EQUITY POLITICS AND MARKET INSTITUTIONS: THE DEVELOPMENT OF STOCK MARKET POLICY AND REGULATION IN CHINA, 1984-2000

A THESIS SUBMITTED TO THE DEPARTMENT OF GOVERNMENT IN CANDIDACY FOR THE DEGREE OF DOCTOR OF PHILOSOPHY (Ph.D.)

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ABSTRACT

As China’s government leads the transition away from socialist planning, how does it build the regulatory institutions that it needs to manage the new market economy? Creating effective institutions, the rules that govern economic transactions that are enforced by regulatory agencies, the courts, media and business, lies at the heart of a successful transition. This thesis explains and evaluates institutional development in China’s stock market during 1984-2000. In the absence of private firms, public actors designed and controlled the development of institutions, orienting them to support their own particular industrial and fiscal priorities. These actors operated within a three-level hierarchy: the principals, the senior leadership (zhongyang); two sets of sub-principals, local (provincial-level) and ministry leaders; and agents, ju-level bureau leaders. The principals experienced two problems in establishing equity institutions that delivered their priorities, financial stability and market development. First, local leaders captured control of ju-level bureaux and used them to maximise investment and fiscal funds. Deficient regulation and regular financial crisis resulted. Second, at the central government level bureau leaders competed to defend their organisational interests. Policy stasis and gaps in regulation resulted. However, by 1996, the capital market was large enough to be used to support state-owned industry and by 1997 the instability caused by local policies had become a serious threat to the financial system. With their incentives thus altered, the senior leadership organised radical institutional change despite opposition at both levels. The result was the creation of a securities regulator with unrivalled administrative authority over the sector, well able to orient market development towards the zhongyang’s priorities. The thesis suggests that the central leadership can manage economic transition through the use of a portfolio of institutional techniques. These include restructuring sector-specific nomenklatura arrangements, recentralising key powers, creating oversight and reporting mechanisms, strengthening Party structures, and clarifying responsibilities within the Centre.
ACKNOWLEDGEMENTS

To build a stock market worth some US$200 billion in the space of ten years is a remarkable achievement. It has been a privilege during the course of this research to meet some of the people involved. Their experience and expertise has shaped my understanding of the development of the market, its institutions and its problems. My hope is that this thesis reflects both the positive and negative aspects of development so far. Many of the people who made the greatest contributions did so on the basis of anonymity. My warm thanks go to the members of the Shanghai and Shenzhen stock exchanges, the China Securities Regulatory Commission, and numerous financial institutions for their time, expertise and willingness to talk to a naïve research student. I owe a special debt of gratitude to the leadership of the Shenzhen exchange for making my stay there in June 2001 one of the highlights of the project. I am grateful to Zhang Jun for facilitating my stay at Fudan University. Thanks also go to friends who work outside of the securities sector: Chen Yixin, Ling Yun, Benjamin Li and Samuel Shen all extended friendship during my stay in Shanghai in 1999-2000 and beyond. Thanks to Tom Mitchell, Laura Burt, Margaret Doyle and all at the Economist Group in Shanghai and Beijing, as well as to friends at Asia’s most sophisticated salsa bar, Tropicana, for some wonderful Friday nights.

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Stephen Green
London
8th March 2002
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<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
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<tbody>
<tr>
<td>ABC</td>
<td>Agricultural Bank of China</td>
</tr>
<tr>
<td>AMC</td>
<td>Asset management company</td>
</tr>
<tr>
<td>BoC</td>
<td>Bank of China</td>
</tr>
<tr>
<td>CASS</td>
<td>Chinese Academy of Social Sciences</td>
</tr>
<tr>
<td>CBC</td>
<td>Construction Bank of China</td>
</tr>
<tr>
<td>CCOD</td>
<td>Central Committee Organisation Department</td>
</tr>
<tr>
<td>CCP</td>
<td>Chinese Communist Party</td>
</tr>
<tr>
<td>CDIC</td>
<td>Central Discipline &amp; Inspection Commission</td>
</tr>
<tr>
<td>CDIC</td>
<td>Central Discipline and Inspection Commission</td>
</tr>
<tr>
<td>CITIC</td>
<td>China International Trust and Investment Corporation</td>
</tr>
<tr>
<td>CLA</td>
<td>Commission for Legal Affairs (NPC)</td>
</tr>
<tr>
<td>CSRC</td>
<td>China Securities Regulatory Commission</td>
</tr>
<tr>
<td>DIB</td>
<td>Discipline and Inspection Bureau (CSRC)</td>
</tr>
<tr>
<td>FAMD</td>
<td>Financial Administration and Management Division (PBoC)</td>
</tr>
<tr>
<td>FEC</td>
<td>Finance and Economics Committee (NPC)</td>
</tr>
<tr>
<td>FELG</td>
<td>Finance and Economics Leading Group</td>
</tr>
<tr>
<td>FII</td>
<td>Financial institutional investor</td>
</tr>
<tr>
<td>FWC</td>
<td>Financial Work Committee</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross domestic product</td>
</tr>
<tr>
<td>GEM</td>
<td>Growth Enterprise Market (or Second Board, SHZSE)</td>
</tr>
<tr>
<td>GITIC</td>
<td>Guangdong International Trust and Investment Corporation</td>
</tr>
<tr>
<td>GORD</td>
<td>General Office's Research Department (NPC)</td>
</tr>
<tr>
<td>HKSE</td>
<td>Hong Kong Stock Exchange</td>
</tr>
<tr>
<td>ICBC</td>
<td>Industrial and Commercial Bank of China</td>
</tr>
<tr>
<td>LC</td>
<td>Law Committee (NPC)</td>
</tr>
<tr>
<td>LCSB</td>
<td>Large commercial state bank (ICBC, ABC, CBC and BoC)</td>
</tr>
<tr>
<td>LIF</td>
<td>Local investment fund</td>
</tr>
<tr>
<td>LP</td>
<td>Legal person</td>
</tr>
<tr>
<td>MoF</td>
<td>Ministry of Finance</td>
</tr>
<tr>
<td>MSG</td>
<td>Market service group</td>
</tr>
<tr>
<td>NASD</td>
<td>National Association of Securities Dealers (US)</td>
</tr>
<tr>
<td>NAV</td>
<td>Net asset value</td>
</tr>
<tr>
<td>NETS</td>
<td>National Equities Trading System (PBoC)</td>
</tr>
<tr>
<td>NBFI</td>
<td>Non-bank financial institution</td>
</tr>
<tr>
<td>NPC</td>
<td>National People's Congress</td>
</tr>
<tr>
<td>NPCSC</td>
<td>National People's Congress Standing Committee</td>
</tr>
<tr>
<td>NPL</td>
<td>Non-performing loan</td>
</tr>
<tr>
<td>NSSF</td>
<td>National Social Security Fund</td>
</tr>
<tr>
<td>NYSE</td>
<td>New York Stock Exchange</td>
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<tr>
<td>OTC</td>
<td>Over-the-counter</td>
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<tr>
<td>P/E</td>
<td>Price-earnings ratio</td>
</tr>
<tr>
<td>PBoC</td>
<td>People's Bank of China</td>
</tr>
<tr>
<td>POLRC</td>
<td>Public Offering and Listing Review Committee</td>
</tr>
<tr>
<td>PRC</td>
<td>People's Republic of China</td>
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</table>
PRM Property rights market
PSB Public Security Bureau
SAFE State Administration of Foreign Exchange (PBoC)
SAO Securities Administration Office
SASAM State Administration of State Asset Management
SCLAO State Council Legislative Affairs Office
SCORES State Commission of Restructuring the Economic System
SCSC State Council Securities Commission
SCSMOM State Council Securities Management Office Meeting
SCSSMO State Council Securities Supervision and Management Organisation (term used in the SL)
SDPC State Development and Planning Commission
SEC Securities and Exchange Commission (United States)
SEEC Stock Exchange Executive Council
SEPG Stock Exchange Preparation Group (Shenzhen)
SETC State Economic and Trade Commission
SEZ Special Economic Zone
SHGSAO/SHZSAO Shanghai/Shenzhen Securities Administration Office
SHGSE/SHZSE Shanghai/Shenzhen Stock Exchange
SHGSMC/SHZSMC Shanghai/Shenzhen Securities Management Commission
SHZDB Shenzhen Development Bank
SIA Securities Industry Association
SIB Securities and Investment Board (UK)
SITIS Shenzhen International Trust and Investment Securities
SL Securities Law
SMC Securities management commission
SMLG Securities Market Leadership Group (Shenzhen)
SMO Securities Management Office (PBoC)
SMSMS Share Market Staff Meeting System
SOE State-owned enterprise
SPC State Planning Commission (later SDPC)
SREOs Securities Regulation Expert Offices
SRO Self-regulatory organ
SSEZSC Shenzhen Special Economic Zone Securities Company
SSMC State Securities Management Commission (proposed in early SL draft)
SSRASC Shenzhen Securities Registration and Settlement Company
STAQS Securities Trading Automated Quotation System
STC Securities Trading Centre
TBF Treasury bond future
TIC Trust and investment corporation
TMC Tradable market capitalisation
TVE Township and village enterprise
UK United Kingdom
US United States
Part I

Theoretical considerations
Introduction: Stock market regulation and institutional change in reform China

As for securities and the stock market, are they finally good or bad? Are they dangerous? Are they things that only capitalism has or can socialism also make use of them? To decide whether they can be used we must experiment first...

Deng Xiaoping, Shenzhen, 1992

As China’s government leads the transition away from the socialist plan, how does it build the regulatory institutions required to manage the new market-based economy? Creating effective institutions, the rules that govern economic transactions that are monitored and enforced by regulatory agencies, the courts, accountants, media and industry participants, lies at the heart of a successful transition. At their most basic, market institutions define property rights, what Harold Demsetz defines as the ‘bundle of rights’ over the use, revenues and transfer of assets. Yet to ensure that use and trading in these rights is fair and transparent and that abuses are appropriately punished, a complex set of institutions must be created, including an architecture of rules as well as organisations to monitor and enforce compliance. For any developing country, creating such institutions is an enormous challenge, but the challenge is especially complex for China’s leaders. Significant public ownership of industrial assets inevitably leads to conflicts of interest for the government in its roles as both owner and regulator. The ambition of the Chinese Communist Party (Zhongguo Gongchandang, hereafter CCP) to retain a monopoly on political power prevents the emergence of the rule of law. Powerful local governments have had discretion over a wide range of policy and can act autonomously, often undermining the coherence of national policy. Moreover, limited private sector involvement in the economy and the policy-making process itself, as well as the lack of electoral competition, means that public actors are largely insulated from

1 WWP (1992).
3 Demsetz (1967).
external pressures when they develop institutions. This is in contrast to Western experience where private-sector interests often lead institutional development. If the interests of market participants are not taken into account and public actors are allowed to institutionalise rent seeking arrangements, market development will inevitably suffer. Given these obstacles, can effective market institutions develop in such a context? What actors, central and local government officials, members of the legislature, institutional and individual investors, are involved in the designing the institutions that do develop? And to what extent will the structure and style of the institutions that are produced adhere to Western norms?

The Shanghai Stock Exchange (Shanghai Zhengquan Jiaoyisuo, hereafter SHGSE) opened on the 19th December 1990. Few other events could so powerfully have symbolised the radical nature of Deng Xiaoping’s market reforms. With the exchange offering trading facilities in the shares of eight enterprises, it was, apparently, a radical capitalist venture. For the first time in forty years, Chinese enterprises had the ability to access capital directly, avoiding the mediation of state-owned banks and the state credit plan. This new stock market had the potential not only to revolutionise the financial sector but it also offered a means of reorganising industrial property rights en masse. Thousands of state-owned enterprises (Guoyou qiye, hereafter SOEs) restructured into shareholding companies during the 1990s, issuing shares to their state owners and employees. A few were allowed to issue shares to the public and publicly list on the Shanghai and Shenzhen exchanges. Ordinary people could then open trading accounts, buy and sell shares and own small parts of the means of production. What is more, this new venture had gained the approval of the senior leadership of the CCP, a radical reversal of both the Party’s economic policies and Communist ideology. In Maoist China, the administrative plan had governed the distribution of industrial credit and the mono-banking system had monopolised capital allocation. Stock markets were not only unnecessary but

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5 Informal financing institutions like rural and urban credit co-operatives and financial societies that evolved during the 1980s involved mediation of some form, see Tsai (1999); Tam (1992); Chen (1998a); Cheng (2000b).
were deemed counter-revolutionary; they represented capitalism at its speculative and exploitative worst. The Shanghai Stock Exchange at No. 422 Hankou Road, with 234 listed companies the largest exchange in Asia at the time, had been closed by the Red Army’s Military Management Group (Junguanhui) on 10th June 1949. Such was the opprobrium stock markets enjoyed only thirty years ago that Vice President Liu Shaoqi, one of Mao’s targets during the Cultural Revolution, was demonised for wanting to establish one. During the 1990s, in contrast, the stock market’s ideological stock rose dramatically. After much debate, it was recognised in 1997 ‘as an important component of the national economy’ at the Party’s 15th Congress. According to General Secretary Jiang Zemin it has since become ‘an essential part of market socialism’. After ten years of remarkable development, its importance to China’s transitional economy was all but self-evident. By the end of 2000, the two stock exchanges together listed 1,050 firms, mostly SOEs, and boasted a tradable market capitalisation (TMC) of some Rmb 1.6 trillion, about 17% of gross domestic product (GDP). The market had become a major source of financing for state-owned industry and an important source of fiscal revenues. During 2000 alone companies raised Rmb 144.9 billion through domestic stock issues while the tax on share trading brought Rmb48.6 billion into state coffers. Already Asia’s third largest by the end of 2000, Mainland China’s stock market was on course to overtake that of Hong Kong before the end of the decade.

China’s development of a stock market reflected both a regional and an international trend. Asia’s financial systems after 1945 were segmented and ‘repressed’, based around interest rate restrictions, administrative credit allocation and protectionism. However, since the late 1970s they have all moved towards the market. Interest rates have been liberalised, walls between different financial businesses have fallen, credit rules have been relaxed and foreign institutions allowed in. Moreover, throughout the region there has been a shift.

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7 Cao (2000), 5.
9 BR (2001), 22.
11 Statistics supplied in private correspondence with the SHGSE.
towards 'disintermediation', the withdrawal of funds from financial intermediaries (like banks), and an increase in direct lending to borrowers through debt and equity securities. Underlying economic conditions provided the basis for this shift. During the 1980s and 1990s the monetary and macroeconomic environments were mostly stable and, after several decades of growth, there was usually a huge base of savings present in the banking system ready to be mobilised. New theoretical orthodoxies encouraged governments to privatise state-owned assets and increase the efficiency of capital allocation by doing less. Private companies sought long-term financing and freedom from directed credit and government intervention. International conditions were also important: stock markets in Asia and elsewhere were nurtured by the world-wide liberalisation of portfolio capital flows after the breakdown of the Bretton Woods system in the early 1970s. Western institutional investors sought to profit from Asia's higher growth rates, especially in the early 1990s, as well as to diversify their risks. While Asia attracted US$600m in portfolio investment during 1977-82, it received US$12.4 billion during 1990-94.13 New technology helped too, facilitating capital flow between markets.

While the priority for any emerging economy's financial sector should be the construction of a competitive banking system, an efficient equity market runs a close second.14 A stock market is useful for a number of reasons.15 First, it can facilitate investment in industry. As the World Bank notes in the case of China, issuance of stock can provide investment resources to areas of the economy left under-financed by an inefficient banking sector.16 Second, as long as prices reflect supply and demand, a stock market can improve the efficiency with which capital is allocated.17 If issuers compete for capital, share prices should reflect the value, at least over the long-term, of their businesses. Moreover, as Nicholas Lardy notes, China's share market 'can increase competition...and stimulate

14 Blommestein (1994).
16 World Bank (1995a), V.
banks to allocate investment resources more efficiently.¹⁸ Third, as Anthony Neoh observes, the stock market can play a crucial role in managing private assets and providing pensions and other forms of long-term private asset management.¹⁹ And fourth, a stock market can provide an important vehicle for attracting foreign investment to a capital-hungry developing economy. However, some economists have reservations about the utility of a stock market, especially during the early stages of economic development. ‘When the capital development of a country becomes a by-product of the activities of a casino’, noted John Maynard Keynes, ‘the job is likely to be ill done’.²⁰ More recently Joseph Stiglitz has questioned the utility of stock markets because of the difficulties involved in creating the complex institutions that are required before they can be economically useful.²¹

As part of the move towards the market, the development of a stock market is an important step forward in the liberalisation of a ‘repressed’ financial sector. However, far from the state ‘withdrawing’, and reducing its administrative capacity and mechanisms of oversight, China’s new market has been accompanied by the construction of new bureaucracies, the creation of new administrative powers and the promulgation of hundreds, if not thousands, of new regulations. This, however, is hardly surprising.²² Even assuming a successful transition to a market economy, the opposite of a planned economy is not a ‘free’ market but a regulated one in which the state develops a new regulatory relationship with the economy.²³ Regulation is here understood as the supervision and control of the activities of private firms and individuals, usually by a public agency. The recent trend of deregulation is better understood as ‘re-regulation’, as governments across the world have withdrawn from the economy as owners and planners, and instead created rules and instituted arrangements with which to govern market-based transactions. As Giandomenico Majone notes, when plans give way to markets the state must change ‘from a producer of

²⁰ Quoted in Caporaso (1992), 111.
²² János Kornai noted bureaucracy’s tendency for ‘self-reproduction’ given the continued dominance of state ownership, Kornai (1990), 139-140. On administrative reform in 1990s China, Yang (2001b).
²³ Vogel (1996), 3-25.
goods and services to...an umpire whose function is to ensure that economic actors play by the agreed rules of the game'. In China’s case, Tony Saich notes that an increase in state capacity is actually a prerequisite for an effective market to function. The Chinese state has yet to reach the end point of Majone’s transition and to become solely an umpire, but it has made much progress. Many of the state’s basic institutions have helped underpin the transition. Looking west, to Eastern Europe and the former-Soviet Union, many have drawn the conclusion that the so-called, and much stylised, ‘big bang’ liberalisation (sudden and comprehensive price reforms combined with wholesale privatisation) failed because the ‘right institutions’ were lacking. Analysts contrast this experience with China, where an incremental reform process has been successful, if somewhat directionless and problematic, apparently because the institutions of political governance provided stability. Qian Yingyi and Xu Chenggang, for instance, argue that China’s ‘M-form’ structure of government (in which regional governments enjoy extensive powers) allowed it the flexibility to experiment with reforms, in contrast to the central ministry-dominated ‘O-form’ arrangement of the Soviet state, which doomed it to failure when it attempted reform. However, other areas of economic reform have suffered from serious institutional failure. Edward Steinfeld describes a situation in which renegade bureaucracies do not respect ownership rights (even in the rare instance that they are clearly delineated), courts do not enforce laws, profit incentives at SOEs are opaque and regulatory authority is blurred between competitive and inefficient state agencies. Commercial banks do not lend on the basis of rational credit assessment but because of administrative interference and bribes. The state has failed to provide a key public good, reliable institutions, and ‘Chinese financial markets are in chaos today’, Steinfeld asserts, as a result. X. L. Ding has shown that effective constraints on bureaucrats are lacking, resulting in the large-scale stripping of state assets. The continued dominance of the Party undermines another aspect of the necessary institutional infrastructure: the

25 Saich (2001a), 2-5.
26 Miller (1996); Pozananski (1992); Lipton (1990); Bruno (1988).
28 Steinfeld (1998), 38, 39, 57, 70.
courts. Guo Sujian argues that there is no 'rule of law' in reform China, but, instead, Party officials use the law instrumentally, bending it around their own policy decisions and ensuring that they themselves are unconstrained by its demands.30

Capital markets are especially reliant on credible institutions because of their need to co-ordinate actors across space and time. Because of the time lag between investment and return, the information asymmetries inherent in financial transactions, and the manifold opportunities these provide for cheating, it is generally accepted that there must exist credible and enforceable rules that allow investors confidence enough to extend financing to firms in the hope of future returns and redress in the event of fraud. Rules must limit the ability of powerful political actors to expropriate wealth from the market. The quality of securities regulations and statutory law, and the powers of the agencies mandated to develop, administer and enforce them, will inevitably determine whether financial resources are efficiently allocated, how much transaction costs cost and to what extent administrative power will interfere with forces of supply and demand.31 The style and efficacy of institutions will also determine to what extent investors are protected, and therefore if and how they choose to participate. Without such institutions in place, Douglass North argues, capital markets will not develop.32 This point, which echoes Stiglitz's concern, is important: if information asymmetries are not corrected, if constraints on price manipulation are not in place, and if the forces of supply and demand are not allowed to determine prices, then the utility, and size, of a stock market will be limited. China's equity institutions matter because they will determine the success or failure of the market they govern.33

30 Guo (1999b), 84.
By 2000, extensive and impressive institutional development had occurred in China’s equity market. On the organisational front, regulatory organs at both the local and central levels of government had been established. The China Securities Regulatory Commission (Zhongguo Zhengquan Jiandu Guanli Weiyuanhui, hereafter CSRC), the national regulator, enjoyed wide-ranging administrative, executive and judicial powers. The sector was governed by statutory legislation passed by the National People’s Congress (Quanguo Renmin Daibiao Dahui, hereafter the NPC) in 1998, and a large body of administrative rules and regulations issued by the State Council, its member bureaux and local governments. Standard and increasingly detailed procedures for a wide range of activities, from corporate disclosure to issuance applications to M&A, had been promulgated and have been increasingly implemented. However, there is also substantial evidence to suggest that China’s equity institutions are not as reliable as they could be. Witness, for example, the large number of scandals involving price manipulation by large individual investors (zhuangjia), SOE and investment fund managers, and the many grossly fraudulent initial public offerings (IPOs) that took place during the 1990s. Weak institutions, understood as rules that are weakly implemented, enabled powerful actors, whether they be well-capitalised speculators or members of the state itself, to expropriate wealth from the market. Although there has been a rise in administrative punishments in recent years, relatively few abuses have been investigated; as of year end 2000 only two securities crimes had been brought to the criminal courts and the civil courts did not offer private investors redress. There is a large gap between formal institutions and actual practice, a gap that has caused deep-seated, popular cynicism about the market. This is perhaps best summed up in the Chinese phrase ‘bu guifan’ (not well-ordered or rule-abiding), an all-too-common idiom used by everyone from Premier Zhu Rongji to the millions of Chinese individual investors to describe their stock market. Others, including the economist Wu Jinglian, have echoed Keynes and simply compared

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34 When not referring to the Shanghai and Shenzhen leaderships, the terms ‘local government’ and ‘local leaders’ refers to provincial government, unless otherwise stated, rather than to sub-provincial levels of government. ‘Bureau’ refers to government units and ‘department’ refers to Party organs, Huang (1996), 28, fn. 3. The CSRC is also referred to by the term bureau, although the regulator is not formally a government organ.

35 Green (2000a); EIU (2000c).

36 Cai (1999), 141
the market to a casino, making the point that at least in a casino the rules are enforced.37

*Equity institutions in China and the West*

Best practice securities regulation is based around three objectives.38 First, investor protection. This necessitates full disclosure by market participants, the licensing of qualified institutional investors, and a comprehensive system of inspection and enforcement. Second, fairness and efficiency, requirements that translate into the need for equal access to information, fair treatment of orders and transparency in the pricing and volume of trading. Third, best practice also aims to reduce systemic risk. Regulatory agencies should isolate individual firm failures and minimise risks that threaten to cause instability in the wider financial system. These broad objectives translate into a diverse set of detailed standards and rules which impact on regulatory practice in each part of the market, as Figure 1 illustrates.

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37 Wu (2001), 1-23.
38 IOSCO (1999).
Figure 1. Securities regulation: a summary of best practice

<table>
<thead>
<tr>
<th>Area of activity</th>
<th>Best practice regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Listed firms</td>
<td>Full, accurate and timely disclosure of all information material to investors' decisions. High quality accounting and auditing standards. Independent checks to ensure that disclosures are accurate and full. Fair treatment of all investors.</td>
</tr>
<tr>
<td>Market intermediaries</td>
<td>Good standards of internal organisation and operational conduct, as well as the proper management of risk. Consistently applied minimum standard of entry, with on-going capital and other prudential requirements. Procedures to deal with the failure of a firm to minimise loss to investors and systemic risk. High quality accounting and auditing standards. Independent checks to ensure that disclosures are accurate and full.</td>
</tr>
<tr>
<td>Regulatory agency</td>
<td>Operationally independent and accountable. Clear and consistent regulatory process. Promotes transparency of trading and can detect and deter manipulation and other unfair trading practices. Comprehensive inspection, investigation, and surveillance powers. Power to enforce the law through administrative sanctions and through the civil and criminal courts. Fair and expeditious process for discipline and complaint resolution.</td>
</tr>
<tr>
<td>Advisors</td>
<td>Licensing regime for investment advisers with minimum standards of entry.</td>
</tr>
</tbody>
</table>

Adapted from (IOSCO 1999).

Such rules rely on organisations, whether they be government bureaux, independent regulatory agencies or industry associations, to develop, refine and enforce them. In each jurisdiction, the powers and responsibilities enjoyed by these agencies, as well as their relations with government (the executive, legislature and judiciary), FIIs and self-regulatory organisations (SROs) will vary. The term ‘equity institutions’ is used to refer to this arrangement of organisations, their responsibilities and powers. The difference between equity rules and equity institutions is broadly similar to the distinction Davies and North make between an institutional environment, ‘a set of fundamental political, social and legal ground rules’, and an institutional arrangement, ‘an arrangement between economic [or political] units that govern the ways in which these units

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can co-operate and/or compete.\textsuperscript{40} Equity institutions can vary a great deal and their arrangement will influence the style and effect of regulation. They influence the ability of business to 'capture' regulation, i.e. to orient it to serve their interests, as well as the susceptibility of regulatory organs to interference from political actors. Equity institutions also affect the costs, flexibility and efficacy of regulation, the frequency and severity of investigation and punishments, as well as the regulator's own legal responsibilities and liabilities.

Equity institutions vary widely from one jurisdiction to another. In the United States, stock market regulation has been organised since the 1930s around the twin structures of the Securities and Exchange Commission (SEC), an independent federal agency entrusted with legislative, executive and judicial powers, and independent SROs like the New York Stock Exchange (NYSE). While the SEC is answerable to Congress, it is insulated from political interference in its policy development and day-to-day administration by rules governing the appointment of its commissioners and other safeguards. At the same time, this arrangement allows autonomy for the SROs to operate independently as profit-making businesses. In the United Kingdom, in contrast, between 1986 and the late 1990s equity regulation was governed by the Securities and Investment Board (SIB) system, an association of industry participants, which oversaw other SROs like the London Stock Exchange and its member companies.\textsuperscript{41} These SROs wrote their own rules, modelled on a rulebook issued by the SIB, and implemented regulation under SIB supervision.\textsuperscript{42} The board was overseen by a government ministry, the Department of Trade and Industry, and was answerable to parliament. In comparison with the American arrangement, SRO-led regulation allows for greater flexibility in regulation and enforcement, greater expertise to be applied, and it is also cheaper to operate. However, the arrangement had at least one serious flaw: it failed to protect investors. The SIB was widely believed to be insufficiently active in enforcing regulation, a weakness that led to accusations of

\textsuperscript{40} Davis and North (1971), 6-7. It is also similar to what Steven Vogel calls 'the regulatory regime', Vogel (1996), 20.
\textsuperscript{41} Goodhart and Schoenmaker (1998), 520-524; McDonald (1998), 506-511; Baldwin (1999), 63-64.
\textsuperscript{42} McElwee (2000), 15.
regulatory capture by business. A second problem was that as global financial markets integrated in the 1990s, the large number of sector-specific SROs, including the SIB, remained uncoordinated. FIIs were confused by the different rules required by different SROs and bad practice flourished in the gaps in-between the different regimes. In contrast, the independent agency approach tends to provide tougher enforcement practices and to be less vulnerable to capture by business interests. Both arrangements, however, ensure that the regulator is independent of government. A third arrangement is one in which regulation is designed and implemented by a government bureau, most often the central bank or ministry of finance, as in France and Japan. One advantage of such an approach, especially in a developing country context, is that equity policy can be more easily dovetailed with macro-economic and industrial policy. However, this arrangement does tend also to create conflicts of interest and facilitates political interference in the execution of regulation. Of course, such simple caricatures of equity institutions inevitably gloss many of the important details of such arrangements in different countries, as well as their development over time. However, this short summary provides an indication of their importance and how they might affect a market's development.

How to organise equity institutions is one of the most important issues facing policy makers overseeing a programme of stock market development. What particular arrangement will balance the requirements of development, stability, transparency and fairness? Which parts of the government bureaucracy, if any, should be involved? To what degree should equity institutions be centralised or managed by local government? How much should executive organs lead and how much should others, market participants, the legislature, the courts and private associations, be enfranchised in the rule-making and supervision processes? These are the questions that have faced senior reformers developing stock market regulation in China during the late 1980s and 1990s. Their responses have changed over time. During 1984-92, policy- and regulation-making powers were concentrated in the hands of local government and the

People's Bank of China (Zhongguo Renmin Yinhang, hereafter PBoC). China's two stock exchanges were established in late 1990 as de jure SROs, but were actively overseen by the Shanghai and Shenzhen municipal governments. Central government had a minimal role. In October 1992, however, after the rioting in Shenzhen, the central government re-organised the institutions of the sector. The State Council Securities Committee (Guowuyuan Zhengquan Weiyuanhui, hereafter SCSC), a senior meeting system, assumed formal policy-making powers and the CSRC was established as its administrative agency. However, at the same time, local leaders established securities commissions and administrative offices that allowed them to retain significant influence over the listing process and enforcement of secondary market regulation. Authority was awkwardly distributed between central and local leaders and between different central government bureaux. As a result, management of the sector became fragmented and disputed. Many of the rules formulated by central government were manipulated, undermined or simply ignored by local officials. A mild reorganisation of institutions occurred in 1995, after a Treasury bond futures scandal in February of that year. However, it was only during 1997-98 that a second major round of institutional change took place. Powers were then centralised in the CSRC and the SCSC was dispersed. By 2000, the CSRC had gained a bureaucratic rank equivalent to a ministry, its own local offices and wide-ranging policy-making powers. The influence of local government leaders, the PBoC and the stock exchanges themselves over both policy and regulatory development was radically reduced. The Securities Law consolidated this new institutional framework and elevated it to the level of statutory law. Thus in the third phase of institutional development during 1997-2000, fragmented and disputed equity institutions were clarified, consolidated and formalised. Long standing disputes were resolved, local leaders were sidelined, effective mechanisms for the monitoring of local bureaux by central government were introduced and a highly centralised system of regulation was created.

**Explaining institutional change**

Why did institutional development occur in such a way? Theories of regulation provide a number of possible explanations. From a traditional 'public interest'
perspective, governments are understood to regulate markets in order to prevent market failures, e.g. natural monopolies, negative externalities, and information asymmetries et al. Regulation is a public good that government provides and develops without gain to itself.\textsuperscript{45} This is the underlying assumption of official rhetoric in reform China, as it is in Western markets. The Securities Law claims, for instance, to ‘protect investors’ legitimate rights and interests [and] to safeguard economic order and the public interests of the society...’ (Art. 1). From such a perspective, changes to institutions of regulation can only be explained by market development, organisational learning, technological change and faulty regulation being revealed to be a mistake. Lacking experience in financial markets in the initial stages of development, it is likely that these factors have some explanatory utility for the changes witnessed in China’s equity institutions. However, they can not explain why such radical institutional change took place over such a short period of time. Nor do they provide a convincing account of agency: they do not identify which actors sponsored (and which actors resisted) institutional development. Nor, of course, do they explain why bureaucrats would be interested in providing regulation in the public interest in the first place.

An alternative approach to regulatory development is provided by neo-institutional and Chicago school accounts.\textsuperscript{46} In general, these accounts argue that private actors, responding to incentives embodied in changing relative prices or other factors that shift their preferences (new economies of scale, externalities, risks or costs involved in running the current institutions), seek changes to rules which they believe will profit them (or protect them from loss).\textsuperscript{47} Property rights law is seen to have evolved in response to the demands of private firms operating in increasingly complex and specialised societies where owners were not managers, capital needed to be accumulated and vast chains of transactions required co-ordination.\textsuperscript{48} The economic theory of regulation (ETR) developed by George Stigler and Samuel Peltzman and influenced by the Chicago School and

\textsuperscript{46} Horn (1995), 37.
\textsuperscript{47} Davis (1971), 10, 59; North (1990), 83.
\textsuperscript{48} North and Weingast (1996), 134-139. Libecap (1996), 58.
Mancur Olson, takes this interest-based approach one step further. Making the assumption that all actors, including those within regulated firms and government agencies, are rational and profit seeking, the ETR argues that private firms themselves demand regulation. The coercive power of the state (regulation) is a useful commodity for private business to purchase since it can be used to raise the costs of market entry for potential competitors and to set rates above cost, allowing rents to be shared among incumbents. Firms seek these benefits and politicians in government respond, providing and developing regulation in exchange for money and votes. Other competitors for the benefits of regulation, such as consumers, are disadvantaged by their collective action problems. The ETR has been deployed to explain regulatory change in the securities sector in the United States. For example, the SEC’s development of extensive disclosure requirements has been viewed as benefiting accountants, lawyers and underwriters, while only confusing small investors. The SEC also stands accused of defending fixed commissions during the 1960-70s, thus favouring securities companies over small investors, until Congress and the Justice Department forced it to liberalise rates in 1975. But the ETR has, of course, been criticised for its rigid assumptions about the interests of the bureaucrats and politicians involved in regulatory change, its often false equation of the winners of regulatory policy with its advocates, and its apparent inability to explain the rise of environmental regulation (where apparently insurmountable collective action problems were overcome) and the recent wave of de-regulation.

Other explanations of regulatory change have taken into account competing interest groups, the heterogeneous incentives facing public officials in different parts of the state, and the role of ideas. Steven Vogel, for instance, offers an account based on government ‘orientation’ (the ideas of the political elite) and the structural relationship between the executive and bureaucracy. Despite these drawbacks, however, neo-institutional theories and ETR offer some useful

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49 The ETR was based on the theory of ‘regulatory capture’, in which business interests gained influence over regulatory agencies originally established in the public interest, Bernstein (1955); Kolko (1963); Levine and Forrence (1990), 178; Olson (1965); Peltzman (1976); Stigler (1971).
50 Stigler (1971), 3-4.
52 On ‘regulatory capture’ at the SEC, Woodward (2000).
54 Noll and Owen (1983).
explanatory tools for use in the Chinese case. The key insights of neo-institutionalism are that economic incentives are the ultimate source of institutional change and that self-interested actors are the first movers in effecting that change. For its part, ETR reveals the strategic nature of regulation and how it can be oriented towards delivering economic goods to powerful actors. These insights will prove useful in understanding institutional development in reform China.

Research question, design and problems

Asking how regulatory institutions develop in reform China is a significant research question for at least four reasons. First, it helps us assess the sustainability of China's gradualist approach to economic reform. Economic growth may have been sustained throughout the reform period, but if underlying market institutions are not effectively built, future growth will be undermined. In particular, if equity institutions are not properly constructed, then the benefits that the stock market offers the wider economy will be constrained. Second, the thesis focuses attention on the issue of state capacity in China. Extensive research, reviewed below, has shown the detrimental effects of a weak central government unable to implement its policies. While this thesis reveals extensive implementation bias (where policies are mis-implemented) and autonomous institution building by local leaders, often with disastrous consequences, it also shows how the central government is, through careful sector-specific institution-building, ultimately able to control economic development. The fact that the Chinese state appeared significantly better co-ordinated in 2000 in the equity sector than at any time since 1986 is enormously significant for our understanding of how the Chinese state is evolving. Third, the research question prompts an examination of how the contemporary Chinese state operates as a whole. While particular attention has been paid in other research to the dynamics of the Centre-Local relationship, the thesis, while focusing considerable attention on this also attempts to explain and evaluate the roles played by other parts of the state, including the resurgent legislature, the members of the executive and the Party in institutional reform. Which organs of the state dominate regulatory development? And how has economic reform affected the ways in which the
different parts of the state operate and are co-ordinated? Fourth, the thesis employs and develops theories of financial regulation that have been used to explain regulatory practice in developed Western markets. Few other studies have applied such theories to reform China and an explicit comparison between the different reasons for why regulation takes place and what it achieves should provide insights into the evolving relationship between the state and the market in China.

Stock market institutions first appeared in the late 1980s, but were rudimentary, fragile, highly localised, and implemented on a largely *ad hoc* basis by local government leaders, with minimal central government involvement. The end point of institutional development in the equity sector, at least in 2000, was a highly centralised, sector-specific government regulator equipped with extensive mechanisms of monitoring and control over its local offices, and closely overseen by the central government and Party leadership. The development of this institutional arrangement is what this thesis seeks to explain. I adopted a single case study and a historical institutional framework. The complexity of stock market development, even within the short span of sixteen years, and the wide range of institutions that have been created, meant that a single case study approach was well suited to the task. It allowed the opportunity for detailed research to be done, allowing the thesis to make a meaningful contribution to knowledge in this one important area of China’s political and economic development. In particular, the thesis intends to make considerable contributions to empirical knowledge about local leaders’ sponsorship of equity markets, (including the Securities Trading Centres, an almost entirely undocumented phenomenon), the drafting process involved in creating the Securities Law, the style of post-1997 equity regulation and changes in state capacity during the 1990s. Given abundant resources, an in-depth comparative study of institutional development in the securities, banking and insurance systems would have been profitable, although chapter twelve does attempt to draw some general conclusions about wider institutional development in China over the past decade. However, the single case study retains its comparative nature because it allows

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for hypotheses and models developed elsewhere to be applied to a new area of research.

A rational ‘framework’ rather than ‘theory’ is employed. Principals, sub-principals and agents, operating within a simplified three-level version of the state, are identified, as are their interests vis-à-vis equity market development. The thesis also identifies and explores the principal’s information and compliance problems and the strategies they use to resolve these problems (as well as the counter-strategies deployed by sub-principals and agents to protect their own autonomy and divergent interests). However, some of the problematic behavioural assumptions of neo-classical theories are avoided. This is partially because of the arduous data demands of game theoretic models and the severe constraints on all types of data and limited access to interviewees that still characterises research in China. The project had to cope with a wide variety of data constraints: information on the policy process at the senior level, as well as on Party and factional activities within China’s financial policy-making community, and in the localities, was generally unavailable. Moreover, empirically identifying the preferences (interests) of bureaucrats is impossible, a common problem for political scientists studying China. Bureaucrats in other countries are known to be keen to maximise their autonomy, to enhance the security of their employment, to render clientilistic favours, to shirk, to aggrandise budgets and/or revenues or simply try to get rich. However, the interests of bureaucrats (as individuals and as groups) and their strategies to attain them, are extremely complex and vary considerably across time and functions, as Patrick Dunleavy, among others, has shown. Some bureaucrats have even been known to act in the public interest, simply implementing policies that they believe are in the public interest. In the thesis, bureaucrats are assumed to be rational and to seek, for the most part, to maximise their personal career security and the revenues that accrue to their bureau or level of government.

59 Huang (1990b), 440.
60 Dunleavy (1991); Przeworski (1997), 420.
These assumptions were supported by the results of much of the empirical research. However, some bureaucrats involved in the sector did appear to also have a keen sense of the ‘public interest’ and to take this into account when determining policy. Thus this preference is not ruled out as an explanatory factor at certain times. A third reason for choosing a historical-institutionalist framework rather than a game theoretic one was that the institutional environment changed rapidly throughout the period under examination. The ideological legitimacy of the stock market, its importance to senior policy makers as a source of funds, the role of the NPC in the policy-making process, the influence of the Shanghai and Shenzhen administrations and other localities, and elite politics within the central government, all changed significantly during 1984-2000. The thesis is therefore essentially qualitative in its approach, using quantitative data wherever possible. While the limitations to the research identified above place constraints on the arguments presented, they do not undermine its central observations and argument. These issues are further discussed in chapter twelve.

The main research was carried out in Shanghai, Beijing, Shenzhen and Hong Kong, during ten months of fieldwork between November 1999 and October 2000 and June 2001. A variety of text-based sources, both primary and secondary, were used, including media, notably the Shanghai Securities News (Shanghai Zhengquanbao), the China Securities News (Zhongguo Zhengquanbao), the South China Morning Post and numerous Chinese academic journals. A number of secondary texts in Chinese also proved helpful.61 Only a small number of internal stock exchange, CSRC and NPC documents were available for consultation. One important source of primary evidence was interviewees. I carried out around 60 confidential interviews with members of the Shanghai and Shenzhen stock exchanges, the CSRC and various financial institutions. A list of interviewee positions, institutional affiliations and dates is provided in Appendix A. Interviews were usually arranged in one of two ways. The first, less successful approach, involved me identifying targets from press and secondary sources and then approaching them directly using a letter, fax or

61 For example, Hu (1999a); Zhang (1998); Jin (1999); Dong (1997); Li (1998b); Cao (2000); Huang (1999d); Hong (2000).
email. More often than not these requests were turned down or simply ignored. A second route involved relying on a small number of contacts in senior positions to arrange interviews on my behalf. I provided a short list of issues (e.g. CSRC/stock exchange relations), about I was interested in finding out more and the contact then sought to arrange an interview with a colleague and/or friend with knowledge or personal experience of this area. About half of my requests were met. Interviews were then conducted in English and Chinese with guarantees of anonymity. They usually lasted about one hour, took place in private and were not recorded. I would usually prepare a list of questions about the issue about which most of the interview would be structured. However, I also asked more open-ended questions which often led to other topics of conversation, e.g. what other positions have you worked in?

Most interviews involved detailing policies and events already known about in broad outline. Many of them were extremely useful in providing the details of organisational structures, how policies were implemented, and what problems were involved. On a small number of occasions, I was aware that I was being given the official line and nothing more. However, many of the interviewees, especially those to whom I was introduced by a senior contact, were willing to talk openly about what 'really' happened. Three factors seemed important in this: guarantees of confidentiality, my ability to show that I already knew more than the official line, and the fact that I was introduced by a colleague/friend. A number of interviews also expressed admiration for the research project and the general importance of academic work. Since systematic interviews were impossible to organise it was difficult to cross check information provided by the interviewees. However, whenever an opportunity did arise I did attempt to do so and on a handful of occasions was able to organise a second interview to check information and pursue other lines of enquiry.

Literature in English on the Chinese stock market can be divided into four main categories. First, a broad but limited body of work provides accounts of market development. Some mention is made of competition between bureaucratic

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organs, and the state's tendency to ‘intervene’ in the sector but no extended analysis of such phenomenon is offered. Of the best studies available, Carl Walter focuses on the market from an investor’s perspective and is reliant on English language sources. Mei Xia, the World Bank and Ellen Hertz all provide in-depth examinations of market institutions but only at fixed points in time, all before 1996. None provides an account of the dynamic nature of institutional change over time. Another literature has examined the process of gufenhua (‘stockification’) by SOEs and the shareholding system in China in the context of industrial reform. Emphasis is placed here on the process of enterprise restructuring and the utility of share issuance in improving firm governance. A third body of work provides accounts of the sector’s regulatory development from a legal perspective. Emphasis is placed on explaining the formal rules: actual practice, as well as the process of rule-creation, is not explored. A fourth set of writings, more technical in orientation, tests financial theories with reference to the Chinese stock market. None of these studies has focused attention on how the state has developed policies, regulation and institutions for its equity market, nor examined the variety of state organs involved or the intense conflicts that took place between them.

A preview of the argument

Imagine the Chinese state as a three-layer hierarchy of principals and agents. An agency relationship arises when a principal delegates some rights to an agent who is bound by a contract to represent the principal’s interests in return for a payment of some kind. At the top of the Chinese state, a small band of policymakers occupying senior positions in the party and government, the zhongyang, are assumed to be the ultimate principals of equity regulation. They set the

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64 Yao (1998); Cohen (1997); Leung (1993); Nicoll (1998); Cai (1999); Tokley and Ravn (1998); Chun (1998).
65 Lee (1997); Wong (1998); Xu (2000).
67 The zhongyang (literally, ‘the Centre’) denotes the senior leadership, made up of members of the Central Committee (who also occupy other senior Party and government posts). It is used in distinction to the terms central government, which refers solely to executive government organs and officials ‘the centre’, which refers to central government and leadership generally in contrast to the local level, On Party and government structures in China, Saich (2001b), 80-140.
broad parameters for market development, define major policies and ensure that equity development supports their wider political and economic goals. For these *zhongyang* leaders, equity institutions should ideally guarantee financial, as well as social, stability and provide support for industrial policy. To implement these aims, they rely upon two sets of agents: leaders of central government bureau and local government. These agents implement policy, collect information, and develop detailed policy. However, they also operate as ‘sub-principals’, assisting the principals in monitoring and controlling the third-level actors, local *ju*-level bureau leaders, those that implement policy and regulate the market on a day-to-day basis.

As in any complex organisation, senior leaders must solve the principal-agent problems of limited information, bounded rationality and opportunism. They can only do this through creating effective institutions: a governance structure that ensures that they have sufficient knowledge about their sub-principals’ and agents’ behaviour, that both have sufficient incentives to act loyally and that mechanisms to discourage defection also exist. During the 1990s, *zhongyang* leaders experienced two problems in building such institutions. First, local leaders ‘captured’ key equity institutions. ‘Institutional capture’ occurs when a group of sub-principals gains *de facto* control of regulation and policy-making powers through their administrative control of a *ju*-level bureau.68 Without effective oversight from above, this enables them to orient the development of institutions to support their own interests. The problem in the equity sector was that local leaders did not share the interests of their *zhongyang* principals and had the capacity to defect, often spectacularly. During 1990-97, local leaders used their capture of equity institutions to maximise local tax revenues and investment funds as well as to minimise regulation. Their strategy resulted in fast market development and regular financial instability. The arrangement of institutions local leaders established was stable and highly resistant to attempts by central bureaux leaders to monitor, intervene or punish defection. However, poor Centre-Local co-ordination has not been the only challenge facing the *zhongyang*. A second set of problems have confronted them at the central

---

68 Unlike regulatory capture, which describes the actions of private actors vis-à-vis public agencies, institutional capture describes public actors vis-à-vis state institutions.
government level where bureau leaders competed to institutionalise their own influence over the equity sector in support of their own organisational goals. This obstructed the rise of the CSRC. The resulting lack of clarity within central government meant that local leaders enjoyed autonomy from effective supervision.

Given the apparent resistance of the Chinese policy-making process to sudden and radical change, and what we know of institutions in general, major institutional change should not have occurred. However, it did: twice in the space of five years. What explains this? Institutional change required two things to change in the incentive structure of the zhongyang leadership. First, growth in the stock market, which heightened zhongyang leaders' interest in it. Once the market was large enough to be credibly integrated into its industrial reform policies equity institutions mattered. However, this was not sufficient to prompt institutional change. For this crisis, a sudden and acute threat to the continued viability of the market, and the state that backed it, (or at least the credible threat of crisis), was required. Low-level defection of local agents, listing poor-quality firms for example, was tolerated since it had only a marginal impact on zhongyang leaders' core interests and was largely hidden from both the public (and central government) gaze. However, as soon as defection became spectacular and destabilising, zhongyang leaders took an interest. It alerted them to problems in institutions and raised the incentives for re-organising them, which they did in 1997-98. The post-1997 settlement, in which the CSRC gained institutional capture, is labelled 'market socialist regulation'. Market socialist regulation is an arrangement of institutions centred on a government bureau with highly centralised powers, minimal oversight by organs outside the executive and the Party, and no participation by industry groups or SROs. By empowering one sub-principal (a central government bureau) over another (local government) the senior leadership had by 2000 largely succeeded in its search for an institutional arrangement that supported its core interests. However, the post-1997 institutions still did not deliver best practice securities regulation because of its political mandate to support industrial reform. Looking to the future, the

69 North (1990), 6; Garrett and Lange (1996), 54-70.
70 Lampton (1987b), 171.
thesis argues, institutional change will continue to be dominated by public actors but market socialist regulation will be increasingly constrained by the state’s need to attract private investors into equities as it accelerates its sale of assets to fund its huge liabilities.

**Chapter plan**

**Chapter two** introduces the main actors. It identifies the important characteristics and interests of investors (both institutional and individual) and government actors (the senior leadership, central government leaders, local leaders, and local bureaux leaders) and explains which actors are significant in terms of designing and implementing institutional development. It also examines the structure of the Chinese state and the permanent state institutions which serve to co-ordinate actors across its different organs. Chapters three to ten each take a separate piece of the institutional framework and examine its development across time. This structure allows a detailed focus on the development of important institutions over time, although the lack of chronological progression may, at first, be slightly disorienting.

Part II is concerned with institutional development at the local level. It shows how local leaders achieved institutional capture, how this delivered important economic goods and how, after 1997, it was replaced by central capture. **Chapter three** examines the sector’s early developments. During 1986-90 non-state actors at both the local and central levels took the lead in designing and lobbying for the institutionalisation of new, informal share markets. As the advantages of stock market growth became evident, local political leaders moved to formalise their operations in the form of stock exchanges. Non-government sponsors of more market-oriented institutions were sidelined as these local leaders gained control of the new institutions and nurtured market development. **Chapter four** shows how local leaders captured the issuance process until 1997. During the early 1990s, provincial-level leaders throughout China established securities management commissions (*Zhengquan Guanli Weiyuanhui*, hereafter SMCs), senior meeting systems, and securities administration offices (*Zhengquan Guanli Bangongshi* (*Zhengguanban*), hereafter SAOs), *ju*-level
bureau under their administrative control. These allowed the IPO process to be systematically exploited to support the financing of local SOEs, many of poor quality. Chapter five reveals the Centre-Local split in equity institutions at its most extreme. It shows how a network of ju-level bureaux in Shanghai and Shenzhen were used by the local leaderships to implement an aggressive and highly effective development program for the secondary market during 1995-97. The crisis triggered by this ‘equity developmentalism’ prompted the zhongyang leadership to organise the take-over of local institutions. Chapter six shows how the Shanghai and Shenzhen stock exchanges, initially established as SROs under the management of local leaders, were also oriented to developmental goals during 1993-97 and effectively resisted oversight by central government bureaux. The chapter also shows how by 1998 the exchanges had lost their SRO status and had been brought under the direct administration of the CSRC. Local capture of equity institutions was not solely limited to Shanghai and Shenzhen. Chapter seven shows how local leaders built securities trading centres (STCs), quasi-stock exchanges, in direct contravention of State Council policy and used them to raise revenues and channel funds towards their favoured investment projects.

Part III examines the development of equity institutions within the central government and the problems zhongyang leaders experienced in co-ordinating the central bureaux, an equally serious problem for them as preventing defection by local leaders. The CSRC’s organisational rise from an administrative office to a ministry-ranking organ is recounted in chapter eight. The regulator was effectively prevented from fulfilling its policy and regulatory mandates before 1997 by both local and central bureaux leaders. However, once the zhongyang leadership had become fully recognisant of the benefits (and threats) that the developing market entailed, and were forged into action by crisis, they determined that concentrating powers within a single sub-principal, the CSRC, was the best means to ensure that their interests were protected. Chapter nine shows how zhongyang leaders attempted to co-ordinate central bureaux, provide policy direction for stock market development and constrain local leaders’ developmental urges during 1993-97 through the SCSC. However, the commission operated as a veto-point for key regulatory improvements, undermined the CSRC and failed to curb defection by local sub-principals. In
terms of China's Constitution, the most authoritative institution maker in the polity is the legislature, the NPC. **Chapter ten** examines how NPC members influenced the development of equity institutions through the drafting the Securities Law during 1992-98. It shows how a two-track policy process opened up as NPC drafters attempted to undermine institutional capture of the market by introducing market mechanisms into the draft, in opposition to State Council policy. Although most of its more radical proposals were rejected, the NPC did succeed in implementing important constraints on the activities of executive organs and can be seen to have played a valuable role in the institutions building process.

Part IV evaluates the post-1997 'end-point' of institutional development and presents the conclusions of the thesis. **Chapter eleven** examines the post-1997 institutional settlement in detail, and provides a comparison of China's equity institutions with those of the United States. The chapter also examines the consequences of this institutional arrangement on enforcement policy, arguing that since market socialist regulation is primarily interested in supporting SOE reform policy, it fails to provide protection to investors, transparency and fairness. **Chapter twelve** presents the conclusions of the thesis and explores the implications of these conclusions for other areas of research on reform China. First, it argues that the senior leadership can improve state capacity through a broad portfolio of sector-specific institutions, including, most importantly, nomenclatura. Second, it explains why, contrary to the implications of neo-institutional theory, China's stock market has grown without adequate market institutions. Third, it identifies the three major policy issues that now dominate the zhongyang's agenda and considers how they will impact upon the future institutional development of the stock market.
Investors, bureaucrats and the institutions of the Chinese state

Develop and perfect securities markets with Chinese characteristics

Inscription at the SHGSE, General Secretary Jiang Zemin, 1992

The government exercises unified and overall management of the stock market without directly or excessively intervening in its operations.

Xinhua, 1993

In this chapter, the actors who are able to influence the development of China’s equity institutions are identified. Two types of market actors, institutional and individual investors, are considered, as well as four groups of bureaucratic actors: China’s senior political leadership (the zhongyang), leaders of bu-level bureaux (ministries and commissions), local (provincial-level) leaders and local ju-level bureau leaders, the actors who directly oversee the implementation of policy and regulation. The interests of each of these actors are considered, and the question of how such interests impact on their institution-building activities is addressed. The next step is to identify the principals and agents among these actors and consider the state institutions which, like the nomenklatura system are generally not subject to change, that govern relations between them. Care is taken to distinguish between the stable institutions of the Chinese state and those institutions, the subject of the thesis, that are specific to the equity sector.

Stock market investors: institutions, individuals and interests

This section considers the interests of investors in China’s stock market, both individuals and financial institutional investors (FIIs), in institutional change, and assesses their ability to influence such change. It is argued that neither group is likely to be able to effect institutional change or effectively lobby for such change. However, because of the close links between FIIs and the state, public officials are at any rate likely to develop regulation that maximises the profits of FIIs.

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71 Xinhua (1993f).
72 Xinhua (1993b).
Institutional investors

In developed markets, FIIs are often powerful actors in fostering regulatory change. It was insistent lobbying by FIIs, for instance, which saw the dismantling of the 1933 Glass Steagall Act (which separated commercial and investment banking) in the United States in 1999. In China, however, because of the relative immaturity of the market, FIIs are small and underdeveloped. Their assets and profits are limited, their holding of Chinese equities is small, and their lobbying power is weak. China’s FIIs include securities companies, trust and investment companies (TICs), investment fund management firms and insurance funds. The former three groups can join the stock exchanges as members; the others trade through legal person accounts via brokerage facilities provided by the securities companies. Stock exchange FII membership during 1991-2000 is shown in Figure 2.

Figure 2. Institutional membership of the Shanghai and Shenzhen stock exchanges, 1991-2000

<table>
<thead>
<tr>
<th></th>
<th>SHGSE</th>
<th>SHZSE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>26</td>
<td>15</td>
</tr>
<tr>
<td>1992</td>
<td>101</td>
<td>177</td>
</tr>
<tr>
<td>1993</td>
<td>378</td>
<td>426</td>
</tr>
<tr>
<td>1994</td>
<td>569</td>
<td>496</td>
</tr>
<tr>
<td>1995</td>
<td>577</td>
<td>532</td>
</tr>
<tr>
<td>1996</td>
<td>547</td>
<td>542</td>
</tr>
<tr>
<td>1997</td>
<td>493</td>
<td>373</td>
</tr>
<tr>
<td>1998</td>
<td>317</td>
<td>329</td>
</tr>
<tr>
<td>1999</td>
<td>310</td>
<td>-</td>
</tr>
<tr>
<td>2000</td>
<td>305</td>
<td>326</td>
</tr>
</tbody>
</table>

Sources: SHGSE and SHZSE fact books and websites.

Most securities companies and TICs trade at both exchanges: the total number of such firms peaked at around 600 in 1995, the majority of them TICs, and subsequently declined to around 350. As of the end 2000, there were 96 dedicated securities companies, about 30 of which had registered capital of

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73 Economist (1999); FOMC (1999); Teweles (1998), 11.
74 Commercial banks have not, since the early 1990s, been allowed to engage in securities business. The ban was formalised in the Commercial Bank Law (1995, Art. 43) to prevent the movement of savings deposits into the share market. Bank managers have, however, found numerous routes to evade the ban, EIU (2001b).
75 An investor may legally open one 'share account' at a stock exchange, but may open multiple 'capital accounts' at securities companies' branches, Interview-46, Shenzhen, 2001.
Rmb500m or above, and could thus legally engage in underwriting and proprietary trading. The Securities Law ruled that companies without this capital could only broker shares. There are no publicly available figures on their holding of equity, although the amount is almost certainly less than 10% of TMC. China’s investment fund sector is also still small, having only been established in its modern form in 1998. By the end of 2000, China’s 34 closed-end investment funds had issued Rmb56.2 billion worth of units and held less than 4% of TMC.\(^7\) Contrast that with the United States where during the 1990s, around 50% of stock market capitalisation was held by institutional funds. Until 1999, insurance funds were not permitted to own shares; after this time, a select number were permitted to purchase small amounts of investment funds. Pension funds have not, as of the end of 2000, been allowed to buy equities. China’s SOEs have also been important players in the share market although statistics on their share holdings are also unavailable. They were banned from share investment during 1997-99 because of fears that they were speculating with public funds intended for industrial investment, though many continued to trade with the complicity of their brokers.\(^8\) According to official figures, individual investors at the SHGSE held Rmb367.3 billion worth of shares, 89% of TMC, while FIIs (excluding SOEs) held only Rmb43.9 billion, only 11% of market value, at the end of 1999.\(^9\)

Although their managements enjoy operational autonomy and are profit-oriented, the majority of China’s FIIs are shareholding companies, with state organs owning the majority of their equity. The government has significant administrative influence over their operations. Appointments to the senior management of all FIIs were subject to the approval of either the local or national branches of the PBoC or the CSRC throughout the 1990s. The PBoC itself appointed many management teams; now boards of directors do so, usually in negotiation with the CSRC. Most companies operate CCP committee systems which organise political work within the firms and the sector’s industry

\(^{76}\) Kumar (1997a).
\(^{77}\) CSRC (2001), 7.
\(^{78}\) Interview-46, Shenzhen, 2001.
\(^{79}\) COL (2000e).
grouping, the China Securities Industry Association (SIA), is run as a *de facto* subsidiary of the CSRC, its top management being appointed by the regulator.

In addition to FIIs, however, financial management companies, financial consultancies and successful individual investors have offered informal asset management services from the late 1990s onwards. These privately raised funds (*simu jijin*) were estimated to be worth some Rmb800-900 billion in mid-2001, some 45% of TMC, around ten times the amount managed by the FIIs. Securities companies also offer similar informal asset management services. Many SOEs use these intermediaries to disguise their speculative use of public funds. Most of this money is traded through individual share accounts, and is therefore indistinguishable from the funds of individual investors. These informal institutional investors (IIIs) were mostly unregistered and entirely unregulated up until the end of 2000. They are suspected of being the prime practitioners of insider dealing, using hundreds, sometimes thousands, of fake share accounts in order to manipulate prices. China's FIIs are relatively small, state-owned and partially integrated into the administrative structure of the state and Party. IIIs are privately owned, most are small in size (although as a group they are the dominant holders of equity), but because of their informal status and desire for secrecy are not active lobbyists of government.

What kind of regulation would such actors be interested in? In general, institutional investors in any market resist administrative interference and seek to maximise self-regulation, as well as financial supports, for their industry. They also tend to advocate minimal punishments, administrative and legal, for illegal activities. Given their superior access to financial resources and inside information, FIIs and IIIs can profit from the poor enforcement of rules and weak disclosure by listed companies more than individual investors. Engaging in price manipulation is especially easy in China because of the peculiar capital structure of listed firms. Throughout the 1990s, the state has retained ownership of the majority of the equity of all listed firms in the form of state and legal person shares, as Figure 3 shows.

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81 EIU (2001f); SZB (2001).
Figure 3. China's share categories

<table>
<thead>
<tr>
<th>Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual A-shares</td>
<td>Domestically listed shares, denominated in local currency, owned by individuals and legal persons. Foreign investors may not own these shares, which make up about one third of a typical listed company's equity.</td>
</tr>
<tr>
<td>Individual B-shares</td>
<td>Domestically listed shares of China-incorporated companies, denominated in US$ in Shanghai and HK$ in Shenzhen, owned by individuals and legal persons. Initially reserved for foreign investors, domestic institutions and individuals now account for most trading.</td>
</tr>
<tr>
<td>Legal person shares</td>
<td>About a third of every listed firm's equity is transferred to domestic institutions (stock companies, NBFIs, and SOEs with at least one non-state owner) and can not be traded on the stock market. During late 2000 an active auction market in legal person shares developed.</td>
</tr>
<tr>
<td>State shares</td>
<td>About a third of equity is transferred to the state (central and local government bureaux, as well as SOEs wholly owned by the state). The ultimate owner is the State Council but these shares are managed by bureaux of the State Asset Management Administration. State shares are not tradable.</td>
</tr>
<tr>
<td>H-shares</td>
<td>Shares of PRC registered companies listed in Hong Kong.</td>
</tr>
<tr>
<td>Red-chips</td>
<td>Shares of companies registered overseas and listed abroad (principally in Hong Kong), having substantial Mainland interests and controlled by affiliates or bureaux of the PRC government.</td>
</tr>
</tbody>
</table>

Figure 4. Capital structure of listed companies in 2000

<table>
<thead>
<tr>
<th>Share type</th>
<th>Proportion of total, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>State shares</td>
<td>37</td>
</tr>
<tr>
<td>Legal person shares</td>
<td>26</td>
</tr>
<tr>
<td>Other</td>
<td>2</td>
</tr>
<tr>
<td>A-shares</td>
<td>26</td>
</tr>
<tr>
<td>B-shares</td>
<td>5</td>
</tr>
<tr>
<td>H-shares</td>
<td>4</td>
</tr>
</tbody>
</table>

As Figure 4 shows, as of 2000 state shares made up 37% and legal person shares 26% of the total market capital structure. This equity is non-tradable. Tradable A-shares only made up 26%. The differentiation between share types was not eroded during the 1990s; instead the proportion of non-tradable shares actually increased. In 2001, 79 companies went public: 80% of their 117.95 billion shares were non-tradable. This small float and rigid share structure has implications for the trading practices of investors, as well as for corporate governance. China’s institutional investors can not gain ownership rights in the companies into which they buy. A M&A market can not develop since majority stakes are not tradable, all take-overs take place through administrative agreement, requiring local government and the CSRC approval. FIIs and IIIIs therefore have a limited interest in long-term investment: a trading strategy oriented to maximising income from short-term increases in the capital value of shares, rather than dividend income, results. The equity structure also damages corporate governance, which increase the incentives for short-term ownership. Dominant shareholders, mostly state bureaux and SOEs, have tended to treat listed firms as assets to be exploited: IPOs and rights revenues are ‘loaned’ to parent and subsidiary companies and not repaid (a form of asset stripping), minority shareholders rights are ignored, few dividends are paid, and administrative interference in firms’ management is extensive. The huge extent of rights issues is another indication of the extent to which small shareholders’ interests are ignored. Given this environment, which advantages short term investment, FIIs and IIIIs will be interested in regulation that facilitates profitable short-term investment or, in other words, regulation which allows for frequent and rapid increases in share prices and manipulation.

In most developed Western markets, because of their extensive resources and small number, FIIs tend to enjoy considerable influence over the development of regulation. Indeed, from an ETR perspective, we would expect them to capture control of the regulatory agency. The lack of any clear public-private divide, however, ensures that the ETR is not suitable for explaining institutional

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82 Only these shares are included in the TMC measure, CSRC (2001), 138.  
83 Wu (2002).  
84 Wei (1998); Jiang (1999b); Chen (2000); (1999); Green (2000d); CSRC (2001).
development in reform China: there is no reason for the government of a one-party state to trade regulation in exchange for funds (or, indeed, votes). However, monopoly public ownership creates a natural harmony of interest between FIIs (and IIIs) and the state. Instead of receiving campaign funds et al., the state benefits directly from the profits and taxes provided by the securities companies, investment funds and SOEs. The state benefits through the profits these companies distribute directly to state shareholders, the corporate taxes they pay and the taxes that are levied on the trading they engage in. The state will therefore be interested in maximising trading turnover and the profits of FIIs. State officials will also be interested, of course, in creating and supporting demand in the market so that SOEs can raise investment and working capital. Public actors therefore have incentives to orient regulation to favour FIIs and even IIIs. In other words, the type of regulation ETR predicts, regulation in support of the interests of large market participants, is likely to occur.

Small investors

Individual investors have an interest in good quality regulation that protects their investments and lives up to the IOSCO principles outlined in the previous chapter. Given their limited resources, the development of effective regulation will advantage them more than it does large institutional investors. They will be interested in full and honest disclosures from listed companies and effective bars on large investors leveraging their access to superior information and larger funds to engage in fraud. They will be interested in the enforcement of punishments for fraud and in regulation that is administered independently of government and the Party. However, small investors lack mechanisms for pursuing these interests and public actors in China generally lack incentives to provide these goods. A bias to poor regulation is therefore likely to occur.

Figure 5 shows the growth of share accounts over the 1990s. By the end of 2000, there were around 60m. Small investors are concentrated in Shanghai and Guangdong province, which together hosted around 30% of all accounts. Most investors are not rich: the majority had annual incomes of Rmb6,000-24,000 in

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85 EIU (2001c).
1999, and traded funds of Rmb50,000-100,000, as Figure 6 and Figure 7 and show.

\[86\] CSRC (2000), 261.
### Figure 5. Number of investor accounts at the SHGSE and SHZSE, 1992-2000

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of investor accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>2.17</td>
</tr>
<tr>
<td>1993</td>
<td>7.78</td>
</tr>
<tr>
<td>1994</td>
<td>10.59</td>
</tr>
<tr>
<td>1995</td>
<td>12.42</td>
</tr>
<tr>
<td>1996</td>
<td>23.07</td>
</tr>
<tr>
<td>1997</td>
<td>33.33</td>
</tr>
<tr>
<td>1998</td>
<td>39.11</td>
</tr>
<tr>
<td>1999</td>
<td>44.82</td>
</tr>
<tr>
<td>2000</td>
<td>58.01</td>
</tr>
</tbody>
</table>


### Figure 6. The monthly incomes of investors at the SHGSE in 1999

<table>
<thead>
<tr>
<th>Monthly income, Rmb</th>
<th>&lt;500</th>
<th>500-1,000</th>
<th>1,000-2,000</th>
<th>2,000-4,000</th>
<th>&gt;4,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proportion of accounts, %</td>
<td>14</td>
<td>40</td>
<td>35</td>
<td>7</td>
<td>4</td>
</tr>
</tbody>
</table>


### Figure 7. The size of investor accounts at the SHGSE, 1999

<table>
<thead>
<tr>
<th>Amount of funds, Rmb</th>
<th>&lt;20,000</th>
<th>20,000-50,000</th>
<th>50,000-100,000</th>
<th>100,000-200,000</th>
<th>200,000-500,000</th>
<th>&gt;500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proportion of accounts, %</td>
<td>18</td>
<td>12</td>
<td>44</td>
<td>12</td>
<td>9</td>
<td>5</td>
</tr>
</tbody>
</table>


### Figure 8. A-share investors at the SHGSE and SHZSE, 1999-2000

<table>
<thead>
<tr>
<th>Year</th>
<th>Total number of investors</th>
<th>Legal person investors</th>
<th>Individual investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>38.93</td>
<td>0.14</td>
<td>38.79</td>
</tr>
<tr>
<td>1999</td>
<td>44.62</td>
<td>0.18</td>
<td>44.43</td>
</tr>
<tr>
<td>2000</td>
<td>57.74</td>
<td>0.26</td>
<td>57.48</td>
</tr>
</tbody>
</table>

Figure 8 shows the number of registered share accounts in 1998-2000 for institutions (legal persons) and individuals. Since institutional accounts numbered 260,000 in 2000 one can conclude that (in theory at least) over 99% of share accounts belong to individuals, in control of their own private assets and investing independently of the government and the Party. The commonly made inference that China’s stock market is dominated by small, private investors is supported by the high turnover rates.\textsuperscript{87} As Figure 9 shows, turnover rates, which measure how often a share is traded, are typically five to six times higher in China than in developed markets, and are also significantly higher than those in other Asian stock markets. Lower turnover rates reflect higher concentrations of long-term holdings, and therefore tend to indicate greater institutional investment.

\textsuperscript{87} Individual investors usually hold shares for less than one month, COL (2000d).
### Figure 9. Trading turnover rates at stock exchanges around the world, 1993-99

<table>
<thead>
<tr>
<th></th>
<th>Shanghai</th>
<th>Shenzhen</th>
<th>Taiwan</th>
<th>Hong Kong</th>
<th>South Korea</th>
<th>New York</th>
<th>Tokyo</th>
<th>London</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>341</td>
<td>213</td>
<td>252</td>
<td>61</td>
<td>187</td>
<td>47</td>
<td>26</td>
<td>81</td>
</tr>
<tr>
<td>1994</td>
<td>787</td>
<td>472</td>
<td>366</td>
<td>40</td>
<td>174</td>
<td>53</td>
<td>25</td>
<td>77</td>
</tr>
<tr>
<td>1995</td>
<td>396</td>
<td>180</td>
<td>228</td>
<td>37</td>
<td>105</td>
<td>53</td>
<td>27</td>
<td>78</td>
</tr>
<tr>
<td>1996</td>
<td>591</td>
<td>902</td>
<td>243</td>
<td>44</td>
<td>91</td>
<td>59</td>
<td>27</td>
<td>58</td>
</tr>
<tr>
<td>1997</td>
<td>326</td>
<td>466</td>
<td>407</td>
<td>91</td>
<td>146</td>
<td>52</td>
<td>33</td>
<td>44</td>
</tr>
<tr>
<td>1998</td>
<td>297</td>
<td>284</td>
<td>314</td>
<td>62</td>
<td>207</td>
<td>66</td>
<td>34</td>
<td>47</td>
</tr>
<tr>
<td>1999</td>
<td>423</td>
<td>372</td>
<td>289</td>
<td>51</td>
<td>345</td>
<td>75</td>
<td>49</td>
<td>57</td>
</tr>
</tbody>
</table>

Note: in the case of Shanghai and Shenzhen, the turnover rate is calculated by dividing the annual trading volume of shares by the number of tradable shares.
CSRC (2001), 255.
Given the apparent huge numbers of individual investors, one might expect public actors to deliver good quality regulation in response to their concerns. Yet the numbers, and importance, of individual share investors in China is easily overstated. The actual trading population has been considerably smaller than the headline figure for accounts throughout the 1990s, perhaps only about one fifth of the size. This is due to four factors. First, a large number of investors trade on both exchanges, meaning that the headline figure should be reduced by around 20% to cancel out the duplication of accounts. Second, some 30-50%, much more by some estimates, of these accounts are counterfeit, opened using false names by FIIs, IIIIs and wealthy individuals. Multiple accounts allow them to 'match orders', i.e. to sell shares between linked accounts to create the impression of trading volume and to push up prices. Having multiple accounts has also facilitated their entry into IPO lotteries: the larger the number of accounts one controls, the greater the chances of gaining the right to buy IPO shares. The dramatic rise in share prices in the first few days of trading guaranteed successful bidders huge profits throughout the 1990s. Third, many individual investors opened accounts to take part in this IPO lottery but they did not hold on to the shares if they were successful, and can not be considered to be active investors. Only in 2000 did regulations force IPO lottery entrants to hold shares in the secondary markets. Fourth, many accounts have fallen disused after their holders sustained losses and lost interest in the market. Data from the stock exchanges shows that only around 40% of share accounts contained shares as of mid-2000. Only 10,000-100,000 accounts were active on a typical trading day at the SHZSE in that year. A generous estimate would therefore put the number of individuals actively trading shares at the end of 2000 at 5m to 10m, a fraction of the 57.7m share accounts, and far less than 1% of China’s total population. Outside periods of extremely active trading, during late 1996 to early 1997 for example, the figure has probably not risen above 15m. The influence of small investors was probably greatest in the early 1990s. The high turnover of shares

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88 EIU (2001f).
90 The IPO lottery system, implemented in 1992, was designed to allocate the right to buy IPO shares to a small number of the subscribers. A bank account, replete with sufficient funds, must be nominated by the investor and if the account is chosen in the lottery, the investor may purchase shares, EIU (2001g).
91 COL (2000e).
reflects the speculative trading strategies of FIIs and IIIs rather than the number of individual investors in the market.

In addition to their limited numbers, small investors face many barriers that prevent them from effecting institutional change. In any market, as a dispersed group, they face collective action constraints on their ability to organise. These organisational problems are multiplied in China. There is no ballot box and therefore no political competition for their support; civil associations organised outside the state remain restricted; and the courts did not as of 2000 offer the opportunity for private suits or class actions. There is no independent press that could campaign on behalf of a small investor readership. Three government-owned and CSRC-licensed newspapers are allowed to report official notices and dominate coverage. They are censored by CCP-appointed editors and have tended not to report corruption. A small number of other publications, including *Caijing Zazhi* (Finance Magazine) and *Nanfang Zhoumo* (Southern Weekend), a newspaper, have broken stories of wrong-doing, but these are recent exceptions. In sum, small investors have very limited means to put pressure on public actors to develop equity institutions that protect their interests.

In response, many investors have exited the market. However, there are disincentives for doing so since few other instruments of asset management are available. Bank deposit interest rates have been set artificially low throughout the 1990s to enable the banks to make low-interest loans to the SOE sector. Investments abroad have not been possible because of capital controls. Of course, the ultimate weapon that small investors have for advocating better regulation is protest. Demonstrations in Shenzhen in 1992, for example, highlighted gross misconduct by local officials and resulted in the wholesale reorganisation of regulation. Individual investors evidently had an immediate impact upon institutional development at this point. However, such protests have been rare, especially considering the numerous scandals that have accompanied

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93 Collective action only succeeds if a group is small, able to deploy 'selective benefits' (i.e. benefits only to participants), or is able to use coercion, Olson (1965), 2-25.
94 Gamble (2000); Potter (1999), 674.
95 EIU (2001e).
the market's development. Protest only takes place when a regulatory problem is felt intensely in one geographical area, affects a large number of people, and is relatively simple to comprehend. One would therefore expect political leaders to take such problems into some account and to moderate their strategies appropriately. However more complex, hidden and dull problems in the regulatory structure that affect a large number of dispersed investors over a longer period are far less likely to trigger protest and are therefore less likely to be addressed by public actors.

The state: actors and interests

Having ruled out investors as sources of institutional change, the interests of government and Party leaders in terms of equity market development and the institutions that underpin it are now considered. In the absence of private business, and with individual investors lacking means to pursue regulatory change, bureaucrats enjoy relative autonomy in creating equity institutions. The most obvious interest they have in developing a stock market is the finance it can provide SOEs. The banking system became increasingly indebted during the 1990s, forced to continue administrative lending to the loss-making SOE sector. While official statistics continued to claim that non-performing loans (NPLs) remained at low levels, Nicholas Lardy calculates that by year end 2000, the four state banks were insolvent.\(^96\) Apparently in an attempt to hold this problem in check, a decision appears to have been made in 1997 to restrict bank lending, following the suspension of credit quotas at the beginning of the year.\(^97\) With bank financing increasingly restricted, the state increasingly turned to the stock market.

Figure 10 shows how the equity market has raised Rmb656 in funding, almost all for the SOE sector, during 1991-2000.\(^98\) Only some 40 non-state firms were trading publicly by the end of the 1990s, most of them through taking over listed SOEs through CSRC-approved M&A deals involving off-exchange transfers of

\(^{96}\) Lardy (1998), 115-124.
\(^{97}\) OECD (2000), 84.
\(^{98}\) This figure includes funds raised through initial and rights and secondary offerings, and from overseas issues, as well as those in the Mainland.
LP and state shares. Figure 11 shows how the stock market compares with bank loans as a financing route for industry. By 2000, it was still clearly a secondary source, providing only a tenth of the capital provided by the banks, but it had grown enormously through the decade and especially since 1997. IPO financing has benefited both local and central leaders, although since the large majority of the 1,050 firms listed by the end of 2000 fell under the administrative control of local leaders, the former have profited proportionately more. Given the importance of SOE reform to all levels of government, it would be reasonable to expect that political actors shaped the institutions of equity regulation around maximising these revenues.

Only a handful of private firms had been allowed to IPO. They have tended to be new economy companies with good political connections; many have state-affiliated organs among their owners. The Fuxing Group, a non-state Shanghai-based pharmaceuticals company, listed in 1998 with Shanghai government backing, raising Rmb348m. Shaanxi province’s Jinhua, a high-tech firm, issued Rmb178m worth of shares in 1997 and Shenzhen’s Taitai Medicine, a successful family-run concern, listed in Shanghai in 2001, Green (2001), 26.
Figure 10. Total raised capital from share issuance, 1991-2000

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of share issuance (Rmb billion)</td>
<td>0.51</td>
<td>9.41</td>
<td>37.55</td>
<td>32.68</td>
<td>15.03</td>
<td>42.51</td>
<td>129.38</td>
<td>84.15</td>
<td>94.46</td>
<td>210.31</td>
<td>655.97</td>
</tr>
</tbody>
</table>

Note: Includes A, B, overseas-listed H-shares, as well as rights and secondary offerings.
CSRC (2001), 33.

Figure 11. Stock market and bank financing compared

<table>
<thead>
<tr>
<th>Year</th>
<th>Domestic capital raised through stock issues (Rmb billion)</th>
<th>Total bank loans (Rmb billion)</th>
<th>Issues as a proportion of bank loans (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>27.6</td>
<td>634.5</td>
<td>4.36</td>
</tr>
<tr>
<td>1994</td>
<td>10.0</td>
<td>721.7</td>
<td>1.38</td>
</tr>
<tr>
<td>1995</td>
<td>8.6</td>
<td>934.0</td>
<td>0.92</td>
</tr>
<tr>
<td>1996</td>
<td>29.4</td>
<td>1,068.3</td>
<td>2.76</td>
</tr>
<tr>
<td>1997</td>
<td>85.6</td>
<td>1,071.2</td>
<td>7.99</td>
</tr>
<tr>
<td>1998</td>
<td>77.8</td>
<td>1,149.0</td>
<td>6.77</td>
</tr>
<tr>
<td>1999</td>
<td>89.7</td>
<td>1,084.6</td>
<td>8.27</td>
</tr>
<tr>
<td>2000</td>
<td>149.9</td>
<td>1,334.7</td>
<td>11.23</td>
</tr>
</tbody>
</table>

Note: Includes banks loans made by shareholding banks and loans to non-corporate borrowers.
In addition to investment revenues, the stock market has been an increasingly important component of fiscal revenues, both local and central. Figure 12 shows developments in the stamp tax (yinhuashui), the tax levied on each share transaction. The first tax on share trading was levied on the seller in June 1990 by the Shenzhen government at 0.6% of the value of the transaction and in June 1992, the National Tax Bureau assumed control over the rate. Stamp tax rates have always been set relatively high. The 0.4% rate, levied on both sides of the transaction, in place from 1998 to mid-2001, is much higher than most other countries' rates, as Figure 13 shows. Given the high tax rate, and high share turnover, it is not surprising that stamp tax revenues have grown significantly through the 1990s. Figure 14 shows how they had increased to Rmb48.59 billion, some 3.6% of total government revenues, by 2000.

100 A 20% tax was also levied on income derived from securities (interest payments on bonds, and dividend payments on shares) from October 1993, under the auspices of the Individual Tax Law, Dong (1997), 45; Wang (1993), 27; Li (1998b), 174; Hu (1998), 9.
### Figure 12. Developments in China's stamp tax, 1990-2000

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>28^th June 1990</td>
<td>SHGSE: A 0.6% stamp tax introduced for the first time in Shenzhen, paid by seller</td>
</tr>
<tr>
<td>23^rd November 1990</td>
<td>SHZSE: A 0.6% stamp tax introduced for the buyer</td>
</tr>
<tr>
<td>12^th June 1992</td>
<td>Introduces a 0.3% rate on both sides</td>
</tr>
<tr>
<td>May 1997</td>
<td>The National Tax Bureau and SCORES assume control and clarify the rate to be 0.3% for each side of the trade</td>
</tr>
<tr>
<td>12^th June 1998</td>
<td>The National Tax Bureau, with State Council authorisation, adjusts the rate from 0.5% to 0.4%</td>
</tr>
<tr>
<td>1^st June 1999</td>
<td>The B-share stamp tax is adjusted from 0.4% to 0.3%</td>
</tr>
</tbody>
</table>


### Figure 13. Stamp tax rates in developed and developing countries, 1999

<table>
<thead>
<tr>
<th>Country</th>
<th>Share stamp tax, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Kingdom</td>
<td>0.05</td>
</tr>
<tr>
<td>Italy</td>
<td>0.15</td>
</tr>
<tr>
<td>Australia</td>
<td>0.15</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>0.13</td>
</tr>
<tr>
<td>South Korea</td>
<td>0.30</td>
</tr>
<tr>
<td>Brazil</td>
<td>0.03</td>
</tr>
<tr>
<td>Singapore</td>
<td>0.05</td>
</tr>
<tr>
<td>Taiwan</td>
<td>0.30</td>
</tr>
</tbody>
</table>

Yang (1999a), 24-25.
Some analysts, including Hua Wannian, claim that the government, at both central and local levels, has purposelessly nurtured bull markets and heavy trading volume to maximise such revenues.\textsuperscript{101} During the height of the bull market in June 1999, for instance, a bull triggered by a \textit{Renmin Ribao} editorial in May 1999, the government took Rmb5.7 billion in stamp taxes in a single month, some Rmb300m every trading day. Local governments have also benefited from the corporate taxes levied on the stock exchanges, securities companies and other FIIs. The SHZSE paid Rmb220m in taxes to the Shenzhen government in 2000 (Figure 15). 89 dedicated securities companies paid Rmb6.2 billion in taxes on their business in fiscal 2000, some 0.5% of total fiscal revenues, Rmb2.7 billion in 1999, as Figure 16 shows. Tax revenues on all institutional investors, including SOEs, would be several times greater, although data is unavailable. One would reasonably expect government leaders at the central and local levels to develop institutions and policies that maximised these revenues and to compete against each other to capture them.

\textsuperscript{101} Hua (1999), 67, 13-14.
However, while state actors would be expected to design and implement institutions that maximise these revenues, an equally important consideration for them is the potential threat presented by the stock market. For example, inflation caused by over-investment, of which securities issuance has historically been a contributing factor, has been a threat to social stability and to the coherence of the macro-economic plan. This was an acute problem in 1988-89 and 1993-94. Another obvious threat was financial system crisis. In 1998 Premier Zhu Rongji, the senior zhongyang leader with responsibility for economic policy since 1993, informed legislators in the NPC that he believed a sudden financial crisis to be a more serious risk to CCP rule than unemployment. There are the obvious dangers of runs on the insolvent banks and, as Carlson Holz shows, a ‘bankrupt’ state unable to meet its financial liabilities. In addition, a serious financial crisis could be triggered by problems in the stock market. Securities companies, banks, TICs and SOEs speculating with public funds and private savings, leading to large losses, could cause immense damage to the financial system. The stock market could also trigger social instability if a large-scale fraud, (when securities companies steal customer funds, for instance), hurt enough small investors. Thus, senior political leaders’ ideal equity institutions would both aim to maximise the

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102 The 1994 fiscal reform resulted in all business taxes being collected by the local government, Saich (2001b), 153-160.
state’s financial revenues from the market and ensure that financial crisis was avoided.

Given then this set of interests on the part of public actors, and the fact that they have enjoyed relative autonomy in which to build institutions that support these interests, why has so much institutional change occurred in such a short period of time? A stable political elite would be expected to be able to plan, methodically pursue, and steadily implement institutional change that supported these ends. This has, however, not occurred; the share market has veered between crisis and stagnation several times during 1984-2000, several institutional reforms have been implemented and then reorganised, and informal practice has diverged enormously from the formal rules. This raises the question of state capacity. According to Joel Migdal, a strong state is one which ‘has capacities to penetrate society, regulate social relations, extract resources and appropriate or use resources in determined ways’. One of the essential characteristics of such a state is that it is internally co-ordinated, able to ensure that local officials implement decisions taken by the top leadership and that information about implementation, or lack thereof, is efficiently delivered back to the top leadership. Analysis of the stock market in China has tended to assume that this is so. Carl Walter, for example, claims that ‘the markets are operated by the state, regulated by the state, legislated by the state, [and] raise funds for the benefit of the state by selling shares in enterprise owned by the state’. While correct from a macro perspective, such analysis tends to overlook the fact that the Chinese state is not a unified, coherent organisation able to systematically exploit the market for its own ends. As analysts such as Wang Shaoguang and Hu Angang have shown, a lack of state capacity, understood largely as poor Centre-Local co-ordination, has led to a number of problems, including undermining the state’s financial resources and causing unequal growth. It is necessary, therefore, to comprehend the interests of different parts of the state vis-à-vis equity institutions and the permanent state institutions that join them together. As the chapters below show, bureaucrats at different levels of the government and in different functional bureaux have had divergent interests when it comes to equity

market development. Actual policy and institutional development has been the product of a competition between them.  

**Zhongyang leaders**

Consider the senior leadership within the zhongyang, the 30-odd members of the Political Bureau of the Central Committee and its standing committee, many of whom also occupy senior positions in the State Council (and some in the provinces). Guided by the Central Finance and Economics Leading Group (Zhongyang Caijing Lingdao Xiaozu, hereafter FELG), the ultimate policy-making body in economic affairs, they are the ultimate arbiters of financial market development and regulation. The FELG has been made up of Jiang Zemin, Li Peng and Zhu Rongji, the top Party leadership, through most of the 1990s; vice premier Wu Bangguo was reported to have joined in early 1995; followed by vice president Hu Jintao in late 2000. A FELG office and the Central Committee's Financial Work Commission (Jinrong Gongzuo Weiyuanhui, hereafter FWC), established in 1998, as well as various research institutes associated with the State Council, supply advice on policy and personnel. One would expect this senior leadership to be interested in developing regulation that, first, ensured financial stability. This in turn would help guarantee social stability: Deng Xiaoping's 1989 coinage of the imperative 'stability above everything' (wending yadao yiqie) echoed throughout the 1990s. The threat of financial instability is one these leaders take seriously since it threatens their own political legitimacy and, if serious enough, could trigger social instability and ultimately regime change. Second, their preferred equity policies would support national economic growth and state-owned industry. The incentives which zhongyang leaders faced were not static, however: they have shifted as the stock market has grown in size and significance. Few benefits accrued to them when the market was new and small. Its small size prohibited ministry-

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108 Lieberthal (1988), 35-41. One quarter of the Politburo chosen at the 1992 14th Congress were regional leaders, as were five of the 1997 15th Congress, including the Shanghai Party Secretary Huang Ju, Saich, T. (2001b), 90.  
110 Fewsmith (2001), 35.  
111 Pei (1999).
administered enterprises, which tend to be larger than enterprises controlled by local authorities, from listing. The fiscal revenues it provided were also small and ideological resistance in the early years further discouraged zhongyang leaders from strongly supporting development or from taking an active interest in institutional development. However, the incentive structure shifted as the market grew in size, as larger SOEs could be listed, as stamp tax revenues increased, as ideological opposition weakened, and as the potential of stock market instability infecting other areas of the financial system grew more serious. As the market grew, zhongyang leaders had greater incentives to actively orient equity institutions towards supporting national industrial policy and ensuring financial stability. They have depended on two sets of 'sub-principals' to deliver these goals: leaders of central government bureaux leaders and local government leaders.

Local leaders

The leaders of Shanghai and Shenzhen, the Party secretaries and mayors, are the subordinates of the zhongyang leaders. From 1984 to 1998, they acted as the zhongyang's primary agents in stock market regulation and, in turn, acted as principals over the municipal bureaux mandated to implement these policies; the stock exchanges, the SAOs, and the local branches of the PBoC. Provincial and sub-provincial leaders throughout China were also involved in governing their own local share markets. Their de facto responsibilities included overseeing the issuance of equity by local enterprises, overseeing on-going disclosures, and supervising any local trading of securities. The problem for the zhongyang leadership has been that these local leaders tended to defect.

Unlike in the USSR, local government in China has long enjoyed significant autonomy from the centre in terms of investment planning, policy development

113 Shanghai's Party secretary and mayor occupy, like provincial party secretaries and governors, a ministry (zhengbu or bu) rank. However, Shanghai is an 'super province' since its Party Secretary was a member of the Politburo and its taxes were a major contribution to national revenues. Thus, its leaders are accorded greater importance than most other provincial-level leaders. The Shenzhen leadership occupies a more junior rank, equivalent to a vice-ministry (jubu), but this is complicated by the fact that the Guangdong provincial leadership, at a similar
Local governments at the provincial level and below were responsible for formulating plans and balancing industrial inputs and outputs in the pre-reform era. However, under Mao the central government still set their budgets and appropriated most of their financial resources: local government could not levy or spend as its chose. In the early 1980s this changed, as the autonomy of local actors was enhanced in enterprise management and, most importantly, over the fiscal system. In 1984, a new tax contract system (caizheng baoganzhi) allowed local authorities to retain profits in excess of a fixed amount payable to the centre. The result was that local governments became the residual claimants over the returns of SOEs operating within their jurisdictions. Fiscal incentives also slanted their industrial preferences, encouraging them to nurture high-tax contributing, short-production cycle, light industry, notably tobacco factories and breweries. The change also gave local leaders an interest in building sources of investment capital autonomous of central government and outside the budget. Local leaders directed bank lending, manipulated local fiscal policy and nurtured extra-budgetary funds in order to maximise their own investment resources. Two other changes have enhanced the autonomy of local leaders during the reform period. As David Lampton argues, one way for reformers within the central government to promote their agenda, bypass ideological opposition within Beijing, and build political support has been to distribute reform ‘experiments’ (and concomitantly devolve down wide-ranging policy-making powers) to local governments. This has the effect of extending de facto autonomy over key policy developments to local leaders. Second, Centre-Local co-ordination problems have been exacerbated by the loss of socialist ideology, and fear, as

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116 Fiscal reform began in Jiangsu province in 1979, but was then rolled out nation-wide in the early 1980s, Ferdinand (1987), 7-9; Walder (1997), 437.
118 Chang (1996), 86-87.
120 On off-budgetary funds, see Tsai (2000); Gore (1999), 32; Lu (2000), 208, 216.
121 Lampton (1992), 54; Shirk (1993), 140-141.
tools of coercion.\textsuperscript{122} While Mao could call on considerable ideological resources, as well as administrative powers, to launch the Great Leap Forward (1957-60) and the Cultural Revolution (1966-76) at the local level, few such resources were available to zhongyang leaders in the 1990s.\textsuperscript{123}

Barry Weingast’s work on federal systems (and unitary ones where extensive powers are devolved down to local actors, as in the case of the PRC) suggests that by decentralising decision-making powers and encouraging competition for resources among locales, local officials are given incentives to support industrial development.\textsuperscript{124} However, another result in China has been that local leaders have developed into economic interest groups (liyi jituan) with preferences of their own, and that their willingness to act as honest agents of the zhongyang leadership has been diminished.\textsuperscript{125} Such is the extent of ‘administrative localism’, the defection of local leaders from central government policy, that some analysts even spoke of the Chinese state ‘deconstructing’ and of ‘federalism, Chinese-style’.\textsuperscript{126} However, this is an exaggerated view: since local leaders are not entirely independent of their principals, defection tends to be considered, strategic and \textit{ad hoc}.

How do these local interests play out with regard to the stock market? Consider the interests of leaders in Shanghai, Shenzhen and in other locales. In general, they will be interested in maximising investment funds from the issuance of shares, supporting the FIIs that they own, and less interested in developing the best practice regulation outlined in the previous chapter. They have incentives to sponsor rapid secondary market development, in order to promote demand for IPOs and to maximise their revenues from stamp taxes, as well as taxes levied on FIIs, and profits from those SOEs and FIIs which they own. They will be

\\textsuperscript{122} Dittmer (2001); Chung (2001), 47-49.  
\textsuperscript{123} Zhao (1994), 21-23.  
\textsuperscript{124} Weingast (1995); Tiebout (1956); Qian (1997), 85-91. See Nee (1996) for a rebuttal.  
Williamson is also sceptical, Williamson (1996), 334.  
\textsuperscript{125} ‘The failure of the regime to be ready with an alternative framework of legal powers for levels of government in the early part of the decade has meant that local officials have \textit{de facto} been able to exploit their own freedom of manoeuvre to the maximum’, Ferdinand (1991), 239. On implementation bias and state co-ordination, see Lieberthal (1988), 3-4, 22-27; Nathan (1990), 26-31; Breslin (1996b), 689-694; Lin (1989), 125-136; Lampton (1987b), 165-166; Lampton (1992), 34; McCormick (1987); Bachman (1987); Breslin (1996a), 695-704; Oi (1999), 9.  
\textsuperscript{126} Goodman (1994); Weingast (1995).
interested in rapid share listings, development of new instruments (corporate bonds, convertible bonds, futures, options, etc.), opening the market up to foreign investment, and are likely to nurture FIIs with favourable tax treatment and loans. Good quality regulation, in contrast, entails a number of costs to them: it restricts market growth, limits trading volume and also prevents indebted and otherwise problematic firms from listing, all of which run against local leaders' economic interests. Two additional factors diminish their incentives for promoting effective regulation. First, they face a moral hazard problem since they are partially insulated from the consequences of poor regulation: while they make exclusive gains from fast stock market growth, most of the costs associated with inflation, firm insolvency or financial instability will be assumed by the central government. It is the central government that ultimately underwrites the national financial system. Second, poor regulation is cheap and easy to practice. Unlike bank loans, or the inflation that results from excess investment, both of which can, to some extent, be measured and identified by central government officials, defective regulation can be easily disguised. Listing firms' balance sheets can be falsified; prices in the secondary market manipulated; standards for issuance informally relaxed: such phenomenon are easily made invisible, both to the public and to central government officials, especially if local bureau operate independently of central government oversight. The lack of an investigative media compounds this problem. Moreover, poor regulation is not costly to provide in terms of financing and staff etc. Given autonomy to develop institutions, as they had during 1986-92, and to a lesser but still significant extent during 1993-97, local leaders can be expected to mould equity institutions to support their own economic objectives, 'hardwiring' the activities of their subordinate local bureaux to support the above objectives.

Andrew Wedeman identifies 'institutional corruption', 'the pursuit of gain by institutions acting collectively and relying on the authority or resources of the [state] to generate or extract income improperly' as a common problem in reform China. Institutional corruption involves a network of public leaders, is essentially predatory and has a negative impact upon regime stability. Although he uses the term 'institution' to denote organs capable of action rather than a structure of governance, Wedeman's argument, based on the expropriation of rural bank
deposits during 1992 by bank officials and local leaders to fund coastal investment, is similar to that advanced here. The three stock market scandals of the 1990s examined in the following chapters show how ju-level bureaux leaders within Shanghai and Shenzhen colluded with their municipal leaders to maximise financial resources for local firms and budgets, with worrisome consequences for financial and social stability. Each time the zhongyang leadership had to deploy central government personnel to intervene and then to reorganise institutions to ensure that the zhongyang was adequately protected. There, however, is at least one important difference between this case study and Wedeman’s. In the equity sector, the ‘manipulation’ of institutions for local (and central) government gain has not occurred on an ad hoc basis. Institutional capture is shown to be an integral part of the process of institutional development itself, providing economic goods to political actors on an on-going basis.\textsuperscript{127}

\textit{Bu-level bureau leaders}

When considering Centre-Local relations in China, central government leaders are sometimes implicitly assumed to be a coherent set of actors with equal access to information, a common understanding of their own shared preferences, and agreed strategies for maximising them. As a heuristic aid for studying Centre-Local relations this assumption is useful, but it should not disguise the fact that significant principal-agent problems also exist within the central government, between zhongyang leaders and their agents in State Council bureaux. While the former set broad political and economic goals, it is bureau leaders and their subordinate bureaucracies which are charged with developing and implementing detailed policies, collecting information, and supervising agents at the local level. Thus, a second organisational issue for the zhongyang leadership is how to best structure the institutions to ensure that their interests are represented within central government.\textsuperscript{128} They will need to decide how best to distribute powers and responsibilities between central government bureau, how to co-ordinate overlapping policy-making processes and how to establish their own monitoring mechanisms. They must also work out how to co-ordinate the activities of their two sub-principals.

\textsuperscript{127} Wedeman (1997), 806-807.
The central government is divided up into functional bureau (*xitong*), commissions (*wei*) or ministries (*bu*), each with unique responsibilities. This is useful, Lampton argues, since it embeds specific responsibilities in each bureau. Major policy initiatives will involve a number of different *xitong*: good ideas are only implemented if agreement can be reached among them. Otherwise, the top leaders are assured that the ‘upturned sieve’ will bring unresolved (and therefore problematic) issues to their attention. There are various institutional mechanisms for co-ordinating the work of central government officials. The State Council leadership, made up of the premier (himself a senior member of the *zhongyang*), his deputies and secretary generals, also serves to co-ordinate the *xitong*, and the *xitong* with the Party. At a lower level, *xitong* like the State Planning Commission (*Guojia Jihua Weiyuanhui*, hereafter SPC and, as of 1998, the State Development and Planning Commission, *Guojia Fazhan Jihua Weiyuanhui*, hereafter SDPC) and the State Economic and Trade Commission (*Guojia Jingji Maoyi Weiyuanhui*, hereafter SETC), serve to co-ordinate policy in areas that stretch across numerous ministries. Partly because of these mechanisms, *zhongyang* leaders have fewer problems monitoring the activities of *xitong* leaders than monitoring those of the local leaders. Membership of a collegiate executive, the State Council, also constrains the actions of central leaders in a way that local leaders never experience: defection is not a major issue at this level. However, poor co-ordination between central bureaux is an equally dangerous problem for *zhongyang* leaders.

Analysts of Chinese politics have long noted the marked capacity of central government organs for debilitating conflict. Bureau leaders tend to protect their organisations’ particular interests, a phenomenon known as ‘bureau protectionism’ (*bumen baohu zhuyi*), and have a well-developed capacity to veto policies antagonistic to these. David Bachman traces the lineage of this form of ‘organisational’ politics back to the 1950s, when a coalition of bureau leaders supported the Great Leap Forward in order to protect their own bureaucratic

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128 On administrative reform, Yang (2001b).
129 Lampton (1992), 38.
interests. Kenneth Lieberthal and Michael Oksenberg argue that this form of politics has become further exaggerated under reform. The dispersal of authority throughout the Chinese state, between government and Party, between State Council members and between central and local bureaux, has led to a ‘fragmented, segmented and stratified’ state. As a result, they argue, the policy process at the State Council level is slow and negotiated; policy change is always incremental. Susan Shirk characterises the policy process as ‘balancism’ (pingzheng zhuyi), the systematic formulation of policy through compromise and ‘satisficing’ each interested and influential actor. Turning to the stock market, the interests are in place to lead us to predict that policy and institutional development proceeded along similar lines. As the market has developed, it has impinged on the interests of numerous central bureau leaders. All ministers would be interested in gaining public listings for firms under their supervision: intense competition would therefore result. Share issuance affected macro-economic aggregate demand and the supply of credit, and thus interested the SPC leadership. Issuance of securities, especially local government debt with high coupons, at times diminished the take-up of Treasury bonds, a matter of concern for the MoF. For its part, the PBoC leadership was, at least in the early 1990s, extremely concerned with the negative effect share investment had on the level of saving deposits. The issuance of foreign currency B-shares, and the issue of foreign entry, has involved the State Administration for Foreign Exchange, while the creation of new fiscal revenues involved the tax authorities. Thus, the key issue for the zhongyang leadership has been how to organise the institutions of central government to ensure that such conflicting interests can be effectively co-ordinated and resolved. For most of the 1990s they failed. Much of the evidence presented in the thesis supports the ‘fragmented state’ model of the Chinese state: inter-bureaucratic competition and extensive mis-implementation were common characteristics of the institution-building process. However, the thesis also points to the limits of this model. Sudden, and often extremely progressive, policy and institutional change also took place during the 1990s, and developments since

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132 Simon (1957); Allison (1971), 70-74; Lieberthal (1988), 269-338.
133 CD (1993b).
1997 have shown that the senior leadership is capable of developing institutional mechanisms to effectively co-ordinate the central government when incentives to do so are sufficient.

**Ju-level bureau leaders**

The leaders of local ju-level bureaux, such as PBoC branches, the stock exchanges and the SAOs, direct the actual implementation of policy and regulation. They usually have two principals, central government bureaux leaders and local leaders. It is assumed that these bureaucrats wish to maximise the revenues of their bureau and to advance their careers. As a result, they can be expected to selectively comply with the directives of their dual superiors, defecting ‘when they have a strong incentive to do so or when they think they can get away with it’.\(^\text{134}\) Defection which can be disguised, which will result in large gains and which will only attract mild punishment if discovered is likely to be common. Defection from one sub-principal to support the other one will be too. Previous work shows that PBoC branch directors, despite being part of a xitong hierarchy, were extremely vulnerable to the influence of local leaders throughout the 1990s. The behaviour of ju-level bureau depends to a large extent on the type of administrative relations that its leader has with his superiors.

**Co-ordinating the Chinese state**

To comprehend how the divergent interests of zhongyang leaders, central ministers and local leaders in equity institutions have been resolved (or left unresolved) one must consider how these interests are filtered through the institutions of the Chinese state.\(^\text{135}\) The Chinese political system is unitary, not federal: local government derives it authority and decision-making rights solely from the central government. However, the state is structured along both sectoral and geographical lines by vertical, functional bureau (xitong) and local (difang) government structures.\(^\text{136}\) Difang government is supposed to complement the xitong structure by providing co-ordination between agencies at the level of implementation and by facilitating information sharing. The formal relations

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\(^{134}\) Huang (1996), 9-10, 310.

\(^{135}\) Ibid., 27-62.

\(^{136}\) Zhao (1994), 19; Schurmann (1968), 88-90; Lampton (1987a), 14; Barnett (1967), 6-8, 441.
between organs within the two structures are governed by three factors; bureaucratic rank (xingzheng jibie), formal classification of the type of bureaucratic relations (guanxi) and the locus of primary authority (weizhu). Although the bureaucratic ranking system of the PRC is notoriously complex it is the primary means of defining how different bureaux (and their leaders) relate to one another. A summary of the ranking system within the two structures is provided in Figure 17. For instance, in general, a ministry enjoys the same rank as a province.

Figure 17. The ranking system of central and local government bureau under the State Council

<table>
<thead>
<tr>
<th>Central government</th>
<th>Local government</th>
</tr>
</thead>
<tbody>
<tr>
<td>Comprehensive ministry [wei], e.g. SPC (as of 1998, SDPC)</td>
<td>‘Super-province’ e.g. Shanghai, Guangdong</td>
</tr>
<tr>
<td>Ministry [zhengbu], e.g. MoF</td>
<td>Province [sheng], centrally-administered cities [zhixiashi], autonomous regions [zizhiu]</td>
</tr>
<tr>
<td>Vice ministry [fu bu]</td>
<td>Provinces capitals [fusheng], e.g. Guangzhou, Plan-autonomous cities [Jihua danli chengshi], e.g. Shenzhen</td>
</tr>
<tr>
<td>General Bureau [zongju]</td>
<td>Provincial commission [weiyuanhui]</td>
</tr>
<tr>
<td>Bureau [ju or si]</td>
<td>Bureau [ting or ju]</td>
</tr>
<tr>
<td>Division [chu]</td>
<td>Division [chu]</td>
</tr>
<tr>
<td>Section [ke]</td>
<td>Section [ke]</td>
</tr>
</tbody>
</table>


Rankings are strictly adhered to. A bureau can not issue instructions to a superior or equal-ranking bureau, even if the document falls squarely within its policy remit. Neither can its leaders negotiate on equal terms with those of a superior bureau. There is a strict division between the xitong and difang structures. Ministries can not issue binding documents (mingling, jueding or zhishi) to provincial governments unless specifically authorised by the State Council; otherwise they must rely on non-binding instructions and guidelines (tongzhi). Most local ju-level bureaux are overseen by both a xitong and a difang bureau. For example, up until 1998, the Shanghai PBoC was overseen by both the Shanghai and PBoC leaderships. Authority between the two sub-principals is

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137 As well as their government ranking, officials have personal ranks, which they carry with them through the bureaucracy, and positions within the CCP hierarchy, both of which will also influence their authority.

138 Plan-autonomous, or 'line item', cities were elevated to provincial status, allowing them to receive priority status in the allocation of funds and materials, Wong (1995), 82.
formally divided through a classification of relations. If a sub-principal enjoys ‘administrative leadership’ relations (*xingzheng lingdao guanxi*) over a *ju* level bureau then it determines policy, as well as appointments, dismissals, payroll and other welfare functions for that bureau. If it enjoys ‘professional’ (or ‘business’) leadership relations (*yewu lingdao guanxi*) then it has influence over policy and operations, as well as some influence over personnel matters. These two types of relations can be glossed as management (*guanli*) and supervision (*jiandu*) relations respectively: the former is more influential, primarily through its control of appointments.\(^\text{139}\) In addition, primary (*weizhu*) authority is usually allocated to one of the two sub-principal bureaux, though it normally resides with the bureau with *guanli* relations. During reform, it has been common for a provincial government to enjoy both primary management and supervision rights over a *ju* level bureau and for a ministry to enjoy secondary supervision rights. This was the situation for the Shanghai PBoC until 1998.

In addition, the PRC has a number of mechanisms through which members of different parts of the state are co-ordinated. Lieberthal and Oksenberg single out meeting systems, work conferences and personnel and policy networks as significant instruments for principals within the *zhongyang*, and sub-principals at lower levels, to ensure compliance from their agents.\(^\text{140}\) A highly persuasive account is provided by Yasheng Huang who, alongside these mechanisms, stresses the importance of the *zhongyang*’s control of appointments (nomenklatura) in influencing the behaviour of its agents.\(^\text{141}\) In the ‘one-level down system’ (*yiji guanli*) of nomenklatura, in operation since 1983, senior leaders appoint, via the Central Committee’s Organisation Department (*Zhongyang Zuzhibu*, hereafter CCOD), junior leaders at one level below them in the rank structure.\(^\text{142}\) Thus all State Council and provincial leaders are appointed directly by the *zhongyang*. *Ju* level leaders are in turn appointed by ministerial party groups (for posts within the *xitong* structure) and by provincial party

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\(^\text{141}\) Li (1998a), 3.

\(^\text{142}\) In the early 1980s a ‘two-level down’ system (*xiajiangi guanli*) allowed leaders to appoint leaders to bureau two ranks below them, Burns (1989), xvii-xxviii.
committees (for local bureau). However, as Huang notes, the CCOD also monitors, and since 1990 has had veto powers over, the selection of ju-level officials. Other strategies, including short tenure, rapid rotation around different posts, selective integration within the zhongyang (when a senior local leader is concurrently a member of the Politburo) are well honed, Huang argues, and have proven effective in curbing ‘administrative localism’. These political institutions are still authoritative, and alleviate principal-agent problems by converging, at least in part, the preferences of the different actors, as well as by providing monitoring functions.

However, there are problems with this argument. The nomenklatura system Huang describes was constant throughout the 1990s, and therefore can not explain the marked shift that occurred in equity policy from extensive administrative localism in the early 1990s to the highly centralised form of regulatory development that characterised the late years of the decade. Other research supports the view that the utility of nomenklatura is limited. Andrew Wedeman argues that the nomenklatura system only allows zhongyang leaders leverage over the provincial leaders whom it appoints, but is not transitive to the bureau level. Here, information asymmetries and the embedded practices of local bureaucrats mean that administrative localism has a relatively free rein. Li Lianjiang and Kevin O’Brien endorse this view, finding that agents are ‘hyper responsive’ to their immediate principals (the more authoritative sub-principals) and indifferent to their nominal superiors higher up the chain of authority. Steven Solnick, based on his study of institutional disintegration in the Soviet Union, argues that the integrity and efficacy of nomenklatura systems should not be assumed to be fixed and exogenous to a reform process. He argues that administrative capacities are vulnerable to change and a nomenklatura system can not guarantee effective principal-agent co-ordination if reforms devolve too much power to the local level, exacerbate information asymmetries, increase the

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143 Moreover, in 1990 appointment of leaders within centrally-administered cities, such as Shenzhen, reverted to the CCOD.
144 Li (1998a), 3; Huang (1996), 119-122, 305-313.
145 Wedeman (1999), 120-122.
146 Li (1997a), 5.
gains of opportunism, and if principals are slow to punish rebellious agents.\textsuperscript{147} Given the limitations of the nomenklatura system, the following chapters attempt to identify the other institutional mechanisms that ensured principal-agent co-ordination and that, by the end of the 1990s, had greatly improved state capacity. Reorganisation of the nomenklatura system within the equity sector itself was important but so was a wide-ranging portfolio of other institutional changes, including restructuring of the \textit{xitong}, reducing the economic incentives for intervention by local leaders, introducing Party oversight, and centralising of specific policy and regulatory powers.

\textit{Concluding remarks}

This chapter has identified the actors involved in institutional change in the equity sector, their interests, and the state institutions through which they interact. It has argued that the source of institutional change in reform China is public actors, rather than private, and that public actors will design regulation to support their budgetary and policy interests. It has shown that while the \textit{zhongyang} leadership, and to a large extent central government bureau leaders, will seek to build institutions that guarantee stability and support national industrial policy, local leaders have incentives to build equity institutions that support fast equity market growth and neglect regulation. These divergent interests mean that a competition over defining equity institutions will take place, a competition where the \textit{zhongyang} attempts to ensure that j"u-level bureau leaders support their interests rather than those of local leaders.

\textsuperscript{147} Solnick (1998), 234-240.
Part II

Local institutional capture
Nascent equity markets and local institution building, 1984-90

It seems that some capitalist concepts can be applied under the socialist system.

Deng Xiaoping, 1992

During the late 1980s there was a groundswell of share issuance by Chinese enterprises, the result of widespread shareholding (gufenzhi) reforms within the SOEs. Despite bans announced by the State Council, informal equity markets appeared on factory shopfloors as employees traded the securities issued to them in lieu of wages. These markets soon spilled over onto the streets. By the end of 1988, the country was covered by a patchwork of small and vibrant curb markets where shares, as well as Treasury and local government bonds, were informally traded. The first formalised share trading, at an over-the-counter (OTC) market, took place in Shenyang, Liaoning province, in August 1986. Four years later, institutionalisation of the sector took a colossal leap forward with the establishment of two stock exchanges in Shanghai and Shenzhen. During the space of six years, a new commodity, equity, as well as an entirely new market in this commodity, had been created.

Given that a new market had sprung up, without the intention or even the permission, of most central government leaders, a dilemma now confronted them: if this market was not to be closed down, what institutions should be put into place to govern its operations? Three basic choices about the institutions of the sector were made. First, rather by default than by design, the PBoC took on the primary management role of the market and its institutions. This led to a number of problems including, most importantly, over-issuance, a phenomenon

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150 An OTC market is a negotiated-price market run by a market maker, Teweles (1998), 195-199.
which can be traced back to the institutional capture of PBoC branches by local leaders. Second, local leaders were granted extensive autonomy to define and develop the institutions of both the primary and secondary markets; central government bureaus had minimal mechanisms of oversight or control. For their part, *zhongyang* leaders acquiesced to these 'experiments' while attempting to implement macro-controls over the scale and location of stock issuance and trading, with variable success. Third, initially institutional change was advocated and planned predominantly by non-government actors who supported market-oriented institutions. They played a key role in fostering the market's initial growth and ideological acceptance. Financiers within the Shanghai and Shenyang banks pushed for the creation of trading counters and then managed these counters. Within central government, a group of financiers and economic reformists worked to persuade key members of the *zhongyang* of the need to experiment with share trading, and then went on to design the stock exchanges. However, local leaders soon became interested supporters of the new share market as its potential to support their economic objectives became clear. By the end of 1990, non-government actors had been sidelined and equity institutions, including the stock exchanges, their design, development, implementation and management, were entirely controlled by the state.

The chapter is divided into two sections. The first looks at China's early shareholding reforms, the emergence of equity in the 1980s and the institutional arrangements that governed its issuance. The second section examines the emergence of secondary markets in equity, the creation of the OTCs in 1986 and the roles played by non-government actors and bureaucrats in establishing China's stock exchanges in 1990.

*Shareholding reform and China's first share*

China's shareholding reforms began in the early 1980s. During 1980-86, 20 shareholding companies were established using three methods.\(^{151}\) Some SOEs transformed themselves into stock-holding companies by carrying out asset evaluations, gaining local (city or provincial) approval, and then issuing shares to

\(^{151}\) Hu (2000), 15-16.
outside investors and/or employees. With government approval a small number of SOEs were merged to form a single shareholding entity. A third method was when assets from different SOEs were extracted and brought together to form a new shareholding company. On 28th December 1987, the Shenzhen Development Bank was established, the product of the merged assets of six urban credit unions. All these companies, however, were created on an *ad hoc* basis without any kind of authorisation or even policy framework being provided by central government. In 1986 the State Commission of Restructuring the Economic System *(Jingji Tizhi Gaige Weiyuanhui*, hereafter SCORES) began more systematic shareholding experiments, with clear *zhongyang* backing, in Shenyang and Guangzhou. Shanghai also received dispensation to experiment with different corporate forms. Premier Zhao Ziyang, one of the chief exponents of these reforms, was in the ascendancy. On 18th August 1986, the *Renmin Ribao* ran an editorial entitled ‘The stock-holding system is the new foundation of socialism’.\(^{152}\) In late 1986 Zhao made a widely publicised, and extremely radical, call for SOEs ‘to take the lead in transforming the existing fund-raising system so that all their capital is raised through the issue of stock and bonds’.\(^{153}\) By November 1986, Shenyang had 216 shareholding enterprises, Beijing seven and Shanghai 1,500 enterprises with issued securities (mostly bonds and debentures) worth Rmb300m.\(^{154}\) In 1987 the shareholding experiment was nationalised, although it remained, officially at least, one of a number of experimental reforms. Its scale was supposed to be tightly controlled: the contract responsibility system was being rolled out on a far more comprehensive basis at the same time. But shareholding had high-level backing: official publications argued that stocks ‘help mobilise more social funds, increase responsibility in the use of money [and] improve economics results’.\(^{155}\) At the October 1987 13th Congress of the CCP, Premier Zhao argued that ‘distribution of bonds and shares [is] a necessary attribute of large-scale socialised production’.\(^{156}\) Economic reformers within the central government liked the shareholding structure because, in theory at least, it minimised local administrative interference in

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\(^{152}\) Liu (1997), 13.

\(^{153}\) Dai (1986), 8.

\(^{154}\) Shenzhen’s first standardised equity issue (Shenzhen Development Bank) took place in March 1987, Lee (1997), 11; Zhang (1998), 68; Guo (1999a), 327; Dong (1997), 125; Li (1998b), 54.

\(^{155}\) BR (1987), 19.
enterprise management. For their part, local leaders approved because of the new capital that could be raised through the sale of equity to state organs and to the public. As a result the shareholding experiment quickly got out of hand. By the end of 1988, 3,800 enterprises had restructured and issued stock with local government assistance.\textsuperscript{157} This was despite central government attempts in both 1985 and 1987-88 to restrain the scale of restructuring.

There is some dispute over which company qualifies as having issued reform China’s first share. All the early so-called ‘shares’ issued between 1980 and late 1984 resembled debentures: capital was returned at maturity and the company often paid interest as well as dividends to its ‘shareholders’.\textsuperscript{158} Both Lee Hingwah and Cao Jianwen report that Chengdu Shudu Building floated Rmb20m worth of ‘shares’ in June 1980, the first documented issue of corporate securities.\textsuperscript{159} It is unclear who subscribed, but the issue was most probably limited to state bureau and employees and was almost certainly a debenture. In November 1983, three Shenzhen companies, Baoan Investment, Yinhe and Sanhe, began restructuring into shareholding enterprises. Baoan was the first SOE in China to do so. They all then issued ‘shares’ (i.e. debentures) on a private placement basis to legal persons, a practice known as dingxiang (literally, ‘fixed direction’).\textsuperscript{160} These ‘shares’ could not be legally traded.

The first official government document on the subject of share issuance was released by the SCORES in May 1984.\textsuperscript{161} The first national regulations on securities were then promulgated in July 1984.\textsuperscript{162} This brief document allowed newly-established collectives, but not SOEs, to issue shares, thereby paving the...

\textsuperscript{156} Jiang (1990), 155.
\textsuperscript{157} Few of these cases involved actual change of ownership: 85% issued (often unstandardised) equity and debt to their employees, 13.5% to other enterprises and only 1.5% to the general public, Naughton (1995), 218.
\textsuperscript{158} Hu (2000), 21-22.
\textsuperscript{159} Cao (2000), 14; Lee (1997), 10.
\textsuperscript{160} Although Cao notes that Rmb9.4m of Baoan’s ‘shares’ were sold to individuals. Dingxiang type shares were abolished under the Company Law, Xinhua (1992a); Huang (1999d), 117-119. In China, a legal person is an organisation which possesses civil legal capacity and assumes civil liability, Tao (1999), 210, fn 33; Cao (2000), 14.
\textsuperscript{161} ‘Main points of the discussion about experimental work in urban economic restructuring’ allowed workers to invest in shares and companies to distribute dividends. The first local equity regulations, issued in August 1984 in Shanghai were ‘The temporary management measures on the issuance of shares’, Huang (1999d), 94; SZB (1995m); Wen (1998), 122.
way for the Feile and Yanzhong issues later that year. It authorised the central bank to approve all issuance. On 18th November 1984, the trust department of the Jingan (Shanghai) branch of the Industrial and Commercial Bank of China (ICBC), with the approval of Shanghai PBoC’s Financial Administration and Management Department (Jinrong Xingzheng Guanlichu, hereafter FAMD), issued 33,000 shares in Shanghai Feile Acoustics. This was the first share in China to be issued without the promise of a return of principal and therefore qualifies as reform China’s first issue of standardised equity. However, it was also a dingxiang issuance. In January 1985, Shanghai’s Yanzhong Industries made the first confirmed public issue (i.e. non-dingxiang) of standardised shares. Both Feile and Yanzhong were collective companies. Indeed, nearly all of the early share-issuing companies were collectives rather than SOEs. By November 1985, around ten companies had issued shares to the public in Shanghai and the city’s first dedicated broker, Jinjiang Trust Company, had opened for business. Budgetary allocations for SOEs were mostly still guaranteed, reducing the incentives for SOE managers to seek alternative routes for raising capital. Moreover, the ideological sensitivity of securities issuance discouraged them, and their administrative patrons, from such dubious experiments. The first SOE to issue standardised shares was Shanghai’s Zhenkong Electronics on 24th January 1987.

The rush to share issuance and governance problems at the People’s Bank, 1986-88

During 1986-88 the issuance of securities across the country ‘grew out of the plan’, or rather grew out of the quota set by the PBoC and SPC. Unofficial securities issuance, often informally authorised by local government bureaux, not by the central PBoC, expanded massively. Of course, no two statistical sources

163 Collective companies could issue time-limited ‘shares’ (debentures), or non-limited ‘shares’ (equity). They had to pay interest at the one-year bank deposit rate, but could also pay dividends up to 3-5% of the share’s face value. Although the regulations banned ‘real-time’ (xianhuo jiaoyi) trading, shareholders wishing to sell their shares were allowed to use bank trust department to sell their shares, Zheng (1994), 17.
164 Hu (1999a), 97.
165 Hu (1999a), 97.
167 On issuance procedures, Zhang (1999b), 54-56.
for issuance (and trading) for this period agree. The author has therefore used a
variety of sources and allowed the contradictions to stand. By the end of 1990,
some Rmb4.2 billion worth of shares had been issued throughout the country,
Rmb1.7 billion of these publicly. Figure 18 shows the regional breakdown of this
issuance. Issuance in Shanghai is illustrated in Figure 20. It is unclear how much
of this equity was standardised. Outside Shanghai and Guangdong, issuance was
particularly high in Sichuan, Shandong and Liaoning provinces where the
shareholding reforms had been implemented by local leaders with particular
enthusiasm. Figure 19 shows the situation nation-wide. Issuance peaked in 1988
and then subsided as monetary retrenchment was implemented in 1989.
According to Dong Shaoping, by the end of 1990, more than 2,700 enterprises in
Shanghai had issued securities: Rmb1.8 billion of enterprise debt and Rmb1.2
billion of equity.\footnote{Dong (1997), 129.}
### Figure 18. Total share issuance by region, at end 1990

<table>
<thead>
<tr>
<th>Region</th>
<th>Public issuance</th>
<th>Non-public issuance</th>
<th>Total issuance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shanghai</td>
<td>868.8</td>
<td>275.3</td>
<td>1144.1</td>
</tr>
<tr>
<td>Guangdong</td>
<td>317.3</td>
<td>438.5</td>
<td>755.8</td>
</tr>
<tr>
<td>Sichuan</td>
<td>58.7</td>
<td>553.6</td>
<td>612.3</td>
</tr>
<tr>
<td>Shandong</td>
<td>30.0</td>
<td>239.2</td>
<td>269.2</td>
</tr>
<tr>
<td>Liaoning</td>
<td>118.0</td>
<td>136.1</td>
<td>254.1</td>
</tr>
<tr>
<td>Zhejiang</td>
<td>30.3</td>
<td>196.6</td>
<td>226.9</td>
</tr>
<tr>
<td>Hubei</td>
<td>14.2</td>
<td>141.8</td>
<td>156.3</td>
</tr>
<tr>
<td>Jiangsu</td>
<td>120.3</td>
<td>4.9</td>
<td>125.2</td>
</tr>
<tr>
<td>Hainan</td>
<td>-</td>
<td>95.6</td>
<td>95.6</td>
</tr>
<tr>
<td>Hebei</td>
<td>47.5</td>
<td>29.5</td>
<td>77.0</td>
</tr>
<tr>
<td>Guangxi</td>
<td>5.6</td>
<td>-</td>
<td>56.0</td>
</tr>
<tr>
<td>Henan</td>
<td>22.0</td>
<td>33.5</td>
<td>55.5</td>
</tr>
<tr>
<td>Jiaxiang</td>
<td>11.7</td>
<td>28.3</td>
<td>39.9</td>
</tr>
<tr>
<td>Yunnan</td>
<td>-</td>
<td>39.6</td>
<td>39.6</td>
</tr>
<tr>
<td>Shaanxi</td>
<td>4.2</td>
<td>34.5</td>
<td>38.8</td>
</tr>
<tr>
<td>Hunan</td>
<td>6.3</td>
<td>31.0</td>
<td>37.2</td>
</tr>
<tr>
<td>Xinjiang</td>
<td>2.7</td>
<td>33.0</td>
<td>35.7</td>
</tr>
<tr>
<td>Guilin</td>
<td>0.4</td>
<td>33.4</td>
<td>33.8</td>
</tr>
<tr>
<td>Beijing</td>
<td>2.6</td>
<td>29.9</td>
<td>32.5</td>
</tr>
<tr>
<td>Guizhou</td>
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<td>30.5</td>
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<tr>
<td>Shanxi</td>
<td>8.7</td>
<td>21.8</td>
<td>30.5</td>
</tr>
<tr>
<td>Heilongjiang</td>
<td>0.3</td>
<td>18.0</td>
<td>18.4</td>
</tr>
<tr>
<td>Anhui</td>
<td>13.2</td>
<td>3.4</td>
<td>16.6</td>
</tr>
<tr>
<td>Fujian</td>
<td>2.6</td>
<td>11.2</td>
<td>14.7</td>
</tr>
<tr>
<td>Jilin</td>
<td>1.5</td>
<td>6.8</td>
<td>8.3</td>
</tr>
<tr>
<td>Inner Mongolia</td>
<td>0.3</td>
<td>6.1</td>
<td>6.4</td>
</tr>
<tr>
<td>Total</td>
<td>1,739.4</td>
<td>2,461.7</td>
<td>4,201.0</td>
</tr>
</tbody>
</table>

Rmb m

### Figure 19. National share issuance, 1987-1990

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Share issuance</td>
<td>-</td>
<td>1.0</td>
<td>2.5</td>
<td>0.7</td>
<td>0.4</td>
<td>4.6</td>
</tr>
</tbody>
</table>

Rmb billion
### Figure 20. Corporate securities issuance in Shanghai, 1984-1991

<table>
<thead>
<tr>
<th>Year</th>
<th>Corporate equity</th>
<th>Internal corporate debt</th>
<th>Internal corporate equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>0.5</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1985</td>
<td>5.3</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1986</td>
<td>-</td>
<td>139.6</td>
<td>102.2</td>
</tr>
<tr>
<td>1987</td>
<td>78.5</td>
<td>47.4</td>
<td>67.3</td>
</tr>
<tr>
<td>1988</td>
<td>44.9</td>
<td>10.1</td>
<td>83.4</td>
</tr>
<tr>
<td>1989</td>
<td>23.6</td>
<td>41.6</td>
<td>22.9</td>
</tr>
<tr>
<td>1990</td>
<td>9.0</td>
<td>54.7</td>
<td>10.9</td>
</tr>
<tr>
<td>1991</td>
<td>132.7</td>
<td>30.5</td>
<td>7.9</td>
</tr>
</tbody>
</table>

Rmb million

'Internal' refers to the practice of issuing securities to staff, often in lieu of wages. 'Corporate equity' appears to be a mixture of dingxiang shares, as well as debentures and standardised shares sold to external individuals and institutions. SZN (1993), 292.

The first State Council promulgation on securities was the 'Circular on strengthening the management of shares and bonds' issued in March 1987.\(^{171}\) This banned SOEs from public issuance and mandated local governments to 'rectify' those large SOEs that had already (illegally) issued shares openly. Any public issue, it re-affirmed, required permission from the PBoC. As such the circular was the central government's ineffective first stab at restricting countrywide issuance, a campaign that would intensify as 1987 progressed. The problem was that share issuance on this scale contributed to inflation. In 1988, the year when securities issuance nation-wide totalled Rmb2.5 billion, national inflation ran at 20%.\(^{172}\) Inflation was primarily caused by a dramatic increase in money supply issued in the form of bank loans throughout the country, but securities issuance contributed. As well as excess issuance, chaotic interest rates (on debt and debenture issues), a phenomenon that threatened to draw down bank deposits as investors sought higher rates of return in securities caused additional problems.\(^{173}\) By the end of 1988, as wage-price inflation spiralled out of control in the urban centres, many members of the senior leadership had already turned against the shareholding reforms, and their most senior supporter, Zhao Ziyang.\(^{174}\) During 1989, as share issuance sharply contracted as central directives on curbing investment became more severe and local leaders reoriented their

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\(^{171}\) SHGSE (1993), 444-445; Hu (1999a), 119-120.

\(^{172}\) Girardin (1997), 90.

\(^{173}\) Zhang (1998), 124.
behaviour to the new political situation. It was not until early 1990 that issuance once again expanded.

The problems of excess bank lending and securities issuance can be sourced back to the same institutional problem: local capture of PBoC branches. From the issuance of the first standardised shares in December 1984 to August 1992, the PBoC, operating under the State Council, was responsible for all rule drafting, regulation and supervision of the equity sector.\textsuperscript{175} It also authorised all issuance.\textsuperscript{176} These activities were undertaken by its FAMD, which the PBoC established in November 1984.\textsuperscript{177} On 29\textsuperscript{th} May 1985, the Shanghai FAMD issued its first regulations governing share and debenture issuance.\textsuperscript{178} Enterprises’ IPO applications were first to be checked by a local bank and then sent on to the Shanghai ICBC’s trust and investment division, which, at the time, had rudimentary underwriting, brokerage and proprietary trading functions. If approved, the application would then be passed onto the Shanghai FAMD for authorisation. If successful, the application would be passed to the central PBoC for approval. But branches of the PBoC suffered institutional capture: their staff operated under the administrative authority (guanli) of local government leaders and ultimately relied on their local leaders for salaries, welfare and future careers. The result, as extensive research has shown, was that PBoC branches underwent difanghua (‘localisation’, or more colloquially, they ‘went native’) and tended to support local investment policies rather than those of the central PBoC and State Council.\textsuperscript{179} From 1985, after which the policy of ‘replacing budgets with loans’ (bo gai dai) meant that budgetary funding for SOEs was reduced, local governments became interested in diversifying funding sources for their SOEs. Extra-budgetary funds, foreign investment, bank loans and equity issuance were the favoured responses. The problem was particularly acute when monetary policy at the Centre was loosened in 1987, and then again in 1992. In Shanghai and Shenzhen, as well as in numerous other locales, senior leaders

\textsuperscript{174} Baum (1994), 221-225.
\textsuperscript{175} Mehran, Quintyn, Nordman and Laurens (1996), 86; Kam (1997), 40-41.
\textsuperscript{176} SHGSE (1993), 39-42; Dong (1997), 124.
\textsuperscript{177} Zhang (1998), 130; Mao (1997), 241; SHGSE (1993), 40; Hu (1999a), 123.
\textsuperscript{178} SHGSE (1993), 417-420.
would meet informally to discuss investment and equity market issues, and the PBoC director would then be informally briefed on issuance policy.\footnote{For example, in November 1988 a securities small group (zhengquan lingdao xiaozu) was established in Shanghai. Shenzhen formed a similar group in April 1990, Cao (2000), 19.} In practice, securities issuance approval was extended by PBoC branches: the central PBoC was sidelined. The central PBoC securities quota (which, until 1993, covered both debt and equity securities) was thereby made irrelevant.

**Reform China’s first equity markets**

Initial policy statements on shareholding experiments had not envisioned the trading of shares. The experiment was rather supported for the capital it would raise and the improvements it would bring to enterprise management. However, once equity had been issued publicly and to employees, it was extremely difficult to prevent it from being traded. Black market trading in Treasury and other types of bonds had started in the early 1980s. From the Feile issue of November 1984, share (or rather debenture) trading began too.\footnote{Zhao (1987), 37; Liu (1997), 13; Hannan (1998), 158.} The first trading sites were probably on the factory floor and on the streets outside Feile.\footnote{Hu (2000), 28.} These ‘curb’, or ‘black’, markets allowed shareholders to trade between themselves and also quickly gave rise to reform China’s first stockbrokers. The creation of these markets led to half-hearted attempts by local officials to crack down and to calls by local financiers to create formal trading facilities.

**The Shanghai and Shenyang over-the-counter markets**

The first formal share trading markets were set up in Shanghai and Shenyang by the trust and investment departments of local banks in 1986.\footnote{On the OTC markets, Xia, Lin and Grub (1992), 103-112.} An OTC market was established in Shenzhen later, in April 1988.\footnote{Caijing (2000b), 75.} Small and bureaucratic they may have been, but these OTCs were revolutionary and essential first steps in the institutionalisation of China’s equity market. Set up by enterprising financiers, they sparked public interest in shares, proved popular demand for share trading existed, and revealed securities to be a potential financing option for SOEs. They were highly local institutions; the zhongyang extended its broad approval to...
financial reform and the PBoC took on board oversight duties, but all the policies and rules for their operations were developed by the managers of the branches themselves, with some oversight provided by the PBoC officials of their host cities.\textsuperscript{185}

In July 1984, the Shanghai PBoC issued regulations allowing the transfer of shares through the trust departments of banks. A seller had to find a buyer and then go together to the trading post to make the transaction together.\textsuperscript{186} However, there is no evidence of this service being provided in Shanghai before August 1986 when the Jingan counter was established. The Jingan OTC was set up as the result of lobbying efforts by a small number of financial officials working within a state bank. In the summer of 1986, Huang Guixian and Hu Ruiquan, managers at the Jingan branch of the Shanghai ICBC TIC securities business, prepared two reports for the Shanghai PBoC.\textsuperscript{187} The reports were proposals for establishing an OTC market. They received no reply. In August 1986, the Shanghai SCORES hosted a discussion meeting on shareholding reform, a meeting called by Jiang Zemin, then Shanghai mayor. Hu Ruiquan argued for the establishment of a secondary market in corporate equity to support the already established primary market. His argument was that ‘the life of shares is in their trading’: only by allowing share transfer, he claimed, would enough demand for shares be created to make a success of enterprise restructuring.\textsuperscript{188} Mayor Jiang gave his personal consent. Hu then re-applied to the PBoC and received permission two days later. A share trading counter (gupiao chutai jiaoyi) was then officially opened on 26\textsuperscript{th} September 1986 at 1,806 West Nanjing Road at the Jingan ICBC TIC.\textsuperscript{189} This was not, however, an OTC in the usual sense of the term. Traders still needed to find a buyer or seller themselves and then go together to the bank to effect a trade, rather than the OTC itself acting as a market maker.\textsuperscript{190} The OTC had listed eight companies by the end of 1989, as Figure 20 shows. A fruit seller quoted in the official media at the time claimed that the difference between the old

\textsuperscript{185} Wen (1998), 86-90.

\textsuperscript{186} Shares issued to employees and to legal persons, however, could not be transferred this way, and required MoF authorisation, Hu (2000), 29-30.

\textsuperscript{187} Huang Guixian was the manager of the Jingan branch. The Jingan OTC was managed by Hu Ruiquan, Zheng (1994), 13-14, 32, 67.

\textsuperscript{188} Zhao (1985), 31.

\textsuperscript{189} Dong (1997), 246; SZB (1994g).

\textsuperscript{190} The OTC had listed eight companies by the end of 1989, as Figure 20 shows. A fruit seller quoted in the official media at the time claimed that the difference between the old
Shanghai stock market and this new OTC was that 'there is [now] no cheating or trickery. It is now impossible to speculate as state banks exercise effective control over the yield and transfer of shares'.\textsuperscript{191} While his optimistic view of corruption is contradicted by other sources, he was correct about the tightness of controls. Only two shares, Feile and Yanzhong, were initially listed, and the ICBC TIC management, under the direction of the PBoC, set their prices. Dividends were also determined administratively. Prices were kept artificially low and dividends small in order to limit movement of bank deposits into shares, a major concern of the PBoC leadership at the time, and an obvious conflict of interest for the central bank.\textsuperscript{192} In fact, Xu Xiaofeng complains that the PBoC actively sought to limit share issuance before 1990 by limiting approvals of issuance at the central level and by levying a high tax rate (20\%) on dividends. There were few new listings, as Figure 22 shows, and since investors were generally sceptical about the advantages of trading shares, prices remained stable, as Figure 23 shows.

\textsuperscript{190} Hu (1999a), 89.
\textsuperscript{191} Dai (1986), 7.
\textsuperscript{192} Zhao (1993), 13; Xu (1990), 14; Hu (1999a), 89.
Figure 21. The first eight listed companies in Shanghai

<table>
<thead>
<tr>
<th>Company name</th>
<th>Type of company</th>
<th>Share capital</th>
<th>Share capital breakdown</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shanghai Feile Acoustics</td>
<td>Collective</td>
<td>5 Rmb m</td>
<td>State 0.7, Danwei 4.3</td>
</tr>
<tr>
<td>(1984)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shanghai Yanzhong Industries</td>
<td>Collective</td>
<td>10 Rmb m</td>
<td>State 1.2, Danwei 8.8</td>
</tr>
<tr>
<td>(1985)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shanghai Aishi Electronic</td>
<td>Collective</td>
<td>2.7 Rmb m</td>
<td>State 0.9, Danwei 1.8</td>
</tr>
<tr>
<td>(1987)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shanghai Zhenkong Electronics</td>
<td>State-run</td>
<td>300 Rmb m</td>
<td>State 148.9, Danwei 2.1</td>
</tr>
<tr>
<td>(1987)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shanghai Shenhua Electrical</td>
<td>Collective</td>
<td>5 Rmb m</td>
<td>State 0.2, Danwei 0.4</td>
</tr>
<tr>
<td>(1987)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shanghai Feile</td>
<td>Collective and state</td>
<td>21 Rmb m</td>
<td>State 6.5, Danwei 2.1</td>
</tr>
<tr>
<td>(1987)</td>
<td>run</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shanghai Xiangyuan</td>
<td>Collective and state</td>
<td>6.5 Rmb m</td>
<td>State 3.6, Danwei 1.2</td>
</tr>
<tr>
<td>(1988)</td>
<td>run</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shanghai Xingye Real Estate</td>
<td>Newly established</td>
<td>20 Rmb m</td>
<td>State 15, Danwei 5</td>
</tr>
<tr>
<td>(1989)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Rmb m  
Note: The term danwei (work unit) refers to what were soon to be known as legal-person shareholders, i.e. state-owned companies or institutions. Also note that the issuance dates of Shenhua and Feile differ in Figure 21 and Figure 22.

Figure 22. Listings on the OTCs in Shanghai and Shenzhen, 1986-90

<table>
<thead>
<tr>
<th>Year</th>
<th>Shanghai</th>
<th>Shenzhen</th>
<th>Number of new listings</th>
<th>Total number of listed companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>Feile Acoustics, Yanzhong Industries</td>
<td>-</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>1987</td>
<td>Aishi Electronics, Zhenkong Electronics</td>
<td>Shenzhen Development Bank</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td>1988</td>
<td>Xiangyuan, Feile</td>
<td>Wanke</td>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td>1989</td>
<td>-</td>
<td>Jintian</td>
<td>1</td>
<td>9</td>
</tr>
<tr>
<td>1990</td>
<td>Shenhua Electronics</td>
<td>Yuanye, Anda</td>
<td>3</td>
<td>12</td>
</tr>
</tbody>
</table>


Figure 23. Securities trading in Shanghai, 1986-91

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasury bonds</td>
<td>-</td>
<td>-</td>
<td>11,980</td>
<td>8,120</td>
<td>7,000</td>
<td>3,048,620</td>
</tr>
<tr>
<td>Financial bonds</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>318,090</td>
</tr>
<tr>
<td>Enterprise bonds</td>
<td>110</td>
<td>27,580</td>
<td>120</td>
<td>-</td>
<td>-</td>
<td>209,960</td>
</tr>
<tr>
<td>Shares</td>
<td>575</td>
<td>2,620</td>
<td>3,400</td>
<td>2,360</td>
<td>37,290</td>
<td>1,182,590</td>
</tr>
</tbody>
</table>

Rmb '000s
Note: Figures previous to 1988 appear to be a composite figure for all securities issued, bought, deposited and brokered. Figures between 1988-90 are for brokered securities only. SZN (1993), 302.
The Shanghai TIC was not the first site in reform China where formalised share trading had taken place. In January 1985, the State Council authorised the Shenyang leadership to experiment with financial system restructuring. On 5th August 1986 the Shenyang TIC opened its own OTC (known locally as *chuangkou jiaoyi*, literally 'window hole trading'). It appears to have formally facilitated the trading of bonds, mainly financial enterprise bonds, but it also facilitated trading in local shares and debentures. By the 5th November 1987, the Shenyang OTC had a total trading turnover of Rmb900,000 and held Rmb38,000 worth of securities on deposit. Mei Xia reports that the OTC's trading volume was limited to Rmb17,000 a day. Zhao Haikuan suggests a far lower figure in the first year of only Rmb2,800 a day. Its services included:

- Fixed price trading: prices were published daily, with a 2% spread between buy and sell quotes.
- Negotiated price trading: sellers of securities could set their own prices, and the OTC would take a 2% commission on trades.
- Credit trading: the OTC lent funds to traders, who used securities as collateral. There was a two-month limit on loans and a 2% interest rate. This is likely to be the first systematic use of *rongzi* (credit financing) in reform China.
- Authentication: the OTC offered securities authentication services for a 1.6% fee.

Both OTCs received a significant boost in November 1986, when the chairman of the New York Stock Exchange met with Deng Xiaoping. Deng presented his visitor with a Shanghai Feile share certificate, a powerful gesture that indicated the pre-eminent leader's approval of the equity experiment. The State Council circular in March 1987 authorised the Shanghai and Shenzhen governments to experiment with stock markets (and banned them elsewhere, including Shenyang), a decision which would have huge consequences for the institutional

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194 Xia, Lin and Grub (1992), 106.
195 Zhao (1987), 38.
development of the sector. In Shanghai, Hu and others had been continuing their lobbying efforts, this time in an effort to upgrade the Shanghai counter to a proper OTC. The circular allowed Mayor Jiang to authorise a standardised share-trading counter (gupiao jiaoyi chutai), which had the ability to act as a market maker, to begin operations.\(^{198}\)

By the end of 1987, there were reports of securities trading taking place unofficially in over 44 cities across China. The majority of this was bond trading (about 90%, if Hu Haitong’s estimate is to be believed) based in bond trading centres, but there was also considerable informal trading in corporate debt, debentures and equity.\(^{199}\) As trading increased, more counters were established in Shanghai and Shenzhen. Between January 1987 and March 1988, eight more TICs established trading counters in Shanghai and by the beginning of 1990, the Shanghai PBoC had authorised 16 companies to do OTC business. They operated more than 40 counters.\(^{200}\) By the same time, Shenzhen had ten companies, the largest of which was run by the Shenzhen Special Economic Zone Securities Company (SSEZSC), established in September 1987, the first dedicated securities firm to be established in reform China.\(^{201}\) SSEZSC accounted for a turnover of Rmb648m in 1990, 39% of all share trading in the city. With the growth in the market, banks and TICs quickly began establishing securities businesses to trade shares as well as provide facilities to broker them. This was done with the active support of the PBoC: the bank put aside Rmb3 billion for capitalising new firms.\(^{202}\) After limited Treasury bond trading was formally authorised at the bond trading centres in March 1988, provincial branches of the PBoC authorised the establishment of 33 securities companies across the country.\(^{203}\)

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\(^{198}\) Advocacy by Huang and Hu was also apparently influential in the creation of China’s Treasury bond markets too. In October 1987, Huang proposed the trading of bonds in order to eliminate black markets and to raise fiscal revenues. His report was sent to Chen Muhua, PBoC governor, who ordered further research. In February 1998, the State Council authorised experimental Treasury bond trading, Zheng (1994), 68.

\(^{199}\) Han (1989), 23.

\(^{200}\) Zhao (1987), 30.

\(^{201}\) The first institution to do securities business in the PRC was the Shenyang Trust and Investment Company when it began trading enterprise bonds in 1980, Li (1998b), 71-73.

\(^{202}\) Caijing (2000c), 70.

\(^{203}\) Li (1998b), 71-74.
Problems in the new secondary markets

The new markets were, however, deeply flawed. The limited facilities of the OTCs could not cope with rapidly growing demand, prices were uncoordinated between counters, even those in the same city, and fees were high. In addition, the OTCs facilitated insider trading. Since the OTC managements set prices under PBoC guidance, brokered shares for clients and were able to trade on their own account, there were ample opportunities for arbitrage and manipulation. Moreover, because price limits did not allow prices to reflect real demand and provided no centralised registration for share certificates, curb trading continued. The problem was that these new markets were growing into a largely unregulated space. The PBoC was not only failing to effectively govern the issuance market: while local branches of the PBoC were authorising the establishment of hundreds of trading sites, the bank was not creating the institutions that were necessary to govern the new secondary market. By the end of 1991, PBoC branches had authorised the establishment of 66 specialised securities companies and 376 TICs to do securities business. Yet it promulgated no rules governing the establishment of these companies, their capital or asset requirements, or their legal status. Moreover, there was no quality control: all firms that applied gained PBoC authorisation. This phenomenon was especially exaggerated in Guangdong province where every district-level administration established a securities firm. Moreover, there were no requirements for firewalls to be set up between the different activities of these firms. Numerous insurance and finance companies were also allowed to open securities operations during 1988-90.

Clearly frustrated by the PBoC's inability to implement regulation, during late 1987 and early 1988 the State Council attempted to rectify unofficial securities trading. It closed the interbank market to PBoC branches and non-bank financial

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204 Xia, Lin and Grub (1992), 106.
205 Hu (1999a), 93-97.
207 Huang (1999d), 304.
208 Interview-26, Beijing, 2000.
209 Huang (1999d), 304-305.
institutions (NBFIs), and attempted to close the informal trading centres that had been established at Shenyang, Wuhan, Chongqing, and Xian. These attempts had limited success. Yet despite their problems, the OTCs proved that public demand for share trading existed. While during 1986-89 they were too small for the municipal leaders to be much concerned with, their potential to become larger, better-governed and more economically significant was evident by early 1990. Local leaders' desire for an improved system of trading and a way of subordinating the market to their industrial and financing needs, led to a single idea: the stock exchange. Political events, however, were to intervene.

Post-Tiananmen economic policy

The year 1990 witnessed intense policy conflict between Deng Xiaoping and the so-called neo-conservatives (xin baoshou zhuyizhe) led, in economic matters, by Chen Yun. According to Joseph Fewsmith, the Chen line had become Party orthodoxy by November 1989, when Zhao (and implicitly Deng) was critiqued for allowing aggregate demand to exceed supply, for allowing imbalances to develop between agriculture and industry, as well as between the inland areas and the coast. Premier Li Peng pushed for retrenchment at the March 1990 NPC plenary session, calling for an end to provincial autarky, or ‘feudal-lord economies’ (zhuhou jingji), centralisation and a re-emphasis on planning. Such sentiments were obviously hostile to the development of a share market. However, there were signs of hope. Local leaders, including Shanghai’s Zhu Rongji and Guangdong’s governor Ye Xuanping, successfully opposed the central government’s attempt to introduce the dual tax system in early 1990. This success, combined with forcing Premier Li Peng to place some emphasis on economic reform in his work report to the NPC, indicated that a powerful constituency, interested in continuing the shareholding experiment and equity markets, existed. Indeed, the lack of any substantial ‘rectification’ or closure of the OTCs in the wake of the Tiananmen crackdown signalled to many that securities markets were there to stay. Even the neo-conservatives wavered: Li

211 Karmel (1994), 1108.
212 Baum (1994), 313-329. The best review of this period is Fewsmith (2001), 22-83. Neo-conservatism (xin baoshou zhuyi) was a development of the 1980s’ new authoritarianism (xin
Peng spoke in support of joint-stock enterprises and capital market development in February 1990 at the National Work Meeting on the SEZs. Various other public announcements hinted at a pro-equity consensus forming within the zhongyang. An article by Huang Shaoan in the April edition of *Economic Research (Jingji Yanjiu)*, an influential academic journal, subtly reasserted the shareholding agenda. ‘Reform of public ownership in China is not a readjustment of the deep structure’, Huang argued, ‘rather a change in its style’.213 In June, the *Renmin Ribao* reported that economic conditions were now ‘paving the way for flourishing stock markets’.214 The economist Li Yiying, known as ‘Mr Shareholding’ to some, again received coverage in the *Economic Daily (Jingji Ribao)* later in the same month. He argued for wider experimentation in securities issuance and trading.215 In September Xinhua announced that ‘it is generally agreed that a securities market is indispensable for China’s reforms’.216

And so, after months of debate, the seventh plenum of the 13th Congress of the CCP convened in December 1990. It formally approved the:

...gradual enlargement of bond and share issuance, and stern strengthening of its management... the development of financial markets, and giving encouragement to other capital raising methods. In big cities where conditions are right, stock markets should be established and perfected, and a standardised trading system should be set up.217

Deng had won out. Stock markets, one of the most radical of the economic reformists’ policies, survived in a Central Committee document otherwise empty of concrete measures and characterised by vague, and often contradictory rhetoric, designed to offend neither reformists nor neo-conservatives.218 Of course, the issue was couched in the rhetoric of compromise; expansion would be ‘gradual’ and any permanent markets would depend on certain unspecified ‘conditions being right’. Nonetheless, the emphasis of the document was, crucially, on further development. This decision paved the way for stock exchanges to be established in late 1990.

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quanwei zhuyi). As a broad ‘orientation’, rather than a coherent philosophy, it emphasised strong central government controls, planning and also contained elements of a resurgent nationalism.  

214 Xinhua (1990c); CD (1990).  
215 Li (1990).  
Establishing the stock exchanges

The year 1990 was dominated by preparations to establish the Shanghai and Shenzhen stock exchanges. Their initial institutional character was shaped by a competition between two groups of actors. One group, based in Beijing and operating outside of the formal government bureaucracy, envisioned a market based upon Western institutions: self-regulating stock exchanges operating independently of government. The other group, based within the local bureaucracy of Shanghai, and a similar group within Shenzhen, was interested in establishing exchanges within the sphere of influence of the local state: stock exchanges not only regulated but also administered by the local political leadership. The two groups co-operated and competed during the year in designing the exchanges and drafting their rules of business. Both the SHGSE and SHZSE were formally established as SROs and did indeed practice some of these powers. However, they were to operate in practice under the administration of the local government and Party leaderships.

Just as local leaders had an interest in maximising the issuance and trading of securities, they also had an interest in establishing stock exchanges. By institutionalising the share market, trading would become permanent and less susceptible to criticism and/or closure if the winds of ideology or economic policy from the zhongyang changed. Compared to an OTC, a stock exchange offered greater liquidity, lower transaction costs and provided a more convenient exit option for the holders of equity. Moreover, an exchange would provide a better framework in which a local government could manage, even control, share trading. Fake share certificates, as well as many other forms of corruption and wild price swings, all potential sources of social, as well as financial, instability, were common in the OTC and curb markets. With the centralised registration and settlement systems and the price limit mechanisms that could be instituted at a stock exchange, such problems could be greatly assuaged. Lastly, of course, a stock exchange would allow a local government to more easily extract tax revenues. With such institutions in place, local leaders could both stabilise and

218 Baum (1994), 322.
profit from the new share market. Throughout China, therefore, they actively sought to establish exchanges.

*The local government in Shanghai*

Shortly after the Tiananmen protests, Zhu Rongji, Shanghai party secretary and mayor, presented Deng with the idea of establishing a stock exchange in the city. Deng gave his personal approval and in November 1989 preparations began.\(^{219}\) On 2\(^{nd}\) December 1989, Zhu opened the first Shanghai Financial Reform Meeting at which the idea was discussed. A three-person Stock Exchange Leadership Group (SELG) was formed, under which members of the Shanghai PBoC FAMD and Shanghai SCORES formed a six-person research group.\(^{220}\) Their initial findings suggested that a stock exchange would not be financially viable since the demand for stocks was too weak.\(^{221}\) That view soon changed. Between May and July 1990, the trading volume on the Shanghai OTC market grew rapidly. As Figure 24 shows, the year witnessed an enormous increase in the trading of all securities, especially in Shenzhen. Signs of *zhongyang* support and better economic conditions underpinned this surge.

**Figure 24. Trading at the OTCs in Shanghai and Shenzhen, 1986-90**

<table>
<thead>
<tr>
<th>Year</th>
<th>Shanghai</th>
<th>Shenzhen</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>0.58</td>
<td>-</td>
<td>0.58</td>
</tr>
<tr>
<td>1987</td>
<td>2.62</td>
<td>-</td>
<td>2.62</td>
</tr>
<tr>
<td>1988</td>
<td>4.45</td>
<td>4.00</td>
<td>8.45</td>
</tr>
<tr>
<td>1989</td>
<td>7.77</td>
<td>23.00</td>
<td>30.77</td>
</tr>
<tr>
<td>1990</td>
<td>49.63</td>
<td>1,760.00</td>
<td>1,809.63</td>
</tr>
<tr>
<td>Total</td>
<td>65.05</td>
<td>1,787.00</td>
<td>1,852.05</td>
</tr>
</tbody>
</table>

Rmb m

Hu (2000), 32.

At the same time, speculation, fuelled by brokerage and bank loans, triggered huge price movements; curb trading flourished. The Shanghai SELG attempted to clamp down. In July 1990, it ordered all trades to be settled in cash, in effect

\(^{219}\) Dong (1997), 243; Cao (2000), 19.

\(^{220}\) The group was comprised of three high-level Shanghai bureaucrats with financial experience: Li Xiangrui (Shanghai ICBC, chairman), Gong Haocheng (Shanghai PBoC, chairman) and He Haosheng (Shanghai SCORES, director). Zhu is reported to have supported the idea of a stock exchange, assuring his subordinates that he would take political responsibility for the policy, Mao (1997), 183. The research group: Wang Dingpu, Wang Huaqing, Chen Zehao, Jin Dajian, Yu Hang and Chen Yu, SHGSE (1993), 40.

\(^{221}\) Hu (1999a), 84-99.
banning credit trading (rongzi) and introduced a daily 3% limit on price movements. In response, the curb-market, where no price limits could be applied, boomed. In August, the SELG ordered government bureaux and SOEs to stop trading, a restatement of a previous ban. It also ruled that all settlement should take place via authorised securities companies and should be completed within seven days of the trade (T+7). These measures only had a limited effect in diminishing black market activity. Then, on 21st November, the municipal government introduced a 5% fine (based on the previous day’s trading price) on black market purchases and reduced the official daily price movement to 1%. OTC trading picked up in response and black market activity subsided, but only to a degree. The local leadership was fire-fighting without the right institutions in place, and it increasingly became aware of the seriousness of the problem. The idea of a stock exchange became ever more attractive. Zhu strategically inserted the SHGSE project into the new Pudong development scheme, and when in late 1990, Yao Yilin, a Politburo standing committee member, senior neo-conservative, and close advisor to Chen Yun, visited Shanghai, Zhu presented him with the Pudong proposals. Yao authorised the scheme. In mid-1990, the SELG suggested establishing the Shanghai exchange in the first quarter of 1991. Zhu, however, ordered it to open in late 1990, perhaps fearing a change of heart from the zhongyang leadership.

Similar events were taking place in Shenzhen, although preparations for an exchange had begun earlier. Shenzhen’s OTC markets had grown quickly in 1989, thanks in large part to the dividend plan announced by the Shenzhen Development Bank early in the year. The bank, directed by the municipal leadership, offered a generous Rmb7 cash dividend, a two-for-one stock dividend and a one-for-one stock split. This sparked enormous popular demand for shares and marked a major turning point in the Shenzhen’s public perception of stocks. While previously they had been treated as a fixed income security, it was

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222 Xu (1990), 12.
223 Lee (1997).
225 Dong (1997), 243.
suddenly obvious that the asset value of shares could actually increase. Trading volume in Shenzhen increased to Rmb23m in 1989 from Rmb4m in 1988, as Figure 24 shows.

In November 1988, the municipal government established a Securities Market Leadership Group (*Shenzhen Zhengquan Shichang Lingdao Xiaozu*, hereafter SMLG) made up of the mayor, deputy mayor and the leaders of several bureaux to develop policy for the new market. In November 1988, the SMLG and Shenzhen PBoC completed a preparatory report on establishing a stock exchange and on 15th November 1989 received the municipal leadership’s permission to proceed. The SMLG then established the Stock Exchange Preparation Group (*Shenzhen Jiaoyisuo Choubeizu*, hereafter SEPG) led by Yu Guogang and Wang Jian, later to be appointed the first leaders of the SHZSE. In early 1990, the Shenzhen leadership applied to the central PBoC and State Council for permission to establish a stock exchange. It is not clear whether their application was formally rejected or whether there was simply no response. Shanghai received formal *zhongyang* authorisation in April 1990; Shenzhen did not. Unperturbed, in March 1990, the SMLG presented a feasibility report to the municipal leadership. As in Shanghai, this report was pessimistic about costs and revenues, estimating that an exchange would require Rmb1.3m of starting capital and would need seven years to break even. This dulled enthusiasm for the project among the municipal leadership. However, as 1990 progressed, trading volume and prices spiralled upwards. The share price of the Shenzhen Development Bank rose from Rmb1.1 in January to Rmb19.7 in December; Jintian rose from Rmb1.3 to Rmb24.3 over the same twelve months, increases of around 1,700%.

Price limits for these stocks encouraged black market trading, usually at multiples several times higher than official prices. As the revenue calculations

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227 Caijing (2000b), 75; Hu (1999a), 97.
229 Hu (1999a), 214; Dong (1997), 130.
230 Hu (1999a), 97.
231 Hu (2000), 36.
were revised upwards, the municipal leadership became more enthusiastic about establishing an exchange.\(^{232}\) By May 1990, all preparations for the SHZSE were complete, well before those in Shanghai.\(^{233}\) On 22\(^{nd}\) November 1990, Li Hao, Mayor Zheng Liangyu and other senior leaders visited the facilities of the yet-to-be-opened SHZSE and discussed a report prepared by the SEPG. The document emphasised the advantages of centralised trading and settlement and estimated that corruption in the sector could be reduced by 75\% with a stock exchange. It further argued:

\[
\text{In our report to Beijing, we must make clear that [the application for a stock exchange] is [based on the advantages of] centralised trading and strengthened management. These are appropriate for Beijing's cautious attitude.}^{234}\]

The Shenzhen leadership was anything but cautious. While still awaiting approval, Li ordered trading to begin and assured his colleagues that he would take political responsibility for the decision.\(^{235}\) On 1\(^{st}\) December 1990 the SHZSE started business with one listed share, Shenzhen Anda.\(^{236}\) The SHGSE opened a few days later on 14\(^{th}\) December 1990.\(^{237}\) Only on 11\(^{th}\) April 1991 did the State Council finally direct the PBoC to authorise the establishment of the SHZSE. Its formal opening then took place on 3\(^{rd}\) July 1991.\(^{238}\) Such is the basis upon which both exchanges claim to be reform China's first stock exchange.

**The Stock Exchange Executive Council**

Establishing stock exchanges was, however, not an entirely local endeavour. In Beijing in late 1989 a group of experienced financiers was already advocating the need for stock markets, developing institutional designs for them and promoting the idea among the senior leadership.

\(^{233}\) Caijing (2000b), 75.
\(^{234}\) Quoted in Hu (1999a), 98.
\(^{235}\) Caijing (2000b), 76.
\(^{236}\) Funding for the SHZSE was arranged from two sources; the Shenzhen Investment Management Company provided Rmb200,000 as a interest-free loan, and the World Trade Building provided office facilities on the understanding that they would be assisted with a listing, Ibid., 75; Crothall (1991).
\(^{238}\) Xinhua (1991a).
In mid-1988, under the sponsorship of leaders within China’s TIC community, an informal stock market promotion group (SMPG) was formed in Beijing. It was made up of financiers recently returned from the United States, those working within the TIC sector, and high-ranking officials within the government.\(^{239}\) Initially, the group appears to have had no formal direction or authorisation from any government or party organs. Indeed, one member of the group termed the whole initiative as ‘private’, though since both government-owned TICs were involved, as well as senior bureaucrats, perhaps the term quasi-private is more appropriate, if more awkward. The important thing, however, is that the group operated outside the confines of the bureaucracy. Free of organisational or bureaucratic interests, they promoted a set of ideas, (which, if successful, they might, of course, have profited from personally in the future), apparently motivated by the desire to build a capital market in support of the country’s economic reforms. The SMPG produced a policy paper entitled ‘Policy suggestions on the standardisation and improvement of the legal system of China’s securities market’ that was circulated among senior officials in mid-1988. On September 8th 1988, Liu Hongru, deputy governor of the PBoC, and one of the leaders of the SMPG, organised a discussion meeting with the SCORES, chaired by Gong Zhuming, at the Wanshou Hotel in Beijing.\(^{240}\) Representatives of the Central Committee General Office, the State Council General Office, the SPC, the SCORES, the MoF and several TICs were present. Most importantly, members of the secretariat of the Central Committee’s FELG, the party organ responsible for financial reform, were present.\(^{241}\) The meeting discussed China’s need for a capital market and provisionally agreed to establish a stock exchange in Beijing, though the question of the site was to spark dispute as preparations progressed.\(^{242}\) After the meeting a small group was designated to prepare a comprehensive report for the State Council and Central Committee, eventually producing a paper entitled ‘Ideas on the Creation and Management of China’s Securities Markets’ (Zhongguo Zhengquan Shichang Chuangban yu

\(^{240}\) Caijing (2000a), 91.
\(^{241}\) Zhao Ziyang’s absence at this November meeting perhaps signals his fall from influence after the price liberalisation debacle of mid-1988, Wang and Fewsmith (1995), 345-362.
On 9th November 1988, the group presented its white paper (baipishu) to the FELG at the Zhongnanhai leadership compound. Representatives of most of the major State Council bureaux were also present. Again, the small group leaders argued that China needed a capital market to support SOE restructuring, bolster the public finances, relieve pressure on the banking system and improve the general efficiency of the economy. For such an end it proposed the establishment of stock exchanges, as well as a national trading system for securities. Yao Yilin, the most senior party figure present, agreed that although economic conditions were 'not mature' for such a market, preparations should nonetheless begin. Over PBoC objections he nominated the SCORES to lead these preparations. After the meeting, the FELG secretariat prepared its own report that extended Central Committee support to the establishment of the SHGSE and a national trading network.

On 15th March 1989, the SMPG founded and dissolved itself into the Stock Exchange Executive Council (Zhengquan Jiaoyisuo Lianhe Sheji Bangongchu, hereafter SEEC). The SEEC, although non-governmental in the sense that it was administratively separate from the bureaucracy and was not funded through the national budget, was placed under the leadership of the SCORES Macroeconomic Management Office. The SEEC thus operated as a quasi-government organ. Writing in 1992, Li Yining listed the SEEC's functions as the making of policy and regulation, the management of stock exchanges and the organisation of other securities experiments. However, these were only the original (and much unfulfilled) aspirations of the council. Based on their experience in America, SEEC members favoured creating equity institutions in

243 Caijing (2000a), 91.
244 Present was Yao Yilin as well as Zhang Jingfu, secretary to the group. Zhou Xiaochuan, then at SCORES and later CSRC chairman, was also present, Dong (1997), 4; Zhang (1997b), 54.
245 SIA (1993), 175.
247 Interview-22, Beijing, 2000; Zhang (1997b), 54.
248 After January 1989, the SEEC was funded by nine NBFIs, including CITIC and GITIC. Each NBI contributed Rmb500,000 to the SEEC's operational costs. These funds lasted for around three years, after which time the SEEC became self-financing. Gong Zhuming became chairman of the SEEC, Wang Boming deputy chairman, and Gao Xiqing became chief counsel. Other key leaders included Zhang Zhifang, who directed day-to-day operations (and later STAQs) and Li Qingyuan, Interview-22, Beijing, 2000; Dong (1997), 126; Li (1992b), 773.
249 Li (1992b), 773.
the image of the NYSE and SEC. Most importantly, and radically, they wished to establish the market independently of government administration. To this end, the SEEC leadership formulated its own fangzhen (policy direction): 'the people lead, the government supports' (minjian faqi, zhengfu zhichí). This fangzhen was apparently the basis of the proposal it made to the FELG, and which apparently subsequently received FELG approval. It implied the development of private securities companies, an independent industry association (like America’s NASD), stock exchanges operating as SROs, and a national and independent regulator modelled on the SEC. Stock markets were to be a private business, governed by non-governmental institutions. Organisations such as the SEEC would be active in designing regulation, providing the minimal management resources stock exchanges required, and providing a go-between between industry and government policy-makers. It was a radical plan and in 1988 it appeared realisable. In the words of Wang Boming, one of the SEEC’s senior members;

\[
\text{We were planning to...allow all parts of the economic system onto the market...to eliminate issuance volumes, allow listed companies to bankrupt, investors themselves to freely chose companies to list, and to give foreign investors an opportunity to join...}^{251}
\]

All work on establishing stock exchanges was halted with the Tiananmen protests of 1989, and the ensuing neo-conservative backlash.\textsuperscript{252} However, soon after, in late 1989, Zhu Rongji re-initiated Shanghai’s plans for an exchange and secured Deng’s approval. At this point, the Shanghai leadership appears to have captured control of the project: no more talk of the exchange being established in Beijing was heard, although the politics behind this decision remain vague. Three factors were probably critical. First, Shanghai, unlike Beijing, had a large stock of SOEs already restructured as shareholding enterprises which were ready to list. Second, with the neo-conservative lobby in the ascendancy in Beijing, Shanghai appeared to offer far more propitious circumstances for stock market development. Third, as a non-state organ, without any substantial backing, the

\textsuperscript{250} Wang (1996b); Hu (1999a), 77.
\textsuperscript{251} Caijing (2000a), 92.
\textsuperscript{252} Tiananmen also brought to a halt preparations for China’s first B-share share issue. A Sino-American joint venture, Squibb Pharmaceutical, was preparing to issue B-shares with Shenyin Securities, Zheng (1994), 129.
SEEC’s backing of Beijing as its preferred site had no sponsor at State Council level; Zhu Rongji was better represented; his former boss in Shanghai was now the General Secretary.

The acting chairman of CITIC and senior SEEC member, Jing Shuping, visited Shanghai with Zhang Jingfu, FELG secretary, sometime in late 1989. Zheng Zhong claims that Zhu Rongji rebuffed their attempt to take over the leadership of the SHGSE project. However, the SEEC was apparently still invited by Zhu to work with the SELG. An interviewee suggested that most of the actual design work for the SHGSE rules and organisation was carried out by SEEC members. However, while the SEEC probably did make the dominant contribution to creating the institutional framework of the exchange, it had little success in propagating its vision of minimal government involvement, or, indeed, of instituting SEEC management over the exchange. Hu Jizhi reports that the Shanghai government wanted control for itself and therefore ended all cooperation with the SEEC after autumn 1990. An interviewee claimed that Zhu Rongji invited the core SEEC personnel to Shanghai to work at the exchange, and offered its members residence permits, an offer that the SEEC members declined. The offer was made, however, on the understanding that since the SHGSE would come under the administrative control of the Shanghai government, so too would SEEC personnel.

Whatever the politics of the divorce, the SEEC continued for a short while to play a significant, if marginal, formal role in China’s stock market development. SEEC ambitions to be active in the management of an equity trading system were given short-lease in December 1990 with the establishment of the STAQS, a national bond (and later legal-person share) trading system run under the leadership of the SCORES (see chapter seven). In addition, the MoF entrusted the SEEC with underwriting Treasury bonds in January 1991 and January 1992, and the SEEC was involved in the launch of Shandong province’s Zibo

253 Ibid., 108.
255 Hu (1999a), 77.
investment fund in November 1992, one of reform China’s first. However, the STAQS experiment soon suffered a serious setback, when the State Council prohibited the listing of legal person shares in May 1993. By late 1990s, the SEEC had transformed itself from a policy research group into a highly successful consultancy, publisher and investment company.

**Concluding remarks**

Three major institutional developments took place during 1984-90. One, local leaders captured the issuance process through their administrative control of PBoC branches. Two, central government leaders authorised development of the stock market and devolved down institution-building powers to local leaders. Three, non-state actors, so vital in initiating early developments, were excluded, leading to state capture of the institution-building process. Institutions are hard things to change, a fact that central government leaders discovered after August 1992. When rioting in Shenzhen revealed PBoC regulation to be inadequate and local equity institutions to threaten *zhongyang* interests, senior leaders attempted to reorganise the institutional architecture, as chapter eight explains. They redesigned equity institutions with the aim of increasing the involvement of the central bureau sub-principals and diminishing the power of local leaders. It proved an extremely difficult task because the norms of operation and mechanisms of influence laid down during 1984-90 could not be easily altered. The competition for the institutions of the sector between local and central government leaders that ensued would define China’s stock market development for much of the 1990s.

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258 Li (1992b), 773; SIA (1993), 173.
259 Li (1998b), 167.
260 The SEEC hosts www.homeway.com, a financial website, runs seminars and publishes *Caijing*, a leading finance magazine.
Institutional capture by local leaders: Share issuance and other problems, 1993-2000

The central government has entrusted us with this experiment and we must dare to take risks.

Li Youwei, Shenzhen Mayor, 1993\textsuperscript{261}

This chapter presents evidence of how local leaders captured the equity institutions governing the issuance market during 1993-97. It shows how such capture enabled them to list SOEs under their administrative control with minimal oversight from the CSRC and limited regard for the formal rules governing the process. Key to this institutional capture was the creation of SMCs formed by senior provincial officials, and their SAOs. Their main role was to select and prepare local enterprises for issuance and public listing. Before 1996 management (guanli) authority over the SMCs and SAOs was exercised by local leaders. The SCSC fangzhen (policy direction), issuance quota and national rules and regulations governed and circumscribed the actions of the SMCs and SAOs. However, these central government macro-institutions allowed extensive discretion for local leaders to pursue their own interests in the listing process and in secondary market regulation. The SCSC and CSRC had few means of overseeing the activities of the SAOs and even fewer means of enforcing their policies. The result was a fractured institutional framework: central bureaux developed policy and regulation but had limited means of implementing either. For their part, local ju-level bureaux leaders had the organisational means to monitor the activities of market participants and to implement regulation, but had a limited interest in doing so. Instead, local leaders in Shanghai and Shenzhen attempted to exploit these equity institutions for their municipalities’ own economic benefit by listing poor-quality firms, maximising revenues from secondary rights issues and creating a permissive regulatory environment in which securities companies and TICs could profit easily, and often fraudulently.

\textsuperscript{261} SCMP (1993b).
The chapter is divided into two sections. The first examines the structure and functions of the SMCs and SAOs and looks at how they operated within Shanghai in detail. The second examines the institutions governing the issuance process during 1993-97 and presents evidence to support the claim that these institutions were manipulated to maximise economic resources for local government.

The Securities Management Commissions

The State Council’s December 1992 circular extended the right to list companies in Shanghai and Shenzhen to local governments throughout China. Each was required to nominate a ‘responsible comrade’ to take charge of the work of nominating and preparing enterprises for listing. In response, SMCs were established, groupings of local leaders normally chaired by the deputy provincial governor in charge of financial affairs. They were usually made up of the leaders of provincial bureau of the same state organs as comprised the SCSC. Each year from 1993 to 1997 each locality received an issuance quota from the SCSC/CSRC, and a list of industries that were to be promoted, discouraged or banned from listing. The quota system is explained in chapter nine. The chief tasks of the SMCs were to chose which SOEs could undergo restructuring, coordinate the competition for listing spaces between these firms and their industrial bureaux, and, approve their public issuance. SMCs also became heavily involved in policy development and had the power to authorise securities companies’ and TICs’ operations within their jurisdictions. In Shanghai and Shenzhen, the SMCs were particularly active in developing policy for the local share markets.

The Shanghai Securities Management Commission

In March 1993, the Shanghai Municipal People’s Congress authorised the establishment of the Shanghai Securities Management Commission (Shanghai

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262 This circular also established the SCSC and the CSRC, and is examined in chapters eight and nine.
264 Interview-34, Shenzhen, 2000.
Zhengquan Guanli Weiyuanhui, hereafter SHGSМС).\textsuperscript{265} Zhuang Xinfu, then deputy mayor responsible for finance, initially chaired the commission.\textsuperscript{266} The Shenzhen municipal government established a similar body on 1\textsuperscript{st} April 1993, chaired by the city’s new mayor, Li Youwei.\textsuperscript{267} An informal leadership group, dominated by the local leaders of the SCORES, SPC, and PBoC had already been active in overseeing share issuance in Shanghai since July 1992.\textsuperscript{268} The establishment of the SHGSMC formalised this group and widened its membership to the directors of nine ju-level bureaux, as shown in Figure 25.

**Figure 25. The membership of the Shanghai Securities Management Commission, 1992.\textsuperscript{269}**

- Shanghai deputy mayor responsible for finance (chair)
- Shanghai PBoC
- Shanghai SPC
- Shanghai SCORES
- Shanghai MoF
- Shanghai Audit Bureau
- Shanghai Foreign Investment Bureau
- Shanghai Justice Office
- Shanghai Securities Administration Office
- The Shanghai Office of the State Administration of State Assets
- Shanghai Stock Exchange\textsuperscript{270}

The SHGSMC met on an *ad hoc* basis about four times a year.\textsuperscript{271} It was dispersed in September 1998, six months after the winding up of the SCSC, on orders from the central government.\textsuperscript{272} The commission had no formal authority in areas where national regulations existed and had an obligation to follow the SCSC’s *fangzhen*. Nevertheless, its sphere of influence was wide and its relative autonomy was considerable (and larger than other local SMCs because of its oversight powers over the SHGSE). During 1993-96 the SHGSMC not only authorised issuance and chose appointees to key regulatory bureaux, but it also

\textsuperscript{265} SHGSE (1997b), 329.
\textsuperscript{266} Xu Kuangdi assumed the chair after Zhuang. In January 1995, deputy mayor Hua Jianming took on the chairmanship, handing over to deputy mayor Chen Liangyu in early 1997, Xinhua (1992d); Interview-15, Shanghai, 2000.
\textsuperscript{267} SZB (1993k); SCMP (1993e).
\textsuperscript{268} Interview-15, Shanghai, 2000.
\textsuperscript{269} Kumar (1997b), 32; c.f. Mao (1997), 243.
\textsuperscript{270} Not a formal member, the SHGSE president attended all meetings, Interview-15, Shanghai, 2000.
\textsuperscript{272} Interview-15, Shanghai, 2000.
exercised huge influence over policy development and market supervision. It authorised securities companies to do business within Shanghai and oversaw appointments to their senior managements. It had nominal powers to supervise the activities of listed Shanghai companies, securities companies and consultants. Most extraordinarily, the SHGSMC claimed the power to set not only detailed policy (zhengce) but to also establish the broader and more strategic ‘policy direction’ (fängzhèn) for the Shanghai share market. This created, in effect, two sets of primary policy principals since the SCSC set a fängzhèn for the national market.

In common with SMCs across the country, up until 1995 the SHGSMC enjoyed de facto authority over the issuance and listing of A-shares within the terms of the quota, as well as rights issuance. By the end of 1992, when the national quota system was introduced and other localities in addition to Shanghai and Shenzhen were allowed to issue shares, the two municipal governments had raised over Rmb10 billion in financing for their own firms, as Figure 26 shows. Even when the right to issue shares was distributed to other localities in 1993, Shanghai was allowed to list a disproportionately large number of companies, some 31 of the 87 enterprises in that year in compensation for the ‘nationalisation’ of ‘its’ stock market (Figure 27). Thereafter the two cities’ dominance of the quota decreased, as the central government, apparently giving way to lobbying by other provincial leaders, gave listing places to the other locales. As a result issuance by Shanghai SOEs fell during 1994-95 to zero. Still, by the end of 1997, the two cities accounted for one third of China’s listed companies (Figure 28).

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Figure 26. A-share issuance in Shanghai and Shenzhen, 1987-93

<table>
<thead>
<tr>
<th>Year</th>
<th>A-share issuance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>1.0</td>
</tr>
<tr>
<td>1988</td>
<td>2.5</td>
</tr>
<tr>
<td>1989</td>
<td>0.7</td>
</tr>
<tr>
<td>1990</td>
<td>0.4</td>
</tr>
<tr>
<td>1991</td>
<td>0.5</td>
</tr>
<tr>
<td>1992</td>
<td>5.0</td>
</tr>
<tr>
<td>1993</td>
<td>19.4</td>
</tr>
</tbody>
</table>

Rmb billion
CSRC (1998), 27.

Figure 27. Money raised in IPOs by Shanghai companies on the SHGSE, 1984-99

<table>
<thead>
<tr>
<th>Number of companies</th>
<th>Total money raised at IPO</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>0.5</td>
</tr>
<tr>
<td>1985</td>
<td>5.3</td>
</tr>
<tr>
<td>1986</td>
<td>0</td>
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<tr>
<td>1987</td>
<td>24.1</td>
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<tr>
<td>1988</td>
<td>6.5</td>
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<tr>
<td>1989</td>
<td>0</td>
</tr>
<tr>
<td>1990</td>
<td>0</td>
</tr>
<tr>
<td>1991</td>
<td>136.6</td>
</tr>
<tr>
<td>1992</td>
<td>16,758.5</td>
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<td>1993</td>
<td>11,559.7</td>
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<td>1994</td>
<td>0</td>
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<td>1995</td>
<td>0</td>
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<td>1996</td>
<td>3,114.9</td>
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<td>1997</td>
<td>11,078.6</td>
</tr>
<tr>
<td>1998</td>
<td>4,064.6</td>
</tr>
<tr>
<td>1999</td>
<td>4,666.4</td>
</tr>
</tbody>
</table>

Rmb m
Tongjiju (2000b), 147-149.

Figure 28. Regional distribution of listed companies in 1997

<table>
<thead>
<tr>
<th>Number of listed companies</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shanghai</td>
<td>112</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>64</td>
</tr>
<tr>
<td>Shenzhen and Guangdong</td>
<td>107</td>
</tr>
<tr>
<td>Total</td>
<td>745</td>
</tr>
</tbody>
</table>

Unlike other SMCs, the SHGSMC and SHZSMC also enjoyed extensive autonomy in the B-share market, enabling them to use the market as a means of financing their own enterprises. They oversaw the drafting of all regulations regarding the issuance, trading, listing and clearance of B-shares in their respective municipalities until 1997, and enjoyed sole authority over their issuance and listing, as well as over the issuance of American Depository Receipts (ADRs). Unlike A-shares, which required CSRC approval from 1993 onwards, the two SMCs had only to inform the CSRC post hoc of their decision to allow a B-share issuance and listing during 1993-97. Over 70% of the B-shares traded in 2000 went through this entirely local authorisation process. The result? Before 1996, only Shanghai and Shenzhen firms issued B-shares and could access the precious foreign exchange this occasioned; thereafter only a sprinkling of other provinces' firms were authorised. By the end of 1998, Shanghai companies made up 75% of the SHGSE B-share market, compared to 14% of the A-share market. Figure 29 shows the funds Shanghai SOEs raised through the market, some US$1.62 billion during 1992-98. The suspicion is that without any kind of oversight, the majority of these companies were of doubtful quality.

Figure 29. B-shares issued by Shanghai companies, 1992-99

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of B-share IPOs</th>
<th>Total funds raised at IPO, US$ m</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>10</td>
<td>655.6</td>
</tr>
<tr>
<td>1993</td>
<td>13</td>
<td>384.6</td>
</tr>
<tr>
<td>1994</td>
<td>10</td>
<td>394.0</td>
</tr>
<tr>
<td>1995</td>
<td>1</td>
<td>22.2</td>
</tr>
<tr>
<td>1996</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>1997</td>
<td>2</td>
<td>63.5</td>
</tr>
<tr>
<td>1998</td>
<td>2</td>
<td>97.0</td>
</tr>
<tr>
<td>1999</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>Total</td>
<td>38</td>
<td>1,616.9</td>
</tr>
</tbody>
</table>

Note: these figures do not include rights offerings
Tongjiju (2000b), 150.

The SHGSMC also held a wide range of strategic powers over personnel appointments, and through these enjoyed effective control of secondary market

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274 Interview-34, Shenzhen, 2000; SIA (1996a), 137.
275 Xinhua (1996c).
276 Huang (1999d), 373; CSRC (1999a), 67.
regulation in the city. The commission nominated the president of the SHGSE and the director of the Shanghai SAO (SHGSAO).\textsuperscript{277} As a membership organisation, the SHGSE’s own board of directors had \textit{de jure} power to appoint their president. But, in practice, before 1997 the municipal leadership chose the SHGSE president. In Shenzhen, in contrast, Zhuang Xinyi, appointed SHZSE president in 1995, was a CSRC nominee, as was Xia Bin in 1993. Appointments to the two cities SAOs also differed in this way, with the CSRC holding much greater sway in Shenzhen than in Shanghai. The main reason appears to be the ranking of the Shanghai and Shenzhen leaderships. The SHGSMC, led by the senior vice-mayor, and supported by the mayor and party secretary (both of whom had minister (zhengbu) ranking, the later, Huang Ju, being a Central Committee member) on important issues, which included these key personnel appointments, outranked the leadership of the CSRC before August 1997. This was in contrast to Shenzhen, where the local party secretary had deputy ministerial rank and was therefore on an equal footing with the CSRC leadership.

The SHGSMC and SHZSMC, unlike other SMCs, operated under the ‘leadership, co-ordination and guidance’ of the SCSC.\textsuperscript{278} However, no administrative means of co-ordination or oversight existed between the SCSC/CSRC and any of the SMCs/SAOs during 1993-97. The CSRC was limited to issuing guidance notices: it could not issue orders to the SAOs. In addition, no regular reporting system existed between the two levels of government. Kumar reports that the SHGSMC was only required to report major problems to the CSRC.\textsuperscript{279} However, only one instance of this taking place was identified by the author. In June 1994, with the Shanghai share index in free-fall, the SHGSMC reported its concerns to the SCSC and requested that the SCSC take action to support the market.\textsuperscript{280} The report was a plea for assistance, rather than a disclosure of problems or a request for advice. Informal conversation on visits appears to have provided one of the few means for the two levels of government to communicate.\textsuperscript{281} The result was that the SHGSMC, like other

\textsuperscript{277} Interview-15, Shanghai, 2000.
\textsuperscript{278} SZB (1993n); Mao (1997), 243.
\textsuperscript{279} Kumar (1997b), 57.
\textsuperscript{280} Wang (1994a); Interview-15, Shanghai, 2000.
\textsuperscript{281} Interview-15, Shanghai, 2000.
SMCs unconstrained by formal protestations of loyalty to the SCSC, worked within the broad parameters of the SCSC fangzhen to maximise local investment and local revenues. Its leaders did this through a network of local state bureaux centred around the SAOs.

**The Securities Administration Offices**

SAOs were established as the SMCs' administrative offices. As a general rule, the more advanced shareholding reform was in an area the earlier the government established a SAO. Otherwise, the local SCORES bureau or, sometimes, the SPC bureau, would assume responsibility for issuance work under the direction of the SMC. When they were established, SAOs were ju-level bureaux which tended to be closely associated with the other local bureaux involved in SOE restructuring. For example, in Shenzhen, the first SAO director, Wang Lin, was a senior Shenzhen SCORES official. The director of the Sichuan SAO, Zhang Yuren, was concurrently the director of the Sichuan SCORES. A similar situation existed at least in Yunnan as well with Guo Junqing concurrently managing the SAO and SCORES. The first director of the SHGSAO, Yang Xianghai, served concurrently as the deputy director of the Shanghai SPC. Obvious conflicts of interest were created through dual appointments. Similarly, in other localities, the local bureau of the SCORES were involved in directing the work of the SAO.

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282 SAOs were established in Beijing (January 1995), Shanghai (March 1993), Tianjin (May 1995), Liaoning (July 1993), Fujian (February 1993), Shandong (May 1995), Hainan (March 1993), Hunan (August 1994), Shanxi (October 1993), Anhui (September 1994), Hebei (September 1993), Special Administrative Region of Inner Mongolia (September 1995), Shenzhen (April 1993), Wuhan (December 1993), Nanjing (May 1994), Harbin, Qingdao (November 1993), Ningbo (1994), Weihai (November 1993), and Dalian, SIA (1996a), 134-145; Ren (1996), 55.

283 Interview-09, Shanghai, 2000.


287 Interview-09, Shanghai, 2000.

288 The SHGSMC established an office, the Shanghai City Securities Management Office (Shanghaishi Zhengquan Guanli Bangongshi, SHGSAO), as its administrative arm in March 1993. The office reported daily to the deputy mayor. The heads of the FAMD and Regulation division of the Shanghai PBoC were transferred to manage it. The SHGSAO initially employed about 15 people and by 2000 the office had expanded to a staff of 38, World Bank (1995a), 23; Hertz (1998), 60; Interview-09, Shanghai, 2000.
While loosely governed by SCSC fangzhen and regulations, in their day-to-day operations the SAOs were wholly autonomous of central government direction and supervision. One interviewee stated that the SHZSAO only reported its ‘very important decisions’ to the CSRC. Local institutional capture of the SAOs was assured by the rules governing appointments to their leadership posts and budgets. Local leaders nominated and appointed the SAO director: SAO staff were local bureaucrats, whose salaries, welfare and future careers depended on local leaders. Moreover, the SAOs enjoyed sources of income separate from the central government budget. Before 1995, the SAOs levied annual fees on local securities companies and TICs and also collected issuance application fees. In addition, the Shanghai and Shenzhen SAOs also appear to have levied a 0.001% ‘supervision tax’ on share trading at the exchanges. At the end of 1995, the MoF ruled that the SAOs should be funded from the central budget and banned the collection of fees by local SAOs. However, at least the Shanghai government (and probably others too) resisted giving up their IPO fees and it was only in September 1998 that these fees were passed to the MoF and the SAOs became financially dependent upon the central government.

Each SMC defined the official duties of its SAO. These typically included:

- Formulation of local regulations on securities supervision and administration.
- Supervision and authorisation of local share issues and listing.
- Supervision of local securities trading.
- Supervision of information disclosure by local listed companies.
- Formulation of detailed policy.
- Training of local securities personnel.

Despite this plethora of official duties, in practice the key role of the SAOs was to prepare local enterprises to list. SAO directors had little incentive to implement their other duties. In the words of one interviewee: ‘the SAOs were not regulatory organs at all’.

As chapter six will show, the SAOs had no jurisdiction over the stock exchanges and, in other locales, did not actively...

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289 Interview-34, Shenzhen, 2000.
290 Interview-09, Shanghai, 2000.
regulate informal share trading organised on the STCs and elsewhere. Only rarely would the SHGSMC issue informal and/or internal administrative warnings to brokers and listed companies in breach of regulations. Regulatory activity in general was limited. Take company disclosure, for instance. During 1993-94 local SAOs were responsible for acquiring, and checking, the accounts filed by listed companies operating within their jurisdiction before passing them on to the CSRC. However, by July 1994, only 75 of the 169 annual reports for 1993 submitted to the CSRC met the data requirements. Some companies did not submit reports at all. Some, like Shanghai United Textile Holdings and China First Pencil presented copies of the newspapers that had carried their reports. Moreover, under SAO administration, the disclosure of forecast profits was unstandardised and frequently fraudulent, with numerous companies predicting hugely unrealistic figures.

The prize of institutional capture: the issuance process

Administrative control of the SAOs and other local ju-level bureaux allowed local leaders throughout the country to capture control of the share issuance process. During 1992-97, for a company to issue publicly tradable shares, it would first have to gain sponsorship from its local industry department (hangye bumen) and win a place on its local government quota list. The distribution of places on this list would usually be determined at a meeting of the SMC, based on advice provided by the local SPC. If chosen, the SAO, SCORES and/or SPC and the company’s industry department would then sponsor the enterprise through the application process. If the company was not already a shareholding company, it would have to be restructured, a process usually overseen by the SCORES. Non-tradable equity was usually allocated to state organs with administrative control or business connections with the SOE. A formal provisional application would then be filed with the SMC. This contained an evaluation of the company’s assets, facilities, operations and land, three years of audited company accounts and a forecast of the next year’s profits. The SAO

292 Interview-09, Shanghai, 2000.
294 Wong (1994).
295 Wu (1999b), 44.
296 Huang (1999d), 128-134.
prepared these documents, together with the SCORES and SPC, local securities companies, accountants and lawyers. Despite the participation of these firms, SAO staff still often took on many of the roles, most notably due diligence, that are usually undertaken by bankers, accountants and lawyers in more developed markets.\(^{297}\) After the provisional application had been considered and approved by the SMC, the enterprise could then formally apply to the SAO. The SAO would then check and evaluate the application materials (which it had itself prepared) and give an opinion on the application within 30 days. When approved (all SMC-authorised applications were) the application would be again reviewed briefly by the SMC. The enterprise would then apply to the CSRC, the SAO normally filing the necessary documents on its behalf. The CSRC then gave its decision within 20 days of the submission. After CSRC approval had been obtained (and previous to 1995, this was guaranteed) the company could apply to a stock exchange of its own choosing for a listing.

While the SAOs were in theory regulatory organs, the clear interest of their directors was to maximise their local government’s revenues from share issuance. This undermined their interest in the veracity of the application materials, not to mention the long-term viability, of the enterprises they authorised. The entire issuance process was run by administrative organs (local SAOs, SCORES, SPC etc.), allowing administrative interference in the choice of companies coming to market. The SMCs in each province decided which SOEs to list and which to reject. There was no opportunity for independent assessment: the SAOs themselves were responsible for the preparation of accounts and other materials and their verification. Even when firms of lawyers and accountants became involved, they were often owned or closely associated with the local government, and thus were similarly compromised. Moreover, before 1995 there was no effective oversight of the process by any central government bureau.

The process outlined above endured in more or less the same form until 1997, but the relative influence of the local SMC/SAO and CSRC shifted considerably over the period.\(^ {298}\) During 1993-95 there was little effective CSRC oversight and


all local government-sponsored companies were listed, despite their variable quality. Before 1995 the CSRC did not reject a single issuance application. However, during this period the CSRC did gain some influence, including a capacity to compel SAOs to supply additional information and correct problems. Most applications had problems that would cause the CSRC Issuance department to return the application, meaning that on average the application process took about two years. Yet even if the CSRC suspected an enterprise had falsified information it had no means of rejecting the application outright. Interviewees, and other sources, identify the main problem as the bureaucratic rank of the CSRC. Since the CSRC was only a non-government organ, without vice-ministerial status before 1995, it was impossible for its leadership to reject applications personally and visibly sponsored by ministry-ranking provincial governors and party secretaries. When the regulator did raise concerns it was not uncommon for these local leaders to make informal complaints to members of the zhongyang to exert pressure in support of the application. Local government leaders viewed their quota allocation as representing their right to list a certain number of shares in each year and did not appreciate CSRC attempts to undermine this ‘right’. The issuance market was clearly subject to complete local capture.

In 1995 the CSRC became able to reject applications outright, although the formal application process outlined above remained unchanged. To the author’s knowledge, no official notice exists outlining how exactly the weight of decision-making power shifted at this time, but it was most likely influenced by the CSRC’s promotion to vice-ministerial status in early 1995. However, three problems remained. First, the informal influence of local leaders remained strong and the quota system was still used as a lever to ensure that their provinces were allowed to issue a set amount of shares. Second, the preliminary preparation and approval of issuance applications was still carried out by the SAOs, who retained a monopoly on the collection of company information. The CSRC Issuance Division could not check the veracity and/or comprehensiveness of information supplied to it. Third, because SAOs fell under the administrative authority of

300 Interview-20, Beijing, 2000.
local leaders, there were no effective means by which the CSRC could punish, or even investigate, negligence or fraud within the SAOs.

Rights issues

As well as overseeing the IPO process, the SAOs authorised (shenhe) rights issues (peigu).\(^{301}\) A rights offering involves a company raising new capital through issuing new shares to its existing shareholders, usually at a discount to the market price. SAOs retained sole authorisation powers over rights issues and drafted all relevant regulations up until September 1994, well after the partial centralisation of IPO authorisation powers in late 1992. Since rights issues were not included in the annual quota, local leaders could use them to evade the central government’s attempt to limit their investment-raising activities.\(^{302}\) For listed companies, rights issues were, and continue to be, a cheap and uncomplicated source of financing.\(^{303}\) Figure 30 shows Shanghai Shenhua Industries’ options for raising funds in 1997: a rights issue was the cheapest option and a similar cost structure obtained throughout the 1990s for most companies. In addition, rights issues did not entail the many administrative difficulties involved in issuing a bond.\(^{304}\) SMC and SAO leaders were keenly supportive of rights issues since they raised investment funds for local industry. This support was especially pronounced in Shanghai and Shenzhen in 1993. The Shanghai Securities News estimates that in each city companies raised around Rmb 1.4 billion in funds through rights offerings during the year, a huge amount compared to the year’s national issuance quota of Rmb 5 billion.\(^{305}\) Local governments throughout the country took advantage of the loophole after 1993. In 1994, for instance, rights issuance accounted for 57% of the revenues raised in IPOs, making a total issuance volume of Rmb 13.7 billion. This was 149% more than the issuance quota for that year, a year in which the State Council had restricted IPOs as part of its monetary retrenchment policy. In 1995, as retrenchment continued and the CSRC attempted to enforce a go-slow policy for

\(^{301}\) EIU (2001c).

\(^{302}\) Interview-48, Shenzhen, 2001; SZB (1994k).

\(^{303}\) Hu (1999a), 152

\(^{304}\) Corporate bonds remain subject to a tightly controlled quota and proceeds, unlike those from an IPO, are taxable, Liu (2000a), 26-28.

\(^{305}\) SZB (1994h); Hu (1999a), 150.
the share market, rights issues raised Rmb6.8 billion, Rmb1.2 billion more than
the IPO market.

The CSRC had limited success in constraining rights issues. In 1993 it ruled that
a year must lapse between issues (an indication of their frequency at the time)
and that less than 30% of a company's stock capital could be issued (an
indication of their size).\textsuperscript{306} It attempted to intervene and prevent specific
company issues authorised by SAOs in 1994, but again with limited success.\textsuperscript{307}
Rights offerings were still liberally authorised by SAOs despite the new rules.
However, in late 1994 the CSRC tightened its grip by ruling that a listed
company required three years 10% after-tax returns on assets to be able to make
a rights issue. In addition, rights issues would require authorisation from both the
SAO and the CSRC.\textsuperscript{308} Companies were also required to inform the CSRC about
the use of funds raised in such issues. As Figure 31, shows these rules curbed
rights issuance relative to IPO issuance after 1995. Rights issues as a proportion
of initial issues fell from 121% in 1995 to 26% in 1996. However, companies
without the required profit levels continued, with the complicity of their local
SAOs, to make secondary issues. Wang Aijian invokes the aphorism \textit{youfa buyi,}
\textit{zhifa buyan} (where a law exists, it is ignored; when implemented, it is not done
seriously) to describe the situation during 1995-96 when widespread rights
issuance by companies with few profits continued and that few, if any, of the
required reports were ever delivered.\textsuperscript{309} An interviewee confirmed that many
companies before 1997 registered fake profits to enable them to issue rights
shares.\textsuperscript{310} The suspicion of many is that, as of 2000, this practice was still
common.

\textsuperscript{306}SZB (1993i); Chen (1997a), 700-711; Wang (1996c), 90; SCMP (1993c).
\textsuperscript{307}Dong (1997), 154.
\textsuperscript{308}ZZPZ (1997), 335; SZB (1994j); Hu (1999a), 50..
\textsuperscript{309}Wang (1996a), 35-37.
\textsuperscript{310}The number of companies registering returns of 10-12% after the 1994 ruling raises many
Figure 30. The costs of raising funds for Shanghai Shenhua Industries, 1997

<table>
<thead>
<tr>
<th>Fund raising method</th>
<th>Costs</th>
<th>Annual cost per share based on raising Rmb107m, Rmb</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rights offering</td>
<td>A one-off 1.376% underwriting fee</td>
<td>0.04</td>
</tr>
<tr>
<td>Convertible bonds</td>
<td>Annual interest payments of 11% and a one-off 0.07% administrative fee</td>
<td>0.33</td>
</tr>
<tr>
<td>Enterprise bond</td>
<td>Annual interest payments of 10% and a one-off 1.5% administrative fee</td>
<td>0.35</td>
</tr>
<tr>
<td>Bank loan</td>
<td>Annual interest payments of 8% and a one-off 1.5% administrative fee</td>
<td>0.21</td>
</tr>
<tr>
<td>Self-financing</td>
<td>10.35%*</td>
<td>0.31</td>
</tr>
</tbody>
</table>

*Opportunity cost calculated from loss of revenues from investing available funds. SHGSE (1997a) quoted in Dong (1997), 152.

Figure 31. Capital raised in initial, rights and secondary offering, 1993-2000

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A- and B-share initial offerings</td>
<td>23.2</td>
<td>8.7</td>
<td>5.6</td>
<td>27.1</td>
<td>73.5</td>
<td>46.8</td>
<td>57.7</td>
<td>102.1</td>
</tr>
<tr>
<td>A- and B-share rights issues (peigui)</td>
<td>8.2</td>
<td>5.0</td>
<td>6.8</td>
<td>7.0</td>
<td>19.8</td>
<td>33.5</td>
<td>32.1</td>
<td>51.9*</td>
</tr>
<tr>
<td>Secondary issues (zengfa)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>3.0</td>
<td>5.0</td>
<td>N/A</td>
</tr>
<tr>
<td>Rights issues as a proportion of initial offerings, %</td>
<td>35</td>
<td>57</td>
<td>121</td>
<td>26</td>
<td>27</td>
<td>72</td>
<td>62</td>
<td>51</td>
</tr>
</tbody>
</table>

* Includes secondary issues

Rmb billion, unless otherwise stated.
CSRC (1999a), 17; CSRC (2001), 33.
The result of institutional capture: poor quality listed companies

The institutions governing share issuance during 1993-97, and particularly during the early years, were dysfunctional in at least two ways. First, they allowed the wrong types of company to be listed. Chen Gong argues that it was a mistake to allow so many processing, commercial and real estate firms to list; they wasted IPO revenues on unproductive and speculative ventures.\(^{311}\) This was especially a problem during 1991-92, and even in 1993 when, with the central government's guidelines that banned such firms from listing in place, 16% of listing firms were commercial or real-estate companies.\(^{312}\) Local leaders, especially in the south and east of China, were keen backers of such firms because of their potential for making large profits quickly. Second, the quality of companies coming to market was not only poor but many firms faked their entire financial histories, presumably with the support of local officials. One interviewee estimated that around 50% of companies listed before 1997 'had problems' in their applications.\(^{313}\) The implication was that they had falsified their profits or liabilities to some extent. His colleague demurred; he believed the figure was nearer 80%. Another interviewee agreed, estimating the figure to be 70-80%.\(^{314}\) In late 2001, China's National Audit Office, in a random check of 32 listed firms, found 23 of their audited accounts to have 'gravely inaccurate' information. If this survey was representative, 72% of China's 1,152 listed firms had similarly problematic reports.\(^{315}\)

Of course, the seriousness of such fraud is difficult to assess. The financial results of listed companies over recent years, however, provide some clues. By early 1999, 72 of China's 851 listed companies, some 8%, had announced they expected to make losses for the year. In April 2001, 118 of the 1,050 listed companies, some 11%, announced losses for the previous year. Many others had cooked their books to avoid having to make their losses public.\(^{316}\) An interviewee stated that by 2000 around three quarters of listed company accounts could be

\(^{311}\) Chen (1994).
\(^{312}\) Dong (1997), 145.
\(^{313}\) Interview-39, Shanghai, 2000.
\(^{314}\) Interview-05, Shanghai, 2000.
\(^{315}\) EIU (2002).
considered accurate but, as chapter eleven suggests, this claim was too optimistic. The total official numbers of loss-making companies is shown in Figure 32. The size of the Special Treatment (ST) and Particular Transfer (PT) categories on the SHGSE and SHZSE gives another indication of the extent of fraud in issuance applications. After 1998, firms with two years of continuous losses or other problems were placed in ST and were subject to 5% daily price limit movements.\footnote{Shao (1999).} By the end of 1999 there were 54 ST companies, over two thirds of which had been listed before 1994.\footnote{In April 1998, SHZSE-listed Liaowuzi became the first ST firm, Li (1998b), 110-111; Huang (2000b), 28.} In July 1999, the two exchanges, under CSRC instructions, created the PT category, to which ST firms with three years losses were transferred.\footnote{Cao (2000), 125; Huang (2000b), 28.} As of year end 2000 there were 61 ST companies (23 at the SHGSE and 38 at the SHZSE) and ten PT companies (seven at the SHGSE and three at the SHZSE).\footnote{The shares of PT firms traded only on Fridays and were also subject to a 5% limit.} Of course, the appalling financial position of these companies can not solely be blamed on fraudulent initial financial accounts; inept management, poor sales, the burden of large welfare payments to staff and asset-stripping are all likely to have contributed to their problems.\footnote{Data supplied by the Shanghai Stock Exchange, December 2000; Green (2001), 35.} However, it is commonly accepted in the industry that such problems could not have appeared immediately after an IPO and that the present state of the companies indicates problems in their finances that were disguised at the time of issuance.

The quality of listing firms was particularly poor in the early 1990s. Figure 33 shows the per share income of companies listed before 1994 falling by two thirds during the decade from an average of Rmb0.298 in 1994 to Rmb0.114 in 1999. The average profitability of companies listed during 1992-94 also compares badly with those that listed later as shown in Figure 34. Companies that listed in 1992 (Shanghai and Shenzhen companies only) had a per share income of Rmb0.1 in 1997, compared to Rmb0.3 for 1996 listees and Rmb0.4 for 1997 listees. Net asset ratios show a similar decline. Such figures cast doubt not only on the quality of these companies (and their suitability for public issuance and

\footnote{OECD (2000), 26-31.}
trading) but on the veracity of the accounts they submitted at listing. The likely explanation is that as the CSRC gained (and local SMCs/SAOs lost) influence over the institutions of issuance during the decade, the quality of listees improved. During 1992-99, according to research published by the SHZSE, only half distributed cash dividends, compared to 85% in the United States, and dividend payments were frequently small. An investment in the Hong Kong share market during 1999 brought a return from dividends of 2.8%; Shanghai's A-share market only delivered 0.4%.  

322 The alternative is that companies listing in 1997 could have been similarly awful but that sufficient time had not elapsed to reveal their real situation.  
323 EIU (2001c).
### Figure 32. Total number of loss-making companies, 1990-2000

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<tbody>
<tr>
<td>Total number of loss-making companies</td>
<td>2</td>
<td>17</td>
<td>31</td>
<td>47</td>
<td>86</td>
<td>81</td>
<td>118</td>
</tr>
<tr>
<td>Loss-making companies as proportion of total, %</td>
<td>0.7</td>
<td>5.3</td>
<td>5.9</td>
<td>6.3</td>
<td>10.0</td>
<td>8.0</td>
<td>12.0</td>
</tr>
</tbody>
</table>

Zhu (2001), 89.

### Figure 33. The average per share income of 200 companies listed before 1994

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</thead>
<tbody>
<tr>
<td>Average per share income, Rmb</td>
<td>0.298</td>
<td>0.219</td>
<td>0.162</td>
<td>0.140</td>
<td>0.077</td>
<td>0.114</td>
</tr>
</tbody>
</table>


### Figure 34. The 1997 results of companies which listed in 1992-97

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Profit to net asset ratio, %</td>
<td>13.0</td>
<td>12.1</td>
<td>7.4</td>
<td>6.1</td>
<td>4.2</td>
<td>6.6</td>
</tr>
<tr>
<td>Per share income, Rmb</td>
<td>0.4</td>
<td>0.3</td>
<td>0.2</td>
<td>0.2</td>
<td>0.2</td>
<td>0.1</td>
</tr>
<tr>
<td>Per share net assets, Rmb</td>
<td>3.1</td>
<td>2.4</td>
<td>2.2</td>
<td>2.5</td>
<td>2.3</td>
<td>2.4</td>
</tr>
</tbody>
</table>

Huang (1999d), 269.
As well as evidence of widespread malpractice in preparation of company accounts, fraud on an enormous scale has also been a serious problem. The first major corruption scandal involved Shenzhen Yuanye, one of the city’s first Sino-foreign joint venture companies.\textsuperscript{324} On 7\textsuperscript{th} July 1992, the SHZSE suspended trading in the shares of the company.\textsuperscript{325} Yuanye, it was discovered, had faked profits and investment capital and had falsely reported its short-term liabilities.\textsuperscript{326} During 1997-2000 numerous other cases of companies whose accounts had been attractively ‘packaged’ (baozhuang) have come to light. They have revealed how local capture of the issuance process up until 1997 resulted in, at the very least, regulatory negligence and, at worse, SAO/SMC complicity in sophisticated fraud.

The public report in early 2000 by the Central Discipline & Inspection Commission (CDIC), the party department charged with investigating breaches of discipline by CCP members, describes how Daqing Lianyi, a petroleum company from Daqing in Heilongjiang province, was supported by numerous local bureaux in its fraudulent efforts to secure a public listing.\textsuperscript{327} Extraordinarily, the report implicated 179 people in 79 different government bureaux and businesses in malpractice. Daqing Lianyi was only approved as a stock-holding company in late 1996. However, its business license was faked by the Heilongjiang SCORES to read late 1993. This allowed the company to claim that it had three years of operations and a 10\% annual return on net assets, both requirements for a public listing. Together with false accounts submitted by its underwriter Shenyin Wangguo Securities, and false certificates provided by the Heilongjiang Securities Registration Company, all approved by the Heilongjiang SAO, the company successfully gained the CSRC’s approval to list in 1997. In another notorious case, Hongguang Industries, from Chengdu in Sichuan province, used similar methods to secure permission to issue Rmb410m worth of shares and list in Shanghai in May 1997.\textsuperscript{328} Hongguang faked profits of Rmb54m for 1996, when in fact the company had made losses of Rmb103m. It then

\textsuperscript{324} Liu (1997), 125-128.  
\textsuperscript{325} Dong (1997), 140.  
\textsuperscript{326} Yuanye was later restructured, renamed and the suspension of its shares lifted, Fu (1998), 359-367; SZB (1995j); Gu (1993), 8.  
\textsuperscript{327} NZ (1999); Chang (1998).
submitted a fraudulent application to the Sichuan SAO to issue additional shares and was subsequently authorised. It made a secondary issue worth Rmb400m in mid-1998. It was only in late 1998 that the CSRC suspended Hongguang’s shares, after which the chairman and general manager received administrative punishments. Chengdu Shudu Accountant Ltd., Chengdu Asset Valuation Ltd., Sichuan Provincial Economic Lawyers Ltd. and the underwriters, Guotai Securities, Chengdu Securities and Zhongxing ITIC, were also fined and their directors banned from securities-related business for their involvement in their fraud.\(^{329}\) It appears inconceivable that members of the Sichuan SAO and SMC could not have been aware of the fraudulent state of Hongguang’s finances. Hongguang and Daqing Lianyi are not isolated cases. Susanshan, Lantian, Dongfang Guolu, Mengpian Guangda, Qiong Minyuan, to name only a few, have also been revealed as *baozhuang* companies.\(^{330}\) All created assets, falsified their registration dates, and/or hid debts during their issuance applications all overseen by their local SAOs.

**Concluding remarks**

Local capture of the equity institutions governing the primary market resulted in the issuance process being skewed to support local industrial and financial interests. In addition, the SMCs/SAOs, at least up until mid-1994, controlled the rights issuance process, providing localities with an additional route for raising funds. The SAOs were not ‘regulatory’ organs in any meaningful sense. Rather they were organs of industrial policy and worked in co-ordination with other local *ju*-level bureaux to maximise local revenues from share issuance. There was extensive administrative involvement in the choice of companies coming to market, little independent assessment of their quality and ample opportunities for fraud. Institutional capture allowed local officials to withhold and/or falsify information; the ability of the CSRC to discipline aberrant local actors was extremely limited. The institutional complex local leaders created effectively excluded the CSRC from any meaningful participation in the issuance process.

\(^{328}\) Green (2000a); Zhen (1999); ZSZ (1999); Gao (2000).

\(^{329}\) AFX (1998c).

\(^{330}\) Pan (1999), 164-173; Chen (1999); Huang (1999b); Caijing (2001a).
until 1996-97. It is probable that the majority of listed companies before 1997 did not meet the formal listing requirements.

There are suggestions that the zhongyang leadership was aware of such problems early in the 1990s. However, the institutional structure, though dysfunctional, did not present an immediate or serious threat to them. Financial stability was guaranteed by the quota system, the rules on secondary rights issuance and the industry guidelines for issuance which were all, more or less, respected. Baozhuang behaviour was widely suspected, but it was invisible from the public eye and did not induce crisis. Without crisis, the CSRC could not gain the high-level support it needed in order for it to organise significant institutional change. It was only the demonstrable failure of local equity regulation during 1996-97, and the threat of financial instability it presented, which gave the senior zhongyang leadership the incentive to effect such a fundamental change. The following chapter examines this particular crisis in more detail and the involvement of the Shanghai and Shenzhen SMCs and SAOs in fostering it.

331 Ma (1993).
Equity developmentalism unbound: the capture of secondary market institutions in Shenzhen and Shanghai, 1995-97

*If we seek just bustle and excitement and ignore the consequences, this reform will come to a premature end.*

Liu Hongru, deputy minister SCORES, 1991

Before 1995, attempts by local leaders in Shenzhen and Shanghai to develop the secondary stock market were mostly *ad hoc* and opportunistic. They employed three main strategies. In policy areas where clear rules did not exist, local *ju-* level bureau leaders had a habit of pre-empting the central authorities by announcing their own policies, with the implicit support of their SMC. An example of this was the SHZSE’s decision in February 1994 to suspend all new listings in order to shore up prices. Alternatively, local organs would engage in ‘implementation bias’ by delaying or amending a central government policy; in the SAOs’ *de facto* refusal to implement supervision over listed companies’ disclosures, for instance. Third, a SAO or stock exchange would sometimes secretly implement a change in the rules and attempt to hide the fact from the CSRC. An example of this was the ‘illegal’ listing of legal person rights shares during 1993-95, as chapter six explains. All three strategies relied upon the lack of effective supervision mechanisms enjoyed by central government over local bureau activities.

This chapter examines the period 1995-97 when local leaders turned to a more aggressive and strategic form of institutional development. Shenzhen and Shanghai leaders, fully exploiting their *de facto* powers as principals over their local share markets, implemented an aggressive and wide-ranging programme of policies aimed at swelling trading volume, attracting new listings and boosting the number of exchange members. They used the numerous micro-economic policy tools at their disposal to boost secondary market activity. Not only were the stock exchanges and SAOs fully enlisted in this effort but other bureaux with

333 Chan (1994d).
jurisdiction over commercial bank and industrial policy were enlisted. The term ‘equity developmentalism’, understood as a program of policies aimed at the rapid development of the share market, is used to describe these activities. Equity developmentalism raised municipal tax revenues, nurtured the local securities industry and supported local industrial development. Rivalry between the two cities exacerbated their developmental ambitions. The central government in general, and the CSRC in particular, had limited means by which it could constrain the policies being rolled out by the local authorities. When they did attempt to intervene they could only do so with blunt administrative instruments: newspaper editorials, manipulation of the issuance quota and investigations. These proved ultimately ineffective and only served to highlight how fragile the zhongyang leaders’ control of their local agents was. By the beginning of 1997, zhongyang leaders, advised by the CSRC leadership, had realised that they required new institutional structures to ensure local actors’ loyalty and the orderly future development of their stock market.

The chapter is laid out as follows. The first section explains how tax revenues from the stock market were shared between central and local governments, and how such revenues provided local leaders with incentives to develop the market. The second section examines the SHZSE and municipal leadership’s aggressive efforts to develop their market during 1995-96. The third looks at Shanghai leaders’ response and the bank loans scandal that ensued. The fourth section shows how zhongyang leaders initially responded to local developmentalism.

Sharing the spoils: the stamp tax

In addition to the investment revenues raised in the primary market, local leaders in Shanghai and Shenzhen benefited from fiscal revenues generated via trading in the secondary market. Initially, the two municipal governments retained all revenues from the stamp tax, the tax levied on each A- and B-share transaction. However, by the end of 2000, the central government had gained control of 94%
of the revenues, the result of a gradual readjustment in the sharing arrangements in the central government’s favour as shown in Figure 35.\textsuperscript{334}

\textsuperscript{334} COL (2000b); COL (2000c).
Figure 35. The stamp tax and the Centre-Local revenue sharing regime, 1990-2002

<table>
<thead>
<tr>
<th>Time period</th>
<th>Rate of stamp tax, %</th>
<th>Ratio split between central and local government</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990-92</td>
<td>0.3-0.6</td>
<td>All to local government</td>
</tr>
<tr>
<td>1992 - 1994</td>
<td>0.3</td>
<td>20:80</td>
</tr>
<tr>
<td>1994 - 1996</td>
<td>0.3</td>
<td>50:50</td>
</tr>
<tr>
<td>1st January 1997 - 9th May 1997</td>
<td>0.3</td>
<td>80:20</td>
</tr>
<tr>
<td>10th May 1997 - 11th June 1998</td>
<td>0.5</td>
<td>88:12</td>
</tr>
<tr>
<td>12th June 1998 - September 2000</td>
<td>0.4</td>
<td>88:12</td>
</tr>
<tr>
<td>1st October 2000 - 2002*</td>
<td>0.4</td>
<td>91:9 moving to 97:3</td>
</tr>
</tbody>
</table>

Note: Stamp tax was levied on both sides of the transaction until March 1998, when the CSRC announced that it would only be levied on the purchase side, thus in effect halving the tax.

* This was the anticipated stamp tax regime at year end 2000. However, in October 2001, the stamp tax rate was revised to 0.3% in order to revive trading sentiment.

Fu (2000), 203.
During the period examined in this chapter, 1995-97, the two localities received control of 50% of these revenues. These funds accrued to municipal budgets and provided local leaders with an incentive to nurture trading volume and to attract trading away from their rival. Figure 36 shows the author’s estimates of how revenues were split between central and local government during 1991-2000. Although the CSRC has made public data on total stamp tax income (columns one and four), no official data is available on how the revenues were split between the two levels of government. Columns two and three were generated by using the Centre-Local sharing ratios presented in Figure 35. Using data on the relative share of trading at the two exchanges, shown in Figure 37, a rough estimate of the amount of stamp tax collected by the Shanghai government can also be made, as Figure 38 shows. The estimate made here is subject to a number of unknown variables; when new rate regimes were actually implemented, for example. It is therefore only a rough guide to municipal stamp tax revenues. Figure 39 shows similar statistics for Shenzhen, but both total tax revenues and stamp tax are sourced from official sources.335

335 Adding the Shanghai (estimates) stamp tax revenues with those of Shenzhen (official) does not equal the total local stamp tax revenues (estimates) as shown in Figure 36. These inconsistencies are allowed to stand though, since the author believes they still offer the best approximation of these revenues.
Figure 36. Stamp tax revenues for local and central government, 1991-2000

<table>
<thead>
<tr>
<th>Year</th>
<th>Total stamp tax revenue, Rmb billion</th>
<th>Shanghai and Shenzhen (combined) stamp tax revenue, Rmb billion</th>
<th>Central government stamp tax revenue, Rmb billion</th>
<th>Total stamp tax revenues as proportion of total national tax revenues, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>0.03</td>
<td>0.02</td>
<td>0.01</td>
<td>-</td>
</tr>
<tr>
<td>1992</td>
<td>0.40</td>
<td>0.32</td>
<td>0.08</td>
<td>-</td>
</tr>
<tr>
<td>1993</td>
<td>2.20</td>
<td>1.76</td>
<td>0.44</td>
<td>0.51</td>
</tr>
<tr>
<td>1994</td>
<td>4.88</td>
<td>2.45</td>
<td>2.45</td>
<td>0.93</td>
</tr>
<tr>
<td>1995</td>
<td>2.64</td>
<td>1.30</td>
<td>1.30</td>
<td>0.42</td>
</tr>
<tr>
<td>1996</td>
<td>12.80</td>
<td>6.40</td>
<td>6.40</td>
<td>1.73</td>
</tr>
<tr>
<td>1997</td>
<td>25.08</td>
<td>5.50</td>
<td>19.58</td>
<td>2.90</td>
</tr>
<tr>
<td>1998</td>
<td>22.58</td>
<td>2.70</td>
<td>19.88</td>
<td>2.29</td>
</tr>
<tr>
<td>1999</td>
<td>24.81</td>
<td>2.98</td>
<td>21.83</td>
<td>2.40</td>
</tr>
<tr>
<td>2000</td>
<td>48.59</td>
<td>5.48</td>
<td>43.11</td>
<td>3.63</td>
</tr>
</tbody>
</table>

Note: Total stamp tax revenues (column one) is provided by CSRC (2001), 16. Author’s calculations using CSRC (2001), 16; CSRC (1999a), 31; Hu (1999a), 237; COL (2000) and private correspondence with the SHGSE.

Figure 37. Share of national trading volume at the SHGSE and SHZSE, 1992-2000

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>SHGSE</td>
<td>36</td>
<td>65</td>
<td>71</td>
<td>77</td>
<td>43</td>
<td>45</td>
<td>53</td>
<td>54</td>
<td>52</td>
</tr>
<tr>
<td>SHZSE</td>
<td>64</td>
<td>35</td>
<td>29</td>
<td>23</td>
<td>57</td>
<td>55</td>
<td>47</td>
<td>46</td>
<td>48</td>
</tr>
</tbody>
</table>

Based on CSRC (2001), 45-46.
Figure 38. Stamp tax revenues and financial revenues of the Shanghai municipal government, 1991-2000

<table>
<thead>
<tr>
<th>Year</th>
<th>Municipal financial revenues, Rmb billion</th>
<th>Municipal stamp tax revenues (estimated), Rmb billion</th>
<th>Stamp tax revenues as a proportion of total financial revenues, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>16.12</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1992</td>
<td>18.26</td>
<td>0.115</td>
<td>0.65</td>
</tr>
<tr>
<td>1993</td>
<td>25.57</td>
<td>1.144</td>
<td>4.47</td>
</tr>
<tr>
<td>1994</td>
<td>18.00</td>
<td>1.740</td>
<td>9.66</td>
</tr>
<tr>
<td>1995</td>
<td>22.67</td>
<td>1.001</td>
<td>4.12</td>
</tr>
<tr>
<td>1996</td>
<td>27.13</td>
<td>2.752</td>
<td>10.14</td>
</tr>
<tr>
<td>1997</td>
<td>30.36</td>
<td>2.475</td>
<td>8.15</td>
</tr>
<tr>
<td>1998</td>
<td>39.22</td>
<td>1.431</td>
<td>3.04</td>
</tr>
<tr>
<td>1999</td>
<td>43.19</td>
<td>1.609</td>
<td>3.73</td>
</tr>
<tr>
<td>2000</td>
<td>-</td>
<td>2.850</td>
<td>-</td>
</tr>
</tbody>
</table>

Note: Financial revenues (column one) were provided by Tongjiju (2000s), 144. Local financial revenues plus central financial revenues transferred to the local government make up the local government's total financial revenue. As well as taxes (estimated to be account for 60-70% of the total), local financial revenues include SOE profits, fines, municipal bond issues, etc. Stamp tax data (column two) is based on author's estimates generated from Figure 36 and Figure 37.
<table>
<thead>
<tr>
<th>Year</th>
<th>Municipal financial revenues, Rmb billion</th>
<th>Stamp tax revenues (official), Rmb billion</th>
<th>Stamp tax revenues as a proportion of total financial revenues, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>2.73</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1992</td>
<td>4.30</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1993</td>
<td>6.72</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1994</td>
<td>7.44</td>
<td>0.17</td>
<td>2.28</td>
</tr>
<tr>
<td>1995</td>
<td>8.80</td>
<td>0.63</td>
<td>7.16</td>
</tr>
<tr>
<td>1996</td>
<td>13.17</td>
<td>3.77</td>
<td>28.63</td>
</tr>
<tr>
<td>1997</td>
<td>14.48</td>
<td>2.29</td>
<td>15.81</td>
</tr>
<tr>
<td>1998</td>
<td>16.49</td>
<td>1.62</td>
<td>9.82</td>
</tr>
<tr>
<td>1999</td>
<td>18.48</td>
<td>1.89</td>
<td>10.23</td>
</tr>
<tr>
<td>2000</td>
<td>22.19</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Note: Municipal financial and stamp tax revenues (columns one and two) were provided by official sources, Tongjiu (2000), 207; Tongjiu (1998), 205; Xinju (2000a), 234.
Figure 38 and figure 39 show a significant rise in the level and relative importance of the stamp tax to the municipal governments during 1996-97 as the developmental policies examined below were rolled out. In 1996, the Shenzhen government received 28.6% of its entire revenues from the stamp tax, Shanghai 10%. Both figures only dropped marginally in 1997. In addition to these revenues, tax income from securities companies and TICs was also significant for them. However, no public information on securities companies’ revenues is available before 1997. Figure 16 shows tax contributions of securities companies during 1999-2000, most of which went to local governments. Of course, local leaders were not solely interested in boosting their fiscal revenues: the stock markets also offered them the possibility of supporting local industry, attracting foreign investment, and building their cities into financial centres. However, the above discussion shows that the financial interest in equity developmentalism was considerable.

**Equity developmentalism in Shenzhen, 1995-97**

After 1993 the SHGSE dominated China’s stock market. Under the presidency of Xia Bin (from 1993 to mid-1995), the SHZSE had lost direction and trading volume to Shanghai. In 1995, the SHZSE only hosted some 23% of national A-share trading. The SHGSE’s daily trading volume was typically three times as great as that of the SHZSE and it listed around two thirds of China’s public companies. However, despite its pre-eminence, the SHGSE’s position was not all that secure. The February 1995 Treasury bond futures crisis had resulted in a clamp down by the CSRC and a messy change of leadership, as chapter six will explain. While the SHGSE was in limbo, the Shenzhen leadership initiated an aggressive programme of equity market development. Mayor Li Zibin and deputy mayor Wu Jiesi were keen advocates of capital market development. A municipal white paper in mid-1995 identified stock market development as one

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337 Xinhua, however, reports that in 1993, local securities companies paid Rmb2.33 billion in taxes to the Shanghai government, about 9% of total municipal revenues. If this rate was sustained, and there is good reason to believe it was, then securities companies, and the high trading volumes they profited from, had enormous fiscal significance for the two governments, Xinhua (1994d).
of the city's policy priorities. It set out several goals: to attract more non-Shenzhen securities companies and listees; to nurture several large Shenzhen-based securities companies with registered capital in excess of Rmb100,000; and to aggressively push for the establishment of Sino-foreign joint investment funds and direct foreign entry into the Shenzhen A-share market.\footnote{ZXJ (1997), 91-93.} The paper set a target trading volume of Rmb1.5 trillion by the year 2000.\footnote{Share trading volume on the SHGSE and SHZSE totalled Rmb6.1 trillion in 2000, SZB (1995n).} On 17\textsuperscript{th} August 1995, a series of a 'Shenzhen stock market development and strategy outline meetings' began. Organised jointly by the SHZSAO and the Shenzhen SIA, the leaders of local securities companies were asked for their suggestions on policy development.\footnote{At least one other meeting took place on 29\textsuperscript{th} August 1995, ZXJ (1997), 62.} This was the first formal instance of an administrative agency seeking the advice of stock market players.

\textit{Revival at the Shenzhen Stock Exchange, 1995-96}

Zhuang Xinyi took over as SHZSE president on 20\textsuperscript{th} October 1995.\footnote{Zhuang's team, including the new deputy SHZSE president, Zhang Yujun (another ex-CSRC staffer), was in place by September 1995. Zhuang had previously worked as the deputy director of the SCSC General Office and at the Construction Bank with Zhou Daojiong, the newly appointed CSRC chairman, Interview-34, Shenzhen, 2000; Ibison (1995a); SCMP (1995b).} Although a CSRC appointee who had previously made his career entirely within the Beijing bureaucracy, Zhuang had a mandate from both the CSRC and the SHZSMC to revive the market.\footnote{Interview-34, Shenzhen, 2000.} Reprised of his background in the central government, media analysts believed he would 'bring the exchange into the central fold' and ensure CSRC control.\footnote{Ibison (1995b).} They were to be proved wrong. Zhuang moved aggressively to reorganise the exchange's internal structure and the relations between the SHZSE and other local equity organs. He centralised decision-making powers in his leadership team, took control of the previously autonomous registration and settlement company and established the SHZSE's own Market Service Department. In late October 1995, the SHZSE announced its new 'work policy direction' (\textit{gongzuo fangzhen}) as 'market upwards, service as the basis' (\textit{shichang daoshang, fuwu weiben}). By bringing down costs,
streamlining decision-making and improving the exchange's services, he set the Shenzhen share market up for rapid growth.

During 1991-95, the SHZSE had relied on a set of committees, a listings committee, an audit committee, and the members meeting, for many of its management and policy decisions. This governance structure undermined the efficiency and speed of the decision-making process. For example, while a listing application at the SHGSE before 1995 simply required the president's say-so for an immediate listing, the same process at the SHZSE took three to six months. This, Zhuang considered, was unacceptable. He scrapped the listing committee, and downgraded the role of the other committees, absorbing powers into his own office. Under Zhuang, an informal working group made up of senior management and department heads met fortnightly to approve listings, shortening the process considerably. The new president also won permission from the municipal leadership to reorganise other institutions. The SHZSMC devolved significant policy-making powers down to his team, including the power to approve listings. The SHZSAO's supervisory powers over the exchange were also reduced. Previously, the SHZSAO had sought to regulate non-Shenzhen companies and the SHZSE, apparently in contrast to the SHGSAO. Before 1995, for example, all SHZSE departments were required to report regularly to the SHZSAO and non-Shenzhen companies had to seek SHZSAO permission before making rights offerings.

The second major institutional change Zhuang organised was the SHZSE's takeover and absorption of the Shenzhen Securities Registration and Settlement Company (SSRASC). The SSRASC had operated independently from the exchange and had established a network of thirty offices nation-wide, maximising its own revenues through charging high fees for listing and other services. This, Zhuang determined, damaged the SHZSE: the equivalent Shanghai settlement company was fully owned by the SHGSE, operated under

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346 Huang (1999c), 186.
348 Interview-34, Shenzhen, 2000.
349 Interview-30, Shenzhen, 2000. See also Huang (1999c), 200.
its leadership and provided cheaper services. Zhuang brought the SSRASC under the control of his office and restructured it into, in effect, a department of the exchange. The result was that the SHZSE could roll out a national account card system and lower registration fees for listing companies during 1996. Third, Zhuang attempted to fulfil his 'work policy direction' by promoting 'market service' (shichang fuwu). In January 1996, the SHZSE set up a market service group (MSG) and began sending teams out into China. The SHZSAO and SHZSE jointly established a market service small group which co-ordinated their work. Market service is a term used to describe a wide range of activities used to attract listings and securities companies to the exchange. At its most mundane the MSG provided information, including hotline assistance, about administrative procedures. The teams also took on a public relations role. On 18th May 1996, the SHZSE held a ‘Shenzhen Securities Market Service Week’ in Beijing, explaining the listing policies and services the exchange could offer. Between May and November 1996, Shenzhen MSG teams held similar meetings in twenty-two provinces. They also visited companies that had applied to the CSRC to make public issues, seeking to persuade them of the advantages of a listing in Shenzhen. In addition, ‘market service’ extended to entertaining the senior management of prospective listees on their visits to Shenzhen. Before Zhuang’s move, both exchanges had been far more passive in their approach to listing companies. Zhuang also promoted changes in fees, trading facilities and technology. The listing fee was reduced in October 1995 from Rmb50,000 to Rmb30,000 for both A- and B-shares, while administration fees were also reduced. The results of these policies were impressive. In 1995, the SHZSE opened 500,000 new trading accounts, over half of them in the fourth quarter. Daily trading volume at the SHZSE increased dramatically from Rmb382m in 1995 to Rmb4.9 billion in 1996.

Zhuang’s developmental policies soon brought him into conflict with the CSRC leadership. The SHZSE did undertake a number of measures (including a

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351 Xiao (2000a), 45
354 Hu (1999a), fn. 1.
355 Ibid., 231; SZB (1995j).
crackdown on credit trading) that supported CSRC policy. However, there were a range of issues that caused tension: volatility of stock prices, listings and punishment for illegal behaviour. First, Zhuang defended price volatility as a natural phenomenon of a market; the CSRC leadership demanded intervention during 1994-95 to moderate it: Zhuang resisted. Second, Zhuang aimed to maximise listings and competed aggressively with the SHGSE for them. The case of Changchun’s Number One Automobile, one of China’s major car manufacturers, was representative of the problems this caused. The CSRC aimed for the company to list in Shanghai, but the SHZSE persuaded the firm’s management to list in Shenzhen much to the CSRC’s (and the SHGSE’s) frustration. It is unclear what inducements were proffered. For its part, the SHGSE ‘persuaded’ Guangdong Meiyan to list in Shanghai. An interviewee estimated that each exchange had successfully mounted such operations for at least 20 companies. Third, Zhuang’s team attempted to minimise the punishments meted out to member companies and listed firms, while the CSRC pushed for more severe fines. From 9th May 1995, the CSRC, SHZSAO and SHZSE began to organise quarterly ‘Examination and Investigation Work Consultation Meetings’ to discuss these differences. However, these co-ordinatory meetings were an ineffective way for the CSRC to implement its preferred policies.

The local institutional complex and equity development in Shenzhen, 1996-97

Whereas most of the impetus for equity development during 1995 came from, and was implemented by, the leadership of the SHZSE, in spring 1996 the Shenzhen municipal leadership became involved, at least publicly, just at the same time as the zhongyang leadership was revising its policy position vis-à-vis the stock market, as chapter eight explains. The Shenzhen government initially strained at the limits of its policy competence, pushing for foreign entry into the market, an area that the central government effectively guarded for itself. However, the Shenzhen leadership quickly learnt to exploit the policy-making tools they did have at their disposal, including industrial, fiscal and bank-lending

357 Huang (1999c), 200.
policy, to nurture ‘its’ stock market. Their ability to do this so effectively lay in their administrative control of a network of ju-level bureaux, including the SAO, the PBoC, SPC and MoF. Local institutional capture delivered spectacular results.

By early 1996, macroeconomic conditions were improving. In April the PBoC ended its interest rate subsidy on bank deposits and began lowering interest rates. \footnote{Dong (1997), 171.} Based on a new consensus within the zhongyang, the CSRC leadership signalled its ambition to quicken development of the stock market to support SOE reform. \footnote{Hu (1999a), 227; Zou (1997), 73.} However, the central government leadership was to be taken by surprise by the ferocity and efficacy with which two localities hijacked this new agenda. In March 1996, Li Youwei, Shenzhen party secretary, announced that the municipal government was considering expanding the B-share market and establishing one or two Sino-foreign funds. \footnote{Dong (1997), 181; Li (1997b),40; SZB (1996p); Li (1996), 11.} Both ideas had appeared previously on the municipal white paper and the Shenzhen government applied to the State Council for permission to implement them. Neither initiative received SCSC, CSRC or any form of central government approval. However, in April 1996, after a special work meeting of the SHZSAO, led by Li Zibin, Shenzhen mayor, the government announced a raft of ten less radical developmental policies, most of which fell within the competence of local government. The most important of the policies were:

1. Loans. The Shenzhen MoF would provide Rmb500m in loans to listed companies. Apparently in addition to this, on 25\textsuperscript{th} May 1996 the Shenzhen TIC announced that it would raise several million renminbi and provide listed companies with low interest rate loans. In the second half of 1996, the government chose 20 companies to receive preferential loans. \footnote{Xinhua (1996b).}

2. Consultation. The formation of a Stock Market Development Small Group to be managed by the Shenzhen SIA was announced. This provided a permanent

\footnote{It is unclear if these companies received these loans; two interviewees claimed to have no knowledge of this, Interview-52, Shenzhen, 2001; Hu (1999a), 231.}
go-between for senior actors within securities companies and the municipal
government.

3. B-share market promotion. A B-share Market Promotion Group was formed
in June 1996 to operate under the SHZSE and SHZSAO. It aimed, at the very
least, to resolve problems in settlement and operations and, at most, to
expand the market and introduce convertible B-share bonds.\textsuperscript{364}

4. Support local securities companies.\textsuperscript{365} Up until 1996, the Shanghai leadership
had been more supportive than Shenzhen in boosting its securities
companies’ registered capital and thus allowing them to underwrite larger
IPOs. In July 1996, the Shenzhen government supported the expansion of
Shenzhen International Trust and Investment Securities (SITIS).\textsuperscript{366} In
September 1996, the Shenzhen Investment Management Company, a
government investment vehicle, took a 30% stake in SITIS. The managing
director of SITIS, Hu Guanjin, was concurrently the deputy director of the
SHZSAO.\textsuperscript{367}

5. Credit financing. The government announced its aim to promote bank
financing (rongzi) for securities companies, a practice banned by the CSRC
and PBoC.\textsuperscript{368}

6. Internationalisation. Dual listings with the HKSE were proposed as well as
and supportive policies for ‘1997 concept shares’, companies that would, it
was claimed, benefit from Hong Kong’s return to the Mainland’s sovereign
control.\textsuperscript{369}

and Dalian Refrigerator announced plans to issue convertible bonds (and
were criticised by the CSRC for announcing their plans before the regulator
had issued rules on the subject).\textsuperscript{370}

On 8\textsuperscript{th} July 1996, the SHZSAO issued a ‘second’ raft of developmental policies.
However, most of these simply repeated those announced earlier. Among the few

\textsuperscript{364} SZB (1996n).
\textsuperscript{365} Chan (1995c).
\textsuperscript{366} Zheng (1993), 55-56.
\textsuperscript{367} ZTS (1993).
\textsuperscript{368} Dong (1997), 186-187.
\textsuperscript{369} Chan (1996f).
\textsuperscript{370} Chan Ibid.
original ideas was the establishment of a Treasury Bond Development Small Group, established in October 1996, and financial provisioning for loss-making listed companies. In September 1996, Li Zibin announced more plans to increase co-operation with the HKSE, including cross-listings, joint membership, information exchange and computer links. That was not all; in June 1996, the Shenzhen authorities unilaterally relaxed controls on the opening of B-share accounts. Previously limited to foreign passport holders, thousands of nationals with hard currency were now allowed to buy into the B-share market. The CSRC attempted to crackdown on this unauthorised move in July 1996, but Shenzhen securities companies ignored its newspaper notices.

As Figure 40 shows, by year end 1996, the SHZSE had a market capitalisation of Rmb145.8 billion, surpassing the Rmb140.7 billion capitalisation of the SHGSE. Investors were enthralled by the Shenzhen leadership’s equity developmentalism. In the first half of 1996, the SHZSE opened 1.05m new trading accounts for investors. The daily average value of trading for this period was four times that of the same period in 1995 as Figure 41 shows. During 1995, Shanghai hosted 75% of China’s trading volume and 65% of all listed companies. However, during 1996 the SHZSE hosted 58% of national trading volume, and then 56% in 1997 (Figure 42). Average P/E ratios increased through 1996, from nine times earnings in January to 35 in December, signalling the development of huge demand.

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371 SZB (1996m).
372 Former SHZSE president Xia Bin had already lobbied the CSRC for permission to dual list enterprises trading on other Asian exchanges, but had been turned down, Caijing (2000b), 77; Wu (1997).
373 Peng (1996a).
375 Zhang (1998), 84.
376 SHZSE (1996).
Figure 40. Market capitalisation of the Shenzhen and Shanghai exchanges, 1993-97

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Shanghai</td>
<td>42.4</td>
<td>58.7</td>
<td>58.7</td>
<td>140.7</td>
<td>251.3</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>43.8</td>
<td>38.2</td>
<td>35.1</td>
<td>145.8</td>
<td>269.1</td>
</tr>
</tbody>
</table>

Rmb billion
CSRC (1998), 32-34.

Figure 41. Daily average trading volume in all securities at the SHZSE, 1991-2000

<table>
<thead>
<tr>
<th></th>
<th>Trading volume</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>11.7</td>
</tr>
<tr>
<td>1992</td>
<td>168.9</td>
</tr>
<tr>
<td>1993</td>
<td>496.8</td>
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<tr>
<td>1994</td>
<td>949.4</td>
</tr>
<tr>
<td>1995</td>
<td>382.4</td>
</tr>
<tr>
<td>1996</td>
<td>4,946.3</td>
</tr>
<tr>
<td>1997</td>
<td>6,978.9</td>
</tr>
<tr>
<td>1998</td>
<td>4,535.8</td>
</tr>
<tr>
<td>1999</td>
<td>6,005.8</td>
</tr>
<tr>
<td>2000</td>
<td>12,323.3</td>
</tr>
</tbody>
</table>

Rmb m
SHZSE (2001), 58.

Figure 42. Trading volumes in all securities at the Shanghai and Shenzhen exchanges, 1992-98

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Shanghai</td>
<td>24.7</td>
<td>238.0</td>
<td>573.5</td>
<td>310.3</td>
<td>911.5</td>
<td>1,376.3</td>
<td>1,238.6</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>43.4</td>
<td>128.7</td>
<td>239.3</td>
<td>93.3</td>
<td>1,221.7</td>
<td>1,695.9</td>
<td>1,115.8</td>
</tr>
</tbody>
</table>

Rmb billion
CSRC (1999a), 32-33.

Figure 43. SHZSE profit after taxes, 1991-99

<table>
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<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net profits</td>
<td>0.46</td>
<td>23.37</td>
<td>69.6</td>
<td>133.3</td>
<td>61.3</td>
<td>565.0</td>
<td>891.8</td>
<td>147.6</td>
<td>463.1</td>
</tr>
</tbody>
</table>

Rmb m
Source: SHZSE annual reports, 1991-99
Zhuang’s developmental drive was also profitable for the SHZSE itself. Figure 43 shows the exchange’s annual net profits during 1991-99, profits that rose to Rmb565m in 1996, and peaked at Rmb892m the following year. To drive home the accomplishment, in September 1996 Zhuang Xinyi announced that the SHZSE was now China’s national stock exchange. Daily trading volume at the SHZSE was averaging about Rmb300m to only Rmb150m at the SHGSE at the time. The first battle of the war of the exchanges had been won decisively by Shenzhen.

*Equity developmentalism in Shanghai, 1995-97*

Initial attempts by the Shanghai leadership to respond to a resurgent SHZSE in late 1995 were unsuccessful. They improved during 1996, but their strategy remained largely derivative of, and not as effective as, that of Shenzhen’s leaders. Part of the reason of the weakness of Shanghai’s response was that municipal leaders and the SHGSE management shied away from institutional reorganisation. In addition, after the 1995 Treasury bond crisis, the SHGSE leadership was constrained by intense scrutiny from the CSRC and other parts of central government and Party organs. To add to their problems, Yang Xianghai, the new SHGSE president lacked experience in finance and was even said, by some of his former employees, simply not ‘to understand stock markets’.

At a meeting on 24th November 1995, Yang argued that ‘development and standardisation, service and regulation’ were the SHGSE’s priorities. The syntax implied a renewed emphasis on the former of each of the two pairs. In the same month, municipal leaders allegedly instructed local securities companies to buy into the share market on the understanding that supervision of trading would be relaxed to support these moves. However, this had little impact as the Shanghai index continued to slide from 760 on 25th October 1995 to 516 on 22nd January 1996. The SHGSE began its own market service tour of the provinces

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377 Zhang (1998), 84.
378 Xiao (2000b) 58.
379 Interview-02, Shanghai, 1999.
381 Interview-08, Shanghai, 2000.
in March 1996, beginning in Shenyang, Liaoning province, seeking opinions from its members and publicising its services to potential listees. Back in Shanghai in April 1996 the SHGSAO and SHGSE began holding meetings to seek industry opinion. On 20th and 21st April 1996, the SHGSE held its fifth annual general meeting at which the leadership presented its new five-year plan. Yang announced his intention to increase the speed of listings, introduce convertible bonds, create a new index, promote the entry of insurance funds into the market and expand Shanghai’s Treasury bond market. It was at this AGM that CSRC deputy chairman Li Jiange signalled the central government’s willingness to expand share issuance. Trading volume at the SHGSE rose dramatically after April. In March 1996, daily volume averaged around Rmb400m; in the last week of April it regularly exceeded Rmb4 billion, and settling at around Rmb1.5-2 billion during May.

Soon after the AGM, the SHGSE lowered its membership fee and administrative charges. Local media was enlisted in the promotional efforts, mixing news stories with flagrant publicity. On 21st May 1996, for instance, the Shanghai Securities News, a newspaper jointly owned by the SHGSE and the Shanghai bureau of Xinhua published, on its front-page, P/E ratios reportedly showing the SHGSE to be a cheaper place to invest than the SHZSE. Shenzhen’s Securities Times responded the following day with an editorial explaining that the discrepancy in P/Es was due to the smaller volume of tradable shares at the SHZSE, a fact which did not affect their relative value. Each cities’ media continued to proclaim the achievements and advantages of their own exchanges.

At a special securities companies/government consultation meeting held on 6th June 1996, the Shanghai deputy mayor responsible for finance and the SHGSMC chairman, Hua Jianming, promised additional support to securities companies. Industry representatives suggested that access to bank loans would be beneficial to their businesses. No official announcement was ever made of any initiative taken on the basis of this suggestion, although later events suggest that certain

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383 SZB (1996b); SZB (1996o).
384 SCMP (1996c); SCMP (1996f).
385 SCMP (1996e).
387 Peng (1996b).
municipal officials, in contravention of the Commercial Bank Law and State Council regulations, responded positively to the request.\textsuperscript{389} On 16\textsuperscript{th} June 1996, the SHGSMC met to determine its zhidaofangzhen (guiding policy direction). Daily trading volume by this time was regularly exceeding Rmb6 billion at the SHGSE and Rmb4 billion at the SHZSE.\textsuperscript{390} Official reports of the meeting state that members discussed the conclusions of the SCSC’s sixth meeting as well as the recent conservative fangzhen.\textsuperscript{391} However, other reports suggest that the discussion soon turned to the question of nurturing local securities companies, supporting listed companies and invigorating the Shanghai share market.\textsuperscript{392} On 20\textsuperscript{th} August 1996, the municipal government announced that all listed companies were to come under the auspices of the Shanghai modern enterprise system experiment, and would thus enjoy preferential treatment, including:

- Participation in government-sponsored investment projects.
- Exemptions or help in paying medical and old-age insurance for employees.
- Assistance in raising further capital from the capital markets via rights and secondary offerings.
- Preferential loans from Shanghai’s banks.
- Assistance in asset re-organisation and M&A from the SHGSAO and local banks.
- Market research support from government institutes.

One month later, on 20\textsuperscript{th} September 1996, Han Zheng, director of the SHGSAO and head of the Shanghai SPC, announced what was billed as a ‘second’ wave of preferential policies.\textsuperscript{393} Much of these built upon, detailed or simply repeated previously announced policies. They included:\textsuperscript{394}

- A lowering of the tax rate for listed companies from the standard material rate of 33% to 15%.

\textsuperscript{388} Hu (1999a), 225, 233; CER (1997b), 14.
\textsuperscript{389} Interview-25, Shanghai, 2000.
\textsuperscript{390} Xiao (2000b), 67.
\textsuperscript{391} SZB (1996k).
\textsuperscript{392} SZB (1996i); Hu (1999a), 233; Dong (1997), 188.
\textsuperscript{393} Chan (1995f).
\textsuperscript{394} SZB (1996j); Hu (1999a), 234; Xiao (2000a), 47
- Subsidised government loans to 'pillar', infrastructural and 'high-quality' listed companies.
- Local banks to provide preferential financial services, including loans, to listed companies.
- Asset-injections for 'high-quality' superior listed companies.
- Promotion of asset reorganisation and M&A.

However, these announcements were more impressive on paper than in substance. They appear to have been largely a propaganda exercise to create the impression that Shanghai could match Shenzhen in preferential policies. For example, the 'new' tax band of 15% for Shanghai-listed companies was simply a continuation of a policy introduced in 1992. In late 1995, the MoF suggested raising corporate tax rates for listed companies to 33%, but the Shanghai leadership lobbied hard for it to be retained at 15% and won. In terms of bank loans, Shenzhen's listed companies did not have the history of debt of Shanghai's, an older industrial centre. Shenzhen banks could therefore afford to extend more loans, which they started to do in May 1995. In Shanghai most listed companies had already been extended large bank loans and were already experiencing problems meeting their interest payments. Some companies enlarged their loans after the announcement but these were limited in number and in size. On 27th September, Liaoning Yuanyang Fishing Industries received a five-month Rmb50m loan from the Pudong Development Bank. It was the first non-Shanghai listed enterprise to receive such a loan. Three SHGSE-listed Shanghai companies had previously signed subsidised loan agreements: Lansheng, Lujian, and Shangcai. Apart from these companies, however, there is no evidence of any other SHGSE-listed companies, from the city or outside, receiving preferential loans based on Han's announcement.

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395 In 1994, tax reform removed localities' rights to authorise preferential tax rates. The standard national corporate tax rate is 33%. SOEs and collective enterprises based in the Shenzhen SEZ enjoyed a preferential tax rate of 12%.
396 Peng (1996f).
398 Dong (1997), 189
399 SZB (1996j).
On 3rd October 1996, the SHGSE introduced more concrete measures to attract traders, including lower fees. The SHGSE also announced that it would introduce 'absent' trading (wuxing chuli baopan jiaoyi). Up until that time, all orders had had to be phoned into the SHGSE to a securities company's representative, who then inputted the order into the SHGSE's trading system. Because of this the SHGSE's system was limited to processing 2,000 orders (baopan) per day. The SHZSE 'absent' trading system in contrast allowed 100,000 orders to be processed a day since orders could be communicated directly by computers at securities companies directly to the SHZSE's trading system. By October 1996, funds were flooding in to both exchanges. Daily trading volume at the SHZSE was regularly exceeding Rmb13 billion, Rmb9 billion at the SHGSE. By 5th December 1996 the total daily turnover of shares in China was Rmb35 billion, more than three times the volume recorded at the HKSE on a strong trading day. This was especially impressive as China's market capitalisation was only a tenth of that of the HKSE. Trading in the B-share market was particularly strong; the Shenzhen B-share index rose 180% from mid-November to mid-December 1996, with the Shanghai index following it up on the expectation of an imminent merger of the A and B-share markets. On 20th November 1996, the SHZSE hit a record daily volume of Rmb18.9 billion and trading at the SHGSE hit a record Rmb19.2 billion on 3rd December.

Commercial bank and securities companies' repo borrowing

In late 1996 and early 1997, members of the Shanghai leadership allegedly instructed local banks to make large loans to local securities companies via the repo market. This would have contravened the Commercial Bank Law that banned banks from securities business. Although this has never been proven or officially acknowledged, the evidence is highly suggestive. That commercial banks in Shanghai could be so enlisted in their political leaders' developmental ambitions illustrates the extent of their capture and the flimsiness of the PBoC and CSRC leaderships' grip on their local bureaux.

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400 SZB (1996); Xiao (2000b).
401 Hu (1999a), 235.
402 Chan (1996a); Chan (1996c).
403 Xiao (2000b), 71.
404 Zou (1997), 73.
To take full advantage of the bull market, cash-strapped securities companies and TICs needed access to more funds. Regulations prevented them from borrowing directly from commercial banks. Although some banks made direct loans to securities companies in contravention of this rule, the practice was fairly easy to spot by the central PBoC.\footnote{SCMP (1996a).} One solution was to utilise the market in Treasury bond repurchase contracts, the repo market that was hosted by the exchanges and STCs. By transferring funds on a short term basis, the repo market is meant to serve the short-term liquidity needs of financial institutions. However, during this period it was used to provide long-term loans for the express purpose of share trading. Securities companies ‘lent’ their Treasury bonds to local banks through repo agreements and received loans in return.\footnote{Interview-59, Shenzhen, 2001.} Informal agreements allowed short-term contracts to be regularly renewed. Many of the contracts were faked or simply signed by the two parties for formal purposes, the bonds never actually being transferred to the banks or even deposited at the stock exchange.\footnote{SZB (1997k).} The practice occurred throughout the country; it was common at the STCs and was most concentrated at the SHGSE, the country’s largest bond market. During late 1996 and 1997 more than Rmb8 billion of savings deposits were transferred from banks to local securities companies and TICs via this market.\footnote{Interview-25, Shanghai, 2000.} Chinese media reported that securities companies borrowed Rmb480m on the market in March 1997 alone.\footnote{SZB (1997b).} Huayin Trust and Investment Company, for example, used Rmb2.2 billion in bank funds to trade shares.\footnote{CER (1997b), 13.} One source estimates that in the first half of 1997 roughly 25% of the trading capital of securities companies was supplied by banks via repo agreements. From October 1996 the flow of bank funds into the market was the main engine behind rising share prices.

\footnote{The US$1 billion figure widely quoted in media sources probably understates the extent of lending. Analysis of the contraction in the repo market after the mid-1997 crackdown suggests it could have been up to six times this amount, IHT (1997c); IHT (1997d); Xinhua (1997a).}{406}
Other financial institutions entered the share market too. Banks entered into informal agreements with their SOE customers who would use bank loans to speculate in shares, with a proportion of the profits being remitted back to the bank. Listed companies, many cash-rich with IPO revenues, speculated in shares, often their own. Insurance companies were also involved trading securities.\textsuperscript{412} There are also unconfirmed reports that the SHGSE leadership established an in-house fund to speculate in and manipulate shares. It is alleged that the SHGSE sold off securities owned by Liaoning Guofa, one of the institutions involved in the February 1995 327 scandal, whose accounts had been frozen in May 1995. The proceeds, over Rmb1 billion, were then allegedly used to trade securities. Speculation and illegal trading practices were rife. Securities companies in Shanghai used the funds to manipulate the share of a small number of stocks: Shanghai Lujiazui Finance and Trade Zone Development, Shanghai Petrochemicals and Shenzhen Nanyou Property Development. Shenyin Wanguo Securities, for example, bought 3m shares in Lujiazui in September 1996, some 80\% of the company’s tradable shares, sold the majority in mid-October, and then bought into the stock again in late October, making a profit of some Rmb23.4m.\textsuperscript{413} The strategy was simple; manipulate prices to dizzy heights, encourage small investors to buy in, and then dump the stock. Figure 44, Figure 45 and Figure 46 show the effect of these various policies on trading volume at the SHGSE and SHZSE. Volume rose spectacularly during 1996 at both exchanges, SHGSE peaking at Rmb400 billion in October, SHZSE at Rmb309 billion in November.

\textsuperscript{412} Interview-17, Shanghai, 2000.
\textsuperscript{413} Cao (2000), 238-239.
### Figure 44. A-share and total trading turnover at the SHGSE, 1996

<table>
<thead>
<tr>
<th></th>
<th>January</th>
<th>February</th>
<th>March</th>
<th>April</th>
<th>May</th>
<th>June</th>
<th>July</th>
<th>August</th>
<th>September</th>
<th>October</th>
<th>November</th>
<th>December</th>
</tr>
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<tbody>
<tr>
<td>A-share turnover</td>
<td>10.0</td>
<td>4.5</td>
<td>13.9</td>
<td>44.1</td>
<td>43.8</td>
<td>89.3</td>
<td>101.0</td>
<td>62.6</td>
<td>74.4</td>
<td>144.2</td>
<td>106.1</td>
<td>199.2</td>
</tr>
<tr>
<td>Total turnover</td>
<td>47.0</td>
<td>27.3</td>
<td>57.8</td>
<td>125.5</td>
<td>142.2</td>
<td>202.2</td>
<td>337.4</td>
<td>378.9</td>
<td>295.6</td>
<td>400.0</td>
<td>325.2</td>
<td>427.0</td>
</tr>
</tbody>
</table>

Rmb billion
Note: total turnover includes A-shares, B-shares, Treasury bonds (spot and repos), funds, corporate bonds, warrants and rights.

### Figure 45. A-share and total trading volume at the SHZSE, 1996

<table>
<thead>
<tr>
<th></th>
<th>January</th>
<th>February</th>
<th>March</th>
<th>April</th>
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<th>June</th>
<th>July</th>
<th>August</th>
<th>September</th>
<th>October</th>
<th>November</th>
<th>December</th>
</tr>
</thead>
<tbody>
<tr>
<td>A-share turnover</td>
<td>2.1</td>
<td>1.3</td>
<td>5.5</td>
<td>31.5</td>
<td>51.9</td>
<td>74.8</td>
<td>139.8</td>
<td>93.4</td>
<td>101.2</td>
<td>239.0</td>
<td>264.7</td>
<td>197.9</td>
</tr>
<tr>
<td>Total turnover</td>
<td>4.8</td>
<td>2.2</td>
<td>8.8</td>
<td>41.3</td>
<td>69.6</td>
<td>90.6</td>
<td>157.8</td>
<td>104.9</td>
<td>111.0</td>
<td>260.3</td>
<td>309.0</td>
<td>234.7</td>
</tr>
</tbody>
</table>

Rmb billion
Note: total turnover includes A-shares, B-shares, Treasury bonds (spot and repos), funds, corporate bonds, warrants and rights.
CSRC (1997), 34-35.

### Figure 46. Total trading volumes at the SHGSE and SHZSE, January to October 1997

<table>
<thead>
<tr>
<th></th>
<th>January</th>
<th>February</th>
<th>March</th>
<th>April</th>
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<th>July</th>
<th>August</th>
<th>September</th>
<th>October</th>
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<tbody>
<tr>
<td>SHGSE trading volume</td>
<td>59</td>
<td>67</td>
<td>196</td>
<td>250</td>
<td>207</td>
<td>133</td>
<td>104</td>
<td>84</td>
<td>78</td>
<td>68</td>
</tr>
<tr>
<td>SHZSE trading volume</td>
<td>117</td>
<td>78</td>
<td>219</td>
<td>252</td>
<td>241</td>
<td>170</td>
<td>132</td>
<td>95</td>
<td>78</td>
<td>134</td>
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Rmb billion
China (1999), 35.
Local leaders' equity developmentalism was especially frustrating for the zhongyang leadership because of their new ambition to enlist the share market in support of SOE reform. While the secondary market was so volatile, manipulation so extensive, the risks of a market crash so high, the CSRC's regulatory abilities so limited and local administrative influence so far-reaching, their programme could not be effectively rolled out. Institutional capture by local leaders over the regulatory bureaux and stock exchanges meant that the usual means for a regulator to intervene and enforce good practice, continual and close monitoring of trading activities, supervision of securities companies' accounts, punishments for illegal practices, et al., were unavailable to the CSRC. The zhongyang leadership was therefore forced into taking ad hoc, and blunt, administrative actions to cool the market; newspaper editorials, limits on daily share price movements and large increases in the issuance quota. This fire fighting had an immediate and dramatic effect, but it did not last. Between April and May 1997, the zhongyang leadership, now informed of large and illegal fund movements from commercial banks into the market, introduced a further set of measures.

On 16th December 1996, a Renmin Ribao front-page special editorial entitled *A correct understanding of the current stock market* (*Zhenque renshi dangqian gupiao shichang*) punctured the share bubble.414 Rumours named Vice Premier Zhu Rongji as the editor of the piece which identified ‘very abnormal and irrational trading’ conditions in the market and which made explicit comparisons with the American stock market just before its 1929 crash.415 It appears that the CSRC and the senior zhongyang leadership (including Zhu) suspected that the index hike in the second half of 1996 was the product of massive manipulation by several large securities companies and SOEs. According to industry sources, the editorial was an attempt to undercut this strategy and pre-empt the sell-off that would have occurred when the FIIs exited.416 While the editorial contained

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415 Xiao (2000b), 73.
416 Interview, Shanghai, February 2000
rhetoric about the eight-word *fangzhen* and the SAOs’ role in supervision, its main impact lay in the new administrative measures it introduced: 417

- A new issuance quota of Rmb10 billion was announced for 1996, twice the 1995 quota. This quota would extend beyond year’s end and portended a massive increase in the supply of equity designed to exceed demand and bring prices down. 418
- The introduction of a 10% daily price limit for shares. 419
- A national investigation into share purchases by FIIs and SOEs by the CSRC, PBoC and State Audit Bureau. 420
- Public naming and shaming of listed companies using IPO revenues to speculate in shares.
- Suspension of the licences of securities companies whose employees were caught engaging in illegal trading practices.

It also appears that a readjustment of the stamp tax sharing ratios was determined at this time. The 50:50 Centre-Local split was changed to 80:20, further reducing local leaders incentive for local developmentalism. The SHGSE A- and B-share indexes each dropped 10% on the day of the editorial and continued to fall in the days following. From a peak of 1,247.7 on 9th December, the SHGSE index slumped to 865.6 on 24th December and then continued to float around 950 during January 1997. 421 Trading volume dropped dramatically too, as Figure 46 showed. On the 18th December, the CSRC published a second editorial under the pseudonym of Zhang Xinmin in the *Renmin Ribao* claiming to be satisfied because the indexes had now ‘adjusted to reasonable levels’. 422 But with confidence damaged, reports of social disturbances in central and western China triggered by small investors’ losses, and substantial criticism within the industry of the heavy-handed intervention, the government attempted to reassure investors about its basic policy line. 423 38 firms waiting to issue H-shares in Hong Kong

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417 Li (1997b), 41.
418 SZB (1996d); SCMP (1996a). On the share quota, see chapter nine.
420 Peng (1996g).
422 SZB (1996c); Peng (1996e); SCMP (1996j).
423 Lam (1996a); SZB (1996s).
were allowed to proceed, signalling the zhongyang’s continued positive attitude to the share market. However, the rhetoric of zhongyang leaders remained conservative throughout 1997. Minimising risk became the new theme around which they all spoke. In January, Zhu Rongji ordered financial risk to be minimised at the National Finance Work Meeting.\footnote{Dong (1997), 194, 231-232.} At the plenary NPC session in March 1997, Premier Li Peng ordered the PBoC and other state organs to ‘sternly check and solve the illegal operations of financial organisations, ensure stability, standardise securities markets and increase risk awareness’.\footnote{SZB (1997g); Dong (1997), 194.} The SCSC deputy chairman, Zhou Zhenqing, repeated calls for standardisation (guifanhua) in April.\footnote{ZXJ (1997), 134-137.} The Renmin Ribao and financial press continued carrying editorials that drove the theme home. 1997, they announced, was ‘risk prevention year’.\footnote{SZB (1997f).}

Xinhua first announced an investigation into illegal bank funding of securities companies on 12\textsuperscript{th} June 1997.\footnote{SZB (19971); RR (1997).} Investigations had begun in November 1996 when the National Audit Office discovered that a number of large SOEs were using bank loans for share speculation on a massive scale while CSRC supervisory personnel newly stationed at the two stock exchanges reported abnormal price and fund movements. The State Council organised two investigation groups. The first, led by the PBoC, was sent to Shanghai, the second, led by the CSRC, went to Shenzhen. An interviewee explained that this division in work was because the State Council leadership believed that the two agencies could not work effectively together.\footnote{Interview-08, Shanghai, 2000.} The CSRC initially suspected securities companies were diverting funds from customer accounts.\footnote{SZB (1997f); RR (1997).} Its investigators applied for and received State Council authority to enable them unrestricted access to bank account information. They did discover that customer funds were being diverted into proprietary trading, but also that securities companies were borrowing bank funds via the repo market on a huge scale.

\begin{thebibliography}{11}
\bibitem{Dong} Dong (1997), 194, 231-232.
\bibitem{SZB} SZB (1997g); Dong (1997), 194.
\bibitem{ZXJ} ZXJ (1997), 134-137.
\bibitem{SZB97f} SZB (1997f).
\bibitem{SZB971} SZB (19971); RR (1997).
\bibitem{Interview} Interview-08, Shanghai, 2000.
\end{thebibliography}
The CSRC team in Shenzhen was successful first: by February 1997 they had uncovered large-scale share price manipulation by Huatian Hotel and Shenzhen Motorways Ltd., two Shenzhen-listed SOEs. The team apparently failed to discover any evidence in Shenzhen of bank lending to securities companies; some interviewees claimed that this was because none had occurred; others suspected that it had simply been well hidden. In Shanghai by May, evidence of bank lending to securities companies had been obtained.

While the market remained subdued during January, by February trading activity was again intense, and the indexes were again rising rapidly. New daily trading records were set in May 1997, with Rmb21.6 billion recorded at the SHZSE on 7th May, and Rmb16.0 billion at the SHGSE on 12th May. Figure 46 shows the monthly trading volume growing again in April. Stamp tax revenues burgeoned. In April 1997, total revenues totalled Rmb2.54 billion, 55 times that of April 1996. The Shanghai and Shenzhen governments would together have taken 20%, some Rmb500m. Since their first wave of fire-fighting having only temporarily dampened the flames, and with most of the details of the PBoC/CSRC investigations known, zhongyang leaders resorted to another round of intervention between April and July 1997. The CSRC announced a new issuance quota of Rmb30 billion, three times that announced in December 1996. The SCSC ordered the stamp tax increased to 0.5% (from 0.3%), making trading more expensive and it also banned SOEs and listed firms from trading shares, formally removing an important source of speculation. In April 1997, SHZSE president Zhuang Xinyi and SHGSE president Yang Xianghai were informed that they would be replaced. Zhou Daojiong was replaced at the head of the CSRC by SCSC chairman Zhou Zhenqing. Then, in May 1997, the central government moved to further reduce the incentives for municipal

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430 A suspicion bolstered by the discovery of extensive misuse of customer funds for proprietary trading in October 1996, SZB (1996r); Interview-19, Beijing, 2000.
431 Interview-08, Shanghai, 2000; Interview-34, Shenzhen, 2000.
433 Xiao (2000b), 78.
434 SZB (1997m).
437 CER (1997c).
438 SCMP (1996b); SZB (1997h).
governments to massage share-trading volume, lowering the share of stamp tax that they received to 12%. Trading calmed, and the indexes dropped from their peaks.

In June 1997, the State Council announced a further set of measures, based on the results of the investigations. The presidents of Shenyin Wanguo, Haitong, Guangfa and China Everbright securities companies were dismissed and their companies each fined Rmb5m and banned from proprietary trading for one year. The chairman of the Shanghai ICBC, the main bank involved in extending financing, Shen Roulei, was dismissed. The SHZDB was also ‘severely punished’. It had reportedly used Rmb311m of its own funds to speculate in shares between March 1996 and April 1997, making Rmb90.3m in profit. The SHZDB president, He Yun, was dismissed in July 1997. Several branches of the Bank of China and Agricultural Bank of China were also fined and forced to undergo ‘compulsory reorganisations’. By the end of June 1997, eight other senior financial executives had been dismissed, and at least six banks and securities companies had been fined. However, it is hard to credit that they had operated entirely upon their own initiative: the scale of the lending strongly suggested that senior leaders within the municipal governments had directed the lending. On 6th June 1997 the PBoC banned commercial banks from the Treasury bond spot and repo markets on the stock exchanges and STCs, a move designed to prevent bank funds leaking into shares. Commercial banks had an estimated Rmb12 billion worth of funds in their Treasury bond trading accounts at the two exchanges. The combined total of bond trading on the stock exchanges and on the new inter-bank bond market in June 1997 was Rmb102 billion, a 53% decrease on the figure for the previous month.

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440 CER (1997a).
442 After details of SHGSE complicity in manipulation became known, Shanghai deputy mayor Hua Jianming is alleged to have flown to Beijing to personally intercede with the senior leadership on the behalf of Yang Xianghai. Yang later became president of a SHGSE-listed conglomerate. Hua Jianming, a protégé of Jiang Zemin, moved to Beijing shortly afterwards, becoming the deputy chairman of the FELG and director of its administrative office, Interview-18, Shanghai, 2000.
443 SZB (1997e); SZB (1997f); SZB (1997i).
444 Interview-17, Shanghai, 2000; Xiao (2000c), 220; Jin (1999), 118.
Initial attempts at central capture of local institutions

In March 1996, apparently without the full backing of the State Council, the CSRC had attempted to assert its jurisdiction over some 25 SAOs by issuing a 'decision'. However, this did little to alter the allegiance of the SAOs' directors to their SMCs (which continued to enjoy guanli authority over them), failed to produce any improvement in market regulation, and did nothing to forestall the equity developmentalism examined above. CSRC chairman Zhou Daojiong had first publicly suggested such a move in January 1995, and probably earlier privately, but local government leaders had successfully resisted encroachment on their regulatory powers. The decision laid out SAO duties and delegated the CSRC's own authority to regulate securities matters to them. SAOs were authorised to carry out routine supervision of securities and futures companies, to ensure that local listed companies obeyed regulations and to investigate breaches of regulations, and were given powers to resolve minor administrative problems (serious cases had to be reported to the CSRC). SAOs were also instructed to make regular reports to the CSRC. In Shanghai, the decision brought only two changes to the day-to-day functioning of the SHGSAO. First, CSRC head office took charge of the investigation of cases involving alleged securities fraud of more than Rmb5m. Previously, cases had not even been formally investigated but rather 'resolved' through informal conciliation and administrative means. Second, the CSRC gained some authority in the issuance process governing B-shares. Yet even this was an old policy that had taken at least a year to implement: as early as the beginning of 1995 the CSRC had announced a US$1 billion quota for B-shares, US$800m of which was to go to non-Shanghai/Shenzhen areas. However, it was not until 1996 that the CSRC was able to roll out this policy in practice.

With these two exceptions, the 1996 decision made little difference to the activities of the SAOs and certainly did not disrupt the influence of the SMCs.

\[446\] SZB (1996u); Chen (1997a), 745-747.
The decision was only issued by the CSRC, a vice-ministry ranking organ at the time, although the document attempted to instigate a major reorganisation of the administrative relations between central and local levels. As chapter two explained, provincial governments were thus under little obligation to attend to notices issued by the CSRC. The fact that such an important document was not issued in the name of the State Council suggests that consensus at this higher level was unattainable. In November 1996, the CSRC issued 'implementing regulations' to the decision. These raised the limit of punishments that SAOs could implement, devolved greater powers of investigation to them, and authorised them to do preliminary work on futures brokerages' licence applications. However, this notice also had little effect, a result over which a CSRC interviewee expressed little anxiety. According to him, the leadership of the CSRC realised that the administrative take-over of the SAOs would require both time and 'the need to demonstrate that the CSRC deserved to manage the SAOs'.

Impetus for high level support for such fundamental institutional change soon came. The Shanghai and Shenzhen SAOs were implicated in the bank loans scandal, both through their negligent supervision of financial institutions and through their active support of equity developmentalism during 1996-97. The CSRC chairman, Zhou Zhenqing, then began planning the CSRC’s full take-over and integration of the SAOs in early August 1997 under the direction of the vice premier, Zhu Rongji. He was now apparently convinced of the deleterious effects of SMC/SAO regulation and increasingly sensitive to the dangers of the financial instability induced by the actions of local leaders.

Concluding remarks

This chapter has shown how local political leaders captured institutions governing the secondary equity markets and then oriented them to support their own economic interests. It has also shown how effective they were in excluding central government bureaux from playing an effective role in equity market

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451 Huang (1999d), 98.
452 Interview-29, Shanghai, 2000.
regulation and policy making. The administrative controls that stretched down from the municipal SMCs into the SAOs, the stock exchanges, local banks, and other ju-level bureaux created an institutional network that allowed a range of developmental policies to be implemented, regulation to be minimised and intervention by central bureaux leaders to be made extremely difficult. Local leaders had effective control over financial assistance to listed companies (including both fiscal subsidies and bank loans), over the tax regime at the stock exchanges, and over the style of de facto market regulation. The result was that significant revenues were derived for local government from the stamp tax, profits on securities companies’ and SOEs’ trading activities. A permissive regulatory environment not only allowed rampant price manipulation to be overlooked: local authorities, at least in Shanghai, also appear to have been complicit in encouraging funds to enter the market illegally.
The Shanghai and Shenzhen stock exchanges: from local leadership and self-regulation to ‘sons of the CSRC’

*The stock exchange serves the construction of a socialist economy.*

Li Peng, Shanghai, 1991

This chapter examines the institutional development of the Shanghai and Shenzhen stock exchanges. As SROs, the exchange leaderships initially enjoyed significant powers: authorisation powers over listings, regulatory responsibilities in the secondary market, the ability to punish exchange members, and some autonomy in policy development. The chapter shows how exchange presidents, with the support of municipal leaders, successfully excluded the CSRC from involvement in regulation, and in a whole range of policy areas, in order to dictate the exchanges’ institutional development during 1990-97. The CSRC leadership attempted to institute mechanisms of oversight and control but, although they had some successes before 1997, their efforts generally failed. The reasons for this failure are explained. However, the chapter also demonstrates that with *zhongyang* backing, since August 1997 the CSRC has used a portfolio of institutional means to capture the two exchanges. Despite the fact that they have retained their formal status as SROs they are now, in practice, micro-managed by the regulator. Central capture has provided a number of goods: institutional coherence, more effective implementation of policy and better quality regulation. However, it has come at a cost, as the dynamism and innovation that characterised development at the exchanges before 1997 has been lost. It is hardly an exaggeration to say that as of 2000 the SHGSE and SHZSE were operating as ‘the trading departments of the CSRC’, or, as another industry joke has it, as ‘the sons of the CSRC’. The change in the governance of the exchanges is striking and it has had important consequences for the trajectory of market development.

The chapter is divided into three sections. They examine, in chronological order, the different institutional arrangements through which the exchanges have developed. The first section examines the stock exchanges as SROs operating under the leadership of the PBoC and local leaders during 1990-92. The next section examines the period from 1993 to 1997, when the exchanges operated under the management of the two sub-principals, local and central government leaders. The February 1995 bond futures crisis is examined in detail since it reveals the shortcomings of the SHGSE’s self-regulatory practices and the weaknesses of this dual management arrangement. The third section examines the institutional capture of the exchanges by the CSRC after August 1997 and its consequences.

The Shanghai Stock Exchange, the PBoC and self-regulation, 1990-92

The SHGSE opened for business on 19th December 1990 in the Pujiang Hotel, just north of the Bund.455 The exchange was established on a non-profit membership basis, with the status of a shiye faren (legal person) organisation, not a government bureau. It had registered capital of Rmb10m (supplied by the municipal government), 49 member seats and 29 members and initially listed 22 bonds and eight company shares.456 After a transitional period in which shares traded on the city’s OTCs were transferred, after February 1991 all share certificates were registered at the exchange by its wholly owned clearing and settlement company.457 As leaders of an SRO the leaders of the SHGSE were empowered to:458

- Authorise the listing and delisting of shares.
- Set the rules of exchange membership.
- Supervise the disclosures of listed companies and members.

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455 On the pre-1949 SHGSE, see Li (1998b), 25-26,78; Cao (2000), 5-11.
457 Lee (1997), 18.
458 Chen (1994c), 504-511; Li (1998b), 78.
‑ Investigate the illegal activities of members and determine disciplinary action. The members meeting, and board of directors, had the power to approve and cancel membership.459

‑ Set settlement and trading rules, subject to the approval of the local PBoC.

However, neither of the SHGSE and SHZSE leaderships had the development of good regulatory practices as their priority, but rather market development. Thus the SHGSE did not conduct regular examinations of trading or perform inspections of members.460 At the time of its establishment, the SHGSE fell under the administrative authority and supervision of the PBoC, as chapter three explained. The bank had sole authority over exchange development and the power to set all rules governing their operations.461 The Shanghai PBoC was authorised to nominate (timing) the president and vice-presidents, appointments the central PBoC ratified (hezhun).462 The SHGSE’s own board of directors was left to formally appoint (pinren) the senior management team. However, as chapter three also explained, before 1998 local branches of the PBoC operated under the guanli authority of local leaders. The central PBoC had limited influence over their activities. This meant that formal PBoC authority over the exchanges between during 1990-92 was more or less a proxy for control of the exchanges by local leaders. Policy development at the SHGSE was organised by the exchange leadership and the municipal stock market small group. SHGSE president Wei Wenyuan enjoyed direct access to the Shanghai deputy mayor in charge of financial work. Wei would suggest ideas and authorisation was usually extended informally; the removal of price controls was accomplished in this way, as was authorisation over the expansion of listings in March 1992.463 It was the small group, which later evolved into the SHGSMC, that controlled appointments to the SHGSE’s senior management and which resolved any

459 Huang (1999d), 164.
460 World Bank (1995a), 38.
461 SHGSE (1993), 431.
462 Zongjìnglì can be translated as 'president' or 'general manager'. The CSRC did not assume significant supervisory control over the two exchanges in 1993, as Walter and Howie (2001), 104 claim.
463 Interview-11, Shanghai, 2000; Hong (2000), 241.
problems of illegal practice.\textsuperscript{464} The Shanghai PBoC had little role in regulation: it did not make a single site inspection of the SHGSE.

The SHZSE was opened only days before the SHGSE, but without State Council or PBoC authorisation. During 1991, it benefited from a developmentalist municipal leadership, in contrast to Shanghai, where leaders remained cautious. The SHZSE management developed new products, listed enterprises outside Shenzhen’s administrative boundaries, and developed institutions that supported rapid market growth. For example, in early 1991 the SHZSE authorised the issuance of US$8m worth of foreign currency bonds by Shenzhen United, a local conglomerate. At the time, the SHGSE announced it was still ‘considering’ its policy on foreign currency bonds.\textsuperscript{465} In March 1991, the SHZSE also beat Shanghai to list the first foreign joint venture, Shenzhen Yuanye.\textsuperscript{466} During 1991-92, the Shenzhen leadership implemented a wide-ranging market stimulus program that involved significant institutional innovations:

- In June 1991, the SHZSE is reported to have begun allowing the trading of legal person shares. This was contrary to State Council regulations and the extent of the trading is unclear.\textsuperscript{467}
- In July 1991, the Shenzhen leadership allowed legal persons (SOEs) to invest in shares, a policy that Shanghai followed only in September 1993.\textsuperscript{468}
- On 17\textsuperscript{th} August 1991, the SHZSE lifted all limits on price movements, a policy the SHGSE followed only eight months later.\textsuperscript{469}
- In its search for more members, the SHZSE also appears to have unilaterally, and in contravention of a State Council notice of mid-1991, enlarged its membership to include securities firms from outside the city. In July 1992, the Shenzhen PBoC authorised SHZSE membership to be extended to 73 securities companies from outside Shenzhen.

\textsuperscript{464} Wang (1992b), 180.
\textsuperscript{465} Crothall (1991).
\textsuperscript{466} Foster (1991). See also chapter four.
\textsuperscript{467} Wang (1992b), 142.
\textsuperscript{468} Xiao (2000a), 8, 21.
\textsuperscript{469} Hu (1999a), 218-219.
As these examples illustrate, local leaders enjoyed extensive authority in setting, and changing, the rules that governed their markets. Allowing SOEs to trade and liberalising price restrictions were of critical importance to nurturing trading volume and would be a power that the CSRC would later take for itself. In early 1992, new Vice Premier Zhu Rongji, emboldened by Deng Xiaoping’s nanxun line, criticised the SHGSE for its slow speed of development and praised the SHZSE for its ‘entrepreneurial spirit’.\textsuperscript{470} As well as organising institutional change, Shenzhen leaders took direct action to invigorate their market. Party organs in the city proclaimed that shares supported the construction of China’s socialist economy and encouraged CCP members to participate in the market.\textsuperscript{471} They also encouraged several companies to offer generous dividend payments to attract investors.\textsuperscript{472} Municipal leaders were also ambitious to internationalise their market. During 1992, the Shenzhen leadership prioritised B-share development and selected companies to issue stocks in Singapore and Hong Kong, apparently without applying for central government approval.\textsuperscript{473} As a result of these developmental activities, average trading volume at the SHZSE was about double that of SHGSE throughout 1991 and 1992.\textsuperscript{474}

\textit{The CSRC and the stock exchanges, 1993-95}

After the Shenzhen riots in August 1992 revealed local equity institutions to be ineffective, the zhongyang leadership placed the two stock exchanges under the management (guanli) of the local leadership and the supervision (jiandu) of the newly established CSRC. Local leaders retained the primary (weizhu) authority.\textsuperscript{475} The causes of the riots and the wider institutional ramifications are dealt with in chapter eight. A SCSC notice in July 1993 further defined the relationship over the exchanges of the two sub-principals.\textsuperscript{476} It attempted to distribute powers between them evenly. Consider the SHGSE. According to the notice, the SHGSE president was to be jointly appointed by the local leadership

\textsuperscript{470} Holberton (1992)
\textsuperscript{471} There are wonderful tales of how loyal old Party members unwittingly became millionaires by responding to this call. Some, perhaps apocryphal, versions of the stories claim that they offered their fortunes back to the Party years later, after discovering what their shares were worth.
\textsuperscript{473} Reuter (1992); Nicoll (1992).
\textsuperscript{474} Hu (1999a), 212; Sito (1992).
\textsuperscript{475} Xinhua (1993c); Chen (1994c), 94-99.
\textsuperscript{476} Huang (1999d), 186; SZB (1993h).
and CSRC, with the board of directors making the formal appointment. The exchange’s board of directors was to include non-executives nominated jointly by the municipal government and the CSRC, as well as some elected by exchange members. The board’s chairman, deputy chairmen and executive directors were to be nominated by the municipal government and the CSRC, and then elected by the board. A stock listing committee was to be established ‘to draft and formulate regulations governing the introduction and marketing of stocks’; one member of the committee was to be appointed by the CSRC, another by the municipal government. The SHGSE’s own rules of business would be subject to the approval of both. In terms of reporting, exchange departments were asked to provide both the SHGSE leadership and the CSRC with quarterly, midterm and annual reports; financial reports were to be sent to both the municipal government and the CSRC.

The new institutional arrangement, however, failed to establish a relationship of equals between the two sub-principals. Three factors remained in local leaders’ favour: the type of authority relations, the low ranking of the CSRC and the de facto mechanisms of oversight they enjoyed. Consider again the SHGSE. First, their guanli authority allowed local leaders to appoint the SHGSE president and vice presidents; the CSRC did not have a voice in these appointments. (The situation was slightly different in Shenzhen where the CSRC leadership appeared to enjoy more influence. Here, Xia Bin, director of the CSRC’s Trading Department, was appointed SHZSE president in 1993; Zhuang Xinyi, another CSRC appointee replaced him in 1995.164 Both were chosen by the CSRC leadership and were expected to facilitate central government control of the SHZSE.) It would not be until August 1997 that the CSRC leadership was allowed to choose the SHGSE president. Second, the regulator was a non-governmental organ which occupied sub-ministerial ranks before August 1997. The SHGSE had a ju-level rank. More importantly, however, was the disparity in ranks between the CSRC and the Shanghai leadership, whose party secretary held the rank of minister (zhengbu). Moreover, throughout most the 1990s, Huang Ju was a member of the Politburo. Unless the State Council or Central

477 Interview-34, Shenzhen, 2000.
Committee explicitly backed a CSRC policy therefore, Shanghai’s leaders could effectively veto it. (The Shenzhen city leadership had far less influence, a fact that partially explains their loss of appointment power over the SHZSE presidency. The Guangdong party secretary is reported to have acted at times to protect the SHZSE, although the extent of his involvement is unclear.) Third, the CSRC had no reliable sources of information about stock exchange activities, even at the SHZSE. The CSRC had no physical presence there, or in either city, until late 1997, and so had limited means to monitor developments. The reporting requirements laid out in the July 1993 SCSC notice were not respected by the exchanges and as a result the regulator had to rely on infrequent reports from the exchange leaderships which did not detail serious problems. CSRC appointees on the boards of directors and listing boards did little to oversee the exchanges on behalf of the regulator. Both boards took their direction from the cities’ SMCs and the exchange leaders.

The opposing interests of the two sub-principals was evident in the speeches given at the third AGM of the SHGSE in January 1993. Zhou Daojiong, deputy chairman of the SCSC, emphasised the need for supervision and macro-controls, while Wei Wenyuan, SHGSE president, spoke to the importance of nurturing the market. Ad hoc policy disputes racked CSRC/SHGSE relations, but one issue in particular caused on-going tension: the listing of rights shares issued to legal persons.

Listing non-tradable shares

To understand the importance of this issue to both local and central leaders a little history is required. As chapter two explained, all SOEs converting into companies limited by shares divided their share capital into roughly three equal parts: individual, legal person and state shares. The later two types were non-tradable and were held by representatives of the state, LP shares by profit-

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478 Interview-06, Shanghai, 2000.
479 SZB (1993g); SZB (1993b).
480 Interview-11, Shanghai, 2000. Tensions between the exchanges and the regulator were not soothed by personalities. Wei’s cavalier style did not endear him to the CSRC leadership. He often refused to meet officials visiting from Beijing and resented the interference of ‘those bureaucrats in Beijing’ in ‘his’ exchange’s activities.
seeking SOEs, state shares by non-profit oriented administrative organs. Conversion between the three categories remains prohibited.

Despite the ban, the managements of listed firms, their LP shareholders and the leaders of the stock exchanges remained interested in listing non-tradable shares, especially when listed companies made rights issues or distributed ‘bonus’ shares as part of a dividend package.\(^481\) When a rights issue occurred all company shareholders would be offered the right to buy shares. The LP shareholder, an SOE, would typically not have enough cash to buy new shares.\(^482\) In any case, the normal rationale for buying rights issues, that they can be sold onto the market for a profit because of their discounted sale price, did not hold for LPs since their rights shares could not be legally sold. Rights shares offered to LP shareholders thus remained unsold. In the case of dividends, the LP preferred to receive cash rather than additional shares. In both cases, the listed enterprise and the LP shareholder would both benefit if the new shares could be publicly listed. This would provide funds to both. The LP could sell the shares on the open market and profit from the discount and for its part, the listed firm could raise additional funds since LPs would be more willing to purchase the shares. Since the stock exchanges were competing to attract customers, their leaders had an incentive to facilitate this. The problem was that the state’s stake in companies could decrease by as much as 10% through rights issues in which state and legal person shares were listed.\(^483\) Thus leaders within the zhongyang were unhappy with legal person rights being listed and banned the practice. During 1993-94, however, the Shanghai and Shenzhen SAOs and stock exchanges, with the backing of local leaders, worked to undermine the ban.

On 20\(^{th}\) May 1993, the SHGSE authorised Guangzhou Zhujiang Industries to list 30m of its LP dividend shares, but was forced to drop the plan after CSRC objections.\(^484\) On 4\(^{th}\) March 1994, the SHZSAO ruled that state and LPs’ rights

\(^{481}\) SG (1999).
\(^{482}\) Peng (1995a).
\(^{483}\) Xinhua (1995a).
\(^{484}\) In two other reported incidents, in April 1993, SHGSE-listed Lujiazui Finance and Trade Development Company distributed 30m state shares to individuals with SHGSE backing and on 24\(^{th}\) July 1993, Harbin’s Yiyao, a SHGSE-listed medicine company, distributed 52m state shares to individual shareholders, Li (1998b), 175-179; Dong (1997), 15, 31-33.
shares issued in 1993 could publicly list. The following day the CSRC announced that the SHZSAO was acting outside of its powers and re-asserted the ban. But the issue would not go away. By April 1994, four large SHGSE-listed companies had gone public with their plans for selling LP shares: Pudong Jinqiao, Hangzhou Zhujiang, Hangzhou Tianmu and Shaoxing Baida. In November 1994, the CSRC again banned the circulation of state and legal person shares. However, during 1994, a total of Rmb660m worth of state and legal person rights shares were reportedly sold to individual investors and to a variety of LPs including non-state companies. These shares could not be legally listed, although the investors believed it was only a matter of time before they would be. On 10th May 1995, the Shenzhen settlement company notified its members that the state and LP rights shares of Yuehua Electricity would soon become tradable. Apparently unable to stem the tide, between January and October 1995 the CSRC allowed seven companies’ state and LP shareholders to sell their rights shares, while at least 24 other companies filed applications for similar treatment. Such problems were to continue into 1995.

The CSRC and exchange leaderships competed over other policy areas too. In February 1994, for instance, without informing the CSRC, the SHZSE announced it was indefinitely postponing all new listings. SHZSE president Xia Bin believed this would boost share prices, but his move was deeply unpopular at the CSRC (and among some of his staff). Shortly afterwards, the regulator grudgingly confirmed that he was acting within his rights but that the year’s Rmb5.5 billion issuance quota, for which the CSRC was responsible, would not be affected. This was obviously not true. Although public issuance and listing are different things, the issuance programme was badly disrupted by the inability to list newly issued shares: investors would not want to buy shares they could not sell. The CSRC’s inability to influence important developments at the SHZSE was again highlighted in August 1994 when the CSRC and PBoC issued criticisms of the exchange’s ‘illegal’ listing of two local investment funds, Tianji

487 They were, but only after many years: the final tranche of these LP shares were listed in late 2001.
and Lantian. Both funds continued trading despite the lack of any authorisation from any central government bureaux.488

Such conflicts were symptomatic of a competition between the regulator and the exchange leaders to define the institutions of the new market. The former sought to stake their claims to competence by issuing rules; the later asserted their de facto ability to control institutional development by ignoring or mis-implementing them. Even when a central government policy was clear, as in the non-listing of legal person shares, the exchange leaderships were able to regularly defect (and disguise their defection), forcing the CSRC to fire-fight and negotiate. Only very gradually did the CSRC gain the authority to set rules and enforce them. It needed SCSC backing for this. At the end of 1994, for example, the SCSC asserted the central government’s authority over settlement, forcing the two exchanges to move to a T+1 system.489 According to exchange rules, settlement was an area over which the exchanges themselves had authority and this was thus an infringement of the exchanges’ SRO status. The SHSGE had introduced T+0 in July 1991, and the SHZSE had followed in November 1993, in order to maximise trading volume.490 However, since T+0 allowed the buying and selling of shares on the same day it also increased volatility and the opportunities for fraud.491 Preventing the later was not a priority for the exchanges’ leaderships. The Market Supervision department at the SHZSE was staffed by only six people before 1997. Their energies, especially during 1994-96, were concentrated on monitoring member companies’ account balances. A number of TICs and finance companies traded shares in excess of their cash deposits at the exchanges and built up huge overdrafts, some even exceeding Rmb1 billion.492 Occupied by this problem, active monitoring of secondary market activity by exchange staff only began to any significant extent after 1997.

488 SZB (1994o).
489 T+1 stands for Trade+one day, meaning that settlement (the exchange of shares and money) took place the day after the trade, Xinhua (1994e).
490 SZB (1993f); Hu (1999a), 225.
491 Li (1996), 15.
The 327 Treasury bond futures (TBFs) crisis in February 1995 at the SHGSE highlighted the institutional problems that plagued the entire securities sector: deficient self-regulation on the part of the exchanges, competition between different bureaux within central government and an ineffectual CSRC. To understand the sources of the crisis, consider the mess that regulation of the futures market was in before 1995. No national-level regulations were issued on TBF trading before 327, and before April 1994 no bu-level bureau had taken responsibility for regulation of the sector. The only set of regulations governing TBF trading was promulgated by the SHGSE in October 1993, ten months after trading had begun. The SHGSE took responsibility for day-to-day supervision. Yet above the SHGSE there was a confused and ineffective structure of oversight. The SHGSAO did not supervise TBFs. The MoF was responsible for Treasury bond trading, but has no clear jurisdiction over TBFs. The SPC had an unspecified role in regulating commodity futures, but apparently had no role in TBF regulation. On the 9th April 1994, the State Council placed the supervision of all futures markets under the SCSC and day-to-day work under the CSRC, an arrangement designed to provide ‘unified regulation’. However, the new arrangement left three problems unresolved: the market was fragmented; the CSRC had few channels of information; and its regulatory responsibilities and powers were disputed. First, the Beijing Commodity Exchange, the Wuhan and Tianjin STCs and the STAQs, as well as the two stock exchanges, competed intensely for TBF business. The STCs, over which the CSRC did not have any jurisdiction, allowed lower margin requirements than those formally set by the SHGSE and allowed participants to set their own contract duration. Xia Tiantian alleges that this put pressure on the SHGSE to lower its margin requirements, which it did thereby breaching its own rules. Second, the stock exchanges had only minimal responsibilities to report to the CSRC (the STCs had none at all) and no CSRC personnel were stationed at any of the exchanges or STCs.

493 Yao (1998), 101-166.
494 SZB (1993j).
495 On the TBF market, Interviews 6, 7, 9, 24, Shanghai 2000.
496 SZB (1994j); Zhang (1998), 179.
497 Li (1998b), 93.
498 Xia (1996).
Securities firms made only minimal reports to the CSRC about their trading and positions. There are suggestions that even Wangguo, the company at the heart of the crisis, was unaware of the total extent of its branches’ exposure to the market. Third, the regulators, the PBoC, MoF and CSRC, remained uncoordinated. Interviewees argued that the CSRC Futures Department had a very limited role in regulating TBFs because of unspecified ‘interference from other government bureaux’. Rectification of futures firms that held illegally large positions or manipulated contract prices during 1994 was obstructed by disputes with the PBoC. The result, in the words of one interviewee, was that before February 1995 the ‘TBF market operated in a regulatory vacuum’, despite its size, potential volatility and importance.

TBF contract 327 was a three-year contract expiring in June 1995. Analysts at Wanguo Securities expected inflation to slow, the coupons on Treasury bonds to fall, and bond issuance for 1995 to total around Rmb150 billion, a 50% increase on 1994 and as a result sold 327 contracts short, expecting the price to fall. By 23rd February 1995, Wanguo held a short position of three million contracts, six times the limit set by the SHGSE. Liaoning Guofa, an SOE, held a similar position. Taking the opposite long position on the 327 contract was MoF-owned China Economic Development Trust and Investment Company and there are suggestions that its leaders had knowledge of what was to happen next. On the evening of 22nd February 1995, the MoF announced its Treasury bond issuance volume for 1995, only a third of the volume, (and with higher interest rates), that Wanguo had been expecting. On the following day, the price of 327 rose from Rmb148.50 to Rmb151.98 and then dropped back to Rmb151.0. Facing catastrophic losses, Wanguo sold 10.6m 327 contracts in the last eight minutes of trading, forcing the price back down to Rmb147.50. Paper worth Rmb310 billion changed hands during this short time. TBF trading volume for the day totalled Rmb850 billion, twenty-three times that of the previous day. Such a sudden fall in the price proved catastrophic for other market players. With potential

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500 To ‘sell short’ is to sell securities one does not own for delivery at a future date. Wangguo’s official name in English was Shanghai International Securities.
502 Li (1998b), 95-96.
losses in excess of Rmb1 billion, around twenty FIIs faced bankruptcy as the market closed.\(^{503}\) However, that evening the SHGSE leadership announced that it was to cancel all trades in TBFs after 4.22pm, suspend the market for three days to allow the renegotiation of the contracts, and launch an investigation into price manipulation. The decision meant that Wanguo faced bankruptcy. Estimates of its losses ranged from Rmb660m-1.3 billion, at least four times its registered capital.\(^{504}\)

The initial reaction from central government was mild: increased deposits were demanded, price limits were established and a SHGSE risk fund set up.\(^{505}\) The State Council announced that it would establish its own investigation team comprised of the CDIC, the CSRC, the PBoC, and the Supreme People's Court. The SHGSE assisted but was not a formal member of the team.\(^{506}\) In the second week of March, TBF trading heated up again and on 14\(^{th}\) April the CSRC again raised the deposit requirement.\(^{507}\) On 11\(^{th}\) May 1995 Liaoning Guofa and several securities companies were discovered manipulating the prices of Contract 319. Guofa was attempting to win back some its losses from the 327 scandal; it, and others, were found to be using multiple accounts to manipulate prices. In response, on 18\(^{th}\) May, the CSRC, on orders from Vice Premier Zhu Rongji (and apparently against CSRC advice), banned TBF trading.\(^{508}\) An estimated Rmb 64 billion was tied up in the TBF market and unwinding of the 2.4m contracts took the CSRC several months, a process complicated by the fact that the market was so fragmented.\(^{509}\) The State Council report into the 327 incident was issued on 21\(^{st}\) September 1995.\(^{510}\) The SHGSE was criticised for its ‘unsound management’, ‘an insufficient estimation of risk’, imperfect trading rules and

\(^{503}\) Liu (1997), 258.

\(^{504}\) SCMP (1995a); Cui (1996), 41; Caijing (2001b), 44.

\(^{505}\) SZB (1995i); SZB (1995h).


\(^{507}\) Xia (1996), 286-299.

\(^{508}\) Guofa was also highly active in the repo market but had no bonds on deposit. Three leaders of Guofa disappeared soon after, presumably overseas, with several million Renminbi, leaving the SHGSE with more debt to add to the already huge liabilities that 327 had left it with. The sensitiveness of the issue, and the fact that they left the SHGSE with huge liabilities, meant that the details of these events were not reported in the national press.

\(^{509}\) Li (1998b), 193.

\(^{510}\) SZB (1995f).
unsatisfactory supervision.\textsuperscript{511} The leadership of the SHGSE, it was found, had removed restrictions on price movements and had allowed illegally large positions to be built up.\textsuperscript{512} There was also the whiff of conspiracy: Guan Jinsheng, Wanguo CEO, was the vice-chairman of the SHGSE’s board of directors. Guan was arrested in July.\textsuperscript{513}

What is striking about the aftermath of 327 is the extent of institutional change that followed it. There was barely any. The TBF market was closed and Wanguo was merged with Shenyin Securities. SHGSE president Wei Wenyuan remained in place while CSRC Chairman Liu Hongru was scape-goated and sacked.\textsuperscript{514} No significant institutional change took place to resolve what were structural problems in the governance of the SHGSE. The CSRC was upgraded to the rank of vice-ministry (\textit{fubu}) in early 1995, but its leaders remained inferior in rank to the Shanghai leadership and they gained no additional mechanisms of supervision. Plans submitted by the CSRC to the State Council proposing increased supervision of the exchange, and the appointment of a CSRC-nominee to its presidency, were vetoed by the Shanghai leadership, and were opposed by other central bureaus, including the PBoC.\textsuperscript{515} Instead, the State Council responded with administrative action; it cut the issuance quota and instructed the CSRC to slow down approvals for share issuance. During 1995, only 15 A-shares were listed raising only Rmb2.3 billion, compared to the 44 companies that had raised Rmb5 billion in the previous year.

It was not long before another scandal highlighted the SHGSE’s liberal attitude to enforcing the central government’s rules. On the 23\textsuperscript{rd} August 1995, the \textit{China Securities News} received a letter concerning Sichuan Changhong Electronic Appliances, a SHGSE listed company.\textsuperscript{516} The letter alleged that Changhong had illegally listed bonus shares allocated as part of a dividend package to legal

\textsuperscript{511} Zhang (1998), 182.
\textsuperscript{512} Xia (1996), 300, 393.
\textsuperscript{513} On 3\textsuperscript{rd} February 1997 Guan was found guilty of abusing public funds and taking bribes and sentenced to 17 years imprisonment. His infringements of securities regulations, although serious, would not have warranted criminal prosecution. By late 2000, however, he had, reportedly, been released, Li (1998b), 191; Interview-07, Shanghai, 2000.
\textsuperscript{514} Peng (1994b); Peng (1999); Peng (1995d).
\textsuperscript{515} Interview-34, Shenzhen, 2000.
persons. After a two-month investigation the CSRC found that 31.1m Changhong LP shares had indeed been listed on 15th August 1995.517 The CSRC also discovered that four other companies had done the same, all with SHGSE assistance.518 The exchange leadership claimed that it had operated within the law since the bonus shares had been issued to the individual investors who had subscribed to the earlier legal person shares' rights offering.519 The zhongyang leadership was not convinced. The new CSRC leadership, already pushing for Wei Wenyuan's dismissal, had new ammunition and in late August the SHGSE president was removed.520 Yet it was the municipal government that nominated and appointed the new president on 18th August 1995. Yang Xianghai was the director of the SHGSAO, and deputy director of the Shanghai SPC.521 The CSRC leadership opposed his nomination, but his appointment confirmed that the Shanghai leadership's capture of the SHGSE was still secure.

**Central institutional capture: The CSRC takes control**

On 8th April 1996 the SCSC met and, while upholding Zhu Rongji's eight word conservative fangzhen (policy direction), called for the stock market to 'better serve the socialist market economy' (genghao wei shehui zhuyi shichang jingji fuwu).522 On 21st April, Li Jiange, deputy chairman of the CSRC, addressed the SHGSE AGM and announced a fundamental shift in policy: the State Council intended to link stock market and industrial policy and was ready to allow an expansion of listings.523 This facilitated the passage of a CSRC-backed plan for the institutional capture of the stock exchanges.

On 21st August 1996 the SCSC passed the Measures for the Administration of Securities Exchanges.524 These superseded the July 1993 Provisional Measures and gave the CSRC authority to both manage (guanli) and supervise (jiandu) the two stock exchanges, although the new measures also reserved the exchanges'
status as SROs and granted them qualified rule-making powers. The CSRC now had de jure authority over the appointment of the exchanges' senior management. It could request the exchanges to punish their members and listed companies; suspend trading; and sanction the exchanges for failure to enforce regulation. The measures also eliminated any administrative jurisdiction over the exchanges by local leaders. At least, that was the theory: actual institutional change was harder to implement as local leaders successfully resisted the central government take-over of their exchanges for another twelve months. CSRC chairman Zhou Daojiong visited both Shanghai and Shenzhen soon after the measures were passed to negotiate a change of presidents. The Shanghai leadership refused to negotiate. The Shenzhen leadership also appears to have put up opposition, and Zhou returned to Beijing almost empty-handed. The only thing he could report was that the two administrations had agreed to the stationing of CSRC representatives at the exchanges, an idea the CSRC had originally proposed in April 1996. Officially, on 25th October 1996 the CSRC placed a permanent supervision 'team' at the SHGSE, as well as at the SHZSE and several futures exchanges. In practice, only one supervisor was stationed at each exchange and they only arrived in January 1997. The supervisors' official duties were to track market operations, follow policy trends and supervise exchange business. They made two daily reports to the CSRC Trading (later Supervision) Department. The first report covered market trends, while the second concentrated on policy developments. For important matters, the supervisors could also report directly to a CSRC vice chairman. Stock exchange departments provided ad hoc reports about developments and monthly reports on trading activities to the CSRC supervisors. In theory, the CSRC supervisors could access any information they required, and even attended official meetings of the exchanges’ senior managements. But there was, of course, still ample room for exchange staff to withhold information.

524 ZZFPZ (1997), 597.
525 Yao (1998), 70.
526 Nicoll (1998), 263.
528 Interview-13, Beijing, 2000.
529 SZB (1996q); Bao (1999), 66.
530 Interview-08, Shanghai, 2000; Interview-29, Shanghai, 2000.
531 SCMP (1996i).
532 Interview-08, Shanghai, 2000.
The stock exchanges lay at the centre of the two municipalities’ equity developmentalism during 1995-97, as the previous chapter has shown. It was appropriate therefore that the zhongyang’s assault on local capture of equity institutions began with them. On the 14th August 1997 the SCSC’s August 1996 measures were finally implemented when the State Council ordered the exchanges to come under the management (guanli) control of the CSRC.\(^{533}\) Tu Guangshao, general secretary of the CSRC, was immediately appointed SHGSE president on 17th August 1997, replacing Yang Xianghai.\(^{534}\) Two other CSRC-staffers, Zhu Congjiu and Liu Huimin, were then transferred to the SHGSE as vice-presidents, the former as a prospective successor to Tu.\(^{535}\) Gui Minjie, director of the International Department at the CSRC, took up the post of SHZSE president on 3rd September 1997, replacing Zhuang Xinyi.\(^{536}\) On the 10th December 1997, the SCSC promulgated its final important set of regulations, the Stock Exchange Management Rules. These confirmed that supervision and management of the exchanges, as well as management of the registration and settlement companies, fell completely under the CSRC.\(^{537}\) These powers were guaranteed in the 1998 Securities Law.

However, the appointment of senior personnel from the central government was not itself sufficient to deliver institutional capture to the CSRC. The tenure of Zhuang Xinyi, as recounted in chapter five, a CSRC appointee who had then supported local economic interests, had shown this. As a Beijing-based official, with his patrons, guanxi networks, not to mention family and friends in Beijing, Zhuang should have been interested in returning to the CSRC. However, he pursued policies that brought him into frequent conflict with the CSRC leadership. The problem for the CSRC was that after he was appointed Zhuang fulfilled his initial mandate, to revive the Shenzhen market, too effectively and with enormous support from the Shenzhen government. He pursued a

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\(^{533}\) Zhang (1998), 186.
\(^{534}\) Tu had previously served as the general manager of the PBoC’s NETS and director of the CSRC’s Trading Department, CD (1997).
\(^{535}\) Liu Huimin had worked as the director of the CSRC Chairman’s Office; Zhu Congjiu had been the former CSRC chairman Liu Hongru’s secretary (mishu).
\(^{536}\) SZB (1997j).
\(^{537}\) Huang (1999d), 98.
developmental agenda, and the CSRC had no institutionalised means of stopping him, with the exception of dismissal, which was extremely hard to effect without just cause.\textsuperscript{538}

In 1997, therefore, CSRC leaders, now with full \textit{zhongyang} backing, launched a wide-ranging assault on the institutions of local capture at the exchanges.\textsuperscript{539} They created numerous mechanisms of supervision and oversight; so many, in fact, that by 2000 they were judged by some CSRC leaders to be excessive. According to the October 1997 Management Rules, the ‘front-line’ regulatory responsibilities of the SHSGE were to:\textsuperscript{540}

\begin{itemize}
\item Supervise trading: make rules on securities types and time limits, ensure order and stop illegal behaviour.
\item Supervise members: check on qualifications and reports of members, supervise all issued information.
\item Supervise listed companies: produce detailed listing rules, ensure order and approve the listing brochure.
\end{itemize}

These vastly reduced responsibilities reflected the fact the exchanges were now micro-managed organs of a single sub-principal, the CSRC. The regulator implemented a range of mechanisms of oversight and controls that remained in place until the end of 2000.

\textit{Senior appointments}

Stock exchange presidents and vice presidents are now appointed, and managed, by the CSRC leadership, to whom they report regularly. The CSRC also appoints the directors of the exchanges’ Finance and Personnel departments. The exchanges must report the appointment (and dismissal) of middle-level managers, and often such actions will be taken in informal negotiation with CSRC officials.

\textsuperscript{538} After co-leading the CSRC investigation into Junan Securities in 1997, Zhuang Xinyi returned to Shenzhen in mid-1998, taking up the post of Shenzhen deputy mayor with responsibilities for education and finance, including the stock exchange, Interview-34, Shenzhen, 2000; HKS (1998).
\textsuperscript{539} This section uses interviews 5, 29 at Shanghai, 2000 and 43, 44, 51 at Shenzhen, 2001, as well as informal conversations at both exchanges.
Management of department activities

Each stock exchange department is directly and closely managed by a corresponding CSRC department. Contact is on a daily basis and is not mediated by any particular exchange personnel. Mid-level stock exchange staff complained of being micro-managed by their ‘superiors’ in the CSRC. Some noted that they were treated as the CSRC’s administrative arm, were used as ‘messengers’ between the CSRC and the exchanges’ listed and member firms, and were often not consulted or, simply left uninformed, about important policy decisions that affected their work.

The Securities Regulation Expert Offices

The CSRC teams stationed at the SHGSE and SHZSE were institutionalized and enlarged in February 1998 as Securities Regulation Expert Offices (Zhengquan Jianguan Zhuanyuan Banshichu, hereafter SREOs), otherwise known as Commissioner’s Offices.541 The SHZSE’s SREO was originally staffed by six CSRC personnel. Its main focus was to oversee the exchange’s trading system and investigate the finances of member firms. All SHGSE departments prepare fortnightly reports for the SREO, which are then passed to the CSRC. Since 1998, however, the role of the SREOs at both exchanges has changed. Investigations have been increasingly managed by the local SAOs, SREO staff numbers have decreased (as of 2000, there were only five CSRC personnel stationed at the SHGSE and three at the SHZSE), and their work has moved away from supervision. The SREOs now only prepare two reports a year for the CSRC. During 2000, members of the SHGSE SREO were involved in researching index futures, while those at the SHZSE assisted in the planning for the GEM, Shenzhen’s proposed second board. This change reflected the fact that the SREOs are now surplus to the monitoring requirements of the CSRC. Since each exchange department’s activities is directly governed by a CSRC department, and the exchanges’ leaders report directly to the CSRC leadership, its oversight functions are redundant. Moreover, the fact that the SREOs are now

541 Hu (1999a), 249.
involved in researching new instruments and markets, rather than carrying out regulatory or oversight duties, reflects the extent to which the CSRC has not only assumed control of regulation but also of the developmental trajectory of the market.

Disciplinary powers

One of the most serious infringements of the exchanges’ SRO status is that they may not punish their members for infractions of rules. Instead, any suspected infraction must be reported to the CSRC Institutions Department, which investigates and determines the action to be taken. If an investigation is to be carried out it is managed by the SAO; only SAO staff may call investors in for questioning. The CSRC may discipline an offending firm directly, or instruct the SHGSE Membership Department to issue a criticism or a fine.

Listing

The exchanges have also lost all authority over listings. Between 1997 to mid-2000, once the CSRC had authorised a firm for issuance it allocated it to either the SHGSE or SHZSE for listing. Neither the company nor exchange management had competence to oppose this choice, although the former could express a preference as to where it was listed. In autumn 2000, against the opposition of SHZSE, Shenzhen and Guangdong provincial leaders, the central government determined that the SHZSE should stop all new listings, in anticipation of the SHZSE establishing the GEM, and the planned transfer of Shenzhen’s A-shares to Shanghai.542

Since late 1997 the exchanges have operated, as Bao Jingxuan and others have noted, more as divisions of the CSRC than as independent businesses.543 Both began regular CCP activities after August 1997, beginning with Jiang Zemin’s san jiang (three stresses) campaign, organised by newly active Party committees. Their members’ meeting, formally at least, remains their highest authority, but in practice authority lies elsewhere. This loss of SRO powers is neatly expressed in

542 Since then all new A-shares have been listed at the SHGSE, a fact that probably augurs the eventual closure of the SHZSE.

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an industry joke: the exchanges have become ‘the sons of the CSRC’. However, in another variation of the joke, and one heard less frequently on the lips of CSRC officials, the stock exchanges are the ‘housemaids’ of the CSRC. In this variation, it is the investment funds that are the ‘sons’ of the CSRC since they are prized and nurtured by the regulator; the exchanges have been, in contrast, downgraded to the status of servants. This said, while institutional capture by the CSRC has meant that the stock exchanges have lost their autonomy and can not innovate in a way that an exchange should ideally be allowed to, central capture has also facilitated more stable market growth since 1998 and has enabled policy development and implementation to be better co-ordinated. Considering the extent of defection before 1997, and the threats that equity developmentalism presented to the wider financial system, it appears that micro management of the exchanges by the CSRC is, at least for the moment, beneficial to the development of the stock market in China.

**Concluding remarks**

From starting life as SROs operating under local leadership, by the end of 2000 China’s two stock exchanges had lost all their *de facto* SRO powers and were being micro-managed by the CSRC. Their style of development shifted accordingly, from one dominated by rapid growth, aggressive development of new instruments and deficient regulation, to one of more stable growth, limited local policy development, and regulation that prevented the kind of crises witnessed in 1995 and 1996-97. Local leaders were strong advocates of exchange development, using them to maximise investment and tax revenues. After assuming control, central government leaders have also been strong supporters of stock market development, but they have also valued stability and implemented controls on the speed and direction of development. They used a broad portfolio of institutional techniques to deliver this capture, including changes to the exchanges’ nomenklatura systems, but also centralising powers, creating new oversight offices and boosting Party structures.
Local institution-making and the securities trading centres

*China is a large country. Two stock exchanges are not adequate. Beijing should open more exchanges immediately.*

Liu Jipeng, consultant to the Stock Exchange Executive Council, 1993

The central government authorised the establishment of stock exchanges in Shanghai and Shenzhen in April 1990 and July 1991 respectively. They were, and remain, the official faces of China’s equity market. However, during 1991-97 provincial and some sub-provincial administrations throughout China, operating without central government authorisation, established at least 42 sites for the listing and trading of securities, including corporate equity.545 These were referred to by the CSRC as ‘off-exchange share trading places’ (*changwai gupiao jiaoyi changsuo*) and by others as China’s OTC markets (*jutai jiaoyi changsuo*).546 Official CSRC statistics claim that the shares of around 512 companies were traded here; another, unofficial, estimate puts the figure at closer to 1,000.547 According to CSRC statistics, the total stock capital of these companies was Rmb38 billion, of which Rmb12 billion circulated on these markets. Over half of these *changsuo* were housed in dedicated facilities with trading floors and centralised computer trading systems, connected to the stock exchanges by fibre-optic and satellite links. These high-tech facilities were known as the securities trading centres (*zhengquan jiaoyi zhongxin*, hereafter STCs), of which there were 27 operating at the end of 1997. They were stock exchanges in all but name: the only things they lacked were a proper regulatory framework and political legitimacy. Apart from a small number that did not

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544 Chu (1993a).
545 Huang (1999d), 97.
546 Some of the information in this chapter is based on an internal (*neibu*) 1999 CSRC report. Although the author believes that the information provided in this report is reliable, it should be borne in mind that corroborating sources for much of the material are unavailable. Since the CSRC was mandated to close down STCs in 1997-99, it would not be expected to emphasise their positive aspects.
547 The standard Chinese term for listing is *shangshi*, but shares listed on the STCs were termed *guapai* (registered), in deference to their semi-legal status, Interview-27, Shanghai, 2000; CSRC (1999b), 78-80.
establish links with the SHGSE and SHZSE, the STCs were primarily a site for the trading of exchange-listed securities. The larger ones also listed Treasury and corporate bonds, corporate equities and investment funds. The STCs and the other changsuo were closed en masse during 1998-99 on orders from the zhongyang leadership.

Like other developing countries, a large amount of financing activity has taken place informally in reform China. Kellee Tsai provides an extensive account of informal lending practices through a wide variety of informal institutions that were usually set up by private entrepreneurs and were supported by city, county, township and village-level officials. Andrew Wedeman has shown how local governments nurtured huge extra-budgetary funds (xiaojinku) to finance their activities. Cheng Enjiang examines how rural credit funds, operating with the support of village leaders throughout the 1980s and early 1990s, raised significant funds for farmers and small-scale entrepreneurs. Many of these activities were organised by actors outside the state; if public officials were involved, they worked at levels of government well below the provincial level. The STCs provide an example of a different type of activity. They were organised by officials at the provincial government level and received support from provincial governors and Party secretaries. By providing dispersed local securities companies and investors facilities through which to communicate and trade with the stock exchanges, they provided a crucial catalyst for stock market growth. They also allowed local administrations to list their own securities, mostly local debt and investment funds, but also corporate equity. While the numerous instances of 'implementation bias' presented throughout this thesis illustrate the autonomy of local leaders in executing policy, the creation of the 27 STCs, an instance of long-term institution building rather than ad hoc defection, reveals an entirely different degree of autonomy.

The chapter is set out as follows. The first section examines the emergence of informal share markets and the bond transaction centres in the late 1980s. The

548 Tsai (1999).
549 Tsai (2000); Wedeman (2000).
550 Cheng (2000b); EIU (2001h).
next explains how these evolved into STCs and the SHGSE’s role in supporting their development. A number of the STCs are considered in detail. The chapter then moves to an examination of the regulatory institutions (or lack thereof) involved in governing the STCs and the sector’s rectification during 1998-99. The fourth section examines local investment funds, another means by which local governments raised investment capital during the early 1990s.

The bond trading centres and informal share trading

During 1985-86, Treasury bonds had only been officially sold (and not traded) in selected urban areas. Yet by the end of 1987, before formal authorisation from the central government had been given, informal trading of bonds was taking place in at least 41 cities. The World Bank reports that black market bonds commonly traded at a discount of over 50% to market prices. On 21st April 1988, the State Council designated seven ‘experimental’ cities to open centres to trade Treasury and other financial bonds issued by local (including sub-provincial) governments. These ‘bond transaction centres’ were formally established during April and May 1988, and, initially, trading was limited to each locality, cross-provincial border trading only being allowed in October 1990. In June 1998, 54 more cities were authorised to follow and by the end of the year more than 100 cities were hosting Treasury bond trading. While trading suffered in 1989 from monetary retrenchment, in 1990 it picked up again with more issues and a relaxation of trading rules. Trading volume totalled Rmb11.6 billion and continued to grow, totalling Rmb105 billion in 1992. As well as bonds, as chapter three showed, unofficial equity issuance took place on a large scale during 1987-88, and then again in 1991-92. Informal markets for these instruments also developed, markets which received a massive boost in early 1992 from Deng Xiaoping’s pro-stock market nanxun comments. While OTC and informal markets in shares and enterprise bonds had existed in numerous

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533 Zhang (1997b), 55.
534 World Bank (1995a), 57.
535 The cities were Shenyang, Shanghai, Shenzhen, Chongqing, Wuhan, Beijing and Guangzhou, Xia (1996), 285, fn 29.
536 SZB (1994c).
537 Xinhua (1990d).
538 Li (1998b), 34-48; Dong (1997), 133.
locales since 1986, it was in 1992 that they boomed. Many developed on the streets and factory floors. The most infamous, the Red Temple market (Hong Miaozi), sprang up in April 1992 in Chengdu, the provincial capital of Sichuan province, whose leaders were at the forefront of promoting the shareholding reform experiment. Before its official closure more than a year later, the share certificates of 42 Sichuan companies were 'listed' and traded here. These shares were mostly dingxiang (fixed placement) legal persons that could not legally be traded by individuals. Without any government involvement, however, a set of informal rules soon developed to govern the trading of these shares between private individuals. Hu Jizhi reports that little cheating occurred. Trading initially developed around the Red Temple and at the North-End stadium, but was soon active at numerous sites throughout Chengdu. By March 1993, over 10,000 people were actively involved. Reports of the daily transaction volumes vary enormously. Hu reports Rmb10 million, while Richard Margolis reports that by early 1993 daily turnover had reached Rmb8 billion. In a 1993 study, the Sichuan SCORES argued that the black market in shares was irrepressible and that closing it down would simply result in it opening again at a different site. It recommended the registration and public trading of shares at the local bond-trading centre. City and provincial leaders supported this position. In July 1993, however, the State Council explicitly ordered Chengdu’s curb markets closed and the Sichuan authorities are reported to have ‘disabled’ the market. According to press reports, Rmb400 million worth of shares were then duly re-registered and the 42 companies were forced to withdraw their negotiable share certificates and issue non-negotiable stock-right cards instead (the official method for dingxiang shares). However, one interviewee claimed that trading continued and that the market was only finally closed down during the rectification programme of 1997-98. Innumerable other curb markets operated throughout China in the early 1990s, concentrated in the areas where the shareholding reforms were most advanced, including Hainan, Jiangsu, Hunan

559 Interview-24, Shanghai, 2000.
561 SCMP (1993h).
562 Margolis (1994).
564 AFP (1993).
and Liaoning provinces.\textsuperscript{566} Figure 47 illustrates the phenomenon. To note: all share trading outside of Shanghai and Shenzhen was illegal after a State Council notice on 28\textsuperscript{th} April 1992.\textsuperscript{567}

\textsuperscript{566} Zhang (1998), 127.

\textsuperscript{567} Xiao (2000a), 14.
Figure 47. Trading volume of shares and other securities in locales across China, 1993

<table>
<thead>
<tr>
<th></th>
<th>Shares Rmb m</th>
<th>All securities, Rmb billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anhui</td>
<td>569</td>
<td>2.1</td>
</tr>
<tr>
<td>Beijing</td>
<td>-</td>
<td>13.7</td>
</tr>
<tr>
<td>Changchun</td>
<td>459</td>
<td>0.8</td>
</tr>
<tr>
<td>Chengdu</td>
<td>-</td>
<td>0.7</td>
</tr>
<tr>
<td>Chongqing</td>
<td>-</td>
<td>0.3</td>
</tr>
<tr>
<td>Dalian</td>
<td>434</td>
<td>3.2</td>
</tr>
<tr>
<td>Fujian</td>
<td>7,491</td>
<td>8.6</td>
</tr>
<tr>
<td>Gansu</td>
<td>245</td>
<td>0.7</td>
</tr>
<tr>
<td>Guangdong</td>
<td>5,409</td>
<td>6.5</td>
</tr>
<tr>
<td>Guangxi</td>
<td>-</td>
<td>0.2</td>
</tr>
<tr>
<td>Guangzhou</td>
<td>4,486</td>
<td>6.3</td>
</tr>
<tr>
<td>Jilin</td>
<td>-</td>
<td>0.7</td>
</tr>
<tr>
<td>Guizhou</td>
<td>-</td>
<td>0.0</td>
</tr>
<tr>
<td>Hainan</td>
<td>19,850</td>
<td>19.9</td>
</tr>
<tr>
<td>Harbin</td>
<td>-</td>
<td>0.3</td>
</tr>
<tr>
<td>Hebei</td>
<td>2</td>
<td>0.3</td>
</tr>
<tr>
<td>Heilongjiang</td>
<td>-</td>
<td>1.3</td>
</tr>
<tr>
<td>Henan</td>
<td>4,674</td>
<td>5.6</td>
</tr>
<tr>
<td>Hubei</td>
<td>-</td>
<td>1.6</td>
</tr>
<tr>
<td>Hunan</td>
<td>8,553</td>
<td>10.0</td>
</tr>
<tr>
<td>Inner Mongolia</td>
<td>25</td>
<td>0.2</td>
</tr>
<tr>
<td>Jiangsu</td>
<td>11,208</td>
<td>19.9</td>
</tr>
<tr>
<td>Jiangxi</td>
<td>1,639</td>
<td>3.0</td>
</tr>
<tr>
<td>Liaoning</td>
<td>30</td>
<td>5.9</td>
</tr>
<tr>
<td>Nanjing</td>
<td>-</td>
<td>9.7</td>
</tr>
<tr>
<td>Ningbo</td>
<td>4838</td>
<td>6.4</td>
</tr>
<tr>
<td>Ningxia</td>
<td>55</td>
<td>0.2</td>
</tr>
<tr>
<td>Qingdao</td>
<td>-</td>
<td>0.3</td>
</tr>
<tr>
<td>Qinghai</td>
<td>-</td>
<td>0.1</td>
</tr>
<tr>
<td>Shaanxi</td>
<td>4,425</td>
<td>6.0</td>
</tr>
<tr>
<td>Shandong</td>
<td>-</td>
<td>0.1</td>
</tr>
<tr>
<td>Shanghai</td>
<td>476,072</td>
<td>516.3</td>
</tr>
<tr>
<td>Shanxi</td>
<td>1,689</td>
<td>2.2</td>
</tr>
<tr>
<td>Liaoning</td>
<td>-</td>
<td>1.1</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>90,550</td>
<td>90.6</td>
</tr>
<tr>
<td>Sichuan</td>
<td>1,370</td>
<td>1.6</td>
</tr>
<tr>
<td>Tianjin</td>
<td>-</td>
<td>4.7</td>
</tr>
<tr>
<td>Wuhan</td>
<td>817</td>
<td>7.7</td>
</tr>
<tr>
<td>Xiamen</td>
<td>2331</td>
<td>2.6</td>
</tr>
<tr>
<td>Xian</td>
<td>1,374</td>
<td>2.4</td>
</tr>
<tr>
<td>Xizang (Tibet)</td>
<td>-</td>
<td>0</td>
</tr>
<tr>
<td>Yunnan</td>
<td>2,023</td>
<td>3.6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>677,041</strong></td>
<td><strong>791.0</strong></td>
</tr>
</tbody>
</table>

Local leaders outside Shanghai and Shenzhen were keen to find ways to list the securities of SOEs under their administration that had already undergone restructuring into shareholding companies. By the end of 1993, around 9,500 SOEs had restructured, of which 1,776 were reported to have issued stock internally to employees. However because of the quota system the vast majority could not gain a listing place at the exchanges. By the end of 1993, only 97 of the country's 6,791 shareholding companies, some 1.4%, had been granted public listings, as Figure 48 illustrates.

**Figure 48. Share-holding enterprises by locality, end 1993**

<table>
<thead>
<tr>
<th>Province</th>
<th>Number of shareholding companies</th>
<th>Total stock capital, Rmb billion</th>
<th>Number of listed companies at the SHGSE and SHZSE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anhui</td>
<td>416</td>
<td>8.5</td>
<td>2</td>
</tr>
<tr>
<td>Beijing</td>
<td>176</td>
<td>9.9</td>
<td>2</td>
</tr>
<tr>
<td>Fujian</td>
<td>343</td>
<td>5.1</td>
<td>8</td>
</tr>
<tr>
<td>Gansu</td>
<td>125</td>
<td>1.6</td>
<td>0</td>
</tr>
<tr>
<td>Hainan</td>
<td>125</td>
<td>20.6</td>
<td>1</td>
</tr>
<tr>
<td>Hebei</td>
<td>306</td>
<td>5.6</td>
<td>0</td>
</tr>
<tr>
<td>Heilongjiang</td>
<td>461</td>
<td>6.9</td>
<td>1</td>
</tr>
<tr>
<td>Hubei</td>
<td>653</td>
<td>9.7</td>
<td>4</td>
</tr>
<tr>
<td>Inner</td>
<td>120</td>
<td>2.0</td>
<td>0</td>
</tr>
<tr>
<td>Mongolia</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jiangsu</td>
<td>645</td>
<td>9.2</td>
<td>4</td>
</tr>
<tr>
<td>Jiangxi</td>
<td>89</td>
<td>1.2</td>
<td>1</td>
</tr>
<tr>
<td>Shandong</td>
<td>1,101</td>
<td>11.7</td>
<td>4</td>
</tr>
<tr>
<td>Shanghai</td>
<td>92</td>
<td>23.3</td>
<td>39</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>171</td>
<td>8.4</td>
<td>9</td>
</tr>
<tr>
<td>Sichuan</td>
<td>827</td>
<td></td>
<td>13</td>
</tr>
<tr>
<td>Tianjin</td>
<td>54</td>
<td>5.1</td>
<td>2</td>
</tr>
<tr>
<td>Xinjiang</td>
<td>111</td>
<td>1.4</td>
<td>0</td>
</tr>
<tr>
<td>Yunnan</td>
<td>106</td>
<td>3.3</td>
<td>1</td>
</tr>
<tr>
<td>Zhejiang</td>
<td>870</td>
<td>8.0</td>
<td>6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>6,791</strong></td>
<td><strong>176</strong></td>
<td><strong>97</strong></td>
</tr>
</tbody>
</table>


Guangdong province alone had 300 enterprises that had issued shares by the end of 1994, but an annual issuance quota of only Rmb100m, enough for only two to three enterprises to list a year.\(^{569}\) Pent-up demand led to calls for additional stock

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\(^{568}\) Wu (1994).
\(^{569}\) Lin (1995), 21.
exchanges to be opened during 1991-92. More stock exchanges, official reports suggested in 1992-93, were probable, with many groups lobbying openly. One of the SCORES top officials, Li Zhangzhe, stated in early 1993 that China required at least five more exchanges.\footnote{SCMP (1993g); CD (1993a).} Leaders of the SEEC supported this call.\footnote{Chu (1993a).} Economists complained that it was inconvenient for inland firms to list at the SHGSE and SHZSE (especially considering the difficulties involved in settlement across provincial boundaries) and that the two existing exchanges were contributing to the flow of capital to the east and south of the country.\footnote{CD (1992).} In 1992, economist Li Yining suggested the immediate opening of new exchanges in Guangzhou, Xiamen and Haikou, and their future opening in Tianjin, Chengdu, Wuhan and Shenyang.\footnote{Li (1999), 215; TKP (1992b).} There are reports that the CSRC under the leadership of Liu Hongru was supportive of the idea of establishing a third exchange in the north of China, probably in Tianjin.\footnote{Chu (1994); SCMP (1994a); Xinhua (1995c).} There is also some evidence that senior leaders within the PBoC supported a similar policy.\footnote{Chu (1993a); Dong (1997), 235.} But despite these efforts official State Council policy remained unchanged; share trading was to be confined to Shanghai and Shenzhen.\footnote{Hu (1999a), 122; Xinhua (1999b); TKP (1992a).}

The securities trading centres

Local governments, however, had other ideas and the bond trading centres provided a convenient site for them to pursue their ambitions. During 1992-94 a large number of these centres were transformed into ‘securities trading centres’, with the eventual aim to establish formal stock exchanges. The first STC was established in Chengdu in September 1991.\footnote{SZB (1994b); Jiangsu (1995); Wen (1998), 132-133.} During 1992, Hainan, Wuhan, Shenyang, Tianjin and Chongqing all upgraded their Treasury bond trading counters into STCs, listing enterprise and local government debt as well as equities and investment funds.\footnote{SIA (1998), 529; Hu (1999a), 111; SIA (1996a), 151.} In April of the same year there were reports of Chen Yuan, son of Chen Yun, and Wang Qishan, vice governor of the China Bank of Construction, lobbying for an exchange to be established in Beijing; an
STC was later set up in the city, although it is unclear if Yun and Wang were involved. In 1993, at least Qingdao also converted its bond centre into a STC and in 1994 Xinjiang, Shandong, Jiangsu, Guangzhou, and Xian followed. The majority of China’s STCs were established in 1994; the year’s large expansion of Treasury bond issuance appears to have raised incentives for upgrading trading facilities. By the end of the year, the country had 19 STCs. By the time of their rectification in 1998, 27 STCs were active: 25 regional centres, plus the two computer-based trading systems run out of Beijing, the SCORES/SEEC STAQs and the PBoC’s National Equities Trading System (NETS). Most allowed trading in securities listed on the two stock exchanges, as well as their own local bonds and equity, while two, Wuhan and Tianjin, only listed their own securities, the majority of which were Treasury bonds. Since the State Council’s April 1993 Provisional Regulations forbade the establishment of stock exchanges without State Council permission local leaders claimed that these markets were not ‘exchanges’ (jiaoyisuo), but rather ‘trading centres’ (jiaoyi zhongxin). However, with centralised registration and settlement of securities and competitive auction-based trading systems, the difference with the official stock exchanges was in name only. In addition to the STCs, many cities established ‘property rights markets’ (PRMs). According to the SIA, at least 23 PRMs were in operation as of 1997. Wang Guogang claims that there were over 100. The PRMs were trading centres where legal person and state shares could be transferred between legal persons. In effect, they were stock exchanges for SOEs and other state organs and proved useful for local administrations interested in nurturing markets for state assets. Although details of their operations and regulation are scant it appears that the PRMs, like the STCs, were never formally authorised by the State Council and were run autonomously of central government.

The STCs were authorised by local authorities: STC general managers and the majority of senior staff were transferred from, and appointed by, PBoC

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582 Their leaderships hoped to be being authorised as independent stock exchanges and believed that linking with the SHGSE would undermine their autonomy, SHGSE (1997b), 529.
583 [World-Bank, 1995 #1474], 77.
584 SIA (1998), 244-249.
branches. Money for establishing the STCs came from a variety of sources: four were loaned capital from their local governments, three from local PBoC branches, and two from local PBoC and MoF bureaux. Six STCs received money from local securities companies and seven relied solely on membership fees. Once established, the STCs became financially independent. Their largest business was 'network trading', facilitating the trading of exchange-listed securities, on which they charged commissions. In 1997 their income from commissions on network business totalled Rmb700m, an average of Rmb25m each. They also earned commissions and charged administrative fees for the trading of Treasury, local government and corporate bonds, corporate debt and equity and investment funds that they listed themselves (guapai). By June 1996, STCs had listed 38 funds of China's 75 local investment funds, an unknown number of local bonds and at least 500 company shares. They also hosted their own Treasury bond repo business and engaged in proprietary trading. Business for them was especially good during 1996-97, as they benefited from the equity development of Shenzhen and Shanghai. The total trading volume of the STCs in 1996 was Rmb497 billion, more than five times the figure for 1995. By the end of 1997, the 27 STCs (including STAQS and NET) had combined assets of Rmb3.8 billion, an average of Rmb140m each. They made a combined profit of Rmb200m, though the CSRC report that many made losses through their proprietary trading and other speculative investments in, for example, real estate. At the time of their closure, the STCs employed a total of 1,259 people.

The Shanghai Stock Exchange and the securities trading centres

The SHGSE was strongly supportive of the development of the STCs since it benefited from their growth. With the expansion of stock trading throughout the country in 1992-93, and facing limits on its own technical capabilities, the SHGSE looked for partners to provide it with additional trading facilities. Informal agreements between the STCs and the SHGSE allowed the exchange to use the regional centres as ‘external trading floors’ throughout China. The

588 CSRC (1999b), 79.
589 Interview-16, Shanghai, 2000.
SHGSE operated a ‘visible seat system’ that required securities companies to telephone in orders to their representatives at the exchange as chapter five explained. This was an extremely arduous process, but if orders were inputted at the STCs and communicated with the SHGSE trading system directly through the fibre-optic and satellite links, the number of trades could be vastly increased. In contrast, the SHZSE had introduced an ‘invisible seat system’ in August 1995 which allowed orders to be inputted into the SHZSE system directly from securities companies, and so lessened the need for STCs. The other major benefit of co-operation for the SHGSE and SHZSE was that the STCs helped solve clearing and settlement problems. After every trade, both shares and the money had to be transferred between the transacting parties. However, since banks in China were poorly co-ordinated across provinces, trading outside of Shanghai and Shenzhen was difficult since settlement could take weeks. The STCs provided clearing and settlement services themselves: they would settle with the exchanges on a wholesale basis and then settle with their retail customers, greatly lowering the transactions costs involved for investors.

The SHGSE provided start-up and on-going development funds and IT hardware to a number of the STCs. When the STC members bought membership seats at the SHSGE, for example, half of the normal fee of Rmb600,000 was contracted back to the STCs to allow them funds for development. Large STCs such as Beijing, Shenyang, and Chengdu each held over 150 seats at the SHGSE by the end of 1997. The smallest, including Ningbo, Taiyuan and Jilin, bought between 20-30 seats each. By June 1998, the STCs had 1,897 member seats on the SHGSE, making up 33% of the exchange’s membership. By 1998, Rmb1.16 billion had been paid to the two stock exchanges in membership fees and half of this had been returned to the STCs. One report suggests that the Xian STC in Shaanxi province started trading SHGSE and SHZSE shares in September.

590 Heath (1994).
591 Walter and Howie (2001), 85, 88-89.
592 Thanks to David Wall for pointing this out.
594 SHGSE (1997b), 529.
595 Jin (1999), 301.
596 CSRC (1999b), 79.
However, it appears that the first STC to formally establish a permanent telecommunications link to the SHSGE was the Xiamen STC in Fujian province in August 1993. By 1996, all but the Wuhan and Tianjin STCs had connected to the SHGSE. During 1995-97, the STCs became increasingly important in terms of trading volume to the SHGSE, as Figure 49 shows. By June 1996, twenty-two STCs accounted for 26.25% of the SHGSE’s share trading volume, 28.12% of its investment fund trading volume and 11% of its Treasury bond business. During 1997, STC trading accounted for 30% of the total trading volume at the SHGSE and 10% of that at the SHZSE. Up until at least 1996, the STCs remitted all stamp tax revenues to the SHGSE, and thus to the Shanghai municipal government.

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597 SZB (1993q).
598 CSRC (1999b), 79.
599 SZB (1996g).
600 CSRC (1999b), 80.
601 After this time, a small proportion may have been remitted back to the STCs’ local authorities, Interview-16, Shanghai, 2000; SZB (1996g); SZB (1997c).
<table>
<thead>
<tr>
<th>Year</th>
<th>Total number of network seats on SHGSE</th>
<th>Total volume of network trades</th>
<th>Corporate equity</th>
<th>Investment fund</th>
<th>Treasury bonds</th>
<th>Treasury bond buy-back contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>1,655</td>
<td>0.90</td>
<td>0.49</td>
<td>0.02</td>
<td>0.16</td>
<td>0.22</td>
</tr>
<tr>
<td>1997</td>
<td>2,012</td>
<td>1.80</td>
<td>1.20</td>
<td>0.16</td>
<td>0.12</td>
<td>0.28</td>
</tr>
</tbody>
</table>

All figures in Rmb trillion, apart from column one.
Author's calculations based on data from SHGSE (1996), 425; SHGSE (1997b), 529.
Note: Data has been compiled from 24 STCs in 1996, and 26 STCs in 1997. In 1996, in approximate order of size (large to small), the STCs were: Beijing, Fujian, Nanfang, Jiangsu, Sichuan, Shenyang, Qingdao, Shandong, Zhejiang, Anhui, Harbin, STAQs, Henan, Xian, Hainan, Hunan, Guangxi, Chongqing, Ningbo, Xinjiang, Yunan, Jilin, Shanxi, Jiangxi. Dalian and Shantou appear additionally in the 1997 data.
Individual securities trading centres

This section details the establishment, development and trading activities of three of the important STCs.

The Hainan Securities Trading Centre

In keeping with the Hainan leadership’s reputation as aggressive reformers, the Hainan STC was one of China’s most innovative and bold. In September 1991, there were reports of 13 ‘securities exchanges’ in operation in Hainan, trading bonds with a combined face value of Rmb490m.602 These were over-the-counter trading posts, which were merged on 20th January 1992 into what was, basically, a stock exchange.603 The new exchange was founded with Rmb200m of registered capital, 29 members and a computerised system of centralised trading. This was done despite the lack of a response from the central PBoC to the Hainan PBoC’s application to establish an exchange.604 Three companies were immediately listed (guapai); four more were prepared to list within three months. One listed company, Minyuan Keji, had only just been established. Even though it had no profits and had issued no financial statements it was soon trading at a price of Rmb10, after an IPO price of Rmb1.605 The central PBoC immediately ordered the exchange closed but the Hainan leadership did not comply. After four weeks of trading, Zhu Rongji reportedly flew to Haikou personally to demand the exchange closed. It appears that whatever the immediate effect of the vice premier’s visit, trading soon resumed and the ‘exchange’ simply assumed a new name: The Hainan Securities Trading Centre. By 1995, the centre was trading Treasury bonds, corporate debentures, short-term corporate financial bonds, convertible bonds, investment funds (many of which were real estate and property funds), and warrants.606 In 1995, the transaction volume for its 19 listed securities totalled Rmb38.4 billion and Rmb4.3 billion of SHGSE-listed securities were also traded. These figures suggest that Hainan was more a local stock exchange rather than a remote trading post for SHGSE-listed securities.

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602 Xinhua (1991b).
604 Chu (1993a); Wang (1992a).
606 SIA (1996a), 149.
There was certainly no shortage of companies wanting to list: by list 1997, 111 companies had publicly issued shares in Hainan, raising Rmb 23 billion.607 Another interesting characteristic of the Hainan STC was that as well as providing 'illegal' trading facilities for legal instruments, it also introduced financial products which had not received approval from the PBoC or CSRC, and which did not even trade on the official stock exchanges. For example, convertible bonds were only formally issued on the SHGSE in 1998 but were actively traded in Hainan starting in 1993.608 Moreover, on 10th March 1993 the Hainan STC started trading SHZSE-index futures. There was at least one contract for sale, a four month contract based on Shenzhen's A-share index.609 This is the only documented instance of such an instrument being traded in China during the 1990s.

The Wuhan Securities Trading Centre

The Wuhan STC was established on 17th April 1992 with a registered capital of Rmb20m by the Hubei province PBoC and Wuhan city leadership.610 Wuhan leaders actively lobbied Beijing to set up China's third exchange throughout 1992 and by November 1993 were anticipating approval.611 It was never given, but this did not hold them back. The leadership invested Rmb40m setting up a second trading hall for 253 dealers and connected with other STCs around the country, although not with the two stock exchanges.612 In 1994, the STC was the country's largest site for the trading of Treasury bonds, and many members of the other STCs traded Wuhan-listed bonds via their links with the STC.613 Daily trading volume of bonds and repos rose to Rmb1-2 billion in early 1995, two to three times the volume traded at the SHGSE. By the end of the same year, the province had issued a total of Rmb14 billion in local bonds and other securities many of which were listed in Wuhan.614 Despite being dominated by bonds, the Wuhan STC also listed other instruments. On 23rd June 1993, for instance, it

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607 Xinhua (1997b).
608 Li (1998b), 117, 170.
609 Xiao (2000a), 19.
610 SIA (1993), 166.
611 SCMP (1993i).
613 Li (1998b).
614 Xinhua (1994f).
started listing local investment funds and by the end of 1995, had listed 12 of them, including three from Guangdong, four from Jiangsu and one from Anhui. In addition, over twenty companies’ shares were listed (guapai). Investment funds and shares accounted for a trading volume of Rmb345m in 1995.\textsuperscript{615} On 12\textsuperscript{th} April 1994, the Wuhan STC started Treasury bond futures trading, apparently without any authorisation from the central PBoC.\textsuperscript{616}

\textit{The Securities Trading Automated Quotation System}

In November 1990, the STAQS, a national bond-trading network, was established in Beijing by the SEEC, as chapter three noted.\textsuperscript{617} Although classified as a \textit{changwai jiaoyisuo} by the CSRC in 1998, the STAQS was different in origin and design from the regional STCs. It was classified as a ‘non-enterprise government institution’ rather than as a financial institution, and could therefore operate under the administrative jurisdiction of the SCORES rather than the PBoC. It had greater political legitimacy than the local STCs but still no State Council regulations were ever issued and no senior Chinese leaders attended the opening ceremony.\textsuperscript{618} Nevertheless, the STAQS leaders’ ambition was to link up with the stock exchanges and the other STCs to form one unified Nasdaq-like national trading system.\textsuperscript{619} In July 1992, with State Council authorisation, the STAQS began listing legal person shares, including those of Guangxi Yuchai Machinery, Hainan Huakai Industries, Zhuhai Hengtong Real Estate and Sichuan Shudou Mansion.\textsuperscript{620} Over 1,300 institutional investors were reported to have taken part in the trading of these shares; a volume of Rmb450m was recorded by the end of the year.\textsuperscript{621} In 1993, the STAQS facilitated trading volume of Rmb400m, around 0.6% of all securities traded in China.\textsuperscript{622} However, owing to \textit{zhongyang} leaders’ concerns over the diminution of state shareholding in May 1993, the CSRC banned new legal person share listings, scuttling the STAQS

\textsuperscript{615} SIA (1996a), 69.
\textsuperscript{616} Li (1998b), 173.
\textsuperscript{617} SIA (1993), 173-175; Yao (1998), 85; Xinhua (1990b); Elliot (1990).
\textsuperscript{618} SIA (1994), 36.
\textsuperscript{619} SIA (1993), 175; Lai (1994).
\textsuperscript{620} Chu (1993b).
\textsuperscript{621} SIA (1993), 174.
\textsuperscript{622} Hainan (1995b), 1.
leaders’ ambitions. By that time the system had listed eight legal person shares and had registered 30,000 investors. The STAQS remained open until 2000, although little trading took place after 1994.

Regulation of the Securities Trading Centres

The STCs had, at best, an unclear legal and policy status. No central government bureau ever assumed regulatory responsibility for them. Indeed, only a small handful of central regulations even mentioned the STCs. It was only in 1998 that the State Council recognised their existence, labelled them ‘illegal’ and ordered their closure. As financial institutions, the STCs should have been authorised by the central PBoC. Sixteen were authorised by provincial PBoC branches; ten were authorised directly by provincial governors; and three received joint local PBoC and local government authorisation. In terms of day-to-day management responsibilities, fourteen STCs fell under PBoC jurisdiction, ten under local SMCs and SAOs and one under a TIC. However, neither local PBoC branches nor local SAOs actively supervised their activities. One interviewee implied that while the central PBoC was keen to protect its formal authority over the sector, it was delinquent in its practice of actual regulation. For their part, the SHGSE and SHZSE had regulatory responsibilities as far as trading in their secondary markets were concerned, but they lacked means of checking on non-local members. The CSRC remained excluded from the sector, although it is unclear what the CSRC leadership’s position on this was. The World Bank reports that since STCs remained under the formal jurisdiction of the PBoC, the CSRC leadership was unwilling (or unable) to ‘interfere’. However, there are also suggestions that the CSRC leadership had little interest in extending its regulatory mandate to the STCs because of the debts and chaotic financial operations that they would then have had to cope with. Another interviewee claimed that during 1995-96 the CSRC proposed plans to the SCSC

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624 Interviews 14, 16, 29, Shanghai, 2000, provided information on STC regulation.
625 There are suggestions that this was because even censorious or disciplinary circulars would imply central government recognition of the sector.
626 This was required by the PBoC’s Regulations on Financial Institutions (1994), Yao (1998), 41-44.
627 CSRC (1999b), 79.
628 Kumar (1997b), 32.
that involved the ‘standardisation’ and cleaning up the sector. Indeed, in August 1996, the CSRC did make a public call to restrict off-exchange trading (changwai jiaoyi) and to rectify the STCs.629 ‘Rectify’, however, did not here mean closure: in this case it meant allowing the STCs to be officially recognised, their problems resolved and then integrated with the stock exchanges to form a multi-level national trading system under the CSRC’s sole jurisdiction. However, the PBoC leadership reportedly vetoed the proposal.

The STCs and the Treasury bond repo market

The STCs’ biggest problem was Treasury bond repo trading.630 This was popular at the STCs, especially during 1995-96 and particularly in Wuhan and Tianjin and on the STAQS. The STCs tended to allow securities companies and TICs to engage in repo trading with very low collateral. Tianjin and Wuhan allowed deposits of bonds worth only 10% of funds borrowed, while the SHGSE had a 100% requirement.631 Such highly-leveraged lending became problematic when the borrowing institution defaulted on the contract and the lending institution was forced to assume the liability. Repo trades would often take place without the bond certificates being deposited at the STCs.632 There was no central depository for Treasury bonds in China during 1993-96. Instead, the World Bank reports that the SHGSE used over 60 regional depositories in August 1995.633 The problem was that this fragmented system of depositories facilitated the de facto (and illegal) short selling of bond certificates. Regional depositories would issue receipts for non-existent bonds, and these were then traded on the STCs and the two stock exchanges. However, if the bonds did not exist, these were in effect short sales. Such practice is thought to have been very common, although no statistics are available. Local PBoC regulation in this area was particularly deficient. No other regulator, least of all the CSRC, had access to information about the scale of the repo loans, the lack of bond-deposits, the uses to which securities companies were putting these short term funds or the extent of the debt they, the STCs or the banks were building up. There is also the suggestion of

632 Interview-14, Shanghai, 2000.
633 World Bank (1995a), 76.
administrative interference in the repo market by local leaders. As chapter five explained, bank funds often found their way, via repo loans, to securities companies and TICs, who used the funds for speculative share trading and real estate investment. These were all sectors local leaders were interested in supporting and for which bank loans were not permitted to be extended. Again, statistics on the scale of this practice are unavailable.

Local securities companies, and many of the STCs, soon became heavily indebted. In November 1995, the *Shanghai Securities News* estimated that securities firms had lost 'several million Renminbi' through their repo business.\(^{634}\) This was probably a conservative estimate. The central government made several attempts to correct the problem. On 9\(^{th}\) August 1995, the PBoC, MoF and CSRC issued a joint-circular banning 'non-authorised exchanges' from repo trading.\(^{635}\) In October 1995, under the direction of the PBoC, CSRC and MoF, the Wuhan STC was forced to re-register all of its repo contracts (in an effort to match depository receipts with actual bond certificates) and to clear up all its associated debt.\(^{636}\) The PBoC also increased the margin deposits required for repo trading and limited the repo trading of certain securities companies. But all to little effect: the volume of STC repo trading expanded, benefiting in late 1996 and early 1997 from the stimulus provided by the Shanghai and Shenzhen leaderships' equity developmentalism. After hitting a record daily volume of Rmb1.9 billion on 11\(^{th}\) April 1996, repo trading volume at the SHGSE continued to increase as shown in Figure 50.\(^{637}\) Around half of this was traded through the STCs.

\(^{634}\) SZB (1995n).
\(^{635}\) Li (1998b), 199; RR (1995).
\(^{636}\) SIA (1996b), 45-46.
\(^{637}\) SZB (1996h).
### Figure 50. Trading of Treasury bond repos at the SHGSE, 1996

<table>
<thead>
<tr>
<th>Repo trading volume</th>
<th>January</th>
<th>February</th>
<th>March</th>
<th>April</th>
<th>May</th>
<th>June</th>
<th>July</th>
<th>August</th>
<th>September</th>
<th>October</th>
<th>November</th>
<th>December</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>18.3</td>
<td>10.7</td>
<td>19.4</td>
<td>37.6</td>
<td>61.2</td>
<td>80.6</td>
<td>138.0</td>
<td>157.1</td>
<td>167.9</td>
<td>190.8</td>
<td>178.0</td>
<td>182.3</td>
</tr>
</tbody>
</table>

Rmb billion

Note: Includes repo traded facilitated by the STCs.

There were other regulatory problems. Since securities companies could join STCs outside of their own locales, strong incentives existed for STCs to compete to create the most attractive regulatory environments for their members. The result was a 'race down to the bottom' as STCs competed to reduce fees and margin requirements, and relax enforcement of what rules did exist. STCs also extended finance to their members to encourage trading and, as their members became indebted, so did they. Second, there was little monitoring of the financial health of STC members. Many were the securities arms of local TICs. In theory, they operated within the PBoC’s regulatory jurisdiction, but due to weak PBoC capacity, they were extremely poorly regulated. Third, illegal activities were widespread. STC management would trade themselves using inside information; some also traded in false Treasury bond certificates and set up fake repo accounts. STCs also co-operated with listed companies in illegal activities. In January 1997, for instance, the CSRC fined the Hunan STC Rmb75,000 for having lent Rmb15m to Zhangjiagie Travel Development for speculation in its own shares. Fourth, the STCs had unclear business scopes. Some directly invested in commercial enterprise and real estate. Losses were concentrated at Wuhan and Tianjin, where repo trading was most active; several other STCs claimed to be profitable.

Rectification of the securities trading centres

A decision to rectify the STCs was taken by the senior leadership in mid 1996. The October 1996 SCSC meeting extended support to the PBoC’s ‘rectification’ of the sector, but implementation was delayed. Based on the FELG’s sanding fangan (‘three decisions plan’) on 22nd June 1997 the State Council Office issued a circular that ordered the sector closed. On 15th October 1998, the CSRC presented its plans to the STCs and FIIs. First, the asset situation of each STC was to be assessed by CSRC investigators, STC managers and independent accountants. Second, management of their accounts, network trading and membership matters was to be passed to the two stock exchanges. Actual

638 CSRC (1999b), 80.
639 SZB (1997n).
640 Interview-16, Shanghai, 2000.
641 SZB (1996e).
642 CSRC (1999b), 80.
resolution of the sector would then involve a selection of solutions. The CSRC would allow some STCs to be acquired by securities companies, some to be restructured and merged to form securities companies, and some to be closed down. The most heavily indebted were to take the later path and in December 1998 the Wuhan STC was closed.\textsuperscript{643} The other major problem, of course, was what to do with the companies whose shares had been listed (guapai) on the STCs. The CSRC used six methods to resolve this issue: \textsuperscript{644}

- Many quality guapai enterprises bought back their own shares.
- Non-listed enterprises were encouraged to buy the shares of guapai companies.
- Other non-listed enterprises in similar industries were encouraged to buy shares in guapai companies and merge with them. Some were offered listing places on the stock exchanges in return for their co-operation.
- Some guapai companies converted their shares into enterprise bonds.
- Some large guapai companies were recommended for listing on the two stock exchanges.
- Many poor quality guapai companies were instructed to encourage their shareholders to continue to hold their shares, even though trading in these shares was now restricted.

Most guapai companies took the first and last options, although a sizeable number of firms who converted their equity into debt.\textsuperscript{645} By mid-2000, about 20 guapai companies had been authorised to list on the stock exchanges. De-listing of guapai companies was largely completed by 30\textsuperscript{th} June 1999.\textsuperscript{646} However, rectification of the heavily-indebted investment fund sector took longer, and was still ongoing at the end of 2000.

\begin{flushright}
\textsuperscript{643} CER (1998b), 13.
\textsuperscript{644} CSRC (1999b), 73.
\textsuperscript{645} Interview-16, Shanghai, 2000.
\textsuperscript{646} CSRC (1999b), 81.
\end{flushright}
Local investment funds

During 1990-93, provincial and sub-provincial governments throughout China established small-scale local investment funds (LIFs). These were nearly all closed-end funds that invested in securities, real estate and local industry, providing an important vehicle for local government fund raising. The only open-ended LIF was the Sichuan Treasury Bond Investment Fund. LIFs were owned and managed by local banks, insurance companies, TICs and some private companies. According to the SIA, the first were established in Shenzhen and Wuhan in October 1991. The Shenzhen fund, the Southern Mountain Risk Investment Fund, raised Rmb80m and invested 70% of its capital in fixed assets, with 26% going to equity and 4% to debt investments. The Wuhan Securities Investment Fund (Phase one) raised only Rmb10m (the smallest of all the LIFs), investing 30% of this in bonds and the rest in undisclosed assets. Companies in Shenzhen, Shenyang, Dalian, Heilongjiang and Guangdong provinces issued at least four funds. Most issued units worth between Rmb60-100m. On average about 60% of their capital went into fixed assets, with the rest mostly going into securities. In addition to the investment funds, localities issued a variety of other unstandardised instruments such as beneficiary and portfolio certificates. These were popular in Jiangsu, Zhejiang and Henan provinces. By 1995, local governments had raised about Rmb 1.5 billion through such unstandardised issues.

By the end of 1993, 21 different local administrations (mostly provinces and cities) had issued fifty-six LIFs with a face value of Rmb4.8 billion. By mid-1996, the STCs listed 38 of the 75 LIFs and the two stock exchanges also listed a
number: SHZSE ten and SHGSE 15. The Shantou Boshi Township and Village Enterprise Investment Fund, for example, traded on the SHGSE, and the Tianjin Enterprise Fund traded on the Tianjin STC. Anjali Kumar cites reports that as of year end 1995 12 funds were listed at the Guangzhou STC, eight at the Shenyang STC, seven at the Dalian STC and four in Hainan. Other funds found even more informal means to trade: the Jiangsu Construction Investment Fund appears to have been traded informally on an OTC basis at branches of the Construction Bank of China’s Jiangsu TIC.

Regulation of the funds

Like the STCs, LIFs were a local initiative; only four received authorisation from the central PBoC as was legally required. In November 1992, the Zibo Township Fund in Shandong province was the first to receive authorisation from the central PBoC; it later listed on the SHGSE in August 1993. Other LIFs were authorised by PBoC branches or local leaders. On 19th May 1993, on orders from the State Council, the PBoC banned the establishment of new funds. However, a few local administrations ignored this notice: the number of LIFs rose from around 60 at the end of 1993 to 75 by 1995. In contravention of the ban on new LIF listings, the SHZSE listed the Tianji and Lantian funds in April 1994. In the main, however, although none were closed, the notice was effective: no new LIFs were established after 1995. Regulation of the LIF sector was deficient. While the funds, and many of the companies that owned them, fell under the regulatory jurisdiction of the PBoC, local branches did not supervise their activities. LIFs engaged in highly irregular investment practices: many built up losses through real estate, hotel and speculative share dealing. They were frequently used to invest in local government-sponsored projects. Many of them refused to issue dividends. The LIFs’ internal management structures were also flawed. Standard practice in the West is for the fund manager and custodian

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657 Feng (1997), 38.
658 SIA (1994), 481.
659 Kumar (1997a), 47.
661 SZB (1994m).
662 ZZPZ (1997), 496.
663 SZB (1994o); Power (1993).
664 SIA (1996a), 106.
665 Tao (1999), 209-211.
to be distinct legal persons, each with legal liability. However, the manager and custodian for 23 LIFs were the same legal person; nine funds had no custodian. 34 LIFs were managed by TICs, where LIF assets could easily moved around their different businesses.

Rectification of the funds

The CSRC gained regulatory powers over the new investment fund sector on 14th November 1997, when the SCSC issued the first national rules for the sector. The PBoC’s role was reduced to regulating the trustee banks. All new funds would require CSRC approval, paid-up capital of at least Rmb300m and would have a minimum term of five years. Planners within the CSRC also introduced administrative rules to ensure good practice. For example, 80% of investment funds assets had be held in securities (to prevent real estate investment et al.) and 90% of the funds’ returns had to be distributed as dividends. CSRC-authorised securities companies set up fund management companies that remain tied to their parents through majority shareholdings. In March 1998, the Jintai and Kaiyuan funds, the first batch of standardised investment funds issued Rmb2 billion of units each. As of the end of 2000, there were eleven such companies managing thirty-four funds which had issued Rmb56 billion, as Figure 51 shows. Around half of these funds were entirely new funds with initial issuance of Rmb2 or 3 billion; the rest were small, only Rmb200-300m in size, the end product of restructured LIFs. Figure 52 shows trading of the entire fund sector, including standardised and old, unstandardised funds, during 1994-2000.

Figure 51. New standardised investment funds, 1998-2000

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number</td>
<td>6</td>
<td>23</td>
<td>34</td>
</tr>
<tr>
<td>Amount issued, Rmb billion</td>
<td>12</td>
<td>51</td>
<td>56</td>
</tr>
<tr>
<td>Turnover, Rmb billion</td>
<td>55.53</td>
<td>162.3</td>
<td>246.6</td>
</tr>
</tbody>
</table>


666 Chen (1997a), 423-425.
In spring 1998, LIFs were officially determined to have been established 'without authorisation' (yuequan), and the CSRC was mandated to rectify the sector. The CSRC estimated that the funds, as of end 1998, were capitalised at Rmb9.6 billion.\footnote{CSRC (1999b), 87-88.} Only three had already reached term by 1999. Rectification entailed restructuring and merging LIFs with more than Rmb200m in assets into standardised investment funds with the assistance of the investment fund companies established in 1997, and closing others. For example, six LIFs in Jiangsu and Zhejiang provinces were merged to form the Jinyue (later Yuhua) Securities Investment Fund in April 2000 managed by Boshi Fund Management.\footnote{COL (2000a).}

**Concluding remarks**

The STC sector reveals the extent of autonomy enjoyed by local leaders, and the marked inability of the central government to dictate institutional development in the equity sector before 1997. During the early 1990s, provincial leaders used STCs and LIFs to raise capital for local industry. Although they varied in size and in the instruments they traded, all STCs facilitated investment in their local economies and boosted fiscal revenues. Such was the significance of the larger STCs that according to a common phrase of the early 1990s China had ‘two exchanges, one network (STAQs), and three trading centres (Tianjin, Wuhan and Shenyang)’ (liangsuo, yiwang, sanzhongxin).\footnote{COL (2000a).} The thesis has shown numerous instance of implementation bias, the alteration, manipulation and delay of policy...
during implementation by local leaders. However, the creation and maintenance of what were, in effect, stock exchanges, in opposition to central government policy, was of an entirely different degree of defection. However, after 1997 the zhongyang leadership spoke with clarity and acted with force, and organised the central government in such a way as to ensure the closure of the STCs. This was no doubt made easier by the SHGSE's new technological capabilities, which meant that it was no longer dependent on the STCs for providing external trading and settlement facilitates. Nevertheless, the move entailed the loss of an important avenue for capital raising and profits for local governments, and its successful implementation is surprising considering the PRC state's tendency for compromise and gradualism. Rectification required substantial co-ordination within the state, something that was obviously lacking during the 1993-96 period.

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Part III

Institution building at the centre
Institutional creation and development: The China Securities Regulatory Commission

_The CSRC is a coveted organisation in China. It represents influence and money._ Anonymous securities analyst, 1994\(^671\)

_Everyone knows we are a tiger without teeth._ Anonymous CSRC official, 1995\(^672\)

The CSRC began life in late 1992 as an agency without any of the powers it needed to fulfil its mandate. It was charged with supervising securities firms, the stock exchanges, and the issuance and transactions of all listed securities. It was to operate under the supervision of the SCSC, the central government coordinating committee for the sector. Despite these extensive responsibilities, the CSRC was given non-governmental status, a low bureaucratic rank, no local offices and no powers of enforcement. It had to co-operate with numerous other government bureaux in order to implement its mandate and its rulings and actions were frequently resisted and ignored. However, by the start of 2000 the CSRC had been transformed: it had achieved ministerial rank, had gained sole managerial (guanli) authority over the stock exchanges and SAOs, and had absorbed a wide range of policy and regulation-making powers from the dissolved SCSC. The zhongyang leadership supported the rise of the CSRC in order to solve two basic institutional problems. Within central government frequent disputes between bureau leaders undermined the authority and clarity of SCSC policy, a situation that local leaders were happy to exploit. Such disputes could only be resolved by concentrating policy-making powers into a single organisation and allowing the CSRC to exclusively represent ‘the centre’ in its dealings with the local bureaux. Second, it was only by gaining guanli administrative control over the SAOs and stock exchanges (and thereby sideling the competing local sub-principals) that the central government was

\(^{671}\) Tong (1994).

\(^{672}\) Engardio (1995).
able to achieve institutional capture of the sector and thereby ensure that the zhongyang leadership’s interests were defended.

The institutional architecture of equity regulation is complex and it is, of course, impossible to separate the rise of the CSRC from other areas covered in this thesis: its relationship with the local SAOs (chapter four), the stock exchanges (chapter six), and, most critically, the SCSC (chapter nine). This chapter attempts to provide an overview of the CSRC’s development not covered in these chapters during 1992-2000. It also aims to identify the factors behind the major institutional changes that took place in the sector in 1992 and after 1997. It is laid out as follows. The first section explains events leading up to the CSRC’s creation in 1992. The second examines developments at the CSRC during 1993-95. The third section shows how the stock market was linked to industrial policy by the State Council in 1996, preparing the way for an upgrading in CSRC rank and powers after the crisis during 1996-97. The fourth examines how institutional capture over the SAOs took place during 1998-99.

**Deng Xiaoping’s nanxun, the 8.10 Shenzhen crisis and the creation of the CSRC**

In spring 1992, China’s stock market took a great leap forward. The problem was that its institutions did not keep up. In August 1992, the sector’s first major crisis ended the period of institutional tinkering and piecemeal regulation described in chapter three. Crisis induced the zhongyang leadership to create two new organisations, the SCSC and the CSRC, the aim of which was to improve the zhongyang leaders’ ability to control equity development through beefing up central government oversight and constraining the powers of local sub-principals. Unfortunately, the institutional framework that was used to accomplish this task was flawed.

An editorial in the *Renmin Ribao* in December 1991 strongly backed the development of the stock market. It stated that the State Council and Central Committee were both ‘very clear about developing a socialist securities market...they will support its development...[it] must be done actively and in a
stable and sound fashion’. This was positive news: since the establishment of the two stock exchanges in late 1990, the zhongyang leadership had been silent on the equity issue and both exchanges had only witnessed limited growth. Only four companies had been listed during 1991. During his nanxun (southern tour) in January-February 1992, Deng Xiaoping publicly backed experimentation with the share market as part of his reform agenda, famously stating that;

As for securities and the stock market, are they finally good or bad? Are they dangerous? Are they things that only capitalism has or can socialism also make use of them? To decide whether they can be used, we must experiment first. If we think they work, if after a year or two we think they are good, then we can expand them. If problems arise, we can close them down, immediately and completely. And even if we close them down, we can do so quickly or slowly, or we could even leave a little tail.

It was classic Deng: a radical proposal was couched in sufficient caution and qualification that neo-conservatives had little room to object. In March 1992 the Politburo met to back Deng’s nanxun line. Economic growth was prioritised and calls for companies to issue ‘as many securities as possible’ were heard from central government officials. As in 1987-88, but to a much larger extent, under the sponsorship of local leaders PBoC branches around the country authorised the issuance of securities. Tens of thousands of SOEs sought permission to restructure into shareholding companies. There are no reliable statistics for how many succeeded, but a variety of sources make clear that the amount of shares issued far exceeded the PBoC’s national securities quota of Rmb4 billion. According to Jin Jiandong, at least 865 enterprises in 34 cities and provinces requested permission to issue Rmb27.7 billion worth of securities during 1992. In Shenzhen and Shanghai alone, one report states that Rmb13 billion worth of securities were issued. Another report by a research institute in Hainan reached

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673 Yuan (1992), 37.
674 CSRC (2001), 134.
678 Xinhua (1992c).
679 CCTP (1992b); SCMP (1994a).
680 Jin (1992), 27.
681 SZB (1993d).
a more conservative conclusion, claiming that nation-wide only Rmb10 billion worth of shares were issued by 53 companies.\textsuperscript{682} The huge scale of issuance inevitably raised concerns in central government. Chen Jinhua, minister at the SCORES worried publicly about localities' 'excessive zeal' in issuing securities.\textsuperscript{683} He no doubt realised that excess issuance would undermine shareholding reform just as much as too little issuance. Despite these concerns, the SCORES pushed the shareholding agenda forward with a policy document in early summer 1992. \textit{The Important Points for Economic System Reform} recommended enlarging the scope of share issuance and allowing localities outside of Shanghai and Shenzhen to issue 'a few basic and high-technology industry shares'. State Council members supported the policy, allowing Guangdong, Fujian and Hainan provinces to experiment with share issuance, but not public trading.\textsuperscript{684} For its part, the SPC announced that some large SOEs would be encouraged to list publicly.\textsuperscript{685} As these policies were rolled out and Deng's \textit{nanxun} comments were publicised, tens of thousands of small investors bought shares. Reform China was experiencing its first flush of \textit{gupiao re} (share fever).\textsuperscript{686}

By August 1992, the Shenzhen stock market was indeed feverish. An estimated Rmb10m was entering the market each day and, despite a government crackdown, a curb market in real and forged share certificates was active outside the exchange.\textsuperscript{687} The SHZSE could not list securities as fast as they were issued. As prices soared, demand for IPO shares swelled. On 9\textsuperscript{th} August 1992, an estimated one million people, half of them from outside of Shenzhen, queued on the city's streets to buy 5m IPO application forms (\textit{rengouzheng}) at 303 sales points around the city.\textsuperscript{688} According to the original PBoC/municipal government plan, 10\% of these forms were to be chosen by lottery and their 'owners' allowed to subscribe to IPO shares. It would have normally required three days for all the \textit{rengouzheng} to sell out, but at 9.00pm, after delays in sales throughout the day,  

\textsuperscript{682} Hainan (1995a), 50.  
\textsuperscript{683} CCTP (1992a).  
\textsuperscript{684} Dong (1997), 137-138.  
\textsuperscript{685} CCTP (1992c).  
\textsuperscript{686} Xinhua (1992e).  
officials announced that all of the forms had been sold. The crowds suspected, correctly as it transpired, that most of the forms had been sold onto the black market and stolen by police, bank staff and the other government officials involved in the sale. On the following day, 10th August (thus the signifier ‘8.10’), this dissatisfaction spilled over into rioting, the most serious social disturbance in China since the 1989 Tiananmen Square protests. Police met placards reading ‘fight corruption’ with tear gas. The Shenzhen stock market small group, headed by the deputy mayor, called in the army and closed the SHZSE. It also quickly issued a second batch of 5m rengouzheng. Official media sources reported that 200 to 300 protestors, led by ‘hooligans’, had caused the disturbance. Western media sources put the figure of those involved at over 10,000, most of whom were simply frustrated investors.

The central government reacts

Zhongyang leaders reacted with extreme concern. There had already been several small IPO-related disturbances in Shanghai in late 1991. Premier Li Peng immediately announced the temporary suspension of all share issuance and listing. An investigative group from Beijing arrived in Shenzhen on 20th August, led by the neo-conservative vice-premier Zou Jiahua. Vice premier Zhu Rongji was also reported to have flown in on 24th September 1992. Their senior rankings indicated the seriousness with which the leadership took the disturbance, and how the riot had fed into battles within Beijing over the direction of reform. The official State Council report released on 10th December 1992 was highly critical of local officials. It stated that 4,180 officials had been involved in stealing and reselling rengouzheng and that

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688 Wang (1992b), 80; Huang (1999d), 120.
689 Gu (1993), 8.
690 Chu (1992); TKP (1992c).
692 SCMP (1992b).
693 Xinhua (1991d).
694 Liu (1997), 130.
695 SZB (1992b); SHZSE (1993); SCMP (1992d).
696 Shenzhen Party Secretary Li Hao and Zheng Liangyu were forced to make public self-criticisms; Zheng was transferred to be vice governor of Jiangxi, while Li was replaced later in 1993. Zhang Hongyi, Shenzhen’s vice mayor responsible for finance, was demoted to vice mayor of nearby Dongyuan City, SCMP (1993d), CCJP (1992); Jen (1992); SCMP (1992c).
100,000 forms had been illegally diverted.\textsuperscript{697} (Hong Kong media estimated that 70\% of the IPO forms, some 3.5m, were stolen and privately sold.\textsuperscript{698}) As well as uncovering extensive corruption, the report found the choice of issuance method to have been flawed. Mayor Zheng Liangyu and Vice Mayor Zhang Hongyi had chosen to limit the number of \textit{rengouzheng} available rather than allowing a limitless number to be sold, as some officials had advised, and as had been standard practice in Shanghai since the beginning of 1992.\textsuperscript{699} The suspicion was that by restricting the supply of forms officials could divert them and maximise revenues from their sale on the black-market where forms sold at five to ten times their face value.

Within the \textit{zhongyang} leadership there was considerable disagreement about how to react to the crisis. Many in the nascent securities industry feared that neo-conservatives would force the complete closure of the sector. Deng’s words about closing the market suddenly appeared prescient. The secretary to leading neo-conservative Chen Yun, and Chen Yuan, his son, had inspected the SHZSE days before the rioting and were reported to have disapproved.\textsuperscript{700} After the riot, Chen Yun publicly called for the need to ‘summarise’ the experiences of the special economic zones, conservative euphemism for closing them, and the stock exchange, down.\textsuperscript{701} Zhu Rongji, who was associated with the stock market because of his personal support for the SHGSE, became vulnerable to personal attack. At a meeting of senior leaders on 19\textsuperscript{th} August, another conservative Chen Xitong, Beijing mayor, claimed that ‘the State Council was responsible for the [8.10] incident’, implying that the crisis was Zhu’s fault.\textsuperscript{702} PBoC governor Li Guixian and the recently removed finance minister Wang Bingqian, pointedly accused another comrade of ‘acting on his own’.\textsuperscript{703} Stock market policy at this juncture became wrapped up with factional struggles within the senior leadership and thus opaque to detailed analysis. The suspicion must be, however, that the pivotal player in resolving the dispute was Deng. It was his \textit{nanxun} speeches that

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\textsuperscript{698} SCMP (1992a).
\textsuperscript{699} SCMP (1992c); Wang (1992b), 126-132; Huang (1999c), 120.
\textsuperscript{700} Li (1992a).
\textsuperscript{701} CM (1992).
\textsuperscript{702} Jen (1992).
\textsuperscript{703} Yeung (1993).
had triggered China's trading fever, and two of his recent appointees, Zhu and General Secretary Jiang Zemin, had both supported share market development.\textsuperscript{704} In addition to the personnel issue for Deng, defence of the stock market was defence of the \textit{nanxun} line. Confirmation that the senior leadership remained pro-equity soon came. In September 1992 the first national securities companies, Huaxia Securities, Guotai Securities and Nanfang Securities, were established with commercial bank and MoF funds.\textsuperscript{705} At the 14\textsuperscript{th} Party Congress in October 1992 Jiang used his political report to speak in favour of ‘nurturing securities, shares and financial markets’. It was an important sign of continued \textit{zhongyang} support; attentive listeners noted that Jiang did not use the word ‘experiment’ to describe the market.\textsuperscript{706} The message was clear: China’s stock market was here to stay. What had still to be decided was how to regulate it.

A special State Council meeting was held to discuss the Shenzhen report and equity regulation in October 1992.\textsuperscript{707} Li Guixian lobbied for an expansion of the responsibilities and powers of the PBoC’s State Council Securities Management Meeting System (SCSMMS), a committee which he chaired established earlier that year. He argued that the ‘technical problems’ involved in the Shenzhen IPO could be resolved and that with more resources the PBoC could deliver effective regulation. As Figure 53 shows, and chapter three explained, the PBoC, at least in theory, was the part of the \textit{xitong} mandated to develop and enforce equity regulation before the riots. However, many senior figures believed that the PBoC, a shareholder in numerous securities companies and TICs, was ill-suited to act as the market’s regulator. The evident capture of its local branches by local leaders, its failure to constrain issuance, and the involvement of the PBoC Shenzhen branch in the 8.10 incident, made it vulnerable to criticism. Moreover, other State Council markets were dissatisfied with their lack of voice and wanted direct mechanisms of influence over equity policy. The MoF, for instance, proposed that a dedicated regulatory organ should be established under its own management.\textsuperscript{708} Others proposed the setting up of a dedicated stock market

\textsuperscript{704} Ren (1992).
\textsuperscript{705} Tong (1992); Chen (1997c), 3.
\textsuperscript{706} Dong (1997), 136.
\textsuperscript{707} Interview-20, Beijing, 2000.
\textsuperscript{708} Hu (1992).
regulator. The SCORES, and a number of NPC deputies, had been lobbying for one to be established since at least 1991. In July 1991, the SCORES had drafted *A Suggestion on Establishing a State Council Securities Management Commission*; deputies within the NPC had produced a similar document.\textsuperscript{709}

\textsuperscript{709} Guo (1999a), 131; Dong (1997), 135.
Figure 53. China's equity institutions, December 1990 to October 1992
Figure 54. China’s equity institutions, December 1992 to July 1997
The December 1992 circular: the creation of the CSRC

These plans were dusted off and under the guidance of Vice Premier Zhu, two new organs were established with the aim of eliminating the two problems Zhongyang leaders had determined were responsible for 8.10: unsupervised local government management of the share market and ineffective PBoC regulation.\textsuperscript{710} After a series of consultation meetings between the SPC, MoF, SCORES, PBoC and the senior leadership, State Council document No. 68, the Circular on Furthering Strengthening Macro-regulation of the Securities Market, was issued on 17\textsuperscript{th} December 1992.\textsuperscript{711} With Central Committee backing, this established the SCSC and the CSRC and mapped out a new division of regulatory work. The official vision was for an institutional order ‘characterised by multi-tiered units with independent functions and responsibilities that work in conjunction with each other under the leadership of the SCSC’.\textsuperscript{712} This is shown in Figure 54.\textsuperscript{713}

The CSRC was established as a shiye danwei, a non-governmental organ. There is some dispute about the bureaucratic rank it was critically assigned. A number of sources suggest that it was given a deputy ministry (fubu) rank; other sources imply that it received a ju-level rank and was then upgraded to a fubu rank in early 1995. (Yet other sources suggest this promotion took place earlier, in January 1994).\textsuperscript{714} Yet, even if the CSRC did initially attain deputy ministry rank, its non-governmental status weakened it. As such it not only lacked standing among State Council members and ministry-ranking organs such as the PBoC, but it also lacked funds and administrative authority. The regulator was not legally authorised to promulgate administrative regulations (xingzheng guize).\textsuperscript{715} Most of the CSRC’s rules had therefore to be promulgated by the SCSC or the State Council (and therefore needed to acquire the consensus of leaders at this senior level). Finance was also a problem: the CSRC was not included in the government budget and neither was it mandated to levy fees on the market. An

\textsuperscript{710} Caijing (2000c), 71.  
\textsuperscript{711} Interview-34, Shenzhen, 2000.  
\textsuperscript{712} Xinhua (1993b); Xinhua (1993e).  
\textsuperscript{713} SIA (1996a), 128; Zhou (1998), 3; Xinhua (1993b).  
\textsuperscript{714} Interview-59, Shenzhen, 2001; Ren (1996), 55; Dong (1997), 261.  
\textsuperscript{715} Jiang (1999a), 23.
initial loan from the MoF for the CSRC’s staff and administration was quickly spent and the commission had then to borrow funds from the SEEC and other organs.\textsuperscript{716} Because of its non-governmental status, moreover, the CSRC had no powers to punish illegal behaviour. The only apparent factor in the CSRC’s favour was that Liu Hongru, its first chairman, had previously held the rank of deputy minister at both the PBoC and SCORES, a personal ranking he would have retained, giving the CSRC more influence than its bureaucratic ranking probably warranted.\textsuperscript{717}

The CSRC was mandated to formulate rules and exercise regulatory powers over the issuance and trading of all listed securities, with the exception of futures instruments. It was also responsible for the day-to-day administration of securities companies. However, in all of these areas it had to share powers with other, more senior, bureaux. Policy-making powers were given to the SPC and the SCORES. The SPC was to make development plans for the securities industry and calculate the national issuance quota, as chapter nine explains. The SCORES was to formulate rules for shareholding reforms. In addition, regulatory duties were given to the PBoC and MoF. The PBoC retained its role of examining, approving, and administering securities organs, a designation that included securities companies, TICs and other intermediaries, although it excluded the stock exchanges. The CSRC/PBoC division of work is also examined in chapter nine. Supervision of accountants was the responsibility of the MoF, though their securities work came under sole CSRC jurisdiction. The MoF also retained management of the primary Treasury bond market.\textsuperscript{718} In addition, the CSRC shared management of the SAOs and stock exchanges with the two municipal governments, as chapters four to six explained. This arrangement, in which regulatory powers were fragmented and the exact boundaries of responsibility were unclear fostered debilitating tensions between central bureaux and created gaps in regulation.

\textsuperscript{716} Caijing (2000c), 72-73.
\textsuperscript{717} SZB (1992a).
\textsuperscript{718} Hong (2000), 244.
Like other new regulatory agencies, the new team at the CSRC was full of zeal. However, as Guo Feng notes, the new regulator resembled an organisation overseeing a self-regulatory system. It lacked legal and administrative authority and its attempts to expand its mandate and accumulate powers were kept in check by other bureaux.

During 1993-94, institutional development proceeded rapidly, the details of the December 1992 settlement were fleshed out and several problems resolved. The most important institutional development during this period were the Provisional Regulations on Stock Issuance and Exchange (April 1993) and on the Provisional Measures on the Regulation of Securities Exchanges (July 1993). Drafted by the CSRC's legal counsel Gao Xiqing, the first of these regulations contained, among other things, detailed provisions on the issuance application process, provisions which endured until 1999, as chapter four explained. The later set out the relationship between the stock exchanges and the CSRC as outlined in chapter six. However, despite the CSRC being formally empowered to authorise such applications, it was local governments that chose the firms to list and members of the SCSC, primarily the SPC, who controlled the issuance volume. The CSRC’s power were considerably enhanced when it gained the right to draft implementing rules to State Council and SCSC promulgations in the middle of the year and in August 1993, it also received the authority to punish illegal behaviour. Both rulings allowed the CSRC to transcend its non-governmental status and broaden the scope of its activities. However, disciplinary decisions were complicated by the fact that they usually impinged upon the jurisdictions of either local government and/or the PBoC. In addition, the CSRC was over-burdened, under-staffed and, on the whole, ineffective in curbing widespread bad practice. It suffered administrative constraints; not

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719 Guo (1999a), 186, 197-201.
720 Li (1998b), 166; Interview-06, Shanghai, 2000.
721 Chen (1997a), 492-505; Li (1998b), 163.
722 Zhang (1998), 133.
723 Jin (1999), 329; SZB (1994e); SZB (1993e).
724 Shi (1993).
least a staff of only 79 as of October 1994. Malpractice was widespread and the regulator was ill-equipped to deal with it. The disclosure requirements that the CSRC issued during 1994 were widely ignored: only 75 of the 169 listed companies’ annual reports issued in April 1994 met with their requirements.\footnote{Xinhua (1994c).} Local securities offices, as chapter four showed, were uninterested in supporting the CSRC line. Disclosures were not just incomplete: many were deliberately misleading. On 6th November 1993, for example, a company called Behai Zhengda Real Estate announced in a Hainan newspaper that it had purchased 5% of the shares of SHZSE-listed Kunshan Sanshan.\footnote{SCMP (1993f).} The CSRC’s April 1993 regulations had mandated such an announcement to protect shareholders in the event of an prospective take-over. Kunshan’s share price rose 40% the next day in response to the news. The day after, however, the CSRC announced that Behai Zhengda did not actually exist and that there were no records of any such trade. Similar, if less outrageous, scams occurred regularly, and the CSRC could do little to stop them. The take-over of SHGSE-listed Yanzhong Industries by SHZSE-listed Baoan was cause for more embarrassment. On 30th September 1993, Baoan gained a 17.1% stake in Yanzhong but had neglected to both report its position and stop buying shares after it had gained a 5% stake, as mandated by the SCSC’s April 1993 regulations.\footnote{Zheng (1993); Xinhua (1993a); Chan (1994a); SZB (1993a); Li (1998b), 171.} After an investigation and Rmb1m fine for Baoan, the CSRC had to allow the take-over to go ahead.

While many rules were ignored, many more had not yet been written. The institutional vacuum created incentives for firms, and their local government backers, to create institutions by setting precedents themselves. As chapter six showed, stock exchange leaders were particular adept at this; listed firms were too. In February 1994, Dazhong Taxi, a SHGSE-listed firm, announced plans to convert its legal person shares into B-shares.\footnote{Zheng (1993); Xinhua (1993a); Chan (1994a); SZB (1993a); Li (1998b), 171.} The proposals were announced before CSRC approval had been extended, before Dazhong had gained a B-share quota allotment and even after the CSRC had made clear that such share conversions were still only ‘under consideration’. The CSRC suspended the plan, stating that ‘a grassroots company has no right to make such a decision without...
state permission’.

Its assertion of jurisdiction, however, did not discourage local leaders from continuing to attempt to set rules themselves. Indeed, it was not at all clear which bureau or level of government had the right to represent ‘the state’.

Standardisation, 1995

In the aftermath of 327 Treasury bond futures crisis, radical ideas, including the transfer of regulatory powers from the SAOs and PBoC to the CSRC, were discussed at a senior level, but were not implemented. Instead, the zhongyang leadership opted for a change of leadership at the CSRC and SHGSE, a go-slow approach to market development and institutional tinkering. In May 1995, Bei Duguang, the deputy director of the CSRC’s International Department, stated that all securities organs, including the STCs, should and would soon come under the CSRC’s supervision. Then, in July 1995, the State Council issued its ‘suggestions’ on securities work for 1995. For the first time the senior leadership stated it was aiming to ‘straighten out the relationship between the multiple bureau’ involved in equity regulation. According to Jin Dehuai, the circular recognised the importance of ‘gradually clarifying’ the relationships of the SCSC, CSRC, State Council bureaux, SAOs, and local futures regulatory offices. It argued for the gradual concentration of powers at the central level of government and for the definition of the authority of the SAOs. However, these proposals were left unimplemented, and it would take another crisis to revive them. Instead, the State Council promoted the CSRC to the status of ‘an organ operating directly under the State Council’ (Guowuyuan zhixia shiye) and, apparently, a rank of deputy-ministry (fubu), (although the CSRC’s previous rank is a matter of dispute). In March 1995, the SCSC approved a CSRC reorganisation plan that involved the establishment of enforcement, accountants and drafting departments. The Futures Department was expanded. CSRC chairman Liu Hongru was dismissed by the SCSC in mid-1995, scapegoated for

728 Jing (1994); SCMP (1994b); Dong (1997), 34.
729 Chan (1994c); Xinhua (1994b).
734 Tsang (1995b); SIA (1996a), 65.
the 327 scandal and internally criticised over his perceived over-emphasis on overseas listings. The new leadership team at the CSRC was led by Zhou Daojiong, SCSC deputy chairman since 1993.\textsuperscript{735} Deputy CSRC chairmen Fu Fengxiang, Tong Zengyin and Zhu Li were replaced by Li Jiange, Wang Yi and Geng Liang. The CSRC’s legal counsel Gao Xiqing resigned soon after Zhou’s arrival, amidst reports of an increasingly bureaucratic environment at the regulator.

The new team at the CSRC was conservative in orientation and had a mandate from the senior leadership to put ‘standardisation’ (\textit{guifanhua}) before development. Zhou Daojiong’s first public statement on 28\textsuperscript{th} April 1995 set the tone: he spoke of controlling the market (\textit{zhishi}), a market he said that was still ‘experimental’.\textsuperscript{736} Preventing further crisis was not the only aim; the new team needed to improve public confidence too. A survey by the SCORES and China Securities, a securities company, in May 1995, showed that only 7.9\% of individual investors believed the share market was ‘effectively supervised’; only 6.6\% believed that market operations were ‘fair’.\textsuperscript{737} The response of the CSRC leadership was to put all progressive equity policy on hold and to concentrate on raising regulatory standards.\textsuperscript{738} On 18\textsuperscript{th} April 1995 the CSRC established a mandatory system of examination, qualification, and certification for all securities professionals.\textsuperscript{739} In September, it ordered prospective listed companies to take on ‘guidance underwriters’ to advise them before and after listing.\textsuperscript{740} Underwriters were expected to help reorganise enterprise assets, ensure good accounting standards, draft articles of association and produce annual financial statements. The new \textit{guifanhua} policy was most forcefully rolled out in the futures market where the CSRC immediately banned the authorisation of new futures brokers and exchanges and a clean-up programme began in August 1994.\textsuperscript{741} The CSRC’s mandate was to reduce the thirty-three futures exchanges, the number of futures brokerages (only some 300 of the 500 had been formally

\begin{footnotesize}
\begin{enumerate}
\item[(\textsuperscript{735})]SZB (1995p); Chan (1996e).
\item[(\textsuperscript{736})]SZB (1995g); Li (1998b), 191.
\item[(\textsuperscript{737})]Xinhua (1995b).
\item[(\textsuperscript{738})]Zhang (1998), 83; Hu (1999a), 247.
\item[(\textsuperscript{739})]Chen (1997a), 152-155, 717-719
\item[(\textsuperscript{740})]Chan (1995b).
\item[(\textsuperscript{741})]Chen (1993c); SZB (1995q); Dong (1997), 15; SZB (1994l).
\end{enumerate}
\end{footnotesize}
approved by the central government) and the 50-plus contract types.\textsuperscript{742} Rectification involved revoking licences for futures brokerages, closing down and merging futures exchanges, levying fines and other disciplinary actions, all which would have all involved considerable disputes with local leaders.\textsuperscript{743} 1995 also saw some joint action with the PBoC and MoF in clearing up the repo market.\textsuperscript{744}

\textit{Policy linkage: SOE reform and the stock market, 1996}

The empowerment of the CSRC and the reorganisation of equity institutions that was to come during 1997-98 was rooted in developments in industrial policy that took place in late 1995 and 1996. While before 1996 the stock market had been a local affair, peripheral to the main thrust of the central government's economic reforms, after 1996 it was subordinated to the most important part of the \textit{zhongyang}'s industrial policy: SOE reform.

An article written by Li Jiange, a CSRC vice chairman and close advisor to Zhu Rongji, in \textit{Gaige} (Reform) magazine set out the new thinking.\textsuperscript{745} The financing problems facing the government, he argued, were threefold. First, the failure of commercial bank reform and the continued lack of discipline in lending meant that capital was not being efficiently allocated, causing investment hunger and bottlenecks in growth. The evidence supports this diagnosis. Albert Park shows that there was no change in the state banks lending practices to the loss-making SOE sector between 1991 and 1998.\textsuperscript{746} This was a problem since the SOE sector was, despite shareholding reform, not improving: 1996 was the first year that subsidies to the sector exceeded its contributions to the state budget. This encouraged the State Council into adopting a more aggressive policy stance: 'grasp the large, let go of the small' (\textit{zhuada, fangxiao}) in 1995-96. Small and medium sized SOEs would be sold off, contracted out or simply closed, and large SOEs would be financed and built into chaebol-like conglomerates. With the banks already heavily exposed to NPLs, the State Council required a new source

\textsuperscript{742} SZB (1994n); Chen (1994b).
\textsuperscript{743} SIA (1996a), 65.
\textsuperscript{744} Li (1998b), 208.
\textsuperscript{745} Li (1996).
\textsuperscript{746} Park and Sehrt (2001), 636-637.
of financing. Second, Li noted the precipitous fall in government revenues: only 10.7% of GDP was collected in taxes in 1995, down from 28.4% in 1979. The central government’s take of total tax revenue had also fallen, from 46.8% to 29.3%, over the same period.\textsuperscript{747} Concern over these ‘two ratios’, promoted by Wang Shaoguang, Hu Angang and other ‘neo-statists’ in government, had been an important factor informing policy since the early 1990s, and was behind the 1994 tax reforms. Declining fiscal revenues created incentives for securing funding sources for the SOEs from outside the budget and also from outside the state banking system, for which the government had an implicit liability. Third, Li noted that personal income and savings had risen dramatically to become an important but under-utilised source of investment capital. By June 1996, China’s banks were holding Rmb3.5 trillion in private savings, five times the figure five years earlier. ‘How can we put together an [capital] accumulation mechanism that promotes social development now that the old mechanism [administrative funding through the budget]...has been broken?’ Li asked. His answer was the stock market. Direct capital allocation was more efficient than the plan, he argued, since information costs were lower. The stock market could link accumulated bank savings with the SOEs’ demand for financing. Large SOEs should now be restructured into shareholding companies and listed, Li argued, a process that would improve corporate governance as well as raise capital.\textsuperscript{748} Vice premier Zhu Rongji appears to have been won round to the new thinking by early 1996.\textsuperscript{749} After intense debates throughout 1997 about the direction of economic policy, Jiang Zemin threw his weight behind this reform agenda at the 15\textsuperscript{th} Congress in October 1997, reviving Zhao Ziyang’s ‘primary stage of socialism’ theory to justify shareholding, \textit{zhuada fangxiao} and increased private sector activity.\textsuperscript{750} The Congress recognised the share market as ‘as an important component of the national economy’.\textsuperscript{751}

\textsuperscript{747} On fiscal revenues, Ahmad, Li and Richardson (2000); Fewsmith (2001), 132-140.
\textsuperscript{748} Li’s article was also extremely frank about the market’s problems: the lack of effective regulation, misuse of IPO funds, the deleterious effects of state-shareholding and administrative interference. However, this critique was not to be addressed as it would have undermined the market’s ability to act as a crude financing mechanism for SOEs.
\textsuperscript{749} Lam (1996b).
\textsuperscript{750} Fewsmith (2001), 193.
\textsuperscript{751} Preface to Zhou (1998); BR (2001), 22.
In March 1996, the plenary session of the NPC passed the ninth Five Year Plan which formally established the stock market as a part of the socialist market economy and an end to the market’s experimental status.\(^{752}\) Public issuance was accelerated. Between January and the middle of March 1996, 12 companies made A-share IPOs, compared to 15 in the whole of 1995, as the CSRC sped up its approvals of issues.\(^{753}\) Then, at the April 1996 SHGSE AGM, Li Jiange announced the zhongyang’s new stance vis-à-vis the stock market: ‘appropriate expansion’ in support of SOE restructuring.\(^{754}\) Share issuance was expanded and the average size of A-share issues also increased, as Figure 55 shows. While in 1995 an average company raised Rmb96m from an IPO, by 1997 larger companies were coming to market and raising three times as much capital. An average IPO in 2000 brought in Rmb730m.\(^{755}\) CSRC authorisation of rights shares issues also increased dramatically. While in 1996 listed companies only raised Rmb7 billion through rights, that figure rose to Rmb19.8 billion in 1997, Rmb33.8 billion in 1998 and stabilised at this level thereafter. By early 1997, the State Council was preparing its 1,000 key SOEs, 120 conglomerates and 100 ‘pilot enterprises experimenting with the modern enterprise system’ for public listing.\(^{756}\)

### Figure 55. Size of an average IPO, 1991-97

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<tr>
<td>Average A-share issue</td>
<td>36</td>
<td>125</td>
<td>160</td>
<td>45</td>
<td>96</td>
<td>234</td>
<td>318</td>
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<td>Rmb m</td>
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Author’s calculations based on CSRC (1999a), 31.

Proposals for institutional change remained alive but were still not implemented. The State Council’s ‘Securities and Futures Work Outline’ for 1996 stated that the CSRC should;

\[\ldots\text{practice systematic regulation of securities organisations’ underwriting and proprietary trading...carry out fixed date investigations into securities organisations, give appropriate punishments for illegal behaviour, up to rescinding licence... and}\]

\(^{752}\) Li (1997b),40; SZB (1996p); Dong (1997), 181.
\(^{753}\) Chan (1996d).
\(^{754}\) Peng (1999).
\(^{755}\) EIU (2001c).
\(^{756}\) Si (1996).
The document suggested the need for the CSRC to assume ‘unified’ powers over the equity sector, euphemism for the elimination of local government and PBoC influence. Although fundamental institutional reorganisation did not come, the CSRC did gain in capacity. Some progress was made in empowering the regulator in February 1996, when it gained permanent access to fee-based revenues from the market. The State Council allowed the regulator to levy fees on trading, as well as on securities companies, TICs, and listing applicants to fund its activities. The fee structure is outlined in Figure 56 and has endured, the only significant change being the trading turnover rate rising to 0.003% on the regulator’s assumption of control of the SHGSAO and SHZSAO in 1999.

As a non-government organ, the CSRC’s annual budget is approved, but not funded, by the MoF. In the event of its annual revenues exceeding the budget, revenues may be put aside for future use but the CSRC may not spend more than its budget without special dispensation from the State Council. In this way the CSRC’s leadership is not endowed with an organisational interest in nurturing trading volume, (unlike the Shanghai and Shenzhen governments were with the stamp tax). Interviewees suggested that this funding structure had by 2000 created a comparatively rich organisation, able to pay its staff salaries roughly

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758 Media reports imply that this was the first time the CSRC had levied such fees. However, an interviewee suggested that the CSRC had previously levied fees informally, on a much smaller scale, SZB (1996t); Interview-46, Shenzhen, 2001.
50% more than the standard rate for central government employees, combined with far superior housing and welfare provision.\textsuperscript{760} Figure 57 shows the author’s estimates of the fees that the CSRC would have collected from A-share trading, the dominant but not exclusive part of its revenues, during 1996-2000. Adding in the other fees, total revenues would probably have exceeded Rmb200m in 2000.

**Figure 57. Estimates of the CSRC’s fee from A-share trading, 1996-2000**

<table>
<thead>
<tr>
<th>Year</th>
<th>Total A-share trading volume, Rmb billion</th>
<th>CSRC revenues from A-share, Rmb m</th>
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<tbody>
<tr>
<td>1996</td>
<td>2,105.2</td>
<td>52.7</td>
</tr>
<tr>
<td>1997</td>
<td>3,029.5</td>
<td>75.7</td>
</tr>
<tr>
<td>1998</td>
<td>2,341.8</td>
<td>58.5</td>
</tr>
<tr>
<td>1999</td>
<td>3,132.0</td>
<td>78.3</td>
</tr>
<tr>
<td>2000</td>
<td>6,082.7</td>
<td>182.5</td>
</tr>
</tbody>
</table>

Author’s estimates based on CSRC data and a 0.0025% fee levied on A-share trading volume 1996-99, 0.003% in 2000. CSRC (1999a), 30-31; CSRC (2001), 6-7.

Moreover, the CSRC’s investigations and disciplinary actions during 1996 suggested a growing capacity for enforcing the law. In October 1996, after a four month investigation, the CSRC imposed a Rmb500,000 fine on the Bohai Group for inflating assets in its mid-term report.\textsuperscript{761} While previously the CSRC had usually taken 12 to 24 months to investigate allegations, the speed of this response signalled a new efficiency in investigative work and perhaps even a willingness to come down hard on malpractice. During November and December 1996, the CSRC carried out investigations and enforcement actions on illegal purchases of IPO shares by FIIs. With 42 institutions named and punished, including large securities companies such as Huaxia, Shenyin Wanguo and Guotai, it was the by far the largest and most significant crackdown in the CSRC’s four-year history.\textsuperscript{762} In addition, it was during 1996 that the CSRC made valiant, if unsuccessful, attempts to extend its influence over the SAOs and over the two stock exchanges, as outlined in chapters four, five and six. Despite this failure things were looking up for the CSRC: the regulatory and policy goods it

\textsuperscript{760} Interview-59, Shenzhen, 2001.
\textsuperscript{761} Peng (1996d).
\textsuperscript{762} Peng (1996c).
was uniquely positioned to deliver were, with stock market expansion planned, going to be increasingly valuable to the *zhongyang* leadership.

**The empowerment of the CSRC, 1997-98**

Detailed planning for a fundamental restructuring of China’s equity institutions began in spring 1997 after the equity developmentalism and bank loan scandals of 1996 and 1997 examined in chapter five. This crisis had persuaded the FELG to implement institutional change that had been discussed and successfully resisted since at least 1995.763 Under orders from Zhu Rongji, SCSC chairman Zhou Zhenqing, together with the FELG secretariat, drafted the *Sanding fangan* (the ‘three decisions’ plan), a document officially authorised by the State Council on 19th October 1998, but whose content appears to have been determined as early as mid-1997.764 The *fangan* was a simple document with three parts. First, it backed the need for a ‘unified and vertically regulated stock market’.765 While its explicit objective was to ‘nationalise’ the entire regulatory structure its implicit aim was to replace local capture of equity institutions with central capture. Steps to achieve this began on 1st July 1997 when the CSRC assumed *guanli* administration of the two stock exchanges; the SAOs soon followed. Second, the *fangan* stated that the CSRC should have ministerial (*zhengbu*) rank and should act exclusively on behalf of the State Council in regulating and developing the stock market. The SCSC would be dispersed and other State Council bureaux, principally the PBoC, excluded from formal involvement in the equity sector. Negotiations between CSRC and PBoC leaders for a transfer of the bank’s regulatory functions over securities companies began, as chapter nine will explain.766 The CSRC was also given its most senior leader yet: Zhou Zhenqing, the minister-ranking SCSC chairman was appointed to replace Zhou Daojiong in mid-1997.767 Third, the *fangan* stated that the CSRC should have sufficient

763 It also coincided with Zhu Rongji’s March 1998 administrative reforms which reduced 40 State Council ministries to 29 and made a 50% cut in staffing levels within the central government, Yang (2001b), 34-40.
764 Xiao (2000a), 69.
766 Huang (1999d), 72.
767 SCMP (1996b); IHT (1997b); COL (1999a); Kwan (1998).
With the absorption of the SAOs, by January 2000 the regulator had a Beijing-based staff of over 300, a local staff of over 700 and had expanded to 15 departments.769

During 17-19th November 1997, the Central Committee and State Council organised the first joint Party/government National Financial Work Meeting since 1949, a signal of the importance the zhongyang leadership now attached to financial reform and regulation. The restructuring laid out in the sanding fangan was announced as well as that of the PBoC branch structure. The National Securities Supervision Work meeting was then brought forward from its usual summer-time slot to January 1998 to allow work associated with the restructuring to progress more quickly. With a broad enabling document in place, more detailed plans were required. The CSRC's Securities Regulation Structure Reform Plan and the Functional Design, Internal Organisation and Rules for Personnel were both passed by the State Council in early 1998. These brought the SAOs under the CSRC's administration. Not only was this a challenging political task which required considerable zhongyang clarity, it was also an enormous logistical project; by the end of 1997 there were at least 45 SAOs operating throughout China. Staff and assets all had to be transferred, a process which took over two years to complete. Preparations began in April 1998 when the CSRC began investigating the resources, operations and personnel of the SAOs.770 At the end of June 1998, the CSRC authorised the SAOs to approve the establishment and operations of securities companies, previously the task of PBoC branches, and a sign that the SAOs were now operating under the de facto control of the CSRC.771 Then, from September 1998 onwards, senior members of the CSRC visited local governments to negotiate the transfer of property and personnel to the CSRC. During 19th - 27th September 1998, for example, Zhou Zhenqing visited Jiangxi, Shanghai, and Anhui and signed transfer agreements with senior local officials. Local governments were reportedly keen to transfer able staff out of the SAOs and to maximise income from the sale of their offices.

768 Interview-13, Beijing, 2000.
769 Interview-10, Shanghai, 2000.
770 CSRC (1999b), 3.
771 Huang (1999d), 72, 97.
to the CSRC.\footnote{Interview-13, Beijing, 2000.} Once these agreements were signed, administrative work on the transfer began in January 1999 and ended in June of that year. It was only in July 1999 that the SAOs formally underwent guapai and came under full CSRC management and supervision.\footnote{Guapai means literally 'to hang or post up a nameplate', in this case on the entrance to an office, and indicates the formal assumption of administrative control, Bao (1999), 69. The SHGSAO changed its name to the Shanghai Securities and Futures Administration Commission (Shanghai Zhengquan Qihuo Guanli Weiyuanhui) in October 1997. Of note is the loss of the city (shi) label, Interview-15, Shanghai, 2000; SHGSE (1997b), 447.} Powers of appointment of senior management and funding and control of the SAOs' budgets passed to the CSRC. At the same time, with PBoC branches giving up their regulatory powers over securities companies, many PBoC staff transferred, leading to the CSRC's expansion from around 300 to over 1,300 staff.\footnote{On the post-1997 CSRC, interviews 34 (Shenzhen, 2000) 43, 52 (Shenzhen, 2001) and 10, 15, 36 (Shanghai, 2000) were extremely useful.} According to one source, most SAO directors were re-appointed by the CSRC and only a few retired or moved to other bureau.\footnote{Interview-10, Shanghai, 2000.}

Institutional capture of the SAOs by the CSRC did not just involve a change in the nomenklatura system. Rather, like the stock exchanges, it involved a range of institutional measures that served to centralise decision-making, create effective oversight mechanisms and transform SAOs staff into agents of the CSRC with minimal room for defection. As of July 1999, the official duties of SAOs have been to:\footnote{CSRC (1999b), 31.}

- Implement national laws and policies.
- Use CSRC authority to supervise and manage all local securities activity.
- Investigate problems.
- Other functions authorised by the CSRC.

The institutional transformation was startling. First, SAOs now have only a minor role to play in the issuance process. They make a provisional assessment of IPO and secondary applications and then pass them to the CSRC Issuance Department for authorisation. According to one interviewee, provincial
governments do not now need to support an enterprise’s issuance application: they are simply notified after the CSRC has finished the authorisation process.\textsuperscript{777} Other sources, however, claim that provincial government support is still crucial in allowing a company to gain a public listing, in terms of authorising its restructuring and providing other administrative and fiscal supports.\textsuperscript{778} Second, since 1998 all investigations have been managed by the CSRC Investigation Bureau (including those involving sums below Rmb5m). Third, SAOs have lost the ability to punish listed companies and securities companies (though, of course, they were not active practitioners of these powers while they had them before 1997). As of 1999, the decision as to whether to issue administrative warnings, fines or pursue criminal prosecution rested solely with the CSRC Investigation Bureau, Market Supervision Department and senior CSRC leadership, a change that eliminated the discretionary powers of local leaders over disciplinary procedures. The fourth major change in regulatory practice at the local level has been the increase in on-site visits of SAO staff to listed companies, undertaken on instructions from the CSRC Companies Department. In 1999, for example, SAO staff were instructed to visit a third of the listed companies in their locales and make more detailed examination of all companies’ annual, mid-term and special events reports.

As well as absorbing the SAOs into its administrative ambit, the CSRC created a new three-tier structure for administering its local offices. This restructuring paralleled the PBoC’s restructuring, also announced in October 1997, whereby provincial PBoC branches, previously operating in each province, were consolidated to form ‘supra-provincial’ offices.\textsuperscript{779} The directors of these regional offices would oversee branches across a number of provinces and would thereby not come under the authority of provincial leaders. This reorganisation of the banking and securities regulatory structures was aimed at severing the formal administrative ties, and at least some of the channels of informal influence, that existed between local government leaders and these ju-level bureaux. ‘The power,’ said Zhu Rongji, ‘of provincial governors and mayors to command local

\textsuperscript{777} Interview-43, Shenzhen, 2001.
\textsuperscript{778} Interview-53, Shenzhen, 2001.
\textsuperscript{779} Lardy (1998), 207.
bank presidents is abolished as of 1998. The same could, apparently, now be said of local leaders’ ability to have their favoured companies issue shares without any effective oversight. By 2000, the CSRC had established nine regional offices which each in turn managed the work of two to three special team offices (tepaiyuan banshichu) in their vicinity. The two SAOs in Hangzhou (Jiangsu Province) and Nanjing (Zhejiang Province) were, for example, converted into representative offices and brought under the authority of the CSRC office in Shanghai. Two offices (zhixia banshichu) were set up in Beijing and Chongqing to be governed directly by CSRC headquarters. In addition, there were moves in 2000 to establish dedicated investigation bureau at the local level to work alongside the CSRC’s offices. One report claimed that these bureau, to be led and staffed jointly by the CSRC and PSB, would eventually have a total staff of 1,400.

The final major institutional change that took place after October 1997 was the creation of CCP committees within the CSRC at each of the three levels (centre, regional and branch). Previously, many of the SAOs did not operate formal Party committees (dangwei) or branches (dang zongzhi or dang zhibu) themselves, though their directors were often members of the CCP committees of other government agencies. A CCP committee structure was established during 1998-99 and in 1999 CSRC staff at all levels underwent training in the sanjiang (three stresses), a political campaign designed to instil Party values and

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781 Regional offices were set up in Tianjin, Shenyang, Shanghai, Jinan, Wuhan, Guangzhou, Shenzhen, Chengdu and Xian, CSRC (1999b), 30-32.
783 CSRC (1999b), 3.
784 As a general rule, state organs with over 50 members establish party committees, while those with less than 50 form party branches, Yang (1995a), 183.
allegiance to the ‘CCP leadership with General Secretary Jiang Zemin at the core’.\textsuperscript{785}

\textsuperscript{785} Lam (1999), 36.
Figure 58. China’s equity institutions, year end 2000.
These four institutional changes to the SAOs, in their integration into a xitong structure, in their reduced regulatory powers, in a new administrative structure which reduced local political influence, and in their establishment of Party committees, facilitated central capture. The result, shown in Figure 58, was an institutional arrangement based on clear lines of authority flowing from the centre to the periphery of the state, and extensive mechanisms available to the newly dominant sub-principal, the CSRC, to ensure the compliance of its agents.

One of the most debilitating problems in China’s equity institutions, the Centre-Local split, had been fused. But to what effect? The reorganisation circumscribed the damaging influence that local leaders exerted over issuance and the secondary market and allowed better co-ordination between policy makers in the Centre and those mandated to implement policy. However, even after this reorganisation co-ordination problems between the two levels of government remained. Questions have been raised as to the ability of the CSRC leadership even now to rely on local staff for full and honest provision of information and complete co-operation. Most SAO personnel have worked within their local bureaucracies for many years and enjoy close relations with other local government organs, securities companies, listed firms and shareholders, state and otherwise. Despite CSRC guanli authority over their offices, these old allegiances are hard to break. One interviewee claimed that since their integration with the CSRC that SHZSAO staff find bureaux in Shenzhen less willing to assist in their investigations, although another interviewee denied this.786 A second problem, of course, is that informal mechanisms of influence, although limited compared to before 1997, are still available to local leaders. A third issue is that local leaders still retain control of industrial and fiscal policy, and this allows them to offer considerable discretionary supports to their listed companies. They are aggressively defensive of their listed firms and use a variety of means to keep them profitable (at least in terms of their balance sheets) and prevent their delisting.787 Tax rates are manipulated, subsidies extended, debts forgiven or restructured and assets imported.788 Such practices undoubtedly

787 Hu (1999b), 23.
788 Cao (2000), 128, 140.
undermine the efficiency of regulation and the transparency of the stock market. Chapter eleven attempts to evaluate the post-1997 settlement in terms of the quality of regulation it delivers, even if a detailed examination of these practices is outside the bounds of the present study.

Concluding remarks

The institutional development of the CSRC solved two critical issues facing the zhongyang leadership: how best to control local agents and how best to organise central government. The CSRC was empowered after 1997 as the sole sub-principal, absorbing powers and responsibilities from competing sub-principals at both the local and central levels. While this chapter has examined the former, the following chapter examines the later. The importance to the zhongyang of solving this problem was not constant through the decade, but was enhanced by both the financial crises that the previous institutional arrangements fostered during 1995-97 and by the decision in 1996 to link stock market and industrial policy. Only when these incentives were present did zhongyang leaders act to achieve central capture of equity institutions.
Incoherence at the Centre: The State Council Securities Commission and CSRC/PBoC relations

Fazhi, jianguan, zilu, guifan.
(The rule of law, supervision, self-discipline and standardisation).
Vice Premier Zhu Rongji, 1995

This chapter examines how equity institutions were organised at the most senior level of government during 1990-98 and evaluates the performance of the SCSC in co-ordinating policy, governing regulation and constraining equity developmentalism at the local level. The SCSC was established on 25th October 1992 to institute controls over local leaders and to co-ordinate the relevant policies of its member bureaux, things that the pre-1992 PBoC meeting system had failed to achieve. Although the SCSC did go some way to constrain local developmentalism and improve central government co-ordination its failures in both these areas were stark. Its institutional design, and the dispersal of powers among State Council bureaux that it entrenched, was wholly unsuitable for its mandate. Rather than serving as a co-ordinary mechanism, the SCSC tended to act as the point at which competing bureaux leaders exercised their veto, thus holding up the rational development of policy and the resolution of important regulatory issues. As a result the central government lacked a clear voice and effective means of supervision and control over local activities during 1993-97. Such institutional incoherence at the Centre enabled local sub-principals to defect and to, often, effectively hide their defection.

The chapter is laid out as follows. In the first section, early institutional attempts at co-ordinating equity policy within the PBoC are examined. The next section explores the structure and function of the SCSC and its office. Particular attention is paid to its work in formulating the government’s ‘policy direction’ (fangzhen) and arranging the issuance quota. In the third section, the CSRC/PBoC relationship is explored.

Early attempts at co-ordination within central government

The earliest attempts within central government to produce a co-ordinated approach to stock market policy occurred in late 1990, as growth in OTC trading and planning for the stock exchanges took place in Shanghai and Shenzhen. In November 1990, just before the official opening of the SHGSE, the State Council held the first of a series of special meetings of eleven of its member bureaux. Then, in April 1991 the PBoC, the organ with regulatory responsibility for the securities market, established the Share Market Staff Meeting System (Gupiao Shichang Bangong Huiyi Zhidu, hereafter SMSMS), a Commission initially made up of eight State Council bureaux. Its formal functions were:

- To set the stock market policy direction (fangzhen) and detailed policy (zhengce).
- Following the state plan, to approve (shending) the scale of issuance. SMSMS members also formed a ‘share issuance approval small group’ to oversee issuance applications.
- To approve (shending) equity market regulations.
- To co-ordinate State Council members’ policies.

Its first meeting was held in May 1991 and the Commission met once or twice a month thereafter. There is some dispute over its leadership; official documentary sources claim that it was chaired by PBoC governor Li Guixian. An interviewee, however, claimed that it was jointly chaired by Li and Vice Premier Zhu Rongji. Administrative services to the SMSMS were provided by the PBoC’s FAMD. Little public information is available on its activities or discussions. The Commission is known, however, to have approved the decision to ‘nationalise’ the share-market and introduce public listings for companies from Guangdong, Hainan and Fujian provinces.

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790 Chen (1990).
791 The initial members included the PBoC, SPC, MoF, SCORES, SASAM and the Tax Bureau. The SETC joined later, SIA (1993), 309; Zhang (1998), 131.
792 Dong (1997), 258.
On 1st July 1992, after a fourteen-month existence, the SMSMS was wound up and replaced by a State Council-level meeting system, the State Council Securities Management Office Meeting (Guowuyuan Zhengquan Guanli Bangong Huiyi, hereafter SCSMOM). The new Commission was officially mandated to strengthen market management and ‘nationalise’ the market. This mild institutional reorganisation appears to have occurred in reaction to the rapid expansion in share trading that occurred after Deng’s nanxun in early 1992. However, there appears to have been no difference between the SMSMS and the SCSMOM in terms of membership, powers or rank. The chairman was still the PBoC governor and/or Zhu, depending on the same sources. Another interviewee claimed that the new group did not have a formal chairman and that administrative responsibilities were left to Jin Jiandong, director of the PBoC’s new Securities Management Office (Zhengquan Guanli Bangongshi, hereafter SMO), an office established under the PBoC’s FAMD in May 1992. Another interviewee stated that the only difference this meeting system had with the SCSMOM was that it was ‘more formal’ and met more frequently. The SMO, staffed by around 24 people, was formally responsible for drafting securities regulations, implementing State Council decisions, organising the daily work of the share issuance small group, preliminarily approving stock exchange listing rules and developing policy proposals. It also worked with the SPC’s Comprehensive Finance Planning Department to determine the annual securities issuance quota.

**The State Council Securities Commission**

In October 1992, having determined that the PBoC had failed in its mandate to regulate the sector and that local leaders required better supervision, the zhongyang leadership transferred the SCSMOM out of the PBoC, expanded its

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794 Dong (1997), 259.
797 Interview-34, Shenzhen, 2000.
798 Dong (1997), 259.
799 According to one interviewee the majority of their time was spent researching overseas securities markets and drafting rules. They did not take an active part in approving issuance or in
powers, endowed it with its own administrative bureau, as well as its own office, and changed its name to the State Council Securities Commission. As chapter eight explained, the CSRC was created at the same time. While the State Council December 1992 Circular affirmed the 'positive role' of stock markets in raising funds and allocating resources, it also noted that 'disorder' had been caused by a 'lack of laws, regulations, and supervision systems' and 'a lack of experience in operating such mechanisms'. The SCSC was created to solve these problems by energising, providing guidance to and overseeing the policy making activities of central bureaux. It was meant to bring 'unity' (tongyi) and 'standardisation' (guifanhua) as well as provide 'guidance, co-ordination, supervision, and inspection over the work of the various localities and bureaux relating to securities markets'. Vice Premier Zhu Rongji took up the post of SCSC chairman; Liu Hongru, CSRC chairman, and Zhou Daojiong, took up the deputy chairs. Having already assumed the governorship of the PBoC earlier in the year, Zhu had now successfully concentrated all financial policy-making powers in his own hands. He was only to abdicate his formal leadership of the SCSC in 1995, when he handed the chairmanship to Zhou Zhenqing, a State Council deputy secretary general. However, despite their disenfranchisement, PBoC leaders retained mechanisms of influence. In fact, one interviewee suggested that the PBoC leadership only agreed to the reorganisation of equity institutions because its former deputy governors, Zhou and Liu, were placed in positions of authority. The SCSC was made up of at least 12 State Council bureaux, although there is some confusion over its exact membership, shown in Figure 59.

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the regulation of trading, activities that were predominantly handled by PBoC branches, Li (1998b), 84; Wang and Fewsmith (1995); Interview-20, Beijing, 2000.
Xinhua (1993c).
SZB (1992a); Interview-29, Shanghai, 2000; Interview-21, Beijing, 2000.
Interview-23, Beijing, 2000.
SIA (1996a), 128.
Chinese press reports misrepresent the frequency of SCSC meetings. The press only reports three SCSC meetings taking place on 10\textsuperscript{th} May 1994, 22\textsuperscript{nd} May 1995, and 8\textsuperscript{th} April 1996.\textsuperscript{805} These meetings were dubbed by the press the SCSC’s fourth, fifth and sixth meetings or ‘plenary sessions’. There is no mention of the SCSC meeting during 1993 or 1997 in any source seen by the author. Yet several interview sources stated that in fact the SCSC met about five times each year from 1993 to 1997 inclusively.\textsuperscript{806} Meetings were held roughly every quarter, as well as on an \textit{ad hoc} basis when requested by the CSRC leadership. The press-reported meetings were used to announce the year’s policy direction (\textit{fangzhen}) and the issuance quota. The deputy minister or vice-chairman responsible for securities work within each member bureau attended meetings, usually accompanied by a secretary.\textsuperscript{807} As well as the CSRC, the commission was supported by a dedicated office.

\textsuperscript{804} It appears that both the State Development Bank and the Domestic Trade Bureau joined between 1993 and 1996. The Procuratorate and Supreme Court are not State Council members but joined in 1993-94 at the request of the CSRC leadership to help in investigations, Interview-29, Shanghai, 2000; Yuan (1997); CSRC (1997), 201.

\textsuperscript{805} SZB (1995a).

\textsuperscript{806} Interview-29, Shanghai, 2000; Interview-38, Beijing, 2000.

\textsuperscript{807} Interview-23, Beijing, 2000.
The SCSC Office

The SCSC Office was initially located within Zhongnanhai, the Party/government leadership compound in central Beijing. Initially headed up by Ma Zhongzhi, formally a director of the PBoC FAMD, the office was comprised of about 15 people working in three divisions. The National Market Division researched the economy, negotiated the issuance quota with the SPC, drafted one- and five-year plans for the stock market, proposed regulations and prepared all the documents for SCSC meetings. The International Market Division conducted research on developed Western markets and the Policy and Research Division was, in theory at least, responsible for making policy proposals to the SCSC. The SCSC office occupied a strategic position in the central government bureaucracy because it provided policy guidance and information to the SCSC. When the Commission met, it usually only reviewed reports prepared by the SCSC Office and the CSRC. These would include reports of the securities work of the previous year, reports on the quota discussions with the SPC and recommendations for future policy. Thus control of the activities of the SCSC Office was an important means of shaping the SCSC’s agenda.

It appears the CSRC leadership gained early influence over the SCSC Office. An interviewee stated that while there was some ambiguity over the administrative allegiance of the SCSC office, that ‘to some extent it was a part of the CSRC’. Consider the lines of leadership. The SCSC Office director was directly responsible to the SCSC chairman and his deputies. However, given that the vice-premier had numerous other responsibilities, the weight of this work fell to Liu Hongru, CSRC chairman, and Zhou Daojiong. Wang Yi, CSRC vice chairman during 1996-98, was acting director of the SCSC Office after Ma Zhongzhi left. Thus it seems likely that the CSRC leadership had day-to-day operational control of the SCSC office. Consider the physical location of the SCSC office. Dong Shaoping claims that the SCSC Office and CSRC merged

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808 This section is based on Interview-21, Beijing, 2000.
809 Dong (1997), 260.
810 Interview-10, Shanghai, 2000.
811 Interview-34, Shenzhen, 2000.
their offices in June 1993. An interviewee supported this claim, stating that the SCSC Office moved to join the CSRC in the Fengzhuan area of Beijing sometime before 1995. Also consider the administration of the SCSC office: by 1997 the CSRC was paying all the salaries of SCSC Office staff. In practice, with only two to three people working in each division of the SCSC Office the majority of the policy and law-drafting work was at any rate carried out within the CSRC. Finally, consider the movement of personnel. Many members of the SCSC Office moved to the CSRC during the 1990s and at the SCSC office’s closure in 1998, again suggestive of close administrative relations.

The powers and functions of the SCSC

Formally, the SCSC took on three specific powers, all transferred from the PBoC and its meeting system:

- Promulgation of equity market fangzhen (policy direction).
- Approval of the issuance quota.
- Authorisation of overseas issuance.

These three core powers were an attempt to give the SCSC ultimate control over the direction of market development (through the fangzhen); the aggregate supply of equity and the speed of market growth (through the issuance quota); and over sensitive policy issues (through control over foreign listings and the development of new financial instruments). In addition the commission had a broad remit to organise drafting activities, co-ordinate bond and share issuance, supervise all securities work, administer the CSRC and authorise the establishment of new stock exchanges. The SCSC was to be the sector’s sub-principal under the close supervision of the zhongyang leadership. It did achieve some successes: issuance was constrained by the quota (and market sentiment manipulated by it); issuance overseas was more or less controlled; and important regulations that underpinned governance of the market until the passage of the 1998 Securities Law were issued under its auspices. Moreover, it is claimed that

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812 Dong (1997), 259.
813 At the beginning of its operations, salary, welfare and other administrative functions had been the responsibility of the State Council General Office, SIA (1996a), 128.
a range of issues were negotiated and resolved at SCSC meetings, although there are few publicly available details.\textsuperscript{814} One apparent success, for example, was when the SCSC co-ordinated bond and equity policy in 1993. After MoF warnings, the SCSC used its May meeting to inform provincial leaders that until they purchased their quota of domestic Treasury bonds their SOEs would not be allowed to issue shares.\textsuperscript{815} Faced with such a threat, provincial leaders responded positively by buying their complement of bonds. However, the SCSC achievements in guiding equity market development were limited: in each of the three core areas its powers were too macro in orientation to be effective and even then in practice they were frequently assumed by other organs or senior leaders.

**Fangzhen**

One of the most visible of institutions in the equity sector, at least until 1998, was the *fangzhen* ('policy direction'). *Fangzhen* are a curious, crucial and not well understood convention of policy making and bureaucratic communication in the PRC. As short strings of abstract nouns or qualified verbal phrases, they are usually frustratingly vague. They do, however, receive an inordinate amount of coverage in the Chinese media, policy debates and academic studies. The reason appears to be that by emphasising key themes *fangzhen* signal the priorities of senior policy makers, thereby providing guidance for sub-principals formulating specific policy (*zhengce*) throughout a large and dispersed bureaucracy. They work, or at least attempt to, through creating an atmosphere and thus supplement more traditional administrative mechanisms of monitoring and control. Stock market *fangzhen* were derived from the more general financial sector *fangzhen*, which were themselves derived from the general economic *fangzhen* set by the FELG each year.\textsuperscript{816} Once formulated, *fangzhen* are communicated throughout the bureaucracy and financial industry through speeches, training sessions and by CCP classes. For example, the sixth meeting of the SCSC on 8\textsuperscript{th} April 1996 issued a new stock market *fangzhen*: *wenbu fazhan, shidong jiahuai* (stable development, appropriate speed). By introducing the concept of development, the *fangzhen* signalled a crucial shift in senior leaders' priorities and the expansion

\textsuperscript{814} Interview-29, Shanghai, 2000.  
\textsuperscript{815} Chen (1993d).  
\textsuperscript{816} Interview-10, Shanghai, 2000.
of issuance, as outlined in chapter eight.\textsuperscript{817} The most important stock market fangzhen, the bazi ('the eight words'): fazhi, jiangguan, zilu, guifan (legal system, supervision, self-discipline and standardisation) was reportedly formulated by Vice Premier Zhu himself in late 1995.\textsuperscript{818} This phrase was used as a centrepiece of the central government's efforts to crack down on corruption and volatility after the 327 crisis. Other fangzhen in the sector have less clear origins. The SCSC was officially mandated to formulate them, but neither the commission nor its office appears to have been involved in their actual formulation.\textsuperscript{819} It seems likely that a small group of senior CSRC staff, together with senior zhongyang leaders, formulated stock market fangzhen during 1994-1997.

However, the crises of 1992, 1995 and 1996-97 suggested that fangzhen were an inefficient means of ensuring co-ordination between government actors. They were easily ignored by local leaders, and those in Shanghai and Shenzhen wrote their own fangzhen for their own markets, ones which often subtly readjusted the original emphasis. Since 1997, fangzhen have not been used by the CSRC leadership very much. They now appear happier formulating more concrete aims and relying on administrative mechanisms to ensure compliance. In 1998, for example, Zhou Zhenqing announced the CSRC's aim to implement the spirit of the 15\textsuperscript{th} Party Congress, to continue implementing the bazi fangzhen, support SOE reform, deepen structural reform and rectify the securities market.\textsuperscript{820} No shortened slogan was promulgated.

**The issuance quota**

The share issuance quota system operated from 1993 to 1998. It was the most important macro-economic tool that the central government had for influencing stock market growth and trading sentiment. Moreover, it allowed the benefits of issuance to be spread throughout the country, although not evenly, and for investment to be channelled towards the State Council's favoured industries.

\textsuperscript{817} Li (1997b), 40.


\textsuperscript{819} Interview-23, Beijing, 2000. Interview-29, Shanghai, 2000 disagreed.

\textsuperscript{820} CSRC (1999b), 1.
Local leaders equity developmentalism, at least for the most part, had to take place within the bounds of the quota.

The quota has been criticised by some analysts as being a dysfunctional legacy of the plan economy.\textsuperscript{821} Certainly it had its problems, but it should be noted that many other developing countries limit access to the share market. Since demand for capital investment remained strong in an economy still marked by investment hunger throughout the 1990s, controlling access to public issuance through administrative means was the only viable means of maintaining market stability.\textsuperscript{822} By the end of 1997, China had over 32,000 shareholding companies, but only 745 of them had been allowed to publicly issue shares.\textsuperscript{823} Moreover, in practice, the quota was not a traditional plan tool. A comparison of the official quota with actual issuance for each year shows that despite the extensive research and negotiation that went into setting the quota, the two figures were rarely the same.

Figure 60 shows the official quota during 1993-97, the publicly announced readjustments made to it and actual issuance. Only in 1994 and 1995 did the official quota provide a more or less accurate guide to actual issuance. The quota was never actually fulfilled in full but was frequently altered by zhongyang leaders in order to stimulate or cool trading sentiment. Announcing a large volume of soon-to-be-issued equity caused loss of confidence in an irrationally exuberant market; a small volume, in contrast, fostered confidence about future prices. For example, the SCSC set an issuance quota of Rmb5 billion for 1993.\textsuperscript{824} In July 1993, a national austerity plan was implemented to restrain inflation and stock prices fell as money supply tightened and unauthorised issuance continued.\textsuperscript{825} In May 1994, the SCSC ordered the postponement of a series of

\textsuperscript{821} E.g. Wu (1999b), 34.
\textsuperscript{822} Investment hunger, a concept developed by János Kornai, describes systematic under-investment in a planning system. Firms are thought to invest excessively in the absence of penalties for wrong decisions (the soft-budget constraint), and expand capacity and stocks as a hedge against uncertainties about the supply of financial resources, Girardin (1997), 67-83; Kornai (1980); Lin (1989), 114; Cohen (1997), 504. For a critical discussion of the concept, Schaffer (1998).
\textsuperscript{823} Su (1997).
\textsuperscript{824} Li (1998b), 172.
\textsuperscript{825} SCMP (1994d); Chu (1993c).
IPOs in response to further falls, and in July 1994 issuance was stopped altogether and the quota was suspended.\textsuperscript{826} This had the effect of temporarily rallying prices. In another infamous instance, outlined in chapter five, in December 1996 the zhongyang leaders' response to high share prices, volatility and financial instability was to upwardly revise the issuance quota to Rmb10 billion. When this failed to curb the bull market the quota was raised to Rmb15 billion in March 1997, and then to Rmb30 billion in May 1997, all of which triggered price falls.\textsuperscript{827} The quota may well have been a tool of intervention, but it had little to do with the plan economy and everything to do with \textit{ad hoc} intervention. Moreover, the issuance quota had little to do with the SCSC. The vice premier approved all issuance quotas before they went to the SCSC for authorisation. On no occasion did the SCSC attempt to change the quota and when the issuance volume was altered on an \textit{ad hoc} basis by the vice premier the revised figure was not re-authorised by the SCSC.\textsuperscript{828}

After the headline issuance figure was approved the quota was divided up into local quotas for provinces and central government bureaux. This work was initially carried out by the SPC Comprehensive Finance Department, but after 1994 the CSRC appears to have assumed responsibility. Information regarding each localities' annual quota is not publicly available and little is known about how the quota was divided up. However, some issuance data is available. Figure 61 shows the capital raised through share issuance by each provincial government during 1993-2000. The way the quota was shared favoured the south and east of China. Economically and politically powerful localities such as Shanghai (which received 10.5% of all A-share capital raised up to the end of 2000) and Beijing (9.75%) benefited the most. The central provinces of Henan, Hunan and Hubei were also important beneficiaries. One obvious anomaly is the small volume received by Guangdong province. Excluding Shenzhen, it only received some 2.6% of issuance volume during this period. Provinces in western China such as Gansu, Qinghai, Xinjiang, received the quota scraps, although Figure 62 shows how western provinces slowly gained a greater share of

\textsuperscript{826} Xinhua (1994a).
\textsuperscript{827} SZB (1996d); Dong (1997), 69.
\textsuperscript{828} Interview-29, Shanghai, 2000.
issuance volume during 1995-98, as the east’s dominance of the market was slightly diminished.
### Figure 60. The A-share share issuance quota, 1993-99

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial quota</td>
<td>5</td>
<td>5.5</td>
<td>None</td>
<td>5.5</td>
<td>10</td>
<td>30</td>
<td>Formal quota system</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>abolished</td>
</tr>
<tr>
<td>Revised quota</td>
<td>5.5</td>
<td>No</td>
<td>5.5</td>
<td>10</td>
<td>15, then</td>
<td>30</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>issuance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>-</td>
</tr>
<tr>
<td>Time of quota revision</td>
<td>-</td>
<td>July 1994</td>
<td>Early</td>
<td>Dec</td>
<td>May 1997</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Actual capital raised through A-share IPOs</td>
<td>19.4</td>
<td>5.0</td>
<td>2.3</td>
<td>22.4</td>
<td>65.5</td>
<td>44.3</td>
<td>57.3</td>
</tr>
</tbody>
</table>

Rmb billion

Note: The quota did not include capital raised through rights and secondary issues.
Author's calculations based on assorted press and secondary sources; row four CSRC (2001), 33.
### Figure 61. Regional distribution of raised capital, end 2000

<table>
<thead>
<tr>
<th>Locale</th>
<th>Capital raised, Rmb m</th>
<th>Proportion of total capital raised, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shanghai</td>
<td>9,017</td>
<td>10.50</td>
</tr>
<tr>
<td>Beijing</td>
<td>8,370</td>
<td>9.75</td>
</tr>
<tr>
<td>Henan</td>
<td>6,204</td>
<td>7.23</td>
</tr>
<tr>
<td>Jiangsu</td>
<td>5,181</td>
<td>6.03</td>
</tr>
<tr>
<td>Hunan</td>
<td>5,044</td>
<td>5.87</td>
</tr>
<tr>
<td>Shandong</td>
<td>4,990</td>
<td>5.81</td>
</tr>
<tr>
<td>Hubei</td>
<td>4,434</td>
<td>5.16</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>3,534</td>
<td>4.12</td>
</tr>
<tr>
<td>Sichuan</td>
<td>3,496</td>
<td>4.07</td>
</tr>
<tr>
<td>Jilin</td>
<td>3,466</td>
<td>4.04</td>
</tr>
<tr>
<td>Inner Mongolia</td>
<td>3,010</td>
<td>3.51</td>
</tr>
<tr>
<td>Zhejiang</td>
<td>2,644</td>
<td>3.08</td>
</tr>
<tr>
<td>Fujian</td>
<td>2,636</td>
<td>3.07</td>
</tr>
<tr>
<td>Hainan</td>
<td>2,368</td>
<td>2.76</td>
</tr>
<tr>
<td>Guangdong (exc. Shenzhen)</td>
<td>2,265</td>
<td>2.64</td>
</tr>
<tr>
<td>Heilongjiang</td>
<td>2,238</td>
<td>2.61</td>
</tr>
<tr>
<td>Tianjin</td>
<td>2,150</td>
<td>2.50</td>
</tr>
<tr>
<td>Hebei</td>
<td>2,005</td>
<td>2.34</td>
</tr>
<tr>
<td>Xinjiang</td>
<td>1,912</td>
<td>2.23</td>
</tr>
<tr>
<td>Liaoning</td>
<td>1,870</td>
<td>2.18</td>
</tr>
<tr>
<td>Guizhou</td>
<td>1,452</td>
<td>1.69</td>
</tr>
<tr>
<td>Shaanxi</td>
<td>1,292</td>
<td>1.50</td>
</tr>
<tr>
<td>Chongqing</td>
<td>1,242</td>
<td>1.45</td>
</tr>
<tr>
<td>Guangxi</td>
<td>964</td>
<td>1.12</td>
</tr>
<tr>
<td>Yunnan</td>
<td>823</td>
<td>0.96</td>
</tr>
<tr>
<td>Gansu</td>
<td>813</td>
<td>0.95</td>
</tr>
<tr>
<td>Ningxia</td>
<td>606</td>
<td>0.71</td>
</tr>
<tr>
<td>Jiangxi</td>
<td>570</td>
<td>0.66</td>
</tr>
<tr>
<td>Anhui</td>
<td>588</td>
<td>0.64</td>
</tr>
<tr>
<td>Qinghai</td>
<td>297</td>
<td>0.35</td>
</tr>
<tr>
<td>Xizang (Tibet)</td>
<td>270</td>
<td>0.31</td>
</tr>
<tr>
<td>Shanxi</td>
<td>154</td>
<td>0.18</td>
</tr>
</tbody>
</table>


### Figure 62. The regional distribution of listed companies, 1995-98

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern China</td>
<td>75.9</td>
<td>66.1</td>
<td>62.9</td>
<td>62.2</td>
</tr>
<tr>
<td>Central China</td>
<td>10.3</td>
<td>17.9</td>
<td>19.6</td>
<td>19.5</td>
</tr>
<tr>
<td>Western China</td>
<td>13.8</td>
<td>16.0</td>
<td>17.5</td>
<td>18.3</td>
</tr>
</tbody>
</table>

In addition to provinces, around 30 State Council bureaux and associated organs succeeded in securing listings for about 100 affiliated companies during the 1990s. As well as heavy industry SOEs run by the coal, steel and energy ministries et al., this included the Public Security Bureau, whose leaders sponsored a Hainan clothing manufacturer's bid to list on the SHZSE. The National Woman’s Association lobbied the SPC and SCSC to allow an affiliated condom manufacturer to issue shares, but failed in its bid.\textsuperscript{829} In 1996, State Council bureaux formally lost the right to receive quota allotments, although there is evidence to suggest this ban was not fully or quickly implemented. The SCSC also attempted to influence the type of enterprises coming to market. Each year the SCSC would issue guidelines for local SMCs to guide them in their work. In 1995, for instance, as in most other years, priority was given to enterprises in the energy, communications, raw/processed materials and high-tech sectors, sectors which generally benefited the national economy.\textsuperscript{830} Financial, real estate firms and light industry, favourites of local leaders because of their fast growth potential, immediate fiscal contributions and beneficial effects on local economies, were banned from listing by the SCSC in 1993. A number still got through, however, notably in real estate. Figure 63 shows how the quota system engineered a massive increase in the number of industrial firms and SOE conglomerates coming to market, especially after 1996. Figure 64 shows how these firms were concentrated in the manufacturing, petroleum and metals industries.

\textsuperscript{829} Interview-53, Shenzhen, 2001.
\textsuperscript{830} ZXS (1995).
Figure 63. Industrial sector of companies listed on the SHGSE and SHZSE, 1992-97

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Heavy and light industry</td>
<td>32</td>
<td>106</td>
<td>160</td>
<td>176</td>
<td>305</td>
<td>445</td>
</tr>
<tr>
<td>Finance</td>
<td>1</td>
<td>1</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Commerce</td>
<td>4</td>
<td>21</td>
<td>44</td>
<td>44</td>
<td>68</td>
<td>86</td>
</tr>
<tr>
<td>Utilities</td>
<td>2</td>
<td>13</td>
<td>25</td>
<td>25</td>
<td>37</td>
<td>53</td>
</tr>
<tr>
<td>Real estate</td>
<td>6</td>
<td>18</td>
<td>24</td>
<td>26</td>
<td>28</td>
<td>27</td>
</tr>
<tr>
<td>Conglomerate</td>
<td>7</td>
<td>17</td>
<td>37</td>
<td>37</td>
<td>75</td>
<td>117</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>52</td>
<td>176</td>
<td>311</td>
<td>311</td>
<td>516</td>
<td>731</td>
</tr>
</tbody>
</table>

Huang (1999d), 265.

Figure 64. Industrial breakdown of listed firms, end of 2000

<table>
<thead>
<tr>
<th></th>
<th>Total number of listed companies</th>
<th>Proportion of total, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>664</td>
<td>61.03</td>
</tr>
<tr>
<td>Machinery and industrial equipment</td>
<td>178</td>
<td>16.36</td>
</tr>
<tr>
<td>Petroleum and chemicals</td>
<td>153</td>
<td>14.06</td>
</tr>
<tr>
<td>Metal and non-metallic mineral products</td>
<td>110</td>
<td>10.11</td>
</tr>
<tr>
<td>Wholesale and retail trade</td>
<td>106</td>
<td>9.74</td>
</tr>
<tr>
<td>Conglomerate groups</td>
<td>78</td>
<td>7.17</td>
</tr>
<tr>
<td>Communication and electronics</td>
<td>60</td>
<td>5.51</td>
</tr>
<tr>
<td>Textiles</td>
<td>59</td>
<td>5.42</td>
</tr>
<tr>
<td>Food and drink</td>
<td>52</td>
<td>4.78</td>
</tr>
<tr>
<td>Social services</td>
<td>51</td>
<td>4.69</td>
</tr>
<tr>
<td>Transport and storage</td>
<td>42</td>
<td>3.86</td>
</tr>
<tr>
<td>Electricity, gas and water</td>
<td>40</td>
<td>3.68</td>
</tr>
<tr>
<td>Real estate</td>
<td>31</td>
<td>2.85</td>
</tr>
<tr>
<td>Agriculture, forestry and fishing</td>
<td>27</td>
<td>2.48</td>
</tr>
<tr>
<td>Construction</td>
<td>21</td>
<td>1.93</td>
</tr>
<tr>
<td>Paper, printing</td>
<td>20</td>
<td>1.84</td>
</tr>
<tr>
<td>Other manufacturing</td>
<td>16</td>
<td>1.47</td>
</tr>
<tr>
<td>Mining</td>
<td>14</td>
<td>1.29</td>
</tr>
<tr>
<td>Plastics and rubber</td>
<td>13</td>
<td>1.19</td>
</tr>
<tr>
<td>Finance and insurance</td>
<td>7</td>
<td>0.64</td>
</tr>
<tr>
<td>Information, culture</td>
<td>7</td>
<td>0.64</td>
</tr>
<tr>
<td>Wood</td>
<td>3</td>
<td>0.28</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,088</td>
<td>100</td>
</tr>
</tbody>
</table>

CSRC (2001), 134.

253
In October 1996, the SCSC altered the quota system to support its industrial policy objective of using the stock market as a key support for SOE reform. First, the size of the quota increased dramatically. During 1996-98, the quota grew from Rmb5.5 billion to Rmb30 billion, as Figure 60 showed. Second, from this time on, the SCSC set a quota for the number of shares to be issued, rather than a renminbi value for the issue. The CSRC would then determine the number of companies in each locale that would be allowed to list.\(^{831}\) Previously, local governments had chosen to distribute a renminbi quota among a large number of small companies. The change was designed to encourage local government to merge small and medium-sized SOEs, thus helping to consolidate the SOE sector.\(^{832}\) However, this change took time to implement, as companies moved through the issuance process. In 1996, over 57% of new listees still had stock capital less than of Rmb100m.\(^{833}\) Figure 65 and Figure 66 show how the size of companies grew during 1996-2000 as a result of the policy being implemented. Whereas by the end of 1996 72% of listed companies had stock capital of Rmb200m or less, by the end of 2000 the figure was only 42%.

**Figure 65. The stock capital of listed companies, end 1996**

<table>
<thead>
<tr>
<th>Rmb</th>
<th>Number of listed companies</th>
<th>Proportion of listed companies, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;100m</td>
<td>198</td>
<td>37</td>
</tr>
<tr>
<td>100-200m</td>
<td>184</td>
<td>35</td>
</tr>
<tr>
<td>200-300m</td>
<td>58</td>
<td>11</td>
</tr>
<tr>
<td>300-400m</td>
<td>34</td>
<td>6</td>
</tr>
<tr>
<td>&gt;400m</td>
<td>56</td>
<td>11</td>
</tr>
<tr>
<td>Total</td>
<td>530</td>
<td>100</td>
</tr>
</tbody>
</table>

CSRC (1997), 57.

**Figure 66. The stock capital of listed companies, end 2000**

<table>
<thead>
<tr>
<th>Rmb</th>
<th>Number of listed companies</th>
<th>Proportion of listed companies, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;100m</td>
<td>77</td>
<td>7</td>
</tr>
<tr>
<td>100-200m</td>
<td>380</td>
<td>35</td>
</tr>
<tr>
<td>200-300m</td>
<td>262</td>
<td>24</td>
</tr>
<tr>
<td>300-400m</td>
<td>149</td>
<td>14</td>
</tr>
<tr>
<td>&gt;400m</td>
<td>220</td>
<td>20</td>
</tr>
<tr>
<td>Total</td>
<td>1,088</td>
<td>100</td>
</tr>
</tbody>
</table>

CSRC (2001), 136.

\(^{831}\) SCMP (1996g).
\(^{832}\) Wong (1998), 62.
\(^{833}\) Wu (1999b), 30; Pan (1999), 73.
Overseas issuance

The SCSC also reserved the right to authorise all enterprises issuing shares abroad. The December 1992 circular banned 'localities or bureaux arbitrarily organising enterprises to issue and list stocks on offshore exchanges'. This was a particularly sensitive issue. Not only did it involve foreign exchange considerations, and China's image abroad, but foreign listings allowed companies access to far deeper capital markets. On its establishment, the SCSC faced a wave of pending PBoC-sponsored overseas listings, mostly in New York and Vancouver. The SCSC delayed the plans of the Brilliance Group, a PBoC-linked group, to list nine subsidiaries abroad. In March 1994, the SCSC then authorised its first batch of 22 companies to list abroad, including some of the Brilliance Group. After 1992, the application procedure for overseas issuance involved a firm obtaining sponsorship from its local government (or State Council bureaux), approval from the CSRC and SPC, approval from the vice-premier himself and then the SCSC. Of course, extensive bargaining went on between State Council bureaux over which firms could issue abroad. Some companies, with local government support, simply bypassed the system. Between December 1992 and May 1993, 13 Mainland companies made backdoor H-share listings in Hong Kong by buying controlling stakes in HKSE-listed companies. In May 1993 the central government moved against this practice, when the CSRC and the HKSEC prevented Guangdong ITIC buying a controlling stake in Hong Kong-listed ASEAN Resources. Subsequent regulations issued by the CSRC, however, did not completely solve the problem. By 1997, about seven more Mainland companies had taken over HKSE vehicles. However, apart from this, the system of SCSC authorisation worked well and gave the central government effective control over overseas issuance. Figure 67 shows the size and number of foreign listings between 1993 and 1998.

834 Xinhua (1993b).
835 Tong (1993a); CD (1994); Tong (1993c).
836 Brilliance Automotive was the first Mainland company to issue shares outside the PRC, Studwell (2002), 76-79; Zhang (1998), 179.
837 Interview-29, Shanghai, 2000.
838 Tong (1993b); Peng (1994a).
839 Chen (1997a), 502.
840 Kumar (1997a), 120.
Figure 67. Overseas issuance, 1993-1998

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of companies</td>
<td>6</td>
<td>11</td>
<td>2</td>
<td>6</td>
<td>17</td>
<td>1</td>
</tr>
<tr>
<td>Initial issues</td>
<td>1.0</td>
<td>2.2</td>
<td>0.3</td>
<td>0.9</td>
<td>4.2</td>
<td>0.2</td>
</tr>
<tr>
<td>Secondary issues</td>
<td>0</td>
<td>0</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
</tr>
<tr>
<td>Convertible bonds</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0.2</td>
<td>0.3</td>
<td>N/A</td>
</tr>
<tr>
<td>Total issuance</td>
<td>1.0</td>
<td>2.2</td>
<td>3.8</td>
<td>1.2</td>
<td>4.7</td>
<td>4.6</td>
</tr>
</tbody>
</table>

US$ billion
CSRC (1999b), 20.

**Regulatory competition within the central government: the PBoC and the CSRC**

The SCSC was mandated to co-ordinate State Council bureaux policies towards the stock market. To a large degree, a full and proper evaluation of its achievements and failures in this regard is impossible to make because of the lack of available information about the commission, its discussions and decisions. However, one important problem within the SCSC that can be studied to some extent is the difficult relationship between the PBoC and CSRC. Under the December 1992 institutional settlement, the two organs shared responsibilities over securities companies and TICs. The PBoC retained a role as the ‘supervising administration over securities businesses’ while its other responsibilities were distributed to other bureaux, mainly the CSRC. The bank was left with powers to examine, approve and administer securities companies and TICs and, as such, it was the only bureaux authorised to extend a financial licence, or retract one, to a firm dealing in securities. The bank was also responsible for the ‘overall financial soundness’ of these companies and had power to appoint their senior managements.\(^{841}\) For its part, the CSRC took on day-to-day supervision of firms’ underwriting, proprietary trading and brokerage businesses.

As well as the stock exchanges, the large majority of China’s securities companies were established by banks and TICs during 1988-91, and initially fell

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\(^{841}\) Interview-58, Shenzhen, 2001.
under the regulatory umbrella of the PBoC.842 During most of the 1990s China had around 90 dedicated securities companies and 220-390 TICs involved in the securities business.843 However, as chapter three explained for the period before 1992, the PBoC’s regulatory capabilities were deficient. Securities companies operated until the end of 1990 without any national regulations governing their organisation, scope of business, qualifications or capital requirements. In October 1990, the PBoC established a licensing system, but this did not include any regulations (or even guidance) on underwriting, proprietary trading, investment funds or portfolio management.844 In theory, PBoC branches engaged in off-site surveillance, mainly through quarterly examinations of companies’ financial reports; on-site surveillance; verification of the qualifications of senior personnel; and the collection of statistics.845 However, the bank was ill equipped to cope with such demands. In Beijing, the PBoC SMO had a staff of only seven during 1994-96 and had the capacity to carry out on-site surveillance at only 16 firms in any one year. While company reports were sent both to local PBoC branches and to the PBoC headquarters, they were often unstandardised and sometimes simply unreadable. No in-depth examination of them occurred at either central and local level. Large TICs and those companies known to be at greatest risk received the regulators’ greatest attention, but even then only key statistics were examined and the details glossed. Staff faced weak incentives to actively regulate companies owned by, or affiliated with their own local government.

Disputes between the CSRC and PBoC were common.846 For example, although in August 1993 the CSRC was granted powers to punish offenders of the April 1993 measures, the CSRC could not cancel the licence of a securities firm without the PBoC’s agreement.847 One interviewee claimed the CSRC’s inability to unilaterally withdraw a licence led to some securities companies’ managers questioning its authority. In practice, CSRC staff had to negotiate any fines they wanted to levy with the PBoC. Serious problems, especially those involving

842 Li (1992b), 853.
843 Huang (1999d), 304
844 Kumar (1997a), 42.
845 Interview-26, Beijing, 2000.
846 Interview-06, Shanghai, 2000.
significant illegal activities, were normally were discussed at the SCSC. However, many cases were left unresolved because of disagreements over the degree of punishment. The result, as the World Bank reports, was that 'little [de facto] monitoring and regulation of securities dealers' took place during 1993-97. However, it was not just enforcement that was undermined; key policy issues were disputed and delayed. For example, as financial institutions the STCs fell within the jurisdiction of the PBoC, but were left unregulated as chapter seven explained. When CSRC leaders proposed to restructure the STCs, bringing the matter up at a number of SCSC meetings during 1994-95, the PBoC leadership reportedly refused to co-operate. With the PBoC veto in place, the STC issue remained unresolved until after 1997. This was not the only area in which PBoC leaders used their de facto veto powers to derail a CSRC initiative.

In mid-1994 share prices were in free-fall, the result of a national credit crunch, an excess of new issues and rising interest rates. Both the Shanghai and CSRC leaderships were concerned. A meeting of the SCSC took place in late July where the CSRC proposed a series of market boosting measures. The PBoC reportedly consented and the SCSC authorised the CSRC to announce a rescue package known as the sanda zhengce (the three big policies) on 28th July 1994.

First, new issuance was halted. Second, the CSRC announced the start of research on allowing bank loans to be extended to securities companies (rongzi) and a figure of Rmb10 billion was floated. Third, the CSRC announced it was considering allowing Sino-foreign investment funds to be established, as well as allowing direct foreign investment in the A-share market. The implication was that these proposals would all soon be implemented and in the first week of August the SHGSE index rose 113% and the Shenzhen index by 73%. It is unclear what then happened. There are reports that the PBoC leadership, opposed to the later two policies, sought support from within the zhongyang leadership and other State Council bureau leaders for non-implementation. One

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847 Chen (1997a); Jin (1999), 329.
853 Chan (1994b).
854 Hu (1999a), 127; Wang (1996c); Ibison (1994); SZB (1994i).
855 BT (1994).
interviewee claimed that the MoF, SPC and SCORES all preferred ‘a gradual approach’ to the financing of securities companies and foreign entry. PBoC leaders apparently opposed the former initiative on the grounds that it would undermine the banking sector’s stability, and the SAFE, a bureau operating under the PBoC, is known to have opposed opening up to foreign portfolio investment because of concerns about currency stability. By October, the sanda zhengce were dead in the water, and investors knew it: share prices were again falling.

The PBoC leadership consistently resisted attempts by the CSRC to assume more responsibility over the sector. In August 1994, the bank issued measures that staked its claim to being the ‘primary manager of all financial institutions’, with no mention of the CSRC. Indeed, the measures warned other government bureaux not to ‘interfere’ in the PBoC’s activities. The CSRC was further marginalised by the Law of the People’s Bank of China, passed in March 1995, which gave the PBoC statutory authority over the entire financial industry. Although the claim is only speculative, it is reasonable to assume that the CSRC’s delay in promulgating rules on detailed business in the securities sector (such as on underwriting and proprietary trading) was due to obstruction by the PBoC. Extraordinarily, such rules were not promulgated until 1996.

These regulations introduced higher capital requirements and, for the first time, several basic regulatory norms: capital asset ratios, limits to the amount of capital that could be traded, and separation of proprietary and customer funds. The CSRC required firms that wished to engage in these businesses to apply for CSRC licences in addition to the PBoC’s Financial Institution licence.

The illegal bank lending to securities companies in Shanghai during 1996-97 reflected particularly badly on the PBoC. Not only was the bank responsible for

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856 Interview-34, Shenzhen, 2000.
857 SZB (1994a).
859 Li (1999b), 176; SZB (1995o).
860 Chen (1997a), 168-172, 201-209.
861 Chengxi Yao notes that these licensing regulations contradicted the Law of the PBoC. If securities companies were financial institutions, then the CSRC had no statutory right to supervise their activities; if they were not, then the PBoC had no legal authority to supervise them in the first place, Yao (1998), 63-65, 85; Kumar (1997a), 42; SZB (1995d); SZB (1996f); Li (1998b), 202.
monitoring funds in the banking system; it was also supposed to be monitoring the activities of the securities companies that received the loans. On the basis of the ‘three decisions plan’ (sandìng fāngàn), the PBoC was forced to surrender its powers over securities companies in April 1998 when all licensing and supervision powers over securities companies were passed to the CSRC.\(^{862}\)

**Concluding remarks**

This chapter has demonstrated how the zhongyang leadership initially attempted to organise the institutions of central government to lead, oversee and constrain the activities of local leaders. The SCSC/CSRC split may have initially appeared a rational division of work. Indeed, the World Bank argued that the ‘two-tier approach’ to regulation embodied in the SCSC/CSRC arrangement, with its inherent checks and balances, could be advantageous to a young stock market.\(^ {863}\)

The SCSC did provide some useful goods: some issues were negotiated and resolved at SCSC meetings and, by formalising inter-bureau negotiations, the SCSC also reduced the dispute-arbitration workload of the State Council. It also constrained the developmental activities of local leaders and ensured that their worse abuses were curbed.

However the SCSC was flawed, unable to deliver the goods demanded by the zhongyang leadership: co-ordination of State Council bureaux, constraining local developmentalism and delivering better quality regulation. While the central government acquired authority over the fangzhen, the issuance quota and access to foreign markets, extensive space was left for local leaders to pursue their own agendas. While the central government oversaw the overall size of total issuance and guided the types of firms that could list, it had no means to supervise the quality of these companies and had manifold difficulties constraining their rights issues. While it could attempt to set the policy mood through the fangzhen, it had few direct means to oversee implementation at the stock exchanges and SAOs. Equity developmentalism, as chapter five revealed, was still eminently possible. The SCSC’s problems were fourfold. First, its structure was unsuited to its duties. Unlike the SPC and SETC, which both co-ordinate the activities of

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\(^{862}\) Huang (1999d), 98; Interview-10, Shanghai, 2000.
multiple central government bureaux, the SCSC was not a bureau in its own right with a permanent leadership able to negotiate and enforce compromise on an ongoing basis. The SCSC's infrequent, *ad hoc* meeting schedule, its lack of independent research facilities and its lack of authority over any specific policy area all prevented it from playing an effective role. Second, its three specific powers, setting the *fangzhen*, setting the issuance quota and authorising overseas issuance, were all macro in orientation: neither the SCSC or its office or its administrative agent had powers of oversight and control to ensure that their policies were implemented. Moreover, even these powers were not practised by the SCSC but by a small number of senior leaders including the vice premier and the SPC leadership. Third, by dispersing responsibility and powers among its member bureaux, the existence of the SCSC prevented the CSRC from gaining a clear mandate to develop policy and regulation. The commission operated instead as a veto point in the central government and thus weakened the central government's influence over the sector. With critical issues such as the STCs left unresolved local leaders were free to defect from official, but not actively implemented, central government policy. The SCSC clouded the zhongyang's leadership's voice. Fourth, the SCSC did not contain a single representative of local government, meaning that there was no institutionalised forum for the two levels of leaders to settle disputes, reach consensus or even have regular opportunities for information sharing or discussion.

These weaknesses were, however, recognised and largely resolved after 1997. The dispersal of the SCSC in early 1998 revealed that senior leaders were capable of learning from institutional failure, of overcoming bureaucratic resistance, and of organising institutional change to improve their controls over local agents given the right incentives. The transfer of the PBoC’s regulatory rights over securities companies to the CSRC was an unmitigated loss for the bank whose leadership had resisted such a move since 1992. Indeed, the SCSC’s dispersal contradicts a central finding of other studies of reform China’s policy-making process: that *zhongyang* leaders do not allow important bureau leaders to

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864 He (1998), 17.
sustain significant losses, and that the logic of compromise always ensures that all interests are ‘balanced’ and ‘satisficed’.
Drafting the Securities Law: the role of the National People’s Congress in creating institutions

*Passing the law was far from an easy task.*

Li Yining, vice chairman of the Finance and Economics Committee, 1998

The Securities Law (SL) of the People’s Republic of China is arguably the most important institution that governs China’s equity market. Until its implementation on 1st July 1999, the sector was regulated through State Council directives, SCSC measures, regulations promulgated by the CSRC, municipal rules and stock exchange ordinances. These had varying degrees of legitimacy and effectiveness. The SL raised the level of the institutional architecture governing the equity market to statutory law, adding permanence and providing legitimacy to the sector and to the CSRC. It laid out extensive rules governing the issuance, trading, settlement and regulation of securities, as well as liabilities for breaches of the law. CSRC chairman Zhou Zhenqing, the media and numerous publishing houses used it as an opportunity to celebrate a new epoch for the protection of investors and ‘standardisation’ (*guifanhua*) of the market.

This chapter examines how such an apparently critical part of the institutional architecture was created and the role China’s legislature, the NPC, had in the process.

Despite the media furore, however, at the time of its promulgation the SL had a very modest impact on the sector and actually had little to offer in terms of institutional change. It contained few new rules to govern issuance or trading, it created no regulatory organs that did not already exist and it extended few new powers to, or constraints upon, the organs already in existence. In contrast to the Securities and Exchange Act (1934) in the United States or the Financial Services Act (1998) in the United Kingdom, both of which created new

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865 Xinhua (1998e).
866 Li (1993), 84-85.
867 COL (1999b); Xinhua (1998b); AFX (1998b); BR (2001), 3; Huang (1999a); Liu (1999a).
institutional structures and empowered new regulatory organs, China's SL appeared largely ceremonial. Rather, as previous chapters have highlighted, it was the hundreds of administrative regulations (xingzheng guize) previously issued by executive organs that had done the real institutional work.\textsuperscript{869} Given this lack of legislative impact, the NPC could be assumed to have been an insignificant actor in terms of defining and designing reform China's equity institutions. This is a serious accusation, especially after two decades of development that have seen the legislature return from the margins of the political system to regain some of its powers.\textsuperscript{870} Kevin O'Brien, Murray Scot Tanner and Michael Dowdle all argue that through its setting of legislative priorities, by regaining a lead role in drafting legislation, and by overseeing the redrafting process, the NPC has, at least partially, asserted its constitutional role as China's chief legislative body. There have even been some moves to enhance its role in supervising the State Council, a role that the PRC’s 1982 Constitution extended to it.\textsuperscript{871} Moreover, recent studies suggest that the Congress has become an actor in the policy-making process in its own right, able to 'think' independently of both the Party and the executive, and even able to act in opposition to them at times.\textsuperscript{872} This chapter provides additional evidence to support many of these claims. It shows how actors within the NPC sponsored radical policies, opposed several important proposals originating from within the zhongyang, and attempted to establish mechanisms to constrain the powers of the CSRC. While most of the proposals were not implemented, the NPC did have a significant, if marginal, impact on the final shape of equity institutions. While this chapter provides evidence of a resurgent NPC able to influence important policy debates, it also reveals a legislature with serious internal co-ordination problems. It was the fragility of the NPC’s own institutions, the rules and procedures that governed its drafting activities, rather than its sidelining by Party or State Council leaders, that undermined its ability to fulfil its full constitutional role.

\textsuperscript{868} C.f. Xinhua (1998f).
\textsuperscript{869} In the UK parliamentary system, legislative powers can be delegated to ministers or other public officials. However, these powers are constrained, bill-specific and detailed, Adonis (1993), 112.
\textsuperscript{870} For background on the NPC, Dowdle (1997); Tanner (1999); O’Brien (1990).
\textsuperscript{871} CD (1999a).
The chapter is divided into three sections. The first discusses the role of legislatures in institutional change, and how such a role might be assessed in the case of China. The second section considers in detail the SL drafting process during 1992-98, including the activities of the NPC committees and the interaction between them and State Council bureaux. The third section considers what the SL drafting process tells us about the role of the NPC in creating institutions in reform China.

Legislative institutions and the revival of the National People's Congress

The PRC state formally operates on the basis of parliamentary sovereignty. The NPC thus resembles the UK's Westminster parliament. In this system, parliament nominates an executive, the cabinet, to govern on its behalf while the parliament retains all legislative competence. Parliament executes law, approves government finances, examines the activities of the executive and is (absent the monarchy in the UK case) sovereign. However, in states with strong party systems (or with one party), parliament tends to be completely controlled by the leadership of the majority party. Thus while the NPC formally nominates and votes for the executive branch of government, the State Council, in practice the NPC operates in a subordinate agency relationship to it and the Central Committee above it. Similarly, the UK parliament tends to operate in a subordinate relationship to the cabinet and prime minister, although it retains its sovereign status more than China's. Because of this, one expects legislative

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872 For examples, O'Brien (1990), 4-11, 175-177; Tanner (1999), 1-15, 161; Dowdle (1997), 1-23, 123.
873 China's 1954 Constitution decreed the NPC's plenary session to be the highest organ of state authority, a formal status that has been retained, Dowdle (1997), 53. In the Westminster model, the concept of the 'Queen in parliament' embraces the three estates of the Monarch, Lords and Commons, which, acting together, constitute the state's supreme legal authority, Punnett (1994), 245-255.
874 In contrast to the American system where legislative and executive powers are shared between the president and congress, Punnett (1994), 206-207; Horn (1995), 8; Neustadt (1960), 3.  
875 Historically of course, the NPC has been more constrained. During the Cultural Revolution (1966-76) the NPC ceased to function. During the 1980s it became active again in executing law, but the State Council Legislative Affairs Office (SCLAO) determined the legislative agenda and State Council bureau drafted all legislation. They then simply handed laws to the NPC to pass onto the statute books. Thus during 1978-92, the NPC had neither initiated legislation itself nor drafted law in house. The arena of dispute over the content of law, and therefore all decisions relating to what institutional structures the state used to regulate its emergent markets, was confined to the executive and the senior levels of the Party.
proposals in both countries to come directly from cabinet, to be drafted within the executive, and to be micro-managed by the relevant minister through parliament, (assuming, of course, that the party in government enjoys a stable majority). Thus, in practice, despite the formal relationship of principal and agent between the parliament and executive, few proposals for law, or significant changes to the content of drafts, from the floor of the parliament will succeed, and none will proceed without explicit ministerial approval and support. In terms of drafting and executing law, we expect parliament to be the agent of the cabinet and the executor of institutions designed within the executive.

There are, of course, important differences between the UK and PRC parliamentary systems. First, the State Council has competence to execute law, unlike the UK cabinet. The 1982 PRC Constitution re-divided legislative authority between the executive and the legislative branches of government. The NPC plenary session was mandated to enact ‘basic’ law, (those laws mostly associated with civil and criminal affairs); the NPC Standing Committee (*Quanguo Renmin Daibiao Dahui Changwu Weiyuanhui*, hereafter NPCSC) became ‘a legislature within a legislature’ mandated to promulgate ‘ordinary’ law (laws in other areas); and the State Council could adopt ‘administrative measures, administrative law and regulations’ (*xingzheng fagui*) with full legal effect. The legislative competence of the State Council was further extended in the same year when the NPC authorised the State Council to promulgate ‘temporary rules’ (*zhanxing tiaoli* and *guiding*) concerned with economic reform. The result has been a fluid legal environment in which the State Council and its member bureaux have far more discretionary power over institutional development than the UK cabinet. Such is the extent to which these powers have been used that there is rarely little practical use for statutory legislation at all. Equipped with this legislative capacity the State Council is able to bypass the NPC at will, and this ability has further undermined the status of both statutory law and the NPC itself during reform. Second, the PRC’s one-party system has undermined the NPC’s claim to be the state’s sovereign authority. The chairman of the NPCSC is appointed by the Politburo (and is usually a member of the

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877 Tanner (1999), 45-46; NPCFEC (1993a), 3; Tanner (1999), 44; O’Brien (1990), 148, 158.
Politburo). The Party committee within the NPCSC, appointed by the CCOD, controls the legislative agenda and many of the activities of the Congress. NPC deputies are selected by electoral colleges made up of local people's congresses which themselves remain subordinate to local Party committees. In practice then, ultimate authority is held by senior Party officials and not by the NPC.

Li Yining claims that the SL marked a breakthrough in the NPC's development and its role in China's political system. He has argued that since it was reform China's first economic law to be drafted by the legislature rather than an executive organ, it provides evidence of 'China's alignment with international legislative norms'. Li has pointed to the fact that the law had a NPC special standing committee as its lead drafter (caoan touzu) and to the extensive role 'social forces' (legislators, academics and business-people) played in the drafting process. Li's claim is simple: NPC organs drafted and therefore influenced, if not determined, the content of the SL and the institutions contained therein. Such a claim has enormous implications for how one understands not only the drafting process, but also how institutions are created in reform China. Recent research on the resurgent NPC suggests that Li's claim is worth investigating. To evaluate the NPC's role, one must step back and consider two questions. First, what institutions co-ordinate the legislature and the executive? Second, how is the drafting process within the NPC organised?

First, consider the institutions that govern the relationships between the legislature, the executive and the Party. The classic communist model views the Party's mechanisms of supervision and coercion over its legislature to be

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878 The NPCSC is made up of around 150 members and meets for a two-week session every two months. Both itself and the plenary session (the full session of 3,000-odd deputies which meets yearly in the spring) have independent legal competence and, in theory, powers to investigate and supervise executive activities. The two groups have equal legal status though the NPCSC's main duties are to oversee the NPC's constitutional responsibilities, administer the NPC bureaucracy and set the legislative agenda. The NPCSC is headed by a 20-25 member Chairman's Group that sets and oversees its agenda. This group is led by the NPCSC Chairman and is comprised of the NPCSC vice chairmen, the chairman of the NPC's special committees and other NPC organs, including the CLA, Dowdle (1997), 26-27; Zheng (1997), 174; O'Brien (1990),149.  
879 Wang (1998a); Qin (1994).  
880 The NPC has eight special standing committees whose main responsibility is to research and draft law. Their agenda is set by the NPCSC and the Chairman's Group, and their role is similar to Westminster's standing committees, which consider bills, rather than select committees, which oversee government activities, Dowdle (1997), 45, 47-48; Punnett (1994), 268-269.
extensive, intricate and effective, allowing the drafting process to be minutely managed. The Party can either do this directly, or through its other loyal agent, the executive. Drafts would be prepared within the Party and/or executive, and then given to the legislature to rubber stamp. Even if the NPC did take on a nominal role in drafting, few significant policy proposals would have been made by NPC delegates. Certainly, no opposition to the Party/executive’s proposals would be brooked. This chapter, in contrast, contributes to the growing body of work that shows that the NPC no longer operates in this fashion. Instead, the legislature operated with surprising autonomy, free from active Party supervision and even from those executive organs, like the CSRC and PBoC, with a legitimate interest in the legislation. The institutions linking the legislative with the executive are shown to be extremely fragile. The second set of institutions examined here are those internal to the NPC, most notably those that define the roles, responsibilities and powers of the NPCSC and the drafting groups. The rubber stamp model does not consider the internal dynamics of the legislature: it does not need to since the traditional communist parliament model did not have any internal dynamics. However, as soon as the zhongyang leadership enfranchised the NPC to draft law in 1992, and extended a measure of autonomy over the drafting process to it, the NPC’s internal institutions became critical. This was a problem since after years of inactivity these institutions were ill-defined, weak and failed to effectively manage the process or resolve the disputes that arose between different actors and organs within the NPC bureaucracy.

Drafting the Securities Law, August 1992 - August 1993: the Finance and Economic Committee’s radical first draft

On 8th August 1992, Wan Li, chairman of the seventh plenum NPCSC, made a formal proposal to the NPCSC to draft a Securities Transaction Law (Zhengquan Jiaoyifa). Members of the NPC’s Finance and Economics Committee (Caijing Weiyuanhui, hereafter FEC), as well as several supporters of stock market reform within the State Council, had proposed the idea while the NPC General Office’s Research Department (Bangongting Yanjiushi, hereafter GORD) was soliciting

The originator of the idea appears to have been Zhang Zhongli. As president of the Shanghai Academy of Social Sciences and an NPC delegate, Zhang is reported to have had submitted a draft Securities Transactions bill to the NPC in 1991. Other reports indicate that several FEC members, including Li Yining, had already prepared a similar (possibly even the same) draft, without any official direction. Li was then vice chairman of the FEC, and was appointed head of the FEC’s Securities Transaction Law drafting group on 11th July 1992. The group, chosen by Li, was initially made up of seven economists without formal government affiliation. They began work on 12th August 1992 and by 27th October had completed a first draft containing ten chapters and 237 articles. At the start of the NPC’s eighth plenum in March 1993 the plenary session formally appointed the FEC as the lead drafter (quantou qicaoren) and on 8th January 1993, a national conference agreed to the FEC’s proposal to change the name of the law to the Securities Law (Zhengquanfa) to allow the law to cover a wider range of issues.

However, the FEC was not the only group involved in drafting securities law. The State Council’s December 1992 circular mandated the SCORES to organise drafting work for all securities legislation. The CSRC soon took over this mandate and presented its own draft of the SL to the NPC informally in mid-1993, a draft largely based on the CSRC’s own April 1993 Provisional

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882 The FEC is one of the NPC’s special standing committees. The GORD operates under the NPCSC, collects legislative proposals from government organs, and has been ‘the major intellectual force behind the institutional development’ of the NPC, O’Brien (1990), 150.
884 ZTS (1992a).
885 ZTS (1992b).
886 Li was initially given Rmb30,000 (US$3,600) for the drafting group’s expenses. Drafters are not paid but have their expenses met, Li (1990); Wang (2000a), 18; Wang (1998b).
887 Tanner reports that special committees are usually made up of senior Party cadres or, in more recent years, retired government officials. In comparison, the FEC drafting group was young, independent, professional and expert. Initially the group was made up of Li Yining, Guo Chengde (Beijing University, Professor of Economics), Wang Lianzhou (Director of the FEC Office), Cao Fengqi, (Beijing University, Professor of Economics), and two PhD research students. Yang Zhihua joined in December 1992, initially as a securities law expert associated with the CASS and then as a CSRC staff member. In March 1993, at the eighth plenum, Li Yining was transferred from the FEC to the LC and formally left the drafting group, Wang (2000a), 18, 34; Interview-28, Beijing, 2000; Tanner (1996), 57-58.
888 Guo (1999a), 184, 197-201; SZB (1993m); Cao (1999), 9; SZB (1993p); Wang (2000a), 19-20, 28-29.
889 Xinhua (1993c).
Regulations on Stock Issuance and Exchange. Faced with this attempt by a non-government organ to hijack the drafting process, the NPCSC leadership suggested that the CSRC should ‘co-ordinate’ with the appointed lead drafter, the FEC, in effect killing the CSRC draft. In response the CSRC withdrew its draft. This appears to be the first successful attempt by the NPC to reject a legislative draft prepared by an executive organ. On the 18th August 1993, the FEC approved the initial draft, the caoan. It contained 13 chapters and 178 articles. The caoan, reportedly the drafting group’s seventh draft, had its first reading at the third meeting of the eighth plenum of the NPCSC on 25th August. Both the FEC and Commission for Legal Affairs (Fazhi Gongzu Weiyanhui (Fagongwei), hereafter CLA) presented reports. Members of the NPCSC did not reportedly make any substantive comments on the caoan and the expectation was that the draft would pass on the second reading, scheduled for December 1993 or in early 1994.

The FEC’s caoan was a radical document, bearing more resemblance to a policy white paper than a set of rules designed to govern an existing market. It contained a radical restructuring plan for the institutions of equity regulation as

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890 Interview-13, Beijing, 2000.
891 Although the NPCSC can not reject a draft forwarded by an executive organ, it can effectively kill any draft by referring it between committees indefinitely.
892 Dowdle claims that the CSRC draft was rejected in 1994. He also claims that the CSRC had started drafting this draft before the NPC. This claim, however, appears to be contradicted by the fact that the CSRC was only established in December 1992, while the FEC drafting group was established in August 1992. According to one interviewee, much of the content of the CSRC draft was incorporated into the FEC draft, Dowdle (1997), 62; Interview-10, Shanghai, 2000; Interview-13, Beijing, 2000.
893 The generic term in Chinese for ‘draft’ is caoan. However, caoan is also the formal term used within the legislative process to describe the first draft that is formally presented to the NPCSC. Subsequent drafts are then termed caoan (xiugai), ‘revised draft’, and then numbered as caoan (dier xuigaigao) ‘second revised draft’ etc. While it would be preferable to refer to each draft as a numbered revised draft, this is not feasible since there were so many revised drafts that the drafters themselves lost count.
894 NPCFEC (1993a), 2.
895 Guo (1999a), 218; Wang (2000a), 42.
896 The CLA is the NPC organ responsible for legislative drafting. It has competence to draft itself, but its main duties are to evaluate the drafts of other bureau (NPC or executive organs), report its opinions to the NPCSC and summarise the views of NPCSC delegates when they considers drafts. The CLA has around 200 permanent staff, is made up of five specialised research offices and an administrative office. It operates under the management of the NPCSC and the Chairman’s Group. One interviewee claimed that the CLA operates as the Chairman’s own office, Interview-12, Beijing, 2000; O’Brien (1990), 152.
897 Wang reports that the draft was generally expected to pass in late 1993, while the report on the draft presented to the NPCSC appears to suggest that the FEC expected passage in June 1994, Wang (2000a), 42; Interview-12, Beijing, 2000.
well as a series of market-oriented policy proposals. It was a clear challenge to State Council policy across a range of issues. Here the focus is on its vision for regulatory institutions. Liu Suinian, vice chairman of the FEC, criticised the initial status given to the CSRC. Since it was only a shiye danwei (non-government unit), he argued, it was not legally entitled to promulgate administrative regulations or issue fines. Liu also criticised the inadequacy of the powers given to the SCSC. In response, the FEC drafted into the SL a system of regulation modelled on America’s SEC. The FEC draft proposed the establishment of a State Securities Management Commission (Guojia Zhengquan Guanli Weiyuanhui, hereafter SSMC), a State Council bureau with sole responsibility for policy-making and regulation of the equity market. The SCSC was to be dispersed, only months after the State Council had designed the SCSC/CSRC system of split regulation. This was not, however, new thinking for NPC delegates. In March 1991, at the fourth plenum of the seventh NPC, fifty-one delegates, including Li Yining, had sponsored a motion entitled Suggestion on Establishing a National Securities Management Commission. The FEC caoan also attempted to undermine the institutions of local capture. Local governments were to be prohibited from establishing securities offices (i.e. SAOs) while the SSMC was to be allowed to set up its own local offices (zhineng bumen). Moreover, local government was to be given no role in the issuance process. However, the caoan differed from the final SL in the role it extended to self-regulation and market mechanisms. Take the SSMC’s proposed relations with the stock exchanges for instance. The caoan allowed the SSMC to send supervisory personnel to the exchanges and to dismiss senior personnel in certain circumstances, including illegal behaviour. In these respects, the FEC’s caoan closely resembled the final version of the SL and actual shape and powers of the post-1997 CSRC. However, in contrast to the final version of the SL, the caoan also guaranteed key aspects of the exchanges’ SRO status. For instance, the stock exchanges had only to report, rather than seek approval for, disciplinary

898 NPCFEC (1993b).
899 Ibid, 393-394.
900 Chen (1993a).
901 Dong (1997), 135; Guo (1999a), 188.
902 NPCFEC (1993b), 394.
903 However, at a July 1993 meeting of NPC and State Council organs, delegates accused the caoan of being ‘too market-oriented’, Wang (2000a), 34; SZB (1993m).
measures and changes to its board of directors and supervisory committee. Moreover, in the caoan, the exchanges also retained the right to decide when to list, suspend and delist shares, powers assumed by the CSRC after 1997. In addition, the power of appointment of senior management was not ceded to the regulator in the caoan, as it was in the SL. The caoan also reserved an important place for the SIA, empowering it to set the rules of off-exchange trading (at the STCs), authorise the establishment of STCs, investigate their members' behaviour and to provide arbitration facilities. The final SL, in contrast, established the SIA as an organ directly managed by the CSRC.904

This regulatory design was part of the FEC members' wider aim to limit the state's institutional capture of the equity market and promote market mechanisms. Towards this aim they avoided institutionalising administrative controls over the stock market.905 For instance, they left out all mention in their draft of the issuance quota system, one of the central government's most important mechanisms of administrative control.906 The draft also avoided all mention of individual, state and legal person shares, shortly after the State Council had created the categories.907 These conspicuous silences were aimed at encouraging the discontinuation of plan mechanisms that the FEC members considered dysfunctional. The FEC drafters also supported the development of OTC trading (changwai jiaoyi), especially for bonds, and the development of the STCs.908 They believed that this was the only way to eliminate black markets in shares, provide investment for smaller firms and guarantee fair treatment for investors outside Shanghai and Shenzhen.909 They also intended to foster more listings by private companies and allow banks to extend financing (rongzi) to securities companies.910 All this was in opposition to State Council policy.911 Yet there were also limits to the FEC members' advocacy of market mechanisms.

904 NPCSC (1993), 364.
905 SZB (1993c); SCMP (1993a).
906 NPCFEC (1993a); Chen (1993a).
908 There is, however, no evidence to suggest that the FEC responded to lobbying or other pressures from local governments, NPCFEC (1993a), 4; Chan (1996b).
910 Credit financing (rongzi) can refer to both the extension of bank finance to securities companies and other intermediaries, and from brokers to their customers, Ren (1993); Xinhua (1993d); Peng (1998b).
They did not, for instance, attempt to legislate an SEC-style registration system for share issuance.\footnote{As long as all relevant information is disclosed to its satisfaction, the SEC is bound to register all securities for public issuance and can not judge their quality.} More importantly, the FEC resisted fully adopting the SEC model. Some FEC delegates suggested that the SSMC should come under the supervision of the NPC but the drafting group instead placed the SSMC under the direction of the State Council.\footnote{Guo (1999a), 189.}

What motivated the FEC drafters to create such a radical document? They had few obvious material or organisational interests to guide them in their work. Their committee was an \textit{ad hoc} grouping of economists: they were not paid, they had little evident personal interest in institutional designs, and few relations with any State Council bureau. Moreover, unlike members of an elected chamber, they had no interest in re-election or delivering goods to their constituents.\footnote{Horn (1995), 8-13.} Instead, they appear to have been motivated by a desire to reduce administrative interference in the equity sector, to introduce more market mechanisms and create effective protections for investors.

\textit{Redrafting the Securities Law, August 1993 - December 1993: the Commission for Legislative Affairs}

After the first NPCSC reading in August 1993, the NPCSC sent the \textit{caoan} to the NPC Law Committee (\textit{Falù Wèiyuànhuì}, hereafter LC) and then onto the CLA.\footnote{According to NPC rules, all legislation has to be reviewed by the NPCSC at least twice before it can become statutory law. Before 1992, however, one reading of a State Council-authorised draft was often sufficient, Dowdle (1997), 74-76; Wang (2000a), 42-45.} From August 1993 onwards, the LC and CLA took formal responsibility for all redrafting work. The FEC drafting group was formally dissolved at this point but did continue to meet and lobby for its ideas and its draft. However, the rules of the NPC state that it could not take part in redrafting work or present its criticisms of the CLA/CL redrafting work to the NPCSC (although this rule was not enforced rigidly as is explained below).\footnote{Interviews 12 and 28, Beijing 2000.}
The formal role of the LC is to summarise the comments of NPCSC delegates during their consideration of drafts and then to redraft legislation appropriately. However, the LC is only an *ad hoc* group of around 18 members that meets irregularly; it lacks both a secretariat and a research staff. The CLA therefore works with the LC to provide legal expertise and redraft the *caoan* in line with the directions of the NPCSC. Once the LC has sent the draft out to relevant bureau under its own name for consultation, the CLA then takes over all substantive redrafting work. Dowdle states that the LC and CLA’s leaderships are distinct and that the two organs thus ‘evince distinct institutional personalities’. However, an interviewee claimed that the LC and the CLA form parts of the same *danwei* (government organ) within the NPC and share the same leadership. The implication was that, at least in the SL drafting process, the CLA leadership had considerable autonomy to redraft the law. Moreover, because the Chairman’s Group relies heavily on the CLA for advice on the status and quality of drafts, the CLA has *de facto* veto powers over the content of drafts. Because of its access to the NPC’s leaders, and its autonomy in redrafting work, the commission is often targeted by interest groups. For their part the CLA leadership reportedly encourages such lobbying, believing that the expression of different groups’ views improves legislation. However, Dowdle notes the danger this involves since the CLA could easily lose its role as an impartial technical advisor to the NPCSC and become involved in the substantive drafting of law.

It was just after the August 1993 meeting of the NPCSC that FEC leaders discovered that the Company Law, then being drafted by the CLA, contained chapters concerning the issuance, trading and listing of corporate equities. In general, it is rare for company law to contain such articles. This was problematic for the FEC since its own *caoan* contained several chapters devoted to the same issues. The incident was the first indication of a lack of co-ordination between the NPC organs. In October, the FEC drafting group held an emergency meeting.

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918 Dowdle (1997), 42, 51.
919 Ibid., 41-44.
920 Wang (2000a), 43.
meeting as more details of the Company Law draft leaked out. However, there were no means by which FEC members could intervene or formally lodge a complaint against the CLA. On 20th December 1993, the LC presented the Company Law and revised SL drafts to the fifth meeting of the eighth plenum of the NPCSC, although only the former was discussed. The Company Law was passed, replete with the disputed articles. The Chairman’s Group, on the suggestion of the CLA representative, recommended that the SL draft be sent down again for further revision by the CLA.922

It was at this point that the CLA’s wider ambitions to gain a substantive role in the drafting of the SL were fulfilled.923 The commission established its own ‘redrafting small group’, led by Bian Yaowu, deputy CLA director, and organised its own research agenda, including a visit to Shanghai in January 1994.924 The group went on not to revise the FEC’s caoan but, as one interviewee succinctly put it: ‘to completely rewrite it’.925 Most significantly for our purposes, the new draft completely restructured the institutions of equity regulation. Arguing that the stock market was not yet mature enough to warrant a dedicated State Council-level regulator, the CLA removed all the articles relating to the SSMC. Second, it proposed dual governance of the local securities offices: the central government would co-ordinate policy and approve share listings, but the local offices, under joint central and local government control, would have powers to investigate illegal behaviour, check information disclosure, punish illegal behaviour and to settle disputes.926 This was in stark contrast to the FEC caoan that had explicitly banned local involvement in equity regulation but in keeping with reality on the ground at the time.

In many other respects the CLA draft attempted to reflect the current institutional situation in the market rather than advocate change as the FEC did. It removed many of the market-oriented institutions in the FEC’s caoan. For example, the

921 World Bank (1995a), 21-22. Much of these sections of the Company Law had been taken from the CSRC’s April 1993 regulations.
922 SZB (1993c).
923 Dowdle (1997), 43-44.
924 NPCCLA (1994a).
CLA draft restricted the scope of the securities covered by the law to only corporate equity and debt, excluding investment funds, futures and options (all instruments that the State Council did not support). The CLA draft also banned credit financing (rongzi), a practice that had been explicitly endorsed in the FEC draft and which, again, the State Council was then opposed to. However, the commission draft did other things too, including defending the turf of its own Company Law. The re-draft did not include any rules on share issuance, and was renamed the Securities Trading Law (Zhengquan Jiaoyifa) to reflect this change. Arguments over the scope of the law would continue until 1998. One of the few areas of agreement between the FEC and CLA was their mutual support for equity development outside Shanghai and Shenzhen: the CLA draft also promoted STC development. However, in sum, if the FEC caoan was a radical document unlikely ever to be implemented, the CLA redraft was conservative and practical.

To justify these enormous revisions, the CLA argued that the FEC draft was 'idealistic' and out of touch with the current policy situation. It did this without an explicit mandate from the NPCSC, although from the point of view of its broader mandate, the CLA's radical redraft was justified. The commission is charged with the management of China's legislative framework, '...to help maintain the uniformity of the legal system and [to] avoid contradictions...' (NPC Organic Law, art. 37). This involves the CLA in guaranteeing the order, coherence and flexibility of statutory law, as well as managing the interface between State Council administrative law and NPC statutory law. If the CLA was to fulfil these duties, then it had to take issue with the FEC's caoan and to rewrite it so as to ensure that the law was practical, and in harmony with State Council policy. Related to this was the fact that by legislating on the powers and duties of the SCMC in the caoan, the FEC had impinged on the State Council's ability to organise itself through administrative decisions. The CLA has an additional informal mandate to preserve the ability of the State Council to define the duties and powers of its member bureaux itself and to ensure that NPC

927 NPCSC (1993), 366.
929 Wang (2000a), 47, 52, 158.
legislation remains sufficiently open-ended in this respect. There is also some suggestion that the CLA was open to lobbying from several executive organs. The CLA draft banned credit financing of customers (rongzi), bank loans to securities companies and proprietary trading by securities companies, all policies favoured by the PBoC leadership at the time.\footnote{Dowdle's sources, however, state that as far the SL went the CLA was not subject to external lobbying, Dowdle (1997), 43.}

**Redrafting the Securities Law, again, March 1994 - December 1994: the search for compromise**

The new draft triggered an intense and protracted period of competition within the NPC. In late March 1994, Wang Lianzhou, one of the leaders of the FEC drafting group, succeeded in obtaining a copy of the CLA revised draft. Two days later, on 28th March the LC, FEC and CLA held a discussion meeting with State Council bureaux, local government and experts at the Yabaolu Hotel in Beijing.\footnote{NPCLC (1994a), 453.} The meeting discussed the two different drafts, apparently the first time this had occurred in NPC history: the CLA’s caoan (xuigaigao) and the FEC caoan.\footnote{Guo (1999a), 217-218; O'Brien (1990), 135.} The FEC produced a point-by-point rebuttal of the CLA draft. Its conclusion:

*We have read in detail your draft of the 18th March 1994 and are of the opinion that it does not fulfil the original draft's basic framework. It has many problems and is an obvious retreat from the original draft.*\footnote{Quoted in Wang (2000a), 53.}

The Yabaolu meeting witnessed a heated discussion on a number of topics, including the regulatory structure. The SCLAO, taking its lead from the State Council leadership, criticised the FEC proposal to empower the CSRC and suggested instead the principle of ‘unified leadership, two-level management’.\footnote{O'Brien (1990), 151.} Several members of local government spoke against the concentration of regulatory powers within a State Council bureau. Some delegates disagreed. Yang Zhihua, a FEC drafting group member and CSRC staffer, argued for the CSRC to be made the prime management bureau for

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\footnote{930 O'Brien (1990), 151.}
\footnote{931 Dowdle's sources, however, state that as far the SL went the CLA was not subject to external lobbying, Dowdle (1997), 43.}
\footnote{932 NPCLC (1994a), 453.}
\footnote{933 Guo (1999a), 217-218; O'Brien (1990), 135.}
\footnote{934 Quoted in Wang (2000a), 53.}
securities.\textsuperscript{936} Others supported him, noting the failures of local government in regulation.\textsuperscript{937} Another aspect of the debate on regulation was stock exchange governance. The CLA draft eliminated many of the SRO powers of the stock exchanges, ceding all power over the authorisation of listings to the government regulator, and gave the state power to set fees and to authorise all changes to the business rules of the exchange.\textsuperscript{938} Unsurprisingly, stock exchange representatives lobbied for constraints on these powers. Another issue was supervision of the regulatory organ itself. One apparently undisputed suggestion was that detailed rules of what the responsibilities (as opposed to powers) of the SSMC should be included in the legislation, and that SSMC expenditures should be carefully controlled. Apart from this, however, the Yabaolu meeting ended without resolution. Many voices had been heard; few decisions had been taken; no consensus had been reached.

On 7th April 1994, NPCSC deputy chairman Wang Hanbin held a co-ordination meeting for the FEC and CLA. Wang was the NPCSC deputy chairman responsible for the CLA, while Tian Jiyun, another NPCSC deputy chairman, supervised the FEC. Wang appointed Li Yining as chief co-ordinator of the two committees' work, and Xu Ju, CLA director, to represent the commission and ordered a compromise draft to be drawn up.\textsuperscript{939} Thereafter, leaders of the CLA and FEC met with the aim of submitting a final draft for approval by the next meeting of the NPCSC, scheduled for June 1994. However, these meetings were tense and proper compromise was impossible to achieve on the major issues. This, however, did not prevent a revised draft, with eleven chapters and 220 articles, being produced.\textsuperscript{940} Unsurprisingly, the new draft was, in the words of one interviewee, 'a mess'.\textsuperscript{941} On the major issues, the CLA’s agenda still dominated: the draft retained the CLA’s positions on the empowerment of local regulatory bureaux; the ban on credit financing; the limited scope of the law; and did not include articles on the powers of the SSMC. On the subject of

\textsuperscript{935} NPCLC (1994a), 456-457; SZB (1994p).
\textsuperscript{936} NPCLC (1994b), 469, 472.
\textsuperscript{937} NPCLC (1994a), 457.
\textsuperscript{938} SHGSE (1994).
\textsuperscript{939} Wang (2000a), 68-71; Interviews 28 and 37, Beijing 2000.
\textsuperscript{940} NPC (1994); NPCLC (1994c), 401.
\textsuperscript{941} Interview-28, Beijing, 2000.
issuance, the draft claimed to cover only 'securities trading-related issuance behaviour', a messy attempt to avoid repeating issues legislated for in the Company Law.\textsuperscript{942} The merged draft was presented by the LC to the eighth meeting of the eight plenum of the NPCSC in June 1994.\textsuperscript{943} Despite its formal exclusion from the reporting process to the NPCSC, it is almost certain that FEC members were able to express their dissatisfaction. An interviewee claimed that either Liu Suinian or Dong Fureng, senior representatives of the FEC, attended and made reports at all the NPCSC sessions that considered drafts of the SL.\textsuperscript{944} In addition, another interviewee stated that NPCSC delegates were fully aware of the controversies associated with the draft.\textsuperscript{945} The FEC apparently published informal reports opinions and distributed these among NPCSC members. The CLA therefore did not enjoy as much a monopoly on the flow of information to the Chairman’s Group and NPCSC as the NPC’s formal rules implied. This was the second formal consideration of the draft by the NPCSC and the draft was then sent down for redrafting and a second round of external consultation.\textsuperscript{946} FEC and CLA leaders were informally instructed by the NPCSC leadership to resolve their differences.\textsuperscript{947}

However, no progress in resolving the FEC/CLA deadlock was made between June 1994 and October 1995.\textsuperscript{948} By 2\textsuperscript{nd} November 1995, the CLA had produced a new draft that contained all its usual positions. This draft was passed to Wang Hanbin, and then onto the State Council deputy secretary generals Zhou Zhengqing (concurrently chairman of the SCSC) and Zhou Daojiong, SCLAO director Yang Jingyu and FEC director Liu Suinian. On 4\textsuperscript{th} December 1995, the State Council standing committee heard reports on the draft from Zhou Zhengqing and Yang Jingyu.\textsuperscript{949} These reports argued that the CLA draft was still problematic and should not be allowed to pass. In response, Premier Li Peng ordered the postponement of work on the law. On 6\textsuperscript{th} December the CLA hosted

\textsuperscript{942} Interview-12, Beijing, 2000
\textsuperscript{943} NPCFEC (1993b)
\textsuperscript{944} Interview-12, Beijing, 2000.
\textsuperscript{945} Interview-28, Beijing, 2000.
\textsuperscript{946} SZB (1994q).
\textsuperscript{947} Interview-12, Beijing, 2000.
\textsuperscript{948} Wang (2000a), 73-78.
\textsuperscript{949} Cao (1999), 11.
a meeting for the FEC, CSRC and SCLAC.\textsuperscript{950} The CLA reportedly wanted to gain support for its draft, which it intended to place again onto the NPCSC docket. In the middle of the meeting, Wang Hanbin, apprised of the State Council's decision by Yang, phoned to inform the delegates that work on the law was to be suspended.\textsuperscript{951}

\textit{Drafting paralysis at the NPC, December 1995 - March 1998: the turn of the CSRC}

One of the FEC drafters, Cao Fengqi, terms the period from the beginning of 1996 to August 1998 as the 'investigation and research phase' of the SL.\textsuperscript{952} This is a rather generous description for impasse and inactivity at the NPC. During the period, NPC organs did no drafting work and no substantive research, although a number of seminars were organised at which the familiar arguments were rehearsed.\textsuperscript{953} Faced with the intransigence of the NPC drafting organs and an immediate need to bolster the regulatory framework in the wake of the 327 TBF crisis, the State Council relied on administrative regulation. It also entrusted drafting responsibilities for the SL to the CSRC. While the NPC remained largely inactive, the CSRC went on to produce a complete draft each year from 1996 to 1998.\textsuperscript{954} Each year the regulator organised an drafting conference, to which members of the CSRC, Shanghai and Shenzhen SAOs and two exchanges were invited.\textsuperscript{955} The CSRC also organised consultation meetings in October 1993, May 1995 and August - September 1998.\textsuperscript{956} In March 1998, the informal group within the CSRC involved in this work was formalised by Zhou Zhenqing into the 'Securities Law Working Group'.

The CSRC leadership used this opportunity to redraft key sections of the law in accordance with its own policy preferences. It completely redrafted and enlarged

\textsuperscript{950} Wang (2000a), 78-81.
\textsuperscript{951} Interview-37, Beijing, 2000.
\textsuperscript{952} Cao (1999), 9.
\textsuperscript{953} Interview-28, Beijing, 2000; Wang (2000a), 94-95; ZZB (1994).
\textsuperscript{954} In 1996, the group spent one month in Beijing, in 1997 the group met in Zhuhai for ten days, and in 1998, the group met in Beijing for one week. Outside these meetings, the draft received continued CSRC attention, Interview-28, Beijing, 2000; Interview-14, Shanghai, 2000.
\textsuperscript{955} Each revised draft was passed to the CLA and the group also had frequent contacts with the SCLAO, Interview-14, Shanghai, 2000.
\textsuperscript{956} Interview-28, Beijing, 2000; Wang (2000a), 122.
the section on issuance, following the FEC rather than the CLA line, and drafted new chapters on registration and settlement, and on the powers of the SSMC, including articles on its powers of investigation. Dowdle suggests that disagreements between the FEC and the CLA crippled the SL drafting process during 1996-98.\(^{957}\) Such an insight is important since it underlines the fact that micro-management by the State Council and Central Committee is not the only factor that undermines the NPC's ability to draft legislation and operate as a sovereign parliament. Rather, internal disputes and a lack of institutions to mediate these disputes, appeared to be the critical problem. However, there are problems with Dowdle's claim all the same. First, it appears to incorrectly identify the issues of dispute between the FEC and CLA. Dowdle reports that the CLA objected to the FEC's support for the STCs, as well as its proposed rules for M&A, trading and settlement. Although there was indeed a complex dispute over the articles on M&A, the key disputes between the two committees were rather the scope of the law, credit financing and the regulatory structure. Second, the claim implies that drafting worked stopped altogether. Rather, disagreements within the NPC only served to sideline the legislature from a continuing drafting process, considerably complicating Li Yining's claim that the SL was wholly drafted by the NPC.

**Drafting revival, March 1998 - October 1998: the rush to compromise within the NPCSC**

The NPC drafting process was revived in September 1998, and after a frantic period of re-drafting and decision making, the SL was placed on the statute books by the NPCSC at the end of the year. The successful resolution of extensive policy disputes within the NPC during this period had its roots in three factors: the arrival of a new, influential NPCSC Chairman; the prioritisation by the zhongyang leadership of financial stability; and crucial decisions made by the zhongyang leaders on the issues that had plagued the law and divided the FEC and CLA.

\(^{957}\text{Dowdle (1997), 44.}\)
On becoming chairman of the ninth plenum NPCSC in March 1998, Li Peng prioritised the passage of the SL and Contract Law, setting a deadline of December 1998 for passage of the former. Li, however, did not at first involve himself in the detail of the FEC/CLA disputes, and simply ordered the groups to speedily devise a compromise draft in line with State Council policy. As a senior party member, and member of the FELG, Li exercised considerably more influence than his predecessor, Qiao Shi, did. Several interviewees emphasised the importance of Li’s arrival, his refusal to delay and the extraordinary pressure experienced by those involved in SL drafting to meet the new deadline. His arrival triggered a scramble to consensus. Related to this is the second factor. As the previous chapters have demonstrated, the October 1997 National Finance Work Meeting had revealed the zhongyang to be determined to reorganise and improve the institutions of securities regulation. The SL was seen as crucial to this effort, if only for what it represented, consensus and policy clarity, rather than for what it did in terms of institution building. The third factor underlying the NPC’s burst of legislative energy was the zhongyang leaders’ resolution of the major issues that had plagued the law since 1993. In late September 1998 the FELG met and is reported to have discussed all the key issues of the law: its scope, issuance procedures, the regulatory structure, whether securities companies should be allowed to engage in proprietary trading, credit financing, M&A rules, governance of the stock exchanges and futures. The result was that crucial sections of the SL could be re-drafted with clarity and without credible opposition from either the CLA or the FEC. After the lengthy discussions within the NPC, it was a consensus worked out within the zhongyang that was eventually imposed upon the law.

958 The passage of the SL from the eighth to ninth plenums was a simple formality, Interview-28, Beijing, 2000; Wang (2000a), 129.
959 After his arrival in the NPCSC in 1993, Qiao Shi began to agitate for the development of the NPC itself and speak in support of the primacy of law. Senior State Council officials were quoted as the NPCSC was ‘abusing its power of legislation and obstructing economic structural reform’ in 1998. However, there is no evidence that Qiao used the SL to obstruct economic reform or undermine Jiang Zemin or his other rivals, Xinhua (1988) quoted in Li (1998a), 20.
960 CSRC (1999b), 92.
The Chairman’s Group met on 22nd September 1998 and heard reports from the CLA, LC and FEC. It was an extraordinary meeting for two reasons. First, Li Peng mediated personally on several disputes between the two committees by ruling on unresolved issues one by one. He determined, for instance, that issuance articles should be included and that credit financing should not be explicitly permitted, although this issue remained problematic. Second, it was again significant that the FEC had formal access to the Chairman’s Group and could voice its concerns directly. With the way unblocked, the CLA accepted without significant revision the sections of the law drafted by the CSRC on issuance, the regulatory structure and registration. In terms of regulatory structure, the CSRC draft laid out the duties and powers of the ‘State Council Securities Supervision and Management Organisation’ (Guowuyuan Zhengquan Jiandu Guanli Jigou, hereafter SCSSMO), the CSRC itself never being formally named (in order, apparently, to preserve the State Council’s ability to rename and reorganise the CSRC). The SCSSMO was given exclusive regulatory responsibilities over the sector and the right to establish local offices under its sole administrative control. It enjoyed enhanced powers to investigate illegal actions, the ability to freeze bank accounts and to organise pre-trial questioning and administrative trials of suspects (juquan and tingzhengquan). The new draft also ensured that the SCSSMO was given formal rights to access documentation, including records of transactions, bank and securities accounts, that could be useful in investigations. Yet, there were also limits to the ability of the CSRC to introduce its own proposals to the draft. For instance, the CSRC attempted to insert a clause to allow it to set detailed regulations concerning issuance procedures and this was rejected by the NPCSC. The CSRC attempted to reduce the maximum fines that could be levied for a securities offence but the NPCSC supported higher fines and ordered the CSRC’s draft rewritten to reflect this. The CSRC also supported the opening of legitimate financing routes for securities companies and pushed for credit financing

962 Wang Hanbin had been replaced by this time by Zhang Chunyun, Bian (1999), 5; Cao (1999), 11-12.
963 Interview-37, Beijing, 2000; Interview-12, Beijing, 2000
966 SCLAO (1999), 544.
967 ZXS (1996).
(rongzi) for retail customers.\textsuperscript{968} The PBoC leadership resisted this in the State Council and at the SCSC.\textsuperscript{969} Both failed to win outright victories on the issue: the October 1998 draft did not mention credit financing and Chairman Li Peng took the issue with him to Shenzhen in November 1998.\textsuperscript{970}

On 7\textsuperscript{th}, 8\textsuperscript{th} and 21\textsuperscript{st} October 1998, the CL/CLA organised redrafting meetings between themselves and the FEC.\textsuperscript{971} Outside these formal meetings, Bian Yaowu and Li Yining met at least ten times during October. The CLA retained the chief drafting role, with Yao doing most of the detailed rewriting work during this period. On 28\textsuperscript{th} and 29\textsuperscript{th} October, the NPCSC met for its fifth meeting of the ninth plenum, and considered the draft for the fourth time.\textsuperscript{972} The draft was then sent out to the CSRC and other bureaux for a third and final round of consultation.

\textit{The end game, November 1998 - December 1998: the NPCSC constrains the CSRC}

There were two major issues to be resolved in the end game of the SL: the powers of the SCSSSMO and whether or not to allow banks to extend loans to securities companies, as well as a number of more minor issues.\textsuperscript{973} The standing committee's energies were focused on circumscribing the powers of the SCSSSMO, and its relative success revealed it to be capable of affecting the institutional design of the equity sector, at least at the margins. In this way, this final stage of the drafting of the SL can be seen as part of the NPCSC's efforts to create rules of procedure for State Council bureaux, construct institutions which would constrain the autonomy of the executive and promote the rule of law.

On 16\textsuperscript{th} and 17\textsuperscript{th} November 1998, the NPCSC Chairman Li Peng held two consultation meetings in Shenzhen.\textsuperscript{974} The securities companies explained their

\textsuperscript{968} SCLAO (1999), 546.
\textsuperscript{969} NPC (1994), art. 8.
\textsuperscript{970} NPC (1998b).
\textsuperscript{971} Interview-28, Beijing, 2000; Guo (1999a), 28; NPCLC (1998a), 408; Wang (2000a), 144.
\textsuperscript{972} NPCLC (1998a).
\textsuperscript{973} Xinhua (1998c).
\textsuperscript{974} The NPC group to Shenzhen included Li Peng, Qiao Xiaying (NPCSC, deputy chair), Chao Shaoyang (CLA), Bian Yaowu, Zhou Zhenqing and Zhou Daojiong, NPC (1998a).
financial difficulties and in response Li Peng appears to have relaxed his personal opposition to banks lending to them. A compromise clause was drafted which banned the ‘illegal’ entry of bank funds into the stock market, and mandated securities companies to use only their own funds and those ‘raised in accordance with the law’, leaving the issue of what was legal to State Council administrative regulation. After Shenzhen, the FEC and CLA continued their drafting meetings during November and December 1998. The most pressing issue now facing the standing committee was de-limiting the SCSSMO’s powers in terms of authorisation over securities issuance, audit and investigation. The NPCSC’s most significant achievement in this area was the creation of the Public Offering and Listing Review Committee (Faxing Shenhe Weiyuanhui, hereafter POLRC). This committee was, after all technical requirements and disclosures had been checked by the CSRC Issuance Department, to determine whether or not an applicant enterprise should be allowed to issue shares. It thus served to reduce administrative interference in the issuance process. While there had been no mention of such a committee in the SL draft before November 1998, a semi-independent listing committee had existed within the CSRC since 1993, but it had been small and had lacked any real power over issuance. It was the leaders of State Council bureaus and local leaders who had in practice determined which enterprises could list, as chapter nine explained. Several NPCSC delegates proposed that the POLRC be made independent of the regulator, and that it be made up of non-CSRC experts. The CSRC leadership opposed absolute independence of the committee and a compromise was reached: the committee was to be set up by and within the CSRC but most of its members would be experts from industry and academia. The rules governing its operating procedures and membership system would be left to the CSRC to draft, but were to be authorised by the State Council. Even though the POLRC limited the

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976 Wang (2000a), 144-150.  
979 NPC (1998b); Interview-13, Beijing, 2000; SZB (1995m).  
981 Interview-37, Beijing, 2000.  
982 In 2000, the POLRC was comprised of about 80 members who rotated between eight committees, Interview-43, Shenzhen, 2001.
powers of the CSRC one interviewee suggested that the CSRC leadership welcomed the committee since it served as an effective means of deflecting political pressure. With the POLRC in operation, the CSRC leadership became more insulated from local and central bureaux leaders when they lobbied in support of their SOEs’ issuance applications. Since the POLRC itself was to have the power of final authorisation over issuance, the language of the draft was changed. Previously the SCSSMO would *pizhun* (authorise) issuance. Post-November 1998 drafts, however, allowed it only to *hezhun* (approve) an issuance decision made by the POLRC.⁹⁸³

The NPCSC determined additional measures to constrain and monitor the activities of the regulator. For example, the draft was revised to extend to the National Audit Bureau powers to supervise the finances of all securities companies, stock exchanges and the SCSSMO itself.⁹⁸⁴ The NPCSC removed the regulator’s ability to carry out pre-trial questioning and administrative trial of suspects, powers that the CSRC had itself drafted in during 1996-97. The NPCSC determined that only the Public Security Bureau and the Supreme People’s Procuratorate should administer such procedures. There is also some evidence that the NPCSC, perhaps on the suggestion of the FEC, supported the extension of limited self-regulatory mechanisms. For example, several NPCSC delegates lobbied for the devolution of listing authorisation powers back to the stock exchanges. They partially succeeded: the SL draft was adjusted to allow the SCSSMO to devolve powers to approve the listings of shares and bonds, as well as powers to suspend and delist shares and bonds, to the exchanges. However, the timing of the devolution of powers was left to the SCSSMO to determine. Other deputies argued for the need to further limit the powers of the

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⁹⁸³ A related issue was the concern among several NPCSC members that the government was distanced from blame in the event of a listed company failing. However, the wording for this escape clause was hard to work out. For example, the October 1998 draft stated that the SCSSMO’s *pizhun* ‘does not express a guarantee of a share’s quality’. The SCORES leadership criticised this wording, however, arguing that it made SCSSMO authorisation meaningless. Article 17 of the SL finally stated that the issuer ‘shall be responsible for changes in the operations and profits: and investors shall be responsible for investment risks arising from these changes’, NPC (1998b).

⁹⁸⁴ NPCLC (1998d), 419.
SCSSMO, suggesting the establishment of an NPC committee to oversee its activities.\textsuperscript{985} This suggestion was rejected.\textsuperscript{986}

Finally, much to the frustration of the CSRC leaders, the NPCSC did successfully assert its view in one other important area, that of M&A.\textsuperscript{987} This is one of the most complex areas of regulation and one of the weakest parts of the SL.\textsuperscript{988} The NPCSC succeeded in legislating its demand that all shares be traded via the centralised market system, despite CSRC lobbying for off-exchange (or off-market) transactions to be allowed. CSRC regulations issued in April 1993 had required that once 30\% of a company had been purchased by an investor, a purchase offer for all the remaining shares had to be made, the so-called ‘mandatory-offer’ system (\textit{shougou yaoyue}). Moreover, at every 5\% change in the ownership stake of the potential buyer, a further announcement had to be made. However, the cost of buying up sufficient shares on the open market with these regulations in place was prohibitive: the announcements alerted others to the potential take-over and attracted buyers, pushing up prices. Moreover, the purchased firm would often require an injection of capital from its new owner to rescue its business. As a result, in practice the CSRC always waived the need to make a purchase offer and authorised the transfer of a majority stake through an off-exchange transfer of non-tradable shares (\textit{xieyi shougou}). NPCSC delegates took the view that this was unfair and open to corruption. However, they were torn between legislating a ‘partial bid’ system or a ‘full mandatory-offer’ system. After much debate, the NPCSC allowed both partial and full bids, but, against CSRC opposition, prohibited the transfer of shares off the trading system of the stock exchanges. The CSRC requested the power of exemption, which it was granted, and which it has since used frequently to authorise block sales of shares between legal persons.

\textsuperscript{985} Xinhua (1998a).
\textsuperscript{986} Interview-37, Beijing, 2000.
\textsuperscript{987} Dongfanggaosheng (2000).
\textsuperscript{988} SHGSE (1999), 720; Interview-28, Beijing, 2000; Interview-13, Beijing, 2000; Neoh (2000); Chun (1998).
On 14th December 1998, the Chairman's Group met and authorised the passage of the SL. On 23rd and 24th December 1998, the sixth meeting of the ninth plenum NPCSC considered the draft. On 25th and 26th December, the LC held a meeting with the FEC and other government bureaux to fill out details about the POLRC and transparency in the approval process. This meeting also decided that a company should have the right to choose its own underwriter, rather than one being chosen for it by the SCSSMO. On 29th December, the NPCSC continued its consideration of the draft. When NPCSC chairman Li Peng moved for a vote, 135 deputies approved, three abstained and none objected, a considerable achievement of consensus compared with other legislation. President Jiang Zemin later signed a declaration making the Securities Law effective law as of 1st July 1999.

Concluding remarks

To what extent did the NPC influence the development of China's equity institutions? The NPC plainly did not fulfil either the rubber-stamp role of a traditional Communist parliament nor the institution creating and supervising role of the UK parliament. Its role lay somewhere in between. To evaluate the NPC's role, consider three means by which its members affected the institutions of the sector: by writing the SL; by designing the institutions laid out within the SL; and through overseeing the implementation of the SL.

Writing the law

To what extent did the NPC retain competence to draft the SL and to what extent was the legislature subject to interference from the Party and management by the executive? The answer is surprising since NPC organs enjoyed enormous autonomy in drafting, more autonomy than is usually enjoyed by parliaments in democratic systems. Drafting and redrafting of the SL took place within the FEC and CLA, largely independently of State Council and Party involvement, at least until 1996. Only one member of the CSRC was on the FEC drafting team, and none participated in the CLA's redrafting work. It was only in 1996 that CSRC

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989 Wang (2000a), 150.
drafters assumed partial control of the draft, and modified crucial parts of it, although even after this, the NPCSC was able to rewrite the CSRC draft.

O'Brien notes that the Central Committee tends only to be involved at the beginning of the legislative process and at the end. This observation broadly holds true for the SL, with two qualifications. First, the Party became involved at those points where the draft could become law but did not: in December 1995, for instance, the Party leadership determined to postpone policy decisions for the equity sector and the drafting process was stopped. The NPCSC played a crucial gate-keeping role here: while the NPC's committees were able to prepare impractical drafts, the zhongyang leadership was able to use the NPCSC to ensure that none of these drafts ever made it onto the statute books. Second, the role of Li Peng is significant. As a senior member of the Politburo, his chairmanship of the NPCSC linked the zhongyang and the legislature in a way that Qiao Shi had never achieved. After his arrival in 1998, the drafting of the SL can be said to have taken place under close Party supervision simply by virtue of his personal management of the process.

Designing institutions

In parliamentary systems, the policy-making component of statutory law is usually the responsibility of the executive: the parliament 'cloaks legislation agreed elsewhere with the form and force of law'. Thus while members of the British cabinet may bargain, at the margins, with members of the parliament, they would certainly not tolerate having policies in opposition to their own being written into draft legislation. Yet this is exactly what happened in the case of the SL, such was lack of co-ordination between the State Council and the NPC. A twin-track policy process developed: the NPC's FEC designed one set of regulatory institutions while the State Council instituted another through administrative regulation. The zhongyang leadership could cope with such a dysfunctional arrangement for as long as legislation was not required, but in the wake of the 1997 bank loans scandal, and the Asian financial crisis, they were

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992 Xinhua (1998e).
994 Adonis (1993), 103.
motivated into action. To then ensure that the draft SL designed institutions that were acceptable to the executive, two things had to happen. First, the zhongyang leadership needed to provide clear direction, clarity on key issues and to speak with a strong voice. Second, personal leadership was critical. Under the chairmanship of Peng Zhen (1983-88) and Qiao Shi (1993-1998) the NPC was used as a platform to oppose, within the constraints of acceptable behaviour, the executive. Under Li’s leadership, however, the NPC was reoriented to actively support the zhongyang and the State Council, which is, in fact, its normal function as a parliament led by a Party leadership. However at the same time, the NPCSC also provided space in which compromise on more minor, but still significant, issues, such as the CSRC’s powers of investigation, could be brokered. In this the NPC operated as both the agent of the zhongyang leadership and a facilitator of the less radical demands of NPC delegates interested in constraining executive powers. This supports O’Brien’s contention that the NPC is ‘only granted [legislative influence] when it is broadly supportive [of State Council and Central Committee policy]...the NPC [exists] to provide informal consultation rather than formal restraint’, even if in the SL at least the NPCSC was allowed to constrain some of an executive agency’s powers. Even under Li Peng, the NPC did not revert to a rubber stamp role.

One thing that did undermine NPC efforts to assert itself, sponsor market-oriented institutions and nurture the rule of law was confusion over the competence and duties of the CLA and the drafting committee. This was a structural problem with the potential to affect other laws. However, there is evidence to suggest that lessons have been learned from the SL and that Li Peng has successfully institutionalised closer relations between the NPC and the executive, as well as means to resolve, or simply avoid, inter-committee disputes. For instance, drafting responsibilities for the Investment Fund Law since March 1999 have been divided between three groups: a leading group (including members from the FEC, the SCLAO and a number of State Council bureaux) which oversees drafting, a consultancy group (academics and industry

specialists) which advises, and the drafting group itself. This last group includes both FEC and CSRC members. While SL drafting groups were made up of independent economists and NPC staffers (with the exception of Yang Zhihua), and operated independently of all direction from executive organs, here the independent economists have been relegated to the role of consultants, and members of the State Council bureaux themselves manage the drafting process. This arrangement is clearly designed to combine the advantages of having access to independent expertise while at the same time keeping the draft law in keeping with policy reality. It should also ensure that the CLA will not be able to make significant substantive revisions.

Of course, putting to one side the extent of their contribution to the SL itself, the basic problem faced by the NPC is that the primary means of executing institutions in reform China remains administrative regulation, not statutory legislation. The CSRC’s powers, not to mention the entire institutional architecture of the equity sector, had full legal effect before the passage of the SL. Until the discretion of the State Council to design and execute institutions is constrained, the NPC will always play a secondary role in institution building in China. This raises an interesting question: why did the zhongyang leadership accord the law such importance when it had such a limited substantive impact? There are two possible reasons. First, statutory law served to bring intra-governmental disputes to resolution. By setting a tight deadline for final passage, Li Peng forced critical decisions to be taken and disputes to be resolved. Of course, many of the fundamental issues, including the structure of the regulatory system, had been previously determined within the zhongyang, and a few other issues, credit financing (rongzi) for example, were simply fudged. But for other issues, including the issuance process, the rules governing M&A and the detailed powers and responsibilities of the CSRC, the need to pass statutory law acted as a catalyst for consensus building among policy makers. Second, statutory law served to bolster the political legitimacy of equity institutions, something the

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997 One area that would repay more research would be policy disputes within the NPC, and how the legislature's own internal institutions have developed since Li Peng's arrival.
999 State Council bureau continue to draft law. The Individually-Owned Enterprises Law, first considered by the NPCSC in April 1999, was drafted by the SDPC, CD (1999b).
zhongyang leadership evidently considered to be important as they faced the heightened threat of financial crisis during 1997-98. Leaders of the CSRC concurred; they believed that the law would provide an added cloak of legitimacy that would enhance their ability to fulfil their regulatory mandate.

Institutional supervision

The third means by which the NPC could affect equity institutions is through overseeing implementation. The 1982 Constitution expanded the mandate of the NPCSC to supervision of State Council work. The NPCSC also has the power to repeal regulations and decisions by the State Council and its bureaux which are in contravention of the constitution and legislation. In general, however, the NPC has failed to establish institutions like control over appointments, budgets and permanent oversight committees which could serve to supervise and constrain the action of the executive. Having successfully captured China’s equity institutions, the CSRC leadership and their zhongyang backers were in no mood to allow NPC organs mechanisms of oversight and control. The fear was that this would have diluted CSRC authority and re-introduced the problem of fragmented authority. Yet NPC delegates continue to supervise the equity market on an ad hoc basis. In July 2001, for instance, the NPCSC published a report on the quality of CSRC regulation, on the basis of an investigation led by the FEC. It was highly critical. However, there are no signs that the zhongyang leadership is willing to accept NPC oversight on a permanent basis. At least for the moment, ad hoc critique from the sidelines of the political system is the best that can be expected from the NPC.

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1000 Potter (1999), 675.
1002 In March 2001, for example, NPC deputies Yang Fan, Zuo Dapei and Han Deqiang called for the FEC to set up a committee which would regularly call government officials, including CSRC officials, to answer on matters of policy, COL (2001c).
Part IV

Conclusions
We have frauds that most mature Western markets haven't seen for one hundred years.

CSRC official, 1994

This chapter examines the institutions of equity regulation that have been constructed since 1997, explains how the central government has effected institutional capture, and shows how this capture has supported the goals of the zhongyang leadership. It also examines the question of why, as of year end 2000, central capture had failed to deliver better quality regulation. As chapter one explained, equity institutions can be organised in different ways. One critical variable is the degree of independence the regulatory agency has from government. China’s post-1997 equity institutions are built around a non-government organ, the CSRC. However, the regulator is directly administered by the executive branch of government, the State Council, and is overseen by the leadership of a political party: it is to all extents and purposes a government agency. However, unlike the SEC, the CSRC is not accountable to the legislature, and the judiciary has limited means to supervise its activities. In addition, China’s stock exchanges and industry association are directly administered by the regulator. A second important characteristic of equity regulation, especially in a state such as China, is to what extent the regulators’ powers are centralised or devolved to local actors. After 1997, the CSRC gained administrative control of local securities offices and the policy-making process became highly centralised. Certainly, in terms of delivering the twin goods prized by the zhongyang leadership of financial stability and market development, the post-1997 institutional order has proved remarkably successful.

As of 2000, similar institutions, highly centralised Party-managed institutions have governed China’s banking and insurance industries. This arrangement is therefore termed 'socialist market regulation', in deference to the stated aim of

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1003 SCMP (1994c).
1004 Horn (1995), 43.
the 14th Party Congress in 1992 to build a socialist market economy. There are obvious advantages to this arrangement. For instance, centralised decision-making ensures that stock market development is dovetailed with macro-economic and industrial policy. Given the huge incentives and evident capacity of local leaders to act in opposition to zhongyang interests, extensive mechanisms of control and supervision over their actions appears justified. Chen Jianxian correctly argues that self-regulatory organs and structures are not yet strong enough. One other result has been that there have been significant improvements in the quality of regulation during the late 1990s as socialist market regulation was implemented. The quality of companies coming to market improved, for example. However, as this chapter shows, this system of regulation also has significant weaknesses, most obviously in its lack of effective enforcement practices. Market socialist market regulation appears primarily oriented towards providing support to the SOE sector. It does this through a wide range of means: by guaranteeing the supply of funds to SOEs (and preventing competition for these funds from non-state enterprises); providing SOEs with regulatory protection from market disciplines (such as delisting and hostile take-overs); limiting public disclosure of SOEs’ performance (through, for example, censorship of the media); and constraining the ability of investors to hold SOE managements to account (by, for example, preventing the judicial system from playing a regulatory role).

The chapter is laid out as follows. After a broad comparative framework for understanding equity institutions is provided, the versions in China and the United States are compared. The second half of the chapter examines the enforcement problem and explains the factors that constrain the effective implementation of regulation in China’s post-1997 stock market.

*Equity institutions: a comparative perspective*

One of the critical issues for any set of equity institutions is the relationship the regulatory organ has with the executive, legislative and judicial branches of government. As chapter one outlined, there are three basic frameworks for such a

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set of relations: the regulator as government bureau; the regulator as SRO; and
the regulator as independent commission. In Europe, government ministries, the
courts and SROs have traditionally administered regulation. The third model,
the independent regulatory agency, is a relatively recent American invention and
attempts to combine the advantages of the previous two models. It has five key
characteristics. First, the regulatory agency is independent of government and
business, reducing the likelihood of both administrative interference and
regulatory capture. Second, the agency enjoys extensive powers of
investigation, prosecution, legislation and adjudication. However, crucially, these
powers are powers of governance not of direct administration. Following Judge
Louis Brandeis’s injunction that sunlight is ‘the best of disinfectants; electric
light the most efficient policeman’, the SEC, for instance, has directed its
energies towards ensuring that full disclosure is made by companies issuing
securities, rather than judging the type and quality of securities. Third, SROs
like the NYSE and the NASD play a substantial role in regulation, developing
their own rules, supervising and disciplining their own members and arbitrating
in disputes between them and their customers. Each is run on a commercial
basis independently of the government. Fourth, the regulatory agency is usually
sector specific, although it does co-operate and have some overlap with other
regulatory organs. Fifth, and perhaps most importantly, despite its extensive
powers and its independence from government, the agency is held accountable.
SEC commissioners, for instance, are answerable to Congress, while SEC rulings
and administrative punishments can be challenged in the civil courts. Legislative
and executive oversight, strict procedural requirements and substantive judicial
review all guarantee that the regulator’s powers are supervised and
constrained.

Numerous Chinese analysts, including former CSRC chairman Zhou Zhenqing
have compared the reorganisation of the CSRC after 1997 with the creation of

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1006 Majone (1994), 78-79.
1007 Karmel (1982); Kripke (1979).
1008 Brandeis (1932), 92 quoted in Karmel (1982), 41.
1009 Karmel (1982), 55-78.
1010 Majone (1994), 93.
the SEC in 1934. Hong Weilu makes the comparison explicit: according to him both the post-1997 CSRC and SEC are ‘centralised and unified regulators, having independent law-making powers and national branch networks’. Indeed, while attempting to explain why China’s regulatory structure has evolved as it has, a number of interviewees remarked that Zhu Rongji had a personal preference for the ‘American model’. There are a number of grounds to this comparison. First, in both instances, the national government became involved in a sector previously governed by local authorities. Previous to the Securities and Exchange Act, stock exchange ordinances and state criminal and civil law had governed securities transactions in the United States. The federal government had no jurisdiction over the sector. Similarly, in China most of the rules before 1993 were set by the Shanghai and Shenzhen governments, although the State Council and PBoC were involved in defining macro-policy for the sector. Second, both regulators, the CSRC and the SEC, had their origins in the government’s response to a financial crisis triggered by corruption and deficient self-regulation. Their creation was accompanied by the government enhancing its administrative influence and downgrading the institutions of self-regulation. In addition, both organs had national branch networks and extensive powers. There are indeed similarities between the CSRC and the SEC and these are detailed below. However, the differences between the two organisations, and the institutional frameworks they operate within, are various, more significant and throw the key characteristics of socialist market regulation into relief.

The CSRC and the SEC compared

This section considers the institutions that define the relationships between the regulator and government, including its executive, legislative and judicial arms, political parties, SROs and FIIs in China and in the United States.

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The regulator and the executive

The US Congress wanted to create an agency that was insulated from administrative interference by the Executive.\textsuperscript{1015} Thus, although the SEC's five commissioners are nominated by the president, their appointments are confirmed by Congress, they are all appointed for staggered five year terms and they can not be removed without due cause. There are no means by which the president can direct the day-to-day work of the SEC. In contrast, the CSRC, although formally a non-governmental organ, operates directly under the State Council. Its policies are subordinate to State Council directives and the premier, and the vice premier responsible for finance, oversee its work.\textsuperscript{1016} This ensures that government officials direct all aspects of equity market development and regulation, including the listing and delisting of stocks, the types of company that come to market, investigations, disciplinary proceedings and personnel appointments. Institutional changes since 1997 have enhanced the powers of the executive over the sector.

The regulator and the legislature

In the United States, the legislature both writes law and oversees the implementation of that law. Consider the oversight function first. The SEC is overseen by the Senate and must operate within the bounds of statuary law laid down in acts of Congress and amendments thereto. The SEC must submit itself to regular inspection and oversight by congressional committees. Cai Wenhai comments that, in contrast, China's Securities Law empowered the central government to govern the equity market 'with tightened administrative and criminal penalties, coupled with unbridled powers to the regulator'.\textsuperscript{1017} As He Xiaoyong notes, no organ regulates the CSRC.\textsuperscript{1018} The NPC certainly has no mandate to supervise CSRC activities.\textsuperscript{1019} Suggestions during the drafting of the SL that the NPC should form a committee to oversee the CSRC were rejected.

\textsuperscript{1015} Karmel (1982), 87-89.
\textsuperscript{1016} In September 1999, Vice Premier Wen Jiabao took over day-to-day supervision of the securities industry, AFX (1999).
\textsuperscript{1017} Cai (1999), 151.
\textsuperscript{1018} He (1999), 47.
\textsuperscript{1019} Interview-58, Shenzhen, 2001.
even by some of the NPC's most market-oriented delegates. However, one pointer towards the future was the NPC's investigation into the implementation of the SL in late 2000. Their report was highly critical of the quality of CSRC regulation.\footnote{1020} This type of oversight is undoubtedly a positive development, even if it is not institutionalised or effectively enforced. However, it is not clear whether a NPC 'progress report' will become a regular occurrence, nor what impact the 2000 report had within the executive.

Consider the second function of the legislature: to write the laws that govern the sector. The SEC does have some capacity to issue rules in its own name, but these are usually limited to technical issues and interpretations of legislation. The CSRC is able to issue administrative regulations that range far more widely leaving the NPC to play a supplementary role. One interviewee suggested that the CSRC would issue regulations on M&A during 2001 that would significantly 're-interpret' (the implication was this meant 'alter') the relevant articles in the SL in order to favour the CSRC's original policy preference.\footnote{1021} Although the CSRC's authority to issue such regulations is generally unquestioned, it is not clear if the practice is legal. The question is whether its status as a non-governmental organ with ministry-ranking confers upon it the right to issue administrative regulations. The 1982 Constitution allows only the State Council and its member bureaux to promulgate administrative laws.\footnote{1022} However, the CSRC is neither a government organ nor a member of the State Council. Zhang Yuren and Zhou Zongan suggest that this means it actually has no legal right to issue administrative regulations.\footnote{1023}

\textit{The regulator and the judiciary}

The judiciary can play two roles in equity regulation. First, it can adjudicate on cases brought against the regulator by market participants. This is important because it helps prevent the regulator abusing its powers. Second, it can accept cases brought by market participants against companies which have allegedly

\footnote{1020} Though a follow up report in late 2001 appeared to have been less critical.\footnote{1021} Interview-28, Beijing, 2000\footnote{1022} Tanner (1999), 45.\footnote{1023} Zhang (1999c), 34; Zhou (2000), 14; Interview-29, Shanghai, 2000.
committed crimes, and thereby play a regulatory role itself. This is also important since allowing private civil suits to be pursued against fraudulent behaviour, and allowing damages to be awarded, creates incentives for regulatory enforcement by private citizens and disincentives for fraudulent behaviour. It also reduces the administrative burden on the regulator.

First, consider the courts' ability to supervise the regulator. Any administrative action or regulation issued by the SEC can be tested against legislation, and overturned by the courts if found to be illegal. Judicial oversight of the SEC provides a critical check on abuse of power, not only gross abuses, but also the subtle ‘creep’ of regulation when the SEC attempts to act outside of its legislated powers, even with the worthy aim of protecting investors. Two companies who had their IPO applications rejected brought the CSRC to court in 2000; they won their cases, the CSRC being found not to have abided by its own administrative rules for assessing the applications. However, with the exception of these cases, as of 2000 the courts exerted little oversight over the CSRC’s regulations and administrative decisions. There have been no reported incidents of companies bringing the regulator to court to question its regulations or enforcement actions. Second, the regulatory role of the courts is also underdeveloped in China. Civil suits have not been encouraged and courts do not recognise class actions, making civil suits expensive to pursue. In addition, the legal framework as of 2000 was vague about the liabilities of those involved in fraudulent securities activities. Although the SL appears to make the underwriter, firm management and accountants personally liable for losses resulting from false disclosures at an IPO, such a liability has not been enforced in practice. Consider the case of a civil suit brought against Hongguang Industries, a notorious baozhuang ('packaged') company, and the underwriters, accountants and lawyers involved in its IPO. In December 1998, Ms. Jiang Mou sued the board of Hongguang (and associated parties) in a Shanghai Pudong

1024 In late 2001 Lantian, a listed company, sued Liu Shuwei, a researcher at the Central University of Finance and Economics, for publishing alleged false claims about its financial accounts. It was unclear at the time of writing whether the courts were to be used on a large scale to intimidate equity analysts, COL (2002b).
People's Court for the Rmb3,137 of losses that she sustained on her purchase of shares in the company. Even though the management of Hongguang had knowingly falsified their accounts and disclosures, the Shanghai court dismissed Ms. Jiang's case, judging that no proof of a causal link between false statements given by Hongguang and her losses had been made. In the United States, a rebuttal presumption operates: unless proven to the contrary by the defendant, the purchaser of securities is assumed to have relied on the defendant's disclosures, thus making liability easier to prove. Cai Wenhai recommends such a presumption should be introduced into China.\(^\text{1028}\) However, proof was not the only issue in the Hongguang case. The Shanghai court also ruled that the CSRC had sole authority to determine such matters and to receive any fines levied for securities crimes.\(^\text{1029}\) This decision was troubling for at least three reasons. First, it removed the financial incentive for investors to bring private suits and thereby reduced the likelihood of small investors playing a regulatory role. Second, by apparently eliminating any role for the courts in regulation the decision placed an enormous administrative burden on the CSRC. Third, the court gave the CSRC considerable discretion to determine disciplinary actions apparently without the possibility of judicial review.\(^\text{1030}\)

**The regulator and political parties**

Direct political interference in the work of the SEC is rare. While the President appoints the five commissioners, only three of the five commissioners may belong to the same political party and congressional confirmation tends to prevent overtly 'political' appointees from being nominated. Once appointed, commissioners are insulated from administrative interference in their day-to-day work: they serve for fixed five-year terms. In contrast, the CSRC operates under the leadership of the Communist Party. Up until 1997, the CSRC leadership was appointed by the CCOD, under guidance from the FELG. Since 1998, a new Central Committee organ, the Financial Work Committee (Jinrong Gongwei, \(^\text{301}\))
hereafter FWC), chaired by Wen Jiabao, has overseen appointments to the senior positions of the CSRC, as well as to the PBoC and CIRC, in co-ordination with the CCOD and under the oversight of the FELG. Until the appointment of Gao Xiqing, a non-party member, as a CSRC vice chairman in 2000, the members of the senior leadership of the CSRC had all been CCP members. There are no fixed terms for CSRC chairmen or their deputies: they tend to be appointed for implementing particular policy programmes. Zhou Daojiong, for instance, was appointed in 1995 with a mandate to institute standardisation (guifanhua) and crackdown on corruption. In 2001, Zhou Xiaochuan, a Western-trained economist, was appointed to deliver more market-oriented development.

Party oversight of the CSRC has been considerably strengthened since 1997. This had been achieved through three sets of institutions:

- The FWC. The FWC’s chief role is to co-ordinate Party management of the financial sector. It receives reports from the Party secretary (i.e. chairman) of the CSRC on a regular basis, monitors general policy developments in the financial sector, and its leaders often also participate in government meetings. However, rather than becoming involved in policy development, the work of the FWC is focused on personnel matters and general staff conduct. It oversees the appointment of senior management, including department heads at the regulator, and the preparation of political programmes and codes of behaviour. For instance, it prepared the ‘Eight Wants and Eight Don’t Wants’, an ethical code that was issued not only to the staff of the CSRC, CIRC and PBoC but also to employees at all the major FIIs. It is also involved in overseeing the appointment of senior management at the major securities companies and stock exchanges.

- The CSRC Party committee. This is made up of the CSRC chairman (Party secretary), deputy chairmen, secretary general and director of the CSRC’s Discipline and Inspection Bureau (DIB). The committee ensures that Party policies are implemented and that its education programmes are properly

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1030 A related issue is that fines levied on the company, as opposed to the board of directors, punishes shareholders. The Company Law (art. 118) implies personal liability in the event of any illegal activities, but this has not been enforced, Zhang (1999a), 21-22.

1031 Laura Cha, formerly with the Hong Kong SFC and a non-Party member was appointed as a CSRC vice chairperson in February 2001.
managed throughout the CSRC. It governs personnel appointments within the organisation and accords significant weight to political reports, as well as a candidate’s expertise and competence in determining positions.

- The DIB. This department was established in 1997 to supervise CSRC staff members’ behaviour. It operates under the dual leadership of the CSRC’s senior leadership and the CDIC, the Party organ charged with ensuring discipline. It manages investigations into allegations of corruption by CSRC staff.

**The regulator and the industry association**

In 1938, Congress amended the SEA, adding Section 15A (the Maloney Act), which mandated the creation of a regulatory body to govern ‘off-exchange’ OTC trading. The NASD was established soon after to fulfil this task. Its mandate was to draw up and enforce rules to prevent fraud, protect investors and discipline its own members. By law all companies engaged in trading OTC securities in the United States must be members of the NASD. As a SRO, the association operates independently of government, supervises its members’ trading behaviour and is empowered to fine and expel its members. During the early stages of stock market development in China there was considerable support for a system of self-regulation, as chapter three explained. The SEEC was well positioned to evolve into a NASD-like organisation managing the STAQs trading system independently of government. However, the SEEC was sidelined and China’s SIA, founded on 28th August 1991, failed to live up to these hopes. Its formal mandate is to support the securities industry, establish a plan for equity development, design a self-regulatory order and strengthen market management. Ma Zhongzhi claims that the association is active in representing the interests of the securities industry to the government. However, in practice there are reasons to question this claim. Zhou Zongan notes that while the SL defines the SIA as an SRO (zilu zuzhi), its representatives have

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1035 Xinhua (1991c); Yao (1998), 72-80.
1036 Dong (1997), 135.
1037 Ma (1995).
neither been actively involved in rule-making nor in significant lobbying on behalf of the industry. Instead, the CSRC closely delimits the SIA’s role, powers and rule-making capabilities.\textsuperscript{1038} The association now operates under the administrative control of the CSRC, (before July 1995 it operated under the PBoC). All SAO senior members are government officials and their work is focused on organising educational programmes.\textsuperscript{1039}

\textit{The regulator and the FIIs}

The SEC is a regulator of private firms. In contrast, the CSRC is both the regulator and administrator of a publicly owned sector. All FIIs are structured as shareholding companies and are owned by organs of the state, most shareholders being local government bureaux or locally administered SOEs. Only a handful, including Galaxy Securities, are owned by central government bureaux. The government is highly protectionist of its securities industry: privatisation is not permitted, as the Junan scandal illustrated.\textsuperscript{1040} In 1996, Junan Securities’ CEO, Zhang Guoqing, used Rmb520m worth of funds of unclear origin to register and capitalise two companies, Xinzhang Ying and Taidong. These companies, both under his control, then secretly bought 77% of Junan’s Rmb700m shares. Shares were also distributed to Junan’s employees. In July 1998, the CSRC was tipped off about Junan’s \textit{de facto} privatisation and launched an investigation. Zhang was arrested and the firm was forcibly re-nationalised and merged with Guotai Securities. The CSRC appointed a CSRC-staffer, Yao Gang, to represent Junan in the merger talks.\textsuperscript{1041} The government’s monopolistic ambitions in this sector are also well illustrated by the extremely limited concessions won by foreign investment banks in China’s accession to the WTO.\textsuperscript{1042} According to the trade and investment agreement China signed with the United States in November 1999, foreign commercial banks will receive national treatment five years after China’s WTO entry, whereas foreign investment banks would by this time still be limited to holding minority stakes in joint venture securities and fund management firms. The CSRC also retains administrative mechanisms of

\textsuperscript{1038} Zhou (2000), 16.
\textsuperscript{1039} Dong (1997), 135; ZTS (1995); Kumar (1997b), 53; Cai (1999), 138.
\textsuperscript{1040} Caijing (1999); Green (2000b).
\textsuperscript{1041} Yao became deputy president of the merged entity, Guotai Junan, in March 1999.
influence over senior management at most FIIs. Practice at each firm varies, depending on the shareholders, but the leaders of most securities companies and investment funds are appointed by, or at least have their appointments authorised by, the CSRC and FWC. Heads of securities companies' trading departments and investment fund managers also require the authorisation of the local CSRC office to be appointed.\textsuperscript{1043} The autonomy of FIIs has increased in recent years, and the CSRC now only tends to intervene in a firm's affairs when illegal activities are suspected. However, these appointment powers allow the government a strategic influence over FII activities that is absent in Western markets. In addition, Party committees overseen by the FWC operate within all major FIIs.

Like many other emerging market regulators, the CSRC is mandated to promote the development of the securities market as well as regulate it. Since 1997, it has led the research and planning work for market development, something that in the United States would be the preserve of FIIs, stock exchanges and other SROs. Such CSRC-led initiatives have included the proposed Shenzhen Growth Enterprise Market (\textit{Chuangye ban}, hereafter GEM), index futures and investment funds.\textsuperscript{1044} As well as controlling the strategic direction of the industry, the CSRC has worked to support individual FIIs, especially in the area of financing. In July 1994, it attempted to allow bank loans to be extended, but failed because, as chapter nine showed, of PBoC opposition. It continued to lobby for such financing routes during the drafting of the SL. Then, in 1999, the CSRC leadership successfully won support in the State Council for securities companies to obtain bank loans, access the inter-bank market, and to expand their registered capital.\textsuperscript{1045} The CSRC has also been actively involved in planning and managing the consolidation of the industry, taking charge of the restructuring of small brokerages, the securities arms of numerous TICs and STCs into securities companies.\textsuperscript{1046}

\textsuperscript{1042} EIU (2000a).
\textsuperscript{1043} Interview-51, Shenzhen, 2001.
\textsuperscript{1044} On the GEM, see Green (2001c). The CSRC leadership appeared to be keen supporters of the project during 1999-2000, but Zhu Rongji postponed the plan.
\textsuperscript{1045} COL (1999c).
\textsuperscript{1046} Xinhua (1998d).
Figure 68 summarises the major differences between the equity institutions of China and the United States discussed above.
Figure 68. The China Securities and Regulatory Commission and the American Securities and Exchange Commission in 2000.

<table>
<thead>
<tr>
<th>China</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Industry scope of securities regulator</strong></td>
<td>Securities markets (including futures), related infrastructure (stock exchanges, clearing organisations), securities companies, TICs' securities businesses, investment fund companies, futures exchanges and brokers.</td>
</tr>
<tr>
<td><strong>Other relevant regulatory organisations (excluding SROs) and their main tasks</strong></td>
<td>The PBoC: co-regulates investment funds' custodian banks with the CSRC; also regulates the non-securities activities of TICs.</td>
</tr>
<tr>
<td><strong>General powers of the regulator</strong></td>
<td>Investigative, legislative and adjudicatory.</td>
</tr>
<tr>
<td><strong>Senior appointments</strong></td>
<td>CSRC chairman and vice-chairmen (variable number) appointed by the State Council, on the advice of CCP organs (the FELG, FWC, the Organisation Department of the Central Committee and the Politburo). They have no fixed terms and can be removed without cause. Until 2000 only CCP members were allowed to take up senior positions within the CSRC.</td>
</tr>
<tr>
<td><strong>Mid-level appointments</strong></td>
<td>CSRC department directors interviewed and approved by the FELG and/or the FWC.</td>
</tr>
<tr>
<td><strong>Relationship with the executive</strong></td>
<td>The CSRC operates directly under the State Council. While not a government organ, or State Council member, the CSRC enjoys administrative powers and ranking comparable to a State Council ministry (buwei).</td>
</tr>
<tr>
<td><strong>Relationship with the legislature</strong></td>
<td>The NPC has no oversight powers.</td>
</tr>
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<td>-------------------------------------------------------------------------------------------------</td>
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<tr>
<td>The role of self-regulatory organisations (SROs)</td>
<td>In theory, the SHGSE and SHZSE are SROs, but in practice they are directly administered by the CSRC and do not in enjoy the powers and responsibilities commonly associated with SROs. The SIA also operates directly under the CSRC. It does not promulgate rules or principles for its members and is only involved in organising education activities for securities professionals.</td>
</tr>
<tr>
<td>SRO appointments</td>
<td>Members of the stock exchange and SIA senior management are appointed by the CSRC.</td>
</tr>
<tr>
<td>Local presence</td>
<td>Nine regional CSRC branches, two municipal offices and 25 ‘emissary offices’ operating under the branches.</td>
</tr>
<tr>
<td>Enforcement mechanisms</td>
<td>CSRC can act administratively to seek fines and the recovery of ill-gotten gains. It can withdraw licences from securities companies and, in co-operation with the PBoC, from TICs. Criminal cases are dealt with by the PSB. The CDIC deals with all matters of Party members acting illegally.</td>
</tr>
<tr>
<td>Legal liability of the regulatory agency</td>
<td>Extremely limited. Actions have only been successfully brought against the CSRC for procedural irregularities.</td>
</tr>
</tbody>
</table>
Market socialist regulation and the enforcement problem

IOSCO recommends that securities regulation should be organised around three broad objectives: the protection of investors; ensuring that markets are fair, efficient and transparent; and reducing systematic risk. How well does regulation in China as of 2000 deliver these goods? As the thesis has shown, during the 1990s much of the non-implementation of formal rules, fraudulent issuance and weak enforcement of trading regulations, was due to local capture of equity institutions. Disputes within the central government prevented an effective response to the developmentalism of local leaders. The post-1997 structure has delivered institutional capture to the CSRC leadership and greatly improved the zhongyang leadership’s ability to oversee and direct development. Policy principals within the leadership calculated that by concentrating powers in a single, central government sub-principal, better implementation of their policies could be assured and in many respects, the post-1997 experience has proven them right. With the new monitoring mechanisms in place, the space for opportunist defection by the leaders of the stock exchanges and SAOs in support of local interests has been greatly reduced. Moreover, since the regulator has gained an exclusive mandate to oversee equity policy, the space for inter-bureau dispute has been reduced (and the old site of veto, the SCSC, has been entirely eliminated). As a result, one might expect an improvement in the quality of regulation in terms of greater transparency, better protection for small investors and fewer systemic threats to financial stability. Has this been the case or have other factors prevented the effective enforcement of the rules that are in place? Such a question is, of course, extremely difficult to answer since illegal activities are by their very nature resistant to investigation and the CSRC, like any other central government bureaux, remains difficult to research. However, the available evidence suggests that although key areas of regulation improved during 1997-2000, these improvements were limited. While there are a number of reasons for this, the fundamental factor is institutional.

1047 IOSCO (1999), 1.
1048 Green (2000e).
Some aspects of regulation, especially issuance, have improved since 1997. It is generally agreed in the industry that the quality of companies coming to market is better, and that the procedures that had been put in place were better able to detect false disclosure. Those involved in fraudulent issues now tend to receive larger fines and more serious administrative punishments than before 1997. A small number of senior managers in the cases of Hongguang Industries, Daqing Lianyi and other baozhuang companies were sacked, fined and even imprisoned.1050 Many other punishments remain undisclosed: one interviewee suggested that the CSRC prefers to deal with most problems in IPOs internally, in order not to panic investors.1051 Moves have been made to improve corporate governance at listed firms.

In the secondary market, many analysts believe that disclosure has also improved. One interviewee estimated that about 70-80% of company reports and accounts were on the whole trustworthy as of the end of 2000, a significant improvement on previous years.1052 The frequency and thoroughness of the inspection of these accounts by SAO staff has also increased. Some SAOs even now systematically monitor press reports and launch investigations on the basis of problems reported there. Others suggest that the managements of listed companies are now less willing to engage in manipulation of their own shares because of a more credible threat of punishments from the CSRC.1053 Securities companies’ use of customer funds to trade shares, an all too common problem during the 1990s, has been significantly reduced. The CSRC estimates that during the year 2000 securities companies ‘borrowed’ (only) about 5% of their customer funds. There has also been a rise in the number of investigations and fines. Figure 69, based on data supplied by the CSRC, shows an increase of

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1050 Regulations issued by the SCSC in August 1993 defined four types of fraud (insider trading, price manipulation, false disclosure and cheating investors), and the relevant punishments (confiscation of ill-gotten gains plus fines of Rmb30,000 to Rmb5m). The CSRC refined these regulations during 1994-97 and heavier punishments were extended in statutory legislation. The Securities Law has 36 articles devoted to liabilities in the event of illegal behaviour. The Criminal Law, revised in October 1997, criminalised fraudulent offerings, insider dealing, the spreading of securities-related rumours, inducing investors to deal in securities and market manipulation, all of which now can lead to a prison term of up to ten years, Pan (1999), 174; Cai (1999), 135.

1051 Interview-36, Shanghai, 2000.


225% in cases punished in 1998 compared to 1997 and a huge increase in the total amount of fines handed out in 1997 compared to 1996. According to another source, between January 1993 and October 2000, the CSRC investigated 440 cases, imposing administrative fines worth Rmb1.4bn in 199 of them.\textsuperscript{1054} These were heavily concentrated during 1998-2000 and appear to indicate the growing use of the considerable powers at the regulator’s and courts’ disposal.

\textsuperscript{1054} COL (2001a).
Figure 69. Punishments of securities (excluding futures) crimes by the CSRC, 1993-1998

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<tbody>
<tr>
<td>Number of cases</td>
<td>4</td>
<td>7</td>
<td>4</td>
<td>11</td>
<td>15</td>
<td>49</td>
<td>90</td>
</tr>
<tr>
<td>Number of organs disciplined</td>
<td>10</td>
<td>7</td>
<td>7</td>
<td>55</td>
<td>19</td>
<td>110</td>
<td>208</td>
</tr>
<tr>
<td>Number of people punished</td>
<td>2</td>
<td>3</td>
<td>2</td>
<td>36</td>
<td>9</td>
<td>94</td>
<td>146</td>
</tr>
<tr>
<td>Total fines (Rmb m)</td>
<td>1.3</td>
<td>29.1</td>
<td>31.4</td>
<td>16.8</td>
<td>265.9</td>
<td>476.8</td>
<td>821.2</td>
</tr>
<tr>
<td>Total amount confiscated (Rmb m)</td>
<td>N/A</td>
<td>25.0</td>
<td>29.1</td>
<td>1.5</td>
<td>236.0</td>
<td>402.9</td>
<td>694.4</td>
</tr>
</tbody>
</table>

Yet despite these improvements, at year end 2000 stock market regulation in China was still gravely deficient. The market bore a strong resemblance to America’s stock market in the 1920s, a market in which matched orders, wash sales and pools were common. Wu Jinglian, an economist with the State Council’s Development Research Centre, has frequently castigated the government on its deficient enforcement practices and in early 2001 went so far as to compare China’s stock market with a casino. The stock market was worse since at least at a casino, he argued, rules were enforced. Pools, associations of large investors (known as zhuangjia) aiming to manipulate a stock, often in alliance with the company’s management, are still common. Interviewees in 2000 and 2001 stated that anywhere between 30% and 70% of China’s listed shares were being manipulated at any one time. One large investor, in conversation with the author, simply laughed at the suggestion that it was getting harder to manipulate stock prices. Another interviewee claimed that the managements of listed companies were still often involved in insider dealing. The spectacular manipulation of the share prices of so-called high-tech companies China Technology Enterprise (Zhongke Chuangye) and Yorkpoint Technology (Yian Keji), both of which involved the companies’ managements, dominated the news in late 2000 and early 2001. Both faked assets injections and high-tech business plans in order to attract investors and, after their prices had soared, the manipulators dumped their holdings. In late 2000, a leaked SHGSE report revealed extensive price manipulation by fund managers at Boshi, Guotai and Nanfang investment management companies. Numerous other companies are suspected of similar practices. One of the most common abuses is matched orders, a practice in which large investors sell shares to themselves, or to connected parties, to force up the price and create the impression of heavy trading. One interviewee claimed that although the problem had been reduced, many FIIIs were ‘still doing this...because the regulation is still so weak.’ There are also serious doubts about the veracity of listed company reports. The

1056 Wu (2001), 1-30. Comments which triggered an angry backlash from other economists, including Li Yining.
1057 Informal conversation with the author, Shanghai, June 2000.
1059 EIU (2001i).
1060 Ping and Li (2000).
National Audit Office, in a random check of 32 audits of listed firms in late 2001, found 23 to have 'gravely inaccurate' information. If the figures are projected for a national stock market that listed some 1,150 companies, about 800 companies in total could be expected to have similarly serious problems.

The regulatory response has been deficient. As of March 2001, only two individuals had been criminally prosecuted for securities fraud, despite the extensive criminal liabilities laid out in legislation.\textsuperscript{1062} As of mid-2000, the CSRC's Investigation bureau in Beijing was only pursuing about five cases of insider trading a year, probably less than 5\% of the total.\textsuperscript{1063} Owing to limited resources, the bureau tended to only investigate a stock for manipulation if its price had risen by over 200\% over a six-month period or if it was reported to it by another bureau or member of the public.\textsuperscript{1064} Although cases of price manipulation and fake accounts were being regularly punished, up to year end 2000, He Shaoqi reports that only case of insider trading had been investigated and administratively punished.\textsuperscript{1065} In the case of companies falsifying their accounts or engaging in illegal activities the CSRC rarely administered fines. Only when a case was extremely serious or had achieved national prominence, like Hongguang Industries and Daqing Lianyi, would harsh punishments be administered. Instead, the regulator typically issued an internal notice outlining the problems it had discovered and requested the firm to correct the problems within a given time period.\textsuperscript{1066} Even when evidence of price manipulation was obtained and the CSRC imposed a fine the sums tended to be small, around Rmb100m.\textsuperscript{1067} Thus, despite its rank, its concentration of powers, its national branch network, its enviable financial resources, arguably the best educated staff in central government, a quality set of legislation and regulation, and public demand for better regulation, the CSRC's enforcement practices continued to be weak. While there a number of reasons for this, including China's lack of 'soft

\textsuperscript{1061} Interview-59, Shenzhen, 2001.
\textsuperscript{1062} Cai (1999), 141
\textsuperscript{1063} Interview-41, Beijing, 2000.
\textsuperscript{1064} Green (2000b).
\textsuperscript{1065} He (2000), 3.
\textsuperscript{1066} Interview-58, Shenzhen, 2001.
\textsuperscript{1067} Manipulators can often profit as much as Rmb1 billion from a single scam, Interview-41, Beijing, 2000.
infrastructure', technical difficulties and the CSRC’s limited administrative capacity, its weak enforcement practices was ultimately an institutional problem.

Because of its integration with the executive, and the lack of other constraints on its actions, the CSRC must follow the dictates of State Council industrial policy. This means its enforcement practices are subordinate to policies designed to protect SOEs from market disciplines and that the regulator is extremely vulnerable to extensive political interference. During 1997-2000, industrial policy dictated the style of regulation that the CSRC practised. The overriding imperative for the State Council, and for the CSRC leadership, was to support the re-financing of the SOE sector. In order to deliver this, the secondary market had to be nurtured, to create the expectation of higher prices and thus demand for primary issues. Tough enforcement practices would in contrast diminish share trading turnover, cause a fall in prices and undermine demand for IPOs, a dynamic best summed up by the aphorism; ‘as soon as one regulates, the market dies; as soon as one relaxes control, there is chaos’ (yiguan jiusi, yifang juilun).1068 ‘The CSRC have their own interests’, explained one interviewee in mid-2000. ‘They need a bullish market so that they can issue and list SOE shares. If they clamped down, the markets would not be half as active as they are now’.1069 Another agreed: ‘We know all this manipulation is going on, but the [CSRC] leadership is not interested in investigating’. The stock market has not only been subordinated to industrial policy: equity institutions have also been oriented to delivering macro-economic goals. For instance, in May 1999, the senior zhongyang leadership appeared to be attempting to recreate the American ‘wealth-effect’ in order to combat price deflation. Through a series of Renmin Ribao editorials propounding the wisdom of share investment and predicting the market’s positive future, the government appeared to be aiming at triggering a bull market in shares that would invigorate consumer spending.1070 The bull market faltered in September 1999, without having any measurable impact on consumer spending, which since less than 1% of the total population invests in shares was hardly surprising.

1070 COL (1999d).
The political logic of equity regulation also extends to delisting. Article 157 of the Company Law states that listed firms with three continuous years of losses, false accounts, serious illegal behaviour or other financial conditions that would disqualify it from an initial listing, must be delisted or, at the very least, be suspended from trading.\(^\text{1071}\) In practice, however, local and central government leaders, have an interest in non-implementation of this rule. Once listed, a company can raise additional finance through rights and secondary issues and the tight quota controls on each province's ability to list companies has meant that each firm that does succeed in gaining a listing is a valuable financial resource for local leaders. Even if the company is insolvent, local leaders will usually attempt to arrange a debt restructuring and asset injection and will strongly resist delisting. For their part, protest from disaffected shareholders is a concern for the zhongyang leaders.\(^\text{1072}\) Consider the case of Zhengzhou Baiwen, a retail firm from Zhengzhou City in Henan province. Baiwen fraudulently listed in April 1996.\(^\text{1073}\) In April 1999, it announced losses of Rmb500m in 1998, a loss of Rmb2.5 per share. Placed in the ST category Baiwen continued to report losses and by the end of 1999 had known net liabilities of over Rmb800m. In September 1999, all its Rmb1.9 billion worth of loans from the ICBC was transferred to the Cinda Asset Management Corporation. After a further audit, Cinda filed for Baiwen's bankruptcy and the CSRC leadership gave its informal nod to the firm being delisted. However, owing to pressure from Zhengzhou city leaders, Baiwen's bankruptcy was delayed and offers for bids for the firm were invited. In December 2000, Sanlian, a retail firm from Shandong province, bought Baiwen for Rmb300m with the Zhengzhou government taking on most of the wage, debt and welfare liabilities of the firm. Sanlian was interested in using Baiwen as a vehicle to secure its own listing place.\(^\text{1074}\) Other highly indebted firms such as Hainan Minyuan have only been saved from delisting by complex


\(^{1072}\) In June 2001, the SHZSE received a bomb threat after news of its delisting of a PT firm, Guangdong Kingman, became public.


\(^{1074}\) The sale of 14.4m state shares to Sanlian was approved by the MoF in October 2001, AFX (2001a).
restructuring and high-level political backing. Suspended in March 1997, Minyuan was wound up and existing shareholders were offered a 1:1 swap for shares in Zhongguancun, (the result of Minyuan’s restructuring and the inheritor of its listing place), a real estate development company given special (and very profitable) dispensation to develop Beijing’s high-tech district. Such political imperatives constrain the ability of the CSRC to implement the rules on delisting.

As well as these institutional constraints, the CSRC also faces a number of organisational and administrative problems in fulfilling its regulatory mandate. First, investigating securities crimes is an expensive, time-consuming and complicated business, made harder by the political connections most FIIs and listed firms enjoy. Hard evidence of wrongdoing is difficult to obtain. The huge number of false share accounts (probably more than 50% of the 58m open at year end 2000), the huge size of the funds used to manipulate prices and the scale of abuse make proper enforcement a Herculean labour. Second, any regulator must rely on ‘soft infrastructure’, boards of directors, lawyers, underwriters, fund managers, accountants and journalists, to help it fulfil its tasks effectively. In developed markets these actors share the regulatory burden: without their support, the regulator will inevitably be over-stretched. China still lacks much of this infrastructure. For example, a CSRC ruling in 2001 stated that by 2003, all listed firms should have three independent directors on their boards. However, it is extremely doubtful that the Mainland has 3,000-odd people with sufficient experience to fill these posts. Chartered accountancy exams only began in 1991 and by February 2001 there were only 70,000 chartered accountants working in 4,600 accountancy firms, and a similar number working within other companies. The MoF estimated that four times this number was required. Intense competition within the accountancy industry has meant that the quality of audits has suffered.

Consider also the media. In the West, the press provides assistance to regulators by revealing corruption and incompetence (in both private companies and in government), collecting evidence and creating a fear of

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1075 Xu (1999); Li (1998b); CER (1998a); SZB (1999); Cao (2000), 135. Deng Pufang, a son of Deng Xiaoping, was reported to have been a major Minyuan shareholder.
1076 Hu (2002).
1077 SCMP (2001c).
1078 EIU (2002).
public shaming for those who do commit crimes. This is beginning to occur in China, but only very recently and only gradually. Publications such as *Caijing* are developing reputations for investigative rigour and an ability to uncover corruption independently of the CSRC. The breaking of the investment fund and China Technology Enterprise scandals marked huge leap forwards in making public malpractice that the CSRC leadership apparently preferred to keep under wraps.\(^{1079}\) However, there are still limits to press coverage. In November 2001, for example, *Securities Weekly*, a sister publication of *Caijing*, claimed that Huaneng Power, an SOE listed on the HKSE, NYSE and SHGSE had been turned into the ‘family business’ of Li Peng, via his son Li Xiaopeng and wife Zhu Lin.\(^ {1080}\) The allegations were officially denied, copies of the magazine were confiscated and the writer, Ma Linhai, placed under house arrest. Reports of corruption that touch members of the Politburo, or their close allies, remain censured.

Third, the regulator still lacks administrative capacity. As of mid-2000, the CSRC’s Investigation Bureau had only 27 staff: it was one of the few parts of the Chinese bureaucracy that was not over-staffed.\(^ {1081}\) If share manipulation does indeed take place on the scale suggested above, between 300-700 companies’ share prices were being manipulated at the time, clearly outstripping its staffing capacity. Similar problems are faced at the local level too. The SHZSAO Company Disclosure department only had seven permanent staff as of year end 2000. As a result, both the CSRC and its local branches commonly ‘borrow’ staff from accountancy and law firms, the stock exchanges, securities companies and listed companies.\(^ {1082}\) Fourth, the CSRC still faces problems of co-ordination with other government bureaux. For instance, despite the fact that commercial banks are formally required to allow the CSRC access to bank records, a provision guaranteed in the SL, they commonly refuse CSRC officials access, citing

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\(^{1079}\) Ping and Li (2000). An alternative explanation is that CSRC staff members, sympathetic to the need to improve enforcement, leak details of their investigations to the press, knowing that public pressure is their only hope of improving the market.

\(^{1080}\) Pomfret (2002).

\(^{1081}\) Cai (1999), 139.

\(^{1082}\) The lending institution continues to pay salary and gains knowledge and personal relations with the borrowing organisation, Interview-58, Shenzhen, 2001.
customer confidentiality concerns. Moreover, the mechanisms of co-operation between the CSRC, the PSB and the Procuratorate in the investigation and prosecution of securities crimes were still deficient as of year end 2000. Once the CSRC had finished an investigation, and its leaders had determined to pursue criminal charges, the case was handed over to the PSB, who then carried out their own investigation. If they decided to pursue the case, the file was then handed to the Procuratorate, whose officers also made an independent investigation. The PSB and Procuratorate are inexperienced in financial sector crimes, and during the lengthy period in which a case moves through the system, defendants (and their funds) often disappear and momentum for prosecution is lost.

**Concluding remarks**

Socialist market regulation has four key characteristics. First, it involves close administrative control of regulatory institutions by the state. Second, these powers are highly centralised; local leaders now have little opportunity to develop policy or oversee its implementation. Third, all policy development and regulation falls under the oversight of the Party, whose organs also control senior appointments at the regulatory organs and market participants. Fourth, there are few other constraints on the powers of the regulator: neither the courts, the media nor the legislature are authorised to supervise its activities. Socialist market regulation is therefore highly discretionary and weakly accountable to organs other than the State Council and Central Committee. This set of institutions has well served the *zhongyang* leadership’s demands for financial stability and stable market development: it has prevented repeats of the financial instability that 1992, 1995 and 1997 witnessed and has ensured that considerable financial resources have been transferred to the SOEs. Some of the abuses by local leaders have been ended, disclosures are improving, fewer customer funds are stolen, and more manipulation is being investigated and punished. Despite these successes, however, socialist market regulation is primarily oriented towards supporting the government’s industrial policy and, as a result, as of year end

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1083 Interview-51, Shenzhen, 2001.
1084 Sito (2001a); Cai (1999). 140. At the end of 2000, there were plans for the CSRC leadership to establish a national network of investigation bureau with the PSB, which may go some way to solve these problems.
2000, enforcement remained weak, market manipulation was still common and small investors continued to be vulnerable.
Equity politics and market institutions

The merchandise of securities is really traffic in the economic and social welfare of our people. Such traffic demands the utmost good faith and fair dealing on the part of those engaged in it. If the country is to flourish, capital must be invested in the enterprise.

President F. D. Roosevelt, on signing the Securities and Exchange Act, 1934

Institutional change in China’s equity sector has been organised by public actors competing to gain economic benefits from the market. This competition has taken place within a three-level state. The challenge for the zhongyang principals has been to build equity institutions that ensure that their two sub-principals (central and local government leaders) and agents (leaders of the ju-level bureaux) act in their interests. This has been difficult for at least two reasons. First, institution-making powers were initially devolved down to local leaders, allowing them to capture equity institutions. Through their management of the SMCs, SAOs, stock exchanges and STCs local leaders gained huge discretion over the design and implementation of equity institutions and oriented these institutions to supply local industry with investment funds and enrich local budgets with fiscal revenues. Poor regulation and regular instability resulted. Second, the equity institutions established within central government in the early 1990s were ineffective: they failed to co-ordinate the divergent agendas of the bureaux involved and offered few mechanisms of control over local agents. Disputes between competing sub-principals, including the CSRC, resulted in policy stasis and gaps in regulation. Radical institutional change after 1997, after years in which problems were apparent but no real change occurred, is explained by two factors. First, as the market grew in size, the financial instability fostered by local capture became an increasingly serious threat to the interests of the zhongyang leadership. Second, equity developmentalism undermined the zhongyang leadership’s 1996 plan to use the stock market as a financing vehicle for large SOEs. The institutions of market socialist regulation constructed after 1997 did much to resolve these two problems.

1086 Quoted in Karmel (1982), 45.
The first part of this chapter considers the model of institutional change developed in the preceding chapters, identifies its weaknesses and maps out areas that deserve further research. In particular, it assesses the role of crisis in institutional change and the problems involved in identifying state actors' interests. The following sections examine three broader issues. First, the question of what institutional development in the equity sector tells us about state capacity in reform China is addressed. In the 1980s, the central government appeared to lose control over the collection and use of the state's financial resources. Yet, in the equity sector, and in other sectors too, the state became remarkably better coordinated during the late 1990s. What explains this enhancement in state capacity? Second, there is what might be called the 'North paradox'. Given that institutional change in China's equity market has not, as yet, supplied regulation that credibly protects property rights, balances information asymmetries or curbs predatory behaviour by FIIs and IIIIs, how has the market been able to grow so large so rapidly? The chapter offers explanations to this apparent paradox. The third section considers the future for socialist market regulation and identifies the forces that will shape its development over the next decade. New policy priorities for the zhongyang will increasingly influence equity policy, none more so than the imperative to fund and manage a modern pension system.

**Institutional change: the role of crisis and the interests of bureaucrats**

Lance Davies and Douglass North propose a model of institutional change that is driven by private actors aiming to capture the potential profits (and/or minimise the potential costs) caused by an exogenous change in their market environment. ETR approaches to regulation then go on to ask why public actors respond to such private initiatives and show how the institutions that are created produce winners and losers. However, as chapter two showed, institutional change in China's stock market is a case of the dog not barking: private business has been absent as an actor. FIIs are state-owned and immature; private individual investors, relatively small in number, face overwhelming collective action problems; IIIIs are predominantly private but because of their quasi-legal status

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have not entered into the public arena to pursue regulatory change. But still, despite the absence of private actors, far-reaching institutional change occurred in the equity sector, twice in the space of six years. How can this be explained? The model of institutional capture developed here has retained ETR's strategic view of regulation (that it apportions goods and 'bads'), but has identified public actors, rather than private individuals and firms, as the key sponsors and promoters of institutional change. The thesis has also shown, in accordance with neo-institutionalist studies, how exogenous change in the market impacted on actors' incentives and therefore their interests vi-a-via institutional design and development. The sudden, and unexpected, increase in share trading in the early 1990s, for example, encouraged local leaders to establish stock exchanges to capture the investment and tax revenues they offered. Given the new imperative presented by industrial policy, the increased size of the stock market in 1996 made it a credible source of funds for SOEs and therefore prompted the senior leadership to expand issuance. The institutional changes after 1997 had their roots in the senior actors responding to the threats a larger stock market now presented them.

Alongside these shifts in incentives, the thesis has shown that crisis, a sudden and acute threat to the continued viability of the system, was also required to 'unblock the logjam', allowing institutional change to be forced through against the opposition of bureaucrats, central and local, which in normal times was sufficient to delay such change. The model advanced here relies on crisis as part of its explanation: significant institutional change, in 1992 and in 1997-98, only occurred in the aftermath of crisis. Such a finding is supported by research in other areas of the economy. Eric Girardin shows that inflationary crisis led the zhongyang to forcefully implement programmes of monetary retrenchment in 1988-89 and 1993-94, which usually errant local leaders dutifully implemented.1088 Barry Naughton argues that it was an economic crisis in 1977-78 that triggered the beginning of agricultural and industrial reforms.1089 Su Fubin and Dali Yang find that at times of leadership transition or social instability, times of crisis or potential crisis, the central government is able to

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1088 Girardin (1997), 87-89.
1089 Naughton (1995), 64-65, 76, 94-96.
impose effective top-down controls on otherwise delinquent localities and effect radical change.\textsuperscript{1090}

Using crisis as an explanatory variable is, however, problematic, not least because in one respect it explains nothing at all: a system which is not working obviously has to be changed. Moreover, there is the danger of engaging in a circular argument: institutional change is caused by crisis; only crisis causes institutional change, etc.\textsuperscript{1091} There is also the issue of determining what constitutes a crisis, in contrast to a serious problem, and the variety of shapes that crisis can take. These issues are significant and can not be completely resolved here: an exhaustive analysis of crisis and its effects on the policy process is outside the scope of this thesis. Moreover, the three crises examined here do not provide sufficient material to construct viable hypotheses about the role of crisis and its effects on institutional development. Instead, here, the three crises, their origins and impact, are briefly considered in order to suggest explanations for their different outcomes: significant but compromised institutional change after 1992, little institutional change at all in 1995, and radical institutional change after 1997. In August 1992, large-scale rioting on the streets of Shenzhen was triggered by government corruption in an IPO. With its roots in local officials' gross abuse of their regulatory powers, 8.10 directly impacted on the investing public and was an obvious threat to social stability. Closing the share market was not an option given the support of Deng but the market's fragile ideological legitimacy and its small size meant that the \textsc{zhongyang} had limited incentives for forcing through central capture. The second crisis occurred in February 1995 when massive manipulation of the TBFs market threatened bankruptcy for several securities companies. No change in the regulatory institutions took place: the SHGSE remained independent of CSRC oversight and the STCs continued trading, although the TBF market itself was closed. The 327 crisis was confined to the futures market, had little direct impact on the investing public and could be blamed on irregularities at a single firm. Closure of the market affected no other policy areas: TBFs had little economic utility since Treasury bond rates were set administratively. Moreover, futures attracted more ideological opposition than

\textsuperscript{1090} Su (2000), 228.
\textsuperscript{1091} I am indebted to Jaime Nino and Jane Duckett for drawing my attention to this point.
the share market because they did not supply funds to the SOE sector. In 1996 and early 1997, a more serious crisis took place when huge amounts of bank deposits were channelled into the share market and several major firms engaged in large-scale manipulation, threatening the entire banking system, as well as a stock market crash. This crisis was significant in its degree and impact. First, it destabilised the banking system and thus impacted on one of the most sensitive areas for the zhongyang leadership. Second, it revealed financial officials throughout the Shanghai and Shenzhen banking and securities industries to be acting in support of local objectives, and defecting from the zhongyang’s interests. The 1997 crisis had clear systemic implications. Comparison of the three periods suggests that crisis which causes social instability and/or which has systemic implications for the financial system is more likely to trigger institutional change than crisis that remains contained and out of the public eye.

However, when the leadership is prompted to respond to crisis, exogenous factors also influence the response: the economic costs of weak institutions, elite attitude to crisis and ideology. First, the costs to the senior leadership of weak equity institutions had increased considerably by 1997, not only in terms of the increased costs associated with crisis, but also because local capture prevented the use of the stock market to finance SOE reform. Second, elite concerns about stability in general increased during the 1990s. The increasing fragility of the financial system during the decade, added to the Asian Financial Crisis which began in July 1997, heightened fears of instability among senior policy makers and increased the incentives for an effective response to crisis. Third, once China’s stock market had become ‘an essential part of market socialism’ in 1997, institution building could occur without ideological constraint: previous to this it was difficult for a xitong bureau that regulated an ‘experimental’ market to be empowered. Figure 70 summarises the key characteristics of the three crises, as well as elite orientation in each of the periods. To explain the institutional response to crisis it is likely that both the endogenous characteristics of crisis as well as the elite’s orientation in terms of economics policy orientation, and ideology are significant. Such variety in the types of crisis experiences and in the context in which they occur makes analysis of crisis as an explanatory variable.
difficult: crisis unblocks logjams in institutional development, this much the thesis has shown, but its effects remain difficult to predict.
Figure 70. Crisis and institutional change in China’s equity sector, 1992-97

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<tr>
<td>Corruption in IPO by local officials</td>
<td>Manipulation of the Treasury bond futures market</td>
<td>Equity developmentalism; bank deposits transferred to stock market; gross manipulation of stock prices</td>
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<tr>
<td>Social disturbance?</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
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<tr>
<td>Crisis destabilises other parts of the financial system?</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
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<tr>
<td>Cost to elite of problem in stock market</td>
<td>Limited</td>
<td>Limited</td>
<td>High</td>
</tr>
<tr>
<td>Stock market significant to national industrial policy?</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Elite concerns about financial stability</td>
<td>Low</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Ideological legitimacy of the equity market?</td>
<td>Fragile</td>
<td>Growing</td>
<td>Established</td>
</tr>
<tr>
<td>Institutional change after crisis?</td>
<td>Yes, but compromised</td>
<td>No</td>
<td>Yes, radical</td>
</tr>
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Another issue that requires further research is the preferences of bureaucrats. The thesis has assumed that bureaucrats are self-interested: at the provincial and ju-bureau levels, this self-interest translates, more often than not, into behaviour oriented towards maximising revenues, while action oriented towards defending organisational general influence is predominant within central government. Such assumptions are problematic for at least two reasons. First, as Patrick Dunleavy argues, the aims to which self-interest can be oriented and the strategies used by bureaucrats are various, complex and context dependent. Budget maximisation as a motive, for example, is not particularly illuminating until one knows which elements of the budget are involved; what non-pecuniary benefits are on offer; the value of different types of work to bureaucrats; and how collective action problems within an agency affect lobbying ability.1092 Such analysis requires detailed information on the operations, structures and decision-making processes within the bureaucracy, something that is not yet possible in China. The broad-brushed assumptions about maximising revenue and the career consideration of ju-level leaders used in this thesis are thus both problematic and unavoidable. Second, the extent of action in the public interest is difficult to assess. Many Chinese officials have a genuine desire to build successful capital markets in order to support economic reform. Some are sincerely concerned about protecting investors; others have quasi-nationalist ambitions to restore China to a significant place in the global economy. It is extremely difficult, for example, to impugn self-interested motives to the involvement of the SEEC officials in the late 1980s. Several interviewees despaired at their inability to enforce protections for small investors. Moreover, bureaucrats, though mostly insulated from private sector interests, are not entirely immune from public interest considerations. To some extent CSRC vice chairperson Laura Cha is correct to assert that ‘the CSRC is subject to the supervision of the general public and the market’.1093 Reaction to many CSRC policies is immediate in terms of their effect on share prices and the investment community is often openly critical. Revelations of corruption undermine the government’s legitimacy and create incentives for at least senior officials to act in the public interest to eliminate it (at least in its most obvious and destabilising forms). As this chapter goes on to argue, taking into

1092 Dunleavy (1991), 147-204.
1093 Hu (2002).
account private investors’ interests will become ever more important as the government is forced to nurture long term demand for equity. However, without greater access to official documentation and to those involved in the policy process, the assumptions about self-interest made in the preceding chapters are justified by the weight of previous research on bureaucratic behaviour in China and elsewhere, and, moreover, appear credible in light of the evidence presented. However, in terms of a further research agenda, as the bureaucracy opens up to more detailed analysis, studies aimed at identifying and ordering the preferences of bureaucrats, the strategies they use to maximise them, and how career ambitions, non-pecuniary benefits, ideological beliefs and public interest considerations affect them would all be worthwhile.

**Co-ordinating the Chinese state**

How does the *zhongyang* leadership ensure co-ordination in the state it oversees? A number of analysts have argued that effective co-ordination is rarely achieved. The bureaucratic politics model developed by Lieberthal and Oksenberg posits a state in which authority is fragmented. A protracted, disjointed and incremental policy process results. As the preceding chapters have shown, many aspects of stock market development have been characterised by such compromise, gradualism and weak state capacity. However, the thesis has also shown the state to be capable at times of dramatic policy change as well as remarkable co-ordination. How can a weak state become stronger? The answer is, of course, though the creation of effective institutions. As chapter two showed, previous research has focused attention on political mechanisms, primarily nomenklatura, in co-ordinating the state. Yet, the thesis has shown that the system of ‘one-level down’ (*yiji guanli*) nomenklatura was ineffective in providing sufficient monitoring mechanisms and incentives to eliminate defection by local leaders (and even more so their subordinate *ju*-level bureau leaders) during most of the 1990s. Given this failure, the thesis has sought to identify other institutions that allow *zhongyang* principals effective control over their agents. It has focused upon changes in the governance of local *ju*-level bureaux, primarily the stock

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1095 For example, Li (1994b); Halpern (1992); Chung (1995), 503.
exchanges and SAOs. Crucially, guanli (management) authority, including the power of appointment of these ju-level bureaux leaders, was transferred to the CSRC after 1997, altering the incentive structures of their agents. Their welfare and career were now dependent upon their central, rather than local, government sub-principals. However, a portfolio of other institutional changes to the governance of these bureaux, including the recentralisation of key powers, the loss of economic incentives to defect, the creation of effective oversight and reporting mechanisms, the strengthening of Party structures, and the clarification of responsibilities within the Centre accompanied this change in the nomenklatura. It was this portfolio of institutional changes that delivered capture to the central government.

During the 1980s, Deng reformed through decentralisation, devolving policy-making and regulatory powers to local leaders. This often involved institutional change. For example, the guanli authority enjoyed by the SPC over its provincial planning commissions was diminished during the 1990s to jiandu relations, allowing for greater local autonomy.\textsuperscript{1096} While broadly successful, however, this strategy extended excess latitude to local leaders to pursue local interests with damaging consequences for the national economy, especially in the financial sector: excess bank lending (leading to inflation), declining (official) fiscal revenues and poor quality listed companies, for example. During the 1990s, the reform agenda shifted, from decentralisation to re-centralisation of key powers and institution building. The shift was driven by an array of imperatives: to increase budgetary revenues, constrain local protectionism, undermine the local state’s capacity to engage in predatory behaviour and create a set of standard rules to govern an increasingly complex economy. The challenge was to centralise the right powers and to do all this without stifling growth.\textsuperscript{1097}

The third plenum of the 14\textsuperscript{th} Congress in November 1993, and \textit{The Decision on Issues Concerning the Establishment of a Socialist Market Economy} it passed,

\textsuperscript{1096} Chung (2001), 54-55.
\textsuperscript{1097} The 1993 Decision contained much that the neo-conservatives supported, notably the re-centralisation of macro-economic controls. However, although Zhu was equally frustrated with the deleterious effects of administrative localism, his reform agenda balanced increased macro-controls with advancing market mechanisms.
were pivotal in this change. Reform China's first comprehensive reform blueprint was comprised of measures aimed at extending market mechanisms, building institutions and centralising macro-economic powers. The implications for financial policy were wide-ranging and immediate. One of the most important measures was reform of China's tax system. Following the Decision, a modern national tax agency was established; a tax-sharing system replaced fiscal contracting as the basis of revenue collection; and all 'shared' taxes were now to be collected at the national level and then distributed to the localities. The National Tax Office was given powers to appoint the directors of local tax offices and the authority to extend tax reduction and exemptions to enterprises was recentralised. In 1994, the exchange rate was unified: previously it had been set at varying rates at PBoC-governed foreign exchange swap centres around the country. After 327, dozens of futures exchanges were forcibly merged and hundreds of futures brokers were forced to close. Futures regulation was concentrated in the hands of the CSRC. Intense local opposition to many of these institutional changes slowed down implementation, but the agenda only intensified as the 1990s progressed. Management authority over PBoC branches was transferred to the PBoC in 1998 and a new regional, rather than provincial, branch structure was created, constraining provincial leaders' ability to direct lending. In 1999, the State Council ordered the quasi-private Rural Credit Foundations to be closed and/or merged with the PBoC-run Rural Credit Co-operatives, despite their superior financial performance. Similarly, in 1995 the private urban credit co-operatives were compelled by a State Council notice to accept municipal governments as majority shareholders.

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1098 Bottelier (1999), 6, 17-22.
1099 The fiscal contracting fiscal system introduced in 1988 increased incentives for local actors to support economic growth and increase revenue collection, but limited the benefits of these actions to the centre. It also led to a decrease in official fiscal revenues (though this was mostly compensated for by increases in extra-budgetary funds managed by local authorities) and frequent negotiations about local remittances to the centre. Experiments in fiscal system reform (aiming to redistribute revenues and clarify spending responsibilities) began in 1992, Saich (2001b), 149-160.
1100 The new system saw the sharing system further clarified: each tax type was classified as being collected by the central government, by local authorities or shared.
1102 These swap centres were merged into a national foreign exchange market in Shanghai, Chung (2001), 55-57.
1103 Liu (1999c); Jiang (1999c).
Thus nationalised, they were renamed Urban Co-operative Banks.\textsuperscript{1105} In the equity sector, the centralisation of regulatory powers and the elimination of local institutions and autonomy for local leaders paralleled these broader trends.

The Chinese state changed in the 1990s. The \textit{zhongyang} leadership was shown to be capable of reorganising institutions, the things that structure the policy-making process and this should prompt a reappraisal of the bureaucratic model of policy-making. If the institutions of a particular sector can be organised so as to concentrate powers in a single sub-principal, as well as to provide clear mechanisms of control and oversight over local agents, then the state in this area becomes less fragmented and better co-ordinated. Institutional reform did not only affect Centre-Local relations: the elimination of the SCSC removed an important veto site within central government.\textsuperscript{1106} The resulting policy process is less likely to be characterised by biased implementation, frequent vetoes and ‘balancism’. In short, state capacity will have been improved and the bureaucratic model becomes less useful as an explanatory tool. Conflict between \textit{xitong} bureaux, and between central and local governments will continue in the financial sector, of course, but these conflicts may well be less frequent and more easily resolved, while implementation bias may well be less extensive than before. Future research should be sensitive to the institutional context of policy creation and implementation. It could be profitably focused on asking how state capacity varies across different sectors and how different institutional arrangements affect the degree and style of the defection by sub-principals and agents.

\textit{The North paradox: can markets develop without institutions?}

Neo-institutional economics holds that only when the state is credibly committed to clarifying and defending institutions will people feel confident enough to engage in economic transactions. ‘Without institutional constraints’, argues

\begin{footnotesize}
\textsuperscript{1104} At their peak RCFs held around Rmb100 billion of deposits compared to Rmb800 billion at the RCCs, Cheng (2000b); EIU (2001h).
\textsuperscript{1105} Huang (forthcoming), 96.
\textsuperscript{1106} In another instance of central government reorganisation, in March 1998 a number of industrial line ministries were eliminated and supervision of most of the state-owned conglomerate groups was brought under the SETC and vice-minister ranking inspectors, Fewsmith (2001), 203.
\end{footnotesize}
North, ‘self-interested behaviour will foreclose complex exchange because of the uncertainty that the other party will find it in his or her interest to live up to the agreement’.\footnote{1107 Alchian (1972); Putterman (1993), 244; North (1990), 33.} This should nowhere be truer than in an equity market, where complex transactions take place across considerable time and space in an environment characterised by uncertainty and information asymmetries. Indeed, the institutional thesis could be used to argue that the development of institutions in China’s equity sector has been highly successful: how else could the market have grown so large? However, although considerable development has occurred, as of year end 2000 socialist market regulation still included few of the constraints that underpin Western stock markets: an active judiciary, an independent and active media, legislative oversight of the regulator, and clear protections for the regulator from political interference. If the state’s predatory behaviour vis-à-vis the stock market has been as great as the previous chapters suggest, how has the market grown so large so rapidly within such an adverse institutional environment?

There are at least six answers to this paradox: the information asymmetries involved in financial regulation; the structure of the equity contract; investors use of short-term trading strategies; administrative intervention; FII’s lack of hard budget constraints; and the incentives provided by poor regulation. First, financial regulation itself suffers from information asymmetries: the regulator knows more about the quality of regulation than investors do. This is always the case, but is especially problematic in China. The press, for example, has until recently been prevented from investigating corruption (much still goes unreported); the activities of the CSRC lack transparency (though they are more transparent than most other central bureaux). Investors who lack information about the deficiencies of regulation are more likely to invest. Second, consider the nature of the equity contract. A debt (bond) issuer is contractually committed to paying interest; a missed interest payment and/or default signals problems at the issuer; a series of such defaults by a number of issuers would destroy the bond market. Equity, in contrast, involves the transfer of claims of ownership, not a guaranteed revenue stream. The investor relies on asset appreciation and
dividend payments, neither of which are guaranteed. Even though a firm did not pay dividends (thus perhaps signalling its lack of revenues and/or profits) some investors would still trade its shares because of the incentives provided by the possibility of capital gains.\textsuperscript{1108} Third, consider investors’ management of risk. In comparison to debt, more risk is transferred to the buyer in an equity transaction. Neo-institutional theory would therefore suggest that more institutional supports are necessary. However, engaging in short-term trading can dramatically reduce the risks that equity investors take on.\textsuperscript{1109} By holding shares for only a few days ‘investors’ can trade in equity not as a set of ownership rights, but simply as a commodity whose price varies with supply and demand. As Harold Demsetz argues in a slightly different context; 'shareholders are essentially tenders of equity capital and not owners...what shareholders really own are their shares and not the corporation'.\textsuperscript{1110} As long as equity institutions guarantee that one receives profits from any appreciation in the shares one buys, then equity institutions are ‘working’ well enough for a market to develop. The fact that the institutions that guarantee long-term ownership rights are lacking does not in itself prevent stock market growth.

The fourth reason why China’s equity market has been able to develop without effective market institutions is that the government has used administrative measures to create both \textit{ad hoc} and structural incentives for investment. Administrative controls in other parts of the financial system have created incentives for share investment: interest rates are suppressed, capital controls prevent investment abroad, and other means of asset management have been absent.\textsuperscript{1111} The corporate bond market has been restricted: issuance remains subject to strict quota controls, interest rates are set administratively and issues are, unlike IPO revenues, taxed.\textsuperscript{1112} Industrial policy has also helped: asset injections, preferential tax treatment and cheap bank loans for listed SOEs have all boosted confidence in listed company share prices. Administrative measures

\textsuperscript{1108} EIU (2001c).
\textsuperscript{1109} International FIIs use similar strategies. According to CLSA, a broker, on average they hold equity in an emerging market for one sixteenth of the length of time that they hold it in developed markets, Hu (2002).
\textsuperscript{1110} Demsetz (1967), 115-116.
\textsuperscript{1111} EIU (2001e).
\textsuperscript{1112}
have been common in the equity market too. In the primary market, for example, up until early 2000 the IPO price was set administratively by the CSRC, at a heavy discount to secondary market prices. From 1993 to 1997, the P/E ratio for IPOs was set at around 14 and with P/Es of 40+ in the secondary markets, share prices increased on the first day of trading by anything up to 900%. This created huge demand for IPOs. According to Li Mingliang, given an investor had Rmb10m to invest in the IPO lottery the average return in 1997 was 100%, and much higher before then. Fixed pricing at IPO therefore guaranteed take-up of equity. In the secondary market, the lack of a credible delisting policy has created moral hazard for investors. 118 companies reported losses for the 1999-2000 financial year, but their shares could still be traded with the confidence that they would not be delisted. In addition, as chapter five showed, the whole gamut of policies associated with equity developmentalism during 1995-97 boosted demand for shares. In leaner times, in the early 1990s, in July 1994 and in April 1999, senior government officials have used newspaper editorials to talk up the market, artificially bolstering confidence. The aphorism zhengce shi (‘the policy market’), known to every share investor in China, indicates the extent to which policy has been used to manipulate the market. Fifth, state ownership of FIIs and other institutional investors, including SOEs, has played a crucial part in the market’s development. One criticism is that FIIs have been vulnerable to political interference to ‘support’ the market when commercial logic dictates otherwise. There were rumours, for example, of an informal agreement between the leaders of several major securities companies not to sell shares in the event of hostilities breaking out in the Taiwan Straits during 1996-97. Perhaps more important, however, is the fact that the SOEs that invest in the stock market, and which extend funds to the IIIIs, operate with soft-budget constraints. Hundreds, if not thousands, of SOEs established small asset management divisions or made informal arrangements with local professional investors to invest SOE funds (often using bank loans or IPO revenues) in shares. This practice is thought to be

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1112 The corporate debt market accounted for only 1% of all outstanding debt instruments in June 2000, Graham (1998); Slater (2000). On China’s Treasury bond market, Xiao (2000c).
1113 EIU (2001g).
1114 The rate fell to 25% in 1999, around 15% in 2000, Li (2000b).
1115 Hua (1999). As Walter and Howie argue, there has been an informal contract between the state and the investing public. ‘Individuals buy shares… in exchange for the state’s unspoken
extensive, although no figures are available. Any losses from such trading could be passed on to the public finances; any profits could be retained and skimmed off.\textsuperscript{1116} Given the lack of moral hazard in their investment practices, it is no surprise that SOEs have been actively involved in the stock market and have bolstered its growth. Sixth, poor quality regulation itself has created incentives for large investors, with their access to superior information and large funds, to engage in share trading using illegal practices.

In summary, stock market growth in the 1990s has been, to a large extent, based not on market institutions and demand for equity from private savings, but upon artificial policy supports and speculative public money. The market's institutional development was driven by the strategic self-interest of state actors: state capture of equity institutions facilitated market growth while at the same time orienting that growth towards benefiting the state.\textsuperscript{1117} Bureaucrats became advocates for, and beneficiaries of, market development, since this helped them maximise state revenues. However, the question this analysis raises is clear: how sustainable is stock market development on such a basis?

\textit{China's stock market, institutional change and the future}

Institutional capture has many critics within China. In late 1994, Chen Gong called for the government to be ‘a manager, regulator and a formulator of rules, not a direct participant in the market’. He also opposed the ‘rescue, boost or suppress’ approach of the government to the market.\textsuperscript{1118} Such criticism is now common. Analysts like Hong Weilu argue that the CSRC’s powers are excessive

\textsuperscript{1116} Wu (1999a).
\textsuperscript{1117} A similar dynamic has been detected in the development of rural industry. Jean Oi concludes that credible institutions protecting property rights were not required for development of the township and village enterprise (TVE) sector in the 1980s. All that was required was the creation of the right fiscal incentives so that local bureaucrats supported, rather than preyed upon, TVE development. Fiscal reforms gave 93,000 government jurisdictions above the village level residual rights to increased revenues, giving bureaucrats incentives to foster local industry, Oi (1999), 193; Walder (1997), 438-444; Francis (1999). Nee (1996) and Wank (1999) show how informal networks and social relations can substitute for formal institutions in supporting economic activity. However, problems in the TVE sector in the 1990s, including their large debts, have again cast doubt on the sustainability of productive economic activity in the absence of market institutions.
\textsuperscript{1118} Chen (1994a).
and that this harms innovation. To promote development, he argues, areas such as the oversight of corporate disclosures and powers to punish rule infringements should be devolved back to the stock exchanges. He Xiaoyong finds serious deficiencies in the SL, notably the lack of any supervision of the CSRC. Wu Xiaoqiu, a long time critic of institutional capture, argues that the state's plan-like controls make it impossible to properly protect the rights of investors. Zhang Caili questions the economic utility of the stock market, and argues, along with Wu Xiaoqiu and others, that it should not be used as a source of finance for the SOE sector. That such ideas are now discussed, and aspects of institutional capture are so openly criticised, undoubtedly creates an environment where more market-oriented change is possible. However, ideas in themselves are not sufficient to cause such change to occur.

By 2000, the actors influencing equity development had grown numerous and it was evident that the authority and independence of the CSRC was being increasingly constrained. As chapter ten showed, some NPC deputies remain keen to establish a mechanism for regularly evaluating the regulator's activities. Small investors will continue to seek redress in civil courts against listed companies that have falsified disclosures. If the extent of fraud is anywhere near that suggested in chapter four, the number of such suits will reach into the thousands. A failure to address valid claims will lead to increased investor discontent and a failure to draw additional private savings into the market. Led by Caijing, newspapers are increasingly ready to investigate and publicise corruption. Another likely constraint on institutional capture will be FIIs themselves. As they grow in size, expertise and confidence, they will become less dependent on the CSRC, agitate for more independence and will lobby against policy that damages their commercial interests. Private FIIs will also enter the market in greater force over the next decade. The several hundred IIIs will be registered and will become a significant private presence in the market.

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1120 He (1999).
1121 Wu Xiaoqiu directs the Finance and Securities Institute at Renmin University, one of the largest financial think-tanks in China, Wu (1999b), 34, 118-134, 156.
Foreign investor entry will also occur, probably before 2010 with the introduction of the QFII arrangement.\textsuperscript{1124} Both will lobby for more market-oriented development.

Such actors will increase in number and in the constraining influence they exert on the practice of market socialist regulation. However, unless extensive change occurs in the political system, senior CCP actors will remain relatively well insulated and will therefore remain dominant in defining institutional development. Their incentives for providing regulation for the ‘public good’ will remain constrained as will market participants’ ability to directly influence them. It is therefore the interests of the zhongyang leadership that are likely to continue to define the basic trajectory of institutional development in the stock market over the next decade. However, this does not necessarily augur the continuation of socialist market regulation. As chapter eight showed, the State Council’s industrial policy was critical in the creation of the post-1997 institutional settlement. If new priorities compete for the senior leadership’s attention, equity policy and institutions will likely be re-oriented to serve these new goals. Three economic issues will occupy the zhongyang over the next decade: the failure of industrial policy, the government’s growing financial liabilities and its need to create an asset management industry to fund pensions. The interplay between these three policies will define how the principals (re)organise equity institutions.

\textit{Industrial policy}

Despite official claims to the contrary, there is considerable evidence to suggest that industrial policy is failing. According to the OECD, after-tax SOE profits fell from 18\% in 1985 to 5\% in 1990 to 0.9\% in 1998. The most recent data for the average total liabilities to assets ratio for all SOEs is 62\%, a debt-equity ratio of nearly two. Even these statistics, based on official sources, probably exaggerate the health of the sector.\textsuperscript{1125} Paul Heytens and Cem Karacadag found

\textsuperscript{1123} Interview-43, Shenzhen, 2001. Large SOEs are also capable of lobbying. In late 2001, for example, they pushed for the corporate debt and convertible bond markets to be liberalised because of the loss of confidence in the stock market.

\textsuperscript{1124} QFII would allow foreign companies to bring in and convert foreign currency into renminbi through a ‘window’ in the capital account managed by the SAFE, and then use the funds to invest in A-shares, subject to certain restrictions, EIU (2001j); Cheng (2000a).

\textsuperscript{1125} OECD (2000), 22-29.
that listed company profits fell during 1995-2000; by the first half of 2000 their median return on equity was only 7% on an annualised basis, while assets (including receivables and inventory) covered less than one third of their liabilities, a debt-equity ratio of three.\textsuperscript{1126} Guy Liu has found that at least 70% of China’s listed companies destroy value.\textsuperscript{1127} Administrative bank lending, share issues, asset injections and debt write-offs sustain SOEs: there is little evidence of increased productivity.\textsuperscript{1128} This failure even afflicts the large SOEs the leadership has chosen to convert into chaebol-like conglomerate groups. Focusing attention on the 120 enterprise groups that as of 2000 made up China’s ‘national team’, Peter Nolan shows that they are not becoming internationally competitive companies.\textsuperscript{1129} Local protectionism has prevented firms from expanding through M&A, the quality of management remains poor and political interference continues to be extensive and damaging. Companies are not allowed to downsize or outsource to cut costs but have instead had to absorb smaller, loss-making SOEs, some 2,000 during 1994-97, to limit unemployment. In addition to these difficulties, industrial policy will become constrained under WTO rules.\textsuperscript{1130} The government will no longer be able to force foreign companies involved in joint ventures to transfer technology to SOEs; stop multinationals from advertising and distributing their own products; or favour SOEs with government procurement contracts. Competition from non-state and foreign-invested firms will increase. Access to cheap financing (via bank loans and equity issues) will be one of the few remaining means by which the state can protect its own firms.

As the state sector declines, the non-state sector increases in importance.\textsuperscript{1131} As a rough measure, excluding collective firms, the private sector accounted for at least 50% of economic activity by the end of the 1990s. However, because bank and equity finance has been monopolised by SOEs, private sector growth has

\textsuperscript{1126} Heytens and Karacadag (2001), 7-8, 13-14.
\textsuperscript{1127} Talk to the China Discussion Group, Chatham House, March 22, 2002.
\textsuperscript{1128} Zhang, Zhang and Zhao (2001). Lo (1999) and Laurenceson and Chai (2000) found more positive results for SOE productivity and efficiency.
\textsuperscript{1129} Nolan (2001), 876-893.
\textsuperscript{1130} Lardy (2002), 63-73, 89-100. See also Liu (2001).
\textsuperscript{1131} There are manifold difficulties involved in identifying private firms in China, let alone measuring their contribution to GDP or employment provision, Qian (1995), 215-222. On the private sector, Gregory (2000); Wall (2001); Tung (1997).
been constrained.\textsuperscript{1132} In 1996, only 3\% of new loans extended by the four LCSBs went to urban collectives; only 0.1\% went to private firms.\textsuperscript{1133} Similarly, at year end 1999 there were only about 40 non-state firms being publicly traded in Shanghai and Shenzhen.\textsuperscript{1134}

What impact will the changing industrial profile have on China’s equity institutions? The senior leadership has at least two incentives for making more listing spaces available for non-state firms. First, in order to sustain job creation finance must be channelled to the private sector. Second, high quality, dividend paying, non-state firms would do much to restore the reputation of the stock market. More private firms will inevitably be listed, but unless a fundamental shift in industrial policy occurs their numbers will remain limited. The case of the Shenzhen GEM is instructive. The new board, initially proposed to be established in 1999, would have offered an alternative to socialist market regulation: more powers would have been devolved down to the SHZSE to authorise listings; listing places were to have been reserved for small- and medium-sized, non-state firms; and these firms would not have had state or legal person shares.\textsuperscript{1135} By year end 2001, however, the GEM project had been postponed, perhaps indefinitely. While the Nasdaq crash and the wholesale failure of second boards outside the United States played a part in this decision, concerns over the GEM’s probable adverse impact on the main board were also substantial. A twin-track stock market would have developed: large, mostly unprofitable SOEs would have remained dominant at the SHGSE; the GEM would have listed smaller, more competitive and profitable companies and investors and their funds would have gradually shifted to the later. This would have been dangerous for the zhongyang leadership for at least two reasons, the same reasons that will continue to restrict private firms from listing. First, liberalising entry to equity capital would divert the flow of financial resources away from the SOEs. Second, the more general threat from listing successful non-state firms is that they would highlight SOEs’ general poor conduct in paying dividends, making disclosures and abusing minority shareholder rights.

\textsuperscript{1132} Huang (2001), 57-58.
\textsuperscript{1133} Huang (forthcoming), 96.
\textsuperscript{1134} Liu (1999b).
For these reasons, given no fundamental change in industrial policy takes place it is likely that SOEs will continue dominating the stock market.

Over the long term, however, a drift towards more extensive privatisation appears inevitable as SOE profits and productivity continue to decline. The SOEs’ demand for subsidies, especially via the banking system, will continue to weaken the state’s finances and create pressure for further disengagement. As the leadership gradually relinquishes industrial policy, (or a regime change faciliates its complete repudiation), equity institutions would then likely develop towards the market. State and LP person shares would increasingly become tradable and gradually cease to exist; considerable numbers of private firms would list; many listed SOEs would be delisted and allowed to bankrupt. As public ownership was reduced, the power of majority state shareholders would be diminished and the influence of private owners would grow. This would have a positive influence on corporate governance and it would diminish the government’s need to use equity institutions to support and protect its own enterprises. Press would gain freedom to investigate listed company corruption and the courts would gain greater autonomy in punishing listed company managements. When securities companies and investment funds were privatised, greater pressure would be brought to bear on the government to make the CSRC independent and accountable. Market socialist regulation would be increasingly constrained under these circumstances. Of course, given the continuation of the current political regime, such changes would necessarily be gradual since a full privatisation programme would take at least ten to twenty years to complete.

Government debt

It appears likely that senior policy-makers’ residual ideological faith in public ownership, as well as their mercantilist ambitions, will be increasingly constrained by the state’s worsening fiscal position. The government’s large and increasing liabilities will force greater reliance on the stock market as a financing mechanism for the state and its affiliates. Official domestic government liabilities amounted to only 14% of GDP at the end of 2000. However, after a

1135 Green (2000c).
decade of administrative lending to the SOE sector, the four LCSBs were estimated by Nicholas Lardy to have NPLs worth 65% of their total loan portfolios, some Rmb4.2 trillion (50-60% of GDP) at year end 2000. In addition, the government was responsible for the following contingent and informal liabilities:

- NPLs at state-owned financial institutions other than the LCSBs (10-12% of GDP)
- Bonds issued to finance the AMCs (14% of GDP)
- External sovereign debt (5% of GDP)
- Bonds issued by the three policy banks (11% of GDP)
- Unfunded pension liabilities (45-95% of GDP)

In total, government debt totalled at least 150% of GDP at year end 2000. With bank lending to SOEs continuing, Treasury bond issues to fund fiscal stimulus planned, and pensions increasingly being funded through the budget, this ratio was set to rise further. Fiscal revenues at 16% of GDP, (well below the developing country average of 23-30%), and slowing economic growth presented additional challenges.

There are a number of options for the government: cutback on welfare spending, print more money (thus inflating the debt away), and increase the sales of state assets. Given that the former two options would likely prompt greater social unrest, it seems probable that the government will promote the asset sale programme. This has the potential to influence change in equity institutions.

The state will likely engage in privatisation by stealth for the majority of listed companies. First, a further relaxation of trading restrictions on LP shares is likely. An auction market in them began in mid-2000. Previous to this LP shares had been exchanged through _ad hoc_ off-market agreements between legal persons, though such transactions were not common. However, rumours in early

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1136 Bottelier (2001).
1137 EIU (2001k).
1138 Carsten Holz's analysis of the state's 'balance sheet' for 1997 reveals that if NPLs at the four LCSBs are at 25% of total loans, then the state's net worth is zero; if the NPL ratio is higher, then the state has negative net worth, Holz (2001), 349, 366-367.
1139 EIU (2001d).
2000 that LP shares would be soon allowed to list and trade like individual shares prompted professional investors (zhuangjia) to buy up LP shares from state and state-affiliated organs. Even though sales took place at fractions of the individual share price, sellers were happy since they received cash: previously LP shares had had little monetary value. LP share auctions were then organised, mainly in Shanghai. Traders were most often zhuangjia who set up companies to facilitate their investments: by June 2001 almost all listed companies’ LP shares had a price recognised nation-wide.\textsuperscript{1140} Even though this new market was highly speculative, it was significant for two reasons. First, the auctions involved the transfer of assets from the state to non-state companies, thus diluting public ownership. Second, the lack of a CSRC crackdown on the auctions, at least up until year end 2001, signalled that senior policy makers were content with the ‘diversification’ of ownership they involved.

Second, the government will also sell off its state shares and allow them to become negotiable. Two experiments in selling state shares in late 1999 and July 2001 failed after difficulties with the management and pricing of the issues.\textsuperscript{1141} The sales also had an extremely negative impact on investor confidence.\textsuperscript{1142} At the time of writing, the CSRC was considering proposals for the continuation of the sales sometime in 2002. The major issue was how to balance the SASAM’s demand that revenues from the sales of state assets be maximised (and that share prices be set using net asset value (NAV) methods) and market participants’ (and many in the CSRC) demands that prices simply reflect market demand (and consequently considerably lower valuations).\textsuperscript{1143} Walter and Howie have estimated that the market value of LP/state shares is only 20-25% the price of tradable individual shares.\textsuperscript{1144} The latter trade at a substantial premium because of their small float, something that NAV valuations do not take account of.

\textsuperscript{1140} Interview-54, Shenzhen, 2001.
\textsuperscript{1141} Jialing Motorcycle and Guizhou Tyre sold state shares in December 1999. Jiangsu Suopu, Changzhou Chemical, and Shaogang Songshan were among the firms which starting selling state shares in July 2001, Xinhua (2001).
\textsuperscript{1142} Wu (2002); Walter and Howie (2001), 55-65; EIU (2001c).
\textsuperscript{1143} The SASAM, and many in the State Council, insist on all IPO shares being priced at above per share NAV. In addition to the fact that an IPO should be priced at, or just below, a market clearing rate, the SASAM’s methodology for calculating NAV, in which assets are valued at replacement cost and no write-down is allowed, is entirely irrational and leads to over-valued equity, Walter and Howie (2001), 122-130.
\textsuperscript{1144} Calculation based on year end 1999 market data.
Assuming non-tradable shares were valued at 20% of individual shares, using year end 2000 statistics, the total number of LP/state shares in China's 1,088 listed companies could be expected to raise only Rmb640 billion when sold, only some 7% of GDP.\textsuperscript{1145} This is low in comparison with other estimates, for example Rmb2 trillion, some 22% of GDP, an official estimate reported by Bloomberg.\textsuperscript{1146} These rough calculations suggest that non-tradable shares can not be a major source of funds for the state, as has sometimes been suggested. To put the figure in context, during the year 2000, Rmb268.7 billion, some 3.0% of GDP, was raised through domestic IPOs. In addition, it should be noted that any large scale sell-off of non-tradable shares would have an enormously negative effect on market prices (they would fall by perhaps two thirds according to Walter and Howie), and would diminish demand for initial, secondary and rights offerings.\textsuperscript{1147}

In addition to the gradual privatisation of listed firms, the state will need to accelerate its listing of SOEs to raise revenues. This will take various forms. Firms from previously banned industry sectors will be allowed to enter the market. For example, financial firms, prohibited from listing since 1993, will be encouraged to list. As of year end 2000, only two securities companies were publicly traded, Hong Yuan Securities and Anshan TIC. Before 2005, five to ten securities companies are expected to list, including CITIC, Guangfa, Guoxin, Guotong and Eagle.\textsuperscript{1148} Banks and insurers will also be listed, as well as most of the country's other large strategic SOEs. Other industrial assets, including the state's considerable holdings of land, could be securitised and sold off.\textsuperscript{1149} The best companies will continue to list abroad, to take advantage of the larger funds available there. In 2000 and 1Q 2001, the subsidiaries of five major SOEs issued equity abroad: PetroChina, SINOPEC, CNOOC, China Unicom and China

\textsuperscript{1145} Based on a tradable market capitalisation (TMC) at year end 2000 of Rmb1.6 trillion, GDP of Rmb8.9 trillion and assuming tradable equity makes up 33% of all equity, CSRC (2001), 12, 138.
\textsuperscript{1146} Tang (2002).
\textsuperscript{1147} Because of these difficulties a number of different proposals have been made to soften the impact of the sales, including one by which the shares would be transferred to a government-owned fund which could only sell the shares after three years.
\textsuperscript{1148} Green (2001), 18.
\textsuperscript{1149} On land ownership, Ho (2001).
Mobile raised a total of US$20.4 billion (Rmb169.3 billion), some 1.9% of China’s GDP.\footnote{Mathieson and Schinasi (2001), 75.}

One important question, however, is the size of the demand that exists for all this equity. The stock market raised Rmb268.7 billion in 2000 (3% of GDP), Rmb90.0 billion in 1999 (1.1% of GDP) and Rmb80.4 billion in 1998 (1.0% of GDP) from domestic issues.\footnote{CSRC (2001), 33.} The huge increase in 2000 was partly due to investor confidence in the midst of a series of market boosting policies and what seemed to be economic recovery. Sustaining such demand will be extremely difficult. The onus will be on the government to open up other sources of finance to buy equities. This section considers the possible sources of demand. Urban resident savings totalled Rmb5 trillion at year end 2001.\footnote{COL (2001b). Personal savings deposits totalled Rmb7.4 trillion.} According to a PBoC survey in early 2002, urban residents held about 9.4% of their total financial assets in shares in the fourth quarter of 2001 and 65.5% in bank deposits.\footnote{Xinhua (2002)} Based on these figures, it can be estimated that individuals had around Rmb718 billion invested in the stock market at year end 2001.\footnote{Based on the fact that TMC at year end 2001 was Rmb1.29 trillion, individual investors apparently held some 55% of TMC. This calculation contradicts other evidence, presented in chapter two, that suggests that individual investors make up a far smaller proportion of TMC. There are a number of explanations. First, investment funds (which include individual investor’s funds and were worth around 6% of TMC) should be discounted. Second, it is likely that a significant proportion of the depositors’ money is being managed by IIIs. Since bank deposits are concentrated (20% of accounts hold 80% of funds), it is likely that a large number of high net} If one makes the assumption that households could put 30-40% of their total financial assets into equities, then, as of year end 2001, there was an additional Rmb1.4 trillion to Rmb2.2 trillion of savings available for equity investment, some 14-23% of GDP. The clear onus is on the government to encourage this movement of funds from bank accounts to equities by improving the quality of listed companies and regulation. Much of this money would be channelled through institutional funds: investment, insurance and pension funds. Institutional funds make up about 50% of the capital in more mature stock markets. In China, closed and open-end investment funds, which could become a more important vehicle for small investor entry, only managed Rmb80 billion of assets by year end 2001, some
6% of TMC.\textsuperscript{1155} As of mid-2001, there were varying estimates for the money entrusted to IIIs and securities companies for informal asset management though Xia Bin’s estimate of Rmb700 billion is perhaps the most reliable (some 50% of TMC), Rmb150-300 billion of which was managed by securities companies.\textsuperscript{1156} However, a large proportion of these funds were public in origin and had been entrusted to these asset managers illegally.\textsuperscript{1157} It was unclear how much legitimate capital from enterprises and high net worth investors was available for equity investment. Insurance and pension funds were only allowed to invest in Treasury bonds and savings deposits during most of the 1990s. In October 1999, however, new regulations allowed authorised insurance companies to invest 5% of their assets in investment funds, a limit that was raised to 15% by year end 2001 for several companies. It is likely that this limit will rise to around 50% over the next decade and that insurers will be allowed to establish their own funds and invest directly in equities. Total insurance industry assets totalled some Rmb300 billion at year end 2001.\textsuperscript{1158} Assuming that 40% of these assets could be invested in equities, this would have made Rmb120 billion of funds available, some 1.3% of GDP. Pension funds, examined in detail below, were not allowed to invest in equities as of the end of year 2001, though they will undoubtedly be allowed to do so in the future. According to Stuart Leckie, China’s pension assets will grow to Rmb2.5 trillion by 2012, and Rmb8.3 trillion by 2022, up from Rmb125 billion at year end 2001.\textsuperscript{1159} However, at year end 2001, assuming that 40% of the Rmb125 billion could have been invested in equities, this would have produced funds of some Rmb50 billion, 0.5% of GDP. Finally, foreign investors could provide demand for equities through a QFII scheme, although the amount would likely be extremely limited at first.

As Figure 71 shows, as of year end 2001, there were several sources of additional funds that could be tapped by the government to meet the supply of equity. The

\textsuperscript{1155} McGregor (2002).
\textsuperscript{1156} Shenzhen’s \textit{Securities Times} put the figure at Rmb120 billion, of which over half came from listed companies, EIU (2001d); SZB (2001); AFX (2001b).
\textsuperscript{1157} In November 2001, however, the CSRC banned listed companies entrusting their IPO proceeds to asset managers.
\textsuperscript{1158} Jingu (2002), 8.
\textsuperscript{1159} SCMP (2001b).
growth of the insurance and pension fund industries will further augment this demand. However, the gap between this potential demand and the huge liabilities the state faces will mean that there will be a clear and increasing incentive for the state to further liberalise the entry of funds into the market and to improve the quality of listed companies and regulation in order to attract the most important segment: individual savings.

Figure 71. Potential demand for equities, year end 2001

<table>
<thead>
<tr>
<th>Source</th>
<th>Estimated amount of funds available, Rmb billion</th>
<th>Funds as proportion of GDP, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Savings</td>
<td>1,400-2,200</td>
<td>14-23</td>
</tr>
<tr>
<td>Insurance funds</td>
<td>120</td>
<td>1.3</td>
</tr>
<tr>
<td>Pension funds</td>
<td>50</td>
<td>0.5</td>
</tr>
<tr>
<td>Enterprise financial assets</td>
<td>N/A</td>
<td>-</td>
</tr>
</tbody>
</table>

Author's calculations based on various sources.

Asset management and the pension problem

China's stock market will play a critical role in supporting the country's pension fund industry.1160 The population is ageing rapidly: the old-age dependency ratio will rise from 11% in 1999 to 36% in 2050.1161 As a result, Goldman Sachs, an investment bank, estimates that Rmb26.6 trillion will be required in pension assets by 2030 to provide sufficient income for 300m over-60s. The state is unprepared: according to Wang Yan and Xu Dianqing it already had an implicit pension-related debt of 71% of GDP by year end 2000.1162 With this demographic profile and the continued disintegration of the SOE-based model of welfare provision, the onus upon the government is to first, raise funds, and second, construct a system that allows both public and private financial assets to be profitably managed over the long term. The three-pillar pension system currently being built sources funds from employees, employers and the state.1163

1160 Neoh (2000).
1161 The number of people aged 65+ to the number of 15-64 year-olds.
1162 The World Bank estimated that total pension reserves in 1995 were less than 1% of GDP. By 2025 the current system will be overwhelmed as contributions will not be enough to cover obligations. Already in 1998, the pension system ran a deficit of Rmb5 billion. On pensions, Akhtar (2001); Saich (2001b), 249-254; Wang (2001), 2-5.
1163 The three pillars: (i) a defined-benefit public pillar (paid for by a payroll tax drawn from pre-tax enterprise revenues); (ii) a mandatory-funded, defined-contribution pillar for each worker
For its part, the state will partially rely on state share sales to raise funds for the National Social Security Fund (NSSF), a fund established by the central government in August 2001 to supplement shortfalls in funding at the provincial level where local pension schemes are currently being pooled. Government bond issuance is another likely source, as well as direct contributions from the MoF. As of year end 2001, the NSSF had accumulated Rmb61.6 billion, a sum projected to reach Rmb100 billion by 2004. At the local (provincial) level pension funds totalled Rmb58.7 billion in mid-1999, though these funds were being drawn down by increasing obligations and difficulties in collection. Second, these assets will have to make real rates of return at least at the same the rate as real wage growth. Investment in the stock market, in combination with Treasury and corporate bond markets, is one of the best ways of achieving this. In the United States, about 60% of pension assets are invested in equities, the reminder going into fixed income securities and cash. In late 2001, the State Council announced it was to allow the NSSF to invest 40% of the funds it derived from the state of state shares (but not MoF-sourced funds) in domestic equities. When this occurs, the NSSF will have a mandate to derive a steady income stream from its assets and conservatively manage its investment risks. The high-risk and speculative trading strategies of securities companies, investment funds and IIIs common in the 1990s will be ill-suited to the needs of the pension and insurance industries. Previously the state had been only the seller of equity; now, in order to create an effective asset management system through which to meet its social liabilities, the government’s own fund managers will have to become purchasers of, and investors in, equity. For this, of course, the central government, on behalf of the NSSF and its pension industry, will require the sort of things that any other investor would require: higher quality listing companies, tougher enforcement practices, reliable financial accounts, more transparency in the regulatory process, a judiciary able to enforce ownership

(paid for by a payroll tax with contributions from both enterprise and employee); (iii) a voluntary supplementary scheme managed by the enterprise or insurance company.

The NSSF is managed by the National Council for Social Security Funds, an organ operating under the State Council.

World Bank (1997), 58.

With 50% marked off for Treasury bonds and 10% for corporate debt. All but Rmb928m of NSSF holdings at year end 2001 were from the MoF. However, the expectation was that the limit on equity investment would be gradually raised, AFX (2001d); AFX (2001c).
Concluding remarks

During the late 1990s, the zhongyang leadership had two main ambitions for their equity institutions: to maximise revenues from listing SOEs and to ensure market stability. Market socialist regulation served these needs well, even if its strategy of artificially boosting demand had costs associated with it. With the need to meet growing liabilities, there are obvious incentives for the zhongyang leadership to attempt to sustain this strategy. However, by 2000 there were signs that this style of regulation had reached its limits. The reputational costs of the scandals of the late 1990s were considerable: the confidence of small investors had been undermined and the amount of financial resources that was ready to invest in equity was limited. This was increasingly problematic since the state needed to attract additional funds to the stock market to enable it to accelerate its asset sales. In addition to this, by the end of the decade a third ambition was being entertained by the zhongyang leaders: the need for the stock market to deliver long-term returns on financial assets owned by the state itself.

The next decade of stock market development will therefore be defined by a competition between industrial and pension policy, between the leadership’s short-term need for the stock market to operate as a fund-raising mechanism and its long-term need for the market to productively manage the government’s own financial assets. There are considerable contradictions between these two priorities in terms of equity policy and the institutions that are created to deliver it. The latter involves making considerable regulatory improvements that will undermine the market’s ability to finance SOEs. Funds, much of them from the public sector, which had entered the market on the basis of the profits that could be made from poor regulation and inflated asset prices would exit if enforcement practices improved. Falling share prices would damage the profitability of securities companies, investment funds and the many SOEs that speculated in the market. Falling prices would also close off the markets for IPOs, rights and secondary issues, undermining industrial policy. However, despite the
contradictions involved, it appears likely that as the failure of industrial policy is recognised and the imperative of financing pensions grows more urgent that stock market policy will be increasingly oriented to supporting the former policy. As state actors shift from being sellers of (and speculators in) equity to being investors, equity policy will move towards the market and the market’s institutions will gradually follow. One can expect better supervision of disclosures, tougher enforcement practices, delistings, and tougher disciplinary actions, including more criminal prosecutions. Institutions will be slower to change. The CSRC will likely remain subordinate to the State Council and Central Committee; neither local governments nor the NPC will be empowered to manage or oversee equity institutions. Movement to a SEC-model or even SRO-led model is unlikely as long as an activist industrial policy is pursued and the government retains a monopoly on political power. Some institutional change at the margins can be expected: limited powers may be devolved down to the stock exchanges; the dominance of state and LP shareholders will be eroded; a compensation fund for defrauded investors could be established; a greater role for the judiciary can be expected; and joint CSRC/PSB investigation bureau will be established to improve investigation.

During 2001, there were already visible signs of a market-oriented shift in stock market policy. The Yinguangxia scandal of mid-2001 appeared to be pivotal. The firm, a favourite among investors, was discovered to have faked profits of Rmb745m during 1999-2000 with the help of Zhongtianqin, one of the country’s top-five accountancy firms. The frustration of some senior leaders was all but tangible, and the most severe crackdown on illegal activities by the CSRC was ordered. This, together with state share sales beginning in July, had a huge negative effect on investor confidence. Market capitalisation was allowed to fall some 30% in the second half of the year before the senior leadership, lobbied furiously by industry participants, postponed the sale of state shares. The bear market diminished SOE financing significantly: only 74 IPOs were made during 2001, around half the number of the year before: only Rmb119.2 billion was raised from the market, down 22.7% on 2000.\footnote{Of which, Rmb46.1 billion came from IPOs, Chan (2002)} Other policy changes hinted
that a different agenda was coming to the fore at the most senior level. In May, the CSRC issued delisting procedures and in December it announced a scheme by which any company recording three years of losses would be automatically suspended. After a six-month grace period, delisting would follow if profitability had not been restored. Three firms were delisted during 2001, Shanghai Narcissus, Guangdong Kingman and Shenzhen Zhonghao, although they were all 're-listed' on an OTC basis.\textsuperscript{1169} Moves to allow the future listing of a small number of foreign-invested enterprises, including the China operations of Unilever and HSBC, and the issuance of China Depository Receipts (CDRs) were set to establish better benchmarks for corporate behaviour on the market.\textsuperscript{1170} In December 2001, the CSRC announced that all listing applications after January 2002 would have to contain an audit of the company by a foreign accountancy firm.\textsuperscript{1171} The CSRC's inspection system for listed companies was improved during 2000-01.\textsuperscript{1172} Gao Xiqing, a CSRC vice chairman, called for investors to be allowed to exercise their rights through courts, apparently supporting the use of the judicial system to punish fraudulent listed companies.\textsuperscript{1173} In February 2002 the Supreme People's Court announced that it would start accepting civil litigation based on false disclosures.\textsuperscript{1174} There were also signs of greater transparency during 2001. For instance, the CSRC invited proposals for how to sell-off state shares, publicised the 4,137 responses and made much of the evaluation process public.\textsuperscript{1175} The State Council was even reported to be considering making new issues fully convertible, a major policy reversal which augured the end of state and LP shares, one of the most important of market socialist institutions.\textsuperscript{1176} After the government-inspired bull markets of 1999-2000, it was clear that something new was happening in equity market policy.

\textsuperscript{1169} The shares were 're-listed' on the \textit{daiban gufen zhuanrang} (off-board stock transfer), an OTC-system established at selected securities companies, with settlement facilities being provided by the SHZSE, Yee (2001); COL (2001d); Sito (2001b).

\textsuperscript{1170} Jingu (2002), 4.

\textsuperscript{1171} EIU (2002). Although later reports indicated that the policy may not be implemented.

\textsuperscript{1172} By giving individual SAO staff personal responsibility for a small number of local listed companies and shuffling the inspectors periodically, Hu (2002).

\textsuperscript{1173} Something which was not helped by the rejection in late 2001 by the Supreme People's Court of class actions, SCMP (2001a).

\textsuperscript{1174} However, the notice restricted the types of cases that could be brought to court and ruled that the CSRC retained competence to determine any financial penalties, COL/Caijing (2002).

\textsuperscript{1175} Wu (2002).
However, because of the continued dominance of industrial policy there will be limits to the improvements that can take place. Moreover, without fundamental institutional change, the regulator will remain vulnerable to political interference; without effective oversight corruption within the CSRC is likely; and until non-tradable shares have been completely eliminated listed companies will remain vulnerable to dominance and abusive state shareholders. The SEC and the other new deal agencies of the 1930s were created as ‘outposts of capitalism’: they were designed, in the words of President Franklin D. Roosevelt, to control the market ‘lest capitalism by its own greed, fear, avarice, and myopia destroy itself’.\textsuperscript{1177} China’s regulatory agencies during the 1990s served a parallel purpose: they were created as outposts of market socialism, orienting the stock market towards supporting the state and its industrial goals. The zhongyang’s success in accomplishing this demonstrates its ability to reorganise institutions in order to improve its control over economic development. It revealed the political leadership able to improve state capacity. However, the evidence collated in this thesis also suggests that the institutions of market socialist regulation that had been constructed by 2000 did not deliver best practice regulation and, moreover, were not sustainable. During the 1980s and early 1990s reform in China was characterised by the market growing out of the plan. However, by the late 1990s the success of reform increasingly depended on the state itself growing out of the plan, developing effective and independent regulatory institutions and allowing its plan-administrative functions to wither away. Over the next decade, China’s stock market will be as good a barometer as any to indicate the success of this most difficult of transitions.

\textsuperscript{1176}Hu Shuli (2002).
\textsuperscript{1177}Allen (1940), 244.
Appendix A. Interview details.

These tables do not show interviewee names or positions since interviewees were assured anonymity.

<table>
<thead>
<tr>
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Abbreviations

BC  Business China (Hong Kong)
BQB  Beijing Qingnian Bao (Beijing Youth Daily)
BR  Beijing Review
BT  Business Times (Singapore)
BW  Business Week
CCJP  Chung-chi Jih-pao (Hong Kong)
CCTP  Chung-chi Tao-pao (Hong Kong)
CD  China Daily
CDBW  China Daily (Business Weekly)
CER  China Economic Review (London)
CJ  Caimao Jingji (Finance and Trade Economics)
CLAP  China Law and Practice
CM  Cheng Ming (Hong Kong)
COL  Chinaonline (www.chinaonline.com)
ED  Economic Daily (Beijing)
EIU  Economist Intelligence Unit
FBIS-CHI  Foreign Broadcast Information Service (China)
FT  Financial Times
HKAFP  Hong Kong Associated Free Press
HKATV  Hong Kong Asia Television
HKEE  Hong Kong Eastern Express
HKST  Hong Kong Standard
HP  Hsin Pao (Economic Journal) (Hong Kong)
IHT  International Herald Tribune
JR  Jingji Ribao (Economic Daily) (Beijing)
JY  Jingji Yanjiu (Economic Research) (Beijing)
KCC  Kuang Chiao Ching (Wide Angle Plus) (Hong Kong)
MP  Ming Pao (The Enlightenment Daily) (Hong Kong)
NZ  Nanfang Zhoumo (Southern Weekend) (Guangzhou)
SCMP  South China Morning Post (Hong Kong)
SG  Shangshi Gongsi (Shanghai)
SWB  Summary World Broadcasts (BBC) (London)
SZB  Shanghai Zhengquan Bao (Shanghai Securities News)
TKP  Ta Kung Pao (Impartial News Daily) (Hong Kong)
WP  Washington Post
WWP  Wen Wei Po (Journal of Convergence of Intellects) (Hong Kong)
YW  Yangcheng Wanbao (Yangcheng Evening News) (Guangzhou)
ZG  Zhongguo Gaige (China Reform) (Beijing)
ZSZ  Zhengquan Shichang Zhoukan (Securities Weekly) (Beijing)
ZSZ  Ziben Shichang Zhazhi (Capital Markets) (Beijing)
ZTS  Zhongguo Tongxunshe (China Communication Service) (Beijing)
ZXJ  Zhengquan Xinwenji (Securities News Collection) (Beijing)
ZXS  Zhongguo Xinwen She (China News Service) (Beijing)
ZZQ  Zhongguo Zhengquanye Peixun Zhongxin (China Securities and Futures) (Beijing)
ZZPZ  Zhongguo Zhengquanye Peixun Zhongxin (China Securities Industry Training Centre)

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