THE PRC SECURITIES MARKET: AN OVERVIEW OF ITS REGULATORY CAPABILITY AND EFFICIENCY

Yujun Zhang
President and CEO
Shenzhen Stock Exchange
To be presented at the Conference on Financial Sector Reform in China
September 11-13, 2001
The PRC Securities Market: An Overview of its Regulatory Capability and Efficiency

By Yujun Zhang, Ph.D

SUMMARY

Over the past ten years, Chinese securities market has been developing at a rapid and steady pace. And, after repeated experiments, a relatively complete securities legal framework and securities regulatory framework have been established. However, how can one assess the regulatory capability and efficiency of the PRC securities market? What are the factors that affect the regulatory capability and efficiency of the PRC securities market? How do these factors affect the regulatory capability and efficiency of the PRC securities market? The author believes that the regulatory capability and efficiency of the PRC securities market depend not only on the establishment of market mechanism and regulatory framework, but to a large extent also on the social environment, cultural tradition, structure of property rights, policy objectives, regulatory mechanism, regulatory devices and other factors. The paper provides a detailed description of the factors affecting the regulatory capability and efficiency.

The first factor affecting the regulatory capability and efficiency is the objective of regulation and policy. So far, the objective of regulation has never ceased to waver between development and regularity in the actual operation of the PRC securities market. As changes in policy are frequent and there is a lack of variation in regulatory means, if development is chosen as the objective of regulation, regulation will be ignored and relaxed and standardisation of market practices will be compromised. On the other hand, if regularity is set as objective, the foundation for normal development of the market will be hurt and stagnation and turmoil in the market will be the price to pay.

The second factor is China’s regulatory mechanism techniques. In terms of the public law enforcement mechanism, the scope of investigatory authority of the CSRC is limited and it lacks the necessary means of investigation, which has seriously limited the capability and efficiency of regulatory and law enforcement authorities. Meanwhile, due to certain reasons, enforcement of criminal provisions of Securities Laws lagged far behind that in developed markets. Furthermore, civil compensation mechanism is basically non-existent in China, and therefore, the function of civil liability as a deterrent has not been put to good use. From the perspective of monitoring technique, the current transaction systems impose difficulties in identifying true offenders, the source of funds and the relationship between them.
The third factor is property rights system, whose impact on regulation and practice of law can be assessed from the following angles: (1) the impact of property rights on social morals and social credibility; (2) the impact of property rights on efficiency; (3) the impact of property rights on acts of the government and regulatory bodies; (4) the impact of property rights on the management structures and acts of companies; and (5) the impact of property rights on the acts of investors.

The fourth factor is cultural and social environment. Cultural factors have a restrictive impact on the implementation of law and the realisation of the social functions of law. In China, a 2000-year old history coloured by feudalism and dictatorship has contributed to the cultivation of a deep-rooted legal culture centred on the rule by people (or, in other words, rule by administration). The imprint and effects of tradition will stay for some time to come. In terms of regulation in the securities market, the culture of rule by administration makes it impossible to carry out regulation in accordance with law.

The fifth factor is the self-regulation in the market. In the PRC securities market, awareness of self-regulation is thin and self-regulating mechanism is incomplete. As a result, the costs of market regulation are very high and the efficiency of regulation is low, which have in turn restrained the improvement of market regulation.

The sixth factor is the quality and quantity of the law enforcement personnel. Although the number of securities regulatory personnel is increasing every year, and attempts are made to enhance the training programmes offered to regulatory personnel in order to improve their regulating standard, the quality and number of regulatory personnel at present cannot satisfy the requirements of the rapid expansion of the market and the increasing complexity of securities businesses.

Based upon the above analysis, the author reached at the following conclusion: First, regulatory capability and efficiency of the PRC securities market have been improving in the years of its development. Second, regulation of the PRC securities market has gone through a zigzagging path. Regulatory capability and efficiency of the PRC securities market are seriously affected by Chinese politics and policies at different periods of time. Third, most of the factors affecting the regulatory capability and efficiency of the PRC securities market are obstructive and negative. Some factors play a decisive role in affecting the regulatory capability and efficiency of the PRC securities market. This indicates that it will be a long time before rule of law is practised in the PRC securities market. Forth, intensification of law enforcement, rather than formulation of law, is the most important issue in the PRC securities market. Fifth, establishment and perfection of law enforcement mechanism and improvement in the skills and level of inspection are important ways to enhancing regulatory capability and efficiency. They are also issues demanding prompt solution. Sixth, improvement of the quality of regulatory personnel and a strengthening of the team of regulatory
personnel are important means of increasing regulatory capability and standard of law enforcement. And, finally, further improvement of the legal system, plugging legal loopholes, improving the applicability of laws and regulations, further localising laws and strengthening the social basis of laws are the ultimate ways to improving regulatory capability and efficiency.
Zhang, Yujun

The PRC Securities Market:
An Overview of its
Regulatory Capability and Efficiency

I. Issues

Over the past decade, remarkable achievements have been made in the development of the PRC securities market. Such achievements have played an important role in promoting Chinese economic development and market reforms. Previously, there was no legal framework governing the PRC securities market. A legal framework based on the Securities Law of the PRC and the Companies Law of the PRC has now been established.

In recent years, the PRC securities market has been developing at a rapid pace. Market participants have become ever more feverish and active. The securities market has become one of the most significant venues in which the general public carries out investment activities. In the second half of last year, there were heated debates concerning supervision in the PRC securities market sparked off by an essay titled “Illicit Fund Activities”\(^1\). The essay brings into question existing supervision and enforcement in the market. In the view of the author, “the stock market has become a heaven for speculators and there is a near absence of regulation, and there was a high level of market making, speculation and price manipulation in the stock market.” In another essay, the Chinese bourse is described as “a big casino”\(^2\). How can one assess the regulatory capability and efficiency of the PRC securities market? What are the factors which affect the regulatory capability and efficiency of the PRC securities market? How do these factors affect the regulatory capability and efficiency of the PRC securities market? This article attempts to answer such questions.

II. Legal Framework and Regulatory Structure Governing the PRC Securities Market

(A) Legal Framework Governing the PRC Securities Market

The law is the basis upon which the PRC securities market is regulated. As the PRC securities market develops and becomes more regulated, laws governing the PRC securities market are gradually established and perfected. The formation of the legal framework can be divided into three stages:

Stage 1: Prior to 1992. This is the stage of the early development of the securities market. The rules and regulations formulated by the Shanghai and Shenzhen governments form the basis upon which experimental operations of stock markets are carried out. Stock markets first developed in both Shanghai and Shenzhen.
Stage 2: 1992 - End of 1998. From 1992, the formulation of securities laws and regulations became a national affair. 1992 is the year which saw the formation of the Securities Commission under the State Council and the China Securities Regulatory Commission (the “CSRC”). The Interim Regulations Governing the Administration of Share Issuance and Transactions published on 22 April 1993 are the first important administrative regulations applicable to the PRC securities market. Such regulations contain specific provisions governing the issuance and transactions of shares and related activities. On 1 July 1994, the Companies Law of the PRC became effective. This is the first law ever which governs the system to be adopted by companies. This is an important legal basis upon which the listing and issuance of shares and corporate bonds and activities of companies are to be governed. After major amendments, the Criminal Law of the PRC became effective on 1 October 1997. It contains additional provisions on securities activities which would constitute criminal offence and the related penalties. This marks the end of the chapter in the Chinese criminal law history in which maintenance of order in the securities market is not covered under any criminal provision. Subsequent to this were the promulgation of securities laws and regulations such as the Regulations Governing the Administration of Corporate Bonds, the Interim Measures for the Administration of Convertible Corporate Bonds, the Special Provisions of the State Council Concerning the Overseas Offering and Listing of Shares by Companies Limited by Shares, the Provisions of the State Council Concerning Locally Listed Foreign-invested Companies Limited by Shares, the Measures for the Administration of Stock Exchanges, the Measures for the Administration of Own-Account Businesses of Securities Companies, the Interim Measures for the Administration of Securities Investment Funds and the Interim Measures for the Prohibition of Fraudulent Securities-related Activities.

Stage 3: Post-1999. The promulgation of the Securities Law of the PRC (the “Securities Law”) on 29 December 1998 signified a new stage in the establishment of a legal system governing the PRC securities market. After the promulgation of the Securities Law, the CSRC and other relevant authorities issued a number of related laws and regulations, including the Share Issuance Review Committee Regulations of the China Securities Regulatory Commission, the Interim Measures for the Administration of Risk Funds of Stock Exchanges, the Interim Measures for the Administration of Risk Funds for Securities Settlement, the Measures for the Administration of Issuance of New Shares by Listed Companies, the Measures for the Inspection of Securities Companies, the Implementing Measures for the Suspension and Termination of Listing of Loss-making Companies, the Measures for the Trial Operation of Share Transfer Business by Securities Companies, the Interim Measures for the Administration of the Reduction of Holding of State-owned Shares and the Raising of Social Security Funds, and the Interim Measures for the Administration of Futures Trading. These laws and regulations further improve the securities law framework of the PRC.

Currently, a fairly complete legal framework governing the securities market has basically been established. Such legal framework is based on the Securities Law of the
PRC. The Securities Law contains provisions governing key aspects of the securities market such as the issuance of securities, securities trading, acquisition by listed companies, stock exchanges, securities companies, securities registration and settlement organisations, securities trading services organisations, securities industry associations and securities regulatory bodies. The principal part of the legal framework is made up of relevant laws (the Companies Law of the PRC, the Criminal Law of the PRC etc.), administrative regulations (more than 20 administrative regulations including the Interim Regulations Governing the Administration of Share Issuance and Transactions) and administrative rules (over 180 administrative rules, mainly issued by the CSRC but also include those issued by other departments under the State Council on their own or jointly with the CSRC). The legal framework is supplemented by business rules formulated by stock exchanges, securities industry associations and self-regulating bodies (such as the listing rules, trading rules, membership rules and registration and settlement rules of the Shenzhen Stock Exchange and the Shanghai Stock Exchange, and the self-regulating rules of the China Securities Industry Association). From a content perspective, the legal framework governing the PRC securities market is made up of securities issuance rules, securities listing and trading rules, information disclosure rules, rules regulating securities organisations and specialised organisations, system of legal responsibility governing securities activities.

(B) Regulatory Framework Governing the PRC Securities Market

1. Basic Framework

Regulation of the PRC securities market is mainly exercised by government authorities and is supplemented by self-regulation. As the securities regulatory body under the State Council, the CSRC exercises centralised regulation of securities markets throughout China in accordance with law, plays a leading role in the regulation of local agencies, stock exchanges and securities industry associations and gives business guidance to such organisations. As the organisers of securities markets, stock exchanges exercise front line regulation on securities markets under the direct leadership of the CSRC and in accordance with law and relevant agreements and as authorised by the CSRC. As the self-regulating bodies of securities companies, securities industry associations exercise self-regulation. A regulatory system based on the CSRC and supported by local agencies, stock exchanges and securities industry associations are formed.

At the same time, judicial organisations and procuratorial organisations exercise judicial regulation on the normal operation of securities markets in accordance with laws and regulations by inquiring into and crushing illegal and criminal activities which seriously affect order in securities markets.

2. The History of Development of the Regulatory Framework Governing the PRC Securities Market
The regulatory framework governing the securities market has evolved from local (diversified) regulation to central (centralised) regulation. The evolution can roughly be divided into three stages:

Stage 1: The initial stage of regulation (From mid-80s to the time before October 1992). During this stage, experiments were carried out in regions and regulation of securities markets was mainly in the hands of local governments. The Shanghai and Shenzhen governments promulgated some local regulations and established local securities regulatory bodies. As the competent finance authority, the People’s Bank of China participated in the regulation of the securities market by providing overall guidance and co-ordination. On the whole, prior to 1992, the Chinese securities market was not put under centralised administration. It was mainly regulated by the People’s Bank of China under the assistance of the Commission for the Reform of State Systems, other government authorities and the Shanghai and Shenzhen governments.

Stage 2: Gradual establishment of a national regulatory framework governing securities markets (From October 1992 to April 1998). At this stage, the State Council decided to establish the Securities Commission and the China Securities Regulatory Commission. The Securities Commission and its members (the People’s Bank of China, the Ministry of Finance and the State Planning Commission) and the CSRC were responsible for centralised regulation of securities markets throughout China. The local people’s governments were also authorised to carry out certain securities regulatory duties. From March 1996, the CSRC authorised the securities and futures regulatory bodies of certain provinces, autonomous regions, municipalities under direct central control, cities listed under the State plan and provincial capitals to exercise a certain degree of regulation on securities and futures markets. A regulatory framework governing securities markets throughout China and characterised by central and local regulation but focused on local regulation was established. In 1997, the State Council decided that the CSRC shall directly administer the Shanghai Stock Exchange, the Shenzhen Stock Exchange and futures exchanges. Offices of supervisors were set up in Shanghai and Shenzhen. Regulatory functions and powers were gradually centralised.

Stage 3: Formation of a centralised securities regulatory framework (From April 1998 onwards). The State Council decided that the Securities Commission was to be abolished and its duties were to be assumed by the CSRC. Local securities regulatory bodies were put under the direct control of the CSRC. As a result, a centralised regulatory system was formed. In 1999, the CSRC set up regulatory offices in Tianjin, Shenyang, Shanghai, Jinan, Wuhan, Guangzhou, Chengdu and Shenzhen, subordinated regulatory offices in Beijing and Chongqing as well as accredited representatives’ offices in other provinces and cities. The regulatory system governing securities markets and regulatory duties were now clarified. A nationwide centralised multi-layered regulatory framework with the CSRC at its core and backed up by local agencies, stock exchanges and securities industry associations was basically formed.
A brief sum-up: In the past decade, the process of development of the PRC securities market is one of formation, standardisation and improvement of the legal framework and regulatory system governing the PRC securities market. After repeated experiments, a relatively complete securities legal framework and securities regulatory framework have been established. On the whole, the above frameworks are compatible with the state of development of the PRC securities market. A legal and regulatory foundation for regulating the operation of securities markets has been laid. Such foundation has played and will continue to play an important role in the regulation and development of the PRC securities market.

III. An Assessment of the Regulatory Capability and Efficiency of the PRC Securities Market

(A) Meaning of and Factors Affecting the Regulatory Capability and Efficiency of Securities Market

Regulatory capability and efficiency of securities market refer to the capability of securities regulatory bodies to supervise and administer securities market in accordance with the relevant laws, regulations and rules and the actual effect of such regulation. Regulatory bodies include State securities regulatory bodies, stock exchanges and self-regulating bodies in the securities industry.

When judging whether regulatory capability is strong or weak, the following key factors ought to be taken into account: (1) the degree of completeness of the laws and regulations on which regulation is based; (2) the degree of soundness of the regulatory system governing the securities market; (3) whether the regulatory power and authority over the securities market is adequate; (4) the degree of sophistication of regulatory techniques; (5) the professionalism and ethics of regulatory staff in the securities market; (6) the concept of regulation as understood by regulatory bodies in the securities market.

The key factors in assessing regulatory capability include: (1) the healthy, stable and continuous development of the securities market; (2) the extent of discrepancy between the concept of regulation and the objectives of regulation; (3) enforcement of laws and regulations in the securities market; (4) order and extent of compliance in the operation of the securities market; (5) the effectiveness of crackdown on illegal activities in the securities market; (6) awareness of compliance and self-regulation among participants in the securities market; (7) material crises and risks in the securities market.

(B) Basic Assessment

Since the establishment of the Shenzhen and Shanghai Stock Exchanges in 1990, the PRC securities market has entered its 11th year. Judging from the development of the
PRC securities market in the past decade or so, the characteristics of the regulatory capability and efficiency are as follows:

1. Regulators have gained certain experience in controlling and administering the market and have become capable of regulating the market in an efficient manner. This is demonstrated in the following ways:

1.1 A fairly complete legal framework and a centralised regulatory structure have been formed. This has been described in details in Section III.

1.2 A team of regulators of a certain size and quality which is empowered to enforce the law. This will be specifically dealt with below.

1.3 Advanced monitoring techniques and facilities have been developed and established. The Shenzhen and Shanghai Stock Exchanges have developed and established a market monitoring system back in the mid-90s. The system has been upgraded several times ever since. The structure of shareholdings and the controlling shareholders of each listed company are installed in the system. The system is capable of carrying out real-time dynamic monitoring of market activities and statistical analysis after market closes. The system is an advanced technique which enables prompt and efficient regulation.

1.4 Establishment of a modernised objective and concept of regulation. Since 2000, and in particular since Zhou Xiaocun became Chairman of the CSRC, a new way of thinking of market development and regulation characterised by full utilisation of market mechanism and ensuring protection of investors’ interests has been established. It was emphasised that the CSRC must shift the focus of its work to market regulation. “Protection of investors’ interests as the most important task of securities regulatory bodies” was proposed. Establishment of such objective and concept of regulation is significant to the confirmation of work direction of regulatory bodies and the improvement of regulatory capability and efficiency.

2. The remarkable achievements over 10 years of development are indicative of the results achieved in securities regulatory work in China. It should be said that regulatory efficiency has been improved over the past 10 years. Such improvement is reflected in the following aspects:

2.1 On the whole, the securities market has been developing at a rapid and steady pace. The PRC securities market has developed from a small, decentralised and local market into a big, centralised and national market. It has become one of the important securities markets in the Asian region. As at the end of June 2001, there were 1,128 companies listed on PRC’s stock markets. Total market capitalisation of these companies was RMB5,363 billion, representing approximately 65% of the GDP of 2000. There were 64,000,000 investors’ accounts. Total turnover during the first half of the year was RMB2,630 billion.
2.2 Degree of market regulation ever increasing. The legal framework governing the Chinese securities market has improved markedly through the full implementation of the Securities Law of the PRC and administrative laws and regulations and rules issued by various authorities to complement the Securities Law. Securities business organisations have been restructured and as a result operation and administration of securities companies by business has been achieved. This has brought about a more standardised operation of securities companies and improved the assets and financial situation of securities companies. Operation of listed companies has become more regulated through stringent enforcement of information disclosure rules on listed companies, requiring listed companies to establish a standardised management structure and establishment of a system of delisting of listed companies. Also, investors have become more mature and aware of the risks involved in investment.

2.3 Law enforcement has been strengthening year after year. Illegal activities have been investigated into and punishments have been imposed. Since 1993, the CSRC have handled 563 cases and settled 365 of them. Administrative penalty has been imposed in 201 cases. 363 organisations and 412 individuals have been punished. Between 1999 and 2000, 285 cases were placed on file. The number exceeds the total number of cases placed on file in the preceding 8 years. During those two years, 162 cases were settled. Administrative penalty was imposed in 83 cases. 92 organisations and 251 individuals were given administrative penalty such as warning, confiscation of illegal gains, fine, suspension of qualification and revocation of practice licence. Total penalty amounted to RMB0.49 billion. In May 2001, the “Yorkpoint Science & Technology” case which had aroused great attention in the market came to a close. Severe penalty was given to Yorkpoint which was charged with market manipulation. The amount of fine and confiscation was RMB0.89 billion. The “China Venture Capital” case, another case of market manipulation, has been submitted to and filed with a judiciary authority.

2.4 Securities intermediaries (securities business organisations, accounting firms, law firms etc.) have become more law-abiding and more aware of self-regulation. On 12 June 2001, the CSRC disclosed a list of securities companies which has not misappropriated the margin deposited by clients. It revealed that securities companies on the list represent 73% of the total number of securities companies. As compared with a few years ago, it was a common phenomenon for securities companies to misappropriate the margin deposited by clients. Clearly, securities companies are exercising more self-regulation and are more aware of the concept of regulation. Accounting firms have become more prudent and objective when auditing the accounts of listed companies. An increasing number of accounting firms refuse to issue an opinion or issue a negative or qualified opinion on annual reports and interim reports of listed companies. The percentage of issue of such
opinion has stood above 15% in the last 3 years and was as high as 19.1% in one of the years.

3. The high risks in the securities market and the complexity of market regulation require a higher level of market capability and efficiency. An emerging securities market such as the PRC securities market requires more stringent and efficient regulation as a basic means to protect the market. There is an obvious discrepancy between regulatory capability and efficiency of the PRC securities market and the requirements for market development. This is reflected in the following aspects:

3.1 Widespread illegal activities. As concluded by authoritative sources, the characteristics of illegal securities activities are as follows: there is a wide range of offenders which include listed companies and their directors, supervisors, senior management staff, securities business organisations, intermediaries etc.; there are various kinds of illegal acts which include insider dealing, market manipulation, false statement, cheating clients as well as over-the-counter trading, change of use of proceeds, placing instead of offering shares for the purpose of early flotation, repurchase of shares, holding of an excessive percentage of shares; in addition, there is a close connection between various illegal acts which are themselves highly infectious, and many illegal acts are involved in a case.

3.2 Imperfect management structures of listed companies. From the perspective of form of organisation, even though all listed companies establish an administrative structure which is made up of a shareholders’ general meeting, a board of directors, a board of supervisors and the management, in reality, some majority shareholders are always not separated from listed companies in terms of personnel, financial affairs and asset management. In effect, two companies are operated by the same team. The administrative structure cannot become effective under such situation. According to a sample survey conducted by a relevant authority, as much as 35.5% of the administrative structures of listed companies are problematic. There is an absence of effective control mechanism in some listed companies and in many cases the interests of minority shareholders are harmed. For example, the majority shareholders of Monkey King and Jinan Motorcycle are not separated from the two companies in terms of personnel, financial affairs and asset management. These companies are dried up by their majority shareholders and are on the verge of bankruptcy.

3.3 Lack of effective protection of the legitimate interests of small and medium investors. A majority of the PRC listed companies are transformed from State-owned enterprises. When these companies are transformed into companies limited by shares, the State as the largest shareholder often has overwhelming control. Medium and small shareholders are unable to effectively exercise their rights as shareholders. The interests of minority shareholders are
often harmed by majority shareholders (such as the cases of Monkey King and Jinan Motorcycle referred to above). In the secondary market, institutional investors often make use of their strength in funds, shareholdings and information to manipulate share prices or spread false news for the purpose of luring medium and small investors into speculation. Medium and small investors suffered damages as a result. As there is no effective control mechanism under which the interests of small and medium investors can be protected, and there is still a lack of relevant laws and regulations on which investors may rely on to seek the necessary compensation. This has aroused great attention among investors at large.

3.4 The costs of law enforcement by regulatory bodies are high. Regulatory bodies lack authority in the imposition of penalties. It is difficult to enforce penalties. Regulatory bodies are subject to various restrictions when enforcing the law. It is difficult for them to investigate into illegal activities and impose penalties. It is extremely costly for regulatory bodies to enforce the law. For example, it took almost two years to investigate into the Hainan Minyuan case, but the penalty imposed was incredibly light. Under such situation, the regulatory bodies involved cannot establish their authority or credibility. In some cases, penalties have been imposed, but it is difficult to enforce such penalties. From the perspective of penal sum and confiscated sum, as at the end of 2000, the amount payable but unpaid by violators was RMB0.54 billion, representing 40% of the total payable amount.

3.5 Stock exchanges and securities industry associations have not exercised self-regulation as are expected of them. In August 1997, the Shanghai and Shenzhen Stock Exchanges were put under the direct supervision of the CSRC. Stock exchanges are placed under the regulation of the CSRC, but they are also subordinated organisations of the CSRC. This relationship eliminates the independence which should be afforded to the CSRC in organising and administering the market and is not conducive to the establishment of authority of stock exchanges in regulating their members and listed companies and ensuring effectiveness in such regulation. It undermines the complete exercise of self-regulation by stock exchanges. It also greatly limits the role of stock exchanges in guiding and pushing forward market development and ventures. In addition, compared with self-regulating bodies of developed foreign countries, the current self-regulation exercised by the Securities Association of China mainly focuses on the servicing aspect. No sound regulatory and control mechanism has been established. It is true that the legal status and functions of securities industry associations are set out in the Securities Law and relevant laws and regulations. But securities industry associations have not been expressly authorised to impose administrative penalty. The system governing the taking of disciplinary action and other complementary systems have not been effectively
implemented. As a result, independence, authority and effectiveness of self-regulation are jeopardised.

Brief sum-up: The extent of standardisation and social recognition of the PRC securities market are gradually increasing. This is publicly recognised and indisputable. This shows that for over 10 years, the regulatory capability and level of law enforcement in the PRC securities market have been ever improving. It is also indisputable that there are obvious and even serious inadequacies in the regulatory capability and level of law enforcement in the PRC securities market. One should be fully aware of this fact. More importantly, a serious study and analysis has to be conducted as to the factors leading to the low regulatory capability and low level of law enforcement in the PRC securities market, which aspects are to be improved urgently within a short period of time, which issues can be dealt with at the level of and within the securities market, and which problems are a part of an inevitable development process.
IV. Factors Affecting the Regulatory Capability and Efficiency of the PRC Securities Market

Analysis

The PRC is being transformed into a market economy. This determines the particularity of the operation of and the difficulty in regulating the PRC securities market. What is particular about the operation of the PRC securities market is that many ideologies and practices of a planned economy are built into the market. The PRC securities market is not entirely a product of market economy and market orientation. For this reason, there are bound to be conflicts between market operation and market control. Regulatory capability and efficiency of the PRC securities market, therefore, depend not only on the establishment of market mechanism and regulatory framework, but to a large extent also on the social environment, cultural tradition, structure of property rights, policy objectives, regulatory mechanism, regulatory devices and other factors. Following is a preliminary analysis of the effect such factors may have on the regulatory capability and efficiency of the PRC securities market.

(A) Impact of Objective of Regulation and Policy

The objective of regulation has a significant impact on regulatory capability and efficiency. Corresponding policy is a means to achieving such objective. It also determines the manner in which the objective can be achieved and reflects the meaning and contents of the objective.

Development and regularity are enduring concerns of the PRC securities market. The two objectives, though sufficiently unified, are obviously in conflict with each other within a specified period of time and often only one of the objectives can be achieved. To take a broad view of the actual operation of the PRC securities market so far, the objective of regulation has never ceased to waver between development and regularity. As changes in policy are frequent and there is a lack of variation in regulatory means, if development is chosen as the objective of regulation, regulation will be ignored and relaxed and standardisation of market practices will be compromised. On the other hand, if regularity is set as objective, the foundation for normal development of the market will be hurt and stagnation and turmoil in the market will be the price to pay.

The development of the PRC securities market is marked by stages. The development of the PRC securities market in the past 11 years can be divided into three stages. The first stage is the local market stage. At this stage, participants in the securities market mainly came from Shenzhen and Shanghai where the Shenzhen Stock Exchange and the Shanghai Stock Exchange are located respectively. Market regulation was mainly carried out by local governments. 1995 and the years before can be considered as falling into this stage. The second stage is the national market stage. At this stage, participants in the securities market came from all over the PRC and the Shenzhen Stock Exchange and the Shanghai Stock Exchange became national markets. The
CSRC was the principal regulator of the market. A centralised regulatory system was eventually formed. This stage spans from 1996 to the end of 1999. The third stage is the market orientation stage. Regulatory authorities expressly stated that more reliance shall be placed in market forces in the future development of the PRC securities market; matters which can be sorted out by market forces must be left to the market; where the market cannot play a useful role, conditions must be created as soon as possible to enable the market to play such a role. This stage commenced from 2000.

The objective of regulation, the regulatory devices and policy adopted in the three stages are vastly different.

1. During the first stage, the ideas of “development before regularity” and “development amidst regularity” prevailed. Prior to 1992, the performance of the Shanghai stock market was weaker than that of the Shenzhen stock market. Under the leadership of the Shanghai government, “development before regularity” was the key thinking behind the operation of the Shanghai stock market. On the contrary, after the “August 10” Incident and the “Yuanye Incident” in 1992 in Shenzhen, regularity became the key concern in the market. Therefore, the thinking of “development before regularity” was followed in market development efforts. However, since 1993, the Shanghai stock market gradually forged ahead of the Shenzhen stock market. Competition was the central task of the two markets. Development was the top concern. The two exchanges committed certain irregular acts which brought dire consequences, including the outbreak of the “327 Incident” which resulted in the close down of national bond and futures markets. Therefore, it can be said that at this stage, market regulation was scattered and nominal.

2. For most periods during the second stage, market stability was the key objective of regulatory authorities. It was only during specific periods that market regulation became the prime consideration. The stage was characterised firstly by the predominance of market stability as a political objective. Particular attention was paid to movements of share indices. This was especially the case at times when market sentiments were low. In order to maintain social stability, the government and regulatory authorities “stablisied the market” or “saved the market” by taking administrative or political measures. Examples are the “three ways to save the market” cherished in July 1994 and an essay by a special commentator published on the People’s Daily in June 1999. The second feature of the stage was that when the market was in a bullish mood, regulatory authorities feared that the market would become overheated and excessive speculation would appear, regulation and regularity would become the prime objectives. Regulatory authorities resorted to various means to suppress activities which would over-heat the market. But as this policy ran contrary to the trend of market development and expectations of investors, it carried very little effect and failed to achieve its objectives. Finally, the government was forced to take extreme measures to suppress and cool down the market. This
led to extreme volatility in the market. During the one and a half year between 1996 and the first half of 1997, the market was bullish. To cool down the market, the government and regulatory authorities issued 12 measures for prevention against risks in the stock market, including the banning of transactions on credit and market manipulation, placing restrictions on own account activities by securities dealers, punishing law-breaking organisations and enhancing education on risks. On 16 December, an essay titled “Correct Understanding of the Current Stock Market”\(^\text{16}\) by a special commentator was published in the People’s Daily. The move was unprecedented. Thirdly, the political policy and economic policy adopted by the government became the key factor affecting market development and regulatory capability and efficient of the market. For example, in the second half of 1997, the State announced as a strategic objective the resolution of the difficulties faced by State-owned enterprises in three years. To achieve this goal, servicing the reforms of State-owned enterprises became the central task of the securities market. One major consequence of adoption of such policy was an over-emphasis of the requirement for overcoming the difficulties plaguing State-owned enterprises and the listing of certain State-owned enterprises under guises, such as Hongguang Industrial and Daqing Lianyi. These gave rise to very serious consequences and significantly undermined the confidence of investors. Afterwards, the market remained in a bearish mood for almost two years.

3. In the third stage, on the basis of experience acquired during the past 10 years of development of the PRC securities market, regulatory authorities proposed market orientation as the direction for development. It was emphasised that “securities regulatory authorities shall facilitate sound and steady development of the market through maintaining good order in the market and guard against market risks. Securities regulatory authorities are not to adjust and control the rise or fall of stock indices and should not regard adjustment and control of stock indices as work objective and goal. The duty of the CSRC is to create favourable conditions for the effective allocation of capital resources and to create good channels for capital demand and supply transactions.” “At present, the principal task is to push for further developments without compromising regularity. A change of duty shall be emphasised by way of strengthened regulation and prevention against risks. In particular, protection of interests of investors shall become an important principle of regulation in order to improve the confidence of investors.”\(^\text{19}\) After one year of trial, even though the market has experienced steep rises, extreme volatility was avoided. Under full-fledged implementation of a number of reform measures, steady operation of the market was maintained. During this period, regulatory capability was enhanced and regulatory efficiency was improved.

After studying the regulatory objectives and policies over the past 10 years, we can reach the following preliminary conclusions: (1) During the 10 years of development
of the PRC securities market, except for certain periods, the objective of regulation remained activating and developing the market. Like other PRC markets, on the whole, the securities market was “in chaos when control was loose and dead when under tightened control”. Even though regulation was relatively loose, the objective of market development was not completely realised. (2) Regulation ranked second place to political requirements such as “predominance of stability over all else” and “serving the reforms of State-owned enterprises”. It was only during critical periods that regulation was top priority. (3) Regulation was exercised by administrative means. The forces of market development and operation efficiency of the market were ignored. The trend of market movement was interrupted in the form of “hard landing”. Extreme volatility was created. Regulation was ineffective and the set objective was not met.  

Policy risk was the greatest risk in the market. Market operation was not dictated by the quality of the market itself (such as the quality of listed companies). Rather, it was dependent upon the promotion by the government. This in turn increased the dependence of market participants on the government and regulatory authorities. The foundation for market development was weakened. At the same time, policy changed frequently and there was no consistent regulatory yardstick. It was hard to anticipate market developments and rationality was missing among market participants. This further encouraged speculation and irregular operation. (4) After 2000, regulatory authorities proposed market orientation as the direction for market development. As market mechanism was fully utilised, the market developed in a steady and healthy manner. Regulation based on market orientation prevented extreme upward and downward movements in the market and was very effective.

(B) Impact of Regulatory Mechanism and Regulatory Techniques

From the point of view of legal sociology, laws are not provisions and codes. Laws are what constitute regularity in social life. Laws are codes of conduct exemplified in the acts of people in social life. However, laws, and in particular statutes laws cannot by themselves fulfil the intent of law makers. The intent must be fulfilled through a law enforcement mechanism.

The law enforcement mechanism is part of the legal system. For example, the law stipulates the scope of authority of a law enforcement agency, the basis upon which a judicial organ puts a case on file, the means by which a person may seek criminal and judicial remedies. But the law enforcement mechanism is also independent of the legal system. Its formation and operation are affected by a number of social, political, economic and cultural factors.

Securities laws and regulations include both the contents of public law and private law. Therefore, the law enforcement mechanism of securities laws and regulations comprises a few mechanisms, including the self-regulating mechanism, the public law enforcement mechanism (for example administrative law enforcement, criminal justice mechanisms) and civil compensation mechanism (i.e. the right of shareholders to take
civil action). Under each mechanism, the intent of securities laws and regulations is fulfilled to some degree by means of law enforcement and to some degree by the imposition of certain legal sanction on law breakers. From past experiences, whether any sanction can effectively serve as a deterrent on potential law breakers depends on two variables. The first variable is the possibility of sanction. The second variable is the severity of sanction. The premises of this theory is that in a market economy, a person is sufficiently free in his acts. Any act or omission is the result of a weighting of advantages and disadvantages.

We will not delve into self-regulating mechanism and factors affecting self-regulation. They are the subject of an in-depth analysis below. We will analyse here the public law enforcement mechanism and the civil compensation mechanism.

1. Public law enforcement mechanism. At present, the public law enforcement mechanism of the securities laws and regulations of the PRC is mainly the administrative law enforcement mechanism, i.e. the securities regulatory system based on the CSRC. Like the Securities and Exchange Commission of the United States, the CSRC is authorised to enforce the law and to make legislation under delegation. Therefore, the CSRC faces a problem common to both commissions in the performance of its duties —- how to maintain a balance between legislation and law enforcement. A bias towards either will affect the efficiency and partiality of law enforcement.

Currently, the CSRC is affected and restricted by policy objectives and regulatory objectives when enforcing the law. The scope of investigatory authority of the CSRC is limited and it lacks the necessary means of investigation. As a result, this has seriously limited the capability and efficiency of regulatory and law enforcement authorities. Under the Securities Law, the CSRC is authorised to investigate into activities which are in violation of securities laws and regulations and impose penalties, including the right to examine, make inquiries, review and make copies of relevant trading records, registration and transfer records, financial and accounting information, and related documents and materials, and the right to make inquiries concerning capital accounts and securities accounts maintained by institutions and individuals. The CSRC may apply to a judicial organ for freezing the funds or securities transferred or hidden illegally if such act is supported by evidence. The CSRC may refer any alleged securities-related criminal offence to a judicial organ. Under the Administrative Penalty Law, the CSRC may issue warnings, impose fines, confiscate illegal gains and illegal property, order cessation of business and operation, suspend or revoke licences or effect other administrative penalty measures permitted under laws and regulations. However, the CSRC does not have the following powers conferred on securities regulatory authorities of developed securities markets outside the PRC: the power to check the savings accounts of institutions and individuals involved in a case; the power to freeze securities accounts and
capital accounts maintained by institutions and individuals involved in a case for the purpose of conducting securities transactions; the power to summon involved personnel and those who wilfully evade such order will be considered as in breach of the law; and the power to apply for a search warrant.

Another part of public law enforcement is enforcement of criminal provisions. Criminal offences involving insider dealing, securities-related fraudulent activities, manipulation of market are covered under the Securities Law and the Criminal Law. There are as yet not many precedents in this respect. Even in cases where criminal proceedings were initiated, for various reasons, only light sentences were imposed. For example, in November 1998, the two persons concerned in the Hainan Minyuan Case were respectively sentenced to two years and three years of fixed term imprisonment. It is because of this lack of deterring criminal sanction that law breakers act recklessly. The causes of this situation are: (1) the CSRC has not established a system of co-operation between it and public security organs and procuratorial organs in investigating into and taking action against securities criminal offences; (2) securities criminal offences are very sophisticated and it is difficult to produce evidence, and it is particularly hard to prove the intent of offenders; (3) the quality of the judiciary in handling securities cases has yet to be upgraded as procuratorial organs have no precedents to rely on and lack experience and are in a difficult position to distinguish between criminal acts and non-criminal acts and therefore are very cautious in bringing public prosecution.

2. Civil compensation. The civil compensation mechanisms of developed securities markets are well-established. But such mechanism is basically non-existent in the PRC. As compared with the public law enforcement mechanism, the civil compensation mechanism possesses certain advantages in the full implementation of securities laws and regulations. One advantage is that as medium and small investors may be able to receive compensation when their interests are harmed, they will be more active in unearthing and reporting criminal offences and having offenders punished and thereby increase the chances of sanctioning the offenders (civil sanction). Another advantage is that the burden of proof in civil actions is generally less onerous than that in criminal proceedings. It is easier for the court to affirm an offence. The likelihood of assumption of civil liability for compensation by an offender is higher. Even though civil liability is not as severe as criminal liability, since the possibility of punishment is high, it is a more effective deterrent to offenders. Nevertheless, at present, courts of the PRC at all levels in general do not accept cases of civil disputes arising from securities-related offences such as insider dealing, market manipulation and providing false statements. The function of civil liability as a deterrent has not been put to good use. There are a few obstacles in the path to establishing a civil compensation mechanism in the PRC securities market. Firstly, the Securities Law and the Companies Law are not comprehensive.
Even though shareholders have many rights under the Companies Law, there are no specific provisions on civil compensation in the Companies Law. It is true that various kinds of civil liabilities are covered under the Securities Law, but the relevant provisions are not operative, and it is not possible for a court to accept and hear a case on the basis of such provisions. The second issue is to prove causation. Many a shareholder loses its case these days because the court considers that it (as plaintiff) has failed to establish causation between the illegal act of the defendant and the losses suffered by it. The third issue is class action. Shareholders of listed companies are not united. Even though their rights have been infringed upon, many minority shareholders are unwilling to take legal action because of the legal costs involved. Relaxation of restrictions on class action has become a trend in developed securities markets. The purpose of such relaxation is to encourage minority shareholders to take legal action. Class action is covered under Articles 54 and 55 of the Civil Procedural Law of the PRC. But the provisions are too general and restrictive when compared with legal provisions governing the taking of class action in securities-related cases in the United States, and are not favourable to medium and small shareholders considering taking class action. The fourth issue is the balance between civil compensation and administrative penalty. At present, it is a normal practice of the CSRC to confiscate illegal gains and impose administrative penalty on offenders. For example, recently, the CSRC confiscated the illegal gains of and imposed a fine on the four institutions which allegedly manipulated the prices of shares of Yorkpoint Science & Technology Co. Ltd. The total sum received by the CSRC added up to RMB898,000,000.24 In this way, medium and small shareholders may not be able to receive any compensation because the company or individual which has been punished may not be capable of assuming any civil liability upon the payment of fine.

3. From the perspective of monitoring technique, securities transactions in the PRC are paperless and invisible and are carried out on the computer and the Internet. In respect of the administration of transaction accounts, a two-level account system is adopted. The transactions conducted by investors are directly administered. Compared with other international markets, the system is designed in such a way as to facilitate investigation into illegal activities. However, there are a lack of associated systems and measures and this seriously affects the full use of the above advantage, and to a certain extent increase the difficulties in conducting investigation. For example, when the system of using real names in financial transactions is not yet fully implemented, offenders may take advantage of the insufficient unawareness of risks among the general public and other weaknesses of the general public to purchase a large quantity (usually thousands) of identity certificates and open accounts at more than a hundred business departments in more than ten provinces and cities to jointly execute illegal operations. Offenders avoid investigation and regulation by means of
dispersed custody, operating various accounts, making use of funds in collaboration, and repeated switching of funds (The Yorkpoint Science and Technology Case is a typical case)\textsuperscript{25} etc. In such a situation, it is extremely difficult to identify of true offenders, the source of funds and the relationship between the two on the real-time monitoring system. As a result, the costs and level of difficulty of investigation are increased.

(C) Impact of Property Rights

Any variation of the structure of property rights will directly lead to different basis and efficiency of the practice of law. The impact of property rights on regulation and practice of law can be assessed from the following angles: (1) the impact of property rights on social morals and social credibility; (2) the impact of property rights on efficiency; (3) the impact of property rights on acts of the government and regulatory bodies; (4) the impact of property rights on the management structures and acts of companies; and (5) the impact of property rights on the acts of investors.

1. The impact of property rights on social morals and social credibility. Zhang Weiying considers that “property rights are the foundation of social morals”\textsuperscript{26} and that “those without permanent property will not persevere and those who do not persevere have no credibility”.\textsuperscript{27} Mr Zhang thinks that the reason why enterprises of the PRC have little credibility is that managers have their eyes on short-term gains rather than the long-term development of enterprises. Or, to put it in another way, managers are only enthusiastic about cultivating grasses but not trees. This short-sightedness takes root in the system of property rights of the PRC and government control. “A basis of property rights which damages credibility imposes restrictions on free competition and necessarily creates chaos in the market and results in widespread cheating. Not only does government regulation fail to establish order in the market, but its effect almost always runs contrary to one’s wishes.”\textsuperscript{28}

2. The impact of property rights on efficiency.\textsuperscript{29} Under certain conditions, different forms of property rights have different levels of efficiency. The efficiency of property rights depends on the completeness of the property rights. The completeness of property rights, in turn, is reflected in the right to operate and make decisions, the right to dispose of assets and the right to share earnings. The low efficiency of State-owned property is determined by the following factors: (1) unclear ownership of State-owned property provides no drive; (2) excessively high costs renders it difficult to enforce and supervise the property rights of the State; (3) enforcement of State-owned property mainly takes the form of State-owned enterprise, and State-owned enterprises are not given full operation and management power and cannot exercise full discretion in making decisions, distributions and claims on surplus assets; (4) enterprises exercising the power of the State often seek political gains and deviate from the motive of
profit maximisation, and have a tendency to take political gains rather than economic gains into account when selecting agents and as a result State-owned property are to a large extent externalised.

3. The impact of property rights on the acts of government and regulatory bodies. At present, government and regulatory bodies at all levels are to a certain extent acting as principal owners or agents of State-owned property, whether they are aware of unaware of their roles. Therefore, when handling issues involving State-owned enterprises or State-owned property, government and regulatory bodies disregard the law for the sake of political gains or local (departmental) gains. The outcome is dislocation of roles and distorted activities. For example, some local governments and authorities not only fail to perform their administrative duties, but instead assist listed companies in committing fraud and deception and violation of laws and regulations and shield such acts. Devices include seeking permission to list unsuitable enterprises by way of administrative interference, assisting majority shareholders of State-owned listed enterprises in the transfer of resources and profits through connected transactions, manipulating business results by fiddling around with accounts and assisting local listed companies in the production of various kinds of false documents and certificates. Once the acts are unearthed, government and regulatory bodies will make use of their special position in disrupting investigations conducted by securities regulatory bodies and the subsequent imposition of punishments, and thereby limiting, to a certain extent, the efficiency of the regulatory system. As far as regulatory bodies are concerned, they often play the dual role of the athlete and the judge in the process of law enforcement. On the one hand, regulatory bodies protect the equity interests of the State. On the other hand, regulatory bodies serve as market regulators and assume the role of law enforcers. There is a consistent conflict of interests between the two roles. As a result, regulators lack authority and awareness of law enforcement. Another impact of property rights on the acts of government and regulatory bodies is that as long as State-owned properties occupy a leading position, government and regulatory bodies are under very little pressure to alter their roles and mechanisms. Government and regulatory bodies will adopt the means and forms of interference customary to a planned economy in interfering with market operations and the selection of key market participants, in particular the operation of stock exchanges, securities business organisations and listed companies.

4. The impact of property rights on management structures and acts of companies. In almost all State-owned enterprises, the State often holds a majority stake or a relatively majority stake. The impact of such shareholding structure on an enterprise is that: (1) Key responsible personnel of the enterprise (the chairman, general manager) are still nominated and appointed by the government, and the acts of the responsible personnel are more representative of the will and interests of the government. (2) Under a shareholding structure with a sole majority
shareholder, the majority shareholder has total control over the shareholders’ general meeting, the board of directors and the board of supervisors. This creates a distortion of the management structure of the enterprise and there are no checks and balances on the majority shareholder. It is easy for the majority shareholder to infringe upon the interests of medium and small investors in a disguised legal manner (the inherent logic of such act being the exercise of authority by the majority shareholder on behalf of the government). This has now become a general phenomenon. (3) As there is no regulatory mechanism, the acts of the management of the enterprise will become more disorderly and freewheeling and will tend to be short-term and personalised. This weakens the foundation for the development of the enterprise. An enterprise may even find itself in dire straits (for example, Monkey King referred to above).

5. The impact of property rights on the acts of investors. Medium and small investors are immediate victims of various malpractices. When their interests are harmed, investors usually press for favourable decisions of the government and regulatory bodies by means of collective appeal to higher authorities and silent protest. From a realistic point of view, these methods have proved to be more effective. The “Yuanye Incident” and the “Hainan Minyuan Incident” were handled in a way which was favourable to medium and small investors. But then such results have increased the reliance of investors on government and regulatory bodies and dampened their enthusiasm in supervising and controlling listed companies. More seriously, the protectionist policy adopted by government and regulatory bodies is accompanied by irrational investment activities, speculative and sheepish in nature, unrestrained by risks in the market. As a result, market risks increase, regulation becomes a more formidable task and there are more challenges in the path of further reforms of the securities market. For example, out of fear that investors might make trouble, in the past except for some specific cases, most companies which were to be delisted were given more than half a year’s grace period.

What the above analysis indicates is that the existing system of property rights of the PRC distorts government acts, dampens the authority, regulatory capability and efficiency of regulatory bodies. At the same time, it reinforces the contemptuous attitude of governments at all levels and State-owned enterprises towards the law as well as the reliance of investors on government and regulatory authorities. It can be said that some of the deep-rooted contradictions of the PRC securities market have their roots in the existing system of property rights.

(D) Impact of Cultural Factors and Social Environment

The impact of cultural traditions of a society, especially the legal awareness and legal traditions of a society on the efficiency and effects of regulation in securities markets cannot be overlooked. Under different legal cultures, the same regulatory structure
and laws may produce sharply different regulatory effects. In other words, cultural factors have a restrictive impact on the implementation of law and the realisation of the social functions of law. It is apparent that effective market regulation requires a legal culture based on the rule of law. A culture based on the rule of law is the psychological basis of an effective operation of modern law. It is also the spiritual conditions for the realisation of a legal society. Harold J. Berman, an American legal scholar, once said: “It is only when law is trusted and therefore strongly enforced upon request that law becomes effective. Leaders who rule by the law have no need to rely on the police all the time…What prevents crimes is a tradition of law compliance. This tradition is rooted in a deep and passionate faith in law as not just an instrument of worldly policies, but also the ultimate goal and meaning of life.”

In terms of legal culture and tradition, there are huge differences between the PRC and the West. The West has a long tradition of rule of law. The legal culture of the West is a culture of rule of law in which the administration of a state is based on law rather than people. Under a system of rule of law, “the source of power is law”, “law reigns supreme” and “equality of all before the law” are upheld. The legal system of the West was established over a few hundred years during which time the idea of rule of law was spread. The process of establishment of faith in law in Western societies was a gradual process. In the West, the law, and not the ruler is the highest authority. The law is regarded as the ultimate and authoritative standard of value judgment. Any one (including the ruling class) must be subject to law and has no privilege above the law. Each citizen accepts the law wholeheartedly and assesses his own acts against a standard which is the law. On the other hand, each citizen will not easily defy the law for fear that the economic and social costs of such act may be too high. This creates a good environment under which people respect the law, willingly implement the law and act in accordance with law. The status and use of law are recognised. The value and functions of law are also fully realised.

In China, a 2000-year old history coloured by feudalism and dictatorship has contributed to the cultivation of a deep-rooted legal culture centred on the rule by people (or, in other words, rule by administration). Under such culture, the state is ruled by administration and the law is merely a tool and means of control. The authority of law is subordinated to the authority of administration. For this reason, a trust in and reliance on law cannot be established. Although there have been remarkable achievements in the PRC since the opening up of the country in the establishment of a legal system and the promotion of the rule of law, the legal system is still in the process of formation and improvement. The imprint and effects of tradition will stay for some time to come. In terms of regulation in the securities market, the culture of rule by administration makes it impossible to carry out regulation in accordance with law. “Non-compliance with law”, “loose implementation of law” and “refrain from punishing law breakers” are still common phenomenon. These phenomenon are reflected in the following manner:
1. The law does not occupy a social position it deserves and it is not an authority in the minds of people. Therefore, the law cannot effectively deter and suppress illegal securities activities. As the concept of legal system is generally skin-deep among principal participants (including individuals and legal entities) of the securities markets and participants have no trust in the law anyway, and as illegal securities-related acts will not arouse strong adverse comments in society or in the securities industry, these point to the conclusion that violation of law carries a small psychological cost. As a result, people in general will not be very concerned about the promulgation of laws or changes to laws. People have a tendency to escape the law or even publicly defy the law in the hope that things may be left to chance. This results in market disorder and continuous illegal securities activities despite repeated crackdowns.

2. The interests of various departments and local protectionism are rather serious issues. Various human factors interfere with and even disrupt the enforcement and implementation of law, preventing a full-fledged exercise of regulation. The PRC is in a state of economic transformation. Existing deep-rooted contradictions and issues have yet to be completely resolved. When enforcing the law, securities regulatory bodies have failed to enlist the cooperation and assistance of the relevant government departments. Rather, such departments often interfere with the law enforcement efforts of regulatory bodies for the sake of departmental gains or local gains. For example, when listed companies or securities companies subordinated to departments-in-charge or local governments breach the law, departments and local governments over-emphasise their difficulties and gains or attempt to suppress the issues through other channels, obstructing the smooth enforcement of law. The consequences of “power overriding the law” are non-compliance with law, incomplete enforcement of law, obstructions in law enforcement and implementation and inability to effectively realise the objective of regulation.

3. Absence of judicial independence and excessive administrative interference. Although judicial independence is stipulated under various PRC procedural laws, until now, the PRC judicial system is not in a real sense separated from the PRC administrative system. Judicial authorities are restrained by administrative authorities in the same way as a horse is controlled by a rein. Therefore, judicial independence is not guaranteed under the PRC judicial system. In reality, courts are subject to the interference of government authorities or superior courts in the handling of cases, especially cases involving the interests of government authorities. Prosecution of cases will be fizzled out in the face of pressure exerted by superior authorities. The normal judicial process is distorted by external interferences.

4. The social basis for the implementation of securities laws is thin. According to research results, laws which are effectively and fully implemented are those
which are plunged into the hearts of society and are consistent with or similar to general practices. A law which can only be implemented by force of the state is destined to fail, no matter how fair and just the law is in theory. Like other PRC laws, the PRC securities laws are transplanted from similar laws of the West. “As these laws are far removed from customary practices of the Chinese people or supplemented by systematic practices, it is not easy for them to be accepted. It may well be that they may be rejected altogether and cannot become the standard against which people act. More often than not, these laws will not, at least during the initial stages of implementation, facilitate the acts of people. On the contrary, it may turn out that people find the implementation of these laws tedious. As a result, statutes and laws of the State will in general be ineffective and weak.”

The above factors present grave problems to securities regulatory bodies and cause a weakening of the strength and effectiveness of implementation of law. However, the establishment of a legal culture with rule of law as its essence and the establishment of law as a social religion cannot be accomplished in a day. These require the joint efforts of all walks of life in promoting and nurturing a legal culture in society in the process of the development of rule of law, and gradually creating a favourable environment for implementation of law.

**(E) Impact of Self-regulation in the Market**

From the experience of development of international securities markets, the long-term and steady development of a securities market requires the exercise of centralised regulation of the market by a regulatory body. However, self-regulation of the market is also extremely important. For over 300 years, self-regulation has played an important part in the regulation of international securities markets. For example, in England where modern day securities market originated, a strengthening of government regulation was proposed only in recent years. This also applies to the Hong Kong securities market. Experiences of developed securities markets indicate that the operation of self-regulating bodies and independent intermediaries, as well as the making of informal arrangements in respect of the concepts of the rule of law and self-regulation constitute the self-regulating mechanism of the market and play a fundamental part in the exercise of market regulation.

It is obvious that regulatory capability and efficiency are stronger in markets in which exists a keen awareness of self-regulation and an adequate self-regulating mechanism. The key reasons are: (1) In a market where there is a keen awareness of self-regulation, key participants are very consistent in their value judgment, are able to reach consensus easily and are more willing to comply with the law, and the market possess a sound basis for the rule of law. (2) In a market where there is a keen awareness of self-regulation, it is easier to establish a sound self-regulating mechanism. Self-regulating bodies play a better regulatory role and market participants are enabled
to act more rationally. As a result, the costs of regulation are lowered. (3) Credibility and reputation are strongly emphasised in markets where there is a keen awareness of self-regulation and an adequate self-regulating mechanism. Intermediaries of markets survive on reputation. Therefore, market participants are more concerned about their reputation and any damages done to it than any punishments they may receive. Intermediaries are reluctant in acting against the law.

Clearly, awareness of self-regulation is thin and self-regulating mechanism is incomplete in the PRC securities market. These are reflected in the following facts: (1) Many securities business organisations act against the law. Statistics gathered between 1994 and 2000 show that securities business organisations represent 61.3% of all the subjects of crime and that such percentage is on the increase. (2) Accounting firms, asset valuation organisations, law firms and other intermediaries do not exercise self-regulation and prepare false accounts and issue untrue reports in an unprofessional manner. (3) Institutional investors, listed companies and large investors engage in insider dealings or joint hands in manipulating the market. “Illicit Fund Activities” reveals how investment funds take advantage of their financial strength to control and manipulate stock prices through illegal means. The Yorkpoint case and the China Venture Capital case are typical cases of joint manipulation of market by large investors. This is the main reason why the general public questions the capability of regulators. (4) The functions of stock exchanges and securities industry associations have not yet been fully put into effect.

To sum up, in the PRC securities market, awareness of self-regulation is low and effective functioning of the self-regulating mechanism is not possible. As a result, the costs of market regulation are very high and the efficiency of regulation is low, which have in turn restrained the improvement of market regulation.

**F) Quality and Number of Law Enforcement Personnel**

Regulatory personnel enforce and implement the law. Whether there are sufficient regulatory personnel and whether the quality of regulatory personnel meets the requirements for efficient regulation directly affect the prompt exercise of regulation and whether anticipated effects of regulation can be achieved. Although the number of securities regulatory personnel is increasing every year, and attempts are made to enhance the training programmes offered to regulatory personnel in order to improve their regulating standard, the quality and number of regulatory personnel at present cannot satisfy the requirements of the rapid expansion of the market and the increasing complexity of securities businesses. This issue is manifested in the following ways:

Serious lack of regulatory personnel. The U.S. Securities and Exchange Commission has a team of over 3,000 specialist regulatory personnel. PRC regulatory bodies have only slightly over 1,400 regulatory personnel. Upon the establishment of the three-tier inspection system, inspectors represent only 10% of the personnel of the CSRC. The number is far from adequate for meeting the requirements for regulation in the market.
The quality of regulatory personnel has to be further improved. The PRC securities market has a very short history. Personnel working for securities regulatory bodies are comparatively young. As the three-tier inspection system has just been set up, most regulatory personnel have only had a preliminary knowledge of securities regulatory work and lack the necessary on-the-job training. The quality of their work is not high. Regulatory personnel also lack practical experience. Their quality is much lower than their foreign counterparts.

The level of judicial personnel fails to meet the requirements for market development. Because they lack the required judicial experience, have difficulty in identifying the boundary between crime and innocence, and also because the number of securities criminal cases filed and handled is small, judicial personnel are unable to effectively punish securities criminal offenders in accordance with criminal law. For civil trials, certain judges are afraid of handling difficult cases because they do not have the relevant securities knowledge and operating experience, securities cases are complicated and legal provisions are not applicable. In particular, in cases involving the protection of the interests of medium and small investors, no systematic guidelines and standard have been set up for the trial of such cases.

After considering the six factors above, it can be concluded that: (1) The PRC is at the initial stage of a society governed by the rule of law and trust. PRC society at large has a weak sense of legal system. The market is not in complete order yet. These in turn limit the regulatory capability and efficiency of the PRC securities market. (2) The regulatory capability and efficiency of the PRC securities market as an important part of the PRC market economy are limited by various factors such as the political system, economic system and social environment. As long as a modern day market economy based on the rule of law is not set up, the PRC securities market cannot break away from actual circumstances and be governed by the rule of law and become regularised. (3) The PRC securities regulatory bodies have to define their role, smoothen regulatory procedures and mechanism, increase and improve inspection methods and skills, give full play to the functions of market mechanism, remove various obstacles to the greatest extent possible, and intensify regulation and law enforcement by economic, administrative and legal means. (4) The adoption of effective measures, inculcating and heightening the sense of self-regulation in market participants, and a full functioning of self-regulating bodies are the basis for improving regulatory capability and efficiency.

V. Conclusion and Measures

1. Regulatory capability and efficiency of the PRC securities market have been improving in the years of its development. The international community marvels at the achievements of the PRC securities market in the past decade.
2. Regulation of the PRC securities market has gone through a zigzagging path. Regulatory capability and efficiency of the PRC securities market are seriously affected by Chinese politics and policies at different periods of time.

3. Most of the factors affecting the regulatory capability and efficiency of the PRC securities market are obstructive and negative. Some factors play a decisive role in affecting the regulatory capability and efficiency of the PRC securities market. This indicates that it will be a long time before rule of law is practised in the PRC securities market.

4. Intensification of law enforcement, rather than formulation of law, is the most important issue in the PRC securities market. Gradual cultivation of faith in law and willingness to abide by the law and an improvement of legal sense among market participants are required.

5. Establishment and perfection of law enforcement mechanism and improvement in the skills and level of inspection are important ways to enhancing regulatory capability and efficiency. They are also issues demanding prompt solution.

6. Improvement of the quality of regulatory personnel and a strengthening of the team of regulatory personnel are important means of increasing regulatory capability and standard of law enforcement.

7. Further improvement of the legal system, plugging legal loopholes, improving the applicability of laws and regulations, further localising laws and strengthening the social basis of laws are the ultimate ways to improving regulatory capability and efficiency.
Footnotes:

1. “Illicit Fund Activities --- An Interpretation and Analysis of a Research Report on Fund Activities” was the front cover essay of Volume 10, 2000 of Caijing Financial Magazine. The essay analysed the investment activities carried out by 22 investment funds managed by 10 fund management companies between August 1999 and April 2000 and revealed certain illegal activities of some fund management companies. The essay aroused great concern in society and sparked off heated debates concerning supervision and law enforcement of the PRC securities market.

2. For reference, see the article and background by Wu Jingwen in the China Economic Times on 8 March 2001.


4. Ditto.

5. As at 31 December 1999, Monkey King Co., Ltd. provided funds for an amount of RMB890,000,000 and a guarantee for RMB244,000,000 to Monkey King Group, its majority shareholder. The aggregate amount of the two items exceed RMB1,130,000,000 and represent 121.4% of its total assets. As a result, Monkey King was operating under great difficulties. On 27 February 2001, the Monkey King Group was declared bankrupt in accordance with law. Monkey King was also on the verge of bankruptcy. Jinan Motorbicycle provided funds and guarantee for an amount of more than RMB2,500,000,000 to the Motorcycle Group, its majority shareholder. This resulted in huge losses for 2001., See Gao Xianmin (Ed.), Secrets of Listed Companies World Publication Press, 2001, pp. 101-110; Jinan Motorcycle: Replay of Monkey King Fiasco, published on 17 June 2001 in Nanfang Weekend.

6. On 22 January 1997, Hainan Minyuan Modern Agriculture Development Co., Ltd. (“Hainan Minyuan”) issued its 1996 Annual Report. From March 1997, the Securities Commission under the State Council, the State Audit Administration, the People’s Bank of China and the China Securities Regulatory Commission carried out investigations into breaches of the PRC accounting system and securities laws and regulations and preparation of false financial reports by Hainan Minyuan in its Annual Report. The Penalty Decision issued by the China Securities Regulatory Commission on 27 April 1998 (Zheng Jian Cha Zi (1998) No. 31) stated that “In the 1996 Annual Report published by Hainan Minyuan, Hainan Minyuan breached the land administration system and the accounting system of the PRC, cheated shareholders and the general public, fabricated income and growth of the capital reserve fund involving an amount of more than RMB1,000,000,000. These constitute serious misrepresentation…..After consideration, it was decided that: (1) As Ma Yuhe, Chairman and General Manager of Hainan Minyuan, Ban Wenshao, Chief Accountant of Hainan Minyuan and Ke Shaoyun have allegedly committed crimes, the China Securities Regulatory Commission has referred the facts and evidence to a judicial authority and criminal responsibility will be pursued. We propose the companies for which they work to terminate their duties in accordance with law. (2) A warning shall be issued to Hainan Minyuan….“

On 12 November 1998, the First People’s Court of Beijing which handled the Hainan Minyuan case passed a first instance verdict. Ma Yuhe was sentenced to three years of fixed term imprisonment on account of a charge for providing false financial reports. Ban Wenshao was
sentenced to two years of fixed term imprisonment for the same charge on two years’ probation. See Gao Xianmin (Ed.), Secrets of Listed Companies World Publishing Corporation, 2001, pp. 85-91.


12. For example, the trading time of the two exchanges are adjusted frequently in order that quotations on one exchange will not affect quotations on the other; funds are offered to securities dealers in order to activate the market.


14. On 28 July 1994, the Shezhen and Shanghai markets had been going downward on a recurrent basis for one year. The markets were in an extremely bearish mood. The Shanghai Stock Index dropped 77.33% to 340 points from over 1,500 points. The Shenzhen Stock Exchange Composite Index was down 73.64% to 97 points from a high level of 368 points. Trading volume shrank dramatically. Confidence of investors in the market was shattered. Under such situation, the CSRC introduced three policies with a view to activating the market. Market participants called these “three policies to save the market”: except for shares which have been issued but not listed, issuance and listing of new shares will be suspended this year; Sino-foreign co-operative funds will be formed and traded on the A share market; the raising of funds for selected securities organisations with good credit standing and management. The Shenzhen and Shanghai stock markets jumped in the wake of the above measures. On 1 August, the Shenzhen Composite Sub-index and the Shanghai Composite Index shot up 31.29% and 33.46% respectively. In August and September, the upward trend continued in both markets. In September, the Shenzhen Composite Sub-index stood at 234.96 points, a surge of 142.23%. But soon market participants realised that apart from the suspension of new listings, the other two policies could not be put into practice under the current circumstances. From October, the markets plunged again. In May 1995, the Shenzhen Composite Sub-index

15. On 12 May 1997, the Shenzhen Composite Sub-index reached a new high of 520.25. It then plummeted. On 18 May 1999, the Shenzhen Composite Sub-index was down 40.7% and stood at 308.30 points. From 19 May, boosted by various news, “skyrocketing quotations” appeared in the market. Regulatory authorities confirmed that the market had recovered. In order to maintain the upward trend in the market and boost the confidence of investors further, an article contributed by a special commentator and titled “Consolidation of Confidence and Regularise Development” appeared in the People’s Daily on 15 June 1999, giving impetus to the market. After the publication of such article, the market continued to rise. A new high of 528.89 points was reached on 30 June. The market surged as much as 70% in 31 trading days. From 1 July onwards, the market fell and the short-term “skyrocketing quotations” disappeared.


17. The predecessor of Hongguang Industrial Co., Ltd. is the state-operated Hongguang Vacuum Tube Factory. The factory was one of the key industrial projects of the First Five-Year Plan. It was where the first colour picture tubes of the PRC were produced. Hongguang Industrial was listed on the Shanghai Stock Exchange on 6 June 1997 and RMB410,000,000 was raised. On 30 April 1998, Hongguang Industrial issued its 1997 Annual Report. The Annual Report revealed that the company incurred a loss of RMB198,000,000 in 1997. Loss per share was RMB0.863. The market was shocked. The huge loss incurred by Hongguang Industrial in its first year of listing aroused great concern amongst the central government and regulatory bodies. After investigating for more than half a year, on 20 November 1998, the China Securities Regulatory Commission published the Report on the Serious Breach of Law by Hongguang Industrial Co., Ltd.. The Report revealed that Hongguang Industrial disclosed information on untrue profits in order to become qualified for listing, withheld information on losses in order to cheat investors, concealed material issues, did not perform its obligations to disclose material events, diverted proceeds raised from the general public to securities trading and had allegedly committed crimes. Responsible personnel and relevant intermediaries were punished. See Gao Xianmin (Ed.), Secrets of Listed Companies World Publishing Corporation, 2001, pp. 5 - 12.

18. The predecessor of Daqing Lianyi is Daqing Lianyi Petrochemical General Factory. In 1996, the Heilongjiang Economic Restructuring Commission approved the restructuring of Daqing Lianyi Petrochemical General Factory as a company limited by shares. In 1998, Daqing Lianyi (Group) Corporation was formed. In order to apply for permission to list and raise huge funds, from 1996 onwards, Daqing Lianyi Petrochemical General Factory perpetrated fraud and deception in an attempt to put up a good image for itself: (1) In the second half of 1996, the Daqing Economic Restructuring Commission sought instructions from the Heilongjiang Economic Restructuring Commission as to the establishment of Daqing Lianyi and the date of the request for instructions was misprinted as 20 September 1993. The Heilongjiang Economic Restructuring Commission issued an approval on 20 March 1997 and the date of approval was misprinted as 20 December 1993. (2) In January 1997, the Daqing Administration for Industry and Commerce issued a business licence to Daqing Lianyi and the date of issuance was misprinted as 20 December 1993. (3) Harbin Accounting Firm and
Wanbang Law Firm knowingly issued an audit opinion and a legal opinion respectively which contained false information for Daqing Lianyi. The lead underwriter, Shenyin Wangguo Securities Co. concealed the facts and submitted documents containing false information to the China Securities Regulatory Commission. (4) In March 1997, Heilongjiang Securities Company provided false securities custody certificates to the China Securities Regulatory Commission. (5) Daqing Lianyi reported untruthfully a profit of RMB161,760,000 for the period between 1994 and 1996 and altered a Notice of Postponement of Tax Payment issued by the Daqing Tax Bureau by changing RMB4,000,000 plus to RMB44,000,000 plus. Under the “assistance” of these authorities, in April 1997, Daqing Lianyi offered 50,000,000 shares to the public and raised RMB481,000,000. See Gao Xianmin (Ed.), Secrets of Listed Companies World Publishing Corporation, 2001, pp. 12 - 15.


20. In 2000, the Shenzhen Composite Sub-Index and the Shanghai Composite Index rose 58.07% and 51.73% respectively. Accumulative total turnover in the two exchanges was RMB6,362,850,000,000, representing an increase of 93.7% from 1999. 13,255,700 new investors’ accounts were opened, representing an increase of 132.36% from 1999. In 2000, the China Securities Regulatory Commission introduced a series of reform measures such as market orientation in the issue of new shares, placement in lieu of public offer to achieve early listing, launching of trial open-ended funds, the set up of the GEM market and speedy development of institutional investors.


23. See 6 above.


25. The Yorkpoint case is a typical case of manipulation. From 5 October 1998, Guangdong Xinsheng Investment Consultants Firm, Guangdong Zhongbai Investment Consultants Firm, Guangdong Baiyuan Investment Consultants Firm and Guangdong Jinyi Investment Consultants Firm pooled together funds and purchased a large number of “Shenjinxing” (later renamed as Yorkpoint Science and Technology) shares through 627 individual securities accounts and 3 company securities accounts. On 5 October 1998, they held 530,000 shares, representing 1.52% of the total number of shares in circulation. On 1 January 2000, they held 30,000,001 shares, representing 85% of the total number of shares in circulation. At the same time, such companies traded shares in various accounts controlled by them without the transfer of ownership and thereby affected the trading price and turnover, and in so doing jointly manipulated the prices of Yorkpoint shares. As at 5 February 2001, RMB449,000,000 was earned by the 627 individual securities accounts and 3 company securities accounts controlled by the four companies above. The balance of shares in such accounts was 770,000 shares. See Securities Times, 26 April 2000.


31. For example, details of the Hainan Minyuan restructuring proposal are as follows: the proposal for establishment (of a new company), issue (of new shares) to designated investors, one-for-one conversion of shares (shares in circulation), issue of additional shares (placing of new shares), Beijing Housing Group Company (“Beijing Housing”) as the majority shareholder, Beijing State-owned Asset Management Co., Beijing Strong, Legend Group, Founder Group and Stone Group as participating shareholders of the new company to be established --- Beijing Centergate Technologies Co. Ltd. On 19 June 1999, Centergate announced a plan for conversion of shares. 187,423,470 Hainan Minyuan shares in circulation would be converted to the same amount of Centergate shares held by Beijing Housing. At the same time, registered shareholders of Hainan Minyuan shares in circulation will convert one Hainan Minyuan share to one Centergate share held by Beijing Housing. Upon conversion, the Centergate shares which were converted would be listed on the Shenzhen Stock Exchange. Within one month from the day of listing, Centergate would issue new shares to shareholders of its circulating shares on a one-for-one basis. One outstanding feature of the restructuring proposal was that only the interests of the investors in publicly offered Hainan Minyuan shares were considered. The interests of shareholders of legal person shares and other shareholders were not taken into account. From the perspective of performance of Centergate shares in the aftermath of listing, on 12 July, the opening price of Centergate shares on the first day of listing was RMB37.58, up 60% from the price of Hainan Minyuan shares at the time of suspension of its listing which was RMB23.49. From the time of listing till the end of 1999, the price of Centergate shares lingered above RMB37 (excluding ex-rights). At the beginning of March 1997, the Shenzhen Composite Sub-Index was at 379.77 points. On 12 July 1999, it was at 471.52 points. The percentage of increase was a mere 24%. In other words, without considering opportunity costs, earnings of shareholders of public of Hainan Minyuan shares are 2.5 times the earnings