, at 399.

[183] LI, CHINESE STOCK MARKET, *supra* note 38, at 331–33.

[184] *See* Wong, *China's Stock Market: A Marriage of Capitalism and Socialism*, *supra* note 92, at 420.

[185] Zhonggong Zhongyang Guanyu Wanshan Shehuizhuyi Jingji Tizhi Ruogan Wenti de Jueding (中共中央关于完善社会主义经济体制若干问题的决定）［*Decisions of the Central Committee on Certain Questions Regarding Perfecting the Socialist Market Economic System]*, RENMIN RIBAO (PEOPLE'S DAILY) (Oct. 14, 2003), http://cpc.people.com.cn/GB/64162/64168/64569/65411/4429165.html [https://perma.cc/6XAP-G8P9].

to misappropriate their clients' money; it undertook a campaign to force misappropriated funds of listed companies to be returned; it adopted special regulations to afford minority shareholders more say in important decisions of their companies; it revised the Company Law and Securities Law to offer minority shareholders more protection; it amended the Criminal Law to punish information falsification and misappropriation of corporate assets; it replaced the quota system for listing with a system of sponsoring underwriters to ensure that only companies with good performance could be listed; it allowed the National Social Security Fund, insurance companies, and enterprise pension funds to invest in stocks which fostered institutional investment; it introduced Qualified Foreign Institutional Investors and encouraged the development of mutual funds; it allowed the shares of state and legal persons to be tradable on the exchanges; and it set up a new board at the Shenzhen Stock Exchange in May 2005 to allow small and medium-sized enterprises to access the stock market.[186] All these efforts finally paid off and the market eventually recovered in 2006 and experienced an enormous boom in 2007.

D. 2006–09: Boom, Bust, and Rebound

Share prices started to rise at the beginning of 2006. In the second half of the year, the market picked up momentum and rose sharply.[187] On December 14, the Shanghai Composite Index surpassed the previous high in 2001 and for the whole year recorded an increase of more than 130%.[188] The market entered 2007 with a choppy start but then continued its upsurge. As share prices shot up and investors rushed in, the government became increasingly concerned that a bubble was being formed and warnings were given.[189] The economy had also become overheated, and between April 2006 and the end of 2007, interest rates were raised on eight occasions, and the bank reserve ratio was also raised.[190] On May 30, 2007, stock indices recorded a huge loss when the stamp duty rate was raised.[191] But the market

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[186] *See* CHINA CAPITAL MARKET DEVELOPMENT REPORT 2008, *supra* note 165, at 175–76, 178, 185, 205, 210–11, 215, 219–21, 228–31.

[187] *See* Jack Perkowski, *Putting China's Stock Market into Perspective*, FORBES (Aug. 17, 2015), http://www.forbes.com/sites/jackperkowski/2015/08/17/putting-chinas-stock-market-into-perspective/#3bac4820b583.

[188] LI, CHINESE STOCK MARKET, *supra* note 38, at 454.

[189] *Id.* at 455–56.

[190] *See* NAT'L BUREAU OF STAT. OF CHINA, CHINA STATISTICAL YEARBOOK 2008, at 19-8, 19-9, http://www.stats.gov.cn/tjsj/ndsj/2008/indexeh.htm [https://perma.cc/MJ9C-EKUZ]; NAT'L BUREAU OF STAT. OF CHINA, CHINA STATISTICAL YEARBOOK 2007, at 20-8, 20-9, http://www.stats.gov.cn/tjsj/ndsj/2007/indexeh.htm [https://perma.cc/7P8Y-R2H7].

[191] Dong Zhixin, *China Triples Stamp Tax on Stock Trading*, CHINA DAILY (May 30, 2007), http://www.chinadaily.com.cn/china/2007-05/30/content_883249.htm [https://perma.cc/DG75-D2E5].

shook this off and surged ahead, peaking eventually on October 16, 2007, when the Shanghai Composite Index reached 6124, nearly six times the level when the bull market started at the beginning of 2006.[192] Share prices then started to drop and, as the global financial crisis intensified, embarked on a free fall. By October 28, 2008, the Shanghai Composite Index sank almost 75% to 1,664.93.[193] The government took a series of actions to prop up the market: the stamp duty was cut twice; IPOs were again suspended; and state-affiliated, controlling shareholders as well as listed companies were ordered to buy shares on the market.[194]

During this round of intense growth, the market became one of the largest in the world. Funds raised through IPOs soared to RMB 459 billion in 2007, by far the highest in the world and more than five times of the previous record in 2000.[195] The government was able to list the major SOEs, the "national champions," including the giant state-owned commercial banks.[196] Market capitalization increased to RMB 32.7 trillion by the end of 2007, 123% of GDP and more than six times higher than the previous record set in 2000, while average daily trading value was more than RMB 190 billion, nearly four times higher than the previous record in 2000.[197] The number of trading accounts reached 143 million by the end of 2007.[198]

The global financial crisis hit China hard. Exports decreased by 27.2% year-on-year for the first two months of 2009.[199] Inward FDI dropped 32.7% in January 2009.[200] GDP decelerated from 11.9% in 2007 to 6.1% in the first quarter of 2009.[201] Thousands of factories were closed and tens of

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[192] *See* Li Zengxin. *A Perfect Close for China's Stock Market 2007*, CHINA DAILY (Dec. 28, 2007), http://www.chinadaily.com.cn/business/2007-12/28/content_6357023.htm [https://perma.cc/K85N-9UCD].

[193] CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 6–9.

[194] LI, CHINESE STOCK MARKET, *supra* note 38, at 483.

[195] *See* CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 6–9.

[196] *See* CHINA SEC. REG. COMM'N, CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, 1 (2012).

[197] *See* CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 6–9.

[198] *See id.*

[199] *Qian 2 Yue Woguo Jinchukou Xiajiang 27.2 Percent, Maoyi Shuncha 438.85 Yi Meiyuan (前2月我国进出口下降 27. 2%，贸易顺差 438. 85 亿美元)［The First Two Months Records a 27.2 Percent Decrease in Export and Import, Trade Surplus Is US $43.885 Billion]*, XINHUA (Mar. 11, 2009), http://news.xinhuanet.com/fortune/2009-03/11/content_10990676.htm [https://perma.cc/8UNS-3XH3].

[200] *Yi Jidu Quanguo Shiji Xishou Waizi Tongbi Jiang 20.6 Percent, Jiangfu Zhuyue Shouzhai (The First Quarter Records a 20.6 Percent Decrease in FDI, Decrease Reduced Month by Month)*, XINHUA (Apr. 15, 2009), http://news.xinhuanet.com/fortune/2009-04/15/content_11191416.htm [https://perma.cc/6SZV-XMLX].

[201] *Yi Jidu Zhongguo Jingji Zengzhang 6.1 Percent, Chuxian Jiji Bianhua (一季度中国经济增长 6. 1%出现积极变化)［Economy Grows by 6.1 Percent in the First Quarter, Positive Signs*

millions of migrant workers lost their jobs.[202] Facing a looming economic crisis, Chinese leadership made a dramatic change in economic policy. In November 2008, the State Council announced that the government would spend RMB 4 trillion to stimulate the economy.[203] The restrictive monetary policy was swiftly reversed. Interest rates and the bank reserve ratio were cut four times in the last four months of 2008;[204] bank-lending quotas were "scrapped,"[205] and new loans almost doubled in 2009 to RMB 9.59 trillion, more than twice the RMB 4 trillion stimulation spending.[206]

The stock market responded fiercely. The Shanghai Composite Index rose from the trough of around 1700 in 2008 to over 3470 on August 4, 2009.[207] As the market regained buoyancy in 2009, IPOs resumed and a large number of companies conducted IPOs on the ChiNext, the new listing board opened in Shenzhen in early 2009 for growth companies.[208] The remaining major SOEs were also listed.[209] Funds raised on the stock market via IPOs in 2010 even surpassed the boom year of 2007.[210]

E. 2010–14: A Prolonged Bear Market

But the rebound was again short lived. The market lost steam after August 2009 and jittered in 2010, with the Shanghai Index overall losing

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Emerging], XINHUA (Apr. 16, 2009), http://news.xinhuanet.com/newscenter/2009-04/16/content_11194063.htm [https://perma.cc/WHR4-Z3DE].

[202] *See* Chris Hogg, *Chinese Migrant Job Losses Mount*, BBC (Feb. 2, 2009, 11:33 A.M.), http://news.bbc.co.uk/1/hi/world/asia-pacific/7864293.stm [https://perma.cc/95WW-YV6D]; Jing Shi, *Road to Riches Ends for 20 Million Chinese Poor*, CNN (Feb. 20, 2009, 8:47 A.M.), http://www.cnn.com/2009/WORLD/asiapcf/02/20/china.economy.family/ [https://perma.cc/L73W-ZYYH].

[203] *See China's 4 Trillion Yuan Stimulus to Boost Economy, Domestic Demand*, XINHUA (Nov. 9, 2008), http://news.xinhuanet.com/english/2008-11/09/content_10331324.htm [https://perma.cc/NX28-3KWF].

[204] *See* Geoff Dyer, *China Authorizes 'Massive' Stimulus Package*, FIN. TIMES (Nov. 10, 2008), http://www.ft.com/cms/s/0/6e89710e-ae91-11dd-b621-000077b07658.html [https://perma.cc/4VHN-SMBL].

[205] *See id.*

[206] *See China Reports Record 9.59 Trln Yuan in Loans in 2009*, XINHUA (Jan. 15, 2010), http://news.xinhuanet.com/english/2010-01/15/content_12816059.htm [https://perma.cc/43YS-F5SG]; *China's 4 Trillion Yuan Stimulus to Boost Economy, Domestic Demand*, *supra* note 203.

[207] *See* YAHOO! FINANCE, https://finance.yahoo.com (enter "SSE Composite Index" in the "Enter Symbol" field; then follow "Historical Prices" hyperlink; then enter "Jan. 1, 2008" in the "Start Date" field; then enter "Sept. 31, 2009" in the "End Date" field; then follow "Get Prices" hyperlink) (last visited July 5, 2016).

[208] *See* Ufuk Gucbilmez, *China's Nasdaq Fails to Get off the Ground as Venture Capitalists Look to the US*, CONVERSATION (Mar. 13, 2014), http://theconversation.com/chinas-nasdaq-fails-to-get-off-the-ground-as-venture-capitalists-look-to-the-us-24170 [https://perma.cc/NCQ7-F4DX].

[209] *See* Shuhe Huang, *Guoyou Qiye Gaige Zai Shenhua (国有企业改革在深化) [The Reform of State-Owned Enterprises Is Deepening]*, QIUSHI (SEEK TRUTH) (Feb. 1, 2014), http://www.qstheory.cn/zxdk/2014/201403/201401/t20140127_316812.htm [https://perma.cc/77BK-Y5HA].

[210] CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 6–9.

16.04%.[211] Concerned about the deluge of bank lending, the government raised the bank reserve ratio in early 2010. As the inflation rate rose in late 2010, the bank reserve ratio was raised further, as were interest rates.[212] In the meantime, the effect of stimulation quickly tapered off and the GDP growth rate fell from 10.4% in 2010 to 9.3% in 2011 and 7.8% in 2012.[213] Profitability of listed companies also decreased and the average return on equity (ROE) dropped sharply.[214] Moreover, the enormous amount of money raised from the market via IPOs was widely believed to have had a deleterious effect.[215] For all these reasons, the downward trend that started in 2010 continued, and by July 2013, the Shanghai Index fell below 2000.[216] As economic growth decelerated, the government loosened its monetary policy somewhat at the end of 2011 and early 2012, and in May 2012, quietly instigated a "stimulus 2.0,"[217] but the impact on economic growth was negligible, like it was on the stock market.

As share prices decreased, the stock market seemed to drift into another crisis. The average daily trading value dropped from more than RMB 225 billion in 2010 to less than RMB 80 billion in November 2012.[218] Of all the trading accounts, less than 40% held stocks at the end of 2012.[219] IPOs were suspended for more than a year from November 2012 to January 2014.[220]

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[211] *See* YAHOO! FINANCE, https://finance.yahoo.com (enter "SSE Composite Index" in the "Enter Symbol" field; then follow "Historical Prices" hyperlink; then enter "July 1, 2009" in the "Start Date" field; then enter "Dec. 31, 2010" in the "End Date" field; then follow "Get Prices" hyperlink) (last visited July 5, 2016).

[212] *A Chronicle of Adjustment of Bank Deposit Reserve Ratio*, *supra* note 147.

[213] NAT'L BUREAU OF STAT. OF CHINA, STATISTICAL COMMUNIQUÉ OF THE PEOPLE'S REPUBLIC OF CHINA ON THE 2012 NATIONAL ECONOMIC AND SOCIAL DEVELOPMENT, Part I (Feb. 22, 2013), http://www.stats.gov.cn/english/NewsEvents/201302/t20130222_26962.html [https://perma.cc/J46S-NNCQ].

[214] *See* CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 282–83.

[215] *See China's Move to End IPO Halt Sparks Rally in Finance*, BLOOMBERG (Dec. 2, 2013), http://www.bloomberg.com/news/articles/2013-12-01/china-sets-ipo-reform-plan-signaling-end-of-freeze-on-listings [https://perma.cc/D7Z7-NNHV].

[216] *See* YAHOO! FINANCE, https://finance.yahoo.com (enter "SSE Composite Index" in the "Enter Symbol" field; then follow "Historical Prices" hyperlink; then enter "Jan. 1, 2010" in the "Start Date" field; then enter "Dec. 31, 2013" in the "End Date" field; then follow "Get Prices" hyperlink) (last visited July 5, 2016).

[217] *See* Huang Ying & Ed Zhang, *'Stimulus 2.0' Aims to Reboot Growth*, CHINA DAILY (June 1, 2012, 10:47 A.M.), http://www.chinadaily.com.cn/bizchina/2012-06/01/content_15445847.htm [https://perma.cc/C7JR-6UYT].

[218] *See Securities Market Statistics in November 2012*, CHINA SEC. REG. COMM'N, http://www.csrc.gov.cn/pub/csrc_en/marketdata/security/monthly/201212/t20121211_217870.html [https://perma.cc/UZ9H-M3EP].

[219] CHINA SEC. DEPOSITORY & CLEARING CORP., ZHONGGUO JIESUAN TONGJI YUE BAO (中国结算统计月报）［CHINESE SETTLEMENT MONTHLY BULLETIN] 5 (June 2013).

[220] Jiening Hou & Baochen Zhu, *Zhongguo Gushi 8 Ci Zanting IPO Huigu (中国股市 8 次暂停 IPO 回顾）［A Review of IPO Suspension on 8 Occasions in China's Stock Market History]*,

Criticism and debate about the future of the market raged again. The reform-minded CSRC chairman, Guo Shuqing, was removed in March 2013 after a stint of only eighteen months.[221]

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

The development of the legal and regulatory framework governing the stock market in China and the evolution of investor protection can be broadly divided into three stages: (1) the period before 1992, when laws and regulations were few and rudimentary; (2) between 1992 and 2000, when a legal framework was created and a centralized and unified regulatory system was finally established; and (3) starting in 2001, when the government, driven by scandals and crises, began to focus on investor protection and tighten up law enforcement.

A. The First Stage Before 1992

There were no laws governing company formation and operation when the shareholding system initially emerged in China. The first such type of legislation did not come until 1984, when the Shanghai government ratified a document drafted by the PBOC Shanghai Branch.[222] It was of great brevity, comprised of only eight articles.[223] At the national level, the first legislation was a 1985 document issued by the State Administration for Industry and Commerce permitting company registration and stipulating some basic requirements for it.[224] Throughout this period, the central government was hands-off. The national legislature—the National People's Congress (NPC) and its Standing Committee—and the State Council did not adopt any company or securities legislation. There were no laws that clarified which Min-

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ZHENGQUAN RIBAO (SECURITIES DAILY) (June 19, 2013), http://finance.china.com.cn/stock/special/xgfxzd/20130619/1562502.shtml [https://perma.cc/Q8Y2-N7YN].

[221] *See* Bob Davis & Lingling Wei, *Beijing to Sideline Top Securities Regulator*, WALL ST. J. (Mar. 13, 2013), http://online.wsj.com/article/SB10001424127887324392804578358303154198298.html [https://perma.cc/F3NH-JBER]; Daniel Ren, *Chief Regulator Guo Shuqing Tipped as Shandong Governor*, S. CHINA MORNING POST (Mar. 13, 2013, 5:24 A.M.), http://www.scmp.com/news/china/article/1189477/chief-securities-regulator-guo-shuqing-tipped-shandong-governor [https://perma.cc/AK4C-WL6U].

[222] *See* Guanyu Faxing Gupiao De Zanxing Guanli Banfa (关于发行股票的暂行管理办法) [Interim Measures on the Administration of Share Issuance] (promulgated by the Shanghai Mun. Gov't, Aug. 10, 1984, effective Aug. 10, 1984), http://www.law-lib.com/law/law_view.asp?id=46101 [https://perma.cc/4LQQ-AMWM].

[223] *Id.*

[224] Gongsi Dengji Guanli Zanxing Guiding (公司登记管理暂行规定) [Interim Provisions on the Administration of Company Registration] (promulgated by the State Admin. for Industry and Commerce, Aug. 14, 1985, effective Aug. 25, 1985), http://www.law-lib.com/law/law_view.asp?id=46832 [https://perma.cc/YB96-M7SQ].

istry had regulatory authority over the stock market. Only in 1986, by a regulation on the banking sector, did the PBOC incidentally acquire the mandate to license non-bank financial institutions and regulate stock and bond markets.[225] But the PBOC in Beijing promulgated only one major piece of relevant legislation during this period.[226] The PBOC was also a decentralized system before 1998 in that local branches were effectively controlled by local governments rather than by the PBOC in Beijing.[227] Hence, at the national level, laws and regulations on companies and stock markets virtually did not exist during this period.

From the very beginning, local governments were the experimenters and promoters of the shareholding system. They became more enthusiastic after the mid-1980s, when leftist ideologies were further loosened. To guide experiments, some local governments adopted some company and securities rules. For example, between 1985 and 1990, the provincial governments of Shaanxi, Guangdong, Fujian, and Heilongjiang and the municipal governments of Beijing, Xiamen, Guangzhou, and others promulgated regulations on share issue and transfer.[228] In Shenzhen, the government passed a regulation in 1986 to guide the transforming SOEs into shareholding companies.[229] This was the first company legislation in the country specifically for the corporatization reform of SOEs.[230] In Shanghai, the short document issued in 1984 was superseded by a longer one in 1987, but it still had only

[225] Zhonghua Renmin Gongheguo Yinhang Guanli Zanxing Tiaoli (中华人民共和国银行管理暂行条例) [Provisional Regulations of the People's Republic of China on the Control of Banks], (promulgated by the State Council, Jan. 7, 1986), arts. 5, 22, 25 (Lawinfochina).

[226] Zhengquan Gongsi Guanli Zanxing Banfa (中国人民银行关于印发《证券公司管理暂行办法》的通知) [Interim Measures on the Administration of Securities Companies] (promulgated by People's Bank of China, Oct. 12, 1990) (Lawinfochina).

[227] *See* CHARLES WOLF JR. ET AL., FAULT LINES IN CHINA'S ECONOMIC TERRAIN 121 (2003). Originally, local governments controlled personnel administration and were responsible for funding local PBOC branches. Following a decision made by the CPC and State Council in 1998, provincial PBOC branches were abolished, and nine cross-province regional branches were set up to cut off the control of local governments over PBOC branches. *See* Guanyu Shenhua Jinrong Gaige, Zhengdun Jinrong Zhixu, Fangfan He Huajie Jinrong Fengxian De Tongzhi (关于深化金融改革，整顿金融秩序，防范和化解金融风险的通知) [Notice on Deepening Financial Reform, Rectifying Financial Order, Preventing and Defusing Financial Risk] (promulgated by the Cent. Comm. of CPC and the State Council, Dec. 6, 1997), http://cpc.people.com.cn/GB/64184/64186/66688/4494459.html [https://perma.cc/GK9D-4LBM].

[228] *See* MA QINGQUAN ET AL., ZHONGGUO ZHENGQUAN SHI, DIYI JUAN (中国证券史，第一卷) [THE SECURITIES HISTORY OF CHINA, VOL. 1] 119–23 (2009) [hereinafter MA ET AL., VOL. 1].

[229] Shenzhen Jingji Tequ Guoying Qiye Gufenhua Shidian Zanxing Guiding (深圳經濟特區國營企業股份化试點暫行規定) [Interim Provisions of Shenzhen Special Economic Zone on the Experimentation of Shareholding System by SOEs) (promulgated by Shenzhen Mun. Gov't, Oct. 15, 1986) (Lawinfochina).

[230] *See* Carl. E. Walter, *The Struggle over Ownership: How the Reform of State-Owned Enterprises Changed China*, 28 COPENHAGEN J. ASIAN STUD. 83, 89 (2010), http://rauli.cbs.dk/index.php/cjas/article/viewFile/2669/3066 [https://perma.cc/W7AA-6CEC].

thirty-eight articles altogether.[231] All this legislation was rudimentary at best. The purpose was to put in place some rules governing company formation while the major contents were the approval requirements and procedures for share issues.[232] Investor protection was not yet on the agenda and shareholders' rights were barely mentioned. Even the most sophisticated regulation—in Shenzhen, which effectively copied Hong Kong's—only vaguely stipulated shareholders' rights to participate in management and supervision and to receive dividends and surplus.[233] It did not provide what remedies were available to shareholders when their rights were infringed. Lastly, the constitutional legality of these local rules was questionable, and the central government later refused to recognize some companies that were set up according to these rules.[234]

Regarding stock trading, the PBOC Shanghai Branch issued a document to regulate the OTC market in 1987.[235] In 1990, the government of Shanghai and in 1991, the Shenzhen government promulgated rules on the operation of the Stock Exchanges.[236] The PBOC Shanghai Branch also issued a separate document regulating securities listing and trading.[237] These rules stipulated the requirement for information disclosure and prohibited insider trading and market manipulation, but lacked details.[238] Again, investor protection was not yet a concern, illustrated by the requirement that listed companies were to disclose information to the government but not to investors.[239]

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[231] Gupiao Guanli Zanxing Banfa（上海市股票管理暂行办法) [Interim Measures on the Administration of Shares] (promulgated by the Shanghai Mun. Gov't, May 23, 1987), arts. 18–21 (Lawinfochina).

[232] *See* MA ET AL., VOL. 1, *supra* note 228, at 117–19.

[233] *See* Provisional Regulations on the Pilot Program, *supra* note 43, art. 7.

[234] *See* Fang Liufang, *China's Corporatization Experiment*, 5 DUKE J. COMP. & INT'L L. 149, 160–63 (1995).

[235] Zhengquan Guitai Jiaoyi Zanxing Guiding (证券柜台交易暂行规定）［Interim Provisions on OTC Securities Trading] (promulgated by the Shanghai PBOC Branch, Jan. 5, 1985, effective Jan. 15, 1987), http://www.shtong.gov.cn/node2/node2245/node75491/node75506/node75508/userobject1ai90549.html [https://perma.cc/5YDC-ANGE].

[236] Gupiao Faxing Yu Jiaoyi Guanli Zanxing Banfa (深圳市股票发行与交易管理暂行办法) [Interim Measures for Administration of Share Issuance and Trading] (promulgated by Shenzhen Mun. Gov't, May 15, 1991) (Lawinforchina); Zhengquan Jiaoyi Guanli Banfa（上海市证券交易管理办法) [Measures for Administration of Securities Trading] (promulgated by Shanghai Mun. Gov't, Nov. 27, 1990) (Lawinfochina).

[237] Shanghai Zhengquan Jiaoyisuo Jiaoyi Shichang Yewu Shixing Guize (上海证券交易所交易市场业务试行规则) [Trial Rules of the Shanghai Securities Exchange on Market Trading Operation] (promulgated by the Shanghai Sec. Exch., Nov. 26, 1990) (Lawinfochina).

[238] *Id.*

[239] *See* Pitman B. Potter, *The Legal Framework for Securities Markets in China: The Challenge of Maintaining State Control and Inducing Investor Confidence*, 7 CHINA L. REP. 61, 87 (1992).

B. The Second Stage: Between 1992 and 2000

Following the "share fever" triggered by Deng's "Southern Tour," a number of laws were enacted at the ministerial level. Among them, three documents issued by the State Commission for Restructuring the Economic System in May 1992 were most prominent.[240] It was the riot in Shenzhen in August 1992, however, that prompted the leadership in Beijing to accelerate legislation and set up a regulatory system.[241] The riot demonstrated that a chaotic market would not only be a risk to the financial system and economic order, but also pose a serious threat to social and governmental stability. The top leadership believed that the lack of regulation was the cause for this mayhem; they felt an urgent need to regulate the stock market to instill order. [242] In October 1992, the State Council announced the establishment of a new regulatory system, consisting of the State Council Securities Committee (SCSC) and the CSRC.[243] In December 1992, following the decision made by the 14th CPC Congress to expand the shareholding experiment and to develop the stock market, the State Council published a document proclaiming that a sound legal system was the precondition for a healthy market and called for speeding up legislation.[244] It also clarified the responsibilities and powers of the SCSC and CSRC. The SCSC would be a meeting system of senior government officials, responsible for policy formulation, coordination and the organization of laws and regulation drafting, while the CSRC would be the executive of the SCSC, responsible for enacting regulatory rules and supervising the securities markets and intermediaries.[245]

1. Creating a Legal Framework

After the SCSC and CSRC were set up, legislation was passed at great pace. The first, the Interim Regulations on the Administration of Share Issu-

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[240] Gufenzhi Qiye Shidian Banfa (关于印发《股份制企业试点办法》的通知) [Measures on Experimenting with the Shareholding Enterprise] (promulgated by the State Comm. for Restructuring the Economic System, May 15, 1992) (Lawinfochina); Gufen Youxian Gongsi Guifan Yijian (股份有限责任公司规范意见) [Opinion on Standards for Companies Limited by Shares] (promulgated by the State Comm. for Restructuring the Econ. System, May 15, 1992) (Lawinfochina); Youxian Zeren Gongsi Guifan Yijian (有限责任公司规范意见) [Opinion on Standards for Limited Liability Companies] (promulgated by the State Comm. for Restructuring the Econ. Sys., May 15, 1992) (Lawinfochina).

[241] *See* Chao Deng, *China's Stock Markets: Nearly 25 Years of Wild Swings*, WALL ST. J. (July 31, 2015), http://www.wsj.com/articles/chinas-stock-markets-nearly-25-years-of-wild-swings-1438328914 [https://perma.cc/392C-Q48H].

[242] Notice on Further Strengthening, *supra* note 97, at pmbl.

[243] *Id.*

[244] *Id.* at Part V.

[245] *Id.* at Part I.

ance and Trading, was adopted in April 1993.[246] This was a pillar of the legal system until the Securities Law was enacted in 1998. It was comprehensive, covering a wide range of issues, such as the conditions and approval procedures for companies to make public offerings, the documentation required for approval and compulsory contents of a prospectus, underwriting and subscription, conditions and procedure for listing, and depository and clearing rules.[247] Listed companies were required to publish both annual and semi-annual reports and disclose material price-sensitive information.[248] Based on the City Code of the United Kingdom, rules on takeovers were laid down. Insider trading, information misrepresentation, and manipulating share prices were prohibited, and penalties against such frauds were clearly spelled out. The CSRC was authorized to investigate violations. On paper, these provisions were "thorough and demanding," comparable to the securities regulations of developed economies.[249] To implement this legislation, the SCSC and CSRC issued special rules on information disclosure and anti-securities fraud in 1993.[250]

The SCSC and CSRC also promulgated a large number of regulations and rules to govern other issues, such as the organization and management of the stock exchanges, the regulation of securities companies and their businesses (like underwriting, proprietary trading, investment consulting, and fund management), and the qualification and disqualification of securities practitioners.[251] Special rules were passed to regulate B shares (domestically listed foreigner-owned shares) and overseas offerings and listings.[252]

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[246] Zhengquan Faxing Yu Jiaoyi Guanli Zanxing Tiaoli (股票发行与交易管理暂行条例) [Interim Regulations on the Administration of Share Issuance and Trading] (promulgated by the State Council, Apr. 22, 1993) (Lawinfochina).

[247] *See generally id.*

[248] *See* Potter, *supra* note 239, at 85–86.

[249] *See* John T. Shinkle, *Observation on Capital Market Regulation: Hong Kong and the People's Republic of China*, 18 U. PA. J. INT'L ECON. L. 255, 272, 283–84 (1997); *see also* John Armour et al., *Law and Financial Development: What We Are Learning from Time-Series Evidence*, 6 BYU L. REV. 1435, 1461 (2009); Tan Lay Hong, *The Legal & Regulatory Framework of the Securities Market in the PRC*, 7 ASIA PAC. L. REV. 69, 89–90 (1999).

[250] Gongkai Faxing Gupiao Gongsi Xinxi Pilu Shishi Xize (Shixing) (证监会关于发布《公开发行股票公司信息披露实施细则（试行）》的通知) [Detailed Implementing Rules on Information Disclosure by Publicly Issuing Companies (Trial Implementation)] (promulgated by the China Sec. Reg. Comm'n, June 12, 1993); Jinzhi Zhengquan Qizha Xingwei Zanxing Banfa (禁止证券欺诈行为暂行办法) [Interim Measures on Preventing Securities Frauds] (promulgated by the China Sec. Reg. Comm'n, Sept. 2, 1993) (Lawinfochina).

[251] *See* MA ET AL., VOL. 1, *supra* note 228, at 277–89.

[252] Guanyu Gufen Youxian Gongsi Jingnei Shangshi Waizigu De Guiding (国务院关于股份有限公司境内上市外资股的规定) [Provisions Regarding Domestically Listed Foreign-Invested Shares of Companies Limited by Shares] (promulgated by the State Council, Dec. 25, 1995) (Lawinfochina); Guanyu Gufen Youxian Gongsi Jingwai Muji Gufen Ji Shangshi De Tebie Guiding (国务院关于股份有限公司境外募集股份及上市的特别规定) [Special Provisions Regard-

Last but not least, an abundant number of normative documents, and notices were issued, dealing with *ad hoc* issues, responding to changes, or providing operational guidance.[253] For example, by 1998 the CSRC had published seven documents mandating the format and contents of an IPO prospectus, annual and semi-annual reports, prospectus for rights issues, report for changes of shareholding, lawyers' work reports, and so on.[254] The total number of relevant laws, regulations, and rules exceeded 250 by 1998.[255]

In December 1993, the Standing Committee of the NPC adopted the Company Law, finally providing a solid legal footing for company formation and operation.[256] This legislation, however, was criticized for its conservatism left over from the era of the Chinese planned economy.[257] At the start, the law incongruously proclaimed that state assets of a company belonged to the state.[258] Moreover, although two types of companies were allowed in general—a limited liability company (similar to a close or private company) and a company limited by shares (equivalent to a joint stock or public company)—only SOEs enjoyed the privilege to be organized as a limited liability company with only one shareholder.[259] In terms of investor protection, the law was lamentable. For example, it did not provide for directors' fiduciary duties; many common measures for minority shareholder protection, such as accumulative voting, shareholders' right to access company information, and the proposal and preemptive right, were absent;[260] shareholders also did not have recourse to remedies such as the shareholder derivative action and appraisal right.[261]

Although other laws and regulations were passed with high efficiency, the adoption of the Securities Law was long delayed. Commencing as early as July 1992, the NPC Standing Committee took charge of drafting the

ing Offerings and Listings Outside China by Companies Limited by Shares] (promulgated by the State Council, Aug. 4, 1994) (Lawinfochina).

[253] *See* Daniel M. Anderson, *Taking Stock in China: Company Disclosure and Information in China's Stock Markets*, 88 GEO. L.J. 1919, 1922–23 (2000).

[254] *See id.* at 1925–27.

[255] *See id.* at 1923.

[256] *See id.*; Nicholas C. Howson, *China's Company Law: One Step Forward, Two Steps Back? A Modest Complaint*, 11 COLUM. J. ASIAN L. 127, 127 (1997).

[257] *See* Howson, *supra* note 256, at 128, 172.

[258] *See* Zhonghuo Renmin Gongheguo Gongsi Fa (中华人民共和国公司法) [Company Law of PRC] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1993, effective July 1, 1994) art. 4 (Lawinfochina).

[259] *Id.* art. 64.

[260] *See* Howson, *supra* note 256, at 140–44, 147–50.

[261] *See* Zhong Zhang, *The Shareholder Derivative Action and Good Corporate Governance in China: Why the Excitement Is Actually for Nothing*, 28 UCLA PAC. BASIN L.J. 174, 189–91 (2011) [hereinafter Zhang, *Shareholder Derivative Action*].

law—the first instance in China's legislative history.[262] But bitter disputes on some key issues and a turf war between two departments of the NPC Standing Committee soon broke out. The legislative process stalled until top leadership intervened in the wake of the Asian Financial Crisis. The Law was eventually passed in December 1998 and took effect on July 1, 1999.[263] It was essentially a codification of previous regulations and rules on public offerings, underwriting, listing, trading, information disclosure, anti-fraud, takeover, stock exchanges, securities companies, and securities businesses. Some provisions were made to confirm policy changes, like abolishing the quota system for share issue and establishing a unified market regulator. There were also technical improvements, particularly in the area of takeovers. Some controversial and unsettled issues, like OTC market regulation, were left untouched.[264] Overall, the law was rigid and restrictive, reflecting the government's approach of heavy regulation and control in the face of wild speculation and lawlessness in the market.[265] Nevertheless, the enactment of the Securities Law marked that a basic legal framework governing the stock market had been established.

With regards to criminal legislation, the first major piece of legislation was a Decision passed by the NPC Standing Committee in 1995 to punish violations of the Company Law.[266] The corporatization of SOEs created an uncertainty as to whether the criminal liabilities stipulated in the Criminal Law of 1979 against graft and bribe-taking by state personnel and SOE managers were applicable to managers of listed SOEs.[267] In the meantime, although the Company Law stated that embezzlement and bribe taking by company managers were criminally punishable,[268] neither the Company Law nor the Criminal Law specified the exact punishments. Hence, loopholes existed whereby miscreant managers might escape criminal punishment. To close them, the NPC adopted the Decision to specify punishments for those ac-

[262] *See* Minkang Gu & Robert C. Art, *Securitization of State Ownership: Chinese Securities Law*, 18 MICH. J. INT'L L. 115, 119, 122 (1996).

[263] Xian Chu Zhang, *The Old Problems, the New Law, and the Developing Market—A Preliminary Examination of the First Securities Law of the People's Republic of China*, 33 INT'L LAW. 983, 983 (1999) [hereinafter Zhang, *The Old Problems*].

[264] *See* GREEN, *supra* note 2, at 18; Zhang, *The Old Problems*, *supra* note 263, at 986, 988–89, 992–97, 1000, 1002.

[265] *See* Zhang, *The Old Problems*, *supra* note 263, at 988, 1008–09.

[266] Guanyu Chengzhi Weifan Gongsifa De Fanzui De Jueding (全国人大常委会关于惩治违反公司法的犯罪的决定) [Decision Regarding the Punishment of Crimes in Violation of the Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Feb. 28, 1995) (Lawinfochina).

[267] Mingxuan Gao & Jianbo Wang, *Woguo Zhengquan Fanzui de Bentuhua Yu Guojihua Sibian (我国证券犯罪的本土化与国际化思辨) [An Analysis of the Localization and Internationalization of Legislation on Securities Crimes in China]*, 1 FAXUEJIA (JURIST) 125–33 (1998), http://www.faxuejia.org.cn/CN/abstract/abstract430.shtml [https://perma.cc/BCH9-QB32].

[268] Company Law of PRC, art. 214.

tions.[269] In addition, the same Decision provided for punishments against fraudulent or unapproved public offerings and false disclosure of financial reports by listed companies.[270] These provisions of the Decision were codified when the Criminal Law of 1979 was amended in 1997.[271] The 1997 amendment also added punishments for insider trading, divulging inside information, fabricating and spreading false information, and manipulating share prices by way of trading.[272] In early 1993, the Interim Regulations on the Administration of Share Issuance and Trading and the special rules on anti-securities fraud criminalized these misdeeds,[273] but they did not stipulate punishments. The 1997 amendment closed these remaining legislative loopholes. But new ones opened after the enactment of the Securities Law of 1998, which designated more misdemeanors as criminally punishable without stipulating what the punishments would be.[274]

2. Establishing a Centralized and Unified Regulatory System

Despite the establishment of the SCSC and CSRC in 1992 as specialized regulators, the regulatory system remained fragmented and locally controlled. The SCSC and CSRC were not the only regulators, as other ministries shared responsibilities and power. The State Planning Commission had the mandate to formulate and distribute quotas for share issues; the PBOC was responsible for licensing and supervising securities institutions and investment funds; the Ministry of Finance was responsible for regulating the accounting sector.[275] Other ministries overshadowed the CSRC, and its authority to issue and enforce rules was questioned, as it was designated as a non-governmental institution with only an administrative rank of vice-ministry.[276] In terms of resources, the number of its employees was limited to only 100 and its funding was insecure.[277] At the local level, the Shanghai and Shenzhen Stock Exchanges were still under the control of their respective governments.[278] Moreover, following the central government's practice,

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[269] Decision Regarding the Punishment of Crimes in Violation of the Company Law, arts. 9–11.

[270] *Id.* arts. 3, 4, 7.

[271] *See generally* Company Law of PRC.

[272] *See* Zhonghua Renmin Gongheguo Xingfa (中华人民共和国刑法) [Criminal Law of PRC] (promulgated by the Standing Comm. Nat'l People's Cong., July 1, 1979, revised Mar. 14, 1997, effective Dec. 25, 1999) arts. 180–182 (Lawinfochina).

[273] *See* Interim Regulations on the Administration of Share Issuance and Trading, art. 78; Detailed Implementing Rules on Information Disclosure by Publicly Issuing Companies, *supra* note 250; Interim Measures on Preventing Securities Frauds, art. 26.

[274] *See* Gao & Wang, *supra* note 267.

[275] Notice on Further Strengthening, *supra* note 97, at Part I.

[276] *Id.*

[277] *See* LIU, *supra* note 37, at 212.

[278] *See* Notice on Further Strengthening, *supra* note 97, at Part I.

Shanghai and Shenzhen set up their own specialized regulators in 1993 and governments in other provinces and cities later followed suit.[279] But these regulators were under the control of local governments and the CSRC had no jurisdiction over them.[280] To sum up, the CSRC was weak, isolated in Beijing, and lacked authority. It even had trouble accessing information about the stock exchanges because it was not physically present and the requirement for the exchanges to report was regularly ignored.[281]

A series of scandals led to changes. As explained earlier, the "327 government bond futures" scandal fully exposed pervasive mismanagement at the Shanghai Stock Exchange and the lax attitude towards regulation and risk control.[282] The competition between Shanghai and Shenzhen to boost stock trading by using local securities companies and bank money to manipulate share prices further revealed the danger of leaving local governments in control. The central government first stripped the two municipal governments of control of the stock exchanges.[283] In August 1996, the central government amended and upgraded the provisional regulations on stock exchanges adopted in 1993 to permanent status, which now stated that stock exchanges were under the administration of the CSRC and the CSRC had the power, in consultation with the local governments, to nominate the chairman and vice chairman of the board of directors for election and to appoint the general and vice general managers.[284] In July 1997, the General Office of the State Council gave notice that the two stock exchanges were to be under the "direct" administration of the CSRC and the CSRC was to have exclusive power over personnel issues.[285] These changes were subsequently incorporated into the regulations. On August 14, 1997, the General Manager of the Shanghai Stock Exchange was replaced by an official from the CSRC, marking the end of local control over the stock exchanges.[286]

The Asian Financial Crisis prompted further changes to the regulatory system. Witnessing that a weak financial sector could devastate the whole

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[279] *See* JANE FU, CORPORATE DISCLOSURE AND CORPORATE GOVERNANCE IN CHINA 115–16 (2010).

[280] *See* Green, *Equity Politics*, *supra* note 91, at 13–14.

[281] *See id.* at 14.

[282] *See* GREEN, *supra* note 2, at 19–21; Green, *Equity Politics*, *supra* note 91, at 14–15.

[283] *See* Green, *Equity Politics*, *supra* note 91, at 24–25.

[284] Zhengquan Jiaoyisuo Guanli Banfa (证券交易所管理办法) [Interim Measure on Securities Exchange Administration) (promulgated by China Sec. Reg. Comm'n, Aug. 21, 1996), arts. 4, 22, 24 (Lawinfochina).

[285] Guanyu Jiang Shanghai Zhenquan Jiaoysuo He Shenzhen Zhengquan Jiaoyisuo Huagui Zhongguo Zhengjianhui Zhijie Guanli De Tongzhi (关于将上海证券交易所和深圳证券交易所划归中国证监会直接管理的通知）［Notice on Putting the Shanghai Stock Exchange and Shenzhen Stock Exchange Under CSRC's Direct Administration] (promulgated by the Gen. Office of the State Council, July 2, 1997) (Lawinfochina).

[286] *See* Green, *Equity Politics*, *supra* note 91, at 21.

economy of other Asian countries, the leadership in China decided it was time to put its own unruly financial system in some order. In November 1997, the Central Committee of the CPC and the State Council held a national financial conference in Beijing where it decided, first, to centralize the administration and personnel management of the PBOC, state-owned commercial banks, and other financial institutions, and second, to enforce the principle of separated businesses, which forced commercial banks to divest their non-deposit-taking and lending businesses.[287] Specifically in the securities sector, the CPC announced a new unified and centralized regulatory system.[288] In April 1998, the SCSC was abolished and the CSRC was upgraded to the rank of a full ministry.[289] The PBOC's power of licensing and supervising securities institutions and investment funds were transferred to the CSRC.[290] The quota system for share issues was abolished so that the State Planning Commission was no longer involved in the regulation of the stock market.[291] In the meantime, the CPC decided that the CSRC should take over the existing local regulators and new ones should be set up across the country. By July 1999, all local regulators had been put under the control of the CSRC.[292] A unified and centralized regulatory system had been established. The CSRC's authority over the stock market was no longer disputed, and it was a physical presence all over the country.

C. The Stage Since 2000

After the new system was established, the CSRC faced an urgent issue—the deterioration in profit performance of listed companies. Despite the short history of the stock market, a large number of listed companies lost money by the end of the 1990s. By 2001, 150 companies, 12.9% of the total, encountered a loss.[293] Some of them had been losing continually for years. In 1998 the Shanghai and Shenzhen Stock Exchange came up with the Special Treatment (ST) label to mark companies having made continuous losses for two years and in the following year, the Particular Transfer (PT)

[287] *See* Notice on Deepening Financial Reform, *supra* note 227.

[288] *Id.* at Part XII.

[289] Hui Huang, *The Regulation of Insider Trading in China: A Critical Review and Proposals for Reform*, 17 AUSTL. J. CORP. L. 1, 3 (2005), http://www.lapres.net/insideinforeg.pdf [https://perma.cc/H76Z-BWRA].

[290] *See* MA ET AL., VOL. 1, *supra* note 228, at 426–27.

[291] *See* Huang, *supra* note 289, at 3.

[292] MA ET AL., ZHONGGUO ZHENGQUAN SHI, DI ER JUAN (中国证券史，第二卷) [THE SECURITIES HISTORY OF CHINA, VOL. 2] 417–21 (2009) [hereinafter MA ET AL., VOL. 2].

[293] *See supra* note 179 and accompanying text.

designation for companies making losses for three consecutive years.[294] There were twenty-six ST companies in 1998 and by 2000 the number increased to sixty-six.[295] The number of PT companies increased from four in 1999 to twenty by 2001.[296] It had become apparent that merely listing SOEs on the stock exchanges would not improve their performance and the governance of listed SOEs was in urgent need of improvement. Early in 1994, the Chinese government issued a document to regulate companies' articles of association, but it was only applicable to companies issuing and listing shares on overseas stock exchanges and the purpose was to ensure those companies met the corporate governance standards of overseas markets.[297] In 1997, the CSRC adopted a similar document for companies listed on the domestic exchanges.[298] In February 2000, Zhou Xiaochuan, a veteran banker who was regarded as capable, reform-minded, and experienced in international finance, became the chairman of CSRC. He saw corporate governance as critical to a healthy market and identified it as a priority for CSRC to tackle.[299] During his thirty-four-month tenure, two corporate governance initiatives were implemented.[300] The first introduced an independent director system. The CSRC issued a document in August 2001 decreeing that at least one-third of directors of a listed company should be independent by mid-2003.[301] The second was the issuance in January 2002 of a corporate governance code for listed companies. Inspired by the Organisation for Economic Co-operation and Development's Principles of Corporate Govern-

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[294] *See* Stephen Green, *The Privatization Two-Step at China's Listed Firms* 25 (Chatham House China Project Working Paper No. 3, 2004), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=598277 [https://perma.cc/XL6Z-8N3A] [hereinafter Green, *Privatization Two-Step*].

[295] *See* Enoch Cheng et al., *The Special Treatment Designation and Information Transmission in the Chinese Stock Market, in* MATHEMATICAL METHODS IN FINANCE AND BUSINESS ADMINISTRATION 139, 140 (Reinhard Neck ed., 2014).

[296] *See* LI, CHINESE STOCK MARKET, *supra* note 38, at 342.

[297] *See* Dao Jingwai Shangshi Gongsi Zhangcheng Bibei Tiaokuan (到境外上市公司章程必备条款) [Mandatory Articles of Association for Overseas Listed Companies] (promulgated by the China Sec. Reg. Comm'n, Aug. 27, 1994) (Lawinfochina).

[298] *See* Shangshi Gongsi Zhangcheng Zhiyin (上市公司章程指引) [Guiding Articles of Association for Listed Companies] (promulgated by the China Sec. Reg. Comm'n, Dec. 16, 1997) (Lawinfochina).

[299] *See* Xiaochuan Zhou, *Gaijin Gongsi Zhili Jiegou Pozaimeijie (改进公司治理结构迫在眉睫) [Improving Corporate Governance Structure in Great Urgency]*, SINA (Sept. 12, 2001), http://finance.sina.com.cn/y/20010912/106290.html [https://perma.cc/8FAX-E5JT].

[300] *See* Tong Daochi, *Securities Market Reform in China: Advancing Corporate Governance*, *in* ASIAN PERSPECTIVES SEMINAR: ADVANCING CORPORATE GOVERNANCE REFORM IN ASIA 11, 13 (Feb. 28, 2002), https://asiafoundation.org/resources/pdfs/corpgov.pdf [https://perma.cc/98AC-VPWH].

[301] Guanyu Zai Shangshi Gongsi Jianli Duli Dongshi De Zhidao Yijian (关于 在上市公司建立独立董事制度的指导意见) [Guiding Opinion on Establishing an Independent Director System in Listed Companies] (promulgated by the China Sec. Reg. Comm'n, Aug. 16, 2001) (Lawinfochina).

ance, it was much more detailed and addressed problems that were particularly serious to Chinese companies, such as the dominance of controlling shareholders, the prevalence of related-party transactions, the dependence of listed companies on their controlling shareholder for business and operation, and so forth.[302]

Zhou Xiaochuan also emphasized the importance of law enforcement. But the sharp increase in enforcement activities from 2000 was driven more by scandal.[303] The years 2000 and 2001 are remembered in the history of China's stock market for the revelation of a series of outrageous scandals. Three types of scandals were especially notorious. The first was market manipulation, including trade-based, information-based, or both. Stock cornering was the most popular trade-based manipulation, whereby a manipulator secretly bought a large number of shares of a company using multiple trading accounts and then sold down after innocent investors were lured in and the share price was high enough. In information-based manipulation, different methods were used to propagate false information. A manipulator might procure the collusion of the top managers of a company or buy control of a company in order to disclose false information or spread rumors privately or through public media.[304] The second type of fraud was information falsification by listed companies, whereby accounting documents like sale contracts, invoices, and tax receipts were all faked. Individuals participated in such fabrication not only for market manipulation but also for other reasons, like meeting the minimum profit requirement for an IPO or secondary offering.[305] The third was misappropriation, whereby a huge sum of money was channeled from a listed company to its controlling shareholder or other related party in the name of a "loan" or without any pretense.[306]

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[302] Shangshi Gongsi Zhili Zhunze (上市公司治理准则) [Principles of Corporate Governance of Listed Companies] (promulgated by the China Sec. Reg. Comm'n, Jan. 7, 2002) (Lawinfochina).

[303] *See* Luo Peixing et al., *Zhengquan Weifa Weigui Chengjie Shixiao He Zhidu Chengben Yanjiu (证券违法违规惩戒实效与制度成本研究) [Research on the Effectiveness and Institutional Cost of Sanctions Against Violation of Securities Laws and Regulations]*, (Shanghai Stock Exchange Joint Research Program Project Report No. 15, 2005), https://biz.sse.com.cn/cs/zhs/xxfw/jysjs/sseResearch/2005lawsnrules/2005lawsnrules_c.pdf [https://perma.cc/P6SS-86GT].

[304] *See* Barry Naughten, *The Politics of the Stock Market*, 3 CHINA LEADERSHIP MONITOR 1, 3–7 (2002), http://media.hoover.org/sites/default/files/documents/clm3_BN.pdf [https://perma.cc/92V3-UTY3]; Sophie Roell, *Chinese Authorities Arrest Two People in Share Price Manipulation Scandal*, WALL ST. J. (Feb. 8, 2001), http://www.wsj.com/articles/SB981622865229017283 [https://perma.cc/PH78-XNMK].

[305] *See* GREEN, *supra* note 2, at 135–41.

[306] *See* Xuanyu Huang, *Scandal-Driven Regulation of China's Stock Market: Dynamics Among the State, Market, and Stockizens* 100–12 (May 2015) (Ph.D. dissertation, Arizona State University), https://repository.asu.edu/attachments/150829/content/HUANG_asu_0010E_15116.pdf [https://perma.cc/NVT8-D6MF].

There are numerous examples of fraud. In October 2000, *Caijing*, a respected business magazine, published an investigatory report on the shady fund management sector.[307] December saw the debacle of the intricate and sprawling manipulation scheme of *Zhongke Chuangye*.[308] The audacious manipulation of *Yi'an Keji* collapsed after the CSRC announced an investigation in April 2001.[309] In August 2001, the CSRC issued a public criticism of *Sanjiu Yiyao* and its board of directors for not disclosing the misappropriation of billions of RMB by its controlling shareholder.[310] In the same month, the extraordinary story of a blue-chip, high-growth company, *Yinguangxia*, came to an abrupt end after *Caijing* discovered that its profits were completely fabricated.[311] It was because of these scandals that the preeminent economist, Wu Jinglian, condemned the market as "worse than a casino," a statement that resonated strongly with investors.[312]

Amid a public outcry, the CSRC took action to investigate these scandals. Punishments were meted out, helped by the revamped regulatory system.[313] With share prices dropping further after 2001, more scandals were exposed. Market manipulators found they were now in an unenviable position in that, as retail investors withdrew from the market, they could not sell down the shares they had secretly accumulated.[314] Instead, to maintain the high price of cornered stocks, more money was needed, which they now found difficult to access.[315] In the end, a large number of manipulation schemes failed and share prices collapsed. Securities companies and other fraudsters that had engaged in these manipulations accumulated huge losses and could not repay the funds they had appropriated from their clients or

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[307] *See* Hu Ping & Jing Li, *Jijin Heimu—Guanyu Jijin Xingwei De Yanjiu Baogao Jiexi (基金黑幕—关于基金行为的研究报告解析) [An Inside Story of the Shady Investment Fund Sector—An Analysis of Research Report on the Behavior of Investment Funds]*, CAIJING (Nov. 10, 2000), http://www.chinanews.com/2000-11-10/26/55317.html [https://perma.cc/V9CF-S6A4].

[308] *See* Shuli Hu et al., *Zhuangjia Lu Liang (庄家吕梁之一) [Market Manipulator Lu Liang]*, CAIJING (Feb. 5, 2001), http://magazine.caijing.com.cn/2001-02-05/110059991.html [https://perma.cc/SY8S-TN5M].

[309] Li, *Who Is Manipulating Yi'an Keji?*, *supra* note 156.

[310] *Zhongguo Zhengjianhui Gongkai Piping Sanjiu Yiyao Ji Zhao Xinxian Deng Zerenren (中国证监会公开批评三九医药及赵新先等负责人) [CSRC Publically Criticizing Sanjiu Yiyao and Zhao Xingxian and Other Responsible Persons]*, CHINA NEWS (Aug. 28, 2001), http://www.chinanews.com/2001-08-28/26/116935.html [https://perma.cc/AV7Q-F5Y4].

[311] Huawei Ling & Shuo Wang, *Yinguanxia Xianjing (银广夏陷阱) [The Trap of Yinguanxia]*, CAIJING (Aug. 5, 2001), http://finance.sina.com.cn/t/20010807/92215.html [https://perma.cc/9A8U-3JFK].

[312] *See* Kuhn, *supra* note 1; McGregor, *supra* note 1.

[313] *See* Huang, *supra* note 306, at 110.

[314] *See* Hu et al., *supra* note 308; Huawei Ling et al., *Xiaoxiong Tang Wanxin (枭雄唐万新) [Tang Wanxin: The Villain]*, CAIJING (Jan. 11, 2006), http://finance.sina.com.cn/stock/t/20060111/18512267862.shtml [https://perma.cc/JY9Z-MRS2].

[315] *See* Hu et al., *supra* note 308; Huawei Ling et al., *supra* note 314.

other sources.[316] The government had to step in to plug the hole.[317] The CSRC acted like a firefighter. It not only needed to investigate the scams and punish the culprits, but also to close down or restructure the bankrupt securities companies and clean up the mess that was left behind. In the process, various rules were adopted to better control the securities companies.[318]

Another problem that needed to be tackled urgently was the misappropriation of corporate funds by controlling shareholders and listed companies' guarantees for loans borrowed by their controlling shareholders or affiliates. The seriousness of the problem was highlighted by the scandal of *Sanjiu Yiyao*. More than RMB 2.5 billion, equivalent to 96% of its total net assets, was channeled from the listed company to its controlling shareholder and more than RMB 1.1 billion was "lent" to one of its sister companies.[319] In 2001, the CSRC instructed listed companies to recover "loans" borrowed by their controlling shareholders.[320] But this was ignored, and more funds of more companies went missing. In 2003, the CSRC, with the newly established State-Owned Assets Supervision and Administration, tried to regulate inter-corporate loans, guarantees, and other financial transactions between listed companies and their controlling shareholders or affiliates, demanding that existing loans and guarantees be reduced by 30% every year.[321] But again, these measures were ineffective. By the end of 2003, misappropriation occurred in 737 listed companies out of a total of 1287, and the total amount of misappropriated funds reached RMB 113.2 billion, while the total profits of listed companies in that year were RMB 178.2 billion.[322] It was only after the State Council's intervention amid the serious crisis in the stock

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[316] *See* Huang, *supra* note 306, at 99, 100–07.

[317] *See id.* at 99.

[318] *See* MA ET AL., VOL. 2, *supra* note 292, at 371–98.

[319] Naomi Li, *Civil Litigation Against China's Listed Firms: Much Ado About Nothing?* 9 (Royal Inst. Int'l Affairs, Asia Programme Working Paper No. 13, Feb. 2004); Mark O'Neill, *Sanjiu Sells $937m in Assets to Repay Debt*, SOUTH CHINA MORNING POST (Sept. 30, 2003), http://www.scmp.com/article/429570/sanjiu-sells-937m-assets-repay-debt [https://perma.cc/SF8W-WJE3].

[320] *92 Yiyuan Zijin Rengbei Zhanyong, Zhongguo Xianqi Shangshi Gongsi Qingqian Fengbao (资金 92 亿元资金仍被占用， 中国掀起上市公司清欠风暴) [9.2 Billion Still Misappropriated, A Whirlwind Surges in China to Force the Return of Misappropriated Funds of Listed Companies]*, RENMIN RIBAO (PEOPLE'S DAILY) (Jan. 14, 2007), http://finance.people.com.cn/GB/5281637.html [https://perma.cc/LBL6-4Z6S].

[321] Guanyu Guifan Shangshi Gongsi Yu Guanlianfang Zijin Wanglai Ji Shangshi Gongsi Duiwai Danbao Ruogan Wenti De Tongzhi (关于规范上市公司与关联方资金往来及上市公司对外担保若干问题的通知) [Notice Regarding Certain Issues Relating to the Regularization of Listed Companies' Financial Transactions with Related Parties and External Guarantees by Listed Companies] (promulgated by the China Sec. Reg. Comm'n, Aug. 28, 2003) (Lawinfochina).

[322] *See* Hui Wang, *Dagudong Guanlian Zhankuan Falu Duice Yanjiu (大股东关联占款法律对策研究）[Research on Legal Countermeasures to Misappropriation by Related Parties of Large Shareholders]*, GONGSI FALU PINGLUN (COMPANY L. REV.) 88 (2005) [hereinafter Wang, *Legal Countermeasures*].

market that progress was eventually made. It took three more years for most of the misappropriated funds to be returned. In the process, the government took criminal action against senior managers of controlling shareholders.[323]

The misappropriation problem exemplified the inherent defects of Chinese listed companies. It exposed the scale of power abuse by controlling shareholders at the expense of public investors who invested their real money in listed companies. Early in 2000, the new CSRC chairman proclaimed the importance of protecting minority investors and improving the quality of listed companies.[324] As scandals continued and the stock market faced a looming collapse, it became urgent to have better protection for investors and to cure the ills of listed companies. A copious number of rules, documents, and *ad hoc* notices were issued to address such issues as related-party transactions, use of funds by listed companies, takeover and asset restructuring, independence of listed companies from their controlling shareholder, and so on.[325] Two high-level documents and one enactment by the CSRC were most important. In January 2004, the State Council published a document on how to resolve the problems in the securities markets and further develop the markets, calling for an improvement in the quality of listed companies and the protection of small investors.[326] In October 2005, the State Council endorsed a document proposed by the CSRC specifically on improving the quality of listed companies.[327] Among the issues it covered were corporate governance, internal control, transparency, related-party transactions, independence, and supervision of listed companies.[328] In December 2004, the CSRC issued a regulation specifically to protect minority investors, giving them the right of veto on such important issues as new issuance of shares, rights issues and reorganization, and the right of cumulative and proxy voting; here, the power of independent directors was also strength-

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[323] *See* Guohua Jiang et al., *Tunneling Through Intercorporate Loans: The China Experience*, 98 J. FIN. ECON. 1, 16 (2010).

[324] *See* Tao Liu, *Jiada Zhengquan Shichang Guifan Lidu—Youguan Fangmian Fuzeren Chuxi Luntan Chanshu Zhengquan Shichang Fazhan Guanjian (加大证券市场规范力度－有关方面负责人出席论坛阐述证券市场发展关键) [Strengthening Supervision of the Securities Markets—Senior Figures of the Responsible Departments Attend a Forum and Explain What Is Critical to the Development of the Securities Markets]*, CHINA DAILY (Dec. 17, 2000).

[325] *See* Jiang et al., *supra* note 323, at 17–19.

[326] Guanyu Tuijing Ziben Shichang Gaige Kaifang He Wending Fazhan De Ruogan Yijian (关于推进资本市场改革开放和稳定发展的若干意见) [Certain Opinions on Advancing Reform, Opening-up and Stable Development of the Capital Markets] (promulgated by the State Council, Jan. 31, 2004) (Lawinfochina) [hereinafter *Certain Opinions*].

[327] Guowuyuan Pizhuan Zhengjianhui Guanyu Tigao Shangshi Gongsi Zhiliang Yijian De Tongzhi (国务院批转证监会关于提高上市公司质量意见的通知) [Notice of the State Council on Approving and Forwarding the Opinions of CSRC on Improving the Quality of Listed Companies] (promulgated by the State Council, Oct. 19, 2005) (Lawinfochina).

[328] *Id.*

ened and fiduciary duties towards the company and minority shareholders were imposed on controlling shareholders.[329]

To further strengthen the protection of minority shareholders and reinforce the authority of the CSRC's existing rules, the Company Law and Securities Law were extensively amended in 2005.[330] The revised Company Law confirmed the independent director system, the fiduciary duties of directors and controlling shareholders, the cumulative and proxy voting right, and rules regarding related-party transactions and reorganization, among others.[331] It also introduced the derivative action; offered minority shareholders appraisal rights, the right to propose resolutions to shareholders' meetings, and to have access to internal information; reduced the shareholding threshold for calling an extraordinary shareholders' meeting; and augmented the powers of the supervisory board.[332] The Securities Law, as amended, confirmed the requirement of underwriter sponsoring for share issues, the third-party custody of investors' funds, and rules regarding risk control and personnel qualification of securities companies; it also established a fund for investor compensation in the event of securities company bankruptcy, offered investors the right to bring lawsuits against securities frauds, and strengthened the CSRC's investigative powers.[333] The Criminal Law was revised as well in 2006 to establish corporate managers' personal liability for misappropriation and to close loopholes in criminal liability for information misrepresentation.[334] Subsequently, rules previously adopted by the CSRC were updated in accordance with these revised statutes and the CSRC issued more operational rules.[335]

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[329] *See* Guanyu Jiaqiang Shehui Gongzhong Gudong Quanyi Baohu De Ruogan Guiding (关于发布关于加强社会公众股股东权益保护的若干规定) [Several Provisions Regarding Strengthening Protection for the Rights and Interests of Public Shareholders] (promulgated by the China Sec. Reg. Comm'n, Dec. 7, 2004) (Lawinfochina).

[330] *See Kangtai Cao, Guanyu Zhonghua Renmin Gongheguo Gongsifa (Xiuding Caoan) De Shuoming (关于中华人民共和国公司法（修订草案）的说明) [Explanations Regarding the Draft Revision of Company Law of PRC]*, STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (Feb. 25, 2005), http://www.npc.gov.cn/wxzl/gongbao/2005-10/27/content_5343120.htm [https://perma.cc/C8WR-QY2Z].

[331] *Id.*

[332] *Id.*

[333] *See Zhengqing Zhou, Zhonghua Renmin Gongheguo Zhengquanfa (Xiuding Caoan) De Shuoming (中华人民共和国证券法（修订草案）的说明) [Explanations Regarding the Draft Revision of Securities Law of the People's Republic of China]*, STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. (Apr. 24, 2005), http://www.npc.gov.cn/wxzl/gongbao/2005-10/27/content_5343116.htm [https://perma.cc/BK6M-BL7B].

[334] Zhonghua Renmin Gongheguo Xingfa Xiuzhengan (Liu) (中华人民共和国刑法修正案（六）) [Amendments (6) to the Criminal Law of PRC] (promulgated by the Standing Comm. of the Nat'l People's Cong., June 29, 2006), art. 9 (Lawinfochina).

[335] *See* Nicholas C. Howson, *Enforcement Without Foundation?—Insider Trading and China's Administrative Law Crisis*, 60 AM. J. COMP. L. 955, 973 (2012). For example, the CSRC

Hence, investor protection was improved considerably. Major deficiencies in primary legislation were corrected and investors offered more legal rights. Regulations, rules, and normative documents for investor protection were abundant—the total number of which exceeded 1200.[336] Enforcement was also strengthened, as evidenced by both the input of resources and output of CSRC enforcement activities. The era of the 1990s, when laws were largely unenforced, was gone. By 2006, a degree of order had been established and fraud that once plagued the market had been curtailed noticeably. The Chinese stock market could no longer be said to be in a state of lawlessness. Nevertheless, the decline of share prices since 2010 provoked a new public outcry over the dismal amount of dividends paid out by listed companies.[337] In terms of securities fraud, insider trading (including so-called "rat trading"[338]) became the focus of public indignation and the primary target of the CSRC's enforcement action.[339]

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

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

1. The Irrelevance of Investor Protection

Investor protection was hardly relevant in China's stock market development before mid-2001. China experienced bouts of "share fever," one of which caused a riot, even before a basic legal and regulatory framework was in place.[340] Certainly, those investors who frantically traded shares in 1990 and those queuing for days to buy a subscription form in 1992 in Shenzhen did not believe substantive investor protection was necessary to engage in trade.[341] In fact, it can be safely assumed that few of them understood what a share of a company actually was, how a company operated,

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issued guidance on the recognition of insider trading and market manipulation, which was internally circulated but not publically available. *See id.*

[336] Gang Xiao, *Jianguan Zhifa: Ziben Shichang Jiankang Fazhan De Jishi (监管执法：资本市场健康发展的基石) [Supervision and Enforcement: The Bedrock for a Healthy Capital Market]*, QIUSHI (SEEK TRUTH) (Aug. 1, 2013), http://www.qstheory.cn/zxdk/2013/201315/201307/t20130729_253982.htm [https://perma.cc/JLD9-WE5B].

[337] *See* Josh Noble, *China's Companies Spurn Directive to Pay 30% Dividend*, FIN. TIMES (May 16, 2013), http://www.ft.com/cms/s/0/a1a0338c-bdd9-11e2-890a-00144feab7de.html#axzz4DJCCLowR [https://perma.cc/VS6F-ZUVU].

[338] "Rat trading" is a type of front running, whereby an investment fund manager buys or sells a stock for his or her personal account before the fund that he or she manages buys or sells.

[339] *See* Xiao, *supra* note 336. Insider trading accounts for more than half of the total number of cases investigated by the CSRC in recent years. *See id.*

[340] *See supra* Part I.A.

[341] *See supra* notes 84–91 and accompanying text.

and what risks would be involved. What some of them might have known was perhaps that their neighbors or friends had bought shares and made money. Many more might not even have been aware of such examples. They just followed suit with only a faint idea that acquiring shares could make money.

Even after the CSRC was set up and major company and securities legislation was adopted, investor protection was still hardly relevant. There was no specific criminal legislation before 1995, the Securities Law was not enacted until 1998, the Company Law of 1993 was defective, and the legal rights and remedies critical for shareholder protection were glaringly absent.[342] More importantly, all the laws and rules for investor protection were largely unenforced, as evidenced by the widespread and blatant frauds that took place. Even the Shanghai and Shenzhen governments organized manipulation to boost stock trading, and the two stock exchanges offered support.[343] By the end of the 1990s and the early 2000s, fraud (in particular market manipulation, false disclosure, and misappropriation) had become systemic. The magnitude of misappropriation has already been detailed.[344] For false disclosure, one study estimated that 72% of listed companies engaged in such misconduct;[345] for market manipulation, even staff from the CSRC openly admitted that at least 30% of stocks were actively manipulated in 2000;[346] and another report revealed that the CSRC estimated 80% of stocks were manipulated in 2001.[347] Observers of the market summarized that "China's stock market is a notoriously corrupt place. Securities firms, investment funds, finance companies and rich individuals all manipulate prices and spread prodigious amounts of false information"[348] and "insider trading and manipulation of the market have been conducted almost half-openly"[349] and were "something of an open secret."[350]

The proposition that laws were largely unenforced is further supported by various empirical studies that found few enforcement activities in the 1990s. The number of cases under CSRC's administrative penalty and Shanghai and Shenzhen Stock Exchange's disciplinary actions against listed companies was a single digit every year between 1994 and 2000, while

342 Anderson, *supra* note 253, at 1924; *see* Howson, *supra* note 256, at 127, 140–41, 147–49.
343 *See* Anderson, *supra* note 253, at 1935, 1947.
344 *See supra* note 322 and accompanying text.
345 *See* GREEN, *supra* note 2, at 135–36.
346 *Id.* at 165.
347 Xiaolu Wang, *Zhengjian Xin Qiju (证监新棋局) [CSRC's New Chess Game]*, CAIJING (July 16, 2012), http://magazine.caijing.com.cn/2012-07-15/111949062.html [https://perma.cc/NF8X-LKYU].
348 GREEN, *supra* note 2, at 164.
349 Zhang, *The Old Problems*, *supra* note 263, at 989.
350 *See* WALTER & HOWIE, *supra* note 2, at 64.

there was an increase from 1998 in the number of cases investigated by the CSRC.[351] On specific fraud, there was only sporadic enforcement against market manipulation, insider trading, and information misrepresentation by listed companies before 2001.[352]

Why were laws for investor protection not enforced during this period? In China, where the rule of law has yet to be sufficiently established, laws that have been promulgated to be effective are not necessarily so in reality. Much depends on whether senior leaders enforce them seriously, which is in turn largely determined by the particular political, economic, and social circumstances of the time. In earlier days, prior to 1990, the stock market was seen as a liability rather than an asset to the economy.[353] Even after the market was designated for SOE financing, the main concern was over the dangers that a bubble would cause to the financial system, to the economy, and to social stability.[354] As articulated earlier, this concern was underscored by the decrees and warnings, the *People's Daily* editorial in 1996, and the punishments of several prominent bankers for market manipulation in 1997.[355] Enforcement was used to prick the bubble rather than for investor protection. On the other hand, although fraud was discovered early in the stock market's history, it was only beginning in 2000 that a series of shocking scandals were exposed to cause public outrage, and the market ran into crisis only after 2001.[356] In a word, the government lacked motivation to enforce the laws because the stock market was economically insignificant and the government faced no political pressure from investors.

The CSRC also lacked enforcement capacity during this period. There was no enforcement department in the CSRC until 1996, and once established in 1996, the department had no more than thirty-three staff until 2001.[357] The CSRC had no physical presence outside Beijing before 1999.[358] The CSRC could not even access information that it needed for legal actions. Local governments were interested in expanding their ex-

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[351] GTA Information Technology Co., *Zhongguo Shangshi Gongsi Weigui Chuli Yanjiu Shujuku (中国上市公司违规处理研究数据库) [Research Database of Enforcement Against Illegal Activities of Listed Companies in China]* (2011).

[352] *See* Luo et al., *supra* note 303; Shi Yongdong & Jiang Xianfeng, *Zhongguo Zhengquan Shichang Weifa Weigui Xingwei De Panbie—Jiyu Neimu Jiaoyi Yu Shichang Caozong De Anli Fenxi (中国证券市场违法违规行为的判别) [Detection and Discrimination of Illegal Activities in Chinese Security Market—Case Studies of Insider Trading and Market Manipulation]*, 3 YUCE (FORECASTING) 24, 76–80 (2005).

[353] *See* GREEN, *supra* note 2, at 4–14.

[354] *See supra* Part I.D.

[355] *See supra* Part I.B.2.

[356] *See supra* Part I.C.

[357] CAO LIJIA, ZHENGQUAN ZHIFA TIXI BIJIAO YANJIU (证券执法体系比较研究) [A COMPARATIVE STUDY OF SECURITIES LAW ENFORCEMENT SYSTEMS] 220–21 (2008).

[358] *See* MA ET AL., VOL. 1, *supra* note 228, at 413.

changes and boosting trade rather than enforcing laws, because of the benefits of increased tax revenue, economic growth, and political status brought by an enlarged exchange. The main concern for the central government was the financial, economic, and social disruption caused by a disorderly market.[359] Thus, it is not a surprise that before 1997, neither local governments nor the Shanghai and Shenzhen Stock Exchanges entered any sanctions against information misrepresentation.[360]

2. Why the Market Grew While Investor Protection Remained Weak

The behavior of those investors rushing to the market without the least concern for protection can be explained by the herding theory of behavioral finance.[361] Investors jumped on the investment bandwagon just because they saw other people buying shares. Such herd behavior is probably more pronounced and pervasive in China, where in a highly collective society with tight-knit social fabrics, information about peer behavior flows quickly and people feel more pressure to conform to collective norms.[362] Behavioral finance also provides explanations for some other traits exhibited by Chinese investors. For example, some retail investors pursued an investment strategy, colloquially called "dancing with [market] manipulators,"[363] signaling those investors' overconfidence that they could beat the manipulators. There were numerous stories about investors holding on to negative performing stocks for years, explicable perhaps by the prospect theory that investors have a tendency to avoid the negative utility of a prospective loss.[364] It is therefore possible that Chinese investors' rationality was bounded.[365] This bounded rationality is further compounded by the fact that individuals dominated the market in the 1990s, while institutional investors were few. These individuals were the first generation of investors with little experience. They paid little attention to a company's fundamentals, but instead followed intuition, rumors, inside information, and other people's actions. They were especially prone to irrationality.[366]

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[359] *See* Green, *Equity Politics*, *supra* note 91, at 13–14, 18–21.

[360] Luo et al., *supra* note 303.

[361] *See* Sushil Bikhchandani & Sunil Sharma, *Herd Behavior in Financial Markets: A Review* 4–5 (Int'l Monetary Fund, Working Paper WP/00/48, Mar. 2000), https://www.imf.org/external/pubs/ft/wp/2000/wp0048.pdf [https://perma.cc/G5Z2-RHQ2].

[362] *See id.* at 4.

[363] *See* Chen, *The China Puzzle*, *supra* note 31, at 31.

[364] *See* David Pett, *Using Prospect Theory to Reduce Risk*, FIN. POST (June 5, 2013), http://business.financialpost.com/investing/using-prospect-theory-to-reduce-risk [https://perma.cc/SV8S-RBV6].

[365] *See* K.C. Tseng, *Behavioral Finance, Bounded Rationality, Neuro-Finance, and Traditional Finance*, 3 INV. MGMT. & FIN. INNOVATIONS, no. 4, 2006, at 7–8.

[366] *See id.* at 9–10.

Second, it is possible that fraudsters needed time to learn their trade and for their skills to spread, causing a time lag between the opening of the stock market and the prevalence of fraud. The fact that widespread frauds were discovered only from 2000 on supports this supposition. A stock market, therefore, always has a grace period to grow before investor confidence is shaken by widespread fraud. During this period, law may be irrelevant. But drawing a conclusion on the experience of this period that investor protection is unnecessary would be wrong.

Third, although bounded rationality and time lag could be common explanations for market growth, the growth of China's stock market is further underpinned by a unique factor. Following the Shanghai and Shenzhen Stock Exchanges' decision to mark companies with two-year and three-year negative performance with an ST or PT label, the CSRC ruled in 2001 that trading of PT companies' shares should be suspended and such companies be delisted if their financial condition did not recover within a year.[367] Local governments thus sponsored a wave of so-called "asset restructuring" to bail out companies in financial difficulty.[368] First, direct subsidies, under different names, were provided to listed companies and tax or other liabilities were waived.[369] Second, the controlling SOE shareholder of a listed company was instructed to waive debts owed to it by its subsidiary or to take over debt liabilities owed by its subsidiary to others; loss-making assets were removed and new assets were inserted.[370] Third, if a controlling SOE did not have the ability to bail out its listed subsidiary, shares owned by the SOE were sold to a private firm at a nominal price on the condition that the private firm insert new assets into the listed company. This is the so-called "backdoor listing," a popular choice in China.[371] Private firms had little chance to become listed through an IPO, so "back door listing" was attractive because of the potential opportunities to raise funds from the market or simply to gain the status and reputation of a listed company.[372] Some companies were also acquired by fraudsters and used as a tool for market manipulation, as the notorious scandals of *Yi'an Keji* and *Zhongke Chuangye* illustrated.

Local governments were highly motivated to bail out listed companies. First, a listed company might be an important employer or source of tax

[367] *See* Kuisun Shangshi Gongsi Zanting Shangshi He Zhongzhi Shangshi Shishi Banfa (亏损上市公司暂停上市和终止上市实施办法) [Implementation Measures for Suspending and Terminating the Listing of Loss-Making Listed Companies] (promulgated by the China Sec. Reg. Comm'n, Feb. 22, 2001) (Lawinfochina).

[368] *See* Green, *Privatization Two-Step*, *supra* note 294, at 14–15.

[369] *See id.*

[370] *See id.*

[371] *See id.* at 79–80.

[372] *See id.* at 4–5.

revenues for a local government. Second, a listed company was an important vehicle for fund raising, which local governments were reluctant to lose. Third, local governments simply did not want to lose face because ST, PT, and delisting showed them in a bad light.[373] By 2001, around 680 listed companies, more than half of the total, had undergone some form of "asset restructuring"—in effect, a bailout.[374] Therefore, investors no longer needed to worry that a company might fail—the downside risk of stock investment was removed, which is another explanation for growth in the market despite weak investor protection.

A well-known study suggested that the quota system for share issuing created incentives for local governments to select viable companies for listing because future allocations of quotas to a local area were linked to the past performance of companies.[375] Considering the widespread fraud and corruption in the IPO process, this explanation for market growth is doubtful. Falsification of information was especially serious in IPOs. One study found that of all CSRC's penalties against accounting firms and accountants between 1994 and 2001, 62.5% were due to misconduct occurring in IPOs.[376] Moreover, the quota system created ample opportunities for rent seeking by government officials in selecting and approving companies for listing.[377] Therefore, even if quota allocation was meant to be merit-based, the system could not ensure only viable companies were listed, as evidenced by the fact that so many companies had to be bailed out soon after being listed.

Financial repression in China also contributed to market growth during this period. Because interest rates set by the government were low and capital control restricted overseas investment, Chinese people had no choice but to invest in the domestic stock market.[378] But the question is, when the risk of losing money in the market was high, why did people not leave their money in banks? There, at least, it would not disappear. It is arguable that there existed separate, deeper reasons behind the financial repression. Bounded rationality, inexperience, bailouts by government, and a time lag

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[373] *See* Xiao Chen et al., *Government Assisted Earnings Management in China*, 27 J. ACCT. & PUB. POLICY 262–74 (2008).

[374] *See* Green, *Privatization Two-Step*, *supra* note 294, at 14–15.

[375] Katharina Pistor & Chenggang Xu, *Governing Stock Markets in Transition Economies: Lessons from China*, 7 AM. REV. L. & ECON. 184, 185, 200 (2005).

[376] Shuang Li & Xi Wu, *Shenji Shibai Yu Zhengquan Shenji Shichang Jianguan—Jiyu Zhongguo Zhengjianhui Chufa Gonggao De Sikao (审计失败与证券审计市场监管－基于中国证监会处罚公告的思考) [Auditing Failure and Regulating the Securities Auditing Market—Thoughts Based on CSRC Penalty Announcements]*, KUAIJI YANJIU (ACCOUNTING RESEARCH) 28–36 (2002), http://wenku.baidu.com/view/cff62bc158f5f61fb7366626 [https://perma.cc/JP8R-3YCW].

[377] Chen, *The China Puzzle*, *supra* note 31, at 159.

[378] *See id.* at 172–73.

between the opening of the stock market and the prevalence of fraud might be fundamental to the growth of the market. These factors, however, could not sustain market growth infinitely, as the history of China's stock market development after mid-2001 demonstrates.

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

Why did the stock market run into a severe crisis between 2001 and 2005 when China's macro economy was at its best? Many so-called "opinion leaders" blamed the State Council's decision in June 2001 to sell down state shares on the exchanges,[379] which was commonly accepted. In China, however, there are too many "opinion leaders" whose words should not be taken too seriously, and as a result, the claim that the crisis was caused by the decision to sell down state shares is questionable. First, the policy to sell was in fact adopted in 1999,[380] but share prices rose continuously until June 2001.[381] Second, the State Council's selling scheme was modest. Only companies undertaking an IPO were supposed to sell, but not those that had already been listed. The number of state shares to be sold was just 10% of the number of new shares to be issued. In addition, funds raised were to be transferred to the National Social Security Fund, of which part would be re-invested in the market.[382] Third, share prices rose on June 13, 2001, when details were publicized by Xinhua News Agency, and throughout June and July there was only a small drop with occasional rises.[383] Fourth, although share prices rose sharply following the government's announcement in October 2001 to suspend and in June 2002 to terminate the scheme, the rallies were short-lived and the downward trend continued until the end of 2005.[384] Lastly, observers have also argued that selling state shares at market price was unfair to public investors, causing them to withdraw from the market.

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[379] *See supra* notes 175 & 176 and accompanying text.

[380] *Decision of the Central Committee on Certain Important Questions Regarding SOE Reform and Development*, *supra* note 151.

[381] *See* YAHOO! FINANCE, https://finance.yahoo.com (enter "SSE Composite Index" in the "Enter Symbol" field; then follow "Historical Prices" hyperlink; then enter "Jan. 1, 1999" in the "Start Date" field; then enter "July 31, 2001" in the "End Date" field; then follow "Get Prices" hyperlink) (last visited July 5, 2016).

[382] Interim Measures on the Management of Reducing State Shares and Raising Social Security Funds.

[383] *See* YAHOO! FINANCE, https://finance.yahoo.com (enter "SSE Composite Index" in the "Enter Symbol" field; then follow "Historical Prices" hyperlink; then enter "June 1, 2001" in the "Start Date" field; then enter "July 31, 2001" in the "End Date" field; then follow "Get Prices" hyperlink) (last visited July 5, 2016).

[384] *See* Huang, *supra* note 306, at 98.

But the Hong Kong market, where many SOEs had been listed and the selling scheme did not stop, was not affected by such practice.[385]

The claim that selling down state shares was responsible for the crisis is not consistently supported by the evidence. It is likely that the market fell in 2001 because the bubble became too big and a large number of companies reported losses.[386] Nevertheless, although statistically hard to prove, it is credible that securities fraud was also responsible for the crisis. First, the exposure of fraud caused a sharp fall in the share price and market value of the companies implicated. For example, the price of *Yi'an Keji* plummeted from its highest point of RMB 126.31 on February 17, 2000 to less than RMB 10 in January 2002, and the share price of *Yinguangxia* plunged from more than RMB 33 in August 2001 to just over RMB 2 at the end of January 2002 and reached the 10% daily limit for fifteen straight days. In another example, a company, *Tuo Pu Software*, reported huge profits in 2001, but huge losses two years later, prompting a subsequent investigation by the CSRC, which revealed that around RMB 1.4 billion—more than the total of its net assets—had been misappropriated.[387] The share price of the company was RMB 48 in July 2000, but less than RMB 5 on June 30, 2004.[388] Another company, *Pi Jiu Hua*, announced in December 2003 that "its chairman had disappeared" and subsequently the company disclosed that it had offered to guarantee RMB 1.787 billion of bank loans, resulting in a share price drop from nearly RMB 17 in December 2003 to just over RMB 3 as of July 11, 2004.[389] In April 2004, *De Long Group*, a notorious private conglomerate which acquired a web of financial institutions and bought control of three listed companies for manipulation, finally crumbled, wiping out RMB 20 billion of market value in ten trading days.[390]

These cases showed that scandals had a devastating effect on the share price and market value of a company. One study identified 212 corporate scandals (defined as an enforcement action taken by the securities regula-

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[385] *See Guowuyuan Jueding Tingzhi Guonei Guoyougu Jianchi (国务院决定停止国内国有股减持) [The State Council Decided to Stop Selling Down State Shares on the Domestic Stock Exchanges]*, XINHUA (June 23, 2002), http://news.xinhuanet.com/newscenter/2002-06/24/content_453700.htm [https://perma.cc/RT7G-AUJD]. Although the policy to sell down state shares was abolished on the domestic exchanges, it continued on overseas stock exchanges. *See id.*

[386] *See* Xu, *supra* note 177.

[387] Zhong Zhang, *Legal Deterrence: The Foundation of Corporate Governance—Evidence from China*, *in* LAW AND ECONOMICS WITH CHINESE CHARACTERISTICS: INSTITUTIONS FOR PROMOTING DEVELOPMENT IN THE TWENTY-FIRST CENTURY 358, 376–77 (David Kennedy & Joseph E. Stiglitz eds., 2013).

[388] *Id.* at 377.

[389] *Id.* at 376.

[390] *Id.* at 377; Ling et al., *supra* note 314.

tors or courts) in the stock market between 1997 and 2005.[391] Hence, the total impact of scandals on market performance was substantial. They were directly responsible for the fall of stock indices and loss of market capitalization during this period.[392] Moreover, a scandal not only affected the stock involved, but also shook the whole market. For example, after the scandal of *Yinguangxia* was publicized, the Component Index of Shenzhen—where the company was listed—lost significant value on the following trading day, whereas the Index moved narrowly during the previous trading week. It is very possible that the sudden plunge might be caused by the revelation of the scandal. Because there were so many similar cases, the market was rocked repeatedly and share prices were hit continually. As a result, scandals were also indirectly responsible for the fall of the market. Eventually, investors found that share investment was too risky and decided to leave the market. The Chinese stock market was not just "worse than a casino," but it also had a reputation as "a minefield full of traps"—one trip and an investor would be "blasted to pieces."[393] Faced with such a high and dangerous risk, investors understandably withdrew from the market. Fraud thus eroded investor confidence in the market, causing them to flee in droves. Lastly, one type of fraud, misappropriation, was a cause for the poor profitability of listed companies. In 2003, 70% of ST companies had experienced misappropriation and misappropriation was an important reason for the failure of those delisted PT companies.[394] If low profitability of listed companies was a cause for the crisis, the fraud of misappropriation must also be blamed.

To conclude, although there are other explanations, such pervasive fraud significantly contributed to the market crisis. The exposure of these scandals was not only responsible for the fall of stock indices and loss of market value, but also damaged investor confidence. Misappropriation was also a cause for the poor profit performance of listed companies. The experience of the Chinese stock market during this period thus demonstrates that investor protection is essential for sustaining the growth of a market. China's experience demonstrates that investors are not just vulnerable to unscrupulous corporate managers, but also to miscreant stock traders. To develop a stock market, it is crucial to protect investors from abuse by stock traders.

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[391] Mingyi Hung et al., The Value of Relationship-Based and Market-Based Contracting: Evidence from Corporate Scandals in China 1, 10–11 (May 2011) (unpublished paper), http://www.hbs.edu/faculty/conferences/2012-imo/Documents/TJ%20Wong.pdf [https://perma.cc/D9XB-ZLDE].

[392] *See id.* at 15–17.

[393] Haizhou Pi, *'Jiyougu': Rangwo Ruhe Gan Maini? ('绩优股'：让我如何敢买你) ['Blue Chip Stocks:' How Dare I Buy You?]*, ZHENGQUAN RIBAO (SECURITIES DAILY) (Oct. 9, 2001), http://money.163.com/editor/011009/011009_62932.html [https://perma.cc/L9RR-NVYC].

[394] Wang, *Legal Countermeasures*, *supra* note 330, at 88–99.

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

The recovery of the market in 2006 developed into an enormous bubble and soon burst. Nevertheless, the Chinese stock market has since reached a new height, and major state-owned "national champions" have been listed.[395] The revival was commonly attributed to non-tradable share reform,[396] but this view is logically flawed and inconsistent with the facts. According to the same logic that the market collapsed in the previous period because of the fear of excessive share supply, the non-tradable share reform should have dampened rather than stimulated the market. After all, non-tradable shares could then be sold on the exchanges after they became tradable and the market would be flooded. Indeed, after the reform scheme was announced in April 2005, share prices dropped further until the end of 2005.[397] It should be noted that during the 2008 crash and again between 2010 and 2014 when the market was in another bear, selling by owners of previously non-tradable shares was blamed.[398]

Certainly, bounded rationality could again be an explanation. Perhaps the turnaround also had to do with the fact that shares became very cheap after falling for four and half years. But the more baffling question is why investors were no longer concerned about fraud. Why did investors become irrational after 2005? As described earlier, it is noticeable that investor protection improved considerably by 2006.[399] Securities fraud that once plagued the market had been greatly curbed and a degree of law and order established in the market.[400] It is plausible that the market resurged in 2006

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[395] *See supra* Part I.D.

[396] *See* Sheng Hua, *Liutong Gu He Fei Liutong Gu Fenlie: Zhongguo Gushi De Zuida Guoqing (流通股和非流通股分裂是中国股市最大的国情) [The Separation of Tradable and Non-Tradable Shares: The Most Important Characteristics of China's Stock Market]*, JINGJI YUEKAN (ECONOMICS MONTHLY) (Oct. 10, 2001), http://www.people.com.cn/GB/jinji/36/20011011/579204.html [https://perma.cc/TKV3-DESM]; Xiaoqiu Wu, *Guquan Liudongxing Fenlie De Bada Weihai—Zhongguo Ziben Shichang Weishenme Yao Jinxing Qanliutong Gaige (股权流动性分裂的八大危害－中国资本市场为什么要进行全流通改革) [8 Damaging Effects of Splitting Tradability of Shares—Why Does China's Securities Market Need Reform to Achieve Full Tradability?]*, CAIMAO JINGJI (FINANCE AND TRADE ECONOMICS) (Jan. 6, 2004), http://finance.sina.com.cn/roll/20040106/1156591572.shtml [https://perma.cc/84FV-8TLY].

[397] *See* YAHOO! FINANCE, https://finance.yahoo.com (enter "SSE Composite Index" in the "Enter Symbol" field; then follow "Historical Prices" hyperlink; then enter "Apr. 1, 2005" in the "Start Date" field; then enter "Dec. 31, 2005" in the "End Date" field; then follow "Get Prices" hyperlink) (last visited July 5, 2016).

[398] Xie Baisan, *Fei Liutonggu Daliang Duixian Zhishi Gushi Changqi Xiadie (非流通股大量兑现致使股市长期下跌) [Non-Tradable Shares Mass Cash-in Causes the Lengthy Bear Market]*, JINRONG TOUZI BAO (FINANCE & INVESTMENT) (June 22, 2012), http://finance.sina.com.cn/stock/stocktalk/20120622/113612381039.shtml [https://perma.cc/X99S-E7FX].

[399] *See supra* Part II.C.

[400] *Id.*

because of the improvement of investor protection. Without such improvement, the revival might not have been possible. If securities fraud was as widespread as it was in the late 1990s and early 2000s, it would be perplexing that the market could survive the spectacular crash in 2008 and the bear market between 2010 and 2014.

After the scandal of *Kelon Group* broke out in August 2005,[401] major fraud had been exposed. The devastating effect of scandals had tapered off. In the end, most of the companies affected by fraud were bailed out and saved from being delisted, avoiding a fatal consequence for investors.[402] By the end of 2005, many of those companies had been "restructured" or a restructuring plan had been put in place. A large number of criminals were sent to prison. Governments also saved securities companies from bankruptcy and compensated investors for their misappropriated funds and stocks. After the intervention by the State Council with the use of criminal sanctions, their campaign to force misappropriated funds of listed companies to be returned was well underway.[403]

Meanwhile, multiple laws, regulations, and rules were adopted to provide more protection for vulnerable investors. As a result, minority shareholders' legal rights were greatly enhanced. Various indicators suggest that by 2006, shareholders' rights in China were comparable to or even more generous than those of major developed economies. According to Franklin Allen, China's "anti-director rights index" was three in 2000.[404] Although Allen's interpretation of Chinese laws might be inaccurate, the total score after error compensation would still be three, falling in the middle among those countries studied by Rafael La Porta. After the Company Law of 2005 introduced the derivative action and cumulative voting,[405] China's score would increase to five, among the highest of all countries.[406] Second, in the "anti-self-dealing index" compiled by Simeon Djankov, which is regarded as "better grounded in theory than the index of anti-director rights,"[407] China scored 0.76, lower than the United Kingdom and Hong Kong, but comparable to Australia, Ireland, and Israel, and higher than the United States and Canada.[408] Third, in the shareholder protection index compiled by John Armour, which is comprised of ten variables and covered the period be-

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[401] *See* Xueqing Long et al., *Gu Chujun Quan Diaocha (顾雏军：全调查) [Gu Chujun: A Comprehensive Investigation]*, CAIJING (Sept. 5, 2005), http://finance.people.com.cn/GB/42774/3668820.html [https://perma.cc/97JY-BCEW].

[402] *See supra* Part III.A.2.

[403] *See id.*

[404] Allen et al., *supra* note 10, at 50.

[405] Company Law of PRC, arts. 106, 152.

[406] *See* Djankov et al., *supra* note 6, at 453–62.

[407] *Id.* at 461.

[408] *Id.*

tween 1995 and 2005, China ranked sixth among twenty countries studied, only after the United Kingdom, the United States, France, Japan, and Canada.[409] China's score might not reflect the improvements brought by the Company Law of 2005 and the Securities Law of 2005, as it did not change after 2003. Otherwise, China's score could be even higher after 2005.

Not only were investors offered more legal rights, but changes made in other areas also enhanced their protection. For example, to prevent securities companies from misappropriating their clients' funds, the CSRC decreed in 2004 that investors' funds be deposited in commercial banks rather than with securities companies. The Securities Law of 2005 formally stipulated this requirement.[410] Since then, securities companies have all but stopped misappropriating their clients' funds. The same law provided that one investor could only open one trading account and the name of the trading account and the investor's name should be identical.[411] As a result, it is much more difficult for manipulators to corner a stock by using multiple trading accounts to hide the fraud. The Securities Law of 2005 also greatly increased the use of the penalties for disqualification, suspension, or revocation of business licenses—the number of circumstances under which such penalties could be used increased from five to twenty-seven.[412] These penalties would have a stronger deterrent effect than administrative fines, which in most cases were a relatively small amount (at most, RMB 300,000 for individuals and RMB 600,000 for legal persons).[413] The revision of the Criminal Law in 2006 made directors and other senior managers of listed companies or the controlling shareholders criminally liable for misappropriation, even if they gained no personal benefit.[414]

Enforcement was also strengthened through a higher input of resources and output of enforcement activities. First, the CSRC's enforcement department branched out of Beijing after taking over local regulators in 1999. In 2001, the enforcement units of nine major local regulators were upgraded to become a bureau directly under the CSRC's control.[415] In the same year,

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[409] John Armour et al., *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis* 1, 2, 15–17, 24–25 (European Corp. Governance Inst., Working Paper No. 108, May 2008), http://ssrn.com/abstract=1094355 [https://perma.cc/A9EY-9GV7].

[410] Zhonghua Renmin Gongheguo Zhengquan Fa (證券法) [Securities Law of PRC] (promulgated by the Standing Comm. of the Nat'l People's Cong., Oct. 27, 2005), art. 139 (Lawinfochina).

[411] *Id.* art. 166.

[412] *Id.* art. 233.

[413] *See*, *e.g.*, *id.* arts. 188, 190.

[414] Zhonghua Renmin Gongheguo Xingfa Xiuzhengan (Liu) (中华人民共和国刑法修正案（六）) [Amendments (6) to the Criminal Law of PRC] (promulgated by the Standing Comm. of the Nat'l People's Cong., June 29, 2006), art. 9 (Lawinfochina).

[415] Wang Ting, Zhongguo Zhengquan Jicha Zhifa Zhidu Bianqian Yu Shizheng Yanjiu (中国证券稽查执法制度变迁与实证研究) [The Evolution of the Inspection and Enforcement Institu-

a specialized enforcement bureau for investigating insider trading and market manipulation was set up at the CSRC's headquarters in Beijing, and the total number of enforcement staff at its headquarters increased by more than 50%. The total number of enforcement staff in the whole system increased to more than 270.[416] A specialized bureau for investigating securities crimes with six local divisions was established in 2002 by the Ministry of Public Security.[417] In 2007, the CSRC's enforcement system was overhauled again. Investigation and adjudication were separated and a new department was set up solely for trials and making penalty decisions. 170 employees, nearly three times the previous figure, were added to the investigation departments in Beijing and 110 were added at the local level. The total number of staff for investigation increased to about 600, nearly twenty times the figure in 1999.[418] In addition, the CSRC was offered more investigative power by the Securities Law of 2005, including the power to inspect and freeze bank accounts and securities trading accounts, to seize assets, property, and evidence; and to restrict securities trading.[419] Furthermore, CSRC's capacity to detect fraud was also enhanced. For example, local regulators were required to undertake regular inspection of listed companies and securities institutions; both the Shanghai and Shenzhen Exchanges set up a surveillance department and sophisticated computer software was installed to monitor abnormal trading and price movements in real time. This surveillance system is now a key instrument for detecting insider trading and market manipulation.[420]

From the output perspective, various studies found that enforcement activities increased markedly from 2001. According to GTA's database, the yearly figure of sanctions imposed by the CSRC and the two stock exchanges increased from a single digit before 2001 to seventy-six per year in 2001 and averaged seventy-seven per year between 2001 and 2005.[421] Other

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tion in China's Securities Market: An Empirical Study] at 65 (2009) (unpublished Ph.D. dissertation, Wuhan University) (on file with author).

[416] *Id.*

[417] *Zhengquan Fanzui Zhenchaju Chengli, Gonganbu quanguo Bukong Zhengquan Fanzui (证券犯罪侦查局成立 公安部全国布控证券犯罪) [Securities Crime Investigation Bureau Established and the Ministry of Public Security Targeting Securities Crimes Across the Country]*, 21 SHIJI JINGJI BAODAO (21ST CENTURY BUSINESS HERALD) (Dec. 24, 2003), http://news.xinhuanet.com/stock/2003-12/24/content_1245775.htm [https://perma.cc/794T-J34M].

[418] *Jiemi Zhongguo Gushi Shouzhi Jicha Zongdui (解密中国股市首支稽查总队) [Demystifying China's First Securities Enforcement Contingent]*, XIN JING BAO (THE BEIJING NEWS) (Jan. 30, 2008), http://news.xinhuanet.com/fortune/2008-01/30/content_7524798_1.htm [https://perma.cc/F4KX-V8J3].

[419] *See* Securities Law of PRC, art. 180.

[420] *See Zhengjianhui Zhuoli Qianghua Jicha Zhifa Jiance Yujing Jizhi Jianshe* (证监会着力强化稽查执法监测预警机制建设) [CSRC Enhancing Surveillance and Early Warning System to Strengthen Inspection and Enforcement], CHINA SEC. REG. COMM'N (Apr. 19, 2013), http://www.csrc.gov.cn/pub/newsite/jcj/gzdt/201304/t20130419_227402.html [https://perma.cc/6B6N-D7BR].

[421] *See* GTA Information Technology Co., *supra* note 351.

studies painted a similar picture. For example, data collected by Katharina Pistor and Chenggang Xu indicated that sanctions by the regulators and stock exchanges more than quadrupled in 2001 from the previous year's figure; [422] Luo Peixing, in his study of law enforcement against listed companies for information misrepresentation, found that the sanctions by the CSRC and stock exchanges more than doubled in 2000 and doubled again in 2001.[423] Though it has been argued that the number of enforcement actions was still too low in light of the total number of listed companies, there is no doubt that enforcement intensified considerably after 2000.[424] Enforcement activities increased further after 2005 and the total number of sanctions by the CSRC and the two stock exchanges have since exceeded 100 every year.[425]

As a result of all these efforts to enhance investor protection, the scale and seriousness of market fraud have decreased significantly since 2006. First, the once-ubiquitous stock-cornering and the audacious fraud of acquiring listed companies for manipulation have largely disappeared, as has the misappropriation of clients' funds and stocks by securities companies. Despite this progress, there are still two types of widespread market manipulation. One is "pump and dump," whereby manipulators make "buy" recommendations or disseminate false information to boost the share price of a company and then secretly sell the shares that they have previously bought.[426] The other is the so-called "short swing manipulation," whereby manipulators create false trading activities and rig price movements by placing false orders or using other tactics.[427] But, judging from media reports, even these types of manipulation have decreased significantly and the culprits have been severely punished by Chinese authorities. For example, in a "pump and dump" case, the owner of an investment advising company was sentenced to seven years in prison, profits of RMB 125 million were confiscated, fines

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[422] *See* Pistor & Xu, *supra* note 375, at 195.

[423] Luo et al., *supra* note 303; *see* Benjamin L. Liebman & Curtis J. Milhaupt, *Reputational Sanctions in China's Securities Market* 8 (Ctr. for L. & Econ. Stud., Columbia Sch. L., Working Paper No. 3318, 2007).

[424] *See* Donald C. Clarke, *Law Without Order in Chinese Corporate Governance Institutions*, 30 NW. J. INT'L L. & BUS. 131, 184–85 (2010); Pistor & Xu, *supra* note 375, at 195–96.

[425] *See* GTA Information Technology Co., *supra* note 351.

[426] *See Dancing with Wolves: Why Chinese Traders Love Manipulated Stocks*, BLOOMBERG (Dec. 29, 2015, 3:25 A.M.), http://www.bloomberg.com/news/articles/2015-12-28/dancing-with-wolves-why-chinese-traders-love-manipulated-stocks [https://perma.cc/38MJ-VGU5].

[427] *See* Hou Jiening & Zhu Baoche, *Xinxing Gushi Caozong Shoufa Dajiemi: Xujia Shenbao, Xiaofei Duidao (新型股市操纵手法大揭秘：虚假申报 小非对倒) [Revealing the New Types of Market ManupilationTactics: Fake Quotes and "Xiaofei" Wash Trade]* , ZHENGQUAN RIBAO (SECURITIES DAILY) (June 22, 2009), http://finance.sina.com.cn/stock/stocktalk/20090622/08206379413.shtml [https://perma.cc/U5BE-EC78].

of RMB 125 million were imposed, the company's license was revoked, and the owner was banned for life from the securities business.[428]

Second, although there are still occasional news reports about controlling shareholders stealing funds from listed companies, the days of widespread theft—when 737 out of 1287 companies experienced such theft—are gone.[429] Third, information misrepresentation is still a serious problem. Companies still invent profits, and a large number still engage in other types of misrepresentation, indicated by the large number of sanctions handed out by the CSRC and stock exchanges each year.[430] Compared to when 72% of listed companies were estimated to have engaged in false disclosure, however, it is reasonable to believe that the situation has improved.[431] Indeed, the chief accountant of the CSRC even claims that more than 90% of financial information disclosed by listed companies is essentially credible.[432] Fourth, insider trading has appeared to be rampant and become a focus of public indignation. There has been a significant increase in enforcement actions against insider trading since 2008, accounting for more than half of the total sanctions imposed by the CSRC.[433] Rather than indicating a deteriorated situation, however, this increase should be seen as a result of better detection and greater determination to crack down on insider trading. Even a city mayor was sentenced to prison for insider trading.[434] Arguably, insid-

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[428] *See* Xiaobo Ao, *Zhengjianhui Yitian Kaichu Sanda Fadan (证监会一天开出三大罚单) [CSRC Metes Out 3 Penalties in One Day]*, JINGHUA SHIBAO (BEIJING TIMES) (Nov. 22, 2008), http://paper.people.com.cn/jhsb/html/2008-11/22/content_144244.htm [https://perma.cc/DM9Q-J58J]; *Gushi Heizui Wang Jianzhong Yishen Bei Pan 7 Nian, Fa Yiyi Duo, Cheng Jiang Shangsu (“股市黑嘴”汪建中一审被判 7 年罚 1 亿多元 称将上诉) [‘Stock Market Black Mouth’ Wang Jianzhong Sentenced to 7 Years in Prison, Fined for More Than One Hundred Million RMB in the First Instance Trial and Said to Appeal]*, XINHUA (Aug. 3, 2011), http://news.xinhuanet.com/fortune/2011-08/03/c_131027532.htm [https://perma.cc/L2DS-67XG].

[429] *See* Wang, *Legal Countermeasures*, *supra* note 322, at 88–99.

[430] *See China Punishes Six Brokerages for Margin Trading Violations—Regulator*, REUTERS (Apr. 4, 2015), http://www.reuters.com/article/china-brokerage-idUSL3N0X102O20150404 [https://perma.cc/7SM4-5CRX].

[431] *See* GREEN, *supra* note 2, at 135–36.

[432] *See Zhengjianhui Shouxi Kuaijishi Jia Wenqin: Chao Jiucheng A Gu Gongsi Xinpi Kexin (证监会首席会计师贾文勤：超 9 成 A 股公司信披可信) [CSRC Chief Accountant Jia Wenqin: More Than 90 Percent of Information Disclosed by Share Companies Is Believable]*, CAIJING (June 14, 2013), http://stock.caijing.com.cn/2013-06-14/112908762.html [https://perma.cc/2ES9-BLLZ].

[433] *See Zhengjianhui Tongbao Jingsannianlai Neimu Jiaoyi Deng Anjian de Zhifa Gongzuo Qingkuang (证监会通报近三年来内幕交易等案件的执法工作情况) [CSRC Brief on Insider Trading and Other Cases of Enforcement]* CHINA SEC. REG. COMM'N (June 27, 2014), http://www.csrc.gov.cn/pub/newsite/jcj/gzdt/201407/t20140702_257166.html [https://perma.cc/R2PT-MHFL].

[434] *Yuan Guangdong Zhongshan Shizhang Li Qihong Bei Pan 11 Nian, Fajin 2 Qianwan (广东中山市市长李启红被判 11 年 罚金 2 千万元) [Former Mayor of Zhongshang City, Guangdong Province, Sentenced to 11 Years and Fined RMB 20 Million]*, NANFANG RIBAO (SOUTHERN DAILY) (Oct. 27, 2011), http://news.xinhuanet.com/legal/2011-10/27/c_122205252.htm [https://perma.cc/ABJ5-A63H].

er trading has a less obvious and immediate effect on investors' confidence, as insider trading can be seen as victimless. All in all, the scale and seriousness of market fraud has decreased considerably since 2006 and it is now no longer true that the stock market is lawless. In contrast to its denunciation in 2001 as "worse than a casino," the stock market was extolled in 2010 by Wu Zhipan, an authority on Chinese financial law and Vice President of Peking University, as being "the most transparent and efficient market with the highest degree of rule of law" in China.[435]

In sum, the stock market rebounded in 2006 after major scandals were exposed and the impact on share prices tapered off. More importantly, by 2006, investor protection had greatly improved and the scale and seriousness of securities fraud had significantly decreased. It is after this improvement that the market recovered and boomed. Without it, it is reasonable to question whether the market would have resurged in 2006 and survived the 2008 crash and the prolonged bear market between 2010 and 2014. The experience of China's stock market between 2006 and 2009 again testifies to the importance of investor protection for sustaining market growth.

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

1. Corporate Profitability, Investment Return, and the Bear Market

After the global economic recession and ensuing market collapse in 2008, the stock market experienced a brief rally after the government injected RMB 4 trillion to stimulate the economy.[436] From early 2010, however, share prices began to taper and fall, heralding another bear market that lasted until the end of 2014.[437] In response to this bear market, the government froze IPOs and market growth stalled.[438] As the value of stocks evaporated, investors again became very angry and opinion leaders were increasingly vocal in their criticism of the market and the government's handling of the situation. This time, however, the public's anger and criticism seemed

[435] Zhipan Wu, *Gushi Shi Toumingdu Zuihao, Zuiyou Xiaolu He Fazhihua Chengdu Zuigao De Shichang (股市是透明度最好最有效率和法制化程度最高的市场) [The Stock Market is the Most Transparent and Efficient Market with the Highest Degree of Rule of Law]*, *in* ZHENGQUAN FAYUAN (證券法苑), 1, 18 (2011).

[436] *See China Seeks Stimulation*, ECONOMIST (Nov. 10, 2008), http://www.economist.com/node/12585407 [https://perma.cc/RC3B-QUP6].

[437] *See The Bubble Question*, ECONOMIST (Apr. 14, 2015), http://www.economist.com/blogs/freeexchange/2015/04/china-booming-stockmarket [https://perma.cc/7KYN-DB9G].

[438] *See supra* note 220 and accompanying text.

to center on the market's low investment return, especially the dismal amount of dividends paid out by listed companies.[439]

In the wake of the bear market, there was much media publicity about the poor performance of China's stock markets in investment return. For example, in July 2013, it was reported that in just four years, the mainland Chinese "market ha[d] lost more money for investors than any other in the world;"[440] another report indicated that between 1993 and 2013 the MSCI China Index, including dividend payments, gained merely 14%, and investors earned less than 1% a year investing in Chinese stocks.[441] China's stock market, however, is highly volatile, and an assessment of market performance based on share prices at one point in time is not really meaningful. For instance, in contrast with reported poor performance, the MSCI China Index returned 680% between November 2001 and October 2007.[442] Nonetheless, measured by the amount of dividends paid, an important source of investment return, the performance of the mainland Chinese market is indeed extraordinarily poor. In the 1990s, few companies paid cash dividends. Even by 1999, 59% companies did not pay any kind of dividends (cash or bonus shares).[443] The proportion of companies paying dividends increased in the 2000s, but performance was still poor. Overall, the average annual dividend/price ratio of the mainland Chinese market was just over 0.75% between 1990 and 2010—the worst by far of the twelve major markets from both emerging and developed economies.[444] Following the CSRC's effort to encourage companies to pay more dividends and the fall of share prices, dividend yields have increased over the last couple years. The ratio in-

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[439] *See China to Encourage Dividend Payouts to Lure Investors*, BLOOMBERG (Jan. 8, 2013), http://www.bloomberg.com/news/articles/2013-01-08/china-to-require-30-company-dividend-payout-to-lure-investors [https://perma.cc/85P6-BWT3].

[440] Richard Frost & Weiyi Lim, *China Stocks World's Worst Losing $748 Billion on Slump*, BLOOMBERG (July 31, 2013, 9:56 A.M.), http://www.bloomberg.com/news/2013-07-30/china-stocks-world-s-worst-losing-748-billion-on-slump.html [https://perma.cc/YW29-F897].

[441] Weiyi Lim & Kana Nishizawa, *China Wealth Proves Elusive as Stocks Earn 1% in 20 Years*, BLOOMBERG (July 15, 2013, 5:02 A.M.) http://www.bloomberg.com/news/2013-07-14/china-wealth-eluding-foreigners-as-equities-earn-1-for-20-years.html [https://perma.cc/G86T-SKHE].

[442] *Id.*

[443] GREEN, *supra* note 2, at 131–32. Most of the companies paid bonus shares rather than cash dividends, but paying bonus shares is only a change in book-keeping and shareholders receive no real benefit.

[444] SHENZHEN STOCK EXCH. RES. INST., JINGNEIWAI SHANGSHI GONGSI FENHONG DE CHAYI JI YUANYIN SHIZHENG YANJIU (境内外上市公司分红的差异及原因实证研究) [AN EMPIRICAL STUDY OF THE DIFFERENCES AND THEIR CAUSES IN PAYING DIVIDENDS BY CHINESE AND OVERSEAS LISTED COMPANIES] 6–7 (Mar. 27, 2012), http://www.szse.cn/main/files/2012/04/17/429275172577.pdf [https://perma.cc/7AQ9-6G57].

creased to 1.04% in 2009, 1.14% in 2010, and 1.82% in 2011.[445] In 2012, the CSRC announced that the average dividend yield of the top performing 300 blue-chip companies reached 2.34% in 2011, exceeding that of the S&P 500 in the United States.[446] The CSRC thus encouraged people to buy shares, proclaiming that China's stock market had a value for long-term investment.

But this claim was misleading. First, much of the dividends paid were from a small minority of big companies, primarily the five largest state-controlled banks. Indeed, the "big five" banks contributed 48% of the total dividend in 2012.[447] Excluding banks, the dividend yield of the market would be much lower. Yet, banks' share prices were among the lowest. For banks, their prospects are dim. Non-performing loans are increasing following years of binge lending.[448] In addition, the guaranteed interest rate margin and oligopolistic market position are no longer tenable if the banking sector is liberalized as expected.[449] On the other hand, risk-free rates of return are much higher in China. Even the government-set, one-year deposit interest rate has been above 3% since April 2011.[450] As a point of comparison, the yield of one-year treasury bills in the United States did not exceed 0.5% from 2010 to the end of 2014.[451] The market interest rates in China are even higher than the official ones. The days when Chinese people could only deposit their money in banks or invest in stocks or bonds are gone. In addition to investing in the booming real estate market, they could buy various "wealth management products" originated by banks, invest in different types of funds sponsored by non-bank financial institutions, and even lend

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[445] Zhifeng Xu, *Gushi Xiadie Cunzai Konghuangxing Yinsu (股市下跌存在恐慌性因素) [Panic Selling Causing the Stock Market Slump]*, RENMIN RIBAO (PEOPLE'S DAILY) (Aug. 1, 2012), http://finance.people.com.cn/n/2012/0801/c1004-18641937.html [https://perma.cc/PVN2-99XT].

[446] *Id.*

[447] Xueyi Zhao, *92 Gu Guxilu Chao Yinian Dingcun, Wuda Yinhang Chao 5 Percent (92股股息率超一年定存 五大银行超5%) [The Dividend Yield of 92 Stocks Exceeding the One Year Deposit Interest Rate and That of the 'Big 5' Banks Exceeding 5 Percent]*, ZHENGQUAN RIBAO (SECURITIES DAILY) (Apr. 20, 2013), http://finance.sina.com.cn/stock/data/20130420/021615212902.shtml [https://perma.cc/93VK-YNJH].

[448] *See Chinese Banks' New Bad Loans More Than Doubled in 2015: Sources*, REUTERS (Jan. 12, 2016), http://www.reuters.com/article/us-china-banking-npl-idUSKCN0UQ04D20160112 [https://perma.cc/HV34-X5FF].

[449] Tao Wang & Shujuan Wang, *Lirun Xiahua, Buliang Shangshen Zaixian Yingyou, 11 Zhi Yinghanggu "Pojing" Dai Fansheng (利润下滑，不良上升再现隐忧，11 只银行股"破净"待翻身) [Profits Declining, Non-Performing Loans Worryingly Increasing and the Price of 11 Bank Stocks Lower Than the Net Assets]*, XINHUA (Sept. 1, 2013), http://news.xinhuanet.com/fortune/2013-09/01/c_117176992.htm [https://perma.cc/9TKJ-XLUC].

[450] *See China's Interest Rates: The Right Call*, ECONOMIST (Nov. 21, 2014), http://www.economist.com/blogs/freeexchange/2014/11/chinas-interest-rates [https://perma.cc/AE7T-25TY].

[451] *See Resource Center: Daily Treasury Yield Curve Rates*, U.S. TREASURY DEP'T, https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield (select relevant time period and click "Go") (last visited June 4, 2016).

their money to private financiers. The size of this so-called "shadow banking" in China tripled between 2008 and 2012 to RMB 20 trillion.[452] Rates of return varied, but even the safest deposit-equivalent, "wealth management products" originated by banks yielded around 5% annually.[453] It is misleading to compare dividend yields between China and the United States without considering the risk-free rates of return—the former is still considerably lower than the latter in China. It is thus understandable why Chinese investors withdrew from the stock market in such numbers.

Another major source of investment return is capital gain. For growth companies with high profitability, retaining profits for business expansion is a better way to reward shareholders. If the low dividend yield of the Chinese market was due to growth companies retaining profits for efficient use, this would actually have benefitted investors. Unfortunately, this was not the case. First, a large number of companies paid no dividend simply because they made little or no profit. Between 2008 and 2010, 710 companies paid dividends each year, while 516 companies paid no dividend at all in any of these years.[454] Of these 516 companies, 72.77% experienced a loss in at least one year,[455] and 153 were ST companies with no profit to distribute.[456] Second, the profitability of companies paying no dividend was much lower as a whole. In 2010, the median return on assets (ROA) and ROE for companies paying dividends was 4.87% and 8.67%, respectively, while the figure for companies paying no dividend was 2.10% and 5.22%, respectively.[457] Third, it is peculiar that in China, growth companies tend to pay dividends and companies paying no dividends do not record much growth. In 2010, the average sale and net asset growth rate for companies paying dividends was 20.16% and 13.33%, while the figure for companies paying no dividend was 9.41% and 2.63%.[458] This oddity is due to the CSRC's effort to compel companies to pay dividends. Responding to public outcry, the CSRC introduced a rule in 2008 that companies could only raise new capital on the market if they paid cash dividends of no less than 30% of their distributable profits continuously for three years.[459] Nevertheless, only

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[452] *See* JOE ZHANG, INSIDE CHINA'S SHADOW BANKING: THE NEXT SUBPRIME CRISIS?, at vii (2013).

[453] *Id.* at 116.

[454] Yang Yang, *56 Zhi A Gu Pingjun Sannian Guxilu Chao 2 percent (56只A股平均三年股息率超2%) [56 A Stocks' Dividend Yield Exceeding 2 Percent]*, 45 GUSHI DONGTAI FENXI 85 (STOCK MARKET TREND ANALYSIS WEEKLY) (2011).

[455] SHENZHEN STOCK EXCH. RES. INST., *supra* note 444, at 22.

[456] *Id.*

[457] *Id.*

[458] *Id.*

[459] Guanyu Xiugai Shangshi Gongsi Xianjin Fenhong Ruogan Guiding De Jueding (中国证券监督管理委员会关于修改上市公司现金分红若干规定的决定) [Decision on Amending Sev-

growth companies have profits to distribute. It is clear that, far from being in high growth with high profitability, companies paying no dividends actually had poor operational and financial performance. These companies would not truly bring investors capital gains.

Ultimately, investment return on the stock market is determined by the profitability potential of a listed company. Profitability determines not only the dividend yield, but also the size of capital gains. Without the support of profitability, the high price of a company's stock would be an untenable bubble. How have Chinese companies fared in profitability? In the 1990s, there was a common saying about listed companies: "First year profit, second year even, and third year losses."[460] Listed companies were described as "a capital-destroying machine" and abundant capital raised from the market was wasted or simply disappeared.[461] One study found that some 70% of listed companies were actually destroying value, in the sense that profits created by these companies were lower than the opportunity cost of the equity capital they owned.[462] The weighted average return on equity (WAROE) published by the CSRC was 7.63% in 2000,[463] lower than that of non-listed companies and much lower than 19.1% of the largest 1000 listed companies from developed countries and 14.62% of the largest 200 companies from emerging markets.[464] The WAROE decreased further to 5.35% and the ROA was only 3.02% in 2001, while the official interest rate for one-year bank loans was 5.85%.[465]

The WAROE gradually increased from 2003, exceeding 10% in 2006 and reaching the all-time high of 14.7% in 2007.[466] It then crashed in 2008, recovered in 2009, but dropped again from 2011, staying at 13.35% in 2012.[467] Admittedly, this figure is much better than in the 1990s and early 2000s, but corporate profitability is still not encouraging. First, other re-

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eral Rules of Paying Cash Dividends] (promulgated by the China Sec. Reg. Comm'n, Oct. 9, 2008), art. 3 (Lawinfochina).

[460] *See* GREEN, *supra* note 2, at 125.

[461] *Id.*

[462] *See* Guy S. Liu & Pei Sun, *The Class of Shareholding and Its Impacts on Corporate Performance: A Case of State Shareholding Composition in Chinese Public Companies*, 13 CORP. GOVERNANCE: AN INT'L REV. 46, 48, 57 (2005).

[463] CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 282–83.

[464] SHANGHAI STOCK EXCH. RES. CTR., ZHONGGUO SHANGSHI GONGSI CHENGBAI SHIZHENG YANJIU (中国上市公司成败实证研究)［AN EMPIRICAL STUDY OF THE SUCCESS AND FAILURE OF CHINESE LISTED COMPANIES] 3–6 (2001).

[465] *Id.* at 177–78; *see* CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 282–83.

[466] CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 282–83.

[467] *Shangshi Gongsi 2012 Nian Nianbao Jianguan Qingkuang Jieduanxing Tongbao (上市公司2012 年年报监管情况阶段性通报)［Circular on the Periodic Supervision of Listed Companies' 2012 Annual Report]*, CHINA SEC. REG. COMM'N (Aug. 16, 2013), http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201308/t20130816_232719.html [https://perma.cc/Y2TU-P6R4].

search suggests that the average ROE of listed companies is actually much lower than the official WAROE. One study found that the average ROE of Chinese companies was only 7.83% in 2010, but the figure of listed companies in the United States was 10.71%.[468] A study by the All-China Federation of Industries and Commerce (ACFIC) indicated that, excluding ST companies and companies listed on the ChiNext, the average ROE was 11.14% in 2010, 9.85% in 2011, and 7.6% in 2012, confirming the downward trend suggested by the official WAROE figure. The median ROA was only 5.58% in 2012, again less than the official interest rate for one-year bank loans.[469] Second, like dividend payments, a few large companies made the lion's share of profits. The top ten most profitable companies, which included seven banks, accounted for more than 70% of the profits made by all listed companies in the first half of 2009 and 50% in 2012.[470] The average ROE of the seven banks was almost 22% in 2012.[471] Excluding the top ten, corporate profitability would be much lower. Third, along with increased ROE, the leverage of listed companies has surged since the mid-2000s. The average liability/asset ratio was less than 50% in 1998, but increased to 86.76% in 2010 and 84.24% in 2011.[472] This increase in ROE was partially caused by heightened leverage, which is no longer sustainable in light of the current high level. Fourth, the ability of Chinese companies to sustain high profitability is weak, as the number of companies with ROE above 10% continuously for five years was only 6.66% in 2010, less than half of the percentage of listed companies in the United States.[473]

It is now clear that for a long time corporate profitability was low and the stock market was in a bubble. This explains why the market was so speculative. Because of low corporate profitability, long-term investment was infeasible. The only chance for investors to make profits was to speculate on price movements. The bear market from 2001 to 2005 could be

[468] SHENZHEN STOCK EXCH. RES. INST., *supra* note 444, at 21.

[469] ALL-CHINA FED'N OF INDUS. & COMMERCE, 2012 NIANDU ZHONGHUA GONGSHANG SHANGSHI GONGSI CAIWU ZHIBIAO ZHISHU (2012 年度中华工商上市公司财务指标指数发布) [2012 ACFIC INDEX OF FINANCIAL INDICATORS OF LISTED COMPANIES] (June 28, 2013), http://www.acfic.org.cn/Web/c_000000010003000100050005/d_12217.htm [https://perma.cc/QUV9-HVJF].

[470] Ye Jing, *10 Da Zui Zhuanqian Gongsi Shixian Jingli 3078 Yi, Zhan A Gu Lirun 70% (RMB 307.8 Billion Profits Made by Top 10 Most Profitable Companies, 70% of the Total by Share Companies)*, XINGXI SHIBAO (INFORMATION TIMES) (Sept. 1, 2009), http://finance.sina.com.cn/stock/s/20090901/14256692033.shtml [https://perma.cc/C7RH-FYM3]; Liu Yonggang & Zhu Ziye, *Shida Zui Zhuanqian Shangshi Gongsi 7 Jia Wei Yinhang, Baijiu Ye Yiran Zui 'Baoli' (7 Banks Among the Top 10 Most Profitable Listed Companies and Liquor Business Remaining to Have an Exorbitant Rate of Return)*, ZHONGGUO JINGJI ZHOUKAN (CHINA ECONOMIC WEEKLY) (May 21, 2013), http://finance.people.com.cn/n/2013/0521/c1004-21549060.html [https://perma.cc/K6ZZ-UUQH].

[471] *See* Yonggang & Ziye, *supra* note 470.

[472] CHINA SECURITIES AND FUTURES STATISTICAL YEARBOOK, *supra* note 50, at 282–83.

[473] SHENZHEN STOCK EXCH. RES. INST., *supra* note 444, at 22.

somehow seen as a major correction of the bubble. Although profitability increased in 2006 and 2007, the enormous surge in prices outgrew increased profits by a massive scale, resulting in the subsequent crash. Since then, the profitability of listed companies has declined. The economic stimulation in 2009 had only a short-term impact on corporate profitability, but hugely inflated share prices.[474] Another bubble arose and the subsequent fall was a correction, sustained by declining corporate profitability. In the meantime, investors had more alternative investment opportunities with higher rates of return. Ultimately, the bear market since 2010 is underscored by the low and declining profitability of listed companies.

2. Reasons for the Low Corporate Profitability

There are multiple reasons why profitability of listed companies in China is low,[475] but weak investor protection is a significant one. Certainly, the widespread misappropriation of listed companies' assets by their controlling shareholders seriously hurt profitability. Although such misappropriation has been reduced since 2006, weak investor protection harms profitability in other ways. China's stock market has long been dominated by SOEs. Although the number of listed SOEs had decreased to 47% of the total by the end of 2011, they still accounted for 90% of total assets, 86% of total revenues and profits, and 74% of total market capitalization.[476] Listing was supposed to improve SOE governance, but serious problems remain. One is the endemic corruption in the form of bribes and embezzlement among corporate managers. For instance, of the three SOEs monopolizing the oil and gas production sector, two had their senior managers arrested for corruption, and the chairman of one company was sentenced to death with reprieve.[477] The "big four" state-owned banks were riddled with corruption and scandals continue after their listing.[478] There is serious corruption also

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[474] *See* YAHOO! FINANCE, https://finance.yahoo.com (enter "SSE Composite Index" in the "Enter Symbol" field; then follow "Historical Prices" hyperlink; then enter "Jan. 1, 2008" in the "Start Date" field; then enter "Dec. 31, 2010" in the "End Date" field; then follow "Get Prices" hyperlink) (last visited July 5, 2016).

[475] *See infra* Part IV.B.

[476] *See Zhongguo Shangshi Gongsi Fazhan Chengguo: Di San Pian (中国上市公司发展成果：第三篇) [The Achievements of China's Listed Companies: Part III]*, CHINA ASS'N. FOR PUB. COMPANIES, http://www.capco.org.cn/zhuanti/cjz/xi_znyq.html [https://perma.cc/5XNS-4SJB] (last visited May 19, 2016).

[477] *See* Aibing Guo et al., *Graft Probe Threatens PetroChina as Executives Targeted*, BLOOMBERG (Sept. 5, 2013, 5:09 A.M.), http://www.bloomberg.com/news/2013-09-04/graft-probe-threatens-petrochina-as-executives-targeted-energy.html [https://perma.cc/35YD-QHYJ]; Richard McGregor, *Sinopec's Corrupt Ex-Chief Gets Death Sentence*, FIN. TIMES (July 16, 2009), http://www.ft.com/cms/s/0/f361af8a-71a1-11de-a821-00144feabdc0.html#axzz2lkTGaMOJ [https://perma.cc/5N5A-B9BZ].

[478] *See Giant Reality Check*, ECONOMIST (Aug. 31, 2013), http://www.economist.com/news/finance-and-economics/21584331-four-worlds-biggest-lenders-must-face-some-nasty-truths-giant-

present in many other "national champions" such as China Mobile, Chalco (China Aluminum), and COSCO (China Ocean Shipping).[479] These are only the cases that have been exposed, and these companies—China's strategic SOEs under the Central Committee of CPC and State Council's close monitoring—are regarded as the best governed in the state sector. It is not an exaggeration to say that corruption is endemic in the SOE sector. The second problem is waste, which has occurred in the form of grandiose office buildings with opulent decoration, luxury limousines, and incessant lavish banquets with top-shelf wine and liquor, which are routinely reported in the news media.[480] The third problem is chronic overinvestment and overcapacity, and the SOE-dominated steel industry is a prime example. Because of overcapacity, this sector as a whole experienced a loss for nearly two years prior to August 2013.[481] The top ten loss-making listed companies in 2012 were all SOEs, and five of them were from the steel industry.[482] Basically, SOE senior managers' top priority is size growth (empire-building), rather than returns for shareholders. Fourth, there are too many cases of mismanagement, the cost of which is enormous. One scandal involving gambling in oil derivatives by a Singapore-listed Chinese SOE caused losses of $550

reality-check [https://perma.cc/4SXS-PS3Y]; Naomi Rovnick, *ICBC Chief on Corruption Charges*, S. CHINA MORNING POST (Oct. 8, 2010, 12:00 A.M.), http://www.scmp.com/article/726833/icbc-chief-corruption-charges [https://perma.cc/K5FE-Y7V9]; Sui-Lee Wee & Samuel Shen, *China Investigates Agricultural Bank Former VP for Corruption*, REUTERS (May 20, 2013, 7:14 A.M.), http://www.reuters.com/article/2013/05/20/china-agbank-corruption-idUSL3N0E122L20130520 [https://perma.cc/HB2N-JM2B].

[479] *See* Doug Young, *Corporate Crackdown Nets Chalco, China Mobile Execs*, S. CHINA MORNING POST (Nov. 28, 2013, 4:54 P.M.), http://www.scmp.com/business/companies/article/1362004/corporate-crackdown-nets-chalco-china-mobile-execs [https://perma.cc/9LWQ-AWK8].

[480] *See, e.g.*, An Baijie, *SOE Managers Curbed on Purchases*, CHINA DAILY (May 8, 2012, 4:37 P.M.), http://usa.chinadaily.com.cn/china/2012-05/08/content_15240169.htm [https://perma.cc/CQ8N-CZ3B]; Joanna Corrigan, *Oh la la! Chinese State Factory Decked Out to Look Like the Palace of Versailles (Much to the Disgust of Neighbors)*, DAILY MAIL (Sept. 8, 2011), http://www.dailymail.co.uk/news/article-2034679/Chinese-state-factory-decked-look-like-Palace-Versailles.html [https://perma.cc/N5ZQ-XCJF]; Christopher Helman, *China's Sinopec Axes Exec After $230k Booze Binge*, FORBES (Apr. 26, 2011, 12:53 A.M.), http://www.forbes.com/sites/christopherhelman/2011/04/26/chinas-sinopec-axes-exec-after-230k-booze-binge/ [https://perma.cc/33SN-3BUA]; Ling Yuhuan, *Govts, SOEs Seen as Most Extravagant*, GLOBAL TIMES (July 12, 2012, 1:25 A.M.), http://www.globaltimes.cn/content/720588.shtml [https://perma.cc/PW35-9EEB].

[481] Xiruo Liu, *Gangqi Gaoji, Meidun Gang Yidu Zhi Zhuan 0.43 Yuan (钢企告急 每吨钢一度只赚 0. 43 元) [Losses at Steel and Iron Enterprises Deteriorating and One Ton Steel Once Producing Only RMB 0.43 Profits]*, XINJING BAO (BEIJING NEWS) (Aug. 1, 2013), http://epaper.bjnews.com.cn/html/2013-08/01/content_454294.htm?div=-1 [https://perma.cc/MW6L-FLAP].

[482] Qun Huang, *Yangqi Baolan Nianbao Kunsun Qiansixi, Gangtieye Cheng Zhongzaiqu (央企包揽年报亏损前四席 钢铁业成重灾区)[Central SOEs Are the Top 4 Loss-Making Companies and the Steel and Iron Industry Is a Severe Disaster]*, SHANGHAI ZHENGQUAN BAO (SHANGHAI SECURITIES NEWS) (Apr. 26, 2013), http://finance.sina.com.cn/stock/s/20130426/085715288926.shtml [https://perma.cc/2VMB-EE3Y].

million, only surviving after being bailed out by its controlling shareholder.[483] Another Hong Kong-listed SOE engaged in foreign exchange gambling and lost $2 billion and again had to be bailed out by its controlling shareholder. COSCO recorded the biggest loss in the Mainland stock market in both 2011 and 2012, totaling RMB 20 billion due to mismanagement and corruption.[484]

Though the abuse of power by controlling shareholders to plunder listed companies has abated, abuse of power by corporate managers to benefit themselves and mismanagement both remain at SOEs. This suggests that investor protection is still extraordinarily weak in China. Corporate profitability suffers from these misdemeanors and market growth is constrained. This experience again demonstrates the importance of law for stock market development.

IV. The Issue of Causality and Market Growth

A. The Causality Between Law and Market Growth

If investor-protection law must be strong for stock market development, there arises the question of why investor protection varies in different countries and how the law develops. Is it true that the enhancement of law is caused by market growth, as is suggested in the United States and United Kingdom?[485] Or is the strength of investor protection in a country predetermined by its legal origin, as is proposed by Rafael La Porta?[486] Or is it dictated by modern politics?[487]

China's experience clearly indicates that, although law is important for sustaining market growth, the trajectory of development is market growth first, followed by law. The shareholding system and the stock market emerged and grew in the 1980s when a basic legal and regulatory framework was absent and investor protection was nonexistent. Though the CSRC was set up and laws were gradually put in place after 1992, they were rudimentary—laws for investor protection were basically unenforced until the severe crisis

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[483] *See* Cao Desheng, *Costly Lessons from the CAO Scandal*, China Daily (Dec. 23, 2004, 9:06 A.M.), http://www.chinadaily.com.cn/english/doc/2004-12/23/content_402605.htm [https://perma.cc/R86N-8CKE].

[484] *See* Ran Liu & Jing Wu, *Zhongyuan De Jukui Yu Jiushu (中远的巨亏与救赎) [COSCO's Colossal Loss and Rescue]*, Xin Shiji (Caixin Magazine) (Feb. 25, 2013), http://magazine.caixin.com/2013-02-22/100493279.html [https://perma.cc/Q5BB-XY99]; *Zhongyuan Gao Zujin Chuan Fubailian Chutan (中远高租金船腐败链初探) [A Primary Investigation on the Chain of Corruption in COSCO's Costly Renting of Ships]*, Xin Shiji (Caixin Magazine) (Sept. 13, 2013), http://china.caixin.com/2013-09-13/100582833_all.html [https://perma.cc/LB5Y-YR4R].

[485] *Cf.* Coffee, *supra* note 13, at 80–81.

[486] *See* La Porta et al., *Law and Finance*, *supra* note 6, at 1116; La Porta et al., *Legal Determinants of External Finance*, *supra* note 6, at 1149–50.

[487] *See* Roe, *supra* note 15, at 516–17.

broke out in the early 2000s,[488] but the market nevertheless grew rapidly. Investor protection improved only after the crisis happened and the market had grown to a significant scale.

China's experience thus supports the proposition that law is strengthened as a result of market growth. Why did market growth lead to stronger law in China? Noticeably, the government's decision in 1992 to establish a legal and regulatory system was prompted by the "riot" in Shenzhen, the market bubble, and the excess of shares issues triggered by Deng Xiaoping's "Southern Tour."[489] Leaders in Beijing clearly saw the danger that an uncontrolled stock market posed to the economy and society. Their motivation was to maintain the economic order and social stability that a rapidly developing stock market might disrupt. In 1996 and 1997, the government clamped down on the market forcefully by resorting to the *People's Daily* editorial, again because of the danger that an enormous bubble would cause to the economy and society.[490] The bubble was triggered partly by the competition between the Shanghai and Shenzhen governments to boost share trading and attract listings.[491] This proved the danger of leaving the market under the control of local governments who were indifferent to regulation. It was no wonder that Beijing decided to centralize control and overhaul the regulatory system.

It was only after the crisis, however, that investor protection really improved. The crisis started with the exposure of a series of grotesque fraud. The media, not the government, were at the forefront of uncovering this fraud. *Caijing*, in particular, played a crucial role and took the lead in investigating and reporting fraudulent companies.[492] These revelations ignited a public outcry and widespread condemnations. As share prices plunged and the market declined, investors became even angrier. Investors used the newly emerged Internet to exchange views, share their sentiment of frustration, and voice anger. By this time, the government was under huge pressure to take action to crack down on fraud. In the early 2000s, the number of stock investors had increased to tens of millions.[493] These investors shared the common experience of suffering tangible losses as a result of securities fraud. They could easily identify with each other. This meant that stock investors were a natural political constituency in China, even though they were and are still not allowed to formally organize themselves.[494] As their

[488] *See supra* Part III.A.1.
[489] *See supra* Part I.B.1.
[490] *See, e.g.*, *Correctly Understanding the Current State of the Stock Market*, *supra* note 124.
[491] *See supra* note 117 and accompanying text.
[492] *See supra* Part II.C.
[493] *See* Chen, *Capital Markets*, *supra* note 23, at 462.
[494] *See id.*

number grew to the tens of millions, this political constituency became very powerful. So powerful that even the Chinese government, with no electoral pressure, had to take heed and respond to their complaints. Moreover, as the number of investors grew, the demand for financial and stock market information increased. In response, financial media and news reports proliferated, helping inform investors and enabling them to express views with stronger collective voices.[495] It can be seen that market growth created a constituency of stock investors whose political power increased as the market grew, which led to better investor protection.

The government was motivated by another consideration to tackle fraud and enhance investor protection. Falling share prices revealed yet more scandals, driving share prices down further. Investors began to lose confidence and withdraw from the market. Listing had to be slowed down and then suspended.[496] The plan to use the stock market to reform SOEs was then derailed. Although the stock market was a liability to the economy in the eyes of Beijing in the early 1990s, it became an important asset by the early 2000s after it had grown to a substantial scale. It was not only an important source of finance for SOEs, but was also seen to offer a solution to their governance problems. Listing was established as the guiding policy for SOE reform, and such a reform strategy seemed to be feasible after the stock market had grown to a significant size.[497] The government finally found a way to transform and revitalize the state sector, calling the shareholding system "the primary form of organization for the state economy" and encouraging SOEs to be listed.[498] With the decline of the market, however, the reform of SOEs by listing had to be halted. To revive the market so that SOE reform could continue, fraud had to be curtailed and investor protection had to be guaranteed. After the stock market had grown to a substantial size, it was not just important for SOE reform but seen as strategic to the whole economy. It was said that the stock market could improve the efficiency of the national economy by allowing the market to play a role in capital allocation, support innovation, and develop the private sector, which was critical to job creation and economic development, and enhance the safety of the financial system by allowing more equity finance to balance bank lending.[499] These were the motivations behind the government's decision to open the Small and Medium-Sized Enterprise Board in 2004 and the

[495] Hu Shuli, *The Rise of the Business Media in China*, *in* CHANGING MEDIA, CHANGING CHINA 77, 77–90 (Susan L. Shirk ed., 2010).

[496] *See supra* Part I.C.

[497] *See supra* Part I.B.3.

[498] *Decision of the Central Committee on Certain Important Questions Regarding SOE Reform and Development*, *supra* note 151.

[499] *Certain Opinions*, *supra* note 326.

ChiNext in 2009 at the Shenzhen Stock Exchange.[500] To achieve these strategic goals, however, fraud had to be checked and investor protection had to be guaranteed in order to ensure that the market could revive and continue to grow.

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

Nevertheless, the virtuous cycle of "growth-law-further growth" is not a guarantee, and market growth may not always lead to stronger investor protection, as evidenced by the fact that serious corruption, waste, overinvestment, and mismanagement are still rampant among listed SOEs. Why are investors in China still vulnerable to these managerial misbehaviors? Why has market growth led to the reduction of market fraud but not managerial misconduct? One explanation is the continuing dominance of state ownership in listed SOEs. Because of this dominance, the CPC and governments still enjoy a monopoly in staffing the senior managerial positions of listed SOEs. The serious agency problems inherent with traditional SOEs persist and managers' incentives to steal and shirk remain.[501] Minority shareholders, who invest real money in listed companies, are powerless, despite CSRC's corporate governance initiatives and increased legal rights. The Company Law of 2005's introduction of cumulative voting and minority shareholders' right to propose resolutions to shareholders' meetings are useless because of the overwhelming state ownership; independent directors are in fact not independent when the controlling shareholders are so powerful they can decide the selection, appointment, and remuneration of independent directors; performance-based remuneration is not workable when the stock market is volatile, companies enjoy monopoly, or the chances of managers being caught stealing are slim; the absence of hostile takeovers—the natural consequence of ownership dominance—and the monopolies enjoyed by many listed SOEs in product markets means market discipline is an illusion, or simply does not work, particularly when staffing is based on

[500] *See id.*
[501] *See* Cuervo-Cazurra et al., *supra* note 25.

political considerations, personal connections, or bribes; and enhanced disclosure, although perhaps a "pesticide" for controlling shareholders' misappropriation, is ineffective in exposing and deterring managers from stealing and shirking.[502] The dominance of state ownership provides an explanation for why market growth has not led to the reduction of managerial misbehavior, and why additional CSRC corporate governance initiatives and increased shareholder rights are ineffective. As long as listed companies are state-controlled and the CPC and governments maintain their power to appoint senior managers, it is doubtful their governance can significantly improve. Apparently, the dominance of state ownership in listed companies is due to the remaining socialist ideology that favors public over private ownership, which is still enshrined in the constitution of both the CPC and the country, and the CPC's political consideration to maintain its rule over the country.[503] Hence, the fundamental obstacle to the improvement of investor protection from market growth is ideology and politics.

Second, the reduction of market fraud is currently achieved through public enforcement of securities laws by the CSRC and the two exchanges under its control, but its remit to oversee the management of listed companies is limited.[504] It has no authority to take legal actions and punish SOE managers for corruption, waste, and mismanagement. In the meantime, private enforcement of laws is negligible and courts are useless for investor protection. Although the Company Law of 2005 introduced the derivative action, shareholders face various hurdles in bringing a derivative lawsuit and so far no action in connection with a listed company has ever been taken.[505] For private securities litigation, investors were incapacitated in using such a lawsuit to protect themselves after the Supreme People's Court imposed various restrictions and the class action was prohibited.[506] The government is just not serious about empowering investors to call corporate managers to task by way of litigation for fear of losing control. Another reason for the impotence of the court is its weak position in the political structure of the state[507]—courts are under the leadership of CPC and subordinate to the People's Congresses. Such an arrangement serves to ensure that the CPC's power is unchallenged. As a result, courts are in a difficult position when adjudicating cases involving SOEs because SOEs are the economic

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[502] *Id.*

[503] *See* XIANFA Mar. 14, 2004, art. 7 (China).

[504] *See* Anderson, *supra* note 253, at 1923–24, 1936, 1939.

[505] *See* Zhang, *Shareholder Derivative Action*, *supra* note 261, at 174–78, 191.

[506] *See* Robin H. Huang, *Private Enforcement of Securities Law in China: A Ten-Year Retrospective and Empirical Assessment*, 61 AM. J. COMP. L. 757, 761–63 (2013); Walter Hutchens, *Private Securities Litigation in China: Material Disclosure About China's Legal System?*, 24 U. PA. J. INT'L L. 599, 600–01 (2003).

[507] *See* Clarke, *supra* note 424, at 187, 197–98; Zhang, *supra* note 261, at 178, 196, 207–08.

foundation of the CPC and a part of the state apparatus. Hence, politics again explains why market growth fails to reduce managerial misbehaviors at listed companies. Last, when corruption is endemic in the whole country, it is unrealistic to expect SOE managers to be any more honest. To ensure that the whole country is less corrupt, fundamental political changes have to be made.

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

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

B. Market Growth in the First Place

If the improvement of investor protection is caused by market growth, it is necessary to ask the fundamental question: why does a market grow in the first place? First of all, the stock market in China grew because of economic reform and development. After funding from government budgets was cut off in the mid-1980s as a result of reform, SOEs were forced to seek alternative financing.[508] A demand for financing via the stock market was created. As the reform scheme expanded, demand increased. Later the stock market was not just a source of SOE financing, but also became a venue for reforming the governance of SOEs, adding more economic rationale for developing the market.[509] Moreover, economic liberalization spurred the phenomenal growth of the private sector, generating a new demand for finance. By the early 2000s, meeting the financing demand of private enterprises became an urgent issue, hence the opening of the Small and Medium-Sized Enterprise Board in 2004 and the ChiNext in 2009.[510] By the end of 2011, more than half of the number of listed companies were private enter-

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[508] *See* Leng Jing, CORPORATE GOVERNANCE AND FINANCIAL REFORM IN CHINA'S TRANSITION ECONOMY 39–62 (2009).

[509] *See supra* Part I.B.3.

[510] *See Certain Opinions*, *supra* note 326.

prises.[511] As of 2014, there were more than 600 companies queuing for an IPO and listing.[512] China's stock market still has huge potential to grow on the demand side. On the other hand, as the economy grew rapidly, so did household disposable income and savings,[513] providing sufficient supply to meet demand. There is no doubt that, because China has maintained a steady growth of household savings since the start of economic reform in 1978, China's stock market has been able to grow rapidly. Chinese households had RMB 50 trillion in bank savings at the end of 2014.[514] Hence, on the supply side, the growth potential of China's stock market could be met. The question becomes whether households will actually invest their money in the market.

Second, the market could emerge and grow also because of ideological, political, and economic liberalization. Such liberalization not only brought about economic growth, which underscored the growth of the stock market, but also directly allowed the market to develop. The government permitted the shareholding system to emerge and develop in the 1980s because the ultra-leftist ideology that regarded capital as being exploitative and evil was gradually abandoned, and the command economic system that banned private ownership of the means of production was relaxed.[515] Speeches by Deng Xiaoping during his "Southern Tour" in 1992 further broke down the leftist dogmas that market and capital were incompatible with socialism.[516] The political stigma attached to the shareholding system and the stock market was then removed and the ideological and political obstacles for stock market development cleared. In 1997, the CCP further liberalized its ideology and policy towards the shareholding system and stock market,[517] and the government has since actively encouraged the development of the stock market. It is clear that without this liberalization, the shareholding system would not have emerged, and the stock exchanges would not have been allowed to open and grow. Lastly, though household income and savings increased rapidly, the opportunities for investment were limited until the mid-2000s. Chinese people did not have much choice but to invest in the stock market or leave their money in banks with low interest

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[511] *See The Achievements of China's Listed Companies: Part III*, *supra* note 476.

[512] Shen Hong, *China Unveils List of 28 Companies Planning IPOs*, WALL ST. J. (Apr. 19, 2014, 6:08 A.M.), http://www.wsj.com/articles/SB10001424052702304626304579511073427245130 [https://perma.cc/YNL3-TT4T].

[513] *See* Allen et al., *supra* note 10, at 4.

[514] NAT'L BUREAU OF STAT. OF CHINA, STATISTICAL COMMUNIQUÉ OF THE PEOPLE'S REPUBLIC OF CHINA ON THE 2014 NATIONAL ECONOMIC AND SOCIAL DEVELOPMENT, Part VII (2014), http://www.stats.gov.cn/english/PressRelease/201502/t20150228_687439.html [https://perma.cc/N72M-6DDD].

[515] *See* Liu, *supra* note 37, at 153–80.

[516] *See supra* Part I.B.1.

[517] Jiang, *15th Congress*, *supra* note 148.

earnings.[518] As a result, the lack of alternative investment opportunities also contributed to the rapid growth of the stock market before the mid-2000s.

Although the bear market and sluggish growth between 2010 and 2014 was explained by the low profitability of listed companies, the low profitability was caused by other factors besides weak investor protection. First, the dominance over the market of inefficient SOEs reduced profitability. Second, it is notable that private listed companies, though more efficient, fare no better in profitability. One study found that between 2002 and 2006, the ROE of private companies was lower than that of listed SOEs. In fact, in 2005 ROE was -1.4% as compared to 8.39% for SOEs.[519] By 2011, the WAROE for private companies was 12.12%, still lower than SOEs at 14.51%.[520] One reason was that SOEs had a much higher level of debt leverage.[521] Another was that private and state companies operate in different sectors with different levels of profitability. As of the end of 2006, 62.47% of private listed companies were from the manufacturing sector with tight profit margins, while SOEs dominated the lucrative sectors such as finance, communications, utilities, infrastructure, and natural resource exploitation.[522] Indeed, only two listed banks are privately controlled, and all the telecommunication network operators and most of the oil, gas, coal, and metal production companies are state-controlled.[523] In those sectors where entry barriers do not exist, private companies are much more profitable than state companies.[524] Because private companies are barred from those lucrative sectors, their profitability is low and the profitability of listed companies as a whole suffers.

Third, the unaccommodating business environment also caused low profitability. Business in China faces endless and inhibiting bureaucracy and predatory financial burdens. A 2013 survey found that, on average, every business sought 17.67 government approvals, received 19.06 government inspections and assessments, and their senior managers attended 24.5 government meetings. In addition, they paid nearly 10% of their revenues in tax

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[518] *See* Chen, *The China Puzzle*, *supra* note 31, at 172–74.

[519] SHENZHEN STOCK EXCH. RES. INST., WOGUO MINYING SHANGSHI GONGSI FAZHAN SHIZHENG YANJIU (我国民营上市公司发展实证研究)［AN EMPIRICAL STUDY OF THE DEVELOPMENT OF CHINA'S PRIVATE LISTED COMPANIES], 32 (Jan. 14, 2008), http://www.szse.cn/main/files/2008/02/25/091811911155.pdf [https://perma.cc/7FN9-TFTG] [hereinafter DEVELOPMENT OF CHINA'S PRIVATE LISTED COMPANIES].

[520] Zhang Hua et al., *Gao Ying Shou, Di Ying Li—2012 Minying Shangshi Qiye Jixiao Baogao* (*高营收，低盈利—2012 中国民营上市企业绩效报告*) [*High Revenue, Low Profit—Chinese Listed Private Enterprise Performance Report*], ZHONG OU SHANGYE PINGLUN (CEIBS BUS. REV.) (2012), http://www.ceibsreview.com/show/index/classid/2/id/2109 [https://perma.cc/UMD5-QAGU].

[521] *See* ALL-CHINA FED'N OF INDUS. & COMMERCE, *supra* note 469.

[522] DEVELOPMENT OF CHINA'S PRIVATE LISTED COMPANIES, *supra* note 519, at 8–11.

[523] *Id.*

[524] *Id.*

and their social security contributions amounted to 40% of employees' total salary.[525] The World Bank's Doing Business 2016 finds that China ranked 84th overall among all 189 economies under assessment. Specifically, in China it takes 30 days to start a business and 274 days to secure a construction permit, all while tax and other mandatory contributions account for 67.2% of a business' total profits, placing China in the 136th, 176th, and 132nd ranks for these categories, respectively.[526] All these reduce the efficiency of business and eat into their profits.

Fourth, low profitability is also due to the fact that industrial and low-end service companies comprise the majority of listed companies in China.[527] The profitability of these companies is much lower than their counterparts in developed economies because they lack technologies, brand names, managerial expertise, innovation, and so on. The case of Apple and its Chinese supplier, Foxconn, whose profit margins were respectively over 30% and 1.5%, is a stark example.[528]

Fifth, from the mid-2000s, the booming real estate market provided Chinese people a highly profitable investment opportunity.[529] In addition, the emergence of shadow banking in the late 2000s offered investors even more options than stock investment.[530]

Last, the profitability of listed companies is linked to macro economic performance. GDP and profitability simultaneously surged in 2007 and recovered in 2009 and 2010. After 2010, as GDP growth decelerated, corporate profitability declined.[531]

The growth potential of China's stock market was constrained by the dominance of SOEs over the stock market and lucrative business sectors, the excessive bureaucracy and cost of doing business in China, and listed

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[525] Qingtai Chen & Yongwei Zhang, *Xingzheng Shenpi Heqiduo (行政审批何其多) [Administrative Approvals Endless]*, RENMIN RIBAO (PEOPLE'S DAILY) (June 17, 2013), http://politics.people.com.cn/n/2013/0617/c1001-21856100.html [https://perma.cc/G3L2-VPJA].

[526] *Ease of Doing Business in China*, WORLD BANK GROUP (2016), http://www.doingbusiness.org/data/exploreeconomies/china#starting-a-business [https://perma.cc/8Q74-8C68].

[527] *See* SHENZHEN STOCK EXCH. RES. INST., *supra* note 444, at 19–21.

[528] Tim Culpan, *Apple Profit Margins Rise at Foxconn's Expense: Chart of the Day*, BLOOMBERG (Jan. 4, 2012, 6:01 P.M.), http://www.bloomberg.com/news/2012-01-04/apple-profit-margins-rise-at-foxconn-s-expense.html [https://perma.cc/5W2E-TF8H]; Erin Wigger, *What a Surprise: Apple Profit Margins Rise at the Expense of Foxconn and Pegatron Corporation*, UNHEALTHY WORK (Jan. 26, 2012), http://unhealthywork.org/recent-entries/what-a-surprise-apple-profit-margins-rise-at-the-expense-of-foxconn-and-pegatron-corporation/ [https://perma.cc/B25L-GAM6].

[529] *See* Xiao Qiao, *A Review of the Chinese Real Estate Market* 2 (U. Pa. Wharton Sch. Bus., Working Paper, Oct. 26, 2010), http://repository.upenn.edu/cgi/viewcontent.cgi?article=1005&context=sire [https://perma.cc/YMV3-6KCW].

[530] *See* Sara Hsu, *The Rise and Fall of Shadow Banking in China*, THE DIPLOMAT (Nov. 19, 2015), http://thediplomat.com/2015/11/the-rise-and-fall-of-shadow-banking-in-china/ [https://perma.cc/2CXW-K692].

[531] *See supra* Parts I.D. & I.E.

companies' limited technological, managerial, and innovation capacity. Again, the dominance of SOEs is due to the ideology and politics that favor state ownership. In addition, the excessive bureaucracy and costs of doing business could be a result of a political system with unchecked government powers. Also, the limited capacity of listed companies can be partly explained by the fact that China is still a developing economy. All in all, China's experience indicates that stock market development is ultimately determined by ideologies, politics, and economic development. This not only explains why market growth does not lead to stronger law, but also why a market does or does not grow in the first place.

CONCLUSION

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

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