GOVERNANCE AND REGULATION OF THE SECURITIES MARKETS IN CHINA

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Summary

This paper argues that the development of regulation of China's securities markets has been a highly political process. Stock riots in the early days of the stock markets provided strong impetus for central government intervention. While the basic institutional framework for securities industry regulation came into being in the late 1990s, the fear of investor discontentment has never been far from the minds of regulators and national leaders. Such a fear has in turn stimulated the growth and maturation of the regulatory apparatus. With the regulatory apparatus in place, securities regulators have increasingly turned to the enforcement of existing laws and regulations. As a result, China's regulators today are tackling issues that are remarkably similar to those found in mature markets such as New York.
When the Shanghai and Shenzhen stock exchanges were formally opened for business in 1990-91, they were officially considered experiments only.\textsuperscript{1} The chill of the 1989 crisis still lingered around. There was a politically sensitive debate on whether stock markets were compatible with socialism.

Deng Xiaoping’s tour to southern China not only helped jumpstart China’s stalled reforms but also gave a major impetus to the development of the securities markets. Yet Deng’s talk on the tour highlighted the uncertain political status of the stock markets. He questioned whether securities and stock markets were unique to capitalism and called for “taking a decisive attitude to give them a try.” But he also noted that, if they were found to be “wrong” after trying them for a year or two, they could be closed. It is on such a political landscape of doubt and hope that China’s stock markets, which like stock markets everywhere tend to various forms of irregularities and excesses, have sunk roots and grown up. By 2001, the combined capitalization of China’s listed companies is second only to that of Japan’s in Asia.

For political and ideological reasons, the Chinese leadership understandably cannot afford to leave the stock markets on their own as had occurred in the early life of stock markets in the United States and other countries. Instead, regulatory development has gone hand in hand with the expansion of China’s stock markets and the incidence of irregularities and excesses. What is remarkable is that China’s leaders and financial regulators have been willing to learn from the best of international practices. Step by step they have built up a reasonably sound regulatory apparatus and thus prepared the ground for the sustained development of China’s securities industry.

The Initial Skirmishes

When they were first set up, the Shanghai and Shenzhen stock exchanges were regulated by the municipal governments and the local branches of the People’s Bank of China. Since the local branches of the PBOC were largely under the sway of local authorities at that time, local authorities were the main players in fostering the growth of these nascent markets. And they pursued rapid growth in the absence of a sound regulatory framework.
Shortly after Deng spoke, however, the risks associated with poorly regulated markets were put under glaring light. On July 7, 1992, the Shenzhen Stock Exchange suspended trading in the highflying stock Yuanye (first listed in 1990) after the Shenzhen branch of the PBOC discovered that Yuanye had engaged in massive accounting irregularities and financial fraud. Since the irregularities and deceit at Yuanye were not unique, they undermined investor confidence in

Still more ominous were the Shenzhen protests of August 1992. At this time, potential investors for IPOs had to first purchase IPO application forms and 10 percent of the forms would be given the right to subscribe. When news of the distribution of the application forms was announced, more than one million people rushed to Shenzhen and queued up, only to find the forms disappear shortly after distribution began. Applicants seethed with anger, as many had waited in line for three days and nights. They suspected, correctly, that officials and clerks charged with the distribution of the forms had given the forms away by the backdoor and marched in protest in the evening.

Incidents such as these underscored the incidence of rampant corruption and pointed to the political dangers of unregulated growth. In October 1992, in the aftermath of stock-related protests in Shenzhen, the central government decided to strengthen central government regulation of this emergent industry. With the establishment of a State Council securities committee and the China Securities Regulatory Commission (CSRC), the local exchanges fell under the dual supervision of the local governments and the CSRC. Nevertheless, the State Council directive on further strengthening the macro-regulation of securities markets stipulated that the Shanghai and Shenzhen stock exchanges were directly overseen by the local governments, subject to the supervision of the CSRC. In the meantime, work began on the drafting of a Securities Law (which finally came into effect in 1997). In a major departure from established practice, the drafting of the Securities Law was initiated and led by the National People’s Congress instead of the State Council.

In spite of the establishment of the CSRC, the central government’s supervisory institutions were to a significant extent toothless. The State Council Securities Committee, composed of representatives from fourteen state agencies including the Economic Reform Commission, the State Planning Commission, the Ministry of Finance,
the central bank, the Supreme People’s Court, and the Supreme People’s Procuratorate, was largely a coordinating institution. Meanwhile, the CSRC was not formally a government department but a non-for-profit institution (shiye danwei) that lacked effective administrative enforcement authority and tools. The local securities committees were neither part of the local governments nor the field offices of the CSRC. Moreover, the CSRC had to share whatever regulatory authority it could come by with the State Planning Commission, the Economic Reform Commission, the Ministry of Finance, and the People’s Bank of China.³

Local governments in Shanghai and Shenzhen remained the key players in promoting the stock markets at this time. They benefited from the collection of the stock transaction or stamp tax and taxes from services related to the securities industry. Propelled by the fiscal incentive, the local governments schemed to best each other and other cities to become the leading securities exchange for China.⁴ Other cities including Wuhan and Tianjin also sought to establish exchanges of their own. Shandong’s Zibo operated an exchange for smaller collective enterprises.

Other local authorities also established their own securities regulatory authorities that worked side by side with government agencies focused on planning, economic management, and reform policies. The focus of these local authorities was less on the regulation of risk and cracking down on financial fraud and accounting irregularities than in promoting the growth of local brokerages and getting more local companies listed on stock exchanges to raise the most funds for local development. In light of these incentives, it was clearly difficult for the local regulatory authorities to be fair referees.⁵ It is widely known that local regulators condoned the “packaging” of poor-performing companies for listing and looked the other way in cases of securities manipulation.⁶ Some local regulators even used their power over the stock listing process to extract personal favors from companies seeking to go public. For example, Zhang Yuren, director of the Sichuan Provincial Economic System Reform Committee, was in charge of approving Sichuan companies seeking IPOs. He was later found to have received at least 145,000 shares of stock (then worth 3.7 million yuan) from these companies.⁷

By 1997, the Shanghai and Shenzhen stock markets had evolved into national institutions that reached practically every corner of China, linked up by satellite and other
means of modern communications. As of August 1997, they listed around 700 companies and boasted of multi-billion-yuan transactions daily. With 30 million stock accounts, the ups and downs of stock market movements touched the hearts and wallets of at least as many families. The burgeoning securities markets also stimulated the growth of brokerages, accounting firms, law offices, asset appraisal firms, as well as financial media. Demands from the securities markets spurred the regulation of accounting firms by the Ministry of Finance and the CSRC. Yet massive irregularities existed, notably the illegal use of bank funds for stock investments (including IPOs) as well as the manipulation of stock prices by brokerages.

Market Expansion and the Assertion of Centralized Regulatory Authority

Even before the Asian financial crisis swept on Chinese shores, the Chinese leadership, having become keenly aware of the growing economic and political significance of the gyrating stock markets, began to launch serious efforts at curbing rampant speculation and manipulation in stock trading. Regulators imposed stiff penalties on a number of bank branches and brokerages that engaged in illegal activities. On December 16, 1996 the People’s Daily capped months of stepped-up regulatory activities by publishing a special commentary that pointed to the various problems afflicting the stock markets and warned investors to beware of investment risks in an immature market. In response, the market indices dived but then quickly recovered and then some in anticipation of China’s takeover of Hong Kong. Regulators then used the adjustment of IPO quotas and of the stamp tax on stock trading. Moreover, in May-June 1997, two major directives were issued to reduce the flow of funds into the stock markets. First, the State Council Securities Committee, the People’s Bank of China, and the State Economic and Trade Commission banned state-owned firms and listed companies from trading in stocks. Second, the People’s Bank of China prohibited banks from allowing various forms of funds into stock trading and speculation. The bubble finally punctured.

The market gyrations and rapid speculation also prompted the central authorities to rethink of the regulatory apparatus for the securities industry. In August 1996, the State Council Securities Committee promulgated the Regulations on Managing the Stock
Exchanges. In a significant departure from past practice, the Regulations empowered the CSRC to directly oversee and manage the stock exchanges, including the authority to nominate, with the concurrence of the local governments, the chairman and vice chairman of the boards of the exchanges as well as the general manager and deputy general manager of the exchanges. The balance of regulatory authority clearly tilted toward the center.9

The onset of the Asian financial crisis accelerated the efforts by the central authorities to gain direct oversight over the stock markets. Advocates for centralization pointed out that most developed economies regulate their securities exchanges under one nationwide unified authority rather than parceling out regulatory authority to local governments. In August 1997, just before the fifteenth Party Congress launched new reform initiatives, the State Council empowered the China Securities Regulatory Commission to directly oversee the Shanghai and Shenzhen stock markets rather than leave them to the dual leadership of the municipal governments and CSRC. With this regulatory change, the CSRC promptly appointed its own choices for the general manager and deputy general managers of the stock exchanges.10 In the meantime, the amended Criminal Law included provisions for prosecuting securities-related crimes including illegal issuance of stocks, insider trading, the spread of false information and other forms of stock manipulation. Most importantly, the financial crisis in the rest of Asia prompted central leaders, notably president Jiang Zemin, to push for the enactment of the Securities Law.

The central government did not just take over the regulatory authority over the stock markets. Without fanfare and in a slap at the federalist argument, it also asserted its right to the stamp tax on securities transactions. Rather than letting local authorities to the bulk of the growing stamp tax revenue, the central government chose to take 88 percent, leaving 12 percent to local authorities in the future.11 In October 2000, the State Council further decreed that the central government’s take would rise to 91 percent beginning in October 2000, to 94 percent in 2001 and 97 percent in 2002.12 As the Chinese stock markets came back to life in 1999-2000, the stamp tax revenue reached 24.5 billion yuan for 1999 and 26.7 billion yuan for the first half of 2000, making it one of the fastest growing tax categories.13
The 1997 National Conference on Financial Work also decided to reform the administrative organization for securities regulation. While so far companies and government agencies largely used the stock markets to collect money from the public to bail out under-performing state forms, the growing size of the stock markets and rapidly expanding scope of public involvement suggested that these markets had become an important economic institution. Stock market movements could have a profound impact on society and politics. For the stability-conscious leadership, such an important institution can simply not be left to local governments. In fall 1998, in a move that paralleled the restructuring of the People’s Bank of China, the central leadership decreed that the system of securities and futures regulation was to be transferred from one of local fiefdoms to one under the direct and unified leadership of the China Securities Regulatory Commission. In what is called vertical administration (chuizhi guanli), the central commission oversaw the staffing size, party organization, and cadre management at local offices. Local regulatory authorities thus became branch offices representing the CSRC. This change required the local offices to place their emphasis on the protection of investors through regulation, standards, and discipline rather than raising the most funds for local companies. With the formal implementation of the Securities Law on July 1, 1999, the CSRC's branches became operational nationwide, thus forming a centralized and unified network of securities supervisors.\(^{14}\)

In short, though still very young, the Chinese securities and futures exchanges have not only adopted cutting-edge technologies but have also been put under a single regulator for the securities and futures exchanges, a goal that has to date eluded the U.S. Securities and Exchange Commission.\(^ {15}\) Finally, in preparation for China’s WTO membership, a joint conference system for banking, securities, and insurance regulators was initiated in Shanghai in mid-2000 to strengthen information sharing and coordination.\(^ {16}\)

**Reforms under Centralized Regulatory Authority**

The assertion of central regulatory authority, analogous to the reform of the central bank, has sped up the adoption and enforcement of unified and transparent rules
for the securities markets. In conjunction with the implementation of the Securities Law on July 1, 1999, the CSRC screened and standardized more than 250 existing laws and regulations and put securities regulation within a unified legal framework. Armed with the Securities Law and a centralized administration, the CSRC has fundamentally reformed the IPO process and has also strengthened supervision over share underwriting, corporate disclosure, insider trading, mutual funds, and so on and cracked down on illegal trading beyond the stock market (including trading on black markets).

Revamping the Share Listing Process

For the first decade of China’s stock markets and about the first 1,000 firms listed, the right to list was administratively rationed and is referred to as “shell (ke)” resource. Getting a quota or the permission to list was license to gather money from eager investors. To get the right to list, enterprise managers falsified information and bribed gatekeepers. This writer personally heard from one manager of a state owned firm say that he gave a car to the influential wife of a deceased state leader in the hope that she would help him secure the right to list.

As regulators promoted IPO reforms, the Chinese government has uncovered a variety of corruption cases in recent years. For example, Zhang Yuren, the former director of the Sichuan provincial securities regulation and supervision office, took shares from several companies in 1993 before he granted these companies the quotas needed for the CSRC to approve the listings.

Perhaps the case of the Kangsai Group, formerly the Huangshi Garment Factory in Hubei province, offers striking illustration of the bribery that enterprise managers engage in to secure listing approval. For several years (1993-96) before the stock was listed, Kangsai’s management offered internal shares to more than 100 officials who could potentially help with getting the firm’s listed. The shares were offered to these officials at one yuan each but had a value of 6.37 yuan per share; they debuted at 11 yuan per share on the first day of trading in 1996 and reached more than 30 yuan per share at one time. Those whose family received such shares included Xu Penghang, a former mayor of Huangshi then serving as vice minister of the State Economic and Trade Commission, and Wu Wenyong, then the minister of the National Council of Textile
Industry (formerly the Ministry of Textile Industry), as well as many local officials in Hubei. Xu was instrumental in helping Kangsai to gain the qualification to list in late 1993. When Kangsai was still not getting the Hubei provincial government’s recommendation to list in spring 1996, Wu came to help. Even though Kangsai was not formally under the National Council of Textile Industry, Wu not only used her influence to persuade Hubei’s leaders to give the green light but also signed on the document recommending Kangsai to the China Securities Regulatory Commission. Armed with cheap pre-IPO shares and other bribes, Kangsai paved its road to the Shanghai Stock Exchange. The Xu family gained 1.1 million yuan while Wu’s son made a quick profit of 890,000 yuan from selling their shares. Having dressed up its accounts for the listing, Kangsai soon began to lose money. Even before the corruption scandal broke, the Shanghai Stock Exchange condemned Kangsai and its majority shareholder for related transactions that harmed the interests of Kangsai shareholders. The corruption scandal further pushed the stock to junk status in 2000. Both Xu Penghang (vice minister of the Commission on National Defense, Science, Technology, and Industry and alternate member of the Central Committee) and Wu Wenying (Member of the Standing Committee of the Chinese People’s Political Consultative Conference) lost their prominent posts in 2000 and were publicly disgraced.

The IPO quotas and high stakes made China’s stock listing a hotbed for corruption and turned Chinese investors into cynics. As with dual prices and land allocation, the administrative rationing of stock listing quotas became an important avenue for the powerful to convert their power into money. Indeed, for the first decade of China’s stock markets, the CSRC, with one possible exception, did not reject any of the companies local governments and ministries recommended for stock listing. Local governments cobbled together state enterprises so that they could use their listing rights to raise funds from investors for under-performing state concerns. It was quite often that firms would come to the market with what seemed to be excellent performance, only to disappoint investors a year or two after (this is known as face change or bianlian) and become basket cases with ST (special treatment) and PT (particular transfer) prefixes.

In response to popular and legislative criticism of lack of transparency in the approval of listing applications, the CSRC began to reform the listing process in order
to curb corruption and win back the confidence of Chinese investors. Since many bureaucratic interests benefited from the system of administrative approval for domestic listings, however, the CSRC moved somewhat tentatively with the listing of Chinese firms overseas under more stringent requirements for accounting and financial disclosure. With the formal implementation of the Securities Law in July 1999, the CSRC announced that henceforth it would approve Chinese companies for listings on overseas markets on merit only and no longer limit such listings to state firms.24

Most fundamentally, the CSRC changed the administrative approval system (shenpi zhi) for stock listing to a market-oriented US-style registration system (zhuce zhi). The new system abolished the right of local offices to recommend stock listings. Instead, the CSRC announced a set of listing criteria for IPOs and set up a committee for examining IPO applications by following established procedures. Underwriters may recommend firms for initial public offerings as long as the firms satisfy listing requirements. The applications are then examined for approval in expert committees. The committee is 78 percent comprised of non-CSRC personnel, including financial experts appointed to two-year terms (maxim: three terms). Applications for IPO would be reviewed by one of eight sub-committees and need the endorsement of two-thirds of the members before they can be approved by the CSRC. Those underwriters as well as law firms and auditors found to have provided fake information can be severely penalized.

With this major reform of the listing process, the CSRC hopes to make the review and approval of stock issues a fairer and more transparent process.25 Impressively, in the first year since the Securities Law came into effect (July 1, 1999-June 30, 2000), the CSRC rejected 40 percent of the IPO applications. Equally interesting, with threat of sanctions for falsifying information, 60 percent of the legal and auditing reports on the applicant firms contained negative opinions.26 No longer could a firm devote its energies to getting a listing quota and be assured of final listing. In fact, the formal introduction of the new listing process in March 2001, with its stricter requirements on the content and form of corporate disclosures, lead to a slowdown in new listings through June 2001.27

Even with the threat of penalties, however, regulators remained diffident about the prospect for a quick behavioral change by domestic professional firms and were worried that domestic firms might still be too short-term oriented and willing to engage in
unethical behavior for quick gains. Such concerns prompted regulators to promote the engagement of professional services firms with a global reputation and much higher stakes. When it opened the door to public listings by financial institutions (commercial banks, insurance companies, and brokerages) in November 2000, the CSRC issued rules on such listings that were clearly designed to curb the falsification of information. The rules not only require disclosures about asset quality, internal control and other accounting items, but also ask that the firms seeking to be listed be audited by international auditing rules. Apparently distrustful of China’s own nascent accounting profession, the auditing must be done by major international accounting firms that appear on the approved list of the CSRC and the Ministry of Finance.28

Rationalizing Professional Services

The State Council leadership has in recent years sought to rationalize and strengthen the intermediary professions, including accountants, lawyers, notaries, appraisers. The government’s twin aims are to make the professions independent of government agencies and accountable to the law in order to enhance the credibility of the system and better prepare these professions and the Chinese economy as a whole for the increased competition following China’s accession to WTO membership

The main problem afflicting China’s intermediary professions arose from the political origins of these professions. Practices ranging from law offices to accounting firms to others were invariably set up by state agencies and put on government payroll. With economic reforms and rising costs, the state agencies eagerly set up such practices to generate incomes and provide employment for extra staff, sometime with the same staff doubling as both government employees and professionals offering accounting, legal, notary and other services. Moreover, there was growing competition among state agencies fighting for regulatory power over the intermediary services, resulting in a convoluted and fragmented regulatory framework for the dozens of intermediary services.

As competition in the services markets grew, the state agencies conveniently used their power and influence to steer business the way of their affiliated intermediary services. Indeed, because of lax regulation and policing, a sort of Gresham’s Law
prevailed; firms had few ethical constraints and often lowered charges as well as professional standards in order to win businesses. By undermining the authenticity and quality of economic information, substandard intermediary services in turn undermined public trust. As vice minister of Finance Zhang Youcai noted in 1999 with respect to the accounting profession, China’s accounting was characterized by fake statistics. It was not unusual for accountants to “dress up” firms for listing with the support of government departments. Zhang warned that the spread of fake numbers had “reached an unbearable situation. If not rectified, not only the entire accounting profession but the entire economy and society could be destroyed in no time.”

There had been some tentative attempts to rationalize the intermediary services before the divestiture of businesses operated by the military, armed police and other state agents. Yet, as in the divestiture of the military businesses, government agencies were reluctant to sever their ties with the intermediary services that generated revenue and patronage opportunities. Nevertheless the successful divestiture of PLA businesses underscored the central leadership’s determination to cleanse the economic environment of unfair business practices and helped give momentum to the rationalization of the professions. In early 1999, the State Council began to tackle the rationalization of intermediary services in earnest. As in the case of the divestiture, the State Council set up an interagency office, State Council Leading Group on Improving and Rectifying Economic-Verification Social Intermediary Organizations, to oversee the rectification of the intermediary services. Finance Minister Xiang Huaicheng served as head of the leading group.

Though there were delays in the severance of ties between government agencies and the service firms, the strong central government commitment carried the day. By the end of 2000, the economic intermediary services, including certified public accountants, certified asset appraisers, certified tax consultants, property evaluators, land evaluators, cost engineers, township enterprise asset appraisers, rural collective assets appraisal organs, lawyers, notaries public, grassroots law services, patent agents, trademark agents, and specialized service agencies, had severed their ties to government departments and organizations and were mostly converted into partnerships or limited liability companies.
More specifically, the service professions had to sever their government ties in terms of name, personnel, finances, and service.

Besides asking professional firms to sever their ties to the government, the Ministry of Finance also decided to promote the consolidation of the different certified professions to facilitate regulation and professional development. In 2000, the professionals in accounting, asset appraisal, and tax service were merged and placed under one professional umbrella. In the area of legal services, efforts were made to sort out the relationship between law firms, other legal services, and notaries public. The Ministry was also studying the various appraisal services (price appraisal, township enterprise evaluation, property evaluation, land evaluation, and project cost consultants) in the hope of consolidating these services.\textsuperscript{32}

In spite of the severance of government-firm times and consolidation of different services, much remains to be done to enhance the professional quality of the Chinese professions. Indeed, this is challenge facing not just emerging economies like China. In the United States, the Securities and Exchange Commission has been concerned about the potential conflict of interest when an accounting firm does both auditing and consulting for the same client firm. Similarly, it is conventional knowledge that securities analysts at brokerages in the United States tend to say nice things about firms with which the brokerages have an investment banking relationship and rarely issue “sell” recommendations.

The segmentation of the professions in China makes it less likely for intermediary services to have the same conflicts of interests as their American counterparts. Instead, the main challenge for the Chinese professions is to learn to follow basic professional ethics. While rationalizing the structure of the professions, the Chinese government has undertaken a variety of measures to strengthen regulation. With an amended Accounting Law, government agencies have imposed penalties while encouraging those that meet good professional standards. In mid-2000, the CSRC admonished 11 companies, their securities underwriters and accounting firms after these companies performed more than 20 percent below the forecasts made when they first listed in 1999.\textsuperscript{33} In December 2000, the Ministry of Finance, in association with the People’s Bank of China and the China Securities Regulatory Commission, began to certify accounting and law firms for
auditing financial businesses and undertaking legal work for firms listing overseas. Such certification, to be renewed annually, may serve as a powerful incentive for the established professional firms to maintain professional standards in order to be eligible for some of the most lucrative assignments in their businesses.34

Shortly after these measures were taken, professional firms began to change their behavior. In a clear recognition of their accountability and liability, accounting and law firms have started to purchase liability insurance. Moreover, there was a rush to merge into large firms to increase competitiveness and the ability to cope with risks. By March 31, 2001, 411 accounting firms had applied for mergers. Following the mergers, 152 accounting firms would remain. Of the firms being merged, 87 were firms under the direct supervision of the China Association of Certified Public Accountants.35

In the US, the credibility of analysts sank like stone as the hype concerning dotcom companies subsided. It is only recently that major brokerage houses have begun to address the problems of conflict of interests, particularly, the connection between analysts and investment banking. In 2001 Merrill Lynch issued a rule prohibiting analysts from buying shares in the companies they cover. For China, the CSRC decided to move toward self-regulation of securities analysts. The Securities Association of China--a 144-member non-governmental organization founded in 1991--took over certification of analysts from the CSRC in 2001 as part of the move toward greater self-regulation of the securities industry. 28,423 analysts had been certified by July 2001.36

**Tightening Accounting Rules and Improving Corporate Disclosure**

Accounting and disclosure are some of the most vexing issues facing even mature markets. In the US, for example, the Securities and Exchange Commission had as of mid-2001 nearly 260 accounting investigations under way, including about 40 that on members of the top 500 firms. In various cases, accounting firms have been slapped large fines. In 2000, the number of restated financial reports rose to 233, twice the number in 1997.37 The demands of accounting reviews and accounting-fraud investigations have strained resources at the SEC.

While the accounting and auditing professions are rationalized, the Ministry of Finance has steadily imposed stricter accounting rules, especially for listed companies. It
is not possible to fully discuss these changes here. Nevertheless, a recent example may indicate the seriousness of the accounting rule changes. At the start of 2001, the Ministry of Finance issued detailed stipulations concerning bookkeeping of intangible property (applicable to listed firms only), cost of lending and leased properties of enterprises. It also adjusted five detailed accounting rules to prevent companies from manipulating profits through debt restructuring and non-monetary deals.  

The CSRC has made stricter demands for improvement in corporate disclosure to bring Chinese standards closer if not yet up to international standards. The reporting requirements issued by the CSRC at the end of 1999 stipulate that listed companies not only issue profit-loss statements but also provide detailed accounting of their assets and operations, including provisions for account receivables and write-offs as well as investment losses. In addition, companies are required to explain their losses and lack of dividends as well as discuss the potential impact of China’s WTO membership. Furthermore, besides publication of summary statements in government-designated financial newspapers, companies are also required to post their full statements on the official web sites of the stock exchanges to facilitate the dissemination of information.  

In order to encourage corporate compliance with the disclosure requirements, the CSRC branches have conducted regular inspections of listed companies to enhance the fullness and transparency of disclosures. The CSRC has begun to impose deadlines for listed firms to issue earnings warnings and also plans to requires listed firms to issue quarterly reports. Finally, the CSRC was considering the establishment of a non-government organization to complement its own role in fighting the disclosure of fake information and insider trading.

Strengthening Enforcement

Unlike local governments that seek to list as many local companies as possible, national policy makers and regulators have increasingly turned its attention to ensuring that expansion of the stock markets be accomplished in a fair manner. At the end of 1999, the CSRC was fortified by the National People’s Congress, which toughened laws to counter insider trading, market manipulation and other crimes in stock and futures exchanges by amending the Criminal Law. The amendments made using or leaking
inside information about securities or futures dealings punishable by up to 10 years imprisonment and fines two to five times the amount of any profits from such crimes. Employees of securities and futures firms could be jailed or fined for releasing false information, making fake transaction records or manipulating market prices for their own gain.42

It was amid growing demands for improving securities industry regulation that Zhou Xiaochuan, a trusted follower of Premier Zhu Rongji, was appointed CSRC chairman in early 2000. Under Zhou, a series of administrative reorganizations and major appointments have been made at the CSRC to strengthen supervision and enforcement. In fall 2000, the CSRC authorized each of its regional branches to set up a Bureau of Investigation (Jichaju), with at least one third of branch personnel, to strengthen the investigation of securities and futures violations and the enforcement of securities laws and regulations. The Investigation Bureaus have cooperated with the Securities Exchanges to improve real-time monitoring of securities transactions and deal with stock manipulations and other forms of irregularities.43 Regional branches of the CSRC have also focused on standardizing the operations of listed companies by conducting periodic inspections of listed companies and making contact with government officials. The heads of the regional branches invariably noted that their primary role was not to intervene in the actual management of firms but to serve as referee by requiring firms as well as local governments to follow laws and regulations.44

Borrowing a page from the cleanup of the Customs Administration, the central leadership appointed a vice-minister of Public Security (Mr. Zhao Yongji) as CSRC vice chairman in charge of investigation and enforcement in mid-2001. With greater clout, the CSRC are no longer confined to the usual tasks of reviewing trading accounts and transaction records. Instead, the new enforcement bureau would allow the CSRC to seal and freeze bank accounts.45 Moreover, a number of individuals with expertise in the securities industry have been appointed to key positions in supervision and enforcement. They include Laura Cha, a U.S.-trained lawyer and former number-two official of the Hong Kong Securities Commission, who was appointed CSRC vice chairman. Equally symbolically, the CSRC appointed Hong Lei, a whistleblower on fraud in the fund management industry, to supervise his former colleagues in the funds industry the CSRC.
By late 2000, the CSRC had launched major investigations into share manipulations by brokerages and fund managers as well as illegal use of bank funds.

In actual enforcement, the CSRC has gradually flexed its muscle, tackling a growing number of cases. Between July 1, 1999, when the Securities Law came into effect, and November 2000, the CSRC launched investigations into 236 cases in stock and futures trading. As a result of the investigations, the CSRC issued administrative penalties in 100 cases and punished 88 institutions and 142 individuals, with total fines of 466 million yuan.46 One of the most prominent cases concerned the IPO of the Daqing Lianyi Petrochemical Co. By late 1999, criminal charges or disciplinary acquired action had been taken against 39 officials for deception, faking figures, bribery, and insider dealing in connection with the IPO. Among the ten officials who lost their jobs and faced criminal charges were the city's deputy party secretary, former chairman of the local people’s congress, and deputy director of the taxation bureau.47

The year 2001 may very well be remembered as the year of improving enforcement of securities laws. While emphasizing investor education, the CSRC has steadily toughened enforcement measures vis-à-vis listed firms and securities firms. In early April 2001, for instance, teh CSRC issued regulations on the methods for inspecting listed companies, which replaced an earlier set of rules issued in 1996, and also the Methods for Implementing the System of Talks with the Chairmen of Listed Firms. The Methods for Inspecting Listed Companies includes provisions on the use of funds raised for earmarked purposes, investor complaints, as well as problems revealed by the media; major reorganizations. In the Methods for Implementing the System of Talks with the Chairmen of Listed Firms requires the CSRC to meet with the chairmen of listed firms in cases of negative equity, major shifts in control, failure to fulfill promises made in listing prospectuses, and so on. No right to refuse or delay is provided.48

It is the actual cases that show the CSRC hard at work on enforcing the laws and regulations. In March 2001, the CSRC publicly reprimanded 12 listed companies for failing to follow the CSRC’s disclosure rules concerning major purchases or sales of assets. The amount of asset transactions by the 12 companies accounted for about one third of such transactions in 2000.49 In April, in a watershed for China’s listed firms, PT Narcissus, a Shanghai-based firm that come to the market in 1992, became the first
delisted firm after having run up hefty losses for four consecutive years. In fighting the
so-called zhuangjia (arch manipulators) that specialize in driving up the prices of certain
 stocks before getting out and leaving small investors holding the bag, the CSRC acted
slowly so that the manipulators had largely left by the time trading was halted in the case
of Yi’an Keji (Yorkpoint Science & Technology Co.). By summer 2001, however, the
CSRC had become far more decisive and effective. In July-August it was able to freeze
these manipulators in the cold in the case of Guangxia (Yinchuan) Industry Co. for
falsifying earnings figures at its Tianjin branch.

The intensification of CSRC monitoring and action against such manipulators
have reportedly prompted the zhuangjia to get out of their stocks of target. And
institutions are clearly feeling the heat. Amid an escalation of the fight against
manipulation, illegal accounts and fund use by institutions, managers of the brokerage
houses were having jitters about being called in by CSRC officials for “talks.” As one
interviewee working in a major provincial securities firm told me, many who have
worked years in the industry were seriously thinking of quitting for fear that their careers
might come to an end under the weight of the CSRC’s aggressive enforcement.

Liberalization of the Chinese Securities Markets

While full convertibility of the Chinese currency and full liberalization of the
Chinese securities markets may be years away, it should be noted that China has steadily
liberalized portions of the financial sector even though the routs in the world’s
technology stock-studded exchanges such as the Nasdaq have served to delay the launch
of China’s own second board.

Beginning with the establishment of B-shares reserved for foreign investors, a
growing list of major Chinese firms, including PetroChina, China Petroleum and
Chemical, Huaneng Power International, China Mobile (Hong Kong), China Unicom
(Hong Kong) have listed in Hong Kong, New York, and other markets. In 2000, Chinese
listings of state-owned companies in New York and Hong Kong raised $21.5 billion, a
sevenfold increase from 1999.50

2001 witnessed the further liberalization of the Chinese market. Domestic
investors were given permission to invest in B-shares, which, in spite of recent pullbacks,
easily became the best performing stock indices among world markets. Moreover, Chinese state companies listed overseas, led by Chinese Petroleum and Chemical Corp or Sinopec, were allowed to issue shares on domestic exchanges.\textsuperscript{51} Furthermore, in July 2001 the Ministry of Foreign Trade and Economic Cooperation issued guidelines for overseas-funded groups doing business in the Chinese mainland to list their shares in China (both the A and B share markets).\textsuperscript{52}

**Registration, Clearing, and Market Integration**

The rapid expansion of the Chinese securities markets has been greatly facilitated by the availability of new technologies. From the very start, China’s stock markets adopted state-of-the-art technologies. By the turn of the century, the Chinese markets are integrated nationwide by a web of computers, high-speed data networks, satellite communications. In fact, the expansion of the securities markets paralleled an equally dramatic growth of China’s telecommunications infrastructure. As a result, a growing number of investors have come to rely on remote access through personal computers, telephones, and even wireless devices.

Yet amid the competition between the Shanghai and Shenzhen stock exchanges, each of the exchanges set up its own registration and clearing system, with different rules and schedule of fees. The lack of integration between the two systems meant that an investor seeking to trade stocks on both exchanges must open two separate accounts. Needless to say, such a practice increased the amount of paperwork and was quite inefficient for investors as well as brokerages.

Borrowing from foreign, particularly US experiences, regulators promoted the creation of a unified clearing system and set the goal of creating a unified securities clearing system at the National Financial Work Conference in 1997. In 2001, the Shanghai and Shenzhen stock exchanges formed a joint venture, the China Securities Registration and Clearing Co. Ltd., with each exchange contributing its registration and clearing services. The merger is to enable a unified set of rules, reduce transactions costs and enhance capital efficiency for investors. It should also boost risk control.\textsuperscript{53}
The Dynamics of Regulatory Change

Even though every securities publication and broadcast program warns investors the risks of investing in stocks, securities regulators and national leaders know full well that they may be blamed when stocks do fall, particularly because of public perceptions of rampant accounting irregularities and share manipulation. As one looks at price/earnings ratios of 50-60 percent for most Chinese stocks, the political implications of a falling market can be potentially destabilizing given that China currently has more than 60 million brokerage accounts.

The rising political importance of the securities markets has attracted much attention from the increasingly assertive National People’s Congress. In May 2001, for instance, the NPC Standing Committee sent an inspection team to four cities to learn about the implementation of the Securities Law. The team was particularly unhappy about the issue of corporate governance, including disclosure of unreliable information, the issue of “arch manipulators (zhuangjia)” manipulating stock prices; failure of majority owner to pay dividends; majority owner taking funds from listed companies at the expense of minority investors, corporate managers not using funds raised for indicated purposes; and the “packaging” (baozhuang) of firms for listing. It noted governments have been heavily involved in various reorganizations of listed firms, making it difficult for securities regulators to delist companies that have performed badly. The inspection team also noted other problems: violations of laws and regulations by brokerages; incompatible law enforcement between the Ministry of Finance and the courts, with the courts not heeding regulations from the Ministry of Finance. It also noted that auditors and accounting firms sometimes cooked the books to deceive investors.

While the NPC actions exert political pressure on the CSRC to take action, the government has nevertheless tolerated and indeed made an informal alliance with the increasingly diverse financial press to promote and protect the interests of small investors. The press, such as Caijing (Financial and economic review), has eagerly published writings and remarks by market critics such as Wu Jinglian and have not hesitated to expose problems of manipulation and fake accounting by individual companies. It was Caijing’s investigative reporting that sent the once high-flying
Guangxia (Yinchuan) into deep freeze.\textsuperscript{55} Not infrequently, press reports have been critical of the CSRC’s performance. For example, in a report about a CSRC exhibition in Beijing designed to educate the investor, the Caijing shibao reported that visitors argued that regulators needed their own education as well in order to increase punishment of malicious manipulators, such as in the case of Yi’an Keji.\textsuperscript{56}

Mindful of public expectations, press criticism, and legislative demands, the CSRC has not only stepped up internal reforms and regulatory action but have taken measures to be more transparent in the formulation of regulations. For instance, the CSRC in May 2001 sought public input on a set of CSRC guidelines requiring listed companies to have independent directors. As of mid-2001, only 204 listed firms (out of more than 1200) had independent directors (numbering 314 altogether), making it easier for majority owners to conduct transactions at the expense of minority shareholders. The proposed guidelines would require all domestically listed companies to have at least one third of the directors to be independent directors within a year.\textsuperscript{57}

\textbf{Conclusions}

When the Shanghai Stock Exchange first launched its operations in 1990, it had only 8 stocks. On May 25, 2001, the combined capitalization (at 5.3 trillion yuan) of stocks listed on the Shanghai and Shenzhen stock exchanges surpassed that of Hong Kong for the first time. At 5.3 trillion yuan, the ratio of stock market capitalization to GDP in China surpassed 50 percent.\textsuperscript{58}

Along with the expansion of the markets, a securities regulatory authority, along with a web of laws and regulations, have also been put in place. From requirements for IPOs to financial statements, the gap between China and more developed markets has become narrower. Indeed, China’s aggressive promotion of a fairer and more transparent regulatory regime prompted Mark Mobius, one of the better known and more outspoken managers of emerging market funds, to comment in May 2001 that China might one day become Asian’s standard-bearer for corporate governance.\textsuperscript{59}

To be sure, policy influences on China’s stock markets are still greater than in mature markets. Enforcement of laws and regulations, such as on illegal bank funds flowing into stock investments, has gone through cycles. Moreover, small investors can
still get little back in cases of fraud and manipulation. Nevertheless, the regulatory apparatus has become more developed and professional and enforcement has become more skilled. While the crackdown on illegal bank funds reminds us of similar crackdowns of the past, the Chinese securities markets have not staying the same but are far more mature. Indeed, investors, now numbering more than 60 million in terms of stock accounts, reacted to the downturn with calm. In short, in spite of its youth, China’s stock markets now face similar problems as their international counterparts, including fair disclosure and enforcement. China’s securities regulators are going up a steep learning curve.
Endnotes:

1 The Shanghai Stock Exchange was inaugurated in December 1990 and the Shenzhen Stock Exchange in July 1991. The Shanghai Branch of the Industrial and Commercial Bank of China set up a securities department in September 1984 and issued the first stock in November that year.
4 The CSRC is also empowered to oversee futures.
5 Dou Ruguang 1998.
6 Ren Jinyang and Dong Zhong, “Zhengquan chuizhi jianguan hao zai na’er” (What is good about the vertical regulation of securities), ZZB 1998-10-19.
7 Xinhua 2000-08-03.
8 RMRBO 1997-05-12.
10 ZZB 1997-08-15.
11 This meant that the amount of revenue these local authorities received would not drop much as long as transactions increased. In June 1998, the State Administration of Taxation lowered the stamp tax to 0.4 percent to stimulate stock trading but keep the central-local division at 88:12 (RMRB, 1998-06-12).
12 Xinhua, 2000-09-29.
15 As of 1999, the exchanges in Shanghai and Shenzhen listed more than 900 companies combined, with total market capitalization valued at about 30% of China's gross domestic product. For the views of Arthur Levitt, Chairman of the Securities and Exchanges Commission, on the need for unified markets and regulation, see WSJ 1999-09-21; 1999-09-24.
16 Xinhua 2000-08-22.
17 Sun Jie, "An Important Milestone in the Construction of A Legal System for the Stock Market -
- an Interview with Zhou Zhengqing, Chairman of the China Securities Regulatory Commission," 

18 In June 1999, regulators at the Shanghai Stock Exchange for the first time rebuked a listed 
company, the state-owned Lingguang Industry Co., for failure to disclose important information 
to investors. Karby Leggett, “China's Securities Regulators Censure Lingguang Industry for 

19 Tianfu zaobao (Sichuan morning post) 2000-11-30.

20 Two Hubei vice governors have lost their jobs on corruption charges.


22 Needless to say, Wu and Xu were punished and publicly humiliated. Moreover, some local 
authorities asked county-level officials to account for their purchases of internal shares or risk 
punishment. The Discipline Commission and Supervision Bureau of Jiangxi province set a 
deadline of November 30, 2000 for such cleansing (ZXS 2000-11-29).

23 The use of quotas for stock issuance not only increased the value of a listing but also led to 
much lobbying and bribery by enterprises to secure listings.


25 The CSRC members of the Approval Committee include, ex officio, the CSRC’s chief 
inspector, chief attorney, and chief accountant, and the directors of the Shanghai and Shenzhen 
Stock Exchanges. Other members of the Approval Committee are: Eight experts from national 
macroeconomic control departments; eight experts from specialist economic management 
departments and other concerned departments; 15 specialists from the CSRC; six experts from the 
stock exchanges; five experts from state-run banks; one expert from the All-China Federation of 
Industry and Commerce; five experts from the Chinese Academy of Sciences, the Chinese 
Academy of Social Sciences, and other scientific research organizations; eight experts from the 
Securities Association of China, the China Association of Certified Public Accountants, the All 
China Lawyers Association, and other concerned public organizations; eight experts from within 
the securities trading industry; three university professors; and five well-known social 
personages. “Stock Issuance Approval Commission Regulations (approved by the State Council 
on 19 August 1999 and issued by the CSRC on 16 September 1999),” XDT 1999-10-14.

26 ZQSB 2000-07-01.

In 1995, the China Certified Accountants Association and the China Certified Auditors Association were merged to become the China Certified Accountants Association and put under the leadership and supervision of the Ministry of Finance and the National Audit Office.

Of course, the certification process may potentially become another rent-seeking opportunity for those with the power/expertise to certify.

Sinopec debuted on the Shanghai Stock Exchange on August 8, 2001, immediately becoming the largest company listed there ranked by capitalization.

This initiative still awaits CSRC implementation regulations. Under the guidelines, the foreign holding companies must keep at least 25 percent of the listed company’s shares in a non-tradeable form.
This is based on Yuegang xinxi bao (Guangdong-Hong Kong Information), June 28, 2001.


Beijing Youth Daily, June 1, 2001.