CHINA'S CAPITAL MARKET AND CORPORATE GOVERNANCE: THE PROMOTION OF THE EXTERNAL GOVERNANCE MECHANISM

Yuwa Wei*

I INTRODUCTION

Companies are fundamental cells of modern commercial society. Although people generally regard the rise and fall of companies as part of the natural circle of corporate development, the collapse of large corporations and the consequentially profound social and economic impact have caused great concern in the community, particularly when corporate failure has resulted from mismanagement. For this reason, issues of corporate governance have attracted enormous attention since the 1980s.

Securities markets and takeover activities are important mechanisms of corporate governance.[1] The law and economics tradition recognises that the hostile takeover performs a desirable disciplinary function by placing management under the market's judgment.[2] According to law and economics literature, the pressure of takeovers and the advantages of being listed on a stock exchange are effective stimuli of promoting good corporate governance. Furthermore, by having a wide and varied scope of owners, listed companies generally tend to improve on their

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* LLB (China), LLM (Australia), Ph.D (Australia); Senior Lecturer, Griffith Law School, Griffith University, Australia; Member, the Socio-Legal Research Centre, Griffith University; Honorary Professor, Harbin University of Science and Technology, China. The Research for this article was supported by a research grant of the Socio-Legal Research Centre, Griffith University, Australia. The author wishes to acknowledge the Socio-Legal Research Centre of Griffith University and Griffith Law School for their support.

1 See Yuwa Wei, 'Maximising the External Governance Function of the Securities Market: A Chinese Experience', *International Company & Commercial Law Review* (forthcoming, 2007) 1.

2 See Frank H Easterbrook & Daniel R Fischel 'The Proper Role of a Target's Management in Responding to a Tender Offer' (1981) 94 *Harvard Law Review* 1161; Frank H Easterbrook & Daniel R Fischel, 'Corporate Control Transactions' (1982) 91 *Yale Law Journal* 698; and Daniel R Fischel, 'Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers' (1978) 57 *Texas Law Review*. 1. John C Coffee Jr, 'Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance' (1984) 84 *Columbia Law Review* 1148.

management standards and efficiency in order to satisfy the demands of their shareholders.

In the past two decades, interesting developments have occurred in this area, particularly in some emerging economies such as China. In China, the securities market and its regulation play essential roles in encouraging and advocating sound corporate governance practices.[3] It is widely recognised for a while that the securities market is not only a place where companies raise funds, but also a means of assisting China's enterprise reforms and promoting good corporate governance.[4] However, structural defects, corporate misconduct, and legal violations in the securities business, have undermined the efforts to reform China's financial sector and enterprise system.[5] These problems have not only jeopardised the efforts to promote sound corporate governance in state-owned listed enterprises but also encumbered the development of the securities market**.**

The Chinese experience has once again proven that a well-functioning securities market and a sound system of corporate governance are mutually dependent: The development of the securities market provides an external monitoring mechanism of corporate governance, and good practice of corporate governance, in turn, ensures the orderly operation of the securities market.[6]

This article attempts to explore the rationalities behind and the functions of securities markets and takeover activities. It analyses the relationship between securities regulation and corporate governance, and investigates the Chinese experience in fully exploiting the monitoring function of the stock market over listed companies. Furthermore, it examines the legal regimes governing securities markets and takeovers in some leading corporate economies including the US, Germany, Japan and the UK. This article will demonstrate that in a world of commercialisation and globalisation, securities markets and speculative activities in securities markets play an increasingly important role in disciplining listed companies. These examination and analyses are to be developed in four parts as set out below:

Part one provides an overview of the historical development of the securities market and a review of literature on the economic functions of stock markets. It investigates the role of human and social cognitive and emotional biases in economic decision making and how they affect market prices and resources allocation. In doing so, it explains the function of speculation in the financial market, its economic benefit, and its undesirable effects on the market. Part one

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3 See generally Daniel M Anderson, 'Taking Stock in China: Company Disclosure and Information in China's Stock Markets' (June 2000) 88 *Georgetown Law Journal*.

4 See Yuwa Wei, 'The Development of the Securities Market and Regulation in China' (2005) 27.3 *Loyola of Los Angeles International and Comparative Law Review* 480.

5 See Yuwa Wei, 'Volatility of China's Securities Market and Corporate Governance' (2006) 29.2 *Suffolk Transnational Law Review* 236.

6 See Wei, above n 1, 1.

will ultimately establish that there is a need for regulatory intervention in order to restrain the undesirable consequences of speculative behaviour.

Part two seeks to measure the potential disciplinary capacity of stock markets as an instrument of corporate accountability. It attempts to ascertain a balanced approach that recognises the social utility of the securities market for corporate control on the one hand, and appreciates the possibility of market failure and the need for limited regulatory intervention on the other.

Part three focuses on the Chinese experience of utilizing the securities market as an effective mechanism of corporate control. The Chinese government anticipates that the securities market will play an important role in promoting good corporate governance in China's listed companies. However, there is a danger that China's endeavours to reform its financial sector and enterprise system may be thwarted by the problems inherent in its corporate system. The Chinese experience suggests that there is a close relationship between the development level of a country's capital market and the nature of its legal system.

Part four analyses the future development of China's financial market in the current environment of economic globalisation. It discusses China's current and future financial sector reforms, and the development of the capital market and corporate governance in post-WTO entry China.

II A REVIEW OF THE SECURITIES MARKET

The securities market is part of the financial market which comprises the securities market and other markets for various financial instruments including commodity markets, money markets, derivatives markets, future markets and foreign exchange markets.[7] Most of the above markets and their transactions are concentrated in a few financial centres called stock exchanges.[8] The securities market includes both the stock market and the bond market. It is the place where shares, debentures and bonds are traded.[9] It is also referred to as the capital market. On some occasions, people used the terms "securities market" and "stock market" interchangeably, owing to the important function of the securities market in providing long-term finance to companies.[10] The modern development of the securities market can be better understood if the evolution of the stock market is known.

The stock market evolved from ancient merchants or bankers associations trading with debts and government securities in Europe.[11] It assumed its modern form around the 17th century, when shares were invented and sold to the public by

7 See Wikipedia, available at <http://en.wikipedia.org/wiki/Financial_markets#Definition>.

8 See Kenneth Midgley & Ronald Burns, *The Capital Market: its Nature and Significance* (1977) 1.

9 See Wikipedia, available at <http://en.wikipedia.org/wiki/Securities_market>.

10 See Zhijun Li, *Securities Market Regulation* (2005) 11.

11 See Wikipedia, available at < http://en.wikipedia.org/wiki/Stock_market#History>.

Dutch, French and English joint stock companies.[12] Share trading in London gained extraordinary momentum by the 18th century due to the flourish of joint stock companies expanding aggressively in overseas and domestic trading.[13] Shares were sold at the Royal Exchange, as well as in taverns and coffee houses between Cornhill and Threadneedle Street in London.[14] It was at this time that specialised brokers and jobbers emerged.[15] Public investment in company shares soon turned into a speculative mania resulting in the incredible inflation of share prices in the stock market, and eventually, the spectacular crash of the market following the burst of the South Sea Bubble.[16] It was not until 1844, when the *Limited Liability Act* was passed by the Parliament, that the UK securities market was able to recover from the South Sea crisis.[17]

Industrial expansion encouraged the continued formation of joint stock companies and the further development of the stock market. In the years following the industrial expansion, the London Stock Exchange evolved into the largest stock exchange in the world, which lasted until the end of the Second World War.[18]

The history of stock markets in the US dates back to 1792 at Wall Street, New York.[19] In 1817, the New York Stock Exchange (NYSE) was formally established.[20] The NYSE only admitted large and well established companies, whilst smaller companies had to trade outside it. This fuelled the formal establishment of the American Stock Exchange (AMEX).[21] The US market developed rapidly by the mid-1800s due to the fast growth of the industrial firms, which required large amounts of capital input.[22] Because European economic powers went up in smoke during World War II, the US replaced the UK in becoming the leading economy in the world after the war.[23] The NYSE also

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12 See K G Davies, 'Joint-Stock Investment in the Later Seventeenth Century', 4.3 *The Economic History Review* (1951-1952) 288, 291-292. See also Josette Peyrard, *La Bourse* (1998) 1.

13 See Alan Jenkins, *The Stock Exchange Story* (1973) 11.

14 See E Victor Morgan & W A Thomas, *The Stock Exchange: Its History and Functions* (1969) 20, 36-37

15 Ibid, 14-17.

16 In 1711 the South Sea Company was established. The new company offered to buy the government's war debts, in return for a monopoly on English trade with the Spanish colonies of South America. Thus, the outstanding short-term war debts, not funded by a specific tax, were converted into equity of the proposed joint-stock company. The company's share price inflated from 120 to 950 before its collapse in 1720. See Morgan & Thomas, above n 14, 29-40.

17 See R J Briston, *The Stock Exchange and Investment Analysis* (1973) 23-24.

18 See Baishan Xie, Xuelai Dai & Lan Xu, 'Comparative Study of US and Chinese Securities Markets', in *International Comparison of Securities Markets* (Baisan Xie ed, Vol 1, 2003) 6.

19 See Editor of *The New Enlightenment*, 'The History of the Stock Market' < http://www.hermes-press.com/wshist1.htm>. See also Li, above n 10, 21.

20 Ibid.

21 The market started at the curbstone on Broad Street near Exchange Place and was moved indoors in 1921. See Wikipedia, <http://en.wikipedia.org/wiki/American_Stock_Exchange>.

22 *See* Wikipedia, <http://www.stockmarketinvestinginfo.com/smi_history.html>.

23 See Encyclopaedia of American History, <http://www.answers.com/topic/market-1>.

replaced the London Stock Exchange and has been the largest stock exchange in the world.

The history of the stock market shows that shares facilitate the expansion of companies, and also demonstrates the fact that the stock market is one of the most important devices by which companies can raise capital. It is therefore necessary to regulate the stock market to ensure its prosperity and efficiency.

The securities market is also known as the speculators' market, and speculation often causes the market to behave irrationally.[24] Investors in the secondary market mainly trade with the goal of making short-term profits by reselling shares to others. The prices of shares are exposed to subjective speculation of investors and the market can therefore become volatile.[25] Individual investors' speculation can result in waves of manias and panics in the market. The common scenario is that share prices are pushed unreasonably high, and then plummet. This is evidenced by the South Sea Bubble event in the London stock market and the disastrous market crashes that occurred on the NYSE in 1929 and 1987. The securities market crash in 1929 instigated a long term economic depression in the US which haunted the country until World War II. The market crash in 1987, though less disastrous compared with the 1929 crash, once again depressed the country's economy.

Facts and empirical studies suggest that irrational volatilities in the securities market do not necessarily have a definite cause, and sometimes are mainly related to investors' psychology.[26] Classic economics investigated the relationship between economics and psychology. Regrettably, psychology faded away in the mainstream neo-classic economics by the 1920s.[27] The dominant view of neo-classic economics is that individuals/investors in the market are rational agents acting according to rational principles. Although they are subject to errors and inconsistencies, they generally make rational decisions and choices, since an individual systematically making mistakes would eventually be ousted from the market.[28] It was not until the 1970s that the concepts of behaviour finance and behaviour economics were revisited by some economists.[29] Behaviour finance and behaviour economics are two related scientific fields studying the role of human cognitive and emotional biases in economic decision-making and how they affect market prices, returns and

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24 See Xie, Dai & Xu, above n 18.

25 Ibid.

26 See general David Cohen, *Fear, Greed and Panic: the Psychology of the Stock Market* (2001).

27 See Wikipedia, available at <http://en.wikipedia.org/wiki/Behavioral_Finance>.

28 See Robin M Hogarth & Melvin W Reder (eds), *Rational Choice: The Contrast Between Economics and Psychology* (1987) 6.

29 See representative works including Daniel Kahneman & Amos Tversky, 'Prospect Theory: An Analysis of Decision under Risk', (1979) 47 *Econometrica* 263-291, and Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance* (1999). See also Matthew Rabin, 'Psychology and Economics' (1998) *Journal of Economics Literature*, or 36(1) *American Economic Association* 11-46; Hersh Shefrin, *Beyond Greed and Fear: Understanding behavioral finance and the psychology of investing* (2002); and Colin F. Camerer, George Loewenstein, and Matthew Rabin (eds), *Advances in Behavioral Economics* (2003).

the allocation of resources.[30] The aim of these two scientific fields is to combine psychological and neo-classical economic theory to explain economic choices where there is uncertainty.[31]

Behaviour finance/economics does provide explanations for volatilities such as bubbles and crashes in the securities market when the orthodox doctrines including the rational choice model and the efficient market hypothesis in neo-classical theory do not satisfactorily rationalise the market behaviour. Behaviour finance/economics acknowledges that individual biases do not impact the securities market.[32] It is only when individual biases evolve into social or cognitive biases that the market may be affected.[33] Notions such as herd behaviour, group thinking, and mass panic are all used to illustrate this point of view.

The highly speculative nature of the securities market makes it vulnerable to manipulative conduct, which under certain conditions will result in social psychological phenomenon such as herd behaviour or mass panics, which may upset the market order. It is therefore important to bring speculation under control. In most jurisdictions, regulation is regarded as an efficient mechanism for controlling the manipulative behaviour in the securities market.[34]

Furthermore, the functions of the securities market and its significant role in the economy, particularly in the developed markets, also justify regulation of the market in a pervasive fashion.[35] The securities market primarily has the following functions: (1) raising capital for companies; (2) mobilizing savings for investment, facilitating company growth, and redistributing wealth; (3) creating investment opportunities for investors; (4) raising capital for governments to develop projects; and (5) through corporate control, it allows managerial failure to be corrected through its markets.[36] Because of the above utilities, no government can overlook the inefficiency of the securities market, and the securities market is usually closely monitored.

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30 See supra note 27.

31 Ibid.

32 Ibid.

33 Ibid.

34 See Li, above n 10, 21-49. See also Xujiang Xie, *China's Capital Market: An Analysis Based on the Theory of Competition* (2004) 43.

35 When the NYSE sneezes, the whole America feels sick. See Thomas Lee Hazen, *The Law of Securities Regulation* (3rd ed, 1998) 8. See also John Coffee & Joel Seligman, *Securities Regulation: Cases and Materials* (2003) 2-7.

36 See Colin Mayer, 'Stock-markets, Financial Institutions, and Corporate Performance' in Nicholas Dimsdale & Martha Prevezer (eds), *Capital Markets and Corporate Governance* (1994) 179; Paul Marsh, 'Market Assessment of Company Performance', in Nicholas Dimsdale & Martha Prevezer (eds), *Capital Markets and Corporate Governance* (1994) 66, 67.

III SECURITIES MARKET AND CORPORATE GOVERNANCE

The securities market has been perceived as a mechanism of corporate governance. The law and economics literature acknowledges the contribution of stock markets in promoting good corporate governance. The main argument of the law and economics tradition is that stock exchanges facilitate takeovers and dispersed ownership, and produce listing rules for listed companies. These functions of the securities market provoke listed companies to improve on their management standards and efficiency.[37]

According to the literature, hostile takeovers perform a unique disciplinary function by placing management under the market's scrutiny.[38] This is because the managerial efficiency of a listed company is closely reflected in the share price of the company.[39] The shares of a poorly managed company are unattractive to investors. Investors may be willing to invest in the company if the company is willing to reduce investors' investment risks by selling its shares at a discount price. In doing so, the company becomes vulnerable to takeover predators. If the company is taken over by a bidder, the bidder usually dismisses the current board and appoints new directors. Takeovers thus pose a threat to the management of a listed company. To avoid becoming a takeover target, one of the predominant aims of management is to improve the managerial efficiency and the economic performance of their companies.[40]

As mentioned above, when a company's shareholdings become dispersed, the chances of the company being taken over increase. This is because small and dispersed shareholders are more likely to sell their shares in the stock market.[41] The securities market makes public investment possible and therefore facilitates scattered shareholdings. This further enhances the threat of takeovers.

Nevertheless, some reports have found that takeovers, as a mechanism of accountability, are imperfect.[42] Some point out that takeovers do not always push corporations to improve management.[43] It could encourage corporate managers to focus on short-term performance, because managers may make business decisions

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37 See Wei, *supra note* 4, 485.

38 See Coffee, *supra note* 2.

39 See Wei, *supra note* 4, 483.

40 See Daniel R Fischel, 'Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers' (1980) 57 *Texas Law Review* 1, 9.

41 Ibid.

42 See Thomas Lee Hazen, 'The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law' (1991) 70 *North Carolina Law Review* 182-183.

43 Ibid.

just to frustrate potential takeovers.[44] For example, company managers may try to make themselves indispensable, and therefore, costly to replace.[45] In addition, studies have shown that the shareholders of the bidder company may be worse off after the takeover.[46]

Given that the takeover threat does not always effectively influence the management of some listed companies, share prices can still act as motivation for management to work towards greater efficiency. It is especially relevant for managers that are only motivated to work for security and enlargement of personal gains. This is because such goals are likely to be best achieved by expanding their businesses into bigger organisations and therefore creating themselves better paid positions.[47] Business expansion requires finance. Poorly performed companies are likely to have difficulties in attracting investors, and thus fail to raise sufficient funds. Hence, it may not be costly for managers to ignore investors' interest and the reputation of their company on the securities market.

Research also shows that price movements often provide incentives or penalties on a personal basis for managers who have shareholdings in their companies.[48] When directors hold significant shares in their companies, they have a personal incentive to improve the economic performance of their companies. This is because poor performance of the companies will result in downgrade of their share prices and eventually cause personal losses to the directors, whereas advancement of the share prices of the companies brings personal gains to the directors.

In addition, a company's share price can have some secondary disciplinary influence over the management. Since depressed share prices indicate ineffective and incompetent management, those managers who do care about their images and reputation in the industries and the labour market will be motivated to promote the economic efficiency of their companies.[49]

Apart from consciousness of share price movements, listed companies are subject to the scrutiny of the stock exchanges. Stock exchanges produce their own rules regulating the participants and transactions. These rules are known as listing rules. Listing rules provide conditions for companies to be admitted to the stock exchanges and regulate the conduct of listed companies.[50] To be admitted into a stock exchange, a company must meet the listing requirements of the specific stock

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44 See Pauline O'Sullivan, 'Governance by Exit: An Analysis of the Market for Corporate Control' in Kevin Keasey, Steve Thompson & Mike Wright, (eds), *Corporate Governance: Economic and Financial Issues* (1997) 125.

45 Ibid.

46 See Hazen, *supra note* 42, 191.

47 See generally Robin Marris, *The Economic Theory of 'Managerial Capitalism'* (1964).

48 See Midgley & Burns, above n 8, 16.

49 Ibid at 18.

50 See Jinqing Zhu, *Securities Law* (2007) 54.

exchange and comply with the rules of conduct. Non-compliance with the rules of conduct may result in the company being de-listed. Stock exchanges either incorporate codes of corporate governance in their listing rules or publish codes of corporate governance as a separate regulatory document.[51] Consequently, higher standards of corporate governance apply to listed companies.

In a market where there is a lack of transparency, business order and effective regulation, share prices are usually distorted and thus do not truly reflect their companies' managerial and economic efficiency.[52] In such a market, market misconduct may have little consequences. Poorly performed companies are likely to conceal their economic failure by misleading or manipulating investors. In such an environment, the market is somewhat handicapped in identifying well managed companies from poorly managed companies. Thus, the function of takeovers as a corporate control mechanism is substantially lessened. Furthermore, since directors can avoid personal penalties through market misconduct, the incentives for directors holding shares in their companies to promote the companies' economic performance diminish. For example, the directors can pass the losses caused by low share prices onto other investors through inside trading.

When a person trades securities based on the information intended to be available only for a corporate purpose and not for anyone's personal benefit, the person engages in insider trading.[53] Directors and managers of companies have access to the companies' price sensitive information unavailable to the public. In a market where insider trading is not effectively controlled, directors and managers are more likely to abuse their positions and trade their shares based on inside information. Sometimes, managers may engage in insider trading in combination with other forms of market misconduct. For example, the directors of an unsuccessful company may disclose misleading information and create false trading impressions on the market, and then sell their own shareholdings right before the market receives the correct information.[54]

The above discussions further demonstrate the need for regulating the securities market. An inadequately regulated securities market cannot function effectively. In a well functioning securities market, there is adequate disclosure to facilitate informed judgements and participants thus are able to act with integrity.[55]

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51 For example, the UK Combined Code contains Code of Best Corporate Governance Practice, while China Securities Regulatory Committee (CSRC) and the State Economic and Trade Commission (SETC) jointly published *Code of Corporate Governance for Listed Companies in China* in 2002.

52 See Li, above n 10, 75-97.

53 See Coffee & Seligman, above n 35, 1071.

54 These situations happened in notorious cases including the Hainan Minyuan case, the Yinguangxia case, and the Beihai Yinhe case.

55 See Commonwealth of Australia, *Financial System Inquiry Final Report* (1997) 16.

IV THE CHINESE EXPERIENCE

In China, the securities market and its regulation have developed in tandem with its economic reforms.[56] They have been means of achieving the goals of the country's economic reforms.[57] This is evidenced by the increasing attention paid to the development and regulation of the securities market by the Chinese government in the past decade. However, at the beginning of China's economic reforms, the development of the securities market was not a significant concern.

Before the economic reforms, China adopted a planned economy. Under the planned economy, enterprises were wholly state-owned and they operated according to state plans. This meant that the state supplied resources and labour for production and was entitled to all the final products. Since there was no connection between production and profitability, the state-owned enterprises had little incentive to promote economic efficiency and technology innovations.[58]

At the initial state of China's economic reforms, the key concern was the modernisation of China's enterprise system by introducing competition and modern managerial mechanisms into the state-owned enterprises. In this process, China took a cautious approach, which contrasted with the Russian's reform strategy.[59] Reforming a planned economy into a market economy was an unprecedented project, since there was not an existing reform model to follow.[60] The goal of the economic reforms was to create a market economy. However, no one could be sure of the best method for achieving the goal. This made the reform an arduous task. The Chinese therefore decided to adopt the approach of trial and error, partial reforms and reinforcing reforms.[61] Western economists describe Chinese reform style as "gradualism". The Chinese themselves described their reform strategy as "crossing the river by feeling stones under foot and stepping on the stones".

In the beginning, the Chinese attempted to introduce incentives and competition into the enterprise system without corporatising and privatising the enterprises.[62] However, the various strategies used brought new problems, and had only a limited

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56 See Wei, *supra note* 4, 1.

57 Ibid.

58 See Shenshi Mei, *Research on the Structure of Modern Corporate Organs' Power: A Legal Analysis of Corporate Governance* (1996) 3.

59 Peter Nolan and Robert F Ash in their research into the Chinese reforms concluded that China's success stems primarily from its refusal to implement 'transition orthodoxy' (shock therapy) which Russia has whole heartedly embraced. See Peter Nolan & Robert F Ash, 'China's Economy on the Eve of Reform', in Andrew G Walder (ed), *China's Transitional Economy* (1996) 35.

60 See Wei, above n 1, 2.

61 See Yuwa Wei, *Investing in China: Law and Practices of Joint Ventures* (2000) 8.

62 See Wen Liang, 'Some Legal Problems of Reforming the State Owned Enterprises into Limited Companies', in Chen Hua & Jiu Jingwei (eds), *Research on the State Owned Enterprise Reform and Corporate Law* (1997) 29-30.

success.[63] In the end, corporatisation became the only solution for modernizing the organisational structure of China's enterprises and an important step in improving the economic efficiency of the enterprises.[64] However, the Chinese government made it clear that corporatisation should not challenge the dominance of public ownership.[65] Consequently, most state-owned enterprises were converted into state-owned companies. Corporatisation commenced in the early 1980s and was mostly completed by the end of the 1990s.[66]

The newly corporatised enterprises were troubled with new problems. The problem that was most difficult to overcome was insider control. Insider control problems existed in state-owned or dominated companies where the state was the sole shareholder or the dominant shareholder. In such companies, the state as a shareholder does not have a physical appearance and must rely on agents.[67] Furthermore, the state lacks information about managerial efficiency and corporate performance. Consequently, managers of the companies seize the control of the companies. In such a company, the directors on the board of directors and the supervisors on the supervisory board are usually appointed by the same government department, and they are likely to work together to promote their common interests at the expense of the shareholder's (the state's) interest.[68] Mechanisms responding to the insider trading problem were needed. To solve this dilemma, the Chinese policy makers envisioned that the securities market could bring external control mechanisms into these companies.[69]

When China decided to develop a securities market in the mid 1980s, the policy makers aimed to achieve three primary goals. Firstly, companies would have new channels to raise funds.[70] With the deepening of the enterprise reforms and reforms in the banking sector, as well as an increase in the exposure to international competition, companies required more and more capital for further expansion.[71] The securities market could aid companies in raising capital. Furthermore, the securities market would assist the development of privately owned enterprises by providing them with a means of obtaining outside finance.

Secondly, the securities market would absorb a large amount of bank savings and

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63 See Comments by Li Guangyuan, in Zhang, Wenmin *et al* (eds), *The Great Economic Debate in China* (1997) 14-15. See also Nicholas R Lardy, *China's Unfinished Economic Revolution* (1998) 22-23.

64 See Dou Jianmin, *Research on the History of Corporate Ideology in China* (1999) 108.

65 See Yuwa Wei, *Comparative Corporate Governance: A Chinese Perspective* (2003) 20-21.

66 Ibid at 103-107.

67 See Mei, above n 58, 34.

68 See the World Bank, *China's Management of Enterprise Assets: the State as Shareholder* (1997) 51. See also Wei, above n 65, 121.

69 See Stephen C Thomas & Chen Ji, 'Privatizing China: The Stock Markets and Their Role in Corporate Reform' (July 1, 2004) *China Business Review* 58.

70 See Baisan Xie, *China's Securities Market* (2002) 3.

71 See Qingquan Ma, *The History of China's Securities Business* (2003) 2-3.

make the best use of them.[72] From 1978 to 1990, individual savings in China had increased dramatically from RMB21,600,000,000 yens to 703,420,000,000 yens.[73] Chinese enterprises also had a substantial amount in bank deposits.[74] The existence of a securities market would allow these net savings to flow to well performing enterprises and efficient sectors, and thus exert their best utility.

Thirdly, the securities market would discipline the listed companies and promote good corporate governance in these companies.[75] To be listed on the stock exchanges, companies needed to satisfy the minimal capital requirement, demonstrate that it made profits in the past three consecutive years, provide evidence that it was not involved in serious breaches in the last two years, etc.[76] After being listed on the stock exchanges, the company was subject to the continuous disclosure requirements and other behaviour rules specifically tailored for listed companies. It was understood that the incentives of being listed on the stock exchanges and the consequences of de-listing for breaches would act as a disciplinary force stimulating listed companies to embrace good corporate governance practice. Therefore, except in the core sectors essential to the national economy and people's livelihood, state-owned/dominated companies were encouraged to be listed on the domestic and foreign exchanges.

The Chinese government's determination to develop a securities market in China resulted in the establishment of two national stock exchanges in the beginning of the 1990s.[77] The past fifteen years have witnessed mixed outcomes. The development of the securities market and related activities occurred in three phases. The first phase was the initial stage of development, which started in 1978 and ended in 1990. In this stage, the concepts of bonds and shares were not well understood by most ordinary Chinese. By 1981, China resumed the practice of issuing government bonds (treasury bonds). Very few were interested. The government had to allocate the bonds to government organisations, state institutions and enterprises for further distributing them to individuals. Senior officers and party members were called on to set an example by subscribing for possibly more treasury bonds. Ten years later, the wealth of those who subscribed for the bonds increased by several hundred times, while those who refused to buy stayed status quo.[78] Gradually, Chinese citizens realised the benefits of subscribing for treasury bonds.

Share issuance began by 1984. The practice from pilot projects extended to some cities, the most notable being Shanghai and Shenzhen. Share issuance was under

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72 Ibid at 3.
73 Ibid.
74 Ibid.
75 See Thomas & Ji, *supra note* 67.
76 See sec. 152 of the *Company Law of the People's Republic of China* (1993).
77 They are Shanghai Stock Exchange and Shenzhen Stock Exchange.
78 See Xie, above n 70, 252.

close government supervision and guidance.[79] Most of the time, the market was quiet. However, this only remained the case until 1990. From March 1990, the securities business suddenly thrived, mainly because the public discovered that the earlier investors made a fortune overnight.[80]

After the establishment of the two national stock exchanges in 1990, China's securities market came into its second phase of development, the era of vigorous development. From 1991 to 2000, the securities market soared. The number of new issues was far behind the demand of investments. The government introduced new procedures including application, casting lots and quota allocation methods for distributing newly issued shares. Quota control was an important strategy of keeping the capital market in check. By having quota control in place, the government firmly took the power of deciding which companies' stocks should be admitted onto the market. Theoretically, quota control would ensure the quality of listed companies. However, because of policy preference quota control was, in fact, exercised to safeguard the interests of state dominated companies. Consequently, state-dominated companies were given priority in obtaining quotas. During this period, various types of shares including A, B, H, and N shares were introduced. A regulatory framework was built up. The market generally exhibited a booming trend, however, also fluctuated violently.[81]

Since 2001, the securities market has come into its third phase of development. This is a period of adjustment. From July 2001, the market experienced more than four years of depression.[82] Between June 2001 and June 2005, the index fell from 2245 points to 998 points.[83] The government has been introducing methods to restore investors' confidence. The pace of reducing state shares has been accelerated. Since April 2006, the market has begun to recover. However, this time the market is even more volatile and manipulation is more acutely felt. The market showed sign of picking up by April and soon dipped 4.84% on 13 July 2006.[84] From September it became clear that bullish market was coming. The market soared by the end of December 2006 and January 2007, and then plummeted on January 31. In the following five weeks, the market fluctuated frequently and drastically. The Shanghai index reached its historical high of above 3000 points on 26 February. In the morning of 27 February the marked opened with 3048 points and fell spectacularly five hours later.[85] The index lost of 8.84% in the single day. On March 14 and 16, the market plunged twice with Shanghai index fell more than 100 points

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79 Share issuance at this stage was subject to government approval.

80 See Ma, above n 71, 60.

81 See Wei, above n 5, 37-38.

82 Ibid, 32.

83 See Baisan Xie, 'China Needs not to Go with the Tide on the US Securities Market', available at <http://cn.biz.yahoo.com/070317/16/l9c6.html>.

84 See Xiaobing Wu, Wenjun Liu & Ye Chen, 'Who Pulled the Trigger?' Available at <http://zhoukan.hexun.com/Magazine/ShowArticle.aspx?ArticleId=11963>.

85 Ibid.

on March 14 and 21.22 points on March 16.[86]

Many factors have contributed to the market depression and volatility. Bubbles existed before 2001. By early 2001, A shares were sold, on average, 70 times above their issuing prices.[87] This was caused by great demand in new issues. Official explanations intimated that the past few years of recession were mainly due to the market's natural adjustment after the substantial market growth.[88] Financial policies including interest rate policies, imperfect regulatory infrastructure, a lack of legal protection for investors, adjustments on macro-economic policies could all contributed to the market recession.[89]

Some researches tend to attribute the market depression and volatility mainly to the market irregularities and irresponsible conduct of listed companies.[90] Many companies see the securities market as a place where they can raise easy and quick money.[91] Instead of improving the corporate governance and economic efficiency of their companies, directors and managers are more interested in manipulating the market and investors by disclosing misleading information or creating false trading impression.[92] Some unqualified companies obtained listing by giving false accounting and auditing information in their applications.[93] As a result, investors' confidence has been heat hardly by notorious cases involving market misconduct. Furthermore, it is reported that China' capital market has been the target of local and international sharks. In 2006 alone, there was at least RMB300,000,000,000 of unknown sources participated in the market.[94] Part of them was probably state assets, and part was international idle money.[95] The inflow of large amounts of speculative money aiming at swaying the market has further increased the uncertainty on China's market.[96]
Statistics indicate that the objectives behind developing securities market have not been effectively achieved. The market has not cured the insider trading problems in state-dominated listed companies, and abuse of the market and misbehaviour by

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86 The Commentator, 'The Market on the Two Stock Exchanges Continues to Fall, and the Index Dives More Than 21 Points', available at <http://finance.people.com.cn/GB/67815/68059/5480901.html>.

87 A shares are shares issued to Chinese investors on the domestic securities markets, and should be paid in Renminbi yens. See China Securities Regulatory Committee, *Studies of Cutting edge Issues concerning the Development of China's Securities Market* (2005) 3, 12-13, 41-43.

88 Ibid.

89 See Qilin Fu, *Well-Known Cases relating to China's Securities Market in the Past Ten Years* (2002) 70. Huang, Z., *Civil Liability and Civil Litigation in US Securities Law* (2003) 7.

90 See Xie, Dai & Xu, above n 18, 1, 3-4; Also see generally Wei, above n 5.

91 See Xie, above n 70, 70, 152, 168.

92 Ibid, 80.

93 Ibid, 202. See also Xie, above n 34, 133-134.

94 See editor, 'Congress Representatives Call for Vigilance against International Hot Money Undermining China's Share Market and Weathering Risks on the Capital Market', available at <http://finance.people.com.cn/GB/67815/5473287.html>.

95 Ibid. See also Shujiang Xie, *China's Capital Market: An analysis based on the theory of competition* (2004) 124.

96 Ibid.

listed companies has been widely reported.[97] Today, insider control continues to plague Chinese listed companies in which the state is the dominant shareholder. This problem undermines China's efforts to promote sound corporate governance in listed companies and is responsible for irregular volatility on the securities market.[98]

In China's capital market, takeovers as an external mechanism of corporate control have contributed little to the improvement of management efficiency in listed companies. Irregularity and widespread breaches have serious undermined the efficiency of the securities market. Fraudulent conduct such as misleading disclosure and market manipulation by listed companies and market intermediaries confuses the market and thwarts investors in their effort to differentiate well performed companies from poorly performed companies. Consequently, the threat of takeover to inefficient management is significantly compromised.

China's experience illustrates that corporate governance and securities markets are interactive and interdependent. Therefore, the economic efficiency in China's companies must be promoted in conjunction with improving corporate governance practice and advancing a transparent and orderly securities market. To build a modern corporate governance system, China needs to make further efforts to rationalise the shareholding structure in its companies. It also needs to continue to develop its securities regulation and reinforce the monitoring function of the securities market.

V THE FUTURE

For the purposes of establishing an efficient corporate governance system in China and ensuring the healthy operation of China's securities market, the Chinese will have to shoulder heavy responsibilities in the coming years. The experience of the successful corporate economies illustrates that a good corporate governance system is one that is adapted to its political, economic, cultural and legal environment, and takes maximum advantage of its political, economic, cultural and legal traditions.[99] The corporate governance system must be reinforced by the political, economic, cultural and legal strength of the system. It should promote and enhance certain social, political, economic, cultural and legal values of the society in which it is implemented.[100] This is evidenced by the co-existence of the diversified but equally successful corporate governance practices in the world's leading corporate economies, namely, the US, Germany and Japan.

While the US corporate governance system is characterised by a highly developed capital market and managerial capitalism, German and Japanese corporate governance systems are described as bank-based and co-operative systems where

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97 See Xie, Dai & Xu, above n 18. See generally also Wei, above n 5.
98 Ibid.
99 See Wei, above n 65, 175.
100 Ibid.

corporate ownership is concentrated, usually in the hands of banks and related companies.[101] In the US, the focus of corporate governance is how to reduce agency costs caused by dispersed ownership and control and hold the management accountable. Takeovers, as a side product of the developed stock market and dispersed ownership, play a significant role in corporate governance. In Germany and Japan, the issue of corporate governance is how to increase corporate finance choices, enhance monitoring capacity of the board and other corporate organs, and reduce pressure on banks.[102]

Whilst China is determined to develop a modern corporate economy with its unique characteristics by retaining a significant proportion of state ownership in its industrial and financial sectors, it has endeavoured to establish a US style securities market and regulatory regime. The question is whether China can reconcile the two contradictory systems and thus create a new method of achieving economic efficiency. From what is occurring in China today, it appears that China has made the efforts. The strategy is to divide shares of a joint stock company into state shares, state-owned legal person shares, and individual shares.[103] While state shares are prohibited to be traded on the stock market, state-owned legal person shares can only be transferred among legal persons.[104] Only individual shares are freely transferable on the market. However, they merely account for thirty per cent of the total shares.[105]

This approach has achieved the purpose of retaining substantial state ownership on the one hand, and introducing market mechanisms on the other. Consequently, wholly state-owned companies continue to be financed by the state via state-owned banks, and state dominated companies are able to have access to external finance through being listed on stock exchanges. In doing so, the companies can prevent losses of state assets, guarantee state domination, and obtain outside investments.

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101 See Alfred D Chandler, *Scale and Scope: The Dynamics of Industrial Capitalism* (1990) 383-592. Also see Johannes Hirschmeieer, 'Entrepreneurs and the Social Order: American, Germany and Japan, 1870-1900' (1977) in Keiichiro Nakagawa (ed), *Social Order and Entrepreneurship* 7-8. See generally also Mark J Roe, 'Some Differences in Corporate Structure in Germany, Japan, and the United States' (1993) 102 *Yale Law Journal*, 1927-2003.

102 See Ronal Gilson & Curtis J Milhaupt, 'Choices as Regulatory Reform: The Case of Japanese Corporate Governance', Columbia University Law School, Center for Law Economic Studies Working Paper No 251; Stanford Law School, John M Olin Program in Law and Economics, Working Paper No. 281; and European Corporate Governance Institute, Law Working Paper No. 22/2004), <http://ssrn.com/abstract=537843>. See also Helmut M Died, *Capital Markets and Corporate Governance in Japan, Germany and the United States: Organizational Response to Market Inefficiencies* (2005) 120.

103 See Chengxi Yao, *Stock Market and Futures Market in the People's Republic of China* (1998) 18.

104 A legal person is a body that has an independent personality in law. A state-owned legal person is usually a state-owned company.

105 See Baishan Xie, 'Huge Deficits of Shen Kang Jia Reveal the Serious Problem in the Company's Share Issue', in Baishan Xie, *International Comparison of Securities Markets* (vol 1, 2003) 170.

In the meantime, it is also expected that these companies will accept market supervision and uphold good corporate governance.

However, as discussed in the beginning of this article and in the previous section, the plan has not worked satisfactorily. Unlisted state-owned companies continue to burden the state banks with non-performing loans.[106] The misconduct of listed companies has not been curtailed by the operation of the stock market, and, in some cases, it has even been exacerbated. Enormous opportunities for profits existing in China's securities market have provoked some companies to purposely engage in irresponsible and manipulative conduct. Inevitably, the market will suffer the consequences. This illustrates the fact that the existence of a securities market does not automatically guarantee a better regime of corporate governance. On the contrary, poor corporate governance may shake investors' confidence and eventually undermine the market.

There are three alternatives to China in regulating its capital market and improving corporate governance of its companies. Firstly, if China is to retain substantial state ownership in essential sectors for social and economic reasons, it may need to look at the experiences of the countries successfully running a corporate economy with a high proportion of state ownership.[107] The representatives of such countries include France and Italy. In France and Italy, a large amount of firms are state owned.[108] It is believed that the state should play an important role in directing large corporations in order to ensure that companies will serve public interests.[109] In such countries, the government bureaucrats have substantial discretional power in the allocation of credit, foreign exchange and licenses.[110] Since China accumulated rich experience in state guidance and control over economic activities under the planned economy, the state oriented model of corporate governance may well be a practicable approach.[111]

China may also draw inspiration from the experience of bank based systems, namely Germany and Japan, to fully exploit state banks' potential in monitoring companies. Since a comprehensive and practical legal infrastructure is a fundamental requirement for building a successful corporate economy (this is evident in all leading corporate economies), China needs to continue to perfect its legal infrastructure. In addition, it is important that China develops a corporate

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106 See Yanrong Hong, *Studies of Legal Issues concerning Asset Backed Securitization* (2004) 223-224; See also Baozhong Gao, *Institutional Analysis of Asset Securitization in China* (2005) 155.

107 *See generally* Simon Johnson, Peter Boone, Alasdair Breach & Eric Friedman, *Corporate governance in the Asian Financial Crisis*, (Rutgers U. Dept. of Econ., Working Paper No. 279, 1999).

108 See Yiwen Deng, *Cross Swords: Great Debate on State Ownership Reforms* (2004) 53.

109 See Henry Hansmann & Reinier Kraakman, 'The End of History for Corporate Law' (Harvard Law School, John M Olin Center for Law, Economics, and Business Working Paper No. 280, 2000) 6.

110 Ibid.

111 See Wei, above n 65, 202.

culture that promotes transparency, business efficiency, fair competition and managerial accountability.

Secondly, if China wants to fully exploit the governance function of the securities market and thus enhance the governance practice of listed companies, it needs to take the following steps to improve the market efficiency:

The first step is to strengthen regulation over the securities market and listed companies by enhancing disclosure requirements. Disclosure is the key in ensuring transparent and orderly transactions on the securities market. It is generally recognised that publicity is the best remedy for social and industrial problems.[112] Disclosure is thus the highlight of most countries' securities regulation.[113] The fact that many incidents of market misconduct in China involve misleading disclosure or non-disclosure further demonstrates the necessity of improving disclosure requirements.

The second step is to increase the protection of investors and small shareholders' remedies. Research has shown that successful corporate economies all seek to provide sufficient remedies to shareholders, particularly small shareholders in their laws.[114] It is important that investors have the option of pursuing a legal remedy. When investors pursue their legal rights, they bring the management of their companies under further scrutiny. Currently Chinese law is silent on what civil remedies share investors may have in the case of market manipulation by corporations.[115] Although amended *Company Law* has made shareholders' derivative actions possible, a lack of detailed stipulation makes the implementation difficult.[116] In the meantime, shareholders' right to class actions is still unclarified. There is a need to improve the Chinese law in order to offer further protection to share investors.

The third step is to gradually reduce state shareholdings and liberalise non-tradable shares. The current price distortion on China's securities market is mainly caused by a lack of transferable shares.[117] Reduction of state shareholdings may ease the pressure, and therefore diminish bubbles in the market.
However, China may wish to go for the third option: that is fully taking the advantage of the securities market, while retaining significant state control in

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112 See Louis D Brandeis, *Other People's Money and How the Bankers Use It* (1971) 92.
113 See Zhu, above n 50, 92.
114 See Simon Johnson, Peter Boone, Alasdair Breach & Eric Friedman, above in 100.
115 See Zhu, above n 50, 164. [115] *Ibid*.
115 See Wei, above n 65, 202.
115 See Louis D Brandeis, *Other People's Money and How the Bankers Use It* (1971) 92.
115 See Zhu, above n 50, 92.
115 See Simon Johnson, Peter Boone, Alasdair Breach & Eric Friedman, above n 100..
116 See sec. 152 of the amended 1993 *Company Law*. The 1993 *Company Law* was amended twice. The first amendment was made in 1999 and the second in 2005. The amendments in 2005 were substantial, with 137 sections amended, 41 inserted, and 46 repealed.
117 See Xie, above n 34, 114, 116, 122..

essential sectors. This is the current approach of the Chinese government, and is the optimal, but ambitious, choice. A difficulty of this strategy is making state owned and dominated companies truly competitive. A possible solution is to terminate the traditionally affinal relationship between the companies and state banks, and make sure that the banks will fully exert their supervisory functions. Currently, China is introducing the practice of securitization. The Chinese government allows the state banks to securitise non-performing loans and sell the bonds on the securities market. In doing so, the government hopes that the state banks and state companies will no longer be tied together, and companies will be under greater pressure to pay back the debts.[118] Using securitization to control non-performing loans is a popular practice in many countries that have introduced securitization, particularly within Asia and Latin America. [119] What distinguishes China from other countries is the fact that securitization in China is expected to play an important role in assisting the banking sector reforms. The outcome of the securitization practice will have far reaching influence on China's economic life in coming years. How far China can go along this path remains to be seen.

The world's financial products and markets are moving towards globalization. China's entry into the WTO has accelerated the integration of its financial sector and securities market into the world economy. China will inevitably achieve greater financial liberalisation and develop a more sophisticated capital market. However, the globalisation of financial services and the capital market could be a double-edged sword. While capital flows do help China's economic growth and bring in new knowledge and technology, Chinese banks will face fierce competition from international financial institutions. China's capital market will offer attractive opportunities to international investors, which will increase competition and result in a race for opportunities. Both China's financial sector and its listed companies will encounter unprecedented challenges in their quest for survival and expansion. A task faced by Chinese policy-makers and the corporate elite is how to enhance the competitive strength of the country's financial sector and national industries, while enjoying a high inflow of international capital. Globalisation is a challenge as well as an opportunity to the Chinese. China can use the opportunity to speed up the reforms in China's financial sector and to modernise China's capital market and corporate governance system. History once again tests the Chinese on their wisdom and determination.

VI CONCLUSION

Large and small investors around the world are hunting for investment opportunities including direct investments, bank deposits, and investing in securities markets or real estate. The development of the securities market in China provides a new channel for capital flow. However, opportunities in securities markets always come

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118 See Baozhong Gao, *Institutional Analysis of Asset Securitization in China* (2005) 161-163.

119 Two notable countries are Japan and Korea. See Baozhong Gao, *Institutional Analysis of Asset Securitization in China* 165 (2005).

with risks. Making informed investment decisions is one way to reduce these risks. It is therefore important to closely watch the investment environment in China's securities market.

Political, social, local, international, economic, and financial pressures all impact on the securities market. The development of China's securities market is part of the economic reform package. The establishment of the market is closely guided and monitored by the Chinese government, and is therefore more responsive to the government's policy changes. However, after the initial stages of development, administrative intervention has become less effective. The problems inherent in China's corporate system and companies have persisted. It is time for the Chinese to respond to these problems and strengthen their regulatory intervention.

Experience indicates that to achieve the goal of the enterprise reforms, China needs to continue to improve its corporate governance practice on the one hand, and standardise securities activities on the other. The two are interactive. Good corporate governance facilitates the transparent operation of the securities market, while an orderly performing securities market can greatly promote good corporate practice in listed companies.