

Scandal-Driven Regulation of China's Stock Market:

Dynamics among the State, Market, and Stockizens

by

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ABSTRACT

Since it was officially established, China's stock market has witnessed rapid cultural, social, economic, and legal transformations during the last two decades. But the development of China's stock market brought with it the frequent occurrence of securities crimes and other types of white-collar crimes that harmed vast numbers of public retail stockholders.

This study reviews sociolegal theories, especially law and finance theories, to shed light on the construction of regulatory mechanisms for the Chinese stock market. The critical point for stock market regulation is to curb securities irregularities and protect investors. This study applies white-collar criminological theories, especially crime-as-choice theories, to link the theoretical analyses of the causes of securities crimes to the laws, policies and practices governing the Chinese stock market. Historical, documentary and policy analyses, case analyses, and analysis of interviews, and observations of weibos and blogs are employed in this study. The data sources consist of: (1) historical information on the development of China's stock market and its regulation, both in terms of legislation and practice; (2) interviews with 40 retail stockholders, each of whom has more than ten years of experiences in stock trading, in two Chinese cities, Shenzhen and Haikou; and (3) online statements and comments of 30 well known Chinese economists, law scholars, financial commentators, lawyers, and securities experts in Sina weibos (microblogs) and blogs.

Based on the analyses, this study suggests revising relevant laws and establishing supporting mechanisms to reduce securities irregularities and crimes in China's stock

market and strength the protection of stock investors. My study also draws attention to the growth of rights consciousness of public retail stockholders, which has potential to propel political and legal reform for the development of the Chinese stock market.

DEDICATION

To Changhua Huang, my father, and Peilian Wang, my mother, whose endless love and patience encouraged me to pursue my life dreams.

To Yong Zhang, my husband, whose sustained support and love encouraged me to complete the study.

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When I faced some difficulties while writing my dissertation, I thought I needed to do something to let my son, William Zhang, be proud of me. This urged me to complete this dissertation. As I remember, when he was only two to three years old, I read the traditional fairy tale *Snow White* to him as I wanted to share with him my childhood. When I told him the happy ending of this fairy tale of the Prince falling in love with Snow White at first sight, Snow White reviving, and they leading a happy life ever after, I expected he would exult at this happy ending like I did. But, he asked me, with a thoughtful expression on his face, “Wasn’t the Prince a stranger to Snow White?”

Did he have a poisoned apple?” His questions took me by surprise and made me so proud of him. I hope he can grow up to be an independent-minded person and a critical thinker. That’s what I should strive for.

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CHAPTER I

INTRODUCTION

Research Context

In 1990, the Chinese government established the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE) and started formal stock trading in P. R. China¹. The stock market was created with the dual goals of raising capital for state-owned enterprises (SOEs) and establishing a modern enterprise system in China. Its initiation was marked by heated ideological debates pertaining to whether this move was capitalist or socialist. Ever since the Chinese Communist Party (CCP) came to power in 1949 and then pushed China to socialism from 1952 to 1956 (Coase and Wang 2012, p. 12), the stock market had been viewed as an evil of capitalism. But once the market was established, Chinese people quickly showed enthusiasm for engaging in the stock market.

The last two decades have seen a swift expansion of China's stock market. In 2010, its total market value reached 26.54 trillion RMB (4.08 trillion US dollar), surpassing that of Japan's and becoming the second largest in the world (CSRC, 2011); in 2013, the total market value of China's stock market dropped to about 23.91 trillion RMB, being the fourth largest in the world (CSRC, 2014). The number of domestic listed companies grew from 14 in 1991 to 2,498 in 2013 (CSRC, 2014). The number of valid stock accounts grew from 370,000 at the end of 1991 to 132,471,500 at the end of 2013 (CSRC, 2014), most of which are personal stockholders'. The Chinese government exclaimed that it took only twenty years for China's stock market to go through a journey

¹ In this study, China's stock market refers to the stock market in mainland China, not including stock markets in Hong Kong and Taiwan.

that required over a hundred years to develop in Western countries (CSRC, 2008). The stock market has become an important part of Chinese people's lives, especially in urban areas. A vast number of stockizens (stock-citizen) —the term used to refer to stock investors or stockholders—have emerged. Chinese stockizens have played important roles in the rapid growth of the stock market and China's subsequent economic development. Some scholars even claim that Chinese stockizens will determine China's future (see, e.g. Wu, 2011).

Accompanying the rapid expansion of China's stock market have been a host of securities frauds and crimes (Chai, 2008; Feng, 2010; Lang, 2004; Li Renhua, 2006; Li Lei, 2009; Liao, 2008, 2013; Mu, 2008; Wu, 2000, 2008; Zhao Xiaoguang, 2006; Zhao Yunfeng, 2011; Zhao and Yang, 2006; Zhou Jianjun, 2008; Zhou Xiangwen, 2008). Wu Jinglian criticized China's stock market as an "unruly casino" (Wu, 2008). Insider trading and illegal manipulation of stock prices are common phenomena in China's stock market (Huang, 2008; Li, Song, Lu, and Zha, 2008; Zhang, 2008; Zhao and Mu, 2008; Zhou, 2009). Although the Chinese government established a series of laws, they have been largely ineffective in controlling securities crime (Feng, 2010; Lang, 2008; Liao, 2008; Zhao, 2006; Zhao and Mu, 2008; Zhao and Yang, 2006). Since they are disadvantaged in terms of capital, information, and expertise, Chinese retail stockholders were often victims of insider trading, manipulation and other securities offences.

Although the Chinese economy developed rapidly and Chinese companies grew fast in the past two decades, the majority of retail stockholders did not profit from their stock investments. It seemed that China's stock market was enhanced at the expense of vast numbers of retail stockholders. In the bear market, corporate or big individual

stockholders could often avoid loss through insider trading, and in such cases retail stockholders would bear the loss (Lang, 2012). Even the mouthpiece of the Chinese government, the website of people.com, published an interview with experts who stated clearly that stockholders were the biggest philanthropist in China (People.com, 2011). The abnormal phenomena that the majority of retail stockholders could not share the achievements of the economic development and were often harmed by rampant securities irregularities ruined investors' confidence in the Chinese stock market.

The prevalent securities irregularities and unfair treatment of public stockholders have roots in China's institutional transition, and reflect the economic, cultural, social, and legal changes taking place in contemporary China. This study applies "law and finance" theories to explore the construction of regulatory mechanisms and the roles of the government and other players in the stock market. The research of La Porta and colleagues (1996) set off an upsurge of study in the field of "law and finance," which surrounds the theme that "law matters" the development of financial markets and stresses the importance of investor protection. As China's stock market is an emerging market in transition, law and finance theories that have been developed and tested in historical and cross-national contexts can shed light on the development of China's stock market and the evolution of market regulation.

Stock market regulation aims to curb securities irregularities and protect investors. This study explores the causes of securities irregularities and related white-collar crimes within Chinese domestic and global contexts. Crime-as-choice theories are applied in this study to link the theoretical analyses of the causes of securities crimes to the laws, policies and practices governing the stock market. This study employs historical,

documentary and policy analyses, case analyses, interviews, and observations of weibos and blogs to address the research questions. Based on the findings, this study proposes some suggestions for further reform and institutional construction. To foster further reform also needs strong social forces. This study draws attention to the rights consciousness and legal awareness of public stockholders that might form a strong force to propel legal reform.

Research Questions

Based on an exploration of the development of the Chinese stock market and the evolution of its regulation, this study examines the institutional and social factors that have bred rampant securities irregularities and related white-collar crime, and aims to propose suggestions for ways to contain securities irregularities and strengthen investor protection. The following research questions will be addressed.

(1) What are the effects of laws and policies governing China's stock market, and how have these changed over time? For example, how did state policies and programs initiate China's stock market? How did laws and policies influence the operation and regulation of China's stock market? Did the loopholes in laws and policies related to the Chinese stock market supply lures to potential offenders? Did relevant laws and rules provide sufficient investor protection and strict measures against offenders?

(2) How is China's stock market regulated? For example, are the implementation and enforcement of laws and rules effective? Is government external oversight credible? Is internal corporate governance effective? What roles did securities firms and other intermediaries play in investor protection? What factors negatively affect

the regulation of China's stock market? What mechanisms might further strengthen market regulation and protect investors?

(3) What have been the experiences of retail stockholders in stock trading, and how do they perceive stock market regulation? For example, how did retail stockholders conduct stock trading? Did they view their stock trading as gambling in a casino? How did they view insider trading, manipulation, misrepresentation, and other securities irregularities? How about legal awareness and rights consciousness of public stockholders?

Data and Research Methods

Historical, documentary and policy analysis, case analysis, interviews, and observations of weibos and blogs are employed in this study to address the research questions. My data sources consist of: (1) historical data on the development of China's stock market and its regulation, both in terms of legislation and practice; (2) interviews with 40 retail stockholders, each of whom has more than ten years of experience in stock trading, in two Chinese cities, Shenzhen and Haikou; (3) online statements and comments of 30 well known Chinese economists, law scholars, financial commentators, lawyers, and securities experts in Sina weibos (microblogs) and blogs.

To collect historical data, I firstly use the official websites of the Shanghai Stock Exchange (SSE), the Shenzhen Stock Exchange (SZSE), and the China Securities Regulatory Commission (CSRC). In China, there are only two stock exchanges, that is, the SSE, established on 26 November 1990, and the SZSE, established on 1 December 1990. These two stock exchanges are governed by the CSRC. The CSRC, established on 12 October 1992, is a ministry-level unit directly governed by the Chinese State Council

to regulate China's securities and futures markets. The official websites of SSE, SZSE, and CSRC have posted historical and current data on listings on the stock market, listed companies, trading and membership, market information, and relevant laws and rules. These sources depict the development of China's stock market and its regulation. From these websites, I can see laws, regulations, judicial interpretations, departmental regulations and provisions, and SSE and SZSE rules from 1990 to the present. I also reviewed media reports and remarks in the China Securities Journal, Securities Times, Wall Street Journal and other financial newspapers and portals in Chinese and English to enhance my understanding of the background of the development of China's stock market. Further, I reviewed scholarly works to get deeper understanding of the development and regulation of China's stock market.

To explore changes over time in the operation and regulation of the Chinese stock market, I review the policies and programs that were implemented to initiate the stock market and the key laws and policies that have influenced China's stock market at different stages. As I proceed, I attempt to highlight the policies, programs, and practices that supplied lures to potential offenders. Then I conduct historical, documentary and policy analyses, and study cases of securities fraud and related white-collar crime. Through the analyses of significant cases in different periods, I investigate the relevant laws and their enforcement of securities crimes, and identify the weaknesses in legislation and law enforcements. This examination allows me to propose suggestions to reduce securities crimes and irregularities and strengthen investor protection.

To explore retail stockholders' experience in stock trading, their views about securities crimes (insider trading, manipulation, financial reporting fraud, illegal

consultation, and so on), and their opinions about the stock market regulation, I conducted interviews with twenty stockholders in each of two Chinese cities (Shenzhen and Haikou). The two cities have witnessed stockholders' enthusiastic involvement in the stock market since its initiation. Shenzhen, since becoming the first special economic zone in China, has been one of the largest economic centers in China. Haikou is the capital city of Hainan Province, which was the largest special economic zone in China in the 1980s. But as the focus of developmental policies shifted, Haikou is no longer an economic center in China today. Currently, Haikou is famous for the high quality of its natural environment, and people here are living relatively slow and cozy lives compared to those in Shenzhen. In order to adopt a historical approach, I selected interviewees who had more than ten years of experience in stock trading. The interviewees in Shenzhen consisted of 8 females and 12 males; the interviewees in Haikou consisted of 10 females and 10 males².

I began interviewing stockholders with whom I already had an acquaintance so that I could gain access, and then I used a loose snow-ball approach to identify other respondents. Although the interviewees were a very small portion of Chinese retail stockholders and findings cannot be generalized to the all retail stockholders, their experience and views could reflect some features of the Chinese stock market regulation and the social atmosphere around it. The interviews were semi-structured. I prepared a set of questions to ask, but I followed the interviewees and adjusted my questions as the interview progressed. The interviews were conducted as relaxed conversations. I talked with the interviewees in the tea house, or took phone interviews if we were not available

² See Table 1 (the description of the interviewees' age, education level, and profession) in Appendix A.

to talk face to face. The length of an interview was flexible. An interviewee even talked with me in a tea house for a whole afternoon. He seemed to like sharing his stories of stock investments and his thoughts about high-profile cases. Compared to a teahouse meeting, a phone interview was much shorter, averaging about thirty minutes. All the interviews covered almost all the questions I prepared. I audiotaped the interviews or took notes if the respondent preferred not to be recorded electronically. In the analysis, these interviews with retail stockholders are coded in the form of “FS01” or “MH01.” The first letter indicates the respondent’s gender, M refers to male, and F refers to female; the second letter indicates the city, S for Shenzhen, and H for Haikou; the third number indicates the order of the interviews.

I also collected online comments regarding the regulation of China’s stock market from Sina weibos and blogs. In the last two years, I followed Sina weibos of 30 known Chinese economists, law scholars, financial commentators, lawyers and securities experts to collect data from their messages related to the regulation of the stock market and the control of securities crimes. They also have blogs that I used for source material. But their weibos provide information on a wider range of topics and have more up-to-date information. The use of weibo in China has grown very fast. Through the internet, weibo users can share their views and words anywhere at any time. Compared to blogs that usually consist of formal articles, weibos provide an easier, faster and more equal form of communications. Sina weibo is one of the largest microblog service providers in China. By 2012, Sina weibo had more than 500 million registered users (Xinhuanet.com, 2013), including a great number of scholars and stars of other circles, for which the service provider confirmed their identities and marked them with a golden letter of “V”

(VIP) following their names in weibo. The experts I followed in my study use their real names in weibo, thus I ensured that the comments reflect their own thoughts. And from their discussions, I observed different views about recent issues involving stock market regulation.

Increasingly, researchers are collecting data from online forums, weibos, blogs, and other internet sources (Chung, 2008; Hartford, 2000; Keohane and Nye, 1998; Kluver, 2005; Liang and Lu, 2010; Lim, 2007; Liu and Halliday, 2009). Based on his ten years of study, Yang Guobin (2013) argued that Chinese internet activists became a strong force to foster social, cultural, and political change in China. In the study of reforms of China's Criminal Procedural Law (CCPL), Liu and Halliday (2009) collected online written discussions related to the CCPL and the practice of defense lawyers from the official internet forum of the All-China Lawyers Association (ACLA). In a footnote in their article, Liu and Halliday (2009) describe that "official censorship and even self-censorship is surprisingly restrained... lawyers on the forum spoke openly and forthrightly, and often very critically, about almost every aspect of legal practice, the courts, the police, the concentration of political power, and the absence of rule of law or democracy" (p. 916-917). I reviewed these experts' weibos every day for two years, and wrote down their comments by hand. The main themes of their comments included discussions on the fundamental defects of the Chinese stock market, the process of making laws governing the stock market (e.g., Professor Cao Fengqi was one of the drafters of the Chinese Securities Law and other laws), the role of securities firms, the weaknesses in the stock market regulation, the adoption of registration system for stock issuance and listing in the near future, and suggestions about further reforms. Their

comments are very open and critical, which displayed the great enthusiasms to urge legal reforms for the development and regulation of China's stock market. These online comments and discussions provided useful sources for my study.

My dissertation will consist of seven chapters. In Chapter 1 (Introduction), I describe the research context, research questions, and data and research methods of this study. In Chapter 2 (Literature Review and Theoretical Framework), I review law and finance theories that have been developed and tested in historical and cross-national contexts to explore the construction of regulatory mechanisms; then I review scholarships of white-collar criminology, especially crime-as-choice theory; I also discuss the growth of rights consciousness of Chinese public stockholders. In Chapter 3, I go over the development of China's stock market and policies and practices of market regulations before the 2004 State Council's Nine Opinions. Then I review the development of China's stock market regulation after the publication of the 2004 State Council's Nine Opinions in Chapter 4. In Chapter 5, I describe and discuss the interviews of public retail stockholders in my study. In Chapter 6, I explore the institutional defects of China's stock market, the weaknesses of the stock market regulation, and propose some suggestions for further reforms. Chapter 7 is the Conclusion.

CHAPTER II

LITERATURE REVIEW AND THEORETICAL FRAMEWORK

Reflections on Financial Regulation in the Wake of the 2000s Global Financial Crises

In the wake of the financial crises early in the 21st century, scholars launched discussions on regulatory patterns and the role of state power in financial market regulation. As Florian Saurwein summarizes (2011, p. 335), starting from the 1970s, the patterns of political steering of economy and society in Western countries shifted “from government to governance (Rhodes, 1996; Rosenau and Czempel, 1992), from hierarchical to a cooperative form of government (Mayntz, 2009, 2003), from an interventionist/positive state towards a regulatory state (Moran, 2002; Majone, 1996, 1999), and even a postregulatory state (Scott, 2004).” But the financial crises, causing damage to the real economy and affecting people on a very large scale, weakened confidence in market and self-regulatory mechanisms (Saurwein, 2011). The exposure of serious financial fraud, such as the Madoff case, demonstrated that regulation had been ineffective and again drew attention to the weaknesses in investor protection within the social context of financialization.

Scholars (Dorn, 2010; Hagan, 2012; Riles, 2011; Shover and Grabosky, 2010; Shover and Hochstetler, 2006) critiqued the deregulation movements resulting from the underlying political philosophy of neo-liberalism that prefers private/self financial regulation to public regulation. In contrast to this major perspective, Arup (2010) argued

that the global financial crises were not just because of deregulation caused by neoliberal policies; instead, the collusion of corporate and state power led to the financial crises. From a global perspective, Arup (2010, p. 363) argues that the collaboration of corporate and state power in the US and the UK shaped the financial market regulation around the world. The financial crises indicated the feature of crony capitalism due to erosion of the economic rule of law, which let the elites grab huge economic and political benefits through rigging the market while ruling out opportunities for the common people (Ramirez, 2013). Dorn (2010, p. 26) calls for “democratization of financial regulation,” which was based on the perspective that the healthy development of the financial market is a public good. Criticizing the view that financial market regulation was just a technical issue, Dorn (2010) argues that government authorities responsible for the public should take charge of financial market regulation and put the regulation under democratic oversight. But due to the difficulty in changing “the culture of elites,” Arup (2010) was pessimistic about the likelihood that financial regulations would be adequately reformed. Dorn (2011, p. 441) also showed his disappointment that the collusion of public authorities and large corporations and interest groups still led to “a continuity in, or even a deepening of, private steering of regulatory rule making.”

In spite of the differences among the discourses, these discussions pointed to how to adjust the regulatory power relationship and realize the effective financial regulation to serve the interests of the common public. China seemed unaffected by the global financial crises since it was not open to the global financial markets. But as some experts challenge, China’s bailout of four trillion yuan in response to the global financial crises, with lax regulation aggravated by corruption of government officials and interest groups,

had negative effects on its domestic financial markets and real economy (Chen, 2011; China.com, 2014; Liu, 2012). This paralleled the effect of bailouts of banks in the Western states as described by Dorn (2011, p. 428), where states became “targets of a mixture of financial speculation and genuine fears and uncertainties over their financial health.” Recently, the Chinese president, Xi Jinping, launched a series of attacks on corrupt high-ranking officials, including provincial governors, ministers, military generals, and even including several vice premier-level state leaders. These cases revealed that these government officials and their relatives actually controlled a bunch of listed companies and received huge benefit from power-money trading with many companies (China Funds Daily, 2014). The scandals showed clear evidence that the Chinese stock market became a platform for systemically transferring interests to the political and economic elites. This calls for an urgent need for further reform to adjust the power relationship and correct the failure of Chinese stock market regulation. As the Chinese stock market is an emerging market in transition, law and finance theories based on abundant historical and comparative studies of financial market regulation across various countries would shed light on political and legal reform for China’s stock market.

Law and Finance Theories

Researchers find that the legal system regarding investor/shareholder protection has great effects on the growth of capital markets (Chen, 2003; Coffee, 1999, 2001; La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV), 1997, 1998, 2000). Weak investor/shareholder protection will hinder further investments or misallocate investments since investors would like to take dividends and not take the risk of continuing investments (LLSV, 2000). Poor investor protection also lowers corporate valuation

(LLSV, 2002). Comparing investor protections (legal rules and enforcements) across 49 countries, LLSV (1997) found that securities markets were more developed in countries with stronger investor protections. A legal system providing outside investors (minority shareholders and creditors) with strong protections against expropriation by insiders (controlling shareholders and managers) will encourage investors to continue investments in stocks and bonds, and thus will promote the growth of capital markets. This reemphasizes the central theme of corporate governance to protect outside investors against expropriation by insiders.

The research of La Porta and colleagues set off an upsurge of study in the field of “law and finance.” As La Porta et al. (1997, 1998) conclude, investor protections are strongest in common-law countries (represented by the US and the UK), in German-civil-law countries and Scandinavian-civil-law countries they are in the middle, and they are weakest in French-civil-law countries. And French-civil-law countries had the least-developed capital markets. In summary, the common law system gives stronger protection to minority investors/shareholders against expropriation by controlling shareholders than does the civil law system. The studies of La Porta et al. drew attention to the impact of legal origin and raised discussions on different families of law in connection with securities regulation and investor protection. But some scholars doubt the determinative importance of legal origin and emphasize law implementation and enforcement of transplanted laws (Berkowitz, Pistor, and Richard, 2003; Pistor, Raiser, and Gelfer, 2000). And some disagree with La Portal et al.’s argument that securities market development in common law countries depends on formal laws providing strong investor protection (Cheffins, 2000; Coffee, 2001). After studying the history of stock

markets in the US and the UK, Coffee (2001) found that before the 20th century the legal system in these two countries did not provide minority shareholders with strong protection, and formal laws lagged behind the development of securities markets. As the securities markets developed, the growth of public stockholders/investors urged legal reforms for stronger investor protection.

Review of early securities market regulation in advanced economies. The development of US securities market regulation was driven by the desire to attract foreign funds for railroad and other capital-intensive industries in the late 19th century (Carosso, 1970; Coffee, 2001). In the early railroad industry, it was common for controlling shareholders to manipulate stock prices, even legitimizing their violation of minority rights by bribing judges and legislatures (Gordon, 1988; Rock, 2001; Coffee, 2001). Legal mechanisms against securities fraud were hindered by the limited scope of laws, judicial corruption, and especially the weak enforcement of laws (Friedman, 2005; Banner, 1998; Coffee, 2001). To attract foreign investors, the US securities market improved corporate governance systems and increased self-regulation through exchanges (Michie, 1987; Coffee, 2001). On the one hand, to gain the trust of foreign investors and ensure the safety of investments, US investment banks spearheaded by J.P. Morgan represented clients to protect their interests and built mechanisms into corporate governance structure to realize their representation. For example, a common practice was for investment banks to send representatives to the issuer's board, and then this became institutionalized in the corporate governance system. This effective means of investor protection increased the stock values of the firms. Moreover, the rise of corporate mergers increased the size of listed companies and thus led to dispersed ownership.

On the other hand, the New York Stock Exchange also played an important role in promoting corporate governance and investor protection (Seligman, 1995; Ripley, 1927; Coffee, 2001). The small-sized NYSE provided restrictions on membership, a high cost of entry, relative freedom to get outside capital, fixed brokerage commissions, and conservative policies in listing stocks, which resulted in high trade volumes, high-quality members, and a good reputation (Michie, 1987; Coffee, 2001). The NYSE also promoted disclosure rules and modern financial reporting standards before the US federal securities laws went into effect in 1933 (Hawkins, 1986; Ripley, 1927). Moreover, the NYSE prohibited listing nonvoting common shares and ensured voting rights of minority shareholders, and thus restricted controlling shareholders from expropriating minority shareholders (Seligman, 1986; Ripley, 1927). Through such means, the NYSE promoted dispersed ownership and fostered “shareholder democracy” (Coffee, 2001, p. 38). As scholars conclude, a concentrated ownership system tends to have low disclosure, lack of transparency, and weak protection for outsiders, so the market cannot play an active role in corporate governance, and this constrains further development of stock markets (Claessens, Djankov, and Lang, 2000; Lang, 2010; LLSV, 1997). In contrast, a dispersed ownership system could avoid the abovementioned risks, and encourage strict disclosure, transparency, market disciplinary mechanism, and thus promote strong stock markets (LLSV, 1997; Coffee, 2001).

In summary, the self-regulation based on oversight by the NYSE of its listed firms and the self-bonding mechanisms between US investment banks and stock issuers, increased dispersed ownership and promoted a strong liquid stock market before formal legal mechanisms were developed in the US (Coffee, 2001). While the NYSE played an

active role in self-regulation of the US stock market, the London Securities Exchange (LSE) adopted a *laissez-faire* approach and began to monitor the quality of stock issuers in the wake of a series of scandals in the 1920s (Michie, 1987). Despite the prevailing political philosophy of social democracy in the US in the 1930s and the leftist trend in the UK in the 1960s, neither government actively intervened into the securities markets (Coffee, 2001; Michie, 1987). Following economic development and securities market growth, self-regulation in the two countries fostered the establishment of legal mechanisms to maintain dispersed ownership. It was financial development and the consequent struggles of massive public shareholders as a growing political force that propelled legal reforms for investor protection (Coffee, 2001).

While the US and the UK governments' inactive involvement helped the development of securities markets, the French and German governments' intrusive interventions curbed the growth of their early securities markets. In contrast to NYSE and LSE as private bodies, the Paris Bourse was a state-administered monopoly, and its agents were officially appointed by the government (Poser, 1991; Goldman, 1992; Coffee, 2001). Under strict control of the government, the Bourse had no real owners, and thus lacked the incentive to develop. As Coffee (2001) argues, the French pattern of paternalist government control did not let self-regulation grow in the early French stock markets, while as mentioned above, in the US the government's inactive involvement provided room for the growth of self-regulation in the securities industry. Although the government strictly controlled the Bourse, the French securities market still had a poor reputation for low quality issuers and lack of transparency (Nunes et al., 1993; Coffee, 2001). This was attributable to the ineffective governmental supervision and lack of self-

regulation. The German securities market regulation in the 19th century reflected the conflicts between the German government and the emerging middle class that favored the stock market (Brophy, 1998; Coffee, 2001). The German government promoted liberal lending by banks and decreased the use of the stock market (Baker, 1970; Coffee, 2001). In the 1890s, heavy taxes on securities transactions and the 1896 Stock Exchange Law as punitive regulations further damaged the German stock market (Brophy, 1998; Coffee, 2001). The state's antagonistic policies and legislations led to the disruption of German stock market (Baker, 1970; Coffee, 2001).

Based on the historical analyses, Coffee (2001) reconsiders the relationship between laws and securities market development as the theme of LLSV studies, and concludes that the development of securities markets appeared to follow a “crash-then-law” cycle (Partnoy, 2000; Banner, 1997), in which formal legal mechanisms usually developed after market crashes. Since the 1960s, major European countries began to copy the US legal and formal mechanisms (e.g., strict legislations, SEC-like regulatory agency, and strong enforcement), and self-regulation exchanges similar to the NYSE (Goldman, 1992; Coffee, 2001). At the end of the 20th century, European stock markets developed quickly in terms of the number of listed companies, market capitalization as a percentage of GDP, and equity capital raised through IPOs; in addition, concentrated ownership is fading in European countries (Coffee, 2001). Based on the comparative studies, Coffee (2001) also critiques the “path dependence thesis” of Bebchuck and Joe (1999) that applies a political explanation for the corporate governance and ownership and argues that political tradition would constrain the growth of securities markets in European social democracies. The various origins of legal differences seem not to be the critical

reason for different developmental levels of securities markets. The transplantation of legal mechanisms for stock market regulation in European countries appeared to follow what Coffee (1999) called functional convergence.

Studies on transitional economies. Law and finance scholars showed great interest in securities market regulation in transitional economies and reflected on how legal transplants work on securities markets in these countries. Coffee (1999) compared the Czech and Polish experiences of securities market regulation in the process of privatization in the 1990s. These two countries were analogous in terms of economy, geopolitics, history, and culture. The Czech adopted a fast approach to privatization and made little effort in securities market regulation. But a few years after its initial prosperity, the Czech securities market experienced sharp declines and then collapsed (Green, 1999; Coffee, 1999). The failure of the Czech securities market was the consequence of deregulation that led to the absence of transparency, lack of incentives to restructure investment funds, rampant insider trading, and serious tunneling phenomena, among other market abuses, which ruined the confidence of foreign and domestic investors (Thiel, 1998; Coffee, 1999; Rouwenhorst, 1999).

In contrast, Poland adopted a slower and more cautious approach to privatization (Estrin, 1999). Although the Polish and Czech substantive corporate laws were very similar, based on the German civil law system, they adopted different paths to securities regulation. Poland applied strict disclosure standards, ownership transparency rules, takeover regulations, and established a regulatory agency like the US SEC (Estrin, 1999; Coffee, 1999). To monitor the securities markets and protect smaller shareholders, Poland created state investment funds to control the privatized firms and serve as the only

agencies for citizens' investment of voucher certificates (Estrin, 1999; Coffee, 1999). At the same time, Poland prohibited the establishment of private investment funds and forbade citizens' direct investments in stocks of newly privatized firms. The strong securities regulation and investor protection led to the more successful stock market in Poland in terms of liquidity, market performance, resistance to outside financial crisis, and so on (Coffee, 1999).

Russia's experience of privatization was another demonstration that deregulation led to securities market failure (Fox and Heller, 1999; Coffee, 1999; Black, Kraakman, and Tarassova, 1999). In the process of privatization, the majority of stocks of privatized firms were assigned to the insiders, especially incumbent managers, who became controlling shareholders through buying shares from minority shareholders, thus forming highly concentrated ownership structures. In addition to controlling shareholders, local governments looted privatized firms in the absence of effective regulation (Fox and Heller, 1999). Furthermore, the underdeveloped legal system and worsened macroeconomic condition in Russia at that time aggravated the problems of securities regulation and investor protection (Black et al., 1999). Following the study of La Porta et al. (1998), Pistor and her colleagues (2000) examined legal protection of investors in 24 transitional economies. They also find that in transition, incumbent managers often took control over the state-owned enterprises and then grabbed the ownership in the absence of state oversight during the process of privatization. Consequently, outside investors had to bear the risks of being expropriated by the incumbent managers. Another prominent problem was that the government based on the residual state-ownership often intervened into decision making of companies.

Although transitional countries usually attempted wholesale legal transplants from advanced market economies, especially from the US, empirical data showed that the legal transplants often failed since transplanted laws could not be adapted well into local conditions and lacked strong enforcements (Pistor et al., 2000). Berkowitz et al. (2003) also posited that the process of legal transplantation is more significant than its legal origins. Pistor et al. (2000) studied the content and enforcement of the corporate law in six countries that transplanted laws from other countries, and compared them to those of origin countries. They found that the evolution of the corporate law in these countries was different from that of the origin countries. The more important problem was the enforcement of transplanted laws. As scholars emphasize, the law in action is more important than the law on the books in promoting investor protection (Pistor et al., 2000; LLSV, 2000). Even with sufficient laws transplanted from advanced market economies, weak legal institutions and enforcements in transitional economies still could not provide strong investor protection. Transitional economies need to adapt transplanted laws to their own conditions and establish their own legal orders for effective enforcement (Pistor et al., 2000; Coffee, 1999; Berkowitz et al., 2003).

Studies on East Asian cases. Claessens et al. (2000) have examined 2,980 listed companies in nine East Asian economies and have found high concentrations of control by large families everywhere except in Japan, as more than two thirds of these companies were controlled by a single shareholder each. The big families usually accomplished the control via pyramid structures, cross-holdings, and other means (Claessens et al., 2000, p. 82; Lang, 2010). For example, in Hong Kong, the largest 15 families held corporate assets worth 84.2% of the GDP in 1996. In contrast, in the US the 15 richest families had

wealth worth only 2.9% of the GDP in 1998 (Claessens et al., 2000, p. 108-109). The highly concentrated ownership would result in poor corporate governance and would restrain legal reforms for investor protection (Claessens et al., 2000; Lang, 2010; Coffee, 2001). Without adequate protective mechanisms, minority shareholders had to bear high risks of being looted by the insiders, especially in market declines. The Asian financial crisis around 1997 exposed weak securities market regulation and poor corporate governance (Johnson et al., 2000; Lang, 2010). Studying securities markets in 25 economies during the 1997 Asian Financial Crisis, Johnson et al. (2000) have concluded that weak investor protection and ineffective law enforcement contributed to the capital market collapses. The problems of corporate governance and market abuses revealed in the Asian Financial Crisis were similar to those in the US in the 1920s (Coffee, 2001). These studies of Asian economies showed evidence of “crony capitalism” in that large families had close connections with the government and exerted great influence on economic policies and legal systems (Claessens et al., 2000; Lang, 2010).

Case studies of China. Chen (2003) provided China’s case as evidence for Coffee’s (2001) “crash-then-law” pattern. In an emerging market like China’s stock market, market growth comes before legal reforms. As observed by Chen (2003), the constituency of stockholders that have a common interest and easily measured damages caused by securities fraud would form a powerful force to foster legal reforms for investor protection and change China’s legal tradition. This “crash-then-law” model was seen in the 1993-1996 bear market that forced the CSRC to apply more aggressive administrative sanctions to attack securities offenses, and then again in the 2001-2003 bear market that urged legal changes to allow civil litigation against securities fraud

(Chen, 2003). The “crash-then-law” perspective does not deny the importance of legal regulation to securities market development, but addresses the time sequence of the emergence of legal and formal regulation and market development in the early stage of stock markets. To further develop stock markets, legal protection of investors should be improved. As Chen (2003) concluded, the “law-then-growth” pattern is applied in a more mature securities market, while “crash-then-law” or “growth-then-law” model is shown in an emerging market.

Pistor and Xu (2005) investigated China’s emerging stock market and found that it performed much better than those in other transitional economies, especially in terms of listed companies’ capacity to raise funds. But China’s performance in formal laws about shareholder protections and law enforcement was below average for transition economies (Pistor et al., 2000; Allen, J. Qian, and M. Qian, 2005; Pistor and Xu, 2005). Pistor and Xu (2005) argued that administrative governance based on the quota system, which started in 1992, was an effective means of regulation in the absence of formal legal mechanisms in the initial stage of China’s securities markets. As they stated, China’s experience was a good example that when the legal rules are not sufficient to govern the stock market, administrative regulation is an efficient supplement to court rulings since the administrative agencies can investigate and punish wrongdoings timely. But mechanisms should be set to curb power abuses by the administrative regulator. They also emphasized that China must develop formal legal regimes to meet the need of securities market growth in the long run.

Local Chinese scholars also follow La Porta et al.’s studies to test law and finance theses within the Chinese context. Shen Yifeng et al. (2004) applied the indices used by

La Porta et al. to measure China's investor protection and concluded that Chinese legislation on investor protection has been strengthened gradually, which fostered the development of the stock markets. Pi (2010) conducted comprehensive analyses on the data from different Chinese provinces from 1995 to 2005 and concluded that without considering governmental actions, improvement in the legal system has positive effects on financial development through increasing the growth of financial intermediaries and financial marketization. Although Pi found that the government helped foster financial development in the early stage of economic transition, the study does not deny LLSV's conclusion that strong legal protection will promote securities market development. The Chinese stock market has become one of the largest in the world, but China's financial system is still dominated by an inefficient banking system that mainly served state-owned enterprises without placing the priority on loan repayment and investment return, and stock prices and investor actions could not reflect the real values of listed companies (Walter and Howie, 2011). Allen et al. (2005) investigated Chinese listed companies and other private enterprises. They applied the measures of investor protection and indices used by LLSV to compare China with the 49 countries in LLSV's study. They found that China was in the middle of common law countries and German civil law countries in terms of investor protection legislations; but China was far below the average level in LLSV's study in terms of law enforcement (such as rule of law, corruption, among others). Compared to India and six other big developing market economies, China's index of corruption was the worst. Through this study, Allen et al. (2005) found that private enterprises used informal financing channels based on connections and reputation and implemented corporate governance based on competition. These informal

mechanisms rooted in Chinese society helped reduce firms' pressure to raise funds and improve corporate governance, contributing to the fast growth of China's economy. Thus, Allen et al. concluded that China's case was an exception to LLSV's thesis.

Allen et al. (2005) conducted case studies on China's two famous private enterprises, Wahaha and SiTong, and investigated corporate governance of state-owned enterprises listed in stock exchanges. They found that corporate governance in private enterprises was better than that of state-owned listed enterprises. But some Chinese scholars argue that private enterprises grew faster than state-owned listed companies, not because of informal mechanisms used by the former, but due to the poor performance and corporate governance of the latter (Pi, 2010). Although this argument conflicts with the conclusion of Allen et al., they reached an agreement that state-owned listed companies did not do well in performance and corporate governance. This is consistent with Lin Yifu's (2002) finding that SOEs listed on stock exchanges for more than five years were not better than those not listed in terms of performance and corporate governance. The Chinese government initiated stock markets to collect funds, introduce modern enterprise systems, and improve the corporate governance for state-owned enterprises. But Lin Yifu's (2002) research found that the stock market did not achieve the goals of state-owned enterprises reform, specifically improving their performance and corporate governance.

Implications for China's securities market regulation. Law and finance theories provide economic justifications for investor protection and display a general frame for securities market regulation (LLSV, 1998; Pistor et al., 2000).

Crash-then-law vs. law-then-growth. Coffee's (2001) "crash-then-law" pattern has implications for transitional economies; even with weak legal institutions, securities markets still can grow through improving corporate governance and self regulation by stock exchanges. The self-regulation mechanisms for minority investor protection arose under the circumstances that competition and innovation were effective (Coffee, 2001). When the market crashed, the state under the pressure of public investors made laws and formal mechanisms to improve investor protection. Self-regulation systems such as stock exchange rules could be the functional substitute before the establishment of formal legal mechanisms for minority investor protection. But strong formal legal protection is the precondition for a fully fledged market (Coffee, 2001). Public investors through common struggles for rights protection formed a powerful political force to propel legal reforms. The 1930s federal securities laws in the US and the 1940s Company Act Amendments in the UK were the outcome of securities market development and the struggling of public investors as a growing political force for stronger protection (Coffee, 2001).

As studies show, the "crash-then-law" pattern was seen in transitional economies. For example, the Czech Republic enacted legal reforms to strengthen investor protection after its stock market collapsed as a consequence of scandals that ruined investors' confidence (Coffee, 1999; LLSV, 2000). China also saw the "crash-then-law" pattern in two long bear markets (Chen, 2003). Although Coffee (2001) provides evidence inconsistent with the LLSV's assertion that the emergence of dispersed ownership and liquid market depends on strong legal protection of minority shareholders, he does not deny the importance of law on securities regulation and argues that strong legal protection of minority investor rights is the prerequisite of a mature securities market.

Coffee (2001) just tends to define law in a broader sense, not confined to formal laws as narrowly defined in LLSV's study. Regardless of which direction the causality goes between financial development and legal reform, the point is that a good legal system with strong investor protection can promote financial development.

The “crash-then-law” pattern can be used to address the hot debates in China on whether the securities market with serious scandals should be closed and then reopened when the legal environment is ready. The legal reform for securities market regulation evolves to meet political, economic, and social changes. It will be an evolving process of learning, doing, and adjusting for market regulation. With the market growth, the development of legal consciousness of public investors in China will be the critical force to propel legal reforms.

Formal convergence vs. functional convergence. As La Porta et al. (1997) conclude, a common law system provides better protection for minority shareholders and breeds stronger stock markets than a civil law system does. For example, common law judges can interpret fiduciary duty broadly (Johnson et al., 2000), with the result that controlling shareholders have less political influence (La Porta et al., 2000), and investors have more rights against corporate directors (Coffee, 2001). Particularly, the US allows class-action as a grievance mechanism for public shareholders (La Porta et al., 1997). But it is not necessary to accomplish legal formal convergence to build good regulation of securities markets (Coffee, 2001). As LLSV (1998, p. 18) stated, they use the index of legal origin just as “a proxy for the law’s general stance toward outside investors.”

Like the civil law system, the Chinese legal system based on statutory laws will encounter legislative lag, which made it difficult to deal with emerging problems. And

judges lack independence and flexible discretion to handle cases against securities market abuses. Moreover, law enforcement often faced resistance from administrative intervention, local protectionism, and corruption. For China's emerging securities market in transition, it is a feasible way to achieve functional convergence in implanting laws and building enforcement mechanisms aiming to strengthen investor protection. Corporate governance reform for investor protection will face opposition from major firms, controlling families, and other interest groups that exert political influence on reform. LLSV (2000) suggested applying enforceable rules and regulations in the existing political and social contexts. The 1930s US securities law reform is a successful example, which combined supervision by the powerful SEC with self-regulation by private intermediaries to enforce strict accounting standards and disclosure rules.

Political ideologies vs. legal determinants vs. economic preconditions. Mark Roe (2000) argued that the political tradition accounted for concentrated ownership and hindered securities market development in European social democracies. As the political tradition of social democracy placed more importance on high employment than profit maximization, firms were forced to use more capital and resources for other constituencies. To counteract high managerial agency costs imposed by political pressures, concentrated ownership is adopted to avoid expenses from management oversight and information disclosure. Bebchuck and Roe (1999) held a path-dependency view and argued that high private benefits from control over the company would cause the controllers to restrain the forming and maintaining of dispersed ownership. Coffee (2001) thought that Roe's (2000) political-precondition thesis, Bebchuck's (1999) path-dependency perspective, and LLSV's (1998) legal-determinant view have in common the

idea that the development of liquid stock markets depends on the legal or political ways to protect outside investors. Coffee showed historical evidence inconsistent with the above theories. As Coffee (2001) found, from the end of the 19th century until the 1930s in the US and the 1960s in the UK, both countries lacked strong legal protections for outsider investors, but dispersed ownership grew and made private corporations become publicly owned. Thus, Coffee (2001, p. 22) concludes that the relationship between law and finance is “reciprocal and interactive.”

Furthermore, Coffee (2001) drew attention to broader political traditions and social contexts that affected legal institutions and in turn were forged by legal institutions. As Coffee (2001) pointed out, the difference between the common law system and the civil law system is that the former was friendlier to private action and encouraged self-regulation, which helped breed stronger securities markets in the US and the UK. In the US in the late nineteenth century, insufficient laws, judicial corruption and weak enforcement drove people to resort to arbitration and self-regulation (Gordon, 1988; Rock, 2001; Friedman, 2005; Banner, 1998; Coffee, 2001). Decentralized power and flexible common laws helped foster a market economy and the growth of stock markets.

In this century, openness to trade, cross-border capital flow, and mass privatization propelled the development of stock markets in Europe (Coffee, 2001). China is also experiencing these economic changes and has adopted a gradual approach to decentralization in economy. But reforms often encountered resistance from pre-existing institutions and old influences. More attention should be paid to the “path dependence” (North, 1981) that comes from a long tradition of Confucian cultures (laying stress on family, connection, etc.) and the legacy of the socialist planned economy

system in the evolution of securities market regulation (Pi, 2010). Allen et al. (2005) found personal connections and reputation could serve as informal mechanisms helpful for economic development, e.g., fund collection based on connections could reduce the capital pressure of firms. But “connection” also exerts negative influence on the regulation of securities market. Those with connections to relevant government officials or corporate insiders would get inside information and could grab huge profits from stock trading, and then formed interest groups in the stock market. The Chinese stock market was criticized as a “connection market.” The interest groups formed in the stock market even used their connections to affect legislators, regulators, and courts, and would restrain legal reforms in order to maintain their interest (Pi, 2010).

Moreover, due to the legacy of the socialist public ownership system, the government has also served as the controlling shareholder for the listed state-owned enterprises. When the interests of state-owned enterprises represented by the government conflicted with the interests of private stockholders, the regulators as governmental departments and the courts lacking independence were often put in an embarrassing position in dealing with the matters. In the meanwhile, stock markets accumulated institutional contradictions (Jiang and Xu, 2006). The coexistence of old and new institutions in the gradual reform would result in dilemmas in regulation. For example, in state-owned listed companies, the rule by the party committee system conflicts with the rule by shareholder meetings or the board of directors system provided by the Company Law. China needs to set laws to delineate rights and duties of parties in the market, to give more room for stock exchanges and self-associations to make private laws and self-regulation to check the state power (Y. Lu, 2008; Pi, 2010; F. Cao, 2014c). At the same

time, the Chinese stock market should follow market principles and the modern enterprise system should be fully established to improve corporate governance (Y. Lu, 2008; Lang, 2012; Pi, 2010).

Self-regulation vs. formal regulation. Law and finance perspectives place importance on formal laws and regulation in securities market development and economic growth. But as La Porta et al. (2000) stated, some “law and economics” perspectives doubt the necessity of formal legal regulation of financial markets since investors and entrepreneurs are bound to their contracts and bear the risks of contract violation, so the market only needs judicial enforcement of contracts as a grievance mechanism (Stigler, 1964; Easterbrook and Fischel, 1991). These scholars felt that the self-bonding system was based on companies’ incentives to increase stock values, thus companies had to fulfill fiduciary duties and comply with investors’ contracts; and learned parties were more competent than regulatory agencies to make financial contracts to meet specific circumstances (Jensen and Meckling, 1976; Stigler, 1964).

In the age of Reagan politics, the market fundamentalism that called for unbridled markets “rationalized and enabled white-collar crime as acceptable and expected in the life of a market” (Hagan 2012, p. 2). Regulation was even regarded as a negative effect on markets, which resulted in the deregulation movements and the policies preferring self-regulation or self-discipline (Friedrichs, 2007; Hagan, 2012; Joseph Stiglitz, 2010: xiii; Williams, 2008). Doubts about the “regulatability and governability” of markets also contributed to deregulation movements (Williams, 2008, p. 485). Some scholars argue that stock exchanges should be superior to the government in market regulation (Mahoney, 1997). Although the US’s and the UK’s early experience show that a private

bonding system and self-regulation would be a functional substitute in the absence of adequate legal protection of minority investor rights, securities markets could not fully develop without strong legal mechanisms to reduce risks of market crashes and maintain public investor confidence (Coffee, 2001). The limitations of self-regulation are that without effective competition, stock exchanges as private bodies lack strong incentives to sanction their own members, and they are incompetent to investigate, punish, and enforce their rules. In addition, even a strong self-regulation system often needs the support of state regulation in its enforcement.

Without a public regulatory agency, minority investors need to go through the difficult process of damage claims by themselves and cannot afford costly actions and enforcements. As the securities market has grown to a huge scale and faces more complex situations, the limitations of self-regulation have become more pronounced. Further, serious consequences caused by rampant fraud urge the development of formal legal mechanisms to determine violations and enforce more severe criminal penalties and punitive fines against offenders (Coffee 2001). As LLSV (2000) point out, debates over whether the market, administrative regulation, or criminal sanction is the most efficient way to protect investors distract from the greater need to implement comprehensive regulation of securities markets. It's the combination of well-functioning private contracting, self discipline, administrative regulation, and legal rules that can help make good capital markets

Governmental regulation vs. statist intervention. A strong governmental regulation is necessary for governing securities markets, but the problem is how to exert appropriate regulation while avoiding excessive intervention. Analogous to European

countries, China's political tradition of paternalism characterizes the governance of its financial system, including securities market regulation. Like those in European countries, banks and financial intermediaries in China are state-controlled and subject to political pressure, and thus cannot guarantee strong protection for minority shareholders. As scholars pointed out, concentrated ownership was adopted to maintain the control by existing interest groups based on the collusion of the politically and economically powerful, while dispersed ownership arose as the private sector grew without excessive statist intrusion (Claessens et al., 2000; Coffee, 2001; Lang, 2010).

China's securities markets seem a counterpart to those in France in the late nineteenth century in terms of direct governmental intervention in deciding listings. Parallel to Germany's bank-centered system, China's bank system is closely controlled by the state and the state-owned-banks follow government instructions to provide SOEs with huge capital resources. This kind of bank-centered system made stock markets less important in fundraising. Germany's antagonist attitude toward securities markets was driven by scandals in the commodity market that made the government regard securities trading as gambling (Coffee, 2001). France's excessive state intervention and Germany's antagonism interrupted the securities market development (Coffee, 2001), which is a lesson for China on how government exerts appropriate intervention in securities market regulation.

Government regulation is an efficient and effective way when the legal system and the judiciary are weak in transition economies, which is demonstrated by the contrast between Poland and the Czech Republic (Coffee, 1999; LLSV, 2000). China's quota system was also a good example of administrative regulation in the absence of formal

legal mechanisms in the early stage of the securities markets (Pistor and Xu, 2005). But government regulation should be used to curb market abuses and securities fraud, while the government should not be actively involved in the direct decisions of stock trading and other economic activities. Otherwise, when the government is both an player and referee in the market, it could hardly remain neutral and guarantee strong protection for outside investors.

Insiders vs. outsiders. Investor protection is a central theme of law and finance studies. It is critical to deal with the relationship between insiders and outsiders. In other words, the task is to protect outsider investors against expropriation by insiders. Conflicts of interest between insiders and outside investors result in agency problems (Berle and Means, 1968; Jensen, 1989; Jensen and Meckling, 1976). Conflicts in a company with dispersed ownership usually occur between managers and minority shareholders, and in a company with concentrated ownership usually happen between controlling shareholders and minority shareholders (LLSV, 2000). Insiders often loot outside investors through “tunneling,” which refers to the transfer of assets, capital, resources, and opportunities of a company to its insiders at the expense of its minority shareholders/outside investors (Johnson, La Porta, Lopez-de-Silanes and Shleifer, 2001).

Tunneling includes self-dealings (dealings between the insider and the company) at below-market prices, extremely high salaries for top managers, guarantees for the insider’s companies, diluting shares, and using insider information in financial transactions (Johnson et al., 2001). Majority shareholders and managers, through their control over the board or shareholder meetings, made self-dealings the legal actions of the corporation and would not take responsibility for the self-dealings. On the other hand,

minority shareholders were denied access to information of self-dealing transactions, excluded from decision making, exposed to risks of being expropriated, and lacked relief mechanisms. China's securities markets saw rampant tunneling revealed in scandals.

In market economies, courts use the duty of care and duty of loyalty (fiduciary duty) to judge whether a transaction constitutes tunneling (Johnson et al., 2001). But the "business judgment rule" is often applied as a defense for self-dealing transactions. The duty of loyalty is aimed at conflict of interest and doesn't allow the management to profit themselves at the expense of shareholders and investors. But the civil law jurisdiction strictly relies on statutes while the common law courts handle self-dealing transaction cases based on the general principle of fairness to minority shareholders/investors. Even in developed economies, tunneling is common and often legal. But in recent years, advanced civil law countries have promoted stock markets with stronger minority protections in order to attract foreign capital and boost technology development. For less developed countries, the 1997 Asian crisis warned the governments of legal failures that accommodated tunneling and impeded securities market regulation, thus negatively affecting economic growth (Johnson et al., 2000).

In Asian countries with the same cultural background of Confucian tradition, "connection" still exerts great influence on securities markets. The 1997 Asian financial crisis revealed poor corporate governance and weak law enforcement in financial market regulation. In market declines, minority shareholders were expropriated more seriously than under conditions of market increases. With political power as their protective umbrellas, big families via concentrated ownership system controlled firms and expropriated public shareholders. This close connection between the political elite and

big families characterizes the so-called crony capitalism in Asian countries. Chinese economists also warned that China is approaching crony capitalism since the collusion of the politically and economically powerful formed interest groups to control the national economy (Wu, 2000; Lang, 2010).

Research concludes that interest groups exert great negative effects on financial development (Rajan and Zingales, 2003). Vested interest groups tend to hinder financial development, especially in economic recessions. Rajan and Zingales (2003) argued that it would be a good way to weaken the power of vested interest groups by enhancing innovation, openness, and competition in the market. Beck et al. (2001) pointed out that compared to a centralized political structure, a decentralized, open, and competitive political structure could work better to reduce the impact of interest groups and enhance long-term financial development. In transitional economies, legal reform will confront more difficulties from vested interest groups. Interest groups that benefit from privatization, often at the expense of the public, tend to maintain the status quo and lack motivation for legal reforms (Hoff and Stiglitz, 2001). Especially for stock markets, big families would like to resist legal reforms that would strengthen minority protection and reduce expropriation by insiders. To prevent the formation of crony capitalism and achieve economic justice, it's critical to improve corporate governance and strengthen the protection of public investors.

How to strengthen investor protection, especially for minority shareholders, is central to improving corporate governance of listed companies and advancing legal reforms to foster stock market development. To improve the legal protection of public investors, we cannot neglect the broader context that shapes institutional arrangements

for stock market development, regulation, and investor reaction. China's stock market was initiated to serve state-owned-enterprise reforms. The stock market acted as a buffer for conflicts from different groups, and public investors bore the cost of reforms (Y. Lu, 2008; Pi, 2010). Especially, power-money trading under the administrative examination and approval system and the weak supervision mechanisms resulted in hidden rules in China's stock market. A series of scandals ruined the reputation of regulators and the confidence of investors.

In summary, law and finance theories can inspire China to establish the notions of investor protection, comprehensive regulation, and effective enforcements, and this will provide valuable implications for legal transplants. First, before the implementation of strong formal legal mechanisms, self-regulation through exchanges would be a good substitute to manage securities markets. Second, competition in open and transparent markets based on strict disclosure rules and listing standards will help strengthen self-regulation and corporate governance. Third, legal transplants will be ineffective if we just copy the common law rules and the government still actively intervenes in economic decision-making in the private sector. Finally, market development will foster growth of publicly dispersed shareholders as a political force struggling for rights protection.

Improvement of securities regulation needs comprehensive reform in legislation, the judiciary, and enforcements. Surrounding the central point of investor protection, the critical question is to balance the dynamics among the state, market, and participants in regulating securities markets. Market mechanisms should operate through self-regulation by the stock exchanges and associations in an open and transparent market with effective competition and innovation (Coffee, 2001). The last and the most important point is that

the state should be the last resort for regulation and it should focus on fighting against market abuse, fraud, and crime.

White-Collar Criminological Analyses of Securities Crimes

Defining securities crime: the concept of white-collar crime. Given ambiguous perceptions of securities crime, a discussion of the broader concept of white-collar crime should be helpful. White-collar crime was originally defined by Edwin Sutherland (1983, p. 7) as “approximately a crime committed by a person of respectability and high social status in the course of his occupation.” White-collar crime was brought forward to draw more attention to wrongdoings of persons with relatively high social status whose injurious behaviors are often ignored or tolerated by society. In this sense, white-collar criminology places more importance on equality and fairness in applying the law to constrain the advantaged from violating the rights of the disadvantaged.

The academic community has widely supported Sutherland’s broad concept of crime. For example, Raymond Michalowski (1985, p. 317) concurred with Sutherland, arguing that criminology’s subject matter should include “analogous social injuries” that refer to “legally permissible acts or sets of conditions whose consequences are similar to those of illegal acts.” Another way to give an expansive definition of white-collar crime is to adopt the sociological concept of deviance that Robert Merton (1938) introduced in his work, *Social Structure and Anomie*. Further, the concept of white-collar crime has been expanded to include corporate and state crimes or elite deviance (Cullen, Cavender, Maakestad, and Benson, 2006; Ermann and Lundman, 2002; Hagan, 2012; Simon, 2006).

Previous studies revealed that white-collar crimes or elite deviance cost more than street crimes, but the economically and politically powerful were less vulnerable or

immune from criminal punishments (Cullen et al., 2006; Hagan, 2012; Reiman, 2007; Rosoff, Pontell, and Tillman, 2007). This unfairness in the application of the criminal law to street crimes and white-collar crimes was embedded in the political and social context. In the book *Who Are the Criminals*, Hagan (2012) explores how the politics framed social attitude and shaped criminal policies toward street crimes and suite crimes. As Hagan (2012) points out, the age of Reagan politics framed “the fear of the streets” (p. 137) and “the freeing of the suites” (p. 168), and led to excessively severe attacks on street crimes and lax regulation over white-collar crimes. Especially for the financial market, the belief in the free market led to the reduction of governmental oversight and the preference of self regulation by the financial sector. It resulted in the decriminalization of financial crimes and lenient treatments to financial wrongdoers (Hagan, 2012). This also concurs with Chambliss’ (1975, p. 165) assertion that “crime is a matter of who can pin the label on whom, and underlying this socio-political process is the structure of social relations determined by the political economy.”

As Sutherland (1940, p. 6) argued, “an unlawful act is not defined a criminal by the fact that it is punished, but by the fact that it is punishable.” The narrow legalistic definition of crime fails to explain the process of criminalization, reflect the transitory nature of the criminal law, and to consider political and social contexts that affect the legal treatment of criminal behavior and offenses (Jones, 2009). China’s stock market is a newly developing capital market and has grown fast in the institutional transition characterizing contemporary China. The expansive definition of securities crime, as a subfield of white-collar crime should be applied to reflect the transitory legal system in China. And the expansive definition will highlight the institutional and social factors that

account for the discrepancy between the lenient legal treatment and serious consequences of white-collar offenses in China's stock market.

From the historical perspective, the definition of securities crime has transformed over the past twenty years, reflective of the larger transformation of the Chinese legal system. When the stock market was first established, China lacked specific criminal laws to regulate its activities. This began to change in 1997, when the Chinese Criminal Law was revised and specific articles were provided to identify securities crimes. The first criminal case of a securities offense occurred in 1998, although statistical reports show that the China Securities Regulation Committee (CSRC) investigated and punished a great number of securities frauds since it was established in 1993 (Liao, 2008). If a narrow legalistic approach is applied, many of the securities offenses that occurred before specific laws were established would fall outside the scope of "crime." In addition, securities offenses have evolved many new forms with the rapid development of information technology. Due to the lag of legislation, the existing statutory criminal laws cannot identify all serious securities offenses.

Even with passage of specific laws, the regulatory agencies still tend to adopt administrative punishment to deal with securities offenses in China (Lang, 2003; Li et al., 2008; Liao, 2008; Zhao and Mu, 2008; Zhao and Yang, 2006). Members of the corporate and state elite often exert their power to influence the enforcement of laws. As Lang (2012) claimed, among 227 cases of insider trading that he researched, 61 cases were placed on file for investigation and only 16 (7 percent) cases were transferred to the criminal investigation agency. By considering the institutional and social factors that affect the legal treatment of white-collar crime in China's stock market, I identify the

subject matter of my study as including what is statutorily defined as crime by existing criminal law, civil and administrative law violations, and analogous social injuries, which cause serious damage to stockholders and harm the operation of China's stock market.

Close attention should be paid to the crimes committed by the economically and politically powerful that damage the interests of vast numbers of retail stockholders. But my study will not be limited to upper-class white-collar crime. With information technologies, even offenders who are not corporate or government elites can obtain the power of discourse to affect the interests of large-scale stockholders. For example, there were cases of illegal provision of consultations on stock trading (Meng, 2009). In these cases, offenders presented themselves as Stock Sages and provided consultations for stockholders. They often used the internet as a platform to spread so-called inside information and predictions, profiting from these consultations. Some of these offenders were just ordinary people without proper qualifications required for securities consultants. In another word, these offenders did not commit securities crimes within their legal occupations although they presented themselves to others as experts. These cases of "Stock Sages" also reflect the speculative culture of China's stock market.

In addition, the subject matter of my study will include individual and corporate or government deviance. In fact, it is often hard to decide whether the crimes were committed by offenders in the pursuit of corporate profits/government policies or personal benefit, and these two often overlap (Cressey, 1995; Shover and Hochstetler, 2006). Corporate insiders often exploit their control of listed companies to conduct activities violating the interest of the companies. In the initial stage of the Chinese stock market, the government excessively intervened into stock transactions and even

manipulated the stock prices in order to fulfill political goals. This made it harder to define the boundary of securities irregularities.

Interpreting securities crimes: crime-as-choice theories. In *Crime and Punishment*, Becker (1968) designs an economic utility model applying economic analysis of choice to address the allocation of resources and punishments to law enforcements. Becker's approach assumes that a person will commit a malfeasance if the expected benefit he/she obtains from it exceeds the benefit obtained from other activities at the same cost. According to Becker's analysis, an increase in the probability of conviction or the punishment would increase the cost and decrease the benefit expected from an offense, and thus would tend to reduce offenses. Adopting a broad concept of crime, Becker (1968, p. 170) views crime as "an economically important activity or industry." In his study, Becker (1968) points out that omission of many white-collar crimes led to an understatement of damages crimes cause to society, and especially argues that white-collar crime should receive more attention.

In tune with Becker's choice perspective, some scholars have proposed "crime-as-choice" theory as a framework for explaining white-collar crime and identifying means of preventing the recurrence of these offenses (Shover and Hochstetler, 2006; Shover and Grabosky, 2010). Using crime-as-choice theory for interpretations of white-collar crime concurs with the culturally and practically dominant notion that crime is a "choice" (Shover and Grabosky, 2010). The majority of explanations of white-collar crime are essentially choice theories since they usually place importance on criminal opportunities (Benson and Simpson, 2009). For example, anomie-strain theory suggests that crime is committed due to the inaccessibility of institutionally approved means and the

availability of illegitimate opportunities (Cloward and Ohlin, 1960). Ronald Clarke (1980) proposes the approach of “situational crime prevention” that views crime as the outcome of choices and aims to reduce the opportunity for crime.

Crime-as-choice theory adopts the element of rational-choice theory that emphasizes deterrence for crime control, but rejects its assumption that criminal choices are rational (Shover and Grabosky, 2010). Rational-choice theory is not only an important way to explain and predict criminal behaviors, but also provides a basis for making policies to minimize criminal choices (Cornish and Clarke, 1986; Felson and Clarke, 1998; Weisburd, 1997; Shover and Hochstetler, 2006). Economic offenses are thought to be the most rational of crimes (Cornish and Clarke, 1986). White-collar criminals generally behave more rationally than street offenders since their conduction is usually based on careful decision making (Shover and Hochstetler, 2006, p. 120). But the deterrent approach for crime control advocated by rational-choice theory has been applied principally to street crime and not to white-collar crime (Cohen and Simpson, 1997; Cullen et al., 2006; Hagan, 2012; Shover and Bryant, 1993; Shover and Hochstetler, 2006).

In fact, white-collar crime has caused more loss than has street crime, but the legal system is lenient toward white-collar crime compared to the legal treatment of street crime (Cullen et al., 2006; Hagan, 2012; Reiman, 2007; Rosoff, Pontell, and Tillman, 2007). Serious white-collar criminal activities were often handled with civil procedures or administrative regulation (Cullen et al., 2006; Hagan, 2012). This seemed violate the principle of fairness and justice, thus more severe deterrence measures should be applied to deal with white-collar crime. One of the main reasons was the difficulty in proving

white-collar crimes. Through the examination of the cases of 452 persons charged by the federal government with insider trading in the US during the 1980s, Szockyj and Geis (2002) found the difficulty in proving guilt and using criminal punishments. The legislation confusion and uncertainty of punishment also led to ineffective regulation and the increase of white-collar crimes (Passas, 1990; Reichman, 1993). For this reason, the expansive concept of white-collar crime should be adopted and appropriately harsh penalties are necessary for fighting against white-collar crime.

More importantly, the state's apparent indifference and negligence have contributed to white-collar crime epidemics. For instance, the scandals associated with the savings and loan institutions in the US in 1980s were due to the loosened oversight that resulted from the deregulation movement (Cullen et al., 2006; Hagan, 2012). The internal regulation of corporations or organizations is often ineffective without strict external supervision since corporate ethics codes generally place priority on the corporate interest, but are negligent with respect to the obligations to comply with the law, protect the public interest and ensure the safety of employees (Cullen et al., 2006; Shover and Hochstetler, 2006). The processes of conducting irregularities by corporations and organizations often showed systemic flaws and "the normalization of deviance" (Vaughan, 1996). Thus, credible external regulation is necessary, but it often fails to keep up with the growing supply of lure, as new government economic programs emerge without sufficient oversight (Shover and Hochstetler, 2006). The state's disinterest in white-collar crime and the lack of support for research on it also reflect the biases of the powerful (Shover and Hochstetler, 2006).

The global economic recession early in the 21st century caused policy makers and scholars to pay more attention to white-collar crime epidemics that contributed to the outbreak of this financial crisis. In a special issue in *Criminology & Public Policy*, Shover and Grabosky (2010), in their article “White-collar Crime and the Great Recession” again propose crime-as-choice theory to explain white-collar crime. Shover and Grabosky (2010, p. 430) highlight five causal variables (offender pool, lure, external oversight, internal oversight and self-restraint, and criminal opportunities) in analyzing sources of white-collar crime.

Exploring causes for securities crimes: the Chinese case

Cultural factors. As Merton (1938, p. 676) argues, individual appetites were “culturally induced” in societies that stressed the ultimate cultural goal of pecuniary success. White-collar crime can be attributed to a particular mode of reaction to the challenge of this cultural goal--“innovation.” In other words, people accept the cultural goal of acquiring material wealth but reject the institutionally approved means (Merton, 1938; Passas, 1990). Coleman (2006) also argues that certain psychological traits are encouraged by the general culture of competition in capitalist economies. Shover and Hochstetler (2006, p. 63) define three cultural components of the middle and upper class that account for the occurrence of white-collar crime as “normatively unbridled competition, a pervasive sense of arrogance, and an ethic of entitlement.” McBarnet (2010, p. 14) described “a culture of circumvention” in the financial markets as law “is simply a nuisance, an obstacle to be overcome, a material to be worked with and reshaped to one’s advantage, a challenge in a regulatory cat and mouse game” (p. 80). Arup (2010, p. 12) emphasizes that in exploring the reform for financial regulation,

scholars should pay more attention to the culture of elites who displayed the “culture of irresponsibility” that means holding power without taking responsibility for the community and the public (Sennett, 2006).

China is on the path of so-called “socialism with Chinese characteristics.” In some aspects, Chinese market socialism appears as the early phase of capitalism, the period of primitive accumulation of capital. At the beginning of the economic reform period in China, Deng Xiaoping brought forward the famous “white cats and black cats” theory, which means that it does not matter whether it is a black cat or a white cat, a cat that catches mice is a good cat. The popularity of this concept helped free people from old ideas and sparked economic reform and opening-up policies in China. But at the same time, this economic pragmatism also invoked the twisted notion that if you can get rich you are successful, regardless of the means taken to get there. This situation is similar to what Merton (1938, p. 681) describes as “the-end-justifies-means doctrine becomes a guiding tenet for action when the cultural structure unduly exalts the end and the social organization unduly limits possible recourse to approved means.”

While traditional and socialist values have to at least some extent collapsed, a new morality has not been established yet. The social condition of contemporary China appears as what Emile Durkheim (1952) called “anomie,” that is a state of normlessness as the consequence of weak social regulation that could not restrain individual aspiration during the sudden economic upheaval. Robert Merton attributes the state of anomie to “the lack of coordination” of the cultural goals of pecuniary success and the institutionally approved means to achieve the goals (1938, p. 682). Merton’s explanation is also applicable to the cause of anomie in contemporary China. Prevalent corruption,

food quality problems, substandard constructions, and other white-collar crimes paint a picture of what Karstedt and Farrall define as “market anomie” that refers to “an erosion of legal norms, moral standards and trust, culminating in a climate of mutual suspicion and rampant moral cynicism” (Karstedt and Farrall, 2007, cited in Jones 2009, p. 131). The white-collar crime epidemic associated with China’s stock market provides a window to see this market anomie caused by the interest-driven offenders.

The supply of lure. The concept of the supply of lure is key to crime-as-choice theory. As Shover and Grabosky (2010) emphasized, states can become important suppliers of white-collar criminal lure by implementing policies and programs, such as tax incentives, low-interest loans, subsidies, and other forms of access to public funds. The lack of accordingly strict regulation would let potential offenders exploit these policies and programs. For example, the US Securities and Exchange Commission (SEC)’s approval of use of mark-to-market accounting schemes supplied lure to Enron and other individuals and corporations to make false financial statements with this method (McClellan and Elkind, 2003; Shover and Grabosky, 2010). Entrepreneurs can also be important providers of white-collar criminal lure. In recent decades, Wall Street investment banks devised financial instruments, such as credit default options and derivatives trading, which fostered financial fraud and criminal exploitation (Shover and Grabosky, 2010; Hagan, 2012).

The US stock market can be taken as an example. As Shover and Hochstetler (2006, p. 35) described the situation, “the rapid infusion of money into stocks along with widespread demand for speculative opportunities is a profound economic change, because eager but naive investors are lure. Just as street hustlers target those who seem

out of place or confused, investment counselors and firms look to attract these ‘under-informed investors’ (Levitt, 2002, p. 43), some of whom rely solely on their purchase recommendations.” Furthermore, the globalization of the securities market makes easy access to vast numbers of potential victims of financial frauds (Shover and Hochstetler, 2006). In sum, the liberal state policies, new technologies, growing private-sector services, and globalization of financial transactions can be major contributors to the increase of lure and its changing forms (Shover and Hochstetler, 2006, p. 29-45; Arup 2010). Indeed, as Shover and Hochstetler (2006, p. 48) asserted, “lure production is a thoroughly political process, and inequality is a major constraint at every step.”

Similarly, China’s stock market can be regarded as a lure supplied by the Chinese government. The Chinese government initiated the stock market in an attempt to collect funds for state-owned-enterprises (SOEs) and facilitate the reforms of SOEs. While the Chinese government gave enterprises and those working in business preferential policies to encourage them to enter into the stock market and access public funds, relevant laws and effective oversight were not established. Some corporations entered into the stock market by means of false registration and financial reporting fraud. Insider trading and market manipulation are common practices in China’s stock market. Without credible protection, vast numbers of retail stockholders become victims of securities crimes and other related white-collar crime.

Governmental regulation. Newman (2005, p. 472-473) put forward capture theory, positing that regulatory agencies change from guardians for public interest to associates with business interests due to the transformation of political conditions. In *The Power Elite*, C. Wright Mills (1957) used the term “revolving door” to describe a

circulation of personnel back and forth between corporations and government agencies, which increased the influence of corporations on government. Due to the revolving door phenomena, regulators continued to hold the perspectives of corporation for whom they worked, which could not lead to fundamental reform for financial regulation (Tsingou, 2010). Interest groups also captured the regulatory agencies in the wake of financial crises, hindering the further reform (Bo, 2006). Political corruption, lax enforcement, and conflicts of interest all constitute criminogenic regulatory structures that impaired the external oversight against corporate or elite deviance in the US (Szasz, 1986).

On the other hand, the deregulation movements begun in the age of Reagan politics also resulted in weak external oversight that led to the increase of white-collar crime in the US (Shover and Hochstetler, 2006; Cullen et al., 2006; Hagan, 2012). The underlying logic of deregulation movements is market fundamentalism that prefers self-regulation to governmental regulation (Friedrichs, 2007; Joseph Stiglitz, 2010, xiii; Williams, 2008). With market fundamentalism prevailing, the relationship between law and the markets was even seen as “exogenous and mutually exclusive” (Williams, 2008, p. 481). The Bush administration overruled the Glass-Steagall Act and withdrew requirements of capital adequacy for some financial transactions. For example, the Commodities Future Modernization Act of 2000 exempted many financial derivatives from regulatory supervision (Greenberger, 2010; Johnson and Kwak, 2010; Arup, 2010; Hagan, 2012). In this sense, deregulation movements also bred a criminogenic environment. Snider (2000, p. 172) shows her concern that in a laissez-faire world “corporate crime can ‘disappear’ through decriminalization (the repeal of criminal law), through deregulation (the repeal of all state law, criminal, civil and administrative) and

through downsizing (the destruction of the state's enforcement capability)." The overexpansion of the financial market with serious frauds led to the "casino economy" of the US (Calavita and Pontell, 1990; Leopold, 2009; Phillips, 2006). Ultimately, this weakened external oversight contributed to the 2008 financial crisis in the US (Leopold, 2009; Prechel and Morris, 2010; Berger, 2011; Shover and Grabosky, 2010).

Arup (2010) even argued that the collusion of corporate and state power, not merely deregulation movements driven by the political philosophy of neo-liberalism, led to the financial crises. In the name of innovation, financiers made financial derivatives and increased risks to the market. Regulators knew and encouraged these high-risk practices, even enacting legislation to confirm them (Stiglitz, 2009). In addition to the impact of the political philosophy of market fundamentalism, political donations from financiers exerted great influence on the lawmakers (Talbot, 2009). Furthermore, the US and Western European governments shaped the policies of international financial organizations and press liberalization on Asian economies in the crises and did not allow them to bail out local business, causing huge damage (Arup, 2010).

China's stock market was founded in the institutional transition from a planned economy to market economy. The Chinese government plays dual roles in the stock market (Zhao, 2006). On the one hand, it is the supervisor in charge of oversight of the stock market. On the other hand, it is the most important participant in stock trading since it controls the listed state-owned enterprises. Securities companies were established jointly by the government, state-owned banks, and trust corporations. Listed state-owned companies prioritized capital collection and often ignored the rules of the stock market. Investment companies closely related to the government often took advantage of their

access to government policies that were not yet publicly disclosed to conduct insider trading and manipulate stock prices (Zhao, 2006). The intertwined relationships between the government, listed companies, and investment companies bred criminogenic regulatory structures in China's stock market. The circulation of personnel back and forth between regulatory agencies and securities firms and investment companies showed the phenomenon of "revolving door" and exemplified "capture theory" in stock market regulation in China (Newman, 2005; Mills, 1957; Zhao and Mu, 2008).

Moreover, criminal laws were lenient to securities criminals and have not exerted sufficient deterrence to potential offenders (Lang, 2003; Li et al. 2008; Liao, 2008; Zhao and Mu, 2008; Zhao and Yang, 2006). Take the case of illegal manipulation of the stock price of Zhong Ke Venture as an example. This case affected more than 20 provinces in China and the amount involved surpassed 5.4 billion yuan. But according to the criminal law, the maximum penalty for the crime of illegal manipulation of the stock market is only five-years of imprisonment. In the court inquiry, the responsible party admitted that before he committed the crime he carried out sufficient legal consultations to determine that it was worth doing. That is, the crime was committed knowing the worst he would receive could be a maximum of five-year imprisonment if his criminal activities were discovered (Zhao and Yang, 2006). The Ford Pinto case also showed an example that lenient sanctions could not curb white-collar crimes (Cullen et al., 2006). Knowing the car design defects that might cause fuel leakage and result in lethal dangers in rear-end collisions, Ford executives decided not to recall and fix the design problems since the prices they would pay for deaths and injuries caused by Pinto crashes would be less than the costs they needed to fix the design problems (Cullen et al., 2006). Ultimately, the

Ford Pinto case caused Ford Company to pay huge punitive damages and recall the cars, which was regarded as “a sign of the times” of the movement against white-collar crime (Cullen et al., 2006, p. 165).

When China’s stock market was initiated, China lacked specific laws and did not recognize the regulatory control necessary for the prevention of securities crimes. Unlike the logic underlying the approach of self-regulation or voluntary compliance adopted in the U.S., the Chinese government resorted to the rule of virtue and self-control that are rooted in both traditional Confucian value and socialist ideology. Although the Chinese government enacted particular laws after the outbreak of serious securities crimes, actual law enforcement proved challenging in the face of increasing corruption and local protectionism. Indeed, the privileged class prefers this semi-market economy that allows them to loot the market for personal gain while maintaining the authoritative regime.

Internal restraint. Sutherland’s differential association theory is illustrated in his study of white-collar crime, and demonstrates how individual actors learned techniques, motives, and rationalizations from their fellow workers or supervisors in their own companies or from others in the same industry (Sutherland, 1983). Through interviews with retired managers of Fortune 500 corporations, Marshall Clinard (1983) found that corporation personnel were often driven by pecuniary interest and ignored ethical standards. Shover and Hochstetler (2006, p. 72) argue that the culture of work organizations, “fluctuations in the business cycle,” “market uncertainty,” and the pervasive belief that credible oversight is lacking are critical factors for internal oversight. Researchers found that performance pressure and the criminogenic cultural conditions led to the increase of criminal choices (Shover and Hochstetler 2006, p. 119). This

criminogenic corporate culture has roots in the broad social contexts that attach little stigma to white-collar criminals. For example, research found that those engaging in insider trading felt little guilt and their family and friends did not forsake them. The obstacles preventing them from reintegrating into society were few (Shover and Hochstetler, 2006). Within these criminogenic cultural conditions, self-restraint does not often work. Sykes and Matza (1957) developed neutralization theory which argues that most offenders tend to employ self-rationalizations or justification to account for their actions in order to neutralize their feeling of obligation to follow the law and respect for conventional values. White-collar criminals often use techniques of neutralization to interpret their behaviors in “non-criminal terms” (Benson and Simpson, 2009, p. 141).

In China, the stock market is viewed as a big casino. As Chinese popular culture shows, Chinese people are enthusiastic about gambling. There is a series of Chinese movies describing the magical stories of “casino heroes.” This kind of “casino culture” associates very little moral stigma with securities offenders. Moreover, as Lang Xianping (2009) states, Chinese culture has its own defects, such as speculative mentality, reckless character, and a rigid way of thinking, which hinder the likelihood that entrepreneurs will comply with rules and build self-restraint. Failure to identify a group of offenders and victims would facilitate the neutralization of the moral stigma and result in a contradictory value system (Berger, 2011). To seek profit while ignoring regulations is prevalent in the securities industry. For a long time, insider trading and market manipulation were viewed as common activities in the operation of the stock market. Numerous reports in financial journals revealed that offenders conducted these illegal actions as customary practices in stock trading and imitated each other.

In summary, the implementation of rules for stockholder protection often meets resistance from institutional arrangements that are often the products of the collaboration between the government and interest groups to loot public investors, from business operational mechanisms that seek maximization of corporate benefits and ignore public investor interest, and from internal cultural influences that attach little stigma to securities offenders. To reduce the kind of cultural defects that hinder compliance with rules and enforcement of laws requires comprehensive engineering to cultivate legal awareness and rights consciousness for the ruling elites and common people, and ultimately form a healthy legal environment.

Rights Consciousness of Chinese Public Stockholders

The theories mentioned above, e.g., Dorn (2010) and Arup's (2010) suggestion of a democratic approach to financial regulation, Coffee's (2001) historical discourse of shareholder democracy, the conception of white-collar crime based on checking elite deviance, and so on, indicated the significance of rights consciousness and civic participation in fostering legal reform for financial market regulation. In China, the emerging stock market encountered undeveloped legal mechanisms, which is in urgent need to cultivate legal/rights consciousness of public investors and form a force to facilitate legal reforms.

Rights consciousness became a hot topic for scholars during the last two decades as the rise of collective protests in China caused wide attention. Collective protests in contemporary China were often viewed as signals of rising rights consciousness (Cai, 2008; Chen, 2000; Guo, 2014; O'Brien and Li, 2006; Xia and Guan, 2014; Yang, 2013).

Especially in the era of the internet, online activists were regarded as a growing force for democratization, and Chinese government's responsive stance toward online complaints also helped promote its legitimacy (G. Yang, 2013). Inconsistent with this kind of accounts, Perry (2008, p. 47) argued that the collective protests in contemporary China showed "rules consciousness" rather than "rights consciousness." As Perry defines, rules consciousness indicates a demand for enforcement of existing laws and central policies, rather than challenging the legitimacy of state power and calling for participation in making laws (Li 2010, p. 4). Perry (2008, p. 46) articulated that these Chinese protests, often using words seen in political slogans and allowed officially, are "an affirmation rather than an affront to state power." Perry also argued that the underlying motives of protests in contemporary China were not very different from those of rebels in the imperial China. Based on the protest statements of Anyuan retirees that Perry analyzed, Li (2010) made a different interpretation, suggesting that the protesters showed doubts about the central authorities and they just used a safer approach to claim their legal rights. Li Lianjiang (2010) argued that the mass protests in contemporary China transcended what Perry (2008) called rules consciousness and actually signaled the rising right consciousness.

As T. H. Marshall assumed, citizenship rights (civil, political, and social rights) are achieved through collective struggles of autonomous individuals and realized through institutionalization of rights (Marshall and Bottomore, 1992; Foweraker and Landman, 1997, p. 1; Guo, 2014, p. 242-243). Citizenship rights consciousness is a process (Isin, 2012) and status (Marshall and Bottomore, 1992). According to the categories defined by T. Janoski (1998, p. 30), civil rights refer to passive rights, e.g. property rights,

procedural rights, and so on; political rights refer to active rights, e.g. the right to vote, the right to participate, and so on. As Perry (2008, p. 38) stated, different from that of the Anglo-American tradition, the conception of rights in Chinese political philosophy has been primarily concerned with social and economic rights including “the rights to subsistence and development” as the central point. The Chinese conception of rights tends to mean demands for specific benefits. The claims of Chinese stockholders show this kind of demand for specific economic interest. The collective stockholder struggles seem like what Guo (2014, p. 424) defines as “passive collective resistance,” applying legal procedures and other legal methods to claim their rights.

Studies on collective actions in contemporary China found that people were at first driven by their specific individual interest to participate in collective actions, and then the participation fostered their rights consciousness and led to democratic practices (Cai, 2008; Chen, 2000; O’Brien, 2006; Xia and Guan, 2014). As Xia and Guan (2014, p. 418) argue, the self interest-oriented participation in the public sphere might be the main approach to fostering rights consciousness and cultivating democratic values in China, due to the shortage of cultural and traditional legacies for active participation in the public sphere. This self interest-driven approach applied to the collective actions of retail stockholders in China. Since stockholder claimants have common interest in stock investments and often have concretely measurable damages from securities offences, they are easily to join together and form public debates in fighting against securities crimes and frauds (Chen, 2003). Chen (2003, p. 451) argued that in China “capital markets are perhaps the most conducive to the formation of a politically powerful constituency and hence more aggressive legal change.”

Public retail stockholders in China have grown to encompass a very large group, estimated to exceed one hundred million people (CSRC, 2014), and the majority of retail stockholders can be regarded as middle class in China. Rampant securities fraud, often resulting from the corruption of government officials and corporations, caused huge damage to stockholders and provoked their demands for right protection. Given the institutional defects, their claims for protection of economic benefits from stock investment often could not be realized through existing mechanisms. It needs further political reform and institutional construction to transform the role of the government, to prevent the collusion of the political and economic elites, and to reallocate benefits among market participants. This kind of passive collective resistance by stockholders would ultimately turn to foster active collective struggles for political rights.

CHAPTER III

DEVELOPMENT OF CHINA'S STOCK MARKET AND POLICIES AND PRACTICES OF MARKET REGULATIONS BEFORE THE STATE COUNCIL'S NINE OPINIONS

Introduction

The stock market in the PRC was initiated within the context of the economic reform that has followed a gradual and pragmatic mode. In order to avoid strong resistance, the post-Mao government made an effort to find “blank spots” outside the original planned economic system and “new economic growth points” inside the original system to carry out reform experiments, and then gradually pushed ahead the establishment of a market economy to take the place of the old system (Wu, 2008; Y. Lu, 2008, p. 9). This approach was also shown in the process of setting shareholding system that began with village and township enterprises, urban collective enterprises and then state-owned enterprises (Y. Lu, 2008). With the setting of a shareholding system, the desire to collect funds to solve the problem of capital shortage and establish the modern enterprise system called for the establishment of the stock market. At the end of December 1990, the P.R. China's stock market was officially opened as the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SSE) were established.

In the beginning, the central government adopted risk-prevention macro policies over the stock market, while local governments developed concrete measures for the operation of the stock market. Local governments adopted policies and even actively participated in buying and selling stocks to intervene in rising and falling market (Kan, 2010; Z. Wang, 2010; Y. Lu, 2008). The government's intervention with the stock market

fostered speculation, manipulation and corruption in the stock market. A series of scandals, e.g., the Champaign case and the Shenzhen 8/10 event, facilitated the establishment of the China Securities Regulatory Commission (CSRC) (Xinhuanet.com, 2012). Then the central government made rules and developed state-controlled institutions to establish its leadership in regulating the stock market.

In 1995, the serious irregularities in speculation on 327 treasury-bond futures led to the closing of the financial products futures market in China. Furthermore, this event propelled the central government to centralize the regulatory power over the securities market and decrease the local governments' influence on the stock market. The central government often influenced the stock market through adjusting new stock issuance, capital scales, stamp tax rates, stock transaction rules, and publishing articles in the mouthpiece media (Y. Lu, 2008). In the wake of the Asian financial crisis, the regulation of the stock market concerned the central government. Serious securities frauds, e.g., the cases of Qiong Minyuan and Hong Guang, fostered creation of the Securities Law. The Chinese Securities Law was enacted on 12 December 1998, and became effective on 1 July 1999, thereby nationally unifying regulation of the securities market.

Facilitated by the central government, the stock market rose swiftly on 19 May 1999 and remained bullish for about two years. The exposure of a series of scandals, including the Zhongke Venture, Yi An, Yin Guanxia, East Electronic, and Jin Tian cases, shattered the miracle of the long bull market. Although the central government unified the market regulation and enacted related laws, this regulatory pattern did not improve the external oversight over the stock market. The serious scandals ruined the confidence of investors in the stock market and raised criticisms by scholars. Wu Jinglian's "casino

theory” (2001) and Lang Xianping’s challenge about fraudulent schemes by the listed companies raised heated discussions and greatly influenced the Chinese stock market.

The rampant market abuses exposed the institutional defects of the Chinese stock market. Acting as a compromise between the reformers and the hardliners, the design of the split share system³ helped the passage of the proposal of establishing a shareholding system for state-owned enterprises and for listing them on the stock market. But this split share system hindered the stock market’s realization of the function of value discovery and caused problems of corporate governance. Ten years after the initiation of the stock market, the government made efforts to reduce non-tradable shares, but the attempts failed since its plans did not gain the support of investors. In addition, serious IPO fraud also revealed the dark side of the quota and approval system. In the very early stage, the quota and approval system was adopted to avoid over-heated stock issuance and fundraising (Pistor and Xu, 2005). But the excessive power of relevant officials and non-transparent administrative operations bred corruption. These institutional defects coming from the previous planning economy system showed the influence of “path dependence” on the operation and regulation of the Chinese stock market (North, 1981; Bebchuck and Joe, 1999; Wu, 2001; Y. Lu, 2008, 2010).

The crazy speculation of stockholders reflected people’s thirst for wealth and success that was suddenly released after being oppressed for decades under the planned economy, but it also became a lure to market manipulators and other potential offenders.

³As is discussed later in this chapter, the split share system refers to the coexistence of tradable shares (individual shares) and non-tradable shares (state shares and institutional shares). Keeping the shares of state-owned assets, a state-owned enterprise could issue additional shares to the public and only the set of shares that were issued to the public could be listed in the stock market. Only about 30 percent of shares of the listed company, called individual shares (*Ge Ren Gu*), were issued to the public and were listed as free-flowing shares on the stock exchanges; the majority (about 70 percent) of the shares of the listed company was retained as state shares (*Guo Jia Gu*) and institutional shares (*Fa Ren Gu*) and could not be traded on the stock exchanges (Lu, 2010; Kan, 2010; Guthrie, 2012).

The high-profile cases brought stockholders risks and raised their rights consciousness. The struggles for interest protection indicated the growth of this consciousness. The case of Zhou Zhengyi was an example of how public opinion exerted pressure on the regulatory and judicial system. The emergence of civil compensation mechanisms also indicated a step forward in protection of stockholders.

Stock Trading before the Establishment of a Planned Economy in the PRC

The history of stock trading in China traces back to the Qing Dynasty. Established in 1872, the China Merchants Steamship Company was the first joint-stock enterprise in China. The company issued stocks to the public to raise funds for developing the national industry. In 1882, the first Chinese stock trading company, Ping Zhun was opened in Shanghai (Yuan 2008). But only one year later, Ping Zhun Company was closed due to a turmoil caused by stock trading (Du, 2002). After that, there was no formal agency for stock trading in China until foreign businessmen organized a market named “Shanghai Shares Public Place” in 1891. A formal stock exchange in Shanghai was established in 1905. After the Qing Dynasty collapsed, the Bei Yang Government enacted the Law of Securities Exchanges in 1914, allowing stock transactions. This was the first Chinese law on securities. In 1929, the Kuomintang Government enacted the Law of Exchanges. Although the Chinese stock market experienced ups and downs as times changed, Shanghai realized the prosperity of stock trading and was recognized as the Oriental financial center in the 1930s (*ibid*).

What is less well-known is that in the 1930s, the Chinese Communist Party (CCP) government opened banks in the Red Zone they occupied, issuing bonds and stocks to collect funds to develop the local economy and support their army (T. Ba, 2001). Right

after the CCP took power, the government made relevant regulations—the Interim Measures for the Regulation of Securities Trading, the Measures for Brokers to Apply for Registration, the Measures for Delivery, and the Regulation of Stock Listing (X. Yu, 2009). But these regulations lapsed soon due to subsequent socialist movements. In the early 1950s, the CCP government eliminated the stock market in the PRC. Once the CCP began building a socialist planned economy, the Chinese population was taught that “a stock market” was an arena for cruel capitalist competition and plundering.

The Establishment of Shareholding System and Stock Issuance

In the late 1970s, the post-Mao government decided to carry out economic reforms to increase productivity and improve the people’s overall living conditions. To reform the old planned economic system, the post-Mao government adopted a path of gradualism and pragmatism to build a market economy. As Deng Xiaoping described metaphorically, the Chinese government has been “feeling stones to cross the river.” China’s economic reform began with economic decentralization, which meant the central government conceded some economic autonomy and interest to local governments and enterprises (Coase and Wang, 2012; Guthrie, 2012; Y. Lu, 2008). The economic decentralization gave local governments incentives to develop the economy, created competition among enterprises, and pushed local governments and enterprises to take responsibility for their activities.

As China’s economic reform was initiated in the rural areas, the seeds of the shareholding system also emerged in the countryside (Y. Lu, 2008). After the Third Plenum of the Eleventh Central Committee of the Chinese Communist Party was held in 1978, the Household Responsibility System replaced the commune system in rural areas

and gave individuals incentives to increase productivity for personal benefit. As a result, the rural economy grew and individuals accumulated personal wealth. In the subsequent process of rural industrialization, the transformation of former communal enterprises faced a shortage of funds, and investments from the central and local governments could not meet the demand. Village and township enterprises began to collect funds in a way that allowed private investors to be shareholders of the enterprises. Then the central government put forward policies and administrative measures to encourage peasants to invest in rural enterprises. In July 1983, Bao An Joint Investment Company, the first shareholding company in a rural area, was established. The majority of this company's registered capital came from individual peasants living in Bao An County in Shenzhen (Yuan, 2008; Y. Lu, 2008).

In the meanwhile, some urban enterprises began to issue stocks to collect funds. It is said that the earliest stocks were issued by Chengdu Industrial Exhibition Trust Company in 1980 (Yuan, 2008). In 1984, the China National Economic Reform Commission published policies that allowed urban collective enterprises and small state-owned enterprises to collect funds from their employees, and the employees could share benefits of the enterprises according to the proportions of their capital investments (Y. Lu, 2008). Local governments began to experiment with a shareholding system in enterprise reforms. In July 1984, instructed by the Shanghai government, the Shanghai Branch of the China People's Bank brought forward Provisional Regulations on the Administration of Issuing of Stocks, which allowed new collective enterprises to issue stocks. According to this regulation, those experimenting with issuing stocks in the early years were collective enterprises. In July 1984, Beijing Tian Qiao Department Store Joint Stock

Limited Company was established and issued three-year-term “stocks” to the public (Yuan, 2008; Y. Lu, 2010). These stocks with an associated term were really more like bonds. In November 1984, Shanghai Fei Le Audio Company, the first shareholding company in Shanghai was established, issuing 10,000 shares of stock with the face value of 50 RMB per share (Kan, 2010; Y. Lu, 2010; Yuan, 2008).

Scenes of issuing stocks in public places are often described in books on the history of PRC’s stock market. The initial public offering of Shanghai Yan Zhong Joint Stock Company is one such example. Shanghai Yan Zhong Joint Stock Limited Company was a subdistrict-office-run collective enterprise. It planned to issue 100,000 shares of stocks to collect 5,000,000 RMB (the face value of 50 RMB per share) in January 1985⁴. The location for the issuing was at Shanghai Jing’an District Stadium. Concerned that the stocks might not sell out, Yan Zhong Company provided an apartment and other promotional incentives—buyers would get numbers for purchasing stocks (one number per share) which would make them eligible for a drawing with big prizes. Attracted by the promotions, huge crowds of people poured into Shanghai Jing’an District Stadium (Kan, 2010).

During this period, theorists began to search for a theoretical basis from Marxist works to justify the establishment of a shareholding system. In 1984, over twenty graduate students of the finance institute established by the People’s Bank of China worked together to write an article, “Discussions on the Strategy of China’s Financial Reform,” which first put forward the idea of initiating stock markets in the PRC (Y. Lu, 2008; Z. Wang, 2010). In 1985, another article, “Socialist Society Needs Capital Markets,” was published in *World Economic Herald*. This article claims that socialist China needs

⁴ In January 1985, 1 USD equaled 2.8 RMB

capital markets including stock markets, which through transferring property rights can concentrate funds in the industrial domains that could produce the highest economic benefits. Actually, transactions of land and enterprise ownership were common phenomena in rural areas; they were also common in Guangdong and other coastal areas where state-owned enterprises collected funds from collective units and individuals. Thus, the establishment of the securities market was just a way to acknowledge the existing property rights transactions (Ding, 1985).

Interestingly, in July 1985, James Tobin, an important American economist and Nobel Prize winner, stated in a famous conference that China would not be ready to open stock markets for at least twenty years (Y. Lu, 2008; Z. Wang, 2010). Although it still remains to be seen whether Tobin's suggestion was right, the Chinese government did not stop exploring the feasibility of opening stock markets in the near future. In November 1986, a Sino-US conference on financial markets was held in Beijing, which the Chinese media titled "Wall Streeter Brings Financial Markets to the People's Great Hall in Beijing" (Ruan, 1986). After the conference, Deng Xiaoping gave the then president of the New York Stock Exchange a share of the Fei Le Company. This was probably the first foreign transfer of stock in the PRC and demonstrated the Chinese leader's support for Chinese enterprises issuing stocks (Y. Lu, 2008; Z. Wang, 2010). In March 1988, a number of overseas Chinese scholars submitted suggestions regarding advancing the legalization and regulation of a Chinese securities market.

Since the mid 1980's, the central government launched a series of policies to foster building a shareholding system in large-medium state-owned enterprises across the fields of industry, commerce, real estate, and finance. In 1986, Shanghai Zhen Kong

Electronic Devices Joint Stock Company became the first large state-owned enterprise that experimented with a shareholding system in Shanghai. Zhen Kong Company issued stocks worth 50 million RMB; thus, its capital was comprised of state-owned, collective, and private capital (Y. Lu, 2008). Although thousands of businesses issued stocks, most stocks were not publicly tradable. In September 1986, Jing An Securities Department of Shanghai Trust and Investment Company (owned by China Industry and Commerce Bank) was opened, becoming the first stock trading agency in the PRC. At its opening, there were only two listed tradable stocks, issued by Shanghai Fei Le Audio Company and Shanghai Yan Zhong Company, respectively. Nevertheless, the opening of Jing An Securities Department announced the return of stock trading that had been suspended for 37 years in China (Kan, 2010).

However, since the stock market in a real sense was not formed and stock prices remained the same for a long time, it was not easy for investors to profit from stock trading. As a result, the passion for stock trading lasted only a short time. In 1987, the reformed Bank of Communications became the first national state-owned joint-stock commercial bank. The first professional securities firm, the Shenzhen Special Economic Zone Securities Firm, was established in Shenzhen (Z. Wang, 2010). In 1988, Shenyin Securities Company, Wanguo Securities Company, and Haitong Securities Company were established in Shanghai; as a result, the early over-the-counter (OTC) market for securities transactions was formed (Kan, 2010; Y. Lu, 2008; Yuan, 2008). By the end of 1988, an estimated 16,000 shareholding enterprises emerged in China, collecting funds surpassing 60 billion RMB through stocks (Y. Lu, 2008).

In its national congress held in September 1988, the Chinese Communist Party (CCP) confirmed its resolution to further develop a shareholding system in enterprise reforms and pointed out: "...shareholding system with public ownership remaining predominant is not privatization, but to transform the abstract ownership to the concrete one..."⁵ But the central government showed hesitation about when to open a formal stock market, although the local governments actively prepared for the establishment of a formal stock market to meet the need to develop enterprises. At that time, the dual-track price system (a coexistence of state fixed price and the market price) caused economic chaos and social unrest, e.g., speculation and forcing up of prices. Moreover, conservative hardliners began political debates on anti-capitalist liberalization. This led the central government to rein in the opening of formal stock markets (J. Zhang, 2001).

Unexpectedly, a political tumult became the catalyst for the central government's decision to open stock exchanges. After the outbreak of the 1989 Tiananmen Square Event⁶, Western countries imposed political and economic sanctions against China. The Chinese central government and the CCP decided to adopt some measures to show their stance of continuing economic reform to regain positive recognition by the international community (Y. Lu, 2008; Kan, 2010). At the end of 1989, in a meeting regarding financial reform in Shanghai, Zhu Rongji, the then mayor of Shanghai, emphasized the priorities of the government to invite foreign banks and establish a stock exchange in Shanghai (Kan, 2010). At this meeting, the Shanghai government decided to open a stock exchange in December 1990 when the chairwoman of the Hong Kong Trade and

⁵ See "Data Base of All National Congress of the Chinese Communist Party" in official website of People's Daily <http://cpc.people.com.cn/GB/64162/64168/64566/65385/4441840.html>

⁶ In June 1989, the Chinese government used force to crush the student movement that began at the Tiananmen Square in Beijing.

Development Bureau would visit Shanghai. This measure was supported by the central government. At the same time, the Shenzhen government was also actively preparing the opening of the Shenzhen Stock Exchange.

The Emergence of Large-Scale Black Markets of Stock Trading

By 1990, Shanghai had eight tradable stocks issued by local companies, and Shenzhen had five (Kan, 2010; Y. Lu, 2008; Z. Wang, 2010; Yuan, 2008). The 1989 Tiananmen Square Event caused stock transactions to decline greatly; thus, about sixty percent of tradable stocks lay idle in the securities company (Kan, 2010). The central government's decision to further economic reform and open stock exchanges again raised people's passion for stock trading and boosted the stock prices. The Shanghai Branch of the China People's Bank worried that the overheated stock trading would cause trouble and give hardliners a reason to oppose the opening of stock exchanges. To curb the sharp rise of stock prices, a notice from the Shanghai Trust Investment Company of the Bank of Industry and Commerce established a delay of delivery date, set limits for stock prices going up or down, required investors to show their IDs, and informed investors of the risks of the stock market. The Shenzhen government also took measures to calm down stock trading (Yuan, 2008)

But the measures did not restrain the overheated stock trading. Due to the provision of limits for stock prices going up or down, the selling of stocks in official agencies could not match the desire for purchasing stocks. The imbalance of stock selling and purchasing, combined with speculation by some investors, led to formation of a large-scale black market for stock trading. Take the Dian Zhen Kong stock as an example. In official securities agencies, its listed price was 110 RMB, while its black

market price exceeded 400 RMB (Yuan, 2008; Kan, 2010). Especially in public places around the official securities agencies, scalpers (in Chinese called “yellow cows”) were standing in roads to solicit passersby to participate in stock trading. Sometimes, the crowds in this black market even caused traffic jams. To fight the black-market transactions, official securities agencies provided rules for stock transfers, e.g. both the buyer and seller must show their ID. But scalpers bribed the staff of some securities companies to ignore the rules in dealing with stock transfers. This was also a main reason why black-market stock trading was rampant. There were cases in which a departmental chief and members of the staff of Haitong Securities Company were arrested for accepting bribes from scalpers (Kan, 2010). The black market lasted until the opening of the stock exchange, which announced the beginning of a formal stock market in the PRC.

The Establishment of Formal Stock Markets and the Split Share System

The heated ideological debates on the nature of the stock market, whether it was socialist or capitalist, had interrupted the process of establishing the formal stock market. At that time, the primary consideration for those supporting the establishment of a stock market was how the proposal to open stock markets could be passed, rather than what the stock market should be (Y. Lu, 2008). As a compromise between the reformers and the hardliners, a split share system was adopted; that is, keeping the shares of state-owned assets, a state-owned enterprise could issue additional shares to the public and only the set of shares that were issued to the public could be listed in the stock market. Only about 30 percent of shares of the listed company, called individual shares (*Ge Ren Gu*), were issued to the public and were listed as free-flowing shares on the stock exchanges; the majority (about 70 percent) of the shares of the listed company were retained as state

shares (*Guo Jia Gu*) and institutional shares (*Fa Ren Gu*) and could not be traded on the stock exchanges (Y. Lu, 2010; Kan, 2010; Guthrie, 2012). In December 1990, the Shanghai Stock Exchange (SSE) was opened for business. The Shenzhen government decided to start the Shenzhen Stock Exchange in December 1990 while trying to get the central government's approval. In mid-1991, the central government permitted the opening of the Shenzhen Stock Exchange.

Local Government's Intervention into the Stock Market

In the beginning of the formal Chinese stock market, the central government seemed to stay behind the scenes, while the local governments managed the two stock exchanges. Local governments, enterprises, and individual investors were highly motivated and assumed active roles in running the stock market. The central government adopted risk-prevention macro policies over the stock market. Local governments and stock exchanges adopted concrete measures for the operation of the stock market. A unified national stock market did not appear at that time.

In January 1991, the Shenzhen government established the Stock Market Regulation Fund to prevent radical rises or falls of the stock market (Y. Lu 2008). The Fund's capital came from the stamp tax on stock transactions, issuing shares at a premium, fund interest and other revenues. The Shenzhen Municipal Finance Bureau, the Municipal Commission for Economic Restructuring, and the Municipal Supervision Bureau assigned representatives to take charge of the Fund. When the stock market was down that year, the Shenzhen government carried out a secret bailout plan. Under instruction by the Shenzhen government, the SZSE managed the stock of Shen Fa Zhan, a

major stock that was regarded as a sensitive barometer of the stock market. Using 200 million RMB from the Stock Market Regulation Fund and other institutions, including money from Shen Fa Zhan Corporation, the SZSE bought huge volumes of Shen Fa Zhan shares and thus raised its price. At the same time, the Shenzhen government decreased the rate of the stamp tax on stock transactions. The measures successfully regained the confidence of stock investors and boosted the stock market. The Stock Market Regulation Fund was the first government-led fund to step into the stock market. With the Fund, the Shenzhen government participated in buying and selling stocks to adjust market indexes and to intervene in market rises and falls.

As admitted later by Yu Guogang, general director of this bailout plan and vice general manager of the SZSE, this bailout plan did not follow economic principles; rather, saving the nascent stock market was the foremost priority at that time (G. Yu, 2000). The government might have taken this kind of measure with a good intention, but its actions of centralizing huge amounts of money to boost some stock prices violated the principle that the stock market must reflect the growth of the real economy and realize the best allocation of capital. The government also set a bad example for market manipulators to rig the market by applying huge amounts of money to boost the stock prices. In this bailout, Shen Fa Zhan Corporation (under instructions by the government) used its money to raise its own stock prices. Usually, it is not lawful for a company to use its money to buy its stock to raise its stock price. But at that time, there was not a law or regulation prohibiting this kind of action, and the government was eager to raise the stock market by boosting the Shen Fa Zhen stock. The bailout also created an image that the government would not let the market fall. Although the bailout caused the market to rise

in a short time and seemed to regain investors' confidence quickly, the approach the government adopted to affect the market created a grey zone for market abuses and irregularities. In the long run, it was not good for the healthy development of the market and the formation of rational investors.

People's Thirst for Stocks

In January 1992, Deng Xiaoping visited a few southern Chinese cities to show his support for the reformers. His speeches in this famous southern tour reconfirmed that China should stay on the path of economic reform. He mentioned his attitude toward the stock market as follows:

Are securities and the stock market good or bad? Do they entail dangers? Are they peculiar to capitalism? Can socialism make use of them? We allow people to reserve their judgment, but we try these things out. If, after one or two years of experimentation, they prove feasible, we can expand them. Otherwise, we can put a stop to them and be done with it. We can stop them all at once or gradually, totally or partially. What is there to be afraid of? So long as we keep this attitude, everything will be all right, and we shall not make any major mistakes. (Deng 1993, p. 373)

Deng's address has been regarded as ammunition for reformers interested in experimenting with the securities industry. This confirmation that the economic reform policies were accepted by the central government fueled the fever for stock investment. According to a survey organized by Shanghai Fudan University in early 1992, 79.35% of

individual investors expressed an interest in buying stocks but were unable to obtain them, and 83.62% of stockholders showed an interest in purchasing more stocks but were unsuccessful due to the insufficient supply of shares available for purchase (Yuan, 2008). Although the Shanghai government had already carried out an adjustment tax on the income from stock by individuals in 1991, this measure did not curb people's thirst for stocks.

The Champaign Case

The first financial fraud in the PRC's stock market was the Champaign case. Shenzhen Champaign Industrial Corporation was one of the only five companies listed on the SZSE when it was opened at the end of 1990, and also the first Sino-foreign joint venture listed on the PRC's stock market. Early in February 1990, Champaign Industrial made its initial public offering (IPO) with a share price of 10 RMB. In a short time, Champaign Industrial appeared as a star in the nascent stock market (Xinhuanet.com, 2010). On 10 March 1991, Champaign's board of directors publicized its 1990 financial report, posting the pre-tax profit of about 32 million RMB, 29 times the profit of 1989 (Yuan, 2008).

On 7 April 1992, the People's Bank of China Shenzhen Branch requested the creditors of Champaign to send their representatives to help check the company's finances, clarify its profit, and set repayment plans. At the same time, authorities blocked Champaign's accounts and detained two of its managers. On 4 May, the Shanghai Securities News announced this event. Actually, the authorities had begun to investigate Champaign for its financial misstatement and unreasonable capital outflow at the end of

1990. But it took more than a year before Champaign's scandals were exposed to the public. After the authorities adopted measures, Champaign filed a suit against the People's Bank of China Shenzhen Branch and Shenzhen Municipal Administration for Industry and Commerce in the Shenzhen Intermediate People's Court for restricting the personal freedom of Champaign's managers. The Intermediate Court made a judgment that the police had the legal right to put the managers in detention for the investigation. Champaign then appealed to the Guangdong Provincial High People's Court.

On 15 June 1992, the Wall Street Journal published the article "One of China's Listed Firms Faces Crisis," exposing the story of Peng Jiandong's fortune (Wall Street Journal, 1992). Peng Jiandong, founder and president of Champaign, obtained a huge fortune from the transactions of Champaign and its stock issuance to public. As revealed, Champaign made a profit of only \$287,000 in 1989, but that same year, Peng Jiandong purchased a two-million USD house in Sidney. This young upstart and his 28-year-old wife lived in this luxury home with Rolls Royces and servants. Champaign also purchased a pasture in Australia in 1989, but this pasture lost Champaign \$396,735 by the end of 1990. After Champaign made its IPO in February 1990, it entered the fields of textile, trading, and real estate, earning a profit of \$6.4 million that year. An executive of Panco (an institutional shareholder of Champaign) admitted that a large proportion of income of Champaign in 1990 came from stock trading. Champaign did not give dividends to stockholders in 1990. But the same year, Peng Jiandong bought a HK\$44

million⁷ (about 5.64 million USD) seaside house in Hong Kong. In 1991, Peng Jiandong obtained Australian citizenship.

Confronted with the authorities' measures against it, Champaign asserted that it was investigated because it had rejected some government officials' requests for its shares. Champaign also publicized in Hong Kong and foreign media that it encountered official harassment, and asked for "international interventions" to protect its interests (Wall Street Journal, 1992; Xiao, 2010). On 20 June 1992, the People's Bank of China Shenzhen Branch announced the conclusion of its investigation, stating that Champaign broke the law severely. As the investigation found, Panco transferred foreign currency worth more than 100 million RMB⁸ owned by Champaign to the affiliated companies. The same day, the Industrial and Commercial Bank of China Shenzhen Branch sued Champaign for its overdue bank loans of 200 million RMB and 3 million USD. A few days later, Champaign encountered another suit filed by the Agricultural Bank Shenzhen Branch for its overdue bank loan of 5 million USD. On 7 July 1992, Champaign stock was suspended on the SZSE.

The Outcome of the Champaign Case

On 9 March 1993, the Shenzhen government formed a special group to guide the restructuring of Champaign. The public stockholders pinned their hopes on the government. The special group concluded that from 1987 to 1991, Champaign changed its equity structure without authorization, misrepresented its capital, adjusted assets on financial accounts, and faked its profits. For example, as shown on its financial accounts,

⁷ In 1990, 1 USD was equal to 7.8 HK\$.

⁸ In 1990, 1 USD was equal to 4.76 RMB.

Champaign's cumulative profit from 1989 to 1991 amounted to 77,425,000 RMB. Actually, Champaign had great losses these three years. Champaign also increased its profit through illegally selling its shares on the stock market. For example, in 1990, Champaign sold its original shares that were under the name of its subsidiaries, earned 32 million RMB from this transaction and recorded it as profit for the term (Wang, 2004). Within five years, the Shenzhen Special Zone Accounting Firm and other accounting and auditing firms in charge of checking Champaign's finances issued seventy-five reports to verify its financial statements. After the financial fraud of Champaign was exposed, those accounting and auditing firms were investigated by the China National Association of Chartered Accountants and the government authorities, and responsible accountants and auditors were seriously punished (M. Wang, 2004).

Based on their conclusions, the special group decided to deprive Panco of its Champaign shares since the capital Panco invested in Champaign had not been approved by relevant authorities and had not been registered. The huge amount of funds that Panco transferred from Champaign constituted the proof of Peng Jiandong's criminal activities. The shares previously owned by Panco were assigned to a state-owned enterprise, the Shenzhen City Construction Development Corporation, which would join the operation of Champaign. Thus, these shares became state-owned shares held by the Development Corporation. On 7 May 1993, the Guangdong Provincial High People's Court ruled that Champaign should repay the overdue bank loans and pay the fines. Through the management of the special group, some subsidiaries of Champaign resumed production and operation. On 5 September 1993, hosted by the special group, a meeting of shareholders of Champaign Company was held to discuss significant changes of the

company. On 29 December 1993, Champaign was restructured and renamed Shenzhen Fountain Corporation (*Shi Ji Xing Yuan*). The Fountain Corporation took over Champaign's rights and responsibilities, and the stockholders of Champaign changed their shares to Fountain shares. On 4 January 1994, Fountain Corporation resumed being listed on the SZSE.

On 6 November 1993, Peng Jiandong was arrested in Hong Kong, accused of embezzlement and illegal transfer of funds overseas, and returned to mainland China. On 28 September 1995, Shenzhen Intermediate People's Court convicted Peng Jiandong of embezzlement and misappropriation (Xinhuanet.com, 2012; Xiao, 2010; Yuan, 2008). He was sentenced to 16 years of imprisonment and deportation due to his status as an Australian citizen, which meant that he would not be imprisoned. In addition, his illicit money of 290,000 RMB was confiscated. Peng Jiandong appealed to the Guangdong Provincial High People's Court, and his appeal was rejected. After this case, Peng Jiandong disappeared from the public eye until 5 January 2006, when the Hong Kong Supreme Court rejected Peng Jiandong's claim for compensation by the majority shareholder and the board of directors of Fountain Corporation.

The Champaign case occurring in the nascent stock market exemplified the typical schemes frequently employed by manipulators (*Zhuang Jia*) to rig the market, such as financial reporting fraud, insider trading, corporate reorganization, and so on. The authorities adopted administration-led restructuring to deal with Champaign. The listing of Fountain in place of Champaign purported to help the stable growth of the nascent stock market and protect the interest of stock investors. But listed companies with such

continued losses should be removed from the stock market according to relevant laws, such as the Provisional Regulation on Stock Issuance and Trading. The administrative measures to restructure Champaign and resume its listing did not follow market principles and violated the laws (Yuan, 2008). The administrative measures might not be good for the operation of Fountain Corporation. In addition, it did not help establish the strict regulation for companies to get in and out of the stock market. Moreover, the administration-led approach seemed to benefit those stock investors of Champaign, but it did not help investors form risk awareness that is critical to a healthy stock market.

The Shenzhen 8/10 Event

In August 1992, the Shenzhen government decided to sell 5,000,000 share subscription application forms on 10 and 11 August. Li Hao, Shenzhen municipal party secretary, said the government planned to use the estimated 1 billion RMB in earnings from the sale of 10 million forms to build roads (Shenzhen Special Zone Daily, 2008). As provided by the government, every person with his/her ID on hand could buy ten forms that entitled him/her to draw lots to get shares that would be issued in the SZSE within a year. Beginning on 7 August, huge numbers of people from different regions swarmed into Shenzhen. As reported by the Shenzhen Special Zone Daily, approximately 1.5 million people crowded into this southern city that had only 600,000 residents. Some even carried big sacks full of ID cards they bought in the countryside (Shenzhen Special Zone Daily, 2008). On 7 August, people camped out in long queues. In the afternoon of 10 August, it was announced that the forms were sold out. Thousands of people were not able to purchase a form, but they did not leave and continued to wait. At the same time,

the speculation of forms was so crazy that forms worth 100 RMB were resold by scalpers for as much as 500 to 800 RMB.

Before long, Hong Kong media revealed the pictures featuring the corrupt practices in selling application forms. This publicity quickly outraged the crowd of waiting people. Protests broke out with slogans such as “down with corruption” and “demand for fairness and against cheating” (Financial Times, 1992; New York Times, 1992). Protestors were marching toward the Shenzhen city hall. At midnight, protestors destroyed several vehicles, including police cars. Due to the chaos, Shenzhen municipal party secretary, Hao Li, hurriedly ordered the Shenzhen government to sell 5 million more share application forms and promised to punish those guilty of corruption. Once this governmental decision was announced, the crowd immediately calmed down. As Hao Li admitted later, the government’s policies allowing the risk-free purchase of initial shares and the procedures of selling forms were defective and directly responsible for the crazy speculation (Shenzhen Special Zone Daily, 2008).

A few days after this incident, the Shenzhen government formed an investigative office that was led by the mayor and comprised of 130 government officials. Their investigation found that over 100,000 share application forms were held back by the staff of financial institutions in charge of selling forms, the supervisory personnel, and government officers. According to the report, 4,180 persons were engaged in various degrees of corruption. In the end, the central government announced that the vice mayor took direct responsibility for the incident and other chief officers were also implicated (J. Zhang 2001). The Shenzhen municipal party secretary and mayor were removed and

assigned to other posts. Zhu Rongji, the Chinese vice Premier, called the 8/10 event a “technical problem out of control” (J. Zhang, 2001).

The Foundation of the CSRC

The Champaign scandal and the Shenzhen 8/10 event caused the central government to promptly establish the China Securities Regulatory Commission and set about a national unified regulation of the nascent stock market (Xinhuanet.com, 2012). The central government began to develop state-controlled securities companies. With these institutional agencies, the central government intended to take an active part in securities trading and establish its leadership in regulating the stock market. In September 1992, the Industrial and Commercial Bank of China, Agricultural Bank of China, and China Construction Bank took the initiative to found three state-backed big securities companies: Hua Xia Securities Company, Nan Fang Securities Company, and Guo Tai Securities Company, each of which had registered capital of 1 billion RMB (Kan, 2010; Y. Lu, 2008).

In October 1992, the Securities Commission of the State Council was formed, with Zhu Rongji as the director. Its working body was the China Securities Regulatory Commission (CSRC). The CSRC adopted a quota and approval system for stock issuance (Pistor and Xu, 2005; Y. Lu, 2008). In accordance with economic demands and conditions of capital markets in the country, the CSRC determined the yearly total quota of stock issuance for the entire country. Then, the CSRC assigned different quotas to provincial regions and departments on the basis of their respective demands, status, and situations. Within the quota limit, provincial governments and departments recommended

enterprises to the CSRC. Lastly, the CSRC examined and decided whether to approve stock issuance by the recommended enterprises. Taking a lesson from the 8/10 event, stock issuance procedures were reformed; e.g., the number of share application forms for drawing lots was unlimited, shares subscription were applied through the trading system of stock exchanges, and so on.

Practically concurrent with the founding of the CSRC, the Fourteenth Party Congress in October 1992 officially confirmed that a socialist market economy should be established in the PRC. This signaled a victory for reformists in political and ideological debates and showed the central government's resolve to develop the market economy. To regulate the stock market, the central government enacted the Provisional Regulation for the Stock Issue and Trading, Provisional Measures for Forbidding Securities Fraud, and Rules for Implementation of Information Disclosure of Companies Issuing Stock Publicly. On 13 December 1992, the State Council issued the Circular on Further Strengthening Macro-Management of the Stock Market.

The First Bailout by the CSRC

In November 1993, the Third Plenum of the Fourteenth Central Committee of the Chinese Communist Party was held, finally confirming the national goal of establishing a modern enterprise system in China. The central government facilitated experiments with a shareholding system for state-owned enterprises. To help state-owned enterprises get out of difficult situations, e.g., capital shortage and poor performance, the central government drew a batch of state-owned enterprises into the stock market. This expanded the scale of the stock market swiftly, but the rapid expansion brought great pressure on

the stock market. On 30 July 1994, Xinhua News published the article “The CSRC and Related Departments of the State Council Adopted Measures to Stabilize and Develop the Stock Market.” Through this article, the CSRC announced three bailout plans: suspending new stock issuance and listing that year, controlling the scale of share allotment of listed companies, and expanding the scale of capital getting into the stock market (e.g., allowing securities companies to collect money and found Sino-foreign joint funds). Immediately responding to the bailout, each of the Shanghai and Shenzhen composite indexes rose by 33.46% on 1 August 1994. Financial media also sensationalized the rising of the stock market. Since that time, adjusting new stock issuance, capital scales, stamp tax rates, and stock transaction rules have become important measures adopted by the central government to affect the stock market (Y. Lu, 2008). Liu Hongru, the first president of the CSRC, admitted that regulatory departments should build an open, just, and fair environment for stock trading and should not violate market principles to affect stock prices, but the CSRC stepped into the stock market under heavy political pressure. For example, when the SSE composite index dropped to 300 or so, the Shanghai government was worried that crazy stock investors who had great losses would cause incidents and submitted an official request to the central government to raise the market. Out of concern about the social stability, the central government required the CSRC to adopt measures to raise the stock market (Zheng, 2006).

The 327 Scandal

On 28 December 1992, the SSE created the treasury-bond futures market, which was accepted by the central government. The SSE set a low threshold for bond futures

investors. Investors were required to provide only 1% of the transaction value as deposit⁹ (Davis and Yu, 1995). As the inflation rate exceeded 20% in 1993, the Chinese People's Bank increased the interest rate for three-year bank deposits and offered inflationary subsidy to treasury bonds (Y. Lu, 2008; Yuan, 2008; Kan, 2010). The rate for inflationary subsidy would vary according to economic conditions and would be announced monthly. The uncertainty of the inflationary subsidy rate and the asymmetry of information obtained by market participants increased room for speculation on bond futures.

The crazy speculation of bond futures trading peaked in the 327 event that was called “the biggest scandal ever” in Chinese securities market (Davis and Yu, 1995). Bonds 327 were three-year treasury bonds that were issued in 1992, with a face value of RMB100 each and coupon rate of 9.5%, and would expire in June 1995. That meant the sum total of principal plus interest of each bond 327 would be RMB128.5 on the due date if the coupon rate remained. When bonds 327 were issued, the three-year bank deposit rate was 8.28%. But in July 1993, as the inflation rate exceeded 20%, the central bank increased the three-year deposit rate to 12.24%. If still at the coupon rate of 9.5%, the return on bonds 327 would be too low. Thus, it was said that the Chinese Finance Ministry would provide an additional inflationary subsidy to increase the return on bonds 327, and would pay RMB148 each on the due date. Guan Jinsheng, the general manager of Shanghai International Securities Company (*Wan Guo*), did not believe this “rumor” because he thought the inflation would decrease in 1995, and the Finance Ministry would not spend 1.6 billion RMB on inflationary subsidies for bonds 327 (Yuan, 2008). He assumed huge volumes of new treasury bonds would be issued in 1995 (Davis and Yu,

⁹ For example, to buy futures contracts with a total face value of RMB 1 million, an investor only needed to offer RMB 10,000. In 1994, 1 USD equaled 8.7 RMB

1995). Guan thought the price of futures contract of bond 327 would fall, thus Wan Guo acted as the biggest one of the bears shorting¹⁰ the market.

Guan Jinsheng was called the “Godfather of China’s securities industry” at that time (Yuan, 2008). He was born in the remote countryside of Jiangxia Province in China, and graduated from Shanghai Foreign Language University. After the Great Cultural Revolution, Guan was sent to Europe for advanced study and obtained two master’s degrees in international business and international law, respectively, from Brussels University in 1983. He returned to Shanghai, and a few years later was appointed as the general manager of Wan Guo, the first joint-stock securities company in Shanghai (Yuan, 2008). In his first year as general manager, Wan Guo performed amazingly and became the leading enterprise in China’s securities industry. Its turnovers of securities trading skyrocketed from RMB 300 million in 1989 to RMB 1,970 million in 1990, RMB 4,610 million in 1991, and to RMB 8,990 million in 1992. Among the 270 member firms on the SSE, Wan Guo was number one in terms of securities trading volume, holding 17.6% of the total turnover of the SSE in 1992 (Yuan, 2008). The success of Wan Guo could not be achieved without Guan Jinsheng’s resolute decisions. As described, Guan was ambitious and lacked a sense of risk (Yuan, 2008; Davis and Yu, 1995). These characters helped him become outstanding in this market laden with speculative craze and lack of regulation. But this time, he met a hard rival in trading futures contracts for bond 327.

The China Economic Development Trust and Investment Company (*Zhong Jing Kai*), an affiliate of the Chinese Finance Ministry, was a big bull¹¹ in trading futures

¹⁰ On the securities market, bears (shorts) are investors who expect prices to fall and sell now, in order to buy later at a lower price and earn profit in a falling market.

¹¹ On the securities market, bulls (longs) are investors who expect prices to rise and buy now, in order to sell later at a

contracts of bond 327. Zhong Jing Kai was founded on 26 April 1988, as the only trust company owned solely by the Chinese Finance Ministry. The first and the only president of Zhong Jing Kai was the former vice minister of the Finance Ministry, and all the general managers of Zhong Jing Kai were officials from the Finance Ministry (Ling and Li, 2002). Zhong Jing Kai was regarded as nobility in the Chinese financial industry. The dealer of Zhong Jing Kai in bond futures 327 trading was Wei Dong, whose father was a professor of the Central Finance and Economics University as well as a senior advisor to the Finance Ministry (Yuan, 2008). On the morning of 23 February 1995, the Finance Ministry announced that it would increase the coupon rate for bond 327. Zhong Jing Kai bought huge volumes and raised the price of future contracts of bond 327 to RMB150 each. The Liaoning Guo Fa Group, which had collaborated with Wan Guo to short the market, began to change its direction and buy in 327 contracts. The price of each contract 327 rose by RMB 3.77 in only ten minutes. The SISCO was facing huge losses of RMB six billion.

Under the great pressure, Guan Jinsheng made a reckless move. In the last eight minutes before the market closed, Wan Guo sold 10,560,000 lots of contract 327, with the total nominal value of RMB 211.2 billion. The entire issue of treasury bonds 327 was only RMB 24 billion. The Wan Guo order went through although it far exceeded the contract limit of 300,000 lots set by the SSE. As the SSE said, Wan Guo made it because the exchange's computer system was designed for share trading and could not detect this violation in bond futures transactions (Davis and Yu, 1995). The huge amount of selling contracts suppressed the price of contract 327 to RMB147.50 at the closure of the market

higher price and earn profit in a surging market;

before the bulls could react. Wan Guo could have earned a profit of RMB 42 billion at this price. But at 11pm or so, the SSE announced that the trades in the last eight minutes were invalid for violating rules, and contract 327 closed at RMB151.30. Then Wan Guo was suspended and investigated for its irregularities in trading contracts 327. On 19 May 1995, Guan Jinsheng was arrested. On 20 September 1995, the Chinese Supervision Ministry and the CSRC published their conclusion of the investigation on the 327 scandal, determining that the irregularities of Wan Guo and Liaoning Guofa Group caused the 327 scandal. On 3 February 1997, Guan Jinsheng was convicted of embezzlement and bribery, and sentenced to 17 years imprisonment (Kan, 2010; Z. Wang, 2010; Yuan, 2008).

The 327 scandal shocked the securities market. Three days after its occurrence, the CSRC and the Finance Ministry jointly issued the Provisional Measures Regarding the Regulation of Treasury Bond Futures Trading. In the following two months, the CSRC, the SSE, and other relevant departments issued more than thirty administrative decisions about the regulation of the state bond futures market. But during this period, a series of irregularities still happened in the treasury bond futures market. Finally, on 17 May 1995, the CSRC issued the Urgent Notice Regarding the Suspension of Experiments of Treasury Bond Futures Trading, suspending the treasury bond futures market indefinitely. The close of the bond futures market drove investors and speculators back to the share market.

The 327 case exposed technical problems in regulating the treasury bond futures market, such as the low deposit requirement, no limits for price movements, lack of position limit, and so on (Y. Lu, 2008). In addition, this scandal touched on the information asymmetry that tended to result in insider trading (Y. Lu, 2008). Whether the

return rate of treasury bonds would increase was determined by the decision of the Finance Ministry on inflationary subsidy. Zhong Jing Kai's close connection with the Finance Ministry naturally caused doubts about insider trading in the 327 scandal. In actuality, the Finance Ministry's plan of increasing the payment of bonds 327 was let out before the official disclosure. This secret was exposed by the financial media after Zhong Jing Kai was closed by the central government in 2002 for violating laws on a serious scale (Ling and Li, 2002). The official investigation on the 327 case did not mention the defects of the information closure system, but after this event, the central government changed its former ways and improved the timeliness of publication and implementation of the decisions regarding finance and securities markets (Y. Lu, 2008). As Yi Lu (2008) argues, the 327 scandal became the turning point, after which the government began to employ more market-oriented methods than commanding means to regulate the market.

Although there is no evidence to demonstrate that the 327 scandal resulted from a fight between the central government and Shanghai government, it indicated the conflict between the two. It seemed that the aggressive actions of local governments and irregularities of their affiliate companies challenged the authority of the central government. After the 327 scandal, the central government began to decrease the local governments' influence and adjust the regulatory structure on the stock market. A direct consequence of the 327 scandal was a change of actual leadership of the securities industry (Y. Lu, 2008). After the 327 scandal, Liu Hongru, the first president of the CSRC, quit the position at the end of March 1995; the general managers of the SSE and the SZSE were relieved of their posts in a few months. On 21 August 1996, the State Council Securities Commission issued the Measures for the Management of Stock

Exchanges to replace the Provisional Measures for the Management of the Stock Exchanges published on 7 July 1993. The 1996 Measures provided that the stock exchanges be supervised and managed by the CSRC, and the executives of stock exchanges be nominated by the CSRC.

The Central Government's Efforts to Curb Speculation and Irregularities

By 1995, more than 100 securities officials and managers in Shanghai were jailed for bribery, embezzlement, and other illegal behaviors in the securities market (Davis and Yu, 1995). However, the punishments did not curb rampant irregularities in the securities market. Especially in the second half of 1996, the stock market rose crazily and bred rampant speculation. Trash stocks such as Qiong Min Yuan rose astonishingly. To rein in the overheated stock market, starting in October 1996 the central government issued a series of 12 urgent orders, known as “twelve pieces of gold-lettered plates” (*Shi Er Dao Jin Pai*), which included the Notice of Issues Regarding Regulating Actions of Listed Companies, Measures for the Management of the Stock Exchanges, and Notice Regarding Preventing Overdraw Behaviors in Stock Issuance (Y. Lu, 2008; Z. Wang, 2010; Yuan, 2008). On 30 October, the CSRC issued the Notice on Strengthening the Regulation and Attacking Actions of Rigging the Market. This Notice caused the market to fall immediately, but could not curb the swift upturn of the market.

On 16 December 1996, the CSRC announced the volume of new stock issuance for the next year, RMB 10 billion, three times that of 1996. At the same time, with approval by the CSRC, the SSE and SZSE limited stock price movements; that is, the price of a stock could not increase or decrease by more than 10% in a transaction day. The

Stock Exchanges also decided to implement the information disclosure system. That day, the People's Daily published an article "Be Aware of the Situation of the Current Stock Market" by a "special guest commentator." This article pointed out the recent swift rise of the stock market was "abnormal and unreasonable," criticized the local governments' intervention with the stock market, and called for a national unified regulation of stock market (Y. Lu, 2008). Immediately upon the publication of that article, the Shenzhen and Shanghai stock markets plummeted. Almost all stocks on the SSE fell down to the limit four minutes after the market was opened (Zheng, 2006). Zhou Daojiong, the then president of the CSRC, admitted years later that the "special guest commentator" in actuality was the CSRC, acting upon instruction by the leaders of the central government in an attempt to curb speculation and teach people risk awareness about stock trading (Zheng, 2006).

In mid 1997, the Chinese stock market again saw the speculative craze. Even state-owned enterprises and listed companies joined crazy stock speculation. The central government increased the stamp tax rate and enhanced the amount of stock issuance to curb the rampant speculation and manipulation. The State Council Securities Commission, the People's Central Bank, and the National Commission of Economy and Trade jointly published a regulation to forbid state-owned enterprises and listed companies from speculating on stocks. But some companies did not obey the rule. For example, the securities department of the Qing Qi Group traded stocks through numerous stock accounts in the names of individuals; the Qing Qi Group also profited from insider trading¹² (X. Yu, 2009). On 6 June 1997, the People's Central Bank published a provision

¹² The CSRC placed an administrative penalty on the Qing Qi Group in 1999 (Yu 2009).

to forbid bank capital to enter the stock market. But the series of measures did not curb the overheated stock market.

In June 1997, the central government through the People's Daily publicized the punishments meted out to a number of presidents of local banks and securities companies for their irregularities in stock markets. This article was just a deliberate act by the central government designed to warn the Shanghai and Shenzhen governments. For example, the CSRC banned He Yun, president of Shen Fa Zhan, from the securities industry for five years because he had used the capital of Shen Fa Zhan to speculate on the stock of Shen Fa Zhan. At the same time, the CSRC punished the president of Shen Yin Wan Guo Securities Company, Zhidong Kan, for his manipulation of the stock price of Lu Jia Zui¹³. As Zhidong Kan (2010) described in his memoirs, he was just following the instructions of the Shanghai government to raise the stock price of Lu Jia Zui, a leading company of Shanghai. At that time, Shanghai and Shenzhen were competing for recognition as the financial center in China, thus each government tried to raise its stock market. The local governments' stepping into the stock market added fuel to the overheated stock speculation and bred rampant irregularities. The central government was angry about the local governments' aggressive actions and decided to attack them. Kan Zhidong was a scapegoat in this fight.

¹³ In 2002, the Shenzhen government appointed He Yun and Kan Zhidong the president and the general manager of the South Securities Company, respectively. The South Securities Company suffered great losses from speculation on stocks. After He Yun and Kan Zhidong led the South Securities Company, the company still could not make up deficits and continued to lose by holding the stocks of the Ha Yi Yao and the Ha Fei. As a result, Kan Zhidong was jailed for 20 days (Kan, 2010).

In the Wake of the Asian Financial Crisis

The 1997 Asian financial crisis exposed the ineffective regulation of stock markets and weak corporate governance that contributed to the capital market collapses in Asian countries (Lang, 2010). China's stock market was not involved in the crisis since it was not open to the outside world, but a series of fraud and irregularities in the domestic market gave the Chinese government concern about the regulation of China's stock market. The State Council decided to implement revised Measures for the Management of Stock Exchanges, which provided that the executives of stock exchanges were nominated, appointed, and removed by the CSRC. Thus, the Stock Exchanges were placed under the direct management and supervision of the CSRC (Y. Lu, 2008).

To improve the quality of listed companies, the CSRC adopted a delisting mechanism (CSRC, 2008). On 16 January 1998, the CSRC published the Notice Regarding the Special Treatment Toward Stocks of Listed Companies in the Abnormal Period. Special Treatment policy aimed at stocks of listed companies that had difficult financial conditions or other abnormal situations. The letters "ST" would be placed before the names of these stocks to warn stock investors that the listed companies were in an abnormal state and investors should be cautious of investment risks. Generally, if a listed company had losses for the last two consecutive years, special treatment would be imposed on its stock and "ST" would be placed before the abbreviated name of its stock. If a listed company had losses for the last three consecutive years, "*ST" would be placed before the abbreviation name of its stock to give an early warning of delisting. On 22 April, the special treatment policy was carried out for listed companies in difficult

financial situations or other abnormal situations. The Liao Wu Zi Company listed in the SZSE became the first listed company with ST (special treatment) shares.

In 1998, the Chinese State Auditing Administration audited securities companies across the country, and found that it was common for securities companies to illegally collect public funds, borrow money from other securities companies without authorization, and misappropriate clients' security deposits to purchase stocks (Z. Wang, 2010). For example, all the audited 88 securities companies had histories of misappropriating clients' security deposits. The CSRC provided the securities companies with two ways to fix the problem of security deposits. One was to expand the volume of shares, then use the increased capital to make up for the misappropriated security deposits. Another was to use the profit earned in the rising market to fill the missing deposits. As Zhou Zhenqing admitted, the CSRC had no choice but to use these measures because the stock market would have collapsed if all the securities companies were punished for their irregularities (Zheng, 2006; Y. Lu, 2008).

The High-Profile Securities Fraud (1996-1998)

Although the Provisional Regulations of Stock Issuance and Trading and the Company Law were effective, the 1996 bull market saw a surge of securities fraud. For example, the Hainan Min Yuan Modern Agriculture Development Company (Qiong Min Yuan) was the biggest dark horse in the bull market, but it turned out to be a typical case of misrepresentation; The Hong Guang Company case was called the biggest case of IPO fraud during this period. These securities frauds shocked the public and the regulatory department.

The Qiong Min Yuan case. From 5 February 1996 to 27 February 1997, the stock price of Qiong Min Yuan increased from 1.5 yuan to 26.4 yuan per share, increasing by 1528% (Z. Wang, 2010). In January 1997, Qiong Min Yuan published its 1996 annual report, stating that its net income reached 577 million yuan, increasing by 1290.68 times. But on the night of 28 February 1997, it was announced that the stock of Qiong Min Yuan was to be suspended. Qiong Min Yuan was reported to the CSRC for making false financial statements. As described by Wang (2010), in response to that, Qiong Min Yuan even sent many workers to attack the CSRC and then the CSRC received an anonymous phone bomb threat.

On 29 April 1998, the CSRC published its investigation of Qiong Min Yuan. In the 1996 annual report, Qiong Min Yuan stated that its profit that year was 571 million yuan, but according to the investigation, 540 million of the 571 million yuan profit was faked. Qiong Min Yuan had seven connected companies in Beijing and eight in Hainan, which had no specific offices or personnel, and Ma Yuhe was the legal representative for most of the companies. The profit was mainly from connected transactions, which made it difficult for auditors to identify its real profit. Qiong Min Yuan also faked a capital reserve fund of 657 million yuan. From its listing in 1993 to 1997, when it was suspended, Qiong Min Yuan changed its accounting firms frequently, which also made it difficult for auditors to get complete accounting documents and judge its performance. The investigation found Min Yuan Hainan Company, the controlling shareholder of Qiong Min Yuan, had engaged in rigging the stock price of Qiong Min Yuan. Before the publication of the Qiong Min Yuan's 1996 mid-year report, Min Yuan Hainan Company collaborated with Shenzhen Nonferrous Metals Financial Company to buy a massive

volume of Qiong Min Yuan shares. They sold the shares before March 1997 and earned huge profits (Z. Wang, 2010).

On 10 June 1998, Ma Yuhe, former president of Qiong Min Yuan, was prosecuted for providing false financial statements. The Beijing No. 1 Intermediate Court publicly tried this case, which was the first criminal case of securities fraud in China. On 12 November, Ma Yuhe was convicted of providing false financial statements and sentenced to three years imprisonment. The related accounting firms and accountants were punished. As to the offense of rigging the market, the Min Yuan Hainan Company's and the Shenzhen Nonferrous Metals Financial Company's illegal profits of 66.51 million yuan and 66.3 million yuan, respectively, were confiscated, and they were warned and fined 2 million yuan each (Z. Wang, 2010).

On 20 November 1998, the Beijing government approved the transfer of state-owned enterprise shares held by the Min Yuan Hainan Company (38.92% of Qiong Min Yuan shares) to Beijing Housing Building and Development Company (Beijing Housing). Beijing Housing and other several companies implemented the restructuring of Qiong Min Yuan and changed it to a new company, Zhong Guan Cun Science and Technology Company (Zhong Guan Cun). Then Qiong Min Yuan was removed and Zhong Guan Cun was listed with the price of 37 yuan per share at the opening. The previous Qiong Min Yuan shares held by common stockholders were changed to Zhong Guan Cun shares according to the ratio of 1:1 (Z. Wang, 2010).

The Hong Guang case. The Hong Guang Industrial Company originated from the State-Owned Chengdu Hong Guang Electronic Tube Factory. In 1993, approved by

the Chengdu government, the Hong Guang Electronic Tube Factory and several local banks and trust companies jointly established the Hong Guang Industrial Company. In 1995, the central and local governments designated Hong Guang Industrial Company as one of the state-owned enterprises experimenting with the shareholding system, and then it obtained a quota for being listed on the stock market. But actually Hong Guang Industrial suffered great losses at that time. As the Chinese Company Law provides, a company must earn a profit during the most recent three years before it is listed on the stock market. To get approval of the CSRC, the Hong Guang's executives falsified financial documents and packed the company to meet the standards for listing. In June 1997, Hong Guang Industrial Company was listed. Its issuance price was about 6 yuan per share, and its price became 14 yuan per share at the opening (Z. Wang, 2010).

Unfortunately, Hong Guang Industrial's 1997 yearly report revealed its loss of 198 million yuan. Its stockholders were trapped. In November 1998, the CSRC found that Hong Guang Industrial had concealed its great losses, faked its profit, and covered the important facts that negatively affected its operation. The CSRC punished Hong Guang Industrial Company and its recommender, the Guo Tai Securities Company. After the fraud was revealed, 11 individual stockholders from Shanghai brought civil suits against Hong Guang for compensation for their losses due to its misrepresentation. This was the first civil case in which investors sued a listed company for compensation for their losses as a result of its misrepresentation in China's stock market. But the court did not accept the case then (Z. Wang, 2010).

In 1999, president He Guangyi and five other executives of Hong Guang Industrial Company were sentenced to imprisonment. Hong Guang became the first

company to receive a criminal penalty in China's stock market. As Zaiman Wang (2010) described, in a media interview with He Guangyi in prison, he said that their making false documents for being listed was driven by "a glorious dream" to develop the enterprise. He said that in reality, making false documents was necessary sometimes. He also said if Hong Guang had cooperated with Sichuan Chang Hong Company, Hong Guang would have developed successfully, but unfortunately Hong Guang failed to get this chance. He attributed this failure to the neglect of the Chengdu government for not actively assisting them in their effort to cooperate with Chang Hong.

The Enactment of the Securities Law and Other Regulations

The surge in securities fraud propelled the central government to make new laws and rules and establish mechanisms to strengthen the regulation of the stock market. In 1997, provisions of securities crime were added to the revised Criminal Law. In the first half of 1998, the CSRC set up branch offices across the country. The State Council Securities Commission was dismissed and incorporated into the CSRC; and other departments' supervisory functions over securities markets were transferred to the CSRC. Finally, the national unified regulation of securities market formed, with the SSE and the SZSE being put under the direct control of the CSRC. Then the Chinese Securities Law was enacted on 12 December 1998, and became effective on 1 July 1999.

The exposure of IPO fraud pushed for reform of the stock issuance system. A quota and approval system was adopted to avoid overheated investment and excessive fundraising and to check the quality of the applicant since efficient channels for information disclosure were lacking at that time. But a series of scandals, e.g. the Lan Tian case, revealed the dark side of the quota and approval system (Z. Wang, 2010;

Huang, Wu and Duan, 2007; Gu and Wang, 2004). As the power for review was excessively centralized and the operations of review were not open and transparent, the quota and approval system provided temptation to potential offenders who were not qualified for listing to attempt to obtain approval by bribery and other fraudulent means. Furthermore, the lack of an accountability system for punishing officials responsible for the failure of examination and approval could not deter power-money trading between officials and stock issuance applicants. The low quality of listed companies was often an outcome of the quota and approval system without effective external supervision. In September 1999, the Public Offering Review Committee was established, composed of 80 members from the CSRC, other government departments, stock exchanges, and academia. In March 2001, the old quota and administrative approval system was replaced by a new approval system for stock issuance that required a joint stock company applying for an IPO and issuance be recommended by a principal underwriter and then voted by the Public Offering Review Committee independently (CSRC, 2008).

The 5/19 Rise and the Long Bull Market

Due to the economic situation, the downturn of the stock market lasted two years after the central government adjusted the stock market in 1997. Especially in early May of 1999, China's stock market fell sharply immediately upon the US bombing of the Chinese embassy in Belgrade¹⁴. Most of China's securities newspapers published an article calling for Chinese stock investors to convert grief into strength, developing a

¹⁴ On 8 May 1999, the Chinese Embassy in Belgrade was hit by five missiles from the US army during the NATO bombing of Yugoslavia. This bombing killed three Chinese reporters and injured more than 20 employees of the Chinese Embassy. According to the US official account, the US army had intended to hit a Yugoslavia military agency, but they used an old map and then bombed the Chinese Embassy by mistake. China did not accept this explanation that it was an accident. The bombing outraged the Chinese public. See http://news.163.com/09/0508/09/58PID62D00011MTO_2.html

stock market that could serve the domestic economy (Wall Street Journal, 1995). Invoked by the advantaged policies adopted by the central government, the stock market rose suddenly on 19 May 1999. Because this upturn began on 19 May 1999, it has been called the 5/19 rise of the Chinese stock market. On 15 June, an article by the special commentator published in the People's Daily asserted that the rise was a resumption of growth after two years of downturn (People's Daily, 1999). This article added fuel to the rising stock market.

The 5/19 market rise did not result from improvement in the performance of listed companies, but was caused by government efforts. With the high stock prices and relatively low earnings, the high price-to-earnings ratio (PE) of the stocks signaled the potential risk of a stock market bubble. After about two years of upturn, on 14 June 2001, the Shanghai index reached 2245.44 points and then went down. On 22 October 2001, the Shanghai index dropped below 1515 points, and then came the longest ever bear market, lasting five years. The lowest Shanghai index was 998.23 points in 2005, a decrease of 55.54% compared to the highest index in 2001. Yi Lu (2008) argued that it was not only a "technical revenge" from the market, but also a penalty for the government's advancing its public credit.

Years later, Zhou Zhengqing, president of the CSRC admitted that this article published in the People's Daily on 15 June 1999 was also from the CSRC (Zheng, 2006). By that time, the market had remained down for more than one and a half years and most investors were trapped in the stock market. Facing doubts about the government's intervention with the stock market, Zhou Zhengqing insisted that the government take measures to raise the stock market out of concern for investors' interest (Zheng, 2006).

He argued that it was unreasonable for the stock market to remain down for so long and most stock investors suffered losses. As he stated, on the one hand, the down market was not good for economic development; on the other hand, investors entered the stock market to support national economic construction, so the government should care about their interest.

But Yi Lu (2008) argued that the 5/19 rise was the central government's scheme to attract a huge volume of capital into the stock market in order to fill the black hole caused by the irregularities of financial firms. In 1999, the central government launched the strictest check on the trust industry, since a large number of trust companies were involved in scandals in securities trading and speculation. Among 329 trust companies in the country, only 50 trust companies were allowed to renew their registration, and the bad accounts of the trust industry worth about RMB 600 billion were written off (Y. Lu, 2008). The 5/19 market rise led to a 200% increase in the number of investors and the amount of investment capital increased greatly. By expanding the volume of shares and raising the stock prices, the government helped the financial institutions collect more money to make up for the huge losses caused by their irregularities, such as illegal speculation, misappropriating clients' security, laundering money, and so on. The securities companies did not receive severe punishment for these irregular practices; instead, the government helped them fix their losses at the expense of the interests of the vast number of investors.

From 2000 to 2005, the total market value of China's stock market dropped from about RMB 4,809 billion to about RMB 3,243 billion, decreasing by 32.6%; the circulated market value dropped from about RMB 1609 billion to RMB 1063 billion,

decreasing by 33.9% (Y. Lu, 2008, p. 111). The decrease of circulated market value was about RMB 545.7 billion, close to the value of the bad accounts worth RMB 600 billion that were written off in the reorganization of the financial industry in 1999 (Y. Lu, 2008, p. 111). Although the government did not admit it, the consequence of the 5/19 rise as shown in the subsequent long bear market and the sharp decrease of market value indicated that stock investors contributed a lot to the financial reform led by the government, at least objectively (Y. Lu, 2008). As the black hole caused by the irregularities of the trust companies and securities firms were filled, these companies were transformed into new securities firms and fund management companies. That allowed the reorganization of the financial industry to go through smoothly without risking runs on these checked trust companies and securities firms (Y. Lu, 2008). In addition, the rise of the stock market seemed a preparation for reducing state-owned shares.

The Rampant Securities Crimes after the Securities Law (1999-2002)

Before the Securities Law was published, the case of Qiong Minyuan was regarded as the biggest scandal. But the Zhongke Venture case, the Yi An case, the Yin Guangxia case, and the Lan Tian case were more serious than the Qiong Minyuan case in terms of misrepresentation and manipulation. These series of securities frauds shattered the miracle of the long bull market of 5/19 rise and further damaged the trust of investors in the regulatory authorities.

The Zhongke Venture case. In the beginning of 2001, right after the sudden crash of Zhongke Venture stock, Lu Liang, the manipulator behind the scene, exposed the

inside stories to the media (Hu, Li, and Li, 2001). Lu Liang was famous for he had raised capital to restructure Zhongke Venture and then exaggerated its performance via media. Lu admitted to the media that he led a bundle of Beijing institutions to rig the stock prices of Zhongke Venture and other listed companies. As described in his statement, when he took over Kondarl (the predecessor of Zhongke Venture) in the early 1999, he got to know that it was a loss-generating company with faked financial statements, and he realized that he fell into the trap of a criminal gang and would soon become one of these offenders (Hu, Li, and Li, 2001). Lu and the institutions continued covering the truth and raised the stock prices to trap public investors and make the company a money-drawing machine. In July 1999, Lu established Zhongke Venture in Beijing, and its president was Liu Yuming who was the vice director of the high-tech research center of the Ministry of Science and Technology. From 1999 to 2000, the institutions led by Lu Liang controlled Kondarl and other several listed companies and made them a net for drawing money on the stock market, which people called the Zhongke Clique. The Zhongke Clique manipulated the stock prices of China-West Medicine, Suibao Heat Electricity, Lai Steel, and other listed companies (Hu, Li, and Li, 2001).

But when the manipulators ran out of funds at the end of 2000, the stock price of Zhongke Venture fell sharply, and its market capitalization decreased by about 5 billion yuan. Then the scandal of Zhongke Venture was exposed and the regulatory authorities began to investigate it. According to the investigation, from November 1998 to January 2001, the majority shareholder of Kondarl (then Zhongke Venture) and accomplices, with funds of about 5 billion yuan raised from the public, used about 1,500 stock accounts under different names to buy and sell the shares without actual change of ownership. In

this way, they held about 55.36% of the whole tradable shares of Zhongke Venture, and caused its stock price to rise by more than 1000% (Hu, Li, and Li, 2001). When its stock price fell, public retail investors suffered losses.

In June 2002, the case of Zhongke Venture came to trial. This case was regarded as the biggest of the Chinese stock market frauds at that time, which involved 120 securities departments across more than 20 provinces and involved 5.4 billion yuan. In 2003, the court made judgments against the responsible persons. For example, the Shanghai Shi Ye Company was fined 23 million yuan for rigging the stock prices; Ding Fu Gen and other five persons were sentenced to imprisonment, from two years and two months to four years, and fined 100,000 to 500,000 RMB. But they were just operators instructed by Lu Liang (China Securities Investor Protection Funds, 2010). Lu Liang, the key figure in this case, disappeared and still has not shown up.

The case of Yi An Science & Technology. While public stockholders were still shocked by the Zhongke Venture scandal, another big scandal, the Yi An Science & Technology case was exposed (J. Li, 2001). On 23 April 2001, the CSRC administratively sanctioned four consulting firms for rigging the stock price of Yi An Science & Technology, confiscating their illegal earnings of 449 million yuan and fining them 449 million yuan, which set a record high in fines for securities fraud (J. Li, 2001). According to the CSRC's investigation, in October 1998, the four consulting firms took control of Shen Jin Xing Company (the predecessor of Yi An Science & Technology), an underperforming listed company and soon increased its stock transaction volume and boosted its stock price. At the same time, the Yi An Group, with Luo Cheng as its president, took Shen Jin Xing as a shell company to enter into the stock market. The legal

representative of two firms was Luo Zhongmin, Luo Cheng's driver, and another firm's legal representative was Luo Dongmei, Luo Cheng's niece. Following the 5/19 rise in 1999, a series of good news about Shen Jin Xing, e.g., corporate asset restructuring, investment and so on, was released. The four consulting firms held the majority of the whole tradable shares of Yi An Science & Technology through 627 individual accounts and three enterprise accounts and boosted its stock, earning 449 million yuan from selling more than 30 million shares at high prices (J. Li, 2001). After the peak, the stock price of Yi An Science & Technology fell sharply, and then public retail stockholders suffered great losses.

One year after the trial of the Zhongke Venture case, the Yi An Science & Technology came to trial. On 25 September 2003, the court made a judgment against five defendants. The former vice CEO and the CFO of the Yi An Group, Li Hongqing and Luo Jianzi, were sentenced to imprisonment of three years and six months and fined 500,000 RMB respectively for rigging the market (China Securities Investor Protection Funds, 2010). But similar to the Zhongke Venture case, the key role in the scandal, Luo Cheng, former president of the Yi An Group, escaped and still has not shown up. The case of Yi An Science & Technology again shocked the regulatory authorities and propelled the publication of the Supreme People's Court's Circular on Issues Regarding the Acceptance of Civil Compensation Cases on Misrepresentation in the Securities Market.

The Yin Guangxia case. The case of Yin Guangxi, exposed in 2001, was called the Chinese Enron incident (Ling and Wang, 2001). In June 1994, the Yin Guangxia Company was listed on the Shenzhen Stock Exchange as the first listed company from

the Ningxia Hui Nationality Autonomous Region. The president of Yin Guangxia was the former head of the Science and Technology Department of Ningxia Provincial Government. From the end of 1999 to the end of 2000, the stock price of Yin Guangxia increased by 440%, and increased by eight times compared to the price before the 5/19 rise. On 1 March 2001, Yin Guangxia announced that it signed an agreement with a German company for exporting extracted products in the coming three years, with the total amount worth 6 billion yuan. Two journalists from the Finance and Economics Magazine doubted the miracle of Yin Guangxia, and after more than one year's investigation, they discovered the fraudulent scheme of Yin Guangxia. On 3 August 2001, the CSRC began to officially investigate Yin Guangxia and suspended it from the stock exchange. According to the investigation, from 1998 to 2001, Yin Guangxia provided false sales income of more than 1 billion yuan and false profit of more than 770 million yuan. After one month's suspension, Yin Guangxia returned to the stock exchange in September 2001. It faced numerous claims for compensation. For example, the Shanghai Jin Tian Cheng Law Firm received more than 1,100 investors who submitted claims for compensation of over 40 million yuan for losses caused by Yin Guangxia's misrepresentation. On 23 April 2002, the CSRC fined Yin Guangxia 600,000 yuan, and ordered it to correct the false statements. Based on the decision of the CSRC, the court began to hear civil compensation cases against Yin Guangxia¹⁵.

On 16 September 2003, the court sentenced Tianjin Guangxia's president and chief financial officer, Dong Bo, to three years' imprisonment for providing false financial statements and fined 100,000 RMB; the other responsible corporate executives

¹⁵ On 25 May 2005, the court decided that Yin Guangxia must compensate the retail stockholders a total of 5.4 million shares (Chinese Securities Investors Protection Fund Limited Company 2010).

were sentenced to imprisonment of less than three years each for providing false financial statements and were fined from 30,000 to 80,000 RMB each. The two partners of the Shenzhen Zhong Tian Qin Accounting Firm were sentenced to imprisonment of two years and six months, and two years and three months, respectively, and fined 30,000 RMB each (Ling and Wang, 2001).

The Case of East Electronic Company. Shortly after the Yin Guangxia case, another serious scandal involving East Electronic Company was revealed (W. Yang, 2003). East Electronic Company was listed on the SZSE in 1997, and its principal underwriter was the famous China Economic and Development Trust Company (*Zhong Jing Kai*), the winner in the 327 event. Before May 2001, East Electronic Company was called the best Chinese listed company and the listing of its internal staff shares created more than 800 millionaires in the company. In four years after its listing, its stock price increased by over 6,000%. But from July 2001, its stock price began to dive sharply. Its abnormal transactions caused the CSRC to investigate it. In April 2002, East Electronic Company's 2001 yearly report revealed its real performance. According to the investigation, the corporate executives provided false financial statements for four years. From April 1997 to June 2001, East Electronic Company earned profits of 1.7 billion yuan from cashing staff shares and other stock transactions, of which 1.6 billion yuan was included as its income from the main business in the financial statements through fabricating sales contracts and invoices. In December 2002, the court sentenced three corporate executives to imprisonment for providing false financial statements.

Zhong Jing Kai was involved in the manipulation of the stock of East Electronic. On 26 July 2002, the general manager of Zhong Jiang Kai, Jiang Jizeng was arrested for

rigging stock prices of East Electronic Company. The defense lawyers argued that the increase of East Electronic stock price resulted from the 5/19 rise. Jiang Jizeng also pleaded that he was not guilty since he had no idea about the activities of rigging the market. He claimed he had adopted measures to restrict the right to finance of the company's departments and unify the company's fund management, which annoyed some people and resulted in his being punished (W. Yang, 2003).

The Lan Tian case. A scholar's report revealed another big scandal, the Lan Tian case in 2001 (Huang, Wu, and Duan, 2007). Having a quota of 30 million public tradable shares given by the Chinese Ministry of Agriculture, the Lan Tian Company was listed on the Shanghai Stock Exchange in June 1996. It was called the first stock of Chinese Agriculture. Actually, in November 1999, the CSRC published its conclusion that Lan Tian provided false application documents for listing. This raised public discontent and some appealed for severe punishment against Lan Tian. But astonishingly, Lan Tian was only fined one million yuan, and its president was fined only 100,000 yuan. The light punishment did not deter Lan Tian from continuing misrepresentation. Lan Tian's yearly reports showed that from 1996 to 2000, its income from the main business increased from 468 million yuan to 1.84 billion yuan (growing by 293%), and its net profit increased from 59.3 million yuan to 432 million yuan (growing by 628%). Doubts were raised about its income and profits, but some agricultural experts and officials expressed they trusted Lan Tian's performance (Z. Wang, 2010).

On 23 October 2001, a short report by Liu Shuwei, a scholar in the Chinese Central University of Finance and Economics, revealed the fraudulent scheme of Lan Tian. Analyzing Lan Tian's financial statements, Liu Shuwei concluded that Lan Tian

was only dependent on bank loans for its survival. This report also cited the description of Su Zhengbin, a journalist of the Guangdong and Hong Kong Information Daily, who investigated the production base of Lan Tian and doubted its performance. Liu Shuwei sent this report to the Financial Internal Reference, a confidential publication for the central government's finance committee, the central bank and relevant high-ranking officials. Surprisingly, the president of Lan Tian, Qu Yongyu, knew of this article and went to Liu Shuwei's office to scold her (Huang, Wu, and Duan, 2007). Then Liu Shuwei sent her detailed analyses to relevant departments. In December, Lan Tian sued against Su Zhengbing and Liu Shuwei for defamation.

Upon the pressure of media and public opinion, the CSRC and the public security department investigated Lan Tian, and soon ten executives of Lan Tian were arrested in January 2002. According to the investigation, Lan Tian fabricated profits of about one billion yuan; with the false financial statements, Lan Tian and its connected companies gained bank loans of more than three billion yuan (Huang, Wu, and Duan, 2007). At the end of 2003, the executives of Lan Tian were sentenced to imprisonment of one and a half years to three years for providing false financial statements and making false registered capital. In November 2004, the former president of Lan Tian, Qu Zhaoyu, was sentenced to imprisonment of two years. Several officials of the Chinese Ministry of Agriculture were involved in the Lan Tian scandal. They bought internal staff shares of Lan Tian and earned profits from sales of the shares. At the end of 2005, 83 investors sued Lan Tian for compensation for the losses caused by its misrepresentation. This initiated numerous civil cases against Lan Tian (Z. Wang, 2010).

Summary of the case analyses. These high-profile cases show some common features and reveal the institutional defects that obstructed the regulation of the stock market. First, the quota and administrative approval system for issuance bred serious corruption (Ling and Wang, 2001; Z. Wang, 2010; Huang, Wu, and Duan, 2007). The Lan Tian case was an example, involving officials of the Chinese Ministry of Agriculture. The excessive centralized power of administrative authorities in the quota and approval system, and the lack of transparency of pre-issuance review gave room for rent-seeking abuses. The potential huge profit from fundraising in the stock market drove corporate executives to bribe the authoritative officials in charge of recommendation and review for IPOs and listing.

Second, the arrangement of internal staff shares produced a temptation to potential offenders (Z. Wang, 2010; W. Yang, 2003). Since the IPO price of a company was always much higher than the price of its internal staff shares, holding internal staff shares meant an opportunity to earn huge profit when they were listed. Internal staff shares were often given to officials in return for their help with IPOs and listing. The Lan Tian case is an example. The officials or their relatives bought internal staff shares, not feeling that they were receiving bribes. In this way, the companies could transfer the cost of bribery to stock investors. In the common interest, the officials made efforts to help companies obtain approval of IPO and issuance. After the IPO, the internal staff shares could be listed in the stock market without restrictions. For example, the listing of the East Electronic Corporation made millionaires of more than 800 people holding internal staff shares. This was a great lure to corporate executives and employees holding internal

staff shares. As a result, they worked harder at making the company get listed on the stock market than improving the company's performance.

Third, in these cases, the increases in stock prices often occurred during the 5/19 market rise. This let the manipulators use the excuse that the increases in stock prices were the outcome of the market trend rather than manipulation (W. Yang, 2003). For example, the general manager of Zhong Jing Kai argued that the increases in stock prices of East Electronic were due to the 5/19 market rise. During sharp changes of the stock market, securities fraud and crimes increased. The 5/19 market rise caused by the government increased speculation and produced opportunity to manipulators and insider traders.

Fourth, a single case often involved different types of securities fraud and crimes, such as misrepresentation, rigging the stock prices, and so on. Manipulators often boosted the stock prices after the companies released good news or provided false financial statements. And insiders would take advantage of the undisclosed information to buy or sell the stocks in advance. For example, the East Electronic Company involved crimes of misrepresentation, manipulation, and insider trading. The manipulators of Zhongke Venture provided false financial statements and then boosted the stock prices.

Fifth, the securities frauds were often implemented through the cooperation of different parties, especially the cases of manipulation. For example, the Zhongke Venture case involved 120 units, more than 1500 accounts, and more than 5.4 billion yuan. This scandal in fact was the work of Zhongke Venture, individual manipulators, securities companies, other institutions, and even local governments (Gu and Wang, 2004). The

case of Yi An Science & Technology was also the work of different units to conduct manipulation and tunneling. These serious scandals showed the crazy fundraising and speculation in the stock market. The ineffective external regulation and the absence of internal corporate supervision gave way to potential offenders.

Last but not least, the companies and the persons responsible for the securities fraud and crimes received light criminal penalties. In these cases, the responsible persons received imprisonment of less than three years, and the fines imposed on them were also small compared to the losses they caused to the investors. The light criminal penalties seemed not in accord with the rule of fairness and would not deter potential offenders. For example, the CSRC's light penalties against the IPO fraud of Lan Tian did not deter its continuing financial reporting fraud. And it was noted that the criminal investigations and corresponding restriction measures were not started in a timely manner, which gave those involved time and opportunity to escape. The Zhongke Venture case and the Yi An case exemplified this trend. In addition, due to their close relationship with the government, the collapses of the companies and persons would be interpreted as their failure in the political strife, since the securities irregularities were common in the market. Thus, fewer stigmas were attached to the securities crimes and criminals.

Funds Scandals

On 14 November 1997, the State Council Securities Commission issued the Provisional Measures on the Management of Securities Investment Funds. Starting in 1998, the central government made efforts to establish fund management companies as state-controlled institutional investors to improve the structure of investors in securities

markets (CSRC, 2008). As publicized, securities investment funds were introduced from mature Western mature stock markets. Investors buy fund shares and entrust them to fund management companies, and fund managers operate the funds for securities investors. The government expected that fund management companies would help bolster the stock market since they tend to operate stock trading in a legal and moderate manner. The development of securities investment funds became important for the central government to realize its political goals and effective regulation of the securities market (Y. Lu, 2008).

But in 2000, a series of scandals of fund management companies was disclosed. At a working conference of the National People's Congress about the draft of the Law on Securities Investment Funds, Cheng Siwei criticized fund management firms that often conspired to manipulate stock prices and caused retail investors to lose in the stock market (Yuan, 2008). Subsequently, an article "Inside Stories of Funds: A Report Regarding the Analysis of Actions of Funds," published in *Finance and Economics Magazine* in October 2000, shocked the securities industry and regulatory authorities (Ping and Li, 2000). This article was based on a report by a staff member in the inspection department of the Shanghai Stock Exchange and was submitted to the State Council. The article revealed that fund management companies acted like unscrupulous speculators, employing matched orders¹⁶, affiliated transactions, insider trading, and so on to manipulate the stock prices. It argued that fund management companies did not play a role as a market stabilizer, but instead aggravated speculation and irregularities in the stock market. Immediately upon its publication, ten funds management firms jointly published a statement in important securities newspapers, arguing that the securities

¹⁶ Matched orders means that according to agreement, the parties act as buyer and seller in trading some stocks at the pre-arranged prices in order to make an illusion in the market and affect the stock prices.

investment funds had the strictest supervision and most open system compared to other investment firms in China. The fund management companies also claimed that the article “Inside Stories of Funds” spread baseless rumors and slandered the funds industry, and they reserved the right to sue the author and the magazine (Y. Lu, 2008; Z. Wang, 2010). But interestingly, the subsequent investigation by the CSRC found that eight of the ten fund management firms had committed irregularities in securities trading (Z. Wang, 2010).

Scholars’ Critiques on the Regulation of the Chinese Stock Market

Exposure of a series of securities frauds caused scholars to criticize the regulation of the Chinese stock market. The most famous was Wu Jinglian’s “casino theory”¹⁷. In an interview by the Chinese Central TV in January 2001, Wu Jinglian stated that the Chinese stock market was worse than a casino since some players could see others’ playing cards and acted fraudulently to rig the market; in this sense, the Chinese stock market was an unruly casino. His talk created quite a stir in the stock market. According to an online survey organized by the Sina.com, of over 30,000 people surveyed, 77.4% showed support for Wu Jinglian (Z. Wang, 2010).

Lang Xianping was another economist whose criticisms on the regulation of the Chinese stock market were influential in these years. Lang Xianping became known for his article “The De Long Clique: the Fundraising Model of Quasi-Family Business in Chinese Stock Market” published in April 2001. In this article, Lang Xianping (2001) discussed the predatory fundraising in the stock market by the De Long Clique, referring to the companies controlled by the Xinjiang De Long Company. For a listed company in

¹⁷ See at <http://www.cnstock.com/index/zhuangti/zggs20zntbbd/jdrwjdrw/201011/965874.htm>

the Chinese stock market, the price per share of non-tradable shares was often much lower than that of tradable shares. For example, in 2000, the average price of enterprise-owned shares for transfer was about 13% of the average price of tradable shares. Since non-tradable shares represented the majority of all shares of a listed company, one can control the listed company with low cost through obtaining non-tradable shares. After controlling the listed company, the holding company often made a series of investments, equity transfers, and allotments, which were seen as good news and thus boosted the stock price. And then the holding company earned huge profits when the stock price rose.

As described by Lang Xianping, the De Long Clique accumulated wealth in a short time through the mechanisms mentioned above, e.g., making investments and share allotments after it controlled a listed company. In fact, the investments were mainly associated transactions; share allotments boosted the stock price, but common investors did not get any profit. During the three years before 2001, Xinjiang Tun He, He Jin Investment, and Hunan Torch, the three listed companies controlled by Xinjiang De Long, increased in share price by 1,100%, 1,500%, and 1,100% respectively (Lang, 2010, p. 47). In addition, through the listed companies, the De Long Clique also controlled or affected some securities companies and financial institutions, which helped it rig the market. Lang Xianping pointed out that this model of predatory fundraising hurt the interest of minority investors. Lang suggested the rule of shifting the burden of proof to the defendant should be adopted in the civil compensation mechanisms to better protect minority investors. Lang Xianping's incisive critiques won support of public investors, and he was called "Lang Regulator" by the media. In 2004, the De Long Clique collapsed and its

irregularities were exposed, which demonstrated the analyses of Lang Xianping were correct.

Attempts of State-Owned Shares Reduction

As Wu Xiaoqiu argued, the problems of the Chinese stock market mainly resulted from the share-split structure (X. Zhang, 2004). Wu Xiaoqiu argued that the growth of the capital market is critical to the development of the Chinese modern financial system, which serves the continuing development of the economy, solves the risks during the development, and lets investors share the wealth as economic development is achieved (X. Zhang, 2004). The share-split structure adopted in the early stage of shareholding reform became an obstruction to the healthy development of the Chinese stock market and the improvement of corporate governance. Under the share-split structure, shares sold to public investors and listed on stock exchanges (about only 30% of the whole shares) were tradable, while other shares were non-tradable. As the majority of shares were not listed and not traded on stock exchanges, the stock market could not realize its function to improve resource allocation and reflect value for listed companies (F. Cao, 2011; Teng, 2006; Quan and Li, 2009; S. Wang, 2010; R. Li, 2005). In addition, the share-split structure was inconsistent with the international common practices and did not help fit the Chinese stock market into the global market.

Moreover, the share-split structure caused problems in corporate governance. The share-split structure resulted in disparity in pricing and unequal rights for shareholders. Non-tradable shares as the majority of the whole shares of a listed company were often held by one or several units as controlling shareholders. With the abstract or unclear

ownership of the state-owned enterprise, the insiders or the management of the holding company controlled the listed company, and non-tradable shares holders could not participate in its oversight. Taking advantage of the concentrated control over the listed company, the insiders or the management could tunnel the company through related transactions, making false financial documents, and in other ways damage the interests of public stockholders (Z. Wang, 2010; Quan and Li, 2009; Yan, 2006; He, Yang, and Liang 2006; W. Xie, 2005). Since the majority of shares were non-tradable, even if the listed company performed badly, its holding company (controlling shareholder) could not be changed by market-oriented measures; e.g., the majority of shares were traded in the stock market and then the right of control over the listed company was changed (Yan, 2006). The rigid ownership structure hindered the listed company from improving performance and corporate governance. In addition, state-owned shares or legal person shares were often sold at low prices through one-on-one negotiations. Without transparent operations, some could obtain control over the listed company at a low cost by buying large numbers of non-tradable shares. After controlling the listed company, they could take advantage of the listed company to collect funds for themselves and exposed minority investors to risks (Z. Wang, 2010; Quan and Li, 2009; Yan, 2006).

To solve the problems of the share-split structure, the government attempted to reduce state-owned shares by selling them in the stock market. On 6 December 1999, some officials of the Finance Ministry stated that the measures to reduce state-owned shares would be issued. China Jialing Company and Guizhou Tyre Company were pilot companies in reducing their state-owned shares by selling the shares to their existing public investors (Y. Lu, 2008). On 12 June 2001, the State Council issued the Provisional

Measures on Raising Social Security Funds Through Sales of State-Owned Shares.

According to the Measures, in the IPO and secondary offerings, a listed company with state-owned shares should sell its state-owned shares worth 10% of the proceeds of public offerings; the state-owned shares should be sold at market prices and the proceeds should be submitted to the National Social Security Fund (CSRC, 2008). The reduction of state-owned shares caused the stock market to fall sharply. On 28 January 2002, the CSRC announced the proposal for state shares reduction. According to the proposal, the price of fully circulated shares would be determined after experiments. Then the holders of non-tradable shares should compensate the holders of tradable shares for the price differentials. Finally the non-tradable shares would go into the market for trading. Upon announcement of the proposal, the stock market fell sharply (Z. C. Chen, 2005). The CSRC immediately suspended the proposal of state shares reduction.

On 24 June 2002, the Ministry of Finance and the CSRC suspended the Provisional Measures on Raising Social Security Funds Through Sales of State-Owned Shares and suspended reduction of state-owned shares in the A shares market. The downturn of the market reflected the potential pressure of market expansion caused by the state shares reduction that the supply of shares might exceed the demand. On the other hand, it reflected the concern of public investors that they would not get appropriate compensation for the reduction of state-owned shares (Gu and Wang, 2004; Z. C. Chen, 2005). Since the holders of state-owned shares had obtained the shares at very low prices, if the state-owned shares were traded at market prices that were much higher than the original prices, the holders of state-owned shares would gain huge profits at the expense of public investors. Moreover, public investors worried that the holders of state-owned

shares, as the majority shareholders, would manipulate the stock prices and transfer risks to retail stockholders (Gu and Wang, 2004; Z. C. Chen, 2005). The failure of attempts to reduce state-owned shares was actually the outcome of the game on interest allocation among the government, the holders of state-owned shares, and the public investors.

The Emergence of Civil Compensation Cases on Misrepresentation in the Stock Market

Although some listed companies and the responsible persons were punished for securities fraud, effective mechanisms were not established to compensate investors for their losses caused by securities frauds. Take the case of Hong Guang Company as an example. In 1998, after the Hong Guang Company was found to commit IPO fraud, some investors brought civil suits for compensation, but the court did not accept the suits due to the lack of legal basis and judicial experience. In 1999, Hong Guang Company was prosecuted. It was the first company in China's stock market to receive a criminal penalty after the Securities Law went into effect. Its six executives were sentenced to imprisonment. The investors continued to claim their rights for compensation through judicial procedures, but they were declined five times in the following four years (People.com, 2002).

After the Supreme Court issued the Circular on Issues Regarding the Acceptance of Civil Compensation Cases on Misrepresentation in Securities Markets on 15 January 2002, the court began to accept this kind of cases (Sina.com, 2002). On 24 January 2002, the Haerbin Intermediate Court accepted the civil compensation case against Da Qing Lian Yi, which was the first accepted case on compensation for losses caused by

misrepresentation in the stock market. On 19 April, the Jinan Intermediate Court heard a civil case against Bo Hai Group, which was the first civil compensation case on misrepresentation in the stock market that came to trial. On 11 November 2002, a stock investor from Shanghai, Peng Miaoqiu, reached a settlement with a director of Jia Bao Industrial Company, the defendant, and dropped the suit. Peng Miaoqiu was awarded 800 yuan as compensation according to the settlement, and became the first stock investor to receive compensation in a civil case about misrepresentation.

In February 2002, the Chengdu Intermediate court accepted the civil compensation suits against Hong Guang Company for misrepresentation. The Guo Tai Securities Company and the Chengdu Fu Di Company (the successor of the Hong Guang Company) were defendants in this case. On 26 November 2002, the plaintiffs and the defendants in the Hong Guang case reached a settlement that the defendants would pay the compensation. In an interview by Chinese Central TV (Sina.com, 2002), the plaintiffs stated that they had experienced difficulty and pressure during the last four years, but they insisted on claiming their rights as investors, not just for money. A plaintiff also said it would be a long way with difficulties to go to the rule of law. Yan Yiming, who represented the plaintiffs in this case and was also the first lawyer who accepted civil compensation cases on misrepresentation in the Chinese stock market, said more than 3,000 retail investors contacted him in attempts to bring such suits against misrepresentation.

On 9 January 2003, the People's Supreme Court published the Regulation Regarding the Trial of Civil Compensation Cases Caused by Misrepresentation in Securities Market, providing more specific provisions for handling this kind of cases in

judicial procedures and introducing the rule of shifting burden of proof to the defendant. This Regulation indicated progress in legal protection of investors' interest, but it was confined to civil compensation cases caused by misrepresentation in the stock market. It still lacked legal mechanisms for investors to claim compensation for losses caused by insider trading, market manipulation, and other securities fraud.

The Victory of Public Opinion: the Collapse of the Richest Person in Shanghai

Zhou Zhengyi was called the richest person in Shanghai by 2003. In 2002, Zhou Zhengyi illegally acquired the right to develop Dong Ba Kuai, a real estate project in Shanghai. He used the land of Dong Ba Kuai as a mortgage to obtain bank loans of seven billion yuan, and then used part of the loans as a pledge to get a loan of one billion yuan from a credit union. Zhou Zhengyi used the capital to purchase two listed companies in Hong Kong and then let these listed companies buy the real estate project assets. With the help of the Bank of China Hong Kong Branch, Zhou Zhengyi obtained huge profits from playing capital between the real estate market and the securities market. His Nong Kai Group accumulated more than 20 billion yuan in only five years. Residents of Dong Ba Kuai were not content with the placement policies for them and protested, which led to the official investigation on Zhou Zhengyi. The case of Zhou Zhengyi caused the collapse of the head of Bank of China Hong Kong Branch, and involved many executives of banks, real estate developers, and local officials. In June 2004, Zhou Zhengyi was sentenced to imprisonment of three years for rigging the stock prices and falsifying the registered capital of his companies. But the light penalty aroused public discontent. Public opinion led to Zhou Zhengyi being arrested again in 2007, at which time he was sentenced to imprisonment of 16 years for bribery, providing false financial documents, and

misappropriation (Wang, 2010). This case showed that the public discontent with light penalties imposed on offenders who obtained huge profits from securities frauds at the expense of public interest.

Conclusion

The gradual and pragmatic mode to establish the Chinese stock market brought institutional defects to market regulation (Wu, 2001; Lu, 2008; Wang, 2010). The first priority of the Chinese stock market was to collect capital for state-owned enterprises and then other listed companies, rather than to give stockholders channels for investment. As a result, not enough attention was paid to the protection of investors, especially public retail stockholders. The stock market gave potential offenders easy access to funds of public investors. Without effective mechanisms for regulation, being listed in the stock market meant fast capital collection for a company, without any risk. Given the huge potential profit, companies often made false statements to meet the requirements for listing. Under the quota system and then the examination and approval system, the relevant officials had excessive power without a strict accountability system, and the process of reviewing for stock issuance and listing were nontransparent. This gave room for government officials to trade power for money. Making the stock market a cash machine without strict regulation, the Chinese government became an important provider of temptation.

Furthermore, the governments played important roles in some “offenses.” For example, in the 327 scandal, the Zhong Jing Kai Company took advantage of inside information from the Ministry of Finance (Y. Lu, 2008; David and Yu, 1995; Yuan,

2008). Given the Beijing-based background for the Zhong Jing Kai and the Shanghai-based background for the SISCO, this scandal was regarded as a conflict between the central government and the Shanghai government. In the case of rigging the stock price of Lu Jia Zui, the Shanghai government was the backstage manipulator (Kan, 2010). The governments' actions blurred the boundaries between irregularities and rightful activities in the stock market. The engagement of governments in irregularities in the Chinese stock market exemplified the assertion of Shover and Grabosky (2006, p. 48) that "lure production is a thoroughly political process."

Notably, the famous 5/19 rise highlighted the role of the central government in the stock market (Y. Lu, 2008; Z. Wang, 2010; Yuan 2008). Although the president of the CSRC argued that the government raised the market with the intention to return profit to investors, the bull market increased fund collection and objectively helped the government avoid risks in restructuring the financial industry. But the government's intervention again drove the stock market into a vicious circle. On the one hand, the bull market caused by the government encouraged speculation and gave room for manipulation and other securities fraud. On the other hand, the government's choice to screen the faults of financial institutions did not help set up effective internal supervision and external regulation of the stock market.

Without the strict external regulation, the internal regulation was incredible. The lack of internal regulation mechanisms gave the corporate insiders opportunities to commit offenses to benefit themselves. Self regulation was lost in the moral crisis in this social atmosphere that money talks. For the major characters of the cases, the scandals did not attach serious stigmas to them. For example, Guan Jinsheng was regarded as an

ambitious but unlucky figure since he tried to save his company in a fight against a Beijing-based opponent who engaged in insider trading (Yuan, 2008; Z. Wang, 2010). Kan Zhidong (2010) viewed himself as a scapegoat in the political strife. The former president of Hong Guang Industrial stated that their use of deceptive means to become listed was driven by their glorious dream to develop the enterprise, but unfortunately they were caught. They placed a priority on achieving their own ambitions, and ignored the interests of common investors.

The speculative craze of public investors also provided temptation to potential offenders. The cases of manipulation showed this easily-ignited fervor. Due to the asymmetry of information, public retail stockholders were in a disadvantaged position and were exposed to risks of becoming victims of securities fraud. The government's frequent adjustments and aggressive intervention made the Chinese stock market a policy-driven market (Y. Lu, 2008; Z. Wang, 2010; Yuan, 2008). Without strict regulation, it provided opportunities for the insider to employ inside information in stock trading. On the other hand, the policy-oriented market made common investors ignore the real performance of listed companies and count on policies or plans, and thus fostered speculation on stocks. Due to the nontransparent process of policy making, investors became obsessed with inside information. This also made opportunities for the manipulator to create topics or rumors to affect the market.

The Asian Financial Crisis caused the central government to be concerned about the regulation of the stock market and further centralize the regulatory power over it. A series of securities frauds also revealed institutional defects that hampered the improvement of corporate governance and the healthy operation of the stock market.

Without administrative transparency, the quota and approval system tended to breed corruption in the process of recommendation and review for IPOs and listing (Ling and Wang, 2001; Wu, 2008). Another conspicuous defect was the share-split structure, as non-tradable shares occupied the majority of the whole shares. Given that price per share of the non-tradable shares was much lower than that of tradable shares, some could control the listed company at a low cost through obtaining the non-tradable shares via one-on-one negotiations (Lang, 2010). This arrangement provided opportunity for potential offenders to conduct vicious manipulations or tunneling that hurt the interest of minority shareholders. A concentrated control and rigid ownership structure hindered improvement in corporate governance and managements via market-oriented measures. The government realized the defects of the share-split system and attempted to change the share structure (CSRC, 2008). But its failure to reduce the proportion of non-tradable shares suggested that the government should carry out policies consistent with the need of investors.

The series of securities fraud taking place during this period also indicated the ineffective enforcement of the 1997 Criminal Law and the 1999 Securities Law. Without institutional supports and a solid social basis, the laws on the books were not realized as expected (Pistor et al., 2000). Offenders often had close relationships with government officials, which hindered the relevant authorities in initiating investigations timely and punishing securities offenders severely. As listed companies were supported by the local governments, local protectionism often obstructed the law enforcement. In addition, the limitations of the existing laws were exposed in their applications. For example, the relevant authorities could adopt measures to restrict the suspect only after the criminal

investigation was filed, which provided time and opportunity for the suspect to escape. Some legal provisions imposed light penalties on the offender compared to the losses they caused to investors. This seemed to violate the rule of fairness and would unlikely deter potential offenders.

It was worth noting that the high-profile cases taught lessons to public retail investors and aroused their legal consciousness, particularly in regard to their rights. Scholars and media played important roles in revealing the dark side of corporate governance and providing suggestions for market regulation. In response to public pressure, the government reformed the issuance system, established the delisting mechanism, and adopted other mechanisms to improve the market regulation. The initiation of civil compensation cases on misrepresentation was also an important step forward in protection of public investors.

CHAPTER IV

DEVELOPMENT OF CHINA'S STOCK MARKET REGULATION AFTER PUBLICATION OF THE STATE COUNCIL'S NINE OPINIONS

Introduction

After three years of a bear market, the State Council published the Opinions on Promoting the Reform, Opening and Steady Development of Capital Markets (the Nine Opinions) on 31 January 2004. This was regarded as a milestone in the development of the Chinese stock market (CSRC, 2008). The Nine Opinions provided the guidelines for further reform and specific measures to refine market mechanisms and the regulation of the stock market. Following the release of the Nine Opinions, the CSRC adopted the sponsorship system to replace the principal underwriter recommendation for stock issuance and listing (CSRC, 2008). The Nine Opinions also proposed the establishment of a diversified capital market, fostering the opening of Small and Medium-Sized Enterprise Board (SME) and then the growth enterprise market (ChiNext). Then the regulatory departments carried on measures to check listed companies and clean up the securities industry. Also driven by the series of scandals, the Company Law and the Securities Law were revised in 2005. This appears to follow what Coffee (2001) calls “crash-then-law” pattern for the development of stock market regulation.

For the regulation of listed companies, tunneling conducted by the majority shareholder or the senior management was a serious problem. Tunneling activities showed as misappropriating funds of listed companies, providing illegal guarantees, related transactions, and so on. The case of Xichang Electric Power, the collapse of De Long Clique, and the case of Gu Chujun evidenced that the corporate executive or the

majority shareholder took advantage of loopholes in laws and regulation to grab profits at the expense of minority shareholders and outside investors, and effective mechanisms were not set to curb tunneling (Shentu, 2008; Z. Wang, 2010).

Meanwhile, the regulatory authorities adopted a series of measures to clean up the securities industry as it was close to bankruptcy at that time. The case of Dapeng Securities Firm showed that the lack of internal regulation would produce opportunities for the corporate executive to control the company for his/her own interests (Ling and Yu, 2005). Listed companies, securities firms, and fund management firms often formed a chain to transfer benefit, making it hard for the regulatory departments to discover irregularities. Rampant rat trading¹⁸, insider trading, market manipulation, and other securities violations in the fund industry discredited the CSRC's efforts to develop institutional investors for reducing speculative craze in the stock market.

The Nine Opinions also promoted the non-tradable share reform to realize market functions of value discovery and improve corporate governance. Learning lessons from the previous attempts, the non-tradable share reform proceeded in a gradual way, trying to follow market principles and giving more consideration to the protection of public investors (CSRC, 2008). The implementation of the non-tradable share reform invited public investors to take part in making decisions on the assignment of interest of listed companies. But three years after the initiation of the non-tradable share reform, the Chinese market fell sharply in early 2008. Public investors and some experts imputed the market fall to the failure of the non-tradable share reform led by the CSRC. Although it

¹⁸ Rat trading refers to the offence that before the fund management firm buys in shares, its staff buys shares in their own names or those of others at a low price, and then when the stock price was raised by the fund management firm, the staff sells the shares at a high price to earn a profit for themselves.

was hard to conclude that the non-tradable share reform failed, irregularities occurred in the implementation of the reform and harmed the interests of investors, especially public retail investors.

As discussed in this chapter, the subsequent death of Wei Dong (the key actor in the 327 event) and the case of Wang Yi (the former vice president of the CSRC), who were reported by the media to have been involved in securities irregularities including the abnormal listing of the Pacific Securities Company (Finance.sina.com, 2010), greatly harmed the image of the CSRC. The case raised questions regarding how to supervise the regulatory departments, e.g. the CSRC, and who should supervise them. The scandals caused a crisis of trust regarding the external regulation of the Chinese stock market.

In the wake of the global financial crisis, the exposure of the Goldman Sachs scandal drew more attention to the role of international investment banks in the Chinese financial market, and caused reflection on the regulation of the Chinese stock market. As argued by some scholars and experts, Goldman Sachs and other international investment banks took advantage of their influence and economic power to rig the Chinese capital market (Finance.ifeng.com, 2010). The inherent vulnerabilities of the Chinese capital market, e.g., the ambiguous rules, the lack of transparency of administrative procedures, the speculative craze, and so on invited speculation and manipulation by the crafty international investment banks (Lang, 2010).

The revised Company Law and Securities Law strengthened attacks on illegal manipulation, fabricating and spreading false information, insider trading and rat trading. For example, Wuhan XinLanDe became the first securities investment consultancy to be

punished for rigging the market through scalping transactions (H. Yu, 2008); the case of Yi Li Company was one of the high-profile cases of fabricating and spreading false information through the internet to affect the stock market in recent years (Liao, 2013); the case of Hang Xiao Gang Gou and other cases showed that the regulatory authorities strengthened attacks on activities involving insider trading. But the frequent occurrence of serious securities fraud still challenged the effectiveness and efficiency of the Chinese stock market regulation. In recent years, corporate restructuring was a hot spot in the Chinese economic construction, and the stocks of listed companies involving restructuring would be boosted. Corporate insiders and related parties often took advantage of inside information about corporate restructuring to trade stocks and gain huge profits, e.g., the case of Zhongshan Public Science & Technology and the case of Huang Guangyu (Liao, 2013). The case of Fat Finger error by the Everbright Securities Firm in 2013 again raised concerns about insider trading.

The rampant securities fraud in the SME and ChiNext revealed the weaknesses of the regulation of these relatively new markets. SME and ChiNext were established to form a diversified capital market and reduce overheated speculation on the stock market. But the ineffective regulation and unsound designs, e.g., the lack of supervision over price setting, also attracted manipulators and speculators. The sponsors held excessive power in determining the listing of companies, but still the mechanisms for supervision were ineffective. Driven by the huge expected profit from the IPOs on the ChiNext, venture capital firms often bribed sponsors to acquire equity in the companies before their IPOs, which formed the hidden rules for IPOs on the ChiNext (Lei, 2010). The case of Green Land Company in 2011 (Securities Market Weekly, 2013) and the case of Wan

Fu Sheng Ke in 2012 (China Business Journal, 2013) shocked the market due to the offenders' undaunted and reckless activities of making false statements. They again revealed that highly expected profits from IPO and the light penalties produced lures to potential offenders. The case of Hontex International on Hong Kong stock provides a good example of the effects of imposing severe penalties on securities offenders (Su and Yang, 2012).

The frequent occurrence of securities fraud in IPOs and listings aroused a public outcry and pressed the regulatory department to reform the stock issuance and listing system. In 2014, the State Council published the Opinions Regarding Further Fostering the Healthy Development of the Capital Market, which is called the New Nine Opinions. As a critical task set in the New Nine Opinions, the registration system will be adopted to replace the approval system for IPO and listing in the near future. The adoption of the registration system needs to change the role of the government in the Chinese stock market. The Securities Law will be revised and corresponding legal system and institutional arrangements will be established to meet the needs of adoption of registration system (Economic News Daily, 2014, September 22). This appears to be the start of a new turn of “crash-then-law” cycle in the development of the Chinese stock market.

The Reforms after the Nine Opinions of the State Council

As the Chinese stock market had remained down for about three years, the State Council published its Opinions on Promoting the Reform, Opening and Steady Development of Capital Markets on 31 January 2004, aiming to change the institutional

defects that obstructed the development of the securities market. The main contents of the Opinions consisted of nine aspects, thus it was called the Nine Opinions of the State Council (*Guo Jiu Tiao*). Following the release of the Nine Opinions, the Provisional Measures on the Sponsorship System for Securities Issuance and Listing went into effect in February 2004, adopting the sponsorship system to replace the principal underwriter recommendation system for issuing and listing securities (CSRC, 2008). A sponsoring institution should be a securities firm or one of the four state-owned asset management companies, which has a license to underwrite IPOs and has at least two qualified sponsoring representatives. Sponsors are in charge of checking the information of applicants and providing guarantees for applicants for public offerings. The CSRC regulates sponsoring institutions and sponsoring representatives, assesses the performance of due diligence by sponsors, requires sponsors to provide independent opinions, and looks into related transactions of applicants (CSRC, 2008).

Following the principle of developing a multi-layered capital market system determined by the Nine Opinions, the Shenzhen Stock Exchange established the Small and Medium-sized Enterprises Board (SME) in May 2005. The establishment of the SME Board aimed to reduce the difficulty of small and medium-sized enterprises in financing and encouraged innovations (CSRC, 2008). Compared to the main board comprised of mainly state-owned enterprises, the SME Board was oriented towards private, fast-growing and profitable small and medium-sized enterprises. In compliance with existing laws and standards, the SME Board was run independently from the main board. On 25 June, eight new stocks went public on the SME Board, and caused heated speculation. On 30 October 2009, the growth enterprise market (ChiNext) was officially opened to

encourage venture investment in China. Although its establishment received wide praise, a few economists, e.g., Wu Xiaoqiu, doubted the value of the ChiNext and predicted it would cause excessive market tremors (Netease Finance, 2009). One year after its establishment, the ChiNext raised more than 100 billion yuan for 131 listed companies.

Specifically, the Nine Opinions determined that the government would follow market principles to fulfill the non-tradable reform. The non-tradable share reform required that non-tradable shares be listed and tradable on the stock exchanges. Since the non-tradable share holders usually obtained the non-tradable shares at low prices, if their shares were listed on the stock exchanges, they needed to compensate the tradable share holders. In April 2005, the CSRC began to issue guidelines and conducted pilot programs of non-tradable shares reform of listed companies. For a listed company conducting non-tradable reform, the non-tradable shares holders should get the consent of those holding tradable shares and reach a settlement on compensation for them. To pass a proposal for non-tradable share reform, it needed the support of two-thirds of the shareholders voting and the support of two thirds of non-tradable shareholders voting (CSRC, 2008).

To meet the need for market regulation and investor protection, the National People's Congress revised the Company Law and the Securities Law in October 2005 and put them into effect on 1 January 2006. The revised Securities Law established the system for securities investor protection funds and defined the civil compensation mechanisms for investors. To cooperate with the implementation of the amendments, the People's National Congress amended the Criminal Law and revised the Enterprise Bankruptcy Law. The State Council and relevant ministries also made a series of

regulations and administrative rules to ensure the enforcement of the new rules and provisions (Gu, 2009).

Checking on Listed Companies

From the end of 2004 to the beginning of 2005, ten presidents of listed companies failed due to scandals (Z. Wang, 2010). In November 2005, the State Council circulated the CSRC's Opinions on Enhancing the Quality of Listed Companies, aiming to strengthen the corporate governance and standardize the operation of listed companies. The tunneling of listed companies by the majority shareholder or the senior management became a prominent problem, e.g., misappropriating funds of listed companies, providing illegal guarantees, and related transactions.

The chains of illegal guarantees. Upon the exposure of the Lan Tian scandal, the regulatory authorities began to pay more attention to the problems of mutual guarantees among listed companies and their related parties. In 2002, the CSRC issued the Circular on Issues Regarding Guarantees Provided by Listed Companies. In August 2003, the CSRC and the SASAC jointly published the Circular on the Regulation of Funds Between Listed Companies and Their Related Parties and the Issues Regarding External Guarantees by Listed Companies. In 2003, the CSRC and the China Banking Regulatory Commission (CBRC) jointly investigated chains of guarantees among listed companies. However, the phenomena of illegal guarantees seemed not to have been curbed effectively. In November 2003, Xinjiang Hops Company was exposed to have had a floating loan of 1.5 billion yuan and provided a 1.8 billion yuan loan guarantee for other companies, yet its net assets were worth less than 600 million yuan. In 2004, the “Hunan

Hongyi Clique” was exposed to have had a total of about 3 billion yuan loan guarantees, of which the amount involved in suits exceeded 1.6 billion yuan. In 2006, Hebei Bao Shuo was exposed to have provided 1.8 billion loan guarantees, of which about 1.7 billion loan guarantees were undisclosed (Z. Wang, 2010)

The Case of Xichang Electric Power was one of the high-profile cases about illegal guarantees. Zhang Liangbin and his brother Zhang Bin, who were regarded as the richest in Southwest China, exploited loopholes in laws and regulations to take control over the listed company (Shentu, 2008). The Zhang Brothers conducted a series of activities to tunnel the assets of Xichang Electric Power. Chao Hua Group (controlled by Zhang Brothers) and its associated companies, faked documents and made Xichang Electric Power provide guarantees for them. The illegal guarantees caused Xichang Electric Power to suffer losses of about 2.5 billion yuan and miss the chance to develop itself (Z. Wang, 2010; Shentu, 2008). The deputy head of Liangshan Prefecture government admitted that due to the lack of legal consciousness the prefecture government as the second largest shareholder did not exert its function to check the Zhang brothers (Shentu, 2008). In 2006, Zhang Liangbin was arrested. After four years of investigation and trials, Zhang Liangbin and his brother were sentenced to imprisonment of 18 years and 15 years, respectively, for misappropriating the funds of Xichang Electric Power.

The scandals about illegal guarantees were the recurring illnesses of the Chinese stock market. In fact, the illegal guarantees were often provided for majority shareholders or related parties at the expense of the listed companies. In addition, the poor risk control mechanisms of banks contributed to the completion of unqualified guarantees (Z. Wang,

2010). Due to the lack of efficient channels and technologies for information flow among banks at that time, banks could not get real information about borrowers and guarantors in time, which exposed the banks to high risks for providing loans based on unqualified guarantees. The chains of mutual guarantees among listed companies and other companies often trapped the listed companies and affected their performance. In the end, minority investors bore the losses caused by the illegal guarantees.

Illegal fundraising. The most famous event in the Chinese stock market in 2004 was the collapse of the De Long Clique (Z. Wang, 2010). The De Long Clique controlled or held equity of more than 200 enterprises including five listed companies. On 14 April 2004, the stock prices of three companies controlled by the De Long Clique, that is, Xinjiang Tun He, He Jin Investment, and Hunan Huo Ju, fell by 10% (the maximum permitted for price movements in a transaction day). This situation lasted for days, and their market capitalization decreased by over 10 billion yuan. It signaled the collapse of the De Long Clique.

In October 2004, after Hua Rong Asset Management Company took over the De Long Clique, the relevant department of the State Council publicized the debts of the De Long Clique, a total of 54 billion yuan, among which the debts in the field of finance were worth 34 billion yuan and the debts in the field of industry were worth 23 billion yuan (Z. Wang, 2010). According to the investigation, the De Long Clique raised tens of billions of yuan by illegal means through its controlled companies including securities companies and trust companies. At the end of 2004, Tang Wanxin, the real controller of the De Long Clique, was arrested for rigging the market and misappropriating more than 50 billion yuan of listed companies. In April 2006, Tang Wanxin was sentenced to

imprisonment of eight years and a fine of 400,000 yuan for the crime of illegally raising public funds. De Long International and Xinjiang De Long were fined 5 billion yuan each.

Misappropriating funds of listed companies. In 2004, Lang Xianping in a speech at Fudan University doubted that the corporate executives of several famous Chinese state-owned listed companies (e.g., TCL, Haier, and Ke Long) encroached the state-owned assets of the companies (Hexun.com, 2014). The fight between Lang Xianping and Gu Chujun, president of Ke Long, caused public attention. A number of mainstream scholars, invited by Gu Chujun, attended a conference to show support for Gu Chujun. But in 2005, the CSRC investigated Ke Long and concluded that Gu Chujun and accomplices were suspected of misappropriating about 3.5 billion yuan of Ke Long funds. Gu Chujun was sentenced to imprisonment of ten years for misappropriating the funds of Ke Long. This famous fight between Lang and Gu again won Lang Xianping a good name and wide support by public investors.

Misappropriation of funds of listed companies often occurred in the process of MBO (Management Buy Out). At the end of 2004, the central government stopped MBO of large state-owned enterprises for the reason that it would damage the separation of ownership and right of management, and the current legal system was unable to curb encroaching state assets through MBO (Z. Wang, 2010). But misappropriation of funds of listed companies by controllers or corporate executives occurred from time to time. In September 2005, the president of Cheng Gong Holding Group, Liu Hong, was arrested for misappropriating 420 million yuan of Xiang Jiu Gui, a listed company controlled by Cheng Gong Group. The real controller of the Hong Yi Family, Yan Caihong, was arrested for misappropriating funds of his controlled listed companies. In March 2006,

Zhong Xiaojian, president of Digital Internet, was arrested for misappropriating 430 million yuan of the listed company and illegally raising more than one billion yuan (Z. Wang, 2010).

Cleaning Up Securities Firms

By 2004, the whole industry of securities firms in China was close to bankruptcy as a result of years of crazy speculation and irregular practices (CSRC, 2008; Y. Lu, 2008; Z. Wang, 2010). Due to the unsound external regulation and corporate governance, irregularities were common in securities companies, e.g., misappropriation of clients' deposits, rigging the market, insider trading and tunneling by controlling shareholders and related parties. From 2004 to 2007, the CSRC carried out comprehensive checks on securities companies and restructured the underperforming ones (CSRC, 2008).

On 2 January 2004, Southern Securities Firm was taken over by the administrative authorities since it had huge losses in stock speculation (Z. Wang, 2010; Kan, 2010; Y. Lu, 2008). According to the investigation by the CSRC, Southern Securities Firm held huge volumes of Ha Medicine stock and Ha Fei stock and manipulated the stock prices; it also misappropriated clients' deposit of 8 billion yuan. On 10 May 2005, the Southern Securities Firm was closed. On 25 January 2006, Dapeng Securities Firm became the first securities company that went bankrupt due to insolvency. By October 2006, the CSRC ruled against a total of 31 securities firms. After the restructuring, the industry of securities firms ended four consecutive years of losses and began to generate profits in 2006 (CSRC, 2008).

The case of Dapeng Securities Firm. Unlike most securities companies that were state-owned, Dapeng Securities Firm was established as a private enterprise in 1993, as Xu Weigo was one of its founders. Its shareholders included Shenzhen ZhaoFu Company and Shenzhen JinCe Company, two private companies controlled by Xu Weigo (Ling and Yu, 2005). In 1999, when the stock market was rising, Dapeng Securities Firm became one of the top 10 securities firms in China. In May 2000, Dapeng Securities Firm increased its equity and 44 enterprises became its shareholders. Its ownership was dispersed as each of its 12 largest shareholders held 4.4% of its whole shares. As Xu Weiguo stated, the company's dispersed ownership was designed to avoid risks on corporate governance and better protect the interests of each shareholder. But it came out as Xu Weiguo's trick to control Dapeng Securities Firm for his own benefit (Ling and Yu, 2005). Xu Weiguo established Dapeng Holding Company as he was its president, and then Shenzhen ZhaoFu and other shareholders transferred shares to it. Dapeng Holding Company obtained 20% of all the shares of Dapeng Securities Firm and became the largest shareholder. Through Dapeng Holding Company, Xu Weiguo controlled Dapeng Securities Firm and led the firm to a difficult situation (Ling and Yu, 2005).

From 1999 to 2001, Dapeng Securities Firm used 2.2 billion yuan to buy shares of Long Teng Science & Technology and held 90% of its tradable shares. Following the 5/19 market rise, the stock price of Long Teng Science & Technology was boosted from 7 yuan to 32 yuan per share at the end of 2001, which made Dapeng Securities Firm earn a profit of 800 million yuan (Ling and Yu, 2005). Led by Xu Weiguo, Dapeng Securities Firm continued to spend a huge amount of money in rigging the market. At its climax, Dapeng Securities Firm used more than 6 billion yuan in stock trading. But finally, it

suffered great losses of 4.4 billion yuan in stock speculation when the market was down (Ling and Yu, 2005). When the CSRC began to investigate Dapeng Securities Firm, Xu Weiguo stated that he had mental illnesses and refused to cooperate. On 14 January 2005, the CSRC revoked the license of Dapeng Securities Firm and closed it. On 12 January 2006, the CSRC banned Xu Weiguo for life from the securities industry and from being an executive in any listed company. In September 2006, Xu Weiguo was sentenced to imprisonment of one year and six months for rigging the market (China Securities Investor Protection Funds, 2010).

The Regulation of Securities Investment Consultancies and Stock Commentators

The new Securities Law specifically strengthened fighting against the activities of rigging the market. In 2007, the CSRC made the Guidelines to Identify Activities of Rigging Securities Markets, defining specific categories of activities of rigging the market that include scalping actions of consultancies or stock commentators. Scalping actions refer to consultancies or stock commentators suggesting their clients purchase shares before they publicly recommend the stocks, selling out the shares after the stock prices are boosted, and finally they share the profit with the clients.

Before the Guidelines were made, there were high-profile cases about consultancies or stock commentators that used these kinds of scalping actions to affect the market and earn profit. These stock commentators were called “black mouths” by the media. After their scalping actions were revealed, they were not punished for the reason of rigging the market due to the lack of legislation. For example, Lei Lijun of Guangdong Golden Fingers Investment Consulting Firm and Zhao Xiaoyun of East Trend Investment

Consulting Firm were famous “black mouths” employing scalping actions to rig the stock market (H. Yu, 2008). In the end, East Trend’s investment consultancy license was revoked because it failed to pass the yearly check. But Zhao Xiaoyun left for England in the early stage of investigation by the regulatory department, and he has not returned to China yet. Lei Lijun’s license was also revoked, but he continued to provide consulting services. When he was caught again, the CSRC banned him for five years from the securities industry. Sun Chenggang, another famous black mouth in the Chinese stock market, had his license revoked and was fined 2,090,000 yuan for his scalping transactions, but the reason given was illegal stock transactions, not rigging the market (H. Yu, 2008).

In 2007, after the Guides were made, the case of Wuhan XinLanDe again caused attention to black mouths employing scalping transactions. Starting from 2000, Wuhan XinLanDe Consulting Firm, with Zhu Handong as its president, operated stock review columns on 142 national and local newspapers, more than 20 TV channels, and 25 financial websites (H. Yu, 2008). This case was about Chen Jie, its client, advised by Wuhan XinLanDe. In 2004, Wuhan XinLanDe began to provide consulting services for Chen Jie. On 17 April 2007, following Zhu Handong’s advice, Chen Jie used 60 million yuan to buy 9.2 million shares of East Electronics. On that day, Zhu recommended this stock on the media and then caused it to rise by 10% the next day. Chen sold out all his shares by 19 April and actually earned 7,640,000 yuan in three days.

An experienced investor noticed these abnormal transactions that occurred right after Zhu recommended this stock and reported it to the regulatory department (H. Yu, 2008). The Shenzhen Stock Exchange immediately initiated real-time monitoring and

found a close correlation between the trend of the stocks and Wuhan XinLanDe's reviews. On 28 May 2007, the CSRC started an official investigation on Wuhan XinLanDe and found Chen Jie. Then Chen and Zhu were restricted from leaving the country. In the past, restrictive measures would be adopted after the results of an investigation came out, which often gave offenders time to escape. As concluded by the investigation group, Chen Jie earned illegal profit of 53,850,000 RMB, of which 7,350,000 RMB was paid to Wuhan XinLanDe as consulting fees. Then the CSRC confiscated Chen Jie's stocks that were legally frozen. On 31 October 2008, the CSRC confiscated 7,350,000 RMB from Wuhan XinLanDe and fined it 7,350,000 RMB, gave Zhu Handong a disciplinary warning, fined him 300,000 RMB, and banned him for five years from the securities industry. Wuhan XinLanDe became the first licensed investment consulting firms that the regulatory department punished for rigging the market.

The Regulation of Funds Management Firms

The National People's Congress adopted the Law on Securities Investment Funds on 28 October 2003, and put it into effect on 1 June 2004. But irregularities of funds management firms continued to plague the stock market. In 2004, the regulatory authorities received more than one thousand tips about offenses by funds firms, and decided to investigate some serious cases (Y. Lu, 2008). But since the stock market was very low at that time, to avoid negatively influencing the market and fund holders, the regulatory authorities kept the investigations low key. The official conclusions about the cases and how the cases had been handled were not publicized (Gu, 2009). The government was worried that disclosure of the cases would trigger a trust crisis about securities investment funds and cause a sharp fall in the stock market (Y. Lu, 2008). The

government's cover-up and light penalties failed to curb rampant irregularities of fund management firms.

With a huge volume of capital at hand, funds companies often collaborated with stock speculators to manipulate the stock price. When the stock price was raised by the speculators, the funds companies purchased the shares at a high price from the speculators. This scheme was frequently used to transfer benefits earned from speculation. In addition, fund managers could easily take advantage of inside information of listed companies obtained in their employment. Some fund managers were punished for insider trading, but the exposed cases were only the tip of the iceberg (Y. Lu, 2008; Z. Wang, 2010). Another kind of irregularity rampant in the fund industry was rat trading. Rat trading refers to the offence that before the fund management firm buys in shares, its staff buys shares in their own names or those of others at a low price, and then when the stock price was raised by the fund management firm, the staff sells the shares at a high price to earn a profit for themselves. As listed companies, securities firms, and fund management firms often formed a chain to transfer benefits, it was hard for the regulatory authorities to discover and check rat trading (Z. Wang, 2010; Gu, 2009).

Rat trading. Starting in March 2008, the CSRC paid more attention to rat trading. For example, on 27 March 2008, the CSRC punished Wang Limin for rat trading; on 8 April 2008, Tang Jian was caught for rat trading. But these cases seemed not to deter rat trading in the funds industry. In 2009, the exposure of the Zhang Ye case again shocked the stock market. The investigation found that from 2007 to February 2009, Zhang Ye, as a fund manager of Rong Tong Fund Firm, took advantage of the unexposed information he received in his duty to conduct stock trading for Zhu Xiaomin. Zhang Ye helped Zhu

Xiaomin earn 9,398,400 yuan and received 2 million yuan from him (C. Zhou, 2009). On 18 June 2009, the CSRC revoked Zhang Ye's license in the fund industry, confiscated his illegal earnings of 2,294,791.90 yuan, fined him 4 million yuan, and banned him for life from the securities industry and being senior manager of any listed company.

There were disputes about how to determine the nature of rat trading. Surrounding this topic, the first issue is whether rat trading causes social harm and whether it constitutes a crime (Z. Feng, 2009; J. Ye, 2009). It seems that rat trading did not hurt specific persons' interests. The question is, if a fund manager helps fund shareholders gain a profit, whether it is a bonus for the fund manager to earn money through rat trading. But the fact was that the staff of the securities industry often ignored their fiduciary duty and earned profit for themselves at the expense of their clients. Even large institutional investors, such as securities companies and funds, suffered great losses in the end. The reason was that vast volumes of rat trading increased the cost of securities investments and often made them lose at the high stock prices. Rat trading created a group of rich persons at the expense of the majority of stock investors who did not have connections and opportunities to conduct rat trading. The connection with important persons of the securities industry became a hidden rule to earn huge profit in the stock market. In a broad sense, rat trading ruined the fairness of the stock market, distorted the function of the capital market to optimize the allocation of resources, and eroded the public trust in the securities industry.

Another issue is what kind of crime rat trading should be designated (Z. Feng, 2009; J. Ye, 2009). Some scholars argued that rat trading is a type of insider trading since information about securities investment (what stocks the fund management company will

buy or sell) were also undisclosed to the public when the staff began rat trading. The other opinion was that information about securities investment was different from inside information. Inside information refers to the undisclosed information that will affect the operation and performance of listed companies, which would cause essential influence on the stock prices of the listed companies. Although information about securities investment by fund management companies would affect the stock prices, the real production and performance of listed companies are the essential factors to determine the stock prices. After all, the operation of stock market aims to optimize the allocation of resources and serve the real production of listed companies, not to let some earn benefit from speculation. The information about what stocks fund management companies would choose to buy is not inside information, so rat trading is not defined as a type of insider trading. It is unreasonable to give rights to fund managers to exploit their positions to earn such “bonus” for themselves through rat trading. As to rat trading, the staff of securities industry actually takes advantage of their position as the agent holding public funds for securities investments. In fact, rat trading constitutes a breach of trust or breach of fiduciary duty (Z. Feng, 2009; J. Ye, 2009).

The disputes about the nature of rat trading made it difficult to make criminal penalties against this kind of market abuse (Y. Lu, 2010). In addition, the administrative measures taken by regulatory authorities were lenient to offenders. For the case of Jian Tang, the CSRC confiscated Tang’s illegal gains of about 1.5 million from rat trading, fined him RMB 500,000, and banned him from entering into the securities industry. Compared to the potentially huge illegal proceeds from rat trading, the amount of fine was too small to punish offenders and warn potential offenders. In addition, the provision

of banning entry into the market performed practically no function, since they could easily conduct stock trading through accounts using other names (Oriental Morning Post, 2009).

Although rat trading was serious in the fund industry, the Criminal Law had not provided criminal penalties against rat trading until the seventh Amendment to the Criminal Law was made on 28 February 2009. The seventh Amendment provided rules to prohibit practitioners of financial institutions from using undisclosed information to conduct stock transactions for their own profit. Zhang Ye avoided criminal penalties since the seventh amendment to the Criminal Law was put into effect ten days after his last activity of rat trading. On 16 October 2009, the Supreme People's Court and the Supreme People's Procuratorate jointly issued the Supplementary Provisions to the Application of the Amendment 7 to the Criminal Law, specifically defining the crime of using undisclosed information to trade securities. In May 2011, Han Gang, former manager of Chang Cheng Jiu Fu Fund Management Firm was arrested for employing undisclosed information to trade 15 stocks during seven months in his position (Liao, 2013). This was the first criminal case of using undisclosed information in securities transactions, and Han Gang was the first practitioner in the fund industry who received criminal penalty for this kind of crime. One month after this case, the former Chief Investment Officer of Guangda Baodexin Fund Management Company was convicted of using undisclosed information in securities transactions. However, how to prevent rat trading was still a big problem due to the factors involving the complicated coordination of different groups in interest allocation (Z. Wang, 2010).

Institutional defects of the regulation of funds. Like rat trading, other irregularities in the fund industry also caused concern about the regulation of this industry. Sponsors for stock issuance or shareholders of most fund management companies were securities companies, banks, insurance companies, and listed companies. Without strict rules for information disclosure, this structure of shareholders of fund management companies bred insider trading, related transactions, conflict of interest transactions, manipulation of stock prices and so on (Y. Lu, 2010). In addition, these institutional investors needed to serve the government's goals for the securities market. The CSRC officially claimed that the development of institutional investors represented by fund management firms changed the structure of investors in the capital market, and the operation of funds changed the investment modes of stockholders from speculation and manipulation to paying more attention to fundamental analyses of listed companies and long-term investments (CSRC, 2008). Fund management firms became the majority of institutional investors. While the fund industry suffered a loss of about 1.5 trillion yuan for the whole year of 2008, the fund industry earned a total of only about 1.4 trillion yuan from 1998 to 2007 (Z. Wang, 2010). This caused public doubts about its expertise and capacity for generating profit. Furthermore, the exposure of rampant scandals ruined investors' confidence in fund management firms.

Serious irregularities in the fund industry had roots in institutional defects in the protection of fund shareholders and the regulation of fund management companies. When shareholders entrusted their funds to fund management firms, they usually could not intervene in the managers' operation of funds. Without effective mechanisms, fund shareholders could hardly exert supervision over fund managers. Moreover, fund management

fees are not linked to the profit from securities investment. This also seemed unfair to fund shareholders. Thus, some fund managers maximized the profit of fund management companies and their own self-interest, rather than work for the best interests of fund shareholders.

The Non-Tradable Share Reform

The government adopted a gradual way for the non-tradable reform, starting from pilot programs to test the market reaction and then promoting the reform on a full scale (CSRC, 2008). It showed the dynamics among the government, the market, and the public investors, exploring to reach a point to balance the interest of different parties. After the initiation of the reform, the non-tradable reform was basically finished within two years. As the CSRC (2008) claimed, by the end of 2007, 1298 listed companies on the SSE and the SZSE, representing 98% of the market capitalization of the whole listed companies subject to the reform, completed the non-tradable reform or were in process; only 33 listed companies did not carry out the reform.

After the initiation of the non-tradable reform, the Chinese stock market remained a bull market for three years, until early 2008 when the Shanghai stock index fell by about 60% from a highest point of 6,124 in 2007; the market capitalization decreased by about 14 trillion yuan, and more than 90% of stock investors suffered losses (Z. Wang, 2010). Although the global financial crisis did not greatly affect China's economy, the Chinese A share market performed badly in 2008. The CSRC was blamed for the decline of the stock market. According to a survey by the Tencent Finance website on 5

September 2008, about 80% respondents thought the market crash was due to the failure of the non-tradable share reform led by the CSRC (Finance.qq.com, 2008).

Some media argued that the market crash was caused by the panic that the release of non-tradable shares would bring huge pressure to the market and would harm public investors' interests (Eastday.com, 2008). How to deal with the release of non-tradable shares became the focus of disputes. In an interview with the People's Daily, Li Kun, a research scientist of the China National Development and Reform Commission, stated that non-tradable shares should be differentiated from common shares and should be placed in a different platform for trading; furthermore, windfall taxes should be imposed on non-tradable shares trading (QQ.com, 2008a). The CSRC denied that the release of non-tradable shares caused the market panic, and argued that the windfall tax should not be imposed on non-tradable shares trading since the holders of non-tradable shares had already given consideration to the holders of public tradable shares (QQ.com, 2008a). A famous financial commentator, Ye Tan, challenged the CSRC and argued that imposing the windfall tax would help maintain the social fairness since non-tradable shares contained interest that the holders obtained with a low cost in the past. According to Ye Tan, the CSRC favored the holders of non-tradable shares and went against its original intention of better protecting public investors at the initiation of non-tradable shares reform (T. Ye, 2008). Another financial commentator, Cao Zhongming (2008), pointed out that the stock market crash reflected the imbalance of interest assignment and appealed to change the current structure of interest assignment and place the protection of public investors at the center of the stock market.

The largest portal of Chinese laws and legal practice published an article pointing out the failures of the non-tradable share reform (Zhong Gu Law Portal, 2009). The article mentioned that the non-tradable share reform became employed by interest groups to save institutional investors. For example, Bao Steel Corporation and Shanghai Automobile allowed institutional investors to obtain their non-tradable shares at low prices. During the reform, the rate of medium and small investors' participation in voting for non-tradable share reform plans decreased. Thus, their interest could not be better protected. The consideration the companies paid to the public investors (e.g., share bonus) also decreased. The fall of the stock indices and transaction volumes and the failure of the majority shareholders' commitment to increase their equity indicated the loss of confidence in the stock market after the non-tradable share reform.

In an interview with the Economic News Daily, Lang Xianping pointed out that the second and third steps of the non-tradable reform failed, and thus the interest of public investors was not protected well (Y. Jiang, 2008). As he emphasized, even the underperforming listed companies were allowed to undertake non-tradable share reform, which would bring lots of low quality shares to the market and increase the pressure on the market; more importantly, after the initiation of the non-tradable reform, the regulatory department's role as an active supervisor over listed companies faded, and thus the insufficient regulation exposed public retail investors to risks caused by irregularities and crimes.

However, it is too early to conclude that non-tradable share reform failed. The decline of the stock market might have been caused by other factors that affected investors' confidence, e.g., market pressures, the global situation, economic cycles, and

so on (QQ.com, 2008a). In general, non-tradable share reform set a legal and institutional frame for a stock market with fully circulated stocks. But it was worth noting the emergence of irregularities that damaged the interests of public investors and showed deviation from the goals of the non-tradable share reform.

The Death of Wei Dong and the Case of Wang Yi

The year of 2008 was an eventful year for the CSRC. On 29 April 2008, Wei Dong, who was called the last baron on the Chinese stock market, committed suicide. As mentioned before, Wei Dong was the dealer of Zhong Jing Kai and played a key role in the famous 327 event. Wei Dong was the actual master of the Yong Jin Clique, which controlled some listed companies, including Jiu Zhi Tang, GuoJin Securities Company and others. Although his family said that he killed himself because he could not endure his acute depression, the media disclosed that Wei Dong was investigated by the regulatory departments (Eastern Daily, 2008). Subsequently, Wang Yi, the vice president of Chinese National Development Bank and former vice president of the CSRC, was investigated by the regulatory departments on 8 June 2008 and then arrested.

Numerous media reports stated that Wang Yi was close to Wei Dong and was involved in securities crimes and irregularities. The listing of Pacific Securities Company was one of the cases the media doubted (Economic Observer, 2008). At the end of 2007, Pacific Securities Company exchanged equity with Yun Da Science & Technology and received non-tradable shares of Yun Da at low prices. At that time, Yun Da Science & Technology was close to being delisted, and Pacific Securities had existed for less than three years with a total loss of more than 80 million yuan for the past two consecutive

years. Apparently, Pacific Securities Company did not qualify for listing. But it was astonishing that when Yun Da Science & Technology was removed from the stock market, Pacific Securities was listed on the stock exchange. Experts in the securities industry doubted the listing of Pacific Securities since it was not reviewed nor approved by the CSRC Stock Issuance Review Committee or the Major Restructuring Committee. Although the CSRC explained its listing was a special case in non-tradable share reform, this abnormal listing incurred public criticism (Caijing.com, 2008). The media revealed some original shareholders of Pacific Securities were relatives of Wang Yi or Wei Dong, and they obtained huge profits from its listing (Ameng, 2008).

However, the procuratorate charged Wang Yi for taking bribery of 11.96 million yuan for helping others get bank loans when he was the vice president of the Chinese National Development Bank. Interestingly, the large number of media reports about securities irregularities in which Wang Yi was involved were not ever refuted or doubted. Although the procuratorate's charge did not include securities crimes that occurred during the period when he was vice president of the CSRC, the case of Wang Yi triggered a crisis of trust in the CSRC. The financial media even pointed out that the revolution of the Chinese stock market should have started from the CSRC (Ameng, 2008).

Lessons from International Investment Banks

It is noteworthy that Chinese enterprises had also suffered huge losses in the international financial market during the period of global financial crisis. For example, 68 Chinese central government-owned enterprises suffered floating losses of 11.4 billion US

dollars in the financial derivatives investments by the end of 2008 (Xinhuanet.com, 2009). As the Vice Director of the Chinese State Asset Commission admitted, excessive speculation, irregular practices, deficiency of risk control, poor corporate governance, lack of experts, and especially fraud by international investment banks contributed to the huge losses (Xinhuanet.com, 2009).

On 6 May 2010, the Chinese Procuratorate Daily published an article discussing the lessons for China's market regulation from the case of the US Goldman Sachs (Yan, 2010). On 16 April 2010, Goldman Sachs was charged by the US SEC for securities fraud by conspiring with some hedge funds and investment banks to short the financial market. This increased market turmoil and caused investors to suffer huge losses. As mentioned, Goldman Sachs had designed the financial derivative products of collateralized debt obligation (CDO) "Abacus 2007-ACI" and induced investors by misstatements that guaranteed stable investment return and concealed potential risks. Consequently, the fraud caused investors to lose more than 1 billion USD. On 10 May 2010, the China Youth Daily published an article "Goldman Sachs' Conspiracies in China" arguing that it caused more losses to Chinese enterprises and investors than to those in the US.

On 12 November 2010, the Chinese A share market dropped sharply. Subsequently, an article "The Sudden Fall Caused by a Report of Goldman Sachs on 12 November" published in Hua Xia Daily on 15 November 2010 aroused severe attacks on Goldman Sachs. The People's Daily (overseas version) published reviews, and then the vice president of the Chinese Supreme Court made a speech in a conference, implying that Goldman Sachs' report emailed to its clients was responsible for the sharp market

decline and may have rigged the Chinese stock market. Responding to these criticisms, Goldman Sachs argued that the report was only about suggesting that its clients sell off their H shares, and it was not related to the Chinese A share market (Ifeng.com, 2010).

Although Goldman Sachs denied that they had shorted the market, its report was so precise and occurred almost at the same time as the fall of Chinese A share market that it caused doubts on the part of some Chinese scholars and financial commentators. Liu Jipeng, a professor of law and economics center of China Politics and Law University said that it was suspicious since Goldman Sachs engaged in too many coincidental activities (Ifeng.com, 2010b). Ye Tan stated that only the international and domestic big institutional investors could see the reports of Goldman Sachs; if they followed its ideas, they could take advantage of their capital and influence to greatly affect the stock market (Ifeng.com, 2010b).

Some practitioners in the securities industry described the way that Goldman Sachs and other leading international investment banks shorted the stock market (Ifeng.com, 2010b). When Goldman Sachs began to sell part of the profit-generating shares they held, they spread information that the stock prices would rise to attract investors to buy their shares at high prices. Then they would spread information that the stock prices would fall and used their shares to facilitate the market fall. After the stock prices fell, they would buy the shares and start a new run of market manipulation. Goldman Sachs had taken advantage of its influence, connections, and public trust to affect the Chinese market to earn huge profits at the expense of Chinese public retail investors. The leading international investment banks were familiar with the rules and practices of Chinese financial regulation. Their maneuvers became more and more covert,

so it was hard to find evidence to demonstrate they had rigged the market (Ifeng.com, 2010b).

There were different voices. Hua Xia Times published an article about interviews with experts, arguing that Goldman Sachs was just a scapegoat for the decline of Chinese A share market (Fu, 2010). Actually, high inflation, adjustment of Chinese monetary policies, increase of the stamp tax rate, interest rate increase, exposure of scandals in the Hua Xia Fund Management Firm, and other factors contributed to the market fall. Dong Dengxin, director of financial research center at Wuhan Science and Technology University, said that the Chinese stock market was not open to international capital and Reminbi could not be freely exchanged; thus, international capital had no access to manipulate the Chinese stock market (Fu, 2010). In the interview, a Hong Kong expert of an investment bank stated that the Qualified Foreign Investment Institutions were occupying only a very small part of the Chinese stock market, thus they could not greatly affect the Chinese stock market. He also remarked that in recent years, conspiracy theories were very popular in explaining some market activities in mainland China, and they would have negative effects on the development of the Chinese stock market, e.g., missing a good chance to reform the price and exchange rate systems and disrupting the invitation of excellent experts from foreign countries (Fu, 2010).

Supervision over the Information Spread through the Internet

Early in 1992, the Securities Commission of the State Council issued the Provisional Measures on Prevention of Securities Fraud, providing rules against fabricating and spreading false information to affect the stock market. The case of Su

Sanshan was the first case of fabricating and spreading information to affect the stock market. But the Criminal Law did not provide criminal penalties against this kind of securities fraud until in 1997, when the revised Criminal Law added articles of the crime of fabricating and spreading false information to affect the stock market. In addition, Article 3 of the Securities Law provides the legal responsibility of the media in spreading information about securities; Article 72 of the Securities Law provides rules against fabricating and spreading false information to affect securities markets. With the development of the internet, the online social media became a ground for spreading false information that affected securities markets. On 28 December 2000, the National Congress Standing Committee enacted the Decision Regarding the Maintenance of Internet Security, providing rules against using the internet to fabricate and spread false information to affect securities markets.

However, financial columns of large websites and online stock clubs were still filled with false information. False information was spread anonymously and quickly via the internet, which made it difficult to identify the offenders. For example, in 2008, amidst false information about the refinancing of stock markets, only a few unconfirmed rumors were cleared up quickly, causing a sharp fall of the stock market with great losses to retail stockholders, securities companies, funds, and other market participants (Liao, 2013). In recent years, the case of fabricating and spreading false information about Yi Li Company was one of the high-profile events. In June 2011, the former president of Inner Mongolia Business Daily and other persons posted an online real-name tip saying that some corporate executives of Yi Li Company tunneled the company. This caused investors to sell shares and made the stock price drop sharply. Consequently, Yi Li

Company and its investors suffered great losses. In 2012, the offenders were convicted of the crime of fabricating and spreading false information to affect the stock market (Xinhuanet.com, 2012)¹⁹. The former president of the Inner Mongolia Business Daily was sentenced to imprisonment of one year and six months with a suspension of one year and six months, and a fine of 30,000 yuan. Other offenders were sentenced to imprisonment with a suspension.

False information might arise from different intentions. Some might spread false information in online forums or stock clubs to vent their grievances. Civil compensation, administrative sanctions or criminal penalties should be applied to those fabricating and spreading false information according to different circumstances (Liao, 2013). Some scholars even suggested that internet users be required to use their real names when posting their comments online (Liao, 2013), but it caused concern about infringing upon freedom of speech. On 13 August 2012, without any signals, the stock price of Citic Securities suddenly dropped by 9.1%, which also caused stocks of other securities companies to fall. But after more than twenty days of investigation, the CSRC concluded that the unexpected fall of the stocks resulted from three retail stockholders who spread complaints and thus caused the negative effect on the stock market. This conclusion raised widespread discontent. Media showed sympathy about common retail stockholders and said the three stockholders who complained were scapegoats (Sina.com, 2013).

Insider Trading

¹⁹ The former president of the Inner Mongolia Business Daily was sentenced to one year and six months' imprisonment with one year and six months' probation, and was fined 30,000 yuan. Other offenders were sentenced to imprisonment with probation and fined. See http://news.xinhuanet.com/legal/2012-01/19/c_122607612.htm

The case of Hang Xiao Gang Gou. The revised Securities Law also aimed to widen the range of insider trading and strengthen its ability to attack stock transactions employing inside information. The case of Hang Xiao Gang Gou in 2007 was the first case of a crime of revealing inside information (H. Yu, 2009). According to the investigation, on 31 January 2007, Luo Gaofeng, deputy director of the Securities Department of Hang Xiao Gang Gou Company, knew that the company was discussing with China International Fund Company a 30-billion-yuan contract for a construction project in Angola (H. Yu, 2009). On 12 February, Luo revealed this inside information to Chen Yuxing, a former employee of Hang Xiao Gang Gou. Then Chen instructed Wang Xiangdong to buy about 7 million shares of Hang Xiao Gang Gou from 12 to 14 February. The abnormal transactions by Chen caught the CSRC's attention. But actually, the information that Hang Xiao Gang Gou signed a contract for a construction project in Angola was false, and the CSRC would investigate it. On 15 March, Chen knew from Luo that the CSRC would investigate Hang Xiao Gang Gou²⁰, and then Chen asked Wang to sell the shares. On 16 March, Wang sold out the Hang Xiao Gang Gou shares and obtained more than 40 million yuan (H. Yu, 2009). It was surprising that the price of Hang Xiao Gang Gou shares continued to rise even after the CSRC began to investigate it.

On 4 February 2008, the court sentenced Luo to imprisonment of one and a half years for committing the crime of revealing inside information; Chen and Wang were respectively sentenced to imprisonment of two and a half years, and one and a half years

²⁰ On 30 April, the CSRC announced the administrative penalty against Hang Xiao Gang Gou for spreading false information that it signed a contract of 4.3 billion USD for a project in Angola and caused the stock price to rise by 10% for more than ten days. The CSRC fined Hang Xiao Gang Gou 400,000 yuan and fined the responsible persons from 100,000 to 200,000 yuan. The public complained that the penalty was too weak and the cost for irregularities was too low.

with a probation of two years; Chen's and Wang's illegal earning of 40,370,000 RMB was confiscated and they were fined 40,370,000 RMB respectively (H. Yu, 2009). This case was called the biggest scandal of insider trading in the bull market. In this case, the insider trading was conducted by offenders outside the listed company. Before this case, there were a few cases about insider trading conducted by the executives of the listed companies. This case indicated the regulatory departments had adopted stricter measures to fight against stock transactions using inside information.

The case of Huang Guangyu. The exposure of the Huang Guangyu case was the most high-profile event in 2010. Born in a poor family in the countryside, Huang Guangyu became a legend in the age of Chinese economic reform. Huang Guangyu had remained No.1 among the mainland China's list of the richest for years until 18 November 2008 when he was put under supervision of the Beijing Public Security Bureau for suspected insider trading. Since 2006, Huang and his company were checked by the public security and tax inspection departments, but he solved the problems with bribery. But this time, he did not succeed, and his case exposed lots of high officials of Guangdong Province and the Ministry of Public Security (Luo and Yu, 2010).

According to the judgment of the Beijing No. 2 Intermediate Court, from 27 April 2007 to 27 June 2007, Huang Guangyu, as the actual controller of the Zhongguancun Company, in the process of assets exchange between Zhongguancun and Pengrun Investment Company that he operated, instructed other people to purchase more than 9.76 million shares of Zhongguancun via six accounts he actually controlled, with a transaction volume of 93.1 million yuan. When the assets exchange was announced on 28 June 2007, the obtained profit in the six accounts was more than 34.6 million yuan.

During the period when Zhongguancun Company planned to purchase whole shares of Pengrun Real Estate for corporate restructuring, from 13 August 2007 to 28 September 2007, Huang Guangyu instructed other people using 79 accounts to buy 104 million shares of Zhongguancun Company with a transaction volume worth 1.322 billion yuan. When the corporate restructuring was announced on 7 May 2008, the profit earned in the 79 accounts was more than 306 million yuan. During the same period, Huang Guangyu instructed another group of people using 30 accounts to buy 31.66 million shares of Zhongguancun with a transaction volume worth more than 414 million, and gained profits of more than 90 million yuan. Finally on 30 August 2010, the Beijing High Court convicted Huang Guangyu of illegal business operation, insider trading, and bribery. For the part of insider trading, he was sentenced to imprisonment for nine years and fined 600 million yuan. This case set a record in penalties for the crime of insider trading.

Subsequently, stockholders of Zhongguancun Company brought civil compensation suits against Huang Guangyu. On 20 December 2012, after three open trials, the Beijing No. 2 Intermediate Court decided against the plaintiffs, determining that they could not demonstrate that Huang's activities of insider trading caused their damage (Liao, 2013). This was the first civil compensation case against insider trading that the court carried out in open trials, but the stockholders failed in the end after about two years' struggle. For insider trading cases, it is often a difficult problem to prove the causal relationship between insider trading and damage to stockholders.

Insider trading involving corporate restructuring. In late June 2010, the president of the CSRC pointed out in a speech that in the process of corporate mergers and acquisitions and restructurings, insider trading had become the major problem for the

regulation of the Chinese stock market. On 31 May 2010, the case of Zhongshan Public Science & Technology was exposed, and Li Qihong, the mayor of Zhongshan City in Guangdong Province, was arrested for insider trading. Taking advantage of being the mayor of Zhongshan, Li knew that Zhongshan Public Science and Technology Company was restructured and would be listed, and then revealed the inside information to her family and friends. Through the operation of other related people, Li and her relatives acquired illegal profit of about 20 million yuan (Liao, 2013). In 2011, Li Qihong, received criminal penalties for insider trading, revealing insider information, and bribery. On 20 November, the CSRC said that the accounts of abnormal transactions were tracked by the real-time monitoring system of the stock exchanges, and the scope for supervision expanded; e.g., all transactions of stocks of the listed companies involving restructuring were tracked (Y. Yang, 2010).

Majority shareholders earned huge profits in the bear market of 2012. The regulatory department strengthened attacking insider trading and punished a series of corporate executives and officials, e.g., Dong Zhengqing (former CEO of GuangFa Securities Company), Xie Fenghua (a sponsoring representative and the executive general manager of the investment bank of Guo Xin Securities Firm), Li Qihong (mayor of Zhongshan City), and so on. In 2011, the president of the CSRC, Guo Shuqing, emphasized that the CSRC adopted a zero-tolerance policy against insider trading. But insider trading seemed not be curbed effectively. In 2012, the total market capitalization of Shanghai and Shenzhen stock markets decreased by more than four trillion yuan. In this way, every stockholder suffered an average loss of about 80,000 yuan. But in the long bear market, many majority shareholders still earned huge profits from stock

transactions. This caused public doubts that the majority shareholders grabbed huge profits through insider trading (Financial Management Weekly, 2013).

According to Financial Management Weekly (2013), in 2012, for 810 listed companies, 1836 majority shareholders (74% institutions, 26% individuals) sold 6.35 billion shares of the companies at high prices when the stock prices rose, earning 66.7 billion yuan in cash. For example, the stock price of Chuan Run Joint Stock Corporation started rising in February 2012, and its actual controller, Luo Lihua and her relatives, sold 75.95 million shares through 12 transactions by April 2012, earning 780 million yuan in cash. The former president of Guang Dian Electric quit his position in November 2011 and then sold out his 120 million shares of the company in July 2012 for 496 million yuan. Many of the majority shareholders seemed to play the capital games so precisely that it again raised doubts about tunneling and insider trading. For example, at the end of January 2012, the stock of East Yuan Lin fell to a record low price. Director Liang and supervisor Deng purchased numerous shares and then sold shares at a high price on 12 September, earning 28.27 million and 1,423 million yuan in cash, respectively. During this period, East Yuan Lin implemented incentive equity and dividend policies to cause its stock price to rise.

The fat-finger event of China Everbright Securities Company in 2013. The most shocking event in the 2013 stock market was the fat finger event of China Everbright Securities Company. Around 11:05am on 16 August 2013, 71 stocks, mainly of state-owned banks and oil companies, rose and closed immediately at the daily limit of moving up, which caused the Shanghai Composite Index to grow by more than 5% in just three minutes, increasing 80% in the transaction volume (Hexun Stock, 2013). This

abnormal surge resulted from the huge buy orders by China Everbright Securities Company, the fifth-largest securities brokerage in China. As China Everbright Securities stated, the huge buy orders were caused by a fat-finger error when a dealer mistakenly sent buy orders worth 23.4 billion yuan to the Shanghai Stock Exchange (the deals closed were worth 7.27 billion yuan) due to a computer technical problem (Hexun Stock, 2013).

On 18 August 2013, the CSRC concluded that China Everbright Securities' huge buy orders in the morning were due to technical errors and internal control defects, but its sales of shares and stock index futures before disclosing the former errors were deemed as insider trading. On 14 November 2013, the CSRC issued an administrative penalty, fining Everbright Securities more than 500 million yuan (five times the profit obtained from insider trading), and banning four company executives responsible for the case for life from the securities industry. The CSRC appeared to encourage retail investors to claim for compensation through legal procedures. More than 60 retail investors filed suits against Everbright Securities for compensation for their losses caused by the fat-finger event. But on 18 February 2014, Beijing No. 1 Intermediate Court accepted the suit against the CSRC brought by Yang Jianbo, former chief of the trading department of the Everbright Securities. Yang Jianbo requested the court to annul the CSRC's administrative penalties, as he claimed that the occurrence of trading errors was not inside information and the sales of stocks and futures in the afternoon were normal practices to offset the loss caused by the technical errors and did not constitute insider

trading (Hexun Stock, 2013). The court overruled Yang Jianbo's claims and supported the CSRC's administrative penalties²¹.

The difficulty of checking insider trading. As the People's Supreme Court admitted, the difficulties in discovery and evidence collection led to a sharp discrepancy between small number of cases handled by the court and the increase of insider trading in reality (Liao, 2013). The cases raised discussions on identification of inside information, classification of the subject of insider trading, and the scope of activities of insider trading. How to identify when the information is made public is a problem. According to Western experience, when the information impacts the securities market, it can be regarded as having been made public (X. Yu, 2009; Liao, 2013). Another issue is whether the inside information must be true, that is whether the inside information obtained is consistent with the information published in the officially designated media. In reality, even the information published in the officially designated media might be faked; for example, some listed companies' financial reports and statements published in the officially designated media were faked; but they were information that affected the securities market. Thus, if the inside information turns out to be in general accord with the information published in the officially designated media, they can be identified as real information (X. Yu, 2009; Liao, 2013). If the information is inconsistent with those published, the person revealing it cannot be the subject of the crime of insider trading, but might be the subject of the crime of making and spreading false information or market manipulation.

²¹ http://news.xinhuanet.com/fortune/2014-12/26/c_127337609.htm

The 1997 Criminal Law added a new article (Article 180) providing penalties against insider trading. After revisions, the maximum term of imprisonment was increased to 10 years. But insider trading has increased greatly in recent years, especially in the process of corporate restructuring. Some scholars argue, considering the striking potential illegal gains and the difficulty of investigation and evidence collection, the maximum penalty of 10 years' imprisonment cannot curb the impulse of offenders (Liao, 2013). On 16 November 2010, the General Office of the State Council forwarded the Opinions Regarding Fighting and Preventing Insider Trading in Capital Markets issued by the CSRC, the Ministry of Public Security (MPS), the Ministry of Supervision, the State-owned Assets Supervision and Administration Commission (SASAC), and the Bureau of Corruption Prevention, jointly. The Notice requires the establishment of a registering system for persons with inside information for corporate self-inspection and administrative regulatory check. According to this Notice, in 2011 the CSRC made the Regulation Regarding Listed Companies' Establishment of Registering and Management System of Persons with Inside Information. But those who knew inside information often used accounts under the name of other persons to conduct stock trading, or revealed inside information to other persons. On 22 May 2012, the Supreme People's Court and the Supreme People's Procuratorate jointly issued the Interpretation Regarding the Application of Specific Laws in Handling Cases of Insider Trading or Revealing Inside Information, and put it into effect on 1 June 2012. Supplementary to the Criminal Law Article 180, the Interpretation specifically defines and classifies the subjects of the crime of insider trading.

Hidden Rules for IPOs on ChiNext

ChiNext produced 500 billionaires and numerous millionaires in one year upon its establishment (H. Pi, 2010). ChiNext brought great wealth to actual controllers of listed companies, corporate executives, securities firms, and venture capital firms; however, at the same time, according to the survey by the media, about 70% of public investors suffered losses from ChiNext (H. Pi, 2010). As summarized by Pi Haizhou, there were three main reasons why the majority of public investors suffered losses from ChiNext (H. Pi, 2010). First, the high price-earnings (PE) ratios (the average PE ratio of the stocks on ChiNext was 65) made the corporate insiders, securities firms, and venture capital firms earn huge profits and exposed the public investors to high risks. Second, excessive speculation plagued ChiNext and often resulted in losses of public investors. Although the issuance prices were high, many listed companies on ChiNext had small volumes of shares and were easily manipulated, which invited manipulators and speculators. Third, ineffective regulation aggravated risks to public investors. For example, in the process of IPOs, securities firms were often both sponsors and shareholders of listed companies. Thus the securities firms had motivation to increase the stock issuance prices. In the process of inquiry for price making, the units for price inquiry often quoted high prices to favor the listed companies and related parties, but the regulatory department did not impose corresponding penalties on misstatements. Measures to curb speculations on new stocks often lagged behind, and the light penalty would not deter potential offenders. Consequently, the insiders got sudden wealth from IPOs on ChiNext at the expense of the majority of public investors.

On 23 June 2010, an article written by a journalist of the 21st Century Economic Report exposed the hidden rules among sponsors, middlemen, and venture capital firms in IPOs on ChiNext (Lei, 2010). The journalist stated he got to know the hidden rules from many insiders of the venture capital firms and investment banks. Since sponsors held great power of recommending applicants for listing and mentoring pre-listed companies, they could request equity of the companies that applied or prepared for listing. An IPO could bring huge profits to the venture capital firm that held equity of the company before it was listed on the stock exchange. Thus, venture capital firms made efforts to rope in sponsors or sponsoring project groups to acquire the chance to get equity of pre-listed companies.

After the establishment of ChiNext, the sudden huge profits venture capital firms gained from IPOs became more conspicuous. According to statistical reports, 80% of the companies listed on ChiNext were supported by venture capital firms. The average investment cycle was two years, and the average book rate of return exceeded ten times (Lei, 2010). For example, Hai Rui Pu set a record high IPO price, Goldman Sachs, holding 12.5% of its equity, obtained a rate of return of 200 times (Lei, 2010). The sudden huge profits from IPOs resulted from inflated appraisals and high premiums for stock issuance. As venture capital firms could not directly step into the process of listing enterprises, and it was hard to get information about the to-be-listed companies through public channels, it was an efficient way for them to contact sponsors. Sponsors had abundant information about the pre-listed companies, and moreover, they played a critical role in deciding the listing of the companies, so the companies usually would not reject the recommendation of sponsors. In addition, some sponsors would take the

initiative to contact venture capital firms, since they would get huge profits from matching venture capital firms to pre-listed companies (Lei, 2010).

Insiders revealed to the journalist that a venture capital firm usually gave sponsors/middlemen intermediary fees equal to 1-1.5% of the pre-listed company's equity it acquired. After ChiNext was established, the intermediary fees increased to about 3% of the equity acquired; for some good projects, sponsors could even get 5% of the equity acquired (Lei, 2010). Another payment method for very promising projects was that in addition to the intermediary fees for acquiring the company's equity, sponsors requested a certain percentage (sometimes even reaching 20%) of the investment profit the venture capital firm earned from selling the equity after the company was listed. The insiders said that this was a common practice in the industry. Driven by expected huge profits, sponsoring representatives in securities firms and sponsoring project group members or senior executives of investment banks often acted as middlemen between the companies and venture capital firms for equity acquiring. Venture capital firms usually would pay them according to agreements under the table in order to keep a long-term cooperation with them. With a lack of effective supervision, the power of sponsors produced room for corruption.

The IPO Fraud Flooded SME and ChiNext

According to the statistical report, 347 companies conducted their IPOs in 2010, among which 81 companies (23.34% of all the newly listed companies) announced the sudden downturn of corporate performance in their first yearly financial reports after being listed; in 2011, there were 282 newly listed companies, among which 75 companies

(26.6%) announced the sudden downturn of corporate performance in their first yearly financial reports after being listed; in 2012, since the market was low, only 153 companies were listed, among which 58 companies announced the sudden downturn of performance in their first yearly financial reports after being listed (China Economic Weekly, 2013). The sudden change of corporate performance caused doubts about misrepresentation in their application in order to meet the requirements of the IPO.

The case of Green Land Company. The case of Green Land Company was the first case of IPO fraud on the Small and Medium-Sized Enterprise Board (SME). In the first three years after its listing, the company frequently changed accounting firms, changed senior executives, and changed financial statements. Especially, from October 2009 to April 2010, Green Land Company publicized its expected profit in 2009 as more than 100 million yuan in the first report; then it changed the number several times, and in the end, it announced that it had a loss of 150 million yuan in 2009 (People.com, 2011). The abnormal activities of Green Land Company caused doubts. In March 2010, the CSRC investigated the company. Actually, when the Green Land Company applied for secondary offerings in 2009, the local securities regulatory department noticed its financial irregularities, rejected its application, and ordered it to correct the problems. But the local regulatory department did not publicize the information (Securities Market Weekly, 2013). After the investigation by the CSRC, the case was sent to the public security department for criminal investigation in September 2010. Before the exposure of the scandal, its four original shareholders sold their shares for huge amounts of cash (Xinhuanet.com 2011, April 02).

In December 2011, the Guandu District Court of Kunming City fined Green Land Company 4 million RMB and sentenced former company president, He Xuekui, to three years' imprisonment with a suspension of four years; other responsible managers were sentenced to several years' imprisonment with a suspension. This judgment caused severe criticisms that the punishments were too light. The People's Procuratorate appealed against the court judgment. Consequently, on 7 February 2013, the Kunming Intermediate Court made the decision to change the first judgment. According to the judicial investigation, Green Land Company inflated its income by 300 million yuan before it was listed and inflated its income by 251 million yuan from its listing to 2009. Through 35 related companies, He Xuekui and managers faked contracts, invoices, and other documents to make false business transactions and inflate assets and income. Green Land Company was convicted of IPO fraud, faking financial documents and destroying accounting documents, and was fined 10.24 million yuan. This time, He Xuekui was sentenced to 10 years' imprisonment with no suspension. He Xuekui appealed to the Yunnan High Court, but the court overruled her appeal and upheld the judgment of the Kunming Intermediate Court. He Xuekui became the first corporate president to be jailed for IPO fraud in the Chinese stock market (Nanjing Evening News, 2012).

Although the criminal penalties provided by the Kunming Intermediate Court were more severe than the first court judgment, the fine of 10.4 million yuan imposed on the Green Land Company was still too small compared to the huge volume of capital, 346 million yuan, raised from IPO (Cnr.cn 2013, February 22). He Xuekui, the former actual controller of the company, who was convicted of IPO fraud, misrepresentation, faking financial documents and destroying accounting vouchers, and was fined only 600,000

yuan. It indicated that the offenders would still keep huge profits obtained from the financial fraud even after they received criminal penalties.

Upon completion of the judicial case of Green Land Company, the CSRC imposed administrative penalties on the intermediary agencies and practitioners for the IPO of Green Land Company. HuaTaiLianHe Securities Firm was fined at the maximum provided by the laws. Two sponsoring representatives had their licenses revoked and were banned for life from the securities industry. Shenzhen Pengcheng Accounting Firm had its license for securities business revoked. But some argued that the punishment was still too light compared to that in Hong Kong, where the sponsoring representative would receive a criminal penalty in addition to his license being revoked (Xinhuanet.com 2013, February 28th).

After exposure of the case, scholars emphasized that the low cost for securities fraud and high expected profit were the main factors luring potential offenders, thus severe punishment should be applied to curb IPO fraud. Some questioned the role of sponsors and the Issuance Review Committee of the CSRC in the IPO of Green Land Company and claimed that the related institutions and regulatory department should be investigated. The vice director of International Finance Research Center of Shenzhen University, Guo Shiping, pointed out that this case revealed three problems of the current Chinese securities regulatory system (Xinhua News 2011, April 2nd). First, lack of supervision over the CSRC in securities issuance review produced more room for corruption. He claimed the power of review and decision making should be assigned to the stock exchanges, and the CSRC should supervise the work of the stock exchanges, which would make a system of checks and balances to reduce the room for corruption.

Second, the lack of effective delisting mechanism encouraged securities fraud of listed companies in this speculative market. Third, too light a penalty imposed on the offender would not deter the potential offenders.

Lawyers also appealed to strengthen and expand the scope of the protection of investors. Currently, administrative penalties or criminal penalties had to be in place before anyone could claim compensation for damages. But as stated by securities lawyer Xue Hongzeng, the stock exchange's penalty measures, e.g., reprimand and decision to order the listed company to rectify, were not the prerequisite for investors to bring a civil compensation case against securities fraud. Thus investors could not claim compensation for their interest being damaged by those listed companies that the stock exchanges adopted measures to punish. The stock exchanges' reprimand and order, these lawyers argued, should be sufficient prerequisite for civil compensation cases (Xinhua News 2011, April 02nd).

The case of Wan Fu Sheng Ke. While the case of Green Land had not yet come to an end, the Chinese stock market was shocked by another big case of IPO fraud on ChiNext. The exposure of the Wan Fu Sheng Ke scandal was triggered by a routine inspection by the CSRC and its Hunan Branch that found problems in the company's 2012 mid-year report. Responding to the investigation, in October 2012, Wan Fu Sheng Ke issued a self-inspection report admitting that the company made false statements in its 2012 mid-year report, inflating income by about 188 million yuan, costs by about 146 million yuan, and net profit by about 40.23 million yuan; after the correction, the actual business income and net profit were 82.17 million yuan and -13.68 million yuan, decreasing by 64% and 144%, respectively (China Business Journal, 2013). The CSRC

then ordered it to self inspect the financial reports for three consecutive years right before its IPO. In March 2013, Wan Fu Sheng Ke issued a self-inspection report to admit that the company made false statements in the 2008-2011 yearly reports and inflated the total of income and net profit by about 740 million yuan and about 180 million yuan respectively. From 2008 to 2010, 47%, 90%, and 84% of the business income, business profit, and net profit, respectively, were fabricated (China Business Journal, 2013).

In August 2013, Wan Fu Sheng Ke Company president, Gong Yongfu, was arrested for IPO fraud, misrepresentation and faking financial bills and invoices. This was the first case of securities fraud in ChiNext. Xia Cao, an accounting expert, said that this honest-looking veteran crippled in the war had cheated the financial experts (Sina.com, 2014). As described by Xia Cao, it was a kind of culture prevalent in the capital circle of Hunan Province that packaging the company was a common step for IPO, and they tended to follow hidden rules and ignore laws and regulations. This culture contributed to the occurrence of IPO fraud, such as the scandal of Wan Fu Sheng Ke.

Upon exposure of the scandals, the CSRC imposed severe penalties on the related intermediary agencies that provided false information for IPO application. Subsequently, among more than 800 enterprises in the process of review for IPO applications, more than 200 companies had their IPO applications revoked (Cao, 2013). Meanwhile, the CSRC sought public comments on the reform for the system of new stock issuance. Ping'an Securities Company, as the sponsor for the IPO of Wan Fu Sheng Ke, was sanctioned by the CSRC. The CSRC reprimanded Ping'an Securities Company, confiscated its income of 25.55 million yuan from the IPO of Wan Fu Sheng Ke, fined it 51.1 million yuan, and suspended its certificate as sponsor for three months (Liao, 2013).

The CSRC also reprimanded Wu Wenhao and He Tao, the two sponsoring representatives, fined them 300,000 yuan respectively, revoked their certificate of sponsoring representative, and banned them for life from the securities industry. In addition, business executives, internal controllers and project coordinators of Ping'an Securities Company for the IPO of Wan Fu Sheng Ke were reprimanded, fined, and their certificates of practitioner in the securities industry were revoked. Before this case, the CSRC usually just punished the sponsoring representatives who signed for the sponsoring business. In this case, the scope and severity of punishment against the sponsor were expanded. The CSRC also punished Zhong Lei Accounting Firm and Hunan Bo Ao Law Firm as the intermediary agencies for the IPO of Wan Fu Sheng Ke.

Ping'an Securities Company stated that it did not intentionally make false financial statements, but was cheated by Wan Fu Sheng Ke (Xinhua News, 2013). But Ping'an Securities Firm was regarded as a notorious financial fraud maker. According to a statistical report by iFind from 2009 to March 2013, Ping'an Securities Firm had sponsored 73 IPO projects, among which 31 companies announced a sudden downturn of corporate performance in the first yearly reports after being listed (Xinhua News, 2013). For investors who suffered in the case of Wan Fu Sheng Ke, Ping'an Securities Company established a special fund holding 300 million yuan, which was the first time that the sponsor took an initiative to compensate investors. But Ping'an Securities Company required that if an investor accepts compensation from the fund, he/she can no longer claim compensation again from the responsible party; if an investor does not accept compensation from the fund, he/she can bring a suit for compensation in accordance with the law, but he/she will bear the costs and risks for the litigation. The controller of Wan

Fu Sheng Ke Company promised to bear the part of the compensation they should pay, and offered 30 million shares of Wan Fu Sheng Ke as a pledge to the China Securities Investors Protection Fund Limited Company for compensation. Although it is likely to have negative effects on the justice of the administrative penalty, Liao (2013) suggests this measure would help efficiently compensate investors who suffered from securities fraud.

Article 189 of the Securities Law provides, “where an issuer fails to meet the requirements of issuance and cheats for the verification for issuance by any fraudulent means, if the relevant securities have been issued, a fine of 1% up to 5% of the illegal proceeds as unlawfully raised shall be imposed. The person-in-charge and any other person directly responsible shall be imposed of fine of 30,000 yuan up to 300,000 yuan.” The Criminal Law provides that the offender “should be sentenced to fix-term imprisonment of not more than five years or criminal detention, and concurrently or independently a fine of 1% up to 5% of the illegal proceeds as unlawfully raised shall be imposed.” For example, Green Land was only fined 10.24 million, while it raised 394 million through the IPO. Wan Fu Sheng Ke raised 425 million yuan through IPO, equal to 21 times its total net profit from 2006 to 2008 before being listed (New Financial Observer, 2013). The penalty of imprisonment of not more than five years was also too light to deter potential offenders. Compared to the huge profit, hundreds of millions or billions of yuan the offender grabbed through IPOs, the amount of fine and incarceration provided by the laws was too small to punish offenders. The causes of the frequent occurrence of IPO fraud were the expected huge profit from IPO and the too-light penalty the current legal system would impose on the offender.

Furthermore, the listed company could not be directly removed from the stock market for IPO fraud. For example, Green Land Company was fined only 10.24 million yuan, and remained listed on the SME board. Upon the exposure of scandals, the stock exchanges revised the rules and provided that if a listed company had recorded losses for consecutive three years or its net asset were negative, its stock would be suspended from the stock exchange. For a listed company on the ChiNext, if it was publicly reprimanded by the stock exchange three times in 36 months, it would be delisted from the stock exchange (New Financial Observer, 2013). But it was a problem that if a listed company were delisted. Investors buying the shares in the IPO or the secondary market would experience difficulty in getting compensation since the raised funds would be hard to return.

The Reflection on the Case of Hontex International in Hong Kong Stock Market

In contrast, Hong Kong securities regulatory departments have applied severe penalties against IPO fraud recently. The case of Hontex International was an example. In December 2009, Hontex International was listed on the Hong Kong stock market, but only three months after listing, it was suspended from the stock exchange since the Hong Kong Securities and Futures Commission (HKSF) alleged that its prospectus included false information and misleading data. According to the investigation, Hontex International inflated its sales income by 381 million HKD (40%), 709 million HKD (220%), 905 million HKD (230%), and inflated its profit before tax by 102 million HKD (730%), 185 million HKD (1750%), and 298 million HKD (2610%) in 2006, 2007, and 2008, respectively (Su and Yang, 2012). The HKSF sued Hontex International in the Hong Kong High Court, requesting that the court ban the company and its four wholly-

owned subsidiaries from transferring or disposing of their assets in Hong Kong, withdraw and take over the net capital of 997 million HKD it raised through IPO, and return the raised capital to investors. In June 2012, the HKSF and Hontex International reached an agreement that Hontex International would buy back the shares from 7,700 public investors at the closing price before the suspension that was about 1.03 billion HKD, more than the capital it raised through IPO. The Hong Kong High Court confirmed the agreement and ordered Hontex International to implement the agreement. In April 2012, the HKSF imposed a record severe penalty on Zhao Feng Capital, the IPO sponsor of Hontex International. The HKSF revoked its license as sponsor, and fined it 42 million HKD, and revoked the license of its president as sponsoring representative (QQ.com, 2012, April 23).

In the case of Hontex International, the severe penalties imposed on the offender by the Hong Kong securities regulators increased the criminal cost to more than the expected profit from the crime, which achieved the goal of social fairness for public investors and would greatly deter potential offenders. More importantly, the HKSF on behalf of the investors sued Hontex International in court, requesting the court to order the company to return the capital raised from IPO to public investors. This relief mechanism is effective and efficient for compensating investors. In mainland China, investors could claim compensation through individual or collective civil litigation, but they need to spend much time and cost and bear risks, and even if they win the case in the end, they would not get enough compensation to cover their losses.

Although the CSRC showed that it would adopt stricter measures to punish IPO fraud and misrepresentation, the recent exposure of its dealing with South Textile

Company again aroused public criticism (Sina.com, 2014b). On 17 May 2014, South Textile Company announced that it received a written decision of administrative penalty from the CSRC. The CSRC imposed a warning and a fine of 500,000 yuan on it for inflating income by more than 344 million yuan from 2006 to 2010; the former president and other corporate managers were warned and fined between 30,000 yuan and 300,000 yuan. This raised questions: South Textile made false statements for five years, but the regulatory department did not discover this for such a long time. According to the Securities Law and other related regulations, a listed company that generated losses for four consecutive years would be delisted. South Textile generated losses for five consecutive years, but was not delisted. The company inflated income by a huge amount, but was fined only 500,000 yuan, and the corporate executives received very light penalties. This case again caused concern about the negative effect of the low cost for crimes and irregularities and the ineffective enforcement of delisting mechanisms.

Reform of the Chinese Stock Market in the Near Future

In November 2013, the Third Plenary Session of the 18th Central Committee confirmed that a registration system would be adopted to replace the approval system for IPO and listing. Subsequently, on 30 November 2013, the CSRC issued the Opinions Regarding Furthering the Reform of New Stock Issuance System, aiming to prepare for the adoption of a registration system (Shanghai Securities Daily, 2014, June 11). The establishment of the registration system would change the role of the government in the stock market. The regulatory department would conduct supervision during the process and after stock issuance, rather than implementing administrative assignment and designation before stock issuance.

On 24 January 2014, the New System of Share Transfer was opened, which is a market for equity transfer of unlisted joint stock companies, especially for medium and small enterprises with high and new technology (Eastmoney.com, 2014). This System is a part of the multi-layer capital market, providing a more efficient and inexpensive channel for medium and small companies in the earlier stage than those on the main board, SME, and ChiNext. In April 2014, the CSRC and HKSRC jointly approved the pilot program of Shanghai- Hong Kong Stock Connect (Hu Gang Tong). The pilot stocks in the two exchanges were open to investors of mainland China and Hong Kong. It was a critical step for investors in mainland China to go into the international capital market, which could at some level change the inflated assessment of stock prices in ChiNext and the too low assessment of prices of blue chips stocks, and improve the investment philosophy of Chinese investors (Sina.com, 2014a, June 28).

In May 2014, the State Council published the Opinions Regarding Further Fostering the Healthy Development of the Capital Market, which is called the New Nine Opinions. The New Nine Opinions proposed to develop indirect and direct financing, especially to increase the ratio of direct financing, which means the equity market representing the direct financing would be given more importance. Some argued that the common problems of the stock market, e.g., poor corporate governance and less attention to investors in the secondary stock market were because the equity market occupied only a small part of the country's economic system and thus did not gain enough attention. For example, in 2013, the funds raised from the equity market were only 401.6 billion yuan, while the funds raised from bonds exceeded 9 trillion yuan, and the funds raised from bank loans exceeded 12 trillion yuan. Equity financing only occupied 1.8% (Xu and Liu,

2014). As its importance and status are enhanced, the corresponding institutions and legal system would be developed to improve the protection of investors (H. Zhou, 2014).

The critical point of the New Nine Opinions is that the goal of the equity market is to foster the development of the real economy (S. Zhang, 2014), which indicated that the development of the stock market would be closely related to the economic development and reflect the status of the real economy. The main tasks of the Chinese stock market in the years to come were summarized in the New Nine Opinions as: to establish the registration system for stock issuance, to facilitate the construction of a multi-layer capital market, to improve the quality of listed companies, to encourage market-oriented merger and acquisition and corporate restructuring, to improve delisted mechanisms, and to cultivate private equity markets. Currently, the pressure from local debts, potential bubbles in the real estate market, and excessive production capacity in the manufacturing industry made the government turn to equity financing for more capital to support the rapid growth of the economy. In another words, the development of the real economy urgently needed an increase in direct financing, the fundraising from the equity market (Xu and Liu, 2014). The adoption of the registration system for new stock issuance and the establishment of New Share Transfer System were aiming to increase equity financing.

The Securities Law will be revised in the near future to meet the need of the adoption of a registration system. As revealed by the drafting group, the revised Securities Law would focus on three concepts: expanding the definition of securities, centering on information disclosure, and fostering comprehensive operations of securities institutions, which would give more autonomy to securities market participants for

investment and financing (Economic News Daily, 2014, September 22). The adoption of registration system for stock issuance requested higher standards for information disclosure by applicants. Applicants for stock issuance would take more responsibility for the truth and integrity of information disclosed. The most-watched focus of the revised Securities Law is the adoption of the registration system for IPO, which would cause the repositioning of the CSRC and the stock exchanges in securities market regulation and operation. The current president of the CSRC, Xiao Gang, showed that the Chinese-style reform for the registration system would be carried out and then implemented after the revision of the Securities Law is completed and the situations are mature (Economic News Daily, 2014, September 22).

Conclusions

The release of the 2004 Nine Opinions of the State Council signaled that the regulatory authorities recognized that the Chinese stock market should follow market principles, comply with the rule of law, and provide stronger protection for public investors. The sponsorship system for stock issuance and listing were adopted to enhance the transparency of administrative actions and invite public supervision. The SME and ChiNext were established to form a diversified capital market and build a closer relationship with public investors. The non-tradable share reform aimed to realize the market function of corporate value discovery and improve corporate governance. Learning from the lessons of previous attempts, the non-tradable share reform invited public investors to participate in the decision making process. Meanwhile, the regulatory authorities adopted measures to clean up the securities industry and check listed companies, attacking misappropriation, illegal guarantees, manipulation, insider trading,

and other offences. The Company Law and the Securities Law were revised to strengthen regulation of the stock market and protection of public investors.

However, implementation of the reforms proposed by the Nine Opinions deviated from the original intentions and violated principles for investor protection. After the initiation of the non-tradable share reform, the protection of investors, especially public retail stockholders, has been the focus of disputes regarding whether the government played an appropriate role in the operation and regulation of the stock market. Given the frequent occurrence of irregularities, the sharp fall of the market three years after the initiation of non-tradable share reform led to blame being placed on the CSRC. The ambiguous rules, inconsistent enforcements, and ineffective regulation invited potential offenders. Corporate insiders and related parties took advantage of their power and resources to grab huge profits from public retail stockholders during the process of non-tradable share reform (Y. Lu, 2010; Lang, 2012; Z. Wang, 2010).

The recurring irregularities and crimes, such as manipulation, insider trading, rat trading and so on, showed the weaknesses in laws and their implementations. For example, the laws still provide light penalties, especially monetary sanctions, towards IPO fraud and misrepresentation. The case of Green Land was an example. Compared to the huge potential profits from the IPO, light monetary sanctions did not reflect the principle of justice and could not deter potential offenders (Securities Market Weekly, 2013). The difficulties in discovering and collecting evidence to demonstrate securities frauds, e.g., insider trading and rat trading, also reduced the possibilities of catching offenders and decreased deterrence by laws and regulations (Liao, 2013). In addition, in some cases it's hard to demonstrate the causal relationship between securities fraud and

losses of investors. For example, in the case of Huang Guangyu, public stockholders claimed compensations for their damages, but they failed to demonstrate that their losses were caused by insider trading (Luo and Yu, 2010).

The enforcement of laws also encountered challenges from the regulatory department's inconsistencies in attacking irregularities. For example, due to concern about the stability of the market, when the market was low, the regulatory authorities tended to be lenient toward the fund management firms that were responsible for irregularities. The recent case of South Textile Company was another example of the inconsistencies in law enforcement (Sina.com, 2014b). Although the CSRC claimed it would adopt stricter measures against misrepresentation, it still did not follow the laws and only imposed too light penalties on the South Textile Company for its misrepresentations. The inconsistencies in law enforcements hurt the integrity and authority of the legal system (Gu, 2009).

Serious IPO fraud, manipulation, misrepresentation, and other securities irregularities quickly plagued the relatively new markets, the SME and ChiNext. The sponsorship system did not help improve the transparency of the administrative procedures and better protect investors. Instead, sponsors took advantage of their excessive power and formed the hidden rules for stock issuance and listing on the ChiNext (Lei, 2010). In addition, some sponsors employed inside information they knew in their duty to grab profits through insider trading. The complicated relationship between the government and interest groups made the external regulation over the stock market ineffective. A series of irregularities pointed to the nature of the Chinese stock market as a money-raising market filled with crazy speculation, which created an environment for

rampant securities irregularities with the ignorance of laws and the absence of respect for public investors.

The above cases, especially those about insider trading, revealed the offender's ignorance of the law or ignoring of the law. The case of Wan Fu Sheng Ke showed a culture in the capital circle that preferred hidden rules to laws and regulations (Xia, 2014). This indicated that the regulatory departments should make greater efforts to provide people with legal knowledge, which would help improve self-regulation and corporate internal regulation. It is worth noting that doubts from scholars and some common people challenged listed companies and pressed the regulatory departments to punish offenders. For example, the investigation on Wuhan XinLanDe was initiated by an investor who reported the abnormal transactions to the regulatory authorities. In addition to academic stars (e.g., Lang Xianping), common people posted comments online from time to time revealing misrepresentation of listed companies. Public supervision brought a positive impact on the regulatory authorities and formed an active part of the external regulation.

The CSRC was created to be a watchdog for the stock market, but it seems not to have met this goal under the current institutional arrangements and environment. In the years to come, a registration system would be adopted to replace the approval system for IPOs and listing. The legal system and institutional arrangements would be adjusted to meet the need of the establishment of the registration system. The registration system will require higher standards for information disclosure and impose stricter responsibilities on the stakeholders. It does not mean that IPOs and listings do not need the supervision of regulatory departments, but rather it indicates the change of the role of the government in the operation and management of the Chinese stock market. The Chinese stock market is

expected to enter into a new stage, which is the outcome of the dynamics among the government, the market, and investors.

CHAPTER V

PUBLIC RETAIL STOCKHOLDERS: THE GROWTH OF STOCKIZENS

Introduction

To explore public retail stockholders' experience in stock trading, their views about securities crimes, and their opinions about the stock market regulation, I conducted interviews²² with 40 retail stockholders of two Chinese cities, Shenzhen and Haikou. The interviews focused on respondents' motivations for stock investment, how to choose stocks, views about misrepresentation, corporate misconduct, insider trading, and manipulation, as well as illegal consultation. All of them thought that securities fraud and crimes were common in the Chinese stock market and public retail stockholders were a disadvantaged group. The majority of the interviewees said the regulation of the stock market improved gradually, but penalties imposed on offenders are still too light and enforcement is still weak.

Although the interviewees were only a very small part and are not representative of the entire population of Chinese retail stockholders, their views provided some reflections on the stock market regulation and investor protection. The experience of the interviewees suggests that the institutional defects aggravated speculation and produced temptation to potential offenders. The government's excessive intervention, corruption, and ineffective regulation, intertwined with rampant securities fraud, led to a twisted stock market. But relevant mechanisms adopted to operate the stock market help increase the transparency of activities of market participants and pressed the government to

²² This is in compliance with IRB Protocol# 1204007760 from Arizona State University.

strengthen external regulation. More importantly, it invited a huge group of stockholders into this market-oriented frame. By 2014, there were about 100 million individual stockholders in China, and the majority were retail stockholders (SSE, 2014; SZSE, 2014). Through the experience in stock investment, public stockholders enhanced their self-awareness and rights consciousness. The interviews also indicated this growth of rights consciousness. Public stockholders have grown to a huge group and are called stockizens; like the emergence of netizens, they are a force to be reckoned with in China.

Public Retail Stockholders

Due to the institutional defects and regulatory weaknesses mentioned above, securities fraud and irregularities plagued the Chinese stock market. Given their disadvantages in capital, information, and expertise, public retail stockholders confronted risks of becoming victims of market manipulation and other securities irregularities. However, many experts also argued that the irrational and speculative investors contributed to the rampant securities irregularities and lured potential offenders. On his weibo, economist Liu Shengjun (2014), argued that an underlying cause of the low-level development of the Chinese stock market was stockholders' addiction to gambling. As a consequence, stockholders could not vote with their feet to press for reform of securities market regulation, resulting in an unhealthy stock market. Currently, 99.3% of stock accounts are individual accounts, and the majority are accounts of retail stockholders for short-term investments (CSRC, 2014). Retail stockholders were often regarded as irrational and speculative. Interestingly, in Chinese terminology, trading stocks is often called "stir-fry stocks" (*chao gu*), which vividly describes the short-swing kind of speculative trading activities. The lack of attention to this group in studies of the social

context for securities irregularities and related white-collar crime and the regulation of the stock market is a limitation of prior research, which this study begins to address.

Interviews with Retail Stockholders

I interviewed 20 retail stockholders in each of two cities in China, Shenzhen (12 males and 8 females) and Haikou (10 males and 10 females). Shenzhen, close to Hong Kong, was the earliest special economic zone in China and remains an important economic center in China. It has a population of more than 10 million people, the majority of whom are from other places in China. Hainan Province was the biggest special economic zone in China. Haikou is the capital of Hainan Province, but it is no longer an economic center in China. It is not a big city in China since its population is only about 1.2 million people. Haikou is famous for its good natural environment, and people here live a relatively slow and cozy life.

Using a loose snow-ball approach, I began interviewing stockholders with whom I already had an acquaintance so that I could get access to, and then identified other interviewees. The interviews were semi-structured, as I prepared a set of questions and adjusted my questions in the interviews. I talked with the interviewees in a tea house or took phone interviews if we were not available to talk face to face. The interviews were conducted as relaxed conversations, and the length of an interview was flexible. An interview in a teahouse took more than one hour while a phone interview averaged thirty minutes. The interviewees seemed open and willing to share their experience and views. Each interview covered almost all the questions I prepared. An interviewee even talked with me in a tea house for a whole afternoon, as he liked sharing his stories of stock

investments and his thoughts about high-profile cases. I audiotaped the interviews or took notes if the respondent preferred not to be recorded electronically. In the analysis, these interviews with retail stockholders are coded in the form of “FS1” or “MH1.” The first letter indicates the person’s gender (M refers to male, F refers to female); the second letter indicates the city (S refers to Shenzhen, H refers to Haikou); the third number indicates the order of the interview.

In terms of age, two interviewees were under 30 (5%), 11 interviewees were in the age range of 30-40 (27.5%), 20 interviewees were 40-50 (50%), four interviewees were 50-60 (10%), and three interviewees were over 60 (7.5%). In terms of education level, three interviewees had less than a college degree (7.5%), 29 interviewees had college degrees (72.5%), and eight interviewees had graduate degrees (20%; four females and three males in Shenzhen, and one male in Haikou). In terms of profession, 10 interviewees were government employees (25%), one interviewee was a doctor in a hospital (2.5%), two interviewees were college/technical school teachers (5%), 10 interviewees were state-owned enterprise employees (25%), four interviewees were bank employees (10%), five interviewees were foreign/private enterprise employees (12.5%), four interviewees were small business owners (10%), one interviewee was self employed (2.5%), and three interviewees were retired people (7.5%).

Motivations for Stock Investments

In the interviews, 38 respondents (95%) said they entered into the stock market just for investment (speculation) and interest as they did not make a living by trading stocks; only two interviewees (5%) ever conducted stock trading for a living, and that was years ago. MS11, a private company employee, said he began stock investments in

early 1990 when he had no job and tried to make a living from stock transactions. At that time, it was much easier to earn money from stock investments since there were only a small number of stocks, and there were comparatively many stock investors. But later, the majority of stockholders suffered losses in the stock market. FS2, who was self employed, described earning her first pot of gold as an intermediary trading shares of enterprises before the stock market was officially established and then profited from stock investments when the Shenzhen Stock Exchange was open, but she lost a lot in later years and now invested with much greater caution.

All the interviewees admitted that when they began trading stocks, they felt it exciting as an enrichment of life. As MS1 (a private company employee) said, when he took his friend's advice to play stocks in early 1990s, he began to feel more autonomy and confidence in his life. MH2, a state-owned enterprise employee, described that he felt he had a fulfilling life after he started to invest in stocks. MH3, a bank employee, felt he was his own master when he conducted stock transactions. MH15, a technical school teacher, described the craze of stock investors in the beginning of the stock market came out of the context that common people had just changed from political creatures in the past to economic creatures with a passion for acquiring wealth. MH11, a retired government official, described that when he had retired, he felt a loss because he was leaving the familiar environment and circle; when he began trading stocks, he regained a substantial life; in all, he earned profit from stock investments, and he felt he made another success in his life. FH16 (a retired state-owned enterprise employee) said she began to buy stocks when she was working, but she lost a sum; after she retired, she continued to play stocks to kill time, and of course, wanted to win back the money.

Among the interviewees, two retired persons (5%) mentioned that they fried stocks to kill time, and admitted they just used their spare money for stock trading. This somehow indicated that the stock market provided a place for retired people in China to have a different life²³, not just surrounding their families like before.

MH10 (a small business owner), who was born in the 1980's, discussed the conditions for stock investment in China. He said it is common for Chinese people to deposit money in banks, but the generation born in the 1980s or 1990s has less inclination to save, preferring to do more investments. He also thought they were not fully comfortable placing their money in banks since things changed too much in this era, e.g., currency devaluation, possible political instability, and unexpected factors. MS4, a government employee, said conducting stock transactions helped him enhance his understanding of wealth and investment knowledge as well as improve his time management. MS10, a private company employee, thought stock investment could be a career for life. FH3, a bank employee, said frying stocks is the most convenient investment for a working person. FH6, an employee of a state-owned enterprise, stated that she had not enough time and money to do other investments, and frying stock was the most suitable investment for her. In the interviews, 38 respondents (95%) said they wanted to increase wealth from stock trading, and stock trading is the most convenient means of investment.

FH1 (a state-owned enterprise employee) said she bought some stocks when she was on maternity leave at home. In the beginning, she was playing the market totally for speculation and fun; if she lost, her life would not be affected too much since she just put

²³ As I saw in some public trading halls and rooms in securities companies, many stockholders there were old people. While they did stock trading, they discussed stocks, chatted and made jokes.

her spare money into it. During the 2006 to 2008 long bull market, she won money from almost everything she bought, and she profited on more than 100% of her investment. Using the money earned from the stock market, she bought a car worth 100 thousand RMB. Her husband did not invest in stocks, and was surprised she did so well. As she said, she was in charge of financial management for her family, and gave her husband pocket money. She continued to add more funds to her stock account. But in the later years, the amount of funds in her stock account fell, and now her stock investments just managed to break even. She said they often shared information about stocks with their friends and colleagues. When they arrived at their office in the morning, they would check WeChat²⁴ for information about stocks and discussed what to buy and sell, just like talking about fashions.

FH13, a government employee, said she has remained in the stock market since she suffered losses and hoped to win back the money. She just spent her spare money on stocks, and losing money in the stock market did not affect her life. She said she earned some money, but was too greedy and bought more stocks at high prices when the index of the stock market was at the very top. She had heard some inside information about the stock of Eastern Square, but she hesitated and then bought shares at the high price of about 20 yuan per share. Now it was about 2 yuan per share. FH9, a bank employee, said she was conservative and did not spend too much on stock investments. She was sensitive to the stock prices, so she would sell out the stock when its price fell a bit. When the stock price changed greatly, she could not sleep and often watched the market trend online. Sometimes she felt like she was riding in a roller coaster.

²⁴ WeChat is a mobile communication service provided by Tencent in China. Now it is the most popular tool for communication in China.

How to choose stocks. Among the interviewees, 36 respondents (90%) stated that they had limited knowledge about the stock market, 31 interviewees said that they had only very basic knowledge about stock trading, and 5 persons expressed they had little knowledge about the stock market. Only 4 persons (10%) expressed they had professional knowledge about stock trading and relevant financial statements. MH5, a government employee, said that he had tried to learn more professional knowledge on stock trading and finance, but he realized those things were not useful for stock investment since the corporate information was not transparent or the information revealed was not true, and situations would change without timely disclosure. MS20, a small business owner, said that almost all financial statements of listed companies were false, so he did not believe the corporate performance publicized. MH4, a government employee, argued that without effective legal protection, even if you went to the listed company's factories or other production bases, you might not figure out the real condition of the company. Among the interviewees, 33 persons (82.5%) said that they paid attention to macro policies regarding the stock market, among them nine persons (22.5%) expressed that they paid close attention to changes in laws regarding the operation and regulation of the stock market. But they said that whether they knew the laws or not had little to do with their choice of stocks. MS12, a private company employee, said he only cared about the macro policies of the stock market and did not care about changes in the laws and policies because they did not affect the stock market. He also felt that strong protection of investors could not be achieved in the near future. FH8, a state-owned enterprise employee, said that she occasionally looked at some changes of laws and rules,

and she thought these might affect the general market trend, but individual stock would have different performances.

Four respondents (10%) said they currently chose stocks only based on their own analyses. They admitted that when they began to invest in stocks, they chose stocks based on advice from friends, including so-called inside information revealed by others, but they suffered losses. Now they did not believe so-called inside information and decided to analyze stocks by themselves. They chose stocks based on the analyses of the company's financial fundamentals, performance, prospect, the general situation of the whole industry, and capital movements. But they also admitted that sometimes the movements of stock prices are not related to the corporate performance. Even if a company had a very bad performance, its stock prices would rise if the manipulators boosted it. Thirty interviewees (75%) chose stocks based on the combination of others' advice and their own analyses. They would like to take the advice of their friends who are experts in securities firms or who have good performance and abundant experience in stock investment. In addition, they would analyze the stocks by themselves. The remaining six interviewees (15%) said they chose stocks only based on advice from friends since they did not know how to analyze the market. They just followed the instructions of their friends who performed well in stock investment. They thought it would be wasting time to think about how to choose stocks by themselves, and it is more efficient to follow experts' opinions. MS14, a state-owned enterprise employee, said he used to look for information, watch news, and combine friends' advice and his own analyses to choose stocks; currently, he lets a securities expert manage his stock investment. If he makes a profit, he and that expert will share the profit according to the

proportion they set; if he loses, he will bear the loss by himself. As a group, the interviewees indicated there was a great need for securities experts to provide advice to public retail stockholders.

Is the Chinese stock market a casino? All interviewees except two (5%) said that the Chinese stock market is still a casino. MH3, a bank employee, argued that the Chinese stock market has been in operation for more than 20 years and has developed into a huge market with the total value of several trillion yuan. Thus, it is not a casino although speculation in the market is serious. MS10, an employee of a state-owned enterprise, said that the Chinese stock market is not well-regulated, but it is far from a casino. But the other 38 interviewees (95%) thought the Chinese stock market is still a casino. FH10, a government employee, said when some government leaders said something, the stock market would fall or rise sharply, so that it could not be a real market for investment. FH7, a government employee, said that unlike investors in advanced stock markets who bought stocks for long-term investment, the Chinese stockholders were in the market just for short-term speculation; but in China, if you did not sell out when you earned money, the stock price would fall and you would never know when it would rise, since there is no standard and rule for the market. MS19, a small business owner, said that the Chinese stock market had little value for investment; for example, the price of a stock he bought 20 years ago was about 20 yuan per share, but now the price was only 2 yuan per share. FS3, a doctor, argued that the Chinese stock market was still a casino, but it has improved little by little. MH4, a government employee, said the government also needs this big casino and should improve its financial functions; otherwise it could not develop. FS9, an employee of a foreign

company, said that even the stock market was a casino, the government should fight against the offenders who violate the rules.

As the interviews showed, the notion that the stock market is like a casino came out of their view of life. MH10, a small business owner, said frying stock is like a life full of changes and uncertainties. MS12, a private company employee, described life as a stock market since we need luck, skills, and sometimes tricks. MS18, an employee of a foreign company, said any investment has a speculative character; as life is a bet, choosing a career is like entering into a casino. FH14, a bank employee, thought that luck played a big part in winning profits from stock trading. MS14, a government employee, thought he would win if his stock investment continued. FH1, a state-owned enterprise employee, said that if you like to bet, you should admit the failure and accept the result when you lose. MS5, a government employee, said the way you play stocks depends on your character; you should blame yourself for the loss if you rushed to buy the stock after the stock price rose abnormally, e.g., rising by the maximum rate in five consecutive days. FS13, a state-owned enterprise employee, said if you take it as a bet, sometimes you should not blame the government for all your losses. FS16, a state-owned enterprise employee, said we need self-control and should not let betting get out of control. As indicated by the statements above, male interviewees seemed to show a risk-taking mind, while female interviewees mentioned luck and emphasized self-control.

Views about financial reporting fraud and other corporate irregularities.

Interviewees had differing opinions about the impact of corporate misconduct on the choice of stocks. Two respondents (5%) said that if a company was involved in fraud, they would not buy its stock since it was unreliable. Nine respondents (22.5%) said that it

slightly affect their choice of stocks. MS4 argued that exposure of corporate misconduct showed that the company's internal corporate governance was not good, and it somewhat affected his choice of stocks. MH5 said that whether he cared about the violations depended on whether the irregularities will materially impact on the company. The remaining 29 interviewees (72.5%) said corporate misconduct little affected their choice of stocks. FS2 believed that almost every Chinese listed company conducted fraud; even if you caught a batch of offenders, other offenders would take their place. She even said that without making false statements, the company's stock price could not rise sharply. FH6 said that if she got inside information that the stock price of the company would rise, she would not care about the negative information on the company. Even if the company was involved in a scandal, its stock price would rise if some manipulators boosted it. FH1 said the publicized misconduct of the listed company executives might affect the stock price a little bit, but the corporate scandals would not affect her choice of stocks. MH18, a state-owned enterprise employee, stated that he did not care about the misconduct of listed company executives that were announced by regulatory departments since the outcome is definitely settled when the information was publicized; but it might affect the related stocks. As the interviews showed, the majority of interviewees did not care much about the publicized corporate misconduct since the official announcements of the misconduct were delayed, movements of stock prices were not closely linked to corporate governance, and corporate misconduct was prevalent. These factors would result in fewer stigmas attached to corporate misconduct.

As for the corporate executives involved in scandals, 37 respondents (92.5%) thought they were criminals, it was a tip of the iceberg, and those caught were just

unlucky. MS12 said the corporate executives involved in scandals were definitely criminals because they robbed their investors' money. FS13 thought they were liars and crooks, although they were regarded as successful big shots. MS18 said, the Chinese stock market is still in an age of barbarism; jungle rules apply, and the winner takes all. As MS5 stated, the law could not deal with the tigers (big shots), but just punished some flies (small potatoes). FS15, a small business owner, stated that rampant corporate scandals are unavoidable in this age of rule of man, thus those caught were just unlucky. All of these 37 interviewees said the penalties imposed on the offenders were too light. MH9 said that since the cost for crime is too small, the expected profit is so high, the legal system is so bad, and the moral standards do not work, anybody in their place would violate the law to earn a profit. There were three interviewees (7.5%) who said some corporate executives might not be criminals. FH6 said corporate executives are ambitious entrepreneurs; in all industries, the executives would make more or less fraudulent schemes; otherwise they would not win exorbitant profit. FH17 said she did not think the offenders are criminals, but she knew that they caused more damage to victims than common crimes, e.g., theft and so on. MH20 made a joke that if he were smart enough, he would have gone to Wall Street to loot profits from investors all over the world.

Views about inside information and insider trading. Among the interviewees, 38 persons (95%) said that in the past, people liked to search for inside information, but now they have become cautious about so-called inside information because of many lessons from past experience. MS18 said that inside information must be confined within a very small circle; when it has spread to your ears, the information might be changed to differ from what it really was. MS17 said manipulators let some people spread false

information in order to affect the stock prices. FH7 said that too much information was spread and caused distraction. MS20 said if you now try to tell “inside information” to someone, he/she would laugh at you and would not believe it. FH1 said that most retail stockholders could not get real inside information, and even getting real inside information would not guarantee you would profit because the plan included in the inside information might not be successfully implemented, or the decision makers changed their mind, or other factors delayed the plan. MH3 said even if you knew the inside information, when to buy or sell is the critical issue to determine whether you would win a profit or how much you would earn.

All the interviewees said that insider trading is common in the stock market. Only two interviewees (5%) said that they usually heard inside information from their friends and took their suggestions to choose stocks and decide when to buy or sell the stocks. FH6 said her friend was so successful in stock investments that he has bought many apartments and stores with the money earned from stock investments. As she said, her friend was close to officials in important departments, such as the National Development and Reform Commission, State-Owned Asset Supervision and Administration Commission, and so on, who knew relevant policies before they were publicized and mastered important inside information of listed companies.

Thirty-eight interviewees (95%) said insider trading is certainly an irregularity or a crime, since it violates the principles of equality, openness, and fairness. As MS1 said, insider trading is definitely a crime employing information asymmetry. All of these 38 interviewees said that it’s necessary to fight against insider trading, but it’s a challenge. FH13 said the channels for spreading insider trading are very wide and secret, thus it is

difficult to catch offenders. FH1 said that there were efforts against securities fraud, e.g., rat trading, but it was useless. MH18 said that he thought insider trading and other securities fraud could not be avoided, just like day and night, or brightness and darkness. MH12 said insider trading is a common crime, it's unavoidable. Even the US stock market saw insider trading, but the US applied strict laws and severe monetary sanctions against offenders. In China, offenders are fined only a small amount of money, but increasing the severity of criminal penalties and the amount of fines would reduce insider trading. Two interviewees (5%) did not think insider trading was a crime. FH6 said that insider trading is a common practice, and it is not a kind of crime. FH17 argued that insider trading is not a crime since knowing inside information did not mean that you would be sure to earn a profit in every transaction. Interestingly, these two interviewees are females in Haikou. This somehow indicated their ignorance of the laws regarding insider trading.

Views about market manipulation. All the interviewees said manipulation is common in the Chinese stock market. The vast majority, 33 interviewees (82.5%) said manipulators were criminals. According to MS12, the manipulators used negative information to suppress the stock price and then bought shares at low prices. They then boosted the prices through matched orders or buying and selling shares among the accounts actually controlled by them, and finally trapped the stockholders who bought shares at high prices. FH13 said although the market manipulators are criminals, almost everyone wanted to be this kind of criminal, or hoped to follow the manipulators to suddenly earn huge profits. MH12 said that the activities of market manipulation have been reduced after 2000 due to strict regulation. MH14 said the regulation of

manipulation has improved since the government needed to give hope to public investors. There were 7 interviewees (17.5%) who said it is not easy to define market manipulation as a criminal action. MS14 argued that he could tolerate market manipulation and speculation since the manipulators also bear risks, but could not tolerate financial reporting fraud. FH7 said she felt it might be a criminal activity, but manipulation made the stock market more provocative and exciting. MS15 said speculation is necessary for the market, but excessive speculation and manipulation could expel the retail stockholders from the market if they never earned any profit.

Views about illegal consultation. For the cases of stock sages (manipulation or illegal provision of consultation), all the interviewees had seen online mock stock trading models, advertisements about software for stock investment and training classes, and other information from so-called stock sages on the internet and cell phone. FH11 said that she never believed the so-called stock sages and even most comments of official securities firms were nonsense; the common investors' speculative craze bred the emergence of the stock sages. FH15 said one of her colleagues was totally a gambler and even asked her to chip in for software from some stock sages. MS3 argued that the Chinese stock market is not a real market, thus China has no real stock sages like Warren Buffet in the US. MS4 said the so-called stock sages knew many loopholes in laws and policies and took advantage of them. MS5 thought the so-called stock sages exploited an advantage of information asymmetry. MH2 said these so-called stock sages, at first had some skills and influence among the public, then some interest groups asked them to help affect the market and reached some agreements to share profit, so they became "black mouths" on behalf of the interest groups. MS8 said the so-called stock sages often spread

faked information for a long time before they were caught, suggesting that maybe the channels for reporting to the regulatory department were not efficient. MH17 said that the regulatory department should adopt new measures to handle new offender tactics. MH18 said that maybe the so-called stock sages at first wanted to do something right, but they could not achieve their goal and their activities went bad.

Public retail stockholders are a disadvantaged group. All the interviewees agreed that the public retail stockholders were a disadvantaged group. As MS14 said, the stock market was initiated to serve state-owned enterprises, and thus the government did not pay enough attention to public investors. MS15 described the market as always working to collect money from public investors. Just like sheep shearing; after the sheep's wool grew longer, the sheep was shorn again. MS4 said the government invited investors into the stock market on a bet, and then they must bear the risk of failure for the bet. MH18 felt angry that Sinopec, the largest state-owned enterprise, trapped a generation of investors; public retail stockholders suffered huge losses from buying shares of Sinopec. As the media exposed, Sinopec spent over ten million yuan on a ceiling lamp for their office.

Majority shareholders and corporate executives often looted profit at the expense of public investors. MS14 said that he felt cheated that he bought stocks that rose in price sharply at the beginning of listing while the majority shareholders and corporate executives transferred their original shares and gained a huge volume of cash. The corporate performance worsened in a year, the stock price dropped sharply, and he was trapped for a long time. MH5 described that he bought a stock and then heard in the news that the corporate executives sold huge volumes of their original shares. Ridiculously,

when journalists asked a corporate executive of the company “why you sold out your original shares while showing optimistic about the prospectus of the company,” he answered that he would like to give investors a chance to gain a profit. FS6 said that the stock market should be set to optimize the allocation of resources, but public investors were often cheated by bad companies.

MS12 said although the Chinese stock market is not fair to retail stockholders, it is the only suitable way for him to do some investments. FH11 said that you should be cautious about your investment and protect yourself, since no measure could strengthen the protection of investors. Among the interviewees, 23 persons (58%) said that in general, the protection of investors improved gradually. MS12 said the regulation improved after regulatory departments adopted zero-tolerance policies toward securities crime. As MH10 said, a policy made in 2012 that investors could choose a securities company to open a stock account and could change the securities firm freely any time was the most helpful measure to protect stockholders from misappropriation by securities firms. Before the policy, a stock investor was tied to a securities firm, and misappropriation of investors’ funds was very common. MH10 said he also helped his friends invest in stocks. He said young people did not feel high risks of securities fraud right now, but those who had experienced securities fraud still felt uneasy about investor protection.

Opinions about the regulation of the stock market. Among the interviewees, 37 persons (92.5%) said the penalties were not light, the remaining 3 persons (7.5%) said they did not know whether the penalties were too light. MH5 said public stockholders were not tolerant of the securities crimes any more. In the past, they were unaware of the

serious securities fraud. FH8 said she was not clear about the Criminal Law about securities fraud, but she saw some news about criminal cases and thought the penalties were too light compared to the huge profit obtained from the crimes. MH12 said although the Criminal Law sets relevant provisions, it should provide more severe monetary sanctions. He also made a joke that if he could earn 100 million yuan, he would be willing to stay in prison for several years, and even in prison he would live a good life by bribing prison officials. FH13 said it's hard to say what kind of law would be appropriate to regulate the market; there is no way but to increase severity of the penalties. MH18 stated that the Chinese legal system has no class action and effective recovery mechanisms, and the light penalties and the lack of a sound credit system made the market regulation ineffective; even if the offenders were caught, they could change their identities and engage in other fraud again.

In the interviews, 35 respondents (87.5%) said it's a challenge to enforce laws to fight against securities crimes. FS13 thought the current political system and administrative institutions bred serious securities fraud and crimes. MS17 said the exposures of some scandals were just the outcomes of political power struggles. MS11 said it is easier to make laws, but it is much more difficult to enforce the laws and realize judicial justice. MH12 opined that sometimes the fights against the offenders became a mere formality. MS12 said under the current political system, the CSRC is weak and could not exert effective regulation. MS17 said, as the rank of the CSRC is low, it could not enforce laws against offenders who were higher-level officials or those with strong political connections. MS13 said the regulation of the stock market depends on the broader legal environment; without the rule of law, it is hard to implement the laws.

The credibility of regulation by the CSRC was doubted. MS14 said that letting the CSRC regulate the stock market was just like letting the weasel guard the henhouse. As FS2 described, in the early 1990s, some of her friends opened bogus companies, faked financial reports, and bribed the government and the CSRC. Finally, their companies were listed on the stock market and they raised huge amount of funds. Since she saw the facts, she was not confident about the regulation of the Chinese stock market. MH18 argued that most listed companies must have bribed the CSRC officials to gain approval to be listed. Since it's a hidden rule, even those companies that were actually qualified for listing and did not engage in financial reporting fraud must have sent money to the relevant officials. Without bribery, you could not have been approved to be listed on the stock market. As MS20 mentioned, his friend got internal shares of some listed companies because his brother was an official of the CSRC. He then sold out the shares at high prices on the stock market. MS4, a government employee, argued that securities crimes are just surface phenomena, while in fact it is a consequence of the growth of crony capitalism in China. Since Wu Jinglian²⁵ in his TV interviews and articles warned of the forming of crony capitalism in China, the term “crony capitalism” has been popular in China²⁶.

Thirty-one respondents (77.5%) said that although there were many problems in the regulation of the stock market, it has improved. MH11 said that in general, the stock market set a threshold to maintain relative fairness in scope and increased the transparency of listed companies. It is not appropriate to close the current stock market

²⁵ Wu Jinglian is a well-known economist in China. His famous “casino theory” greatly influenced the Chinese stock market. He was voted People of the Year 2001 and was called the conscience of the economic circle in China.

²⁶ The term “crony capitalism” has been often seen in messages posted online showing anger about securities fraud and unfairness to public retail stockholders.

and then reopen a new one, but it should be reformed. As MH5 said, at least now the frauds are not obvious like those before, and the false financial documents seemed like real ones and would cause confusion. As MH4 stated, we should view the situation of regulation dialectically; this is a trap, but also a chance, since the legal system will develop through crises. MS11 stated that he thought advanced countries have much better legal systems; although some serious fraud occurred in the advanced stock markets, the advanced countries have mechanisms for self-rectification. MH10 said that he was not familiar with the US history of stock market regulation, but he thought it developed through scandals and crises, and then formed relatively sound mechanisms for self-rectification. MH4 said that China should learn from democratic countries, and he believed that China would follow the way of rule of law, but this is a process and needs time; it depends on the ruling party's level of governing the country and the adjustment of interest allocation. MH10 was optimistic about the development of the stock market since President Xi Jinping has adopted tough policies and measures to attack corruption, improve public goods and wellness, and simplify administrative procedures. As he said, he just opened a small company and found that he did not have to deal with complex procedures.

Reflections on the Interviews

As the interviews showed, male interviewees seemed more likely to conduct analyses of the stocks than female interviewees, who tended to ask for their friends' advice. In the interviews, male interviewees talked more than female interviewees, liked to share their stories and analyze the institutions and practices of stock market regulation. Compared to male interviewees, female interviewees seemed more likely to express their

views briefly. In the interviews, the female interviewees in Haikou seemed more relaxed about frying stocks. The female interviewees in Shenzhen seemed to show stronger opinions about securities crimes than did the female interviewees in Haikou. The reason might be that those in Shenzhen were from other places in China and appeared more independent in life. They received more education as 50% of them had graduate degrees while the female interviewees in Haikou were native Hainanese and only had college degrees or below. But in general, most interviewees in the two cities showed similar comments about securities crimes and corporate misconduct. They all agreed that securities crimes and corporate misconduct were common and public retail stockholders were a disadvantaged group.

Gamblers vs. victims. The economic reform starting from the late 1970's released the passion for making a fortune that was restricted by the previous planned economic system. But due to the high requirements of time and money needed for general investments, common people with nine-to-five jobs could not afford to indulge in investments. The opening of the stock market in 1990 provided a more convenient way for common people to do business for themselves. As mentioned by an interviewee, the stock market facilitated the transformation of common people from political creatures that were inculcated with abstract doctrines or just watched the economic changes, to economic creatures that tried to enhance their wealth and became their own bosses through stock investments. In the very beginning, the stories of successful stock investors, e.g. Yang Millionaire, a household grass-root hero in the stock market, attracted common people to crowd into the stock market.

Unlike advanced stock markets that were usually natural results of economic development, the Chinese stock market was mainly a product of a government-led reform that aimed to serve state-owned enterprises. The government's excessive intervention led to a policy-oriented stock market and violated market principles. For example, to attract investors, the government made policies advantageous to state-owned enterprises, or even manipulated the market to raise the stock prices of the companies with poor performances. As the interviewees showed, since the stock market did not follow market principles, financial knowledge and analyses were often not helpful in choosing stocks and thus people were not interested in financial analyses of the corporate performance. The movement of stock prices did not reflect the corporate performance, which aggravated speculation and did not realize the market function of optimizing the resource distribution. Since the government's decisions often greatly affected market movements and administrative transparency and information symmetry were lacking, officials and their relatives would often exploit unpublicized policies or other inside information to gain profits from the stock market.

Driven by huge expected profits, companies packaged themselves by making false financial statements and bribed the CSRC officials to obtain approval for their listing. The ineffective supervision and regulation produced room for corruption and made financial reporting fraud rampant in the stock market. As the interviewees stated, they did not believe the listed companies' publicized financial statements about their corporate performance. Corporate scandals did not often affect the stock prices of companies involved. The company's stock price would rise if manipulators boosted it. Thus investors did not care much about the corporate scandals when they chose stocks.

All interviewees thought corporate fraud to be common in any industry, and those exposed were just unlucky to be caught. Thus, there is little stigma attached to offenders. In addition, light penalties and delay in law enforcement neither exert great deterrence to potential offenders nor urge the improvement of internal corporate governance and individual self-regulation. Since investors' choice of stocks were not closely related to corporate performance and governance of listed companies, their stock transactions were more like speculations than investments.

In the very beginning of the stock market, due to the information asymmetry and lack of transparency, it was widely spread that some earned profits by taking advantage of inside information, so stockholders were eager to search for inside information. Manipulators often exploited this obsession with inside information and let some persons spread disinformation to trap investors and rig the market. Due to lots of lessons, e.g., false inside information or the unsuccessful implementation of expected plans, investors became cautious about so-called inside information that they heard. Although the phenomenon of spreading so-called inside information was curbed, a small circle close to policy makers or corporate insiders still often took advantage of real inside information to earn huge profits. Although insider trading did not ensure that they would make a profit, it violated the principles of equality, openness, and fairness, and hurt common investors' interests.

Manipulation was also common in the stock market. Manipulators used their advantages in capital, information, and other resources to rig the market. There emerged so-called stock sages who spread false information, sold investment software, received fees for training classes, or provided illegal consultations. The cases of stock sages often

involved large scale of investors and lasted a long time. Actually, behind these so-called stock sages were often the interest groups as manipulators. The loopholes in the laws, difficulties in detecting the offenders, light penalties, poor law enforcement due to local protectionisms, corruption, unreliable regulators, and so on, led to the low cost for crimes. The expected huge profit and the low cost for the crime lured potential offenders. As common retail stockholders were disadvantaged in terms of capital, information, and expertise, they were exposed to high risks of becoming victims of securities fraud and crimes.

In summary, the institutional defects aggravated speculation in stocks and lured manipulators and other securities offenders. The government's excessive intervention, corruption, and ineffective regulation, intertwined with rampant financial reporting fraud, insider trading, manipulation, and other securities misconduct, bred a twisted stock market in the transition period. Stockholders' passion for being rich in this abnormal market was fomented to the speculative craze that was exploited by the offenders.

State-owned interest vs. private interest/self-consciousness. In 2003, the Third Plenary Session of the 16th Central Committee of the CPC specifically put forward that the stockholding system is the main form to realize the public ownership system. In 2004, an Amendment to Article 13 of the Chinese Constitution included lawfully earned income from stock investments into the categories of lawful private property rights of citizens, which indicated progress in confirming private property rights and protecting the interest of stock investors in China. Before the official confirmation of the stockholding system, state-owned enterprises and collective enterprises were regarded as the primary units of the public ownership system. State-owned enterprises refer to those owned by the

people as a whole. But in the real operation, the abstract concept of “the whole people” leads to the absence of ownership or unclear ownership; government officials or corporate executives obtain actual control over state-owned enterprises in the absence of effective supervision. As a result, state-owned enterprises were often exposed to risks of tunneling by corporate insiders or executives, and the problem of erosion of state assets arose during the economic transition. The adoption of a stockholding system could give substantial ownership to state-owned enterprises by distributing equity to institutions and individuals. To check the majority shareholders or corporate executives from taking advantage of their power to tunnel the companies and hurt the interest of the minority shareholders, corporate governance mechanisms were designed to solve the agency problem resulting from the separation of ownership and management, to supervise majority shareholders or corporate executives, and to protect minority shareholders and investors (Lang, 2010). Furthermore, listing state-owned enterprises on the stock market could further the transparency of corporate operation and governance, and enhance external regulation and public supervision.

Although the institutional defects of the Chinese stock market curbed the fulfillment of the strengths of the stockholding system and the stock market mentioned above, the operation and development of the stock market was of particular significance to China in the transition. It has fostered the cultivation of individuals with self-awareness, right consciousness and independent critical spirits. As the interviewees expressed, they felt more autonomy and freedom after they entered the stock market. Their experience in stock investments actually increased their participation in the economic and political sphere. It is noted that although the amount of funds raised was

small compared to that in banks or bond markets, the stock market invited the rapid growth of economists and financial experts, raised public comments on economic policies, and increased dialogues between the common people and the government. The sense of participation also promoted their rights consciousness and social responsibilities, especially when confronting securities fraud and government corruption.

In the past, under a planned economy, common people were imbued with the notion of the paramount importance of state interest and collectivism, thus self-consciousness and individual rights were suppressed. But this raised the problem that the ruling class would loot the common people in the name of state or collective interest, and without the transparency of administrative management and given the lack of information flow, people could hardly know they were being exploited. But now, common people cared more about their individual interest in daily life rather than the “vague” state interest. The stockholders’ online comments especially showed the concrete cases of this transformation. For example, in contrast to the advanced stock markets that usually reflected the real economy, the Chinese stock market performed poorly while the Chinese economy has grown very fast, and thus the majority of retail stockholders suffered losses. Although the Chinese stock market could not reflect its real economy due to multiple factors, stockholders complained that they did not share the economic achievements, and the blind seeking of GDP caused many negative effects, and so on. Some of the largest state-owned enterprises entered into the world’s top 500 enterprises through being listed on the stock market. The official media sang high praise for it as a demonstration of the Chinese economic development. But some stockholders criticized that those largest state-owned enterprises actually performed badly, and just took advantage of the resource

monopoly provided by the government and looted huge profits from the common people²⁷. Sinopec (China Petroleum & Chemical) became a target of public outcry. Some stockholders criticized that Sinopec allowed foreign investors to earn huge profits from its listing on the foreign stock market, but sacrificed the interest of domestic stockholders to give benefit to foreign investors and trapped a generation of Chinese stockholders in the domestic stock market.

Furthermore, the stock market increased the transparency of corporate operations and regulation of listed state-owned enterprises. Namely, state-owned enterprises represent the interest of all the people in the country. But the majority of investors often suffered losses from buying stocks of the state-owned enterprises while these companies collected huge sums from investors. In addition, the frequent exposure of scandals discredited the traditional notion or the government statement that state-owned enterprises were more reliable than private enterprises. Possessing privileges, monopoly, massive resources, and an intertwined relationship with the government, listed state-owned enterprises actually would impose more difficulties on external regulation and cause more risks to investors than private enterprises would. The revelation of scandals told common stockholders that the stock market was plagued with power-money trading and bred crony capitalism. Without effective regulation, no matter whether they are state-owned enterprises or private enterprises, listed companies would be used as tools for the economically and politically powerful to loot stockholders. The scandals caused trust crises among stockholders and urged the government to strengthen the regulation of listed companies.

²⁷ See at online stock clubs, e.g., www.eastmoney.com, www.jrj.com and so on.

Casino culture vs. rules of the game. As the interviews indicated, the notion that the stock market is a casino is actually an expression of their view of life. The image of Chinese people is that they are diligent and cautious at work and are able to endure hardships, but at the same time they like gambling. Casinos in Las Vegas and Macau are often frequented by crowds of Chinese people. Interestingly, it is said that the word “casino” came from a dialect of Fujian (a province of China) -- “*kai shi lou*” that means “start”²⁸. The early oversea Fujianese liked to play games of betting after work, and they usually yelled “*kai shi lou*” to begin the games. It is not sure whether it is the real origin of the word “casino,” but the Chinese people’s passion in gambling became an interesting element of the Chinese culture. This casino culture was exaggerated by movies, especially a series of Hong Kong movies about the God of Gamblers. The characters in these movies were household names in China and even other Asian countries. In reality, except for those who indulged in betting and ruined their lives and families, or those who used government funds to bet in casinos, most people just went to casinos for entertainment. As a Chinese saying goes, “Occasional and small bets add aesthetics and spiritual pleasure.”

Apparently, this kind of Chinese casino culture or gamblers’ culture showed Chinese people’s obsession with luck or escapist fantasy. It also showed the stamps of traditional Confucianism and Taoism. The majority of common people are diligent and cautious in their vocations, work hard for their families, and try to play well in their social roles. This shows the positive side of the frame of mind that is cultivated by the long tradition of Confucianism. At the same time, they would like to escape from the

²⁸See at <http://collection.sina.com.cn/hwdt/20111129/113946955.shtml>

burdens in the secular world and seek an easy and free life style, which also reflects the influence of Taoism. In playing games of chance, they could relax and feel excited. The cultural traits are also shown by retail stockholders in their speculative activities in the stock market. Not only did the stock market help them release their passion for earning wealth, but it also provided a convenient platform for them to play other roles. Frying stocks became a part of life sometimes. As mentioned above, some interviewees felt they became their own bosses in stock investments, and some did stock transactions during a break at the office, or talked about stocks with friends like discussing fashions.

Chinese people love to say, “If you would like to make a bet, you should be willing to accept the failure when you lose.” Some interviewees mentioned that saying in the interviews. But this does not mean that the majority of stockholders are indifferent to the losses or tolerant of those engaging in securities fraud. Even though they view the stock market as a casino, they bet for luck. It is the rule for gambling that every gambler is equal and has the same chance, and only luck determines the results. But as Wu Jinglian (2001) has criticized, the Chinese stock market is worse than a casino; it was a casino without rules since the manipulators and offenders could see the others’ playing cards before they engaged in fraud. This violates the principles of equality and fairness, even for gamblers in a casino. Stockholders were not indifferent to the securities fraud or tolerant towards the offenders. In the very early stage of the stock market, they just were unaware of the frauds that resulted in their losses. It was the government that attracted public investors into the stock market, and the excessive administrative intervention fostered speculation. In a sense, the government was an initiator of market manipulation, insider trading, and other securities irregularities that trapped the stockholders. In

addition, serious power-money trading and corruption in stock issuance and listing aggravated the twisted market and hurt the interest of stockholders.

Conclusion

Institutional defects aggravated speculation in the stock market and invited potential offenders. The exposure of a series of scandals led to an erosion of public trust in the government, aroused public doubt about the pattern of paternalistic governance, and raised the public call for stronger protection of common retail stockholders. This was shown in the statements of most interviewees that securities frauds were common and public retail stockholders were a disadvantaged group, and they suggested that more severe penalties should be adopted to punish offenders and increase the cost for crime. As the former president of the CSRC, Guo Shuqing publicly claimed in 2012, the stock market should be reformed to regain the confidence of investors since they were not fools like before (Liao, 2013). Although sometimes the speculative craze of stockholders exerted negative influence on the stock market, it is not convincing to conclude that irrational retail stockholders were the root cause for the abnormal stock market, since it was the institutional defects of the market regulation that invited and aggravated speculation and manipulation. And it is not useful to wait for public retail stockholders to become mature or rational enough to press for reform. That might be used as a pretext to postpone further reform.

Although the Chinese stock market was still far from a mature market and was criticized as the channel for interest transferring through power-money trading and securities irregularities, it set a legal framework for adoption of relevant mechanisms to

enhance the transparency of activities of market participants and strengthen external regulation. More importantly, it invited a huge group of stockizens to join a game with the government in a market-oriented framework. Stockizens consisted of the majority of the middle class in China, which would be an important force to foster the country's economic and political development. Through their experiences in stock investment and participation in fights against securities irregularities, stockholders enhanced their self awareness and rights consciousness. The fights against securities irregularities in the current stage of the Chinese stock market are actually about the interest distribution between the politically and economically powerful and common public stockholders, and would be of significance to foster further political reform for a more just and fair society.

CHAPTER VI

EXPLORATION OF INSTITUTIONAL DEFECTS OF REGULATION OF THE CHINESE STOCK MARKET AND PROPOSED REFORMS FOR REGULATORY MECHANISMS

Introduction

As an emerging market in the transition period, the Chinese stock market was initiated to raise funds for listed companies, and its investment function was ignored. Moreover, excessive administrative intervention violated market principles and increased speculation. Especially, the approval system for stock issuance and listing bred corruption and could not contain IPO fraud. In addition, the ineffective delisting system could not improve the quality of listed companies and impose sufficient punishment on the listed companies engaging in fraud. A series of cases of insider trading, rat trading, market manipulation, and other securities irregularities indicated that penalties provided by the relevant laws against securities irregularities were still too light to deter potential offenders.

In addition, legislations lagging behind emergence of problems, insufficient resources for implementation of the laws, and lack of supporting mechanisms (e.g., the absence of civil compensation mechanisms) discredited claims that investors were protected. The “revolving door” phenomenon (Mills, 1957) aggravated the weak external regulation of listed companies and securities intermediaries and exemplified the “capture theory” in the regulation of the stock market (Newman, 2005). These weaknesses in the laws and their enforcement allowed interest groups to “construct law in a manner that is

minimally disruptive to the status quo” (Edelman, 1992, p. 1535). This made relevant laws and regulatory programs symbolic rather than instrumental (Dwyer, 1990; Tushnet and Yackle, 1997; Edelman, 1992; Ryken and Jenness, 2008; Gusfield, 1967). The institutional defects and weak regulation of the stock market lured potential offenders.

To reshape the role of the government in the stock market and further reform market regulation, in 2014 the State Council confirmed that the registration system for stock issuance and listing would be adopted in the near future (Shanghai Securities Daily, 2014, June 11). But some scholars showed concern that the registration system would fail to improve the situation if the regulation did not have supporting mechanism (B. Xie, 2014a; S. Lu, 2013). This chapter proposes the introduction of such mechanisms, e.g., the whistleblower program and class action, to enhance public and internal supervision, increase the cost for crimes, and improve the legal environment for the regulation of the Chinese stock market.

The discussion in this chapter draws on many statements posted on weibos and blogs of known Chinese economists, law professors, securities experts, financial commentators, and lawyers. The regulation of the stock market is one of the hot topics for scholars and experts in this field, and their posts often receive wide attention. For example, Professor Fengqi Cao, one of the drafters of the Chinese Securities Law, had 7,669,642 fans and a huge number of visits to his Sina weibo²⁹. On their weibos and blogs, scholars and other experts shared information about what they experienced in making laws, regulation, law practices; posted opinions about the latest policies and reforms; and suggested further reforms, which provided abundant information and data

²⁹ See Fengqi Cao’s Sina Weibo at http://www.weibo.com/1594643405/B4EUFcUSI?type=comment#_rnd1430692012630

for the study of the development and regulation of the Chinese stock market. Some lawyers on their weibos called on investors who were victims of securities fraud to bring suits against the offenders. They were outspoken in their remarks on institutional defects of the stock market and severely attacked corruption and ineffective regulation. Professor Liu Jipeng (2013, June 11) said that he drafted the first report to suggest establishing the CSRC, and made great efforts to advise the CSRC on improving the market regulation. Now, however, he was disappointed with the CSRC and feels closer to netizens through weibo. Professor Baisan Xie (2014, November 24) posted on his weibo that he brought suits against the Ministry of Finance and then the CSRC for adopting some measures that hurt the interests of public investors. Through their weibos and blogs, scholars and experts have played active roles in educating people and fostering further reforms.

Institutional Defects of the Chinese Stock Market

It seemed that the Chinese stock market did not reflect the development of the Chinese real economy, and the majority of public retail stockholders did not benefit from the growth of listed companies. In the 1990's, the majority of companies in different economic sectors were not listed, thus the stock market did not reflect the real economy (S. Ba, 2014). After that, the structure of the Chinese stock market was a main cause. For the long time, the majority of listed companies had been state-owned enterprises, even reaching 55% of all the listed companies. By July 2013, the percentage had gone down to 45%, but the market capitalization of state-owned enterprises listed on the market still exceeded 80% of the total market capitalization (B. Xie, 2014c). The state-owned enterprises served the national economy and did not pay close attention to stock prices and dividends; private enterprises had low profits under intense competition and did not

seem to care about the interests of investors (S. Ba, 2014). Under pressure from more intense competition in China, financial reporting fraud and insider trading were more serious in China than in other countries (S. Ba, 2014).

In addition, listed companies and underwriters collaborated to determine high issuance prices that resulted in high price-earnings ratios and high volumes of excessive funds raised³⁰ (what has been called the “three high” phenomena) (F. Cao, 2014e). Furthermore, the stock’s price at its first day of being listed on the stock exchange (that means it entered into the secondary market for trading publicly) was much higher than its issuance price, with an increase of 100% on average during the last two decades. Potential huge profits from stock issuance and listings with almost zero risk drove companies and the insiders to make every effort, including financial reporting fraud or bribery, to get tickets so that they could be listed. Since public retail investors rarely were able to obtain stocks in the primary market³¹, the primary market was manipulated by institutional investors and big investors, and the public investors had to buy stocks at high prices and thus bear high risks. This formed the separation of the primary market and the secondary market³² in the Chinese stock market that participants in the primary market always earned profits and the investors in the secondary market mainly suffered losses (F. Cao, 2014e).

Securities Fraud and Irregularities in Recent Years

³⁰ Excessive funds raised refer to the part of funds that the listed company raised from stock issuance exceeded the amount planned for its investment projects.

³¹ The primary market refers to the market where the listed companies issue new stocks to raise funds before the stocks are listed on the stock exchanges. In the primary market, public retail investors have few chances to obtain new stocks.

³² The secondary market refers to the market where stocks were listed on the stock exchanges for public trading.

Without strict supervision and severe penalties, IPO fraud, insider trading, market manipulation, and other securities irregularities, intertwined with government corruption, plagued the stock market. The stock market became a platform for the politically and economically powerful to loot huge profits from the majority of public retail investors.

IPO fraud and misrepresentation. As Fengqi Cao (2014c) argued, the administrative examination and approval system for stock issuance and listing was the biggest obstacle to the development of the Chinese stock market. It resulted in approval of a listing becoming a precious resource sought by companies competitively. The demand for stocks exceeded the supply, which led to the deflection of stock prices from the real values. Moreover, the administrative examination and approval system created more room for corruption. Driven by huge expected profits, companies used every means, including false financial reports and bribery, to package themselves so they could obtain tickets to be listed on the stock market. Although IPO fraud and misrepresentation were rampant, the listed companies engaging in fraud seldom paid compensation to investors who were their victims. At the end of 2013, some regulations were promulgated, aiming to increase the cost for IPO fraud and deter potential offenders. For example, the Shenzhen Stock Exchange revised the Guidelines for the Content and Format of Stock Listing Announcements, providing that the listed company engaging in IPO fraud should buy back all their shares publicly traded on the stock market (Securities Times, 2013).

Another important factor accountable for serious IPO fraud was the ineffective delisting system that did not actually kick the offenders or low-quality companies off the stock market. Starting in 1993, the establishment of delisting mechanisms was placed on the table for discussion. In 2001, the CSRC and the stock exchanges made related

regulations on delisting. But by June 2014, only 78 companies had been delisted, only 3% of the total of more than 2500 listed companies in the Chinese stock market (T. Ye, 2014a). According to rules and common practices of the Chinese stock market, the delisted companies were placed in the Share Transfer System. They usually returned to being listed on the stock market after they improved their financial numbers through increasing profit, or being merged or restructured. Usually, the delisted companies were sought by other companies for back door listing. For example, the ST Xin Ye was suspended from being listed in 2013. It realized a net profit of 4.178 billion yuan through successful debt restructuring and then applied for resumption of listing. On 5 June 2014, Chang Hang Oil Carrier, listed for 17 years, was delisted from the stock market due to three consecutive years of losses from 2010 to 2013. It was the first central government-owned enterprise delisted from the Chinese A share market. This event seemed to show that the regulatory department resolved to improve the delisting mechanisms and gave a warning to investors. But one week before it was delisted, its stock price was boosted by more than 10%, which indicated that investors did not believe it would be removed from the market and thought that they might profit when the company returns to the stock market through restructuring (Sina.com, 2014a).

Actually, the delisting system has not been effectively applied to kick out the low-quality listed companies from the stock market. Tan Ye (2014a) suggests that the difficulty in effective implementation of the delisting system arises from the following reasons. First, many listed companies are central government-controlled enterprises or supported by local governments, thus, the CSRC faced great obstacles in removing them from the stock market. Second, investors would not support delisting. If a company were

delisted because of continued losses caused by financial fraud or tunneling by the controlling shareholder, without effective compensation mechanisms, public retail stockholders would bear great losses and have no chance to win it back through stock trading.

In October 2014, the CSRC issued the Opinions for Reforming and Strictly Enforcing the Delisting System, confirming that the listed company which conducted IPO fraud or serious misrepresentation will be delisted compulsorily (Xia, 2014). According to the Opinions, if the delisted company applies for renewal of listing, it should meet the standards equivalent to IPO standards. In the past, it was much easier for a company to be listed through buying or controlling an existing listed company or delisted company (back door listing). Thus, the delisted company or the listed company close to being delisted would be used as a shell for back door listing. As a result, the delisting system could not achieve the goal of removing a company with poor performance or irregularities from the stock market. As the standards for renewal of listing are equated with those for IPO, the cost for back door listing increases so that the delisted company will not be the precious resource sought by other companies for listing. It was hoped that this new policy would fix the loophole in the delisting system (Qiao, 2014).

Insider trading. From 2008 to 2013, the CSRC investigated a total of 785 cases of insider trading, making up 52% of the cases it investigated during this period; the CSRC sent the police 95 cases of insider trading, comprising 57% of the cases sent for criminal investigation (SZSE, 2014). In May 2013, the Cai Xin Website reported that the majority of the recent insider trading cases occurred on SME and Chinext (Caixin.com, 2013). It was found that lots of controlling shareholders and corporate executives

coincidentally sold their shares after the stock prices were raised or right before the corporate reports of losses were published. Information about corporate restructuring was often employed to conduct insider trading. Ye Tan mentioned on her weibo the news spread online that a known actress held shares of ST Hei Long for three years; after the stock resumed listing through corporate restructuring, she sold out all her shares and earned 27 million yuan (T. Ye, 2014b). This caused doubts about insider trading, but the regulatory department did not take any measures to investigate it.

Li Daxiao (2014a), an economist of a securities firm, posted a description of the “correlation” between restroom visits and the abnormal movements of stock prices on his weibo. When listed companies had meetings of board of directors discussing important issues, the regulatory departments, local governments, financial organizations, and other units would use excuses to send their staff to attend the meetings. After they knew the corporate inside information, they could not wait to the end of the meeting and rushed to restrooms. When they went to the restroom, abnormal movements of some stock prices occurred, presumably because they contacted their offices or related persons with this inside information or purchased/sold stocks themselves while out of sight in the restroom. This showed that insider trading was common practice and seemed not to be regarded as a securities irregularity or crime.

As mentioned, the criminal penalties against insider trading were too light to deter potential offenders and failed to accomplish the principles of justice and fairness. In addition to increasing the length of punishments to restrict the physical freedom of offenders, experts appealed for the application of severe monetary sanctions to offenders. As experts complained, currently monetary sanctions against insider trading seemed too

light to deter potential offenders. For example, corporate executives of Shen Zhou Tai Yue were fined only 480,000 yuan, equal to 10% of the transaction amount of insider trading. In contrast, in May 2013, the Hong Kong regulatory department imposed a fine of 24.675 million HK Dollars on Sun Min, who earned 55.1 million HK Dollars from insider trading with the transaction amount of 88.06 million HK Dollars (Caixin.com, 2013).

Rat trading. In the past two years, more than ten fund management firms were found to be involved in rat trading scandals (Cnstock.com, 2014). In 2014, the CSRC and judicial departments publicized that more than 15 fund managers were guilty of rat trading, and the cases involved amounts from more than 20 million yuan to more than one billion yuan. In actuality, many more firms and individuals involved in scandals have not yet been exposed. Although more and more cases of rat trading were exposed, no fund management firm was punished for rat trading. The fund management firms said those were personal actions of the individual offenders and thus excused the firms from punishment.

It was noted that those fund managers caught were regarded as members of the social elite, with high education and high income levels. But they still took advantage of their employment to violate laws and amassed huge profits in a short time from rat trading. For example, from 2009 to 2012, Su Jing used two million yuan to start transactions, and earned more than 36.5 million yuan. Su Jing was finally sentenced to imprisonment for two and a half years. Another example was Wei Libo. From 29 December 2007 to 28 December 2009, while Wei Libo was a fund manager, the loss of the funds he managed reached 27.15%, and the media called him the worst fund manager

that year. But he earned more than 2.7 million yuan for himself from rat trading in only six months. The recent rat trading case of Ma Le again received public attention. Ma Le traded more than 70 stocks in 26 months, accumulating more than 1 billion yuan from these transactions, and he made a profit of more than 18 million yuan. Ma Le was sentenced to imprisonment for three years, but was put on probation for five years. This led to criticisms that the criminal penalties were too light. Some investors expressed that the court's light penalty encouraged potential offenders to take risks. On 8 December 2014, the Supreme People's Procuratorate appealed against the court judgment of the Ma Le case. The Ma Le case might foster the publication of the judicial interpretation of the Supreme Court on insider trading and rat trading (Cnstock.com, 2014).

The seventh Revision to the Criminal Law effective in 2009 included rat trading in the categories of securities crimes. Since Han Gang became the first fund manager to receive a criminal penalty for rat trading, cases of rat trading were exposed and offenders received criminal penalties. But they received sentences of imprisonment of not more than four years. Although the regulatory department applied "big data" technology and bore fruit in detecting and discovering rat trading, the light penalty and the lack of effective regulation mechanism still led to the low cost for rat trading and did not deter the potential offenders.

Market manipulation. Compared to the market manipulators in the earlier stage of the stock market who often used numerous accounts to conduct matched orders to rig stock prices, market manipulators in recent years took advantage of their information superiority, e.g., spreading information through online clubs, weibo, and wechat to affect stock prices. The activities of market manipulation in recent years appeared more

dispersed and concealed (Xinhuanet.com, 2014). In addition, the government's excessive intervention into the stock market through bank policies, tax policies, and corporate mergers and restructuring also created room for insiders to rig the market.

The structure of stockholders on the Chinese stock market is also another important factor that invited frequent market manipulation. The majority of investors in the Chinese stock market are retail stockholders who are disadvantaged in capital, information, and expertise, thus they are often the victims of market manipulators. Manipulators tended to select stocks with small volumes of shares and with mainly retail investors, who are easy to be manipulated (Xinhuanet.com, 2014). Manipulators also liked to speculate on the stocks of companies engaging in mergers and restructuring. In recent years, some medium or small-cap stocks, especially those of companies with poor performances, were crazily rigged by market manipulators (T. Ye, 2014c). Market manipulation was often accompanied by insider trading. Stocks involving merger and restructuring became the main subjects of manipulation and insider trading.

The Weaknesses of the Current Regulation and Suggestions for Improvement

Legislations lagged behind. Legislative lag is the first factor accountable for the weak regulation of the stock market. Fengqi Cao (2014a), who was one of the main drafters of the Chinese Securities Law, described the process of making this law on his weibo. The Chinese Securities Law was the first law outside the Chinese Constitution that the Chinese National People's Congress (CNPC) organized experts to draft; drafting of other laws was usually organized by the State Council. The drafting group for the Chinese Securities Law mainly consisted of the personnel of NPC and scholars of Peking

University. They drew on securities laws and regulations of the US, UK, Japan, Korea, Hong Kong, and Taiwan for reference. They began to work on the draft in 1992 and expected to publish it in 1993. But due to resistance from different departments and disagreement by the CNPC Legislative Affair Commission, the drafting of the Chinese Securities Law became deadlocked. The draft was not put on the table for legislative discussion until 1998, when the securities market saw rampant irregularities and the related parties came to a rough agreement on the perspectives about the regulation of the securities market. Moreover, the Asian Financial Crisis sent a warning and pressed the government to make laws to regulate the Chinese securities market. Although there were 250 regulations and rules about the securities market before the enactment of the Chinese Securities Law, they were inconsistent and lacked authority. The Chinese Securities Law went into effect in 1999 and set a legal frame for the regulation of the Chinese securities market. But Fengqi Cao (2014a) stated that the draft which he had expected to be published in 1993 was even better than the version effective in 1999, and was closer to the 2005 version.

The making of criminal provisions about securities crimes also showed a lag of legislation in response to endemic corporate scandals and securities fraud. While the Chinese Criminal Law as revised in 1997 provides articles of securities crimes, the Provisions Regarding Standards for Prosecution of Cases of Economic Crimes including securities crimes was issued in 2001. But soon the 2001 Provisions could not meet the needs for rapid development of the economy and the emergence of new types of crimes. In 2003, the Supreme People's Procuratorate and the Ministry of Public Security began to revise the 2001 Provisions. It took five years to finish the Supplementary Provisions to

define specific standards for securities and futures crimes provided in the Criminal Law, and to connect the Criminal Law with the Company Law and the Securities Law.

Although rat trading was serious in the securities market, it was not included into the categories of securities crimes in the Criminal Law until 2009.

The Chinese Securities Law was only revised once, in 2005, after it went into effect in 1999. This could not catch up with the rapid development of the stock market. Take the US Securities Law as a contrast. The US Securities Law has been revised more than 40 times since it was enacted in 1933, which means that on average it was revised once every two years (F. Cao 2014a). In 2014, it was announced that the revisions of the Chinese Securities Law would be discussed by the NPC. The president of the CSRC publicly admitted that the revision of the Securities Law would encounter resistance from different departments competing for the assignment of regulatory power.

Insufficient resources for law implementation. Xiao Gang, president of the CSRC, admitted that the resources for regulation could not meet the needs for investor protection as securities irregularities increased rapidly in recent years. The number of securities irregularities cases increased by 14% on average from 2009 to 2012, increased by 21% in 2012, and increased by 40% in the first half year of 2013 (China.com, 2013). Among these cases, insider trading cases occupied more than half, and misrepresentation and IPO fraud increased greatly. In actuality, a great number of securities irregularities were not revealed. The increase might not mean that the number of securities irregularities were more than in the past, as they could instead reflect the increased exposure of irregularities. But the resources, e.g., personnel, capital, and technology of the regulatory departments were still insufficient for investigation and law enforcement.

Xiao Gang (China.com, 2013) admitted that currently there were more than 1,200 laws, regulations, and rules for the capital market, among which there were more than 200 provisions about criminal, administrative, and civil responsibilities; but more than two thirds of the provisions were not ever applied. As Xiao stated, the problem was that the law making and revising were not timely and specific; this largely accounted for the ineffective implementation of laws and regulations. In addition, incompatible enforcement systems, local protectionism, and other interruptive factors led to poor law enforcement. Xiao Gang publicly complained that some securities irregularities involved complex relations; e.g., the Party and government officials interrupted law enforcement by the CSRC and other regulatory departments. The ineffective enforcement of the law due to obstacles from administrative and political power made the law symbolic rather than instrumental (Dwyer, 1990).

Difficulties in evidence collection and determination. As Liao (2013) stated, the regulation of the stock market became stricter, but the market manipulation and insider trading continued to grow. One of the important reasons is the difficulty in evidence collection and determination. In addition, even when evidence of market manipulation was found, it was hard for the investors to be compensated. And if the investors brought civil actions for compensation, the court seldom supported the investors since the law's provisions were not clear and the investors could not readily demonstrate the causal relationship between the securities irregularities and their losses. To solve this difficulty, many advanced countries adopted processes for administrative conciliation, and some countries even had 80% to 90% of cases resolved by administrative conciliation (Liao, 2013).

On 19 December 2014, the CSRC issued the Implementation of the CSRC Administrative Conciliation Pilot Measures and requested public comments. Before this, for the case of Wan Fu Sheng Ke, the Ping An Securities Firm set a fund to compensate the investors, which was similar to administrative conciliation. The CSRC administrative conciliation means that during investigation by the CSRC of those suspected of violating related securities regulations and at their request, the CSRC and those being investigated reach a settlement to rectify the suspected irregularities and compensate investors damaged by the offences. Then the CSRC stops the investigation. This could help provide an efficient and low-cost way to compensate investors. But some experts expressed their concern that this would expand the administrative power of the CSRC and create room for corruption (Liao, 2013). The adoption of administrative conciliation also needs supporting mechanisms, and relevant laws and more specific judicial interpretations should be made. Ma (2014) suggests the introduction of the public hearing system into the administrative conciliation processes to increase the transparency of administrative conciliation processes.

Administrative Measures have been Dominant in the Regulation. The Chinese legal tradition and practices preferred criminal and administrative penalties to civil compensations. But this model could not meet the needs of economic development and social transformation in China. Criminal and administrative penalties alone are not sufficient for curbing violations that let offenders make huge profits while economically damaging victims. Without effective civil compensation mechanisms to make offenders pay victims of securities violations, investors would bear higher risks and the cost for crimes would be too low. In this era of “money first,” the low cost for crime and high

expected profit drive potential offenders to risk committing crimes and violations. The combination of criminal and administrative penalties and civil compensation would be more effective to increase the cost for crimes and deter potential offenders.

It has been criticized that the criminal penalties are too light while administrative penalties have been dominant in regulating the stock market. The CSRC's measures toward the Everbright Securities Fat Finger Event also showed the dominance of administrative penalties in dealing with securities scandals (S. Lu, 2013d). Although the media praised the CSRC's sanctions against those responsible for Everbright Securities Fat Finger Event for setting a record in severity of administrative penalties, Suiqi Lu (2013d) showed his disagreement with the CSRC's measures on this scandal. Lu Suiqi criticized the CSRC for placing its administrative penalties above the judicial system since it did not send the case to criminal investigation. The CSRC determined that this scandal was just a technical error or a fat finger event, and thus evaded the crucial point and chose administrative penalties to deal with this case.

Administrative measures often lacked transparency. For example, Suiqi Lu (2013b) questioned where the huge amount of fines and confiscated money that were put into the Investor Protection Fund of the CSRC went, and whether they were used for compensating the victims of securities crimes and irregularities. The dominance of administrative penalties in stock market regulation tends to create more room for corruption and reduce judicial authority. In addition, the administrative regulation often lagged behind the needs of the market. The application of civil compensation mechanisms would invite investors to join the supervision over participants of the stock market. Although the 2005 Chinese Securities Law strengthened civil compensation and

penalties for violations, the number of articles on civil responsibilities is still less than that of criminal and administrative responsibilities. Moreover, the articles of civil responsibility are more like general principles and lack specific provisions. Thus it is hard to apply them in real cases (Ren, 2008). Furthermore, the forms of lawsuits allowed in securities civil compensation cases do not provide effective and efficient support for victims of securities fraud to realize their claims for compensation.

The problems of civil compensation mechanisms. Before September 2001, the court would not consider civil compensation actions against securities crimes and fraud. In 2001, the Yi An Science & Technology case and the Yin Guangxia case shocked the public and raised heated discussions on the establishment of securities civil compensation mechanisms. Upon the exposure of these scandals, even the CSRC encouraged the public retail stockholders to claim compensation through civil procedures. Subsequently, 365 retail stockholders of Yi An Science & Technology brought actions claiming compensation of 24.6 million yuan, and several hundred investors brought suits against Yin Guangxia Company. But on 21 September 2001, the Supreme Court issued a notice stating that securities civil compensation cases would not be accepted temporarily. This notice raised criticisms from the academic community and the CSRC. On 15 January 2002, the Chinese Supreme Court issued the Notice Regarding Issues on Acceptance of Civil Compensation Cases Caused by Misrepresentation in Securities Markets. On 9 January 2003, the Supreme Court published the Provisions Regarding the Trial of Civil Compensation Cases Caused by Misrepresentation in Securities Markets.

Although the Chinese Supreme Court took a step forward, the 2003 Provision only allows the acceptance of civil compensation cases caused by misrepresentation in

securities markets, excluding civil compensation cases caused by insider trading and market manipulation that occupy a large proportion of securities fraud cases. In addition, it provides that the prerequisite for acceptance of the cases is the CSRC's valid administrative penalties or the criminal judgments. This also shows the Court's preference for administrative penalties in regulation of the stock market. But this provision of a prerequisite led to a delay of compensation for investors as the offenders would transfer their assets to avoid enforcement. Moreover, the current Securities Law does not provide specific rules on how to compensate victims, and thus could not protect investors and ensure that they would be compensated for the damage caused by offenders (Ren, 2008). In the case of Yin Guangxia, the investors brought actions claiming compensation, and the court supported their claims, but Yin Guangxia said it was bankrupt and had no money to compensate the investors. In the end, the investors won the case, but did not receive compensation.

In addition, the 2003 Supreme Court's Provision only allows for individual or joint action (for not more than 10 individuals in a party). On the one hand, this caused high litigation costs for individual claimants and thus halted most victims of securities violations from claiming compensation through legal proceedings. For example, in the Hong Guang case, an investor sued for compensation of 300,000 yuan, but he could not afford the cost and did not insist on his claim. In the end, the investor reached a settlement with the company outside the court and was compensated 6,000 yuan. On the other hand, this increased the burden on the courts. For example, in the ZhongKe Venture case and the Lan Tian case, the number of victims reached 7.83 million to 7.92 million and they were living in different districts of the country (Ren, 2008). The court could not

handle such a huge volume of cases if all the victims brought individual or joint actions. The form of action is important to ensure that victims could claim for compensation through legal procedures. Many Chinese scholars appealed for the adoption of class action to solve the problems of securities civil compensation mechanisms and strengthen investor protection, but the class action system has not yet been adopted in China.

Poor corporate governance and internal regulation. Use of funds raised from the stock market is one of the sources of public criticism. The funds raised should be used for companies to conduct technological innovation, increase production scale, and enhance competitiveness, but it seemed that the funds were not always used for these purposes (B. Xie, 2014c). In addition, the excessive funds the companies raised from the stock market were often unaccounted for. While individual investors seldom saw returns on their investments, the majority shareholders and corporate executives often became billionaires. Without transparent financial management and strict supervision, funds raised from the stock market became a lure for potential offenders.

China Times exposed the huge entertainment expenses of central government-controlled listed companies, causing public discontent (Hao, 2013). It was revealed that the China Railway Construction spent 837 million yuan on entertainment in 2012, and China Life Insurance spent 1.4 billion yuan on entertainment. The total amount of entertainment expense of ten state-owned listed companies exceeded 2.9 billion yuan, and the total amount of entertainment expense of 1,720 listed companies was about 13.8 billion yuan (Hao, 2013). As the China Times revealed, it was only the tip of the iceberg. For example, in addition to its entertainment expense of 837 million yuan, China Railway Construction Corporation spent 808 million yuan on travel, 578 million yuan on office

expenses, and 2.24 billion yuan on “other” expenses. When the journalist asked a few central government-controlled companies what the entertainment expense covered, they did not reply. Compared to the extravagant manner of the central government-controlled listed companies, private listed companies spent much less on entertainment. For example, Long Yuan Construction Corporation, the brand leader of private construction enterprises, spent 17 million yuan on entertainment, about 0.12% of its business income (Hao, 2013). The huge expenses of central government-controlled companies and their unclear uses reflected the lax corporate internal regulation, which created room for tunneling and corruption by corporate insiders.

As scholars (Lang 2010; B. Xie, 2014c) point out, the concentrated ownership structure in Chinese listed companies had negative impacts on corporate governance and protection of minority investors. The majority of listed companies on SME and Chinext are family-controlled enterprises. They used the stock market to collect funds for themselves and ignored the interests of public retail investors. The problem of concentrated ownership also showed in state-owned listed companies in another way. Namely, the majority of shares of state-owned companies belonged to the country, but due to the lack of strict supervision, the state-owned companies were actually controlled by corporate executives and did not form effective mechanisms to regulate the abuse of corporate executive power. In recent years, a series of scandals of state-owned listed companies were exposed, which discredited the government’s original intention to improve corporate governance of state-owned enterprises through listing them on the stock market.

Another issue is that corporate personnel often placed the corporate interest above the interest of public investors. For example, Yang Jianbo, was punished for insider trading in the case of Everbright Securities Firm fat finger event. He sued the CSRC and argued that his activities did not constitute insider trading. He stated his sales of index futures contracts before the fat finger error was publicly announced merely followed the decision of Everbright Securities Firm, and the stock exchange and the Shanghai Securities Regulation Bureau knew of these transactions (P. Lu, 2014a). He claimed that his activities were just a natural reaction to reduce the losses of the corporation, and thus they were professional activities and did not violate the rules. His statements showed that he placed the corporate interests above the interests of public investors. This case reflected a dangerous way of thinking that gaining a profit for the company became the principal goal and an intrinsic value of corporate personnel (P. Lu, 2014a).

As Fengqi Cao (2014b) stated, the operation of the Chinese stock market deviated from the original design and produced interest groups. Majority shareholders and corporate executives often placed their own interests above corporate interest and grabbed huge profits at the expense of minority investors. In recent years, Chinext became a target of public criticism since it produced billionaires from corporate insiders and venture capital firms while the majority of investors suffered losses. Right after the company was listed, venture capital firms sold their equity and gained an extremely high investment return. Corporate executives and majority shareholders also transferred their shares at much higher prices compared to the original prices. Xiaolei Zuo (2013a) argued that Chinext should not be set as a channel for venture capital firms to withdraw their investments. Withdrawal of majority shareholders, corporate executives and venture

capital firms right after listing is not good for the growth of the companies. In addition, it fostered speculation on Chinext rather than investment. Since the majority shareholders and corporate executives became billionaires in a short time, they would care less about the long-term development and corporate governance of the company.

Weak external regulation over listed companies. Without effective external regulation, internal regulation could not be maintained, especially toward the majority shareholders and corporate executives, who actually control the company. But the role of the government in the stock market made it difficult to enforce external regulation. Although listed on the stock market, state-owned enterprises still applied the planning-style appointment and personnel system. Especially for the largest central government-controlled enterprises, corporate executives also had the status of high-ranking officials. In 2013, the president of China Ocean Shipping Company, one of the largest central government-controlled enterprises, argued that the huge losses of the company were due to the situation of the industry and had little to do with corporate management. He said that if the Party Central Committee and the State Council understood him, he would feel satisfied. His bureaucratic tone raised public discontent. Online comments complained he should apologize to public investors for causing their losses rather than requesting the understanding of the Party and the government (Xiao Zhao, 2013). But the institutional arrangement of state-owned listed companies determined that corporate executives were to be appointed by the Party and the government, so that they cared less about stockholders/investors. This imposed high risks on corporate governance and investor protection.

In addition, the intertwined connection of regulatory department officials and corporate executives affected market regulation. As the Investor Newspaper reported, by the end of 2009, 768 listed companies in the Chinese A share market employed former government officials or even current government officials as senior executives. Among these listed companies, more than 70% were state-owned enterprises (T. Ye, 2013). Corporate executives would employ their influence and connection to affect the external regulation. Pingbo Lu (2013a) suggested adoption of the withdrawal system for the regulatory department. For example, since almost all the previous and current presidents of the CSRC were selected from presidents of the biggest state-owned banks, they should withdraw from (i.e., recuse themselves from) the cases arising in the state-owned banks when they worked there.

As the stock market was initiated to help collect funds for state-owned enterprises and extended to serve the development of enterprises in general, the regulatory departments tend to lean toward listed companies. For example, in Zhao Xiao's (2014) weibo, a journalist revealed that the CSRC in an internal meeting with financial media asked the journalists not to discredit listed companies. In 2013, a journalist was arrested by the police for fabricating securities information. The journalist claimed his analyses were based on the information publicized by the listed company, and he and his relatives were not involved in trading the company's shares (Shuli Hu, 2013). In addition, Fengqi Cao (2013b) suggested applying market mechanisms to implement supervision over listed companies. He suggested an independent third party system should conduct risk assessments on corporate governance of listed companies, and investors could go on the assessments to make investment decisions.

The role of securities intermediaries. For the case of Wan Fu Sheng Ke, five famous Chinese legal scholars appealed to the CSRC that the sponsoring representatives and other employees of Ping An Securities Firm involved in the case of Wan Fu Sheng Ke had fulfilled their duties and the penalties placed on them were excessive, which would hurt the passion of professionals in the securities industry (Sina.com, 2013). Lu Suiqi and some scholars in their weibos complained that the legal scholars seemed unfamiliar with the dark side of the stock market, in which securities firms and listed companies often conspired to engage in securities fraud. These scholars argued that the CSRC's penalties against the sponsoring representatives were actually still too light (S. Lu, 2013c). Generally, tactics of IPO fraud included making false financial statements, exaggerating business prospects, covering up problems, conducting related party transactions, and concealing the actual controller of the company (S. Lu, 2013c). The intermediaries for IPO, such as securities firms, accounting firms, and law firms employed their expertise to help listed companies conduct fraud. S. Lu (2013b, May 22) on his weibo even argued that in addition to the listed company, the sponsor, the securities firm, and relevant departments of the CSRC, e.g., the IPO Review Committee, should be responsible for the Wan Fu Sheng Ke case. S. Lu (2013a, May 19th) thought that although the CSRC suspended some securities intermediaries from IPO business, if the regulatory environment did not improve, companies would change their securities intermediaries to other firms with closer relationships to the regulator and being more clever in conducting fraud.

The main reason for the lax regulation of securities intermediaries was the close relationship between the regulatory departments and securities intermediaries. For

example, Liu Jipeng (2014a) carped that the Investor Protection Fund founded by the CSRC had run for eight years but had not used any funds for investor protection. Instead, it became a large shareholder of the An Xin Securities Firm that took advantage of its privilege to conduct irregular practices. According to a report by Beijing Youth Daily, since 1998, more than 60 officials left the CSRC and took office in public funds management firms, among which more than 40 became senior executives of the firms and about 20 became general managers of fund management firms. In 2014, more than seven CSRC officials resigned. It was estimated that the plan of establishing the registration system for IPO would create a new wave of CSRC officials leaving (Beijing Youth Daily, 2014). The reason might be that the CSRC officials were attracted by high salaries provided by fund management firms, and the registration system would reduce the room for grey income. This created a “revolving door” in the regulation of the Chinese stock market (Mills, 1957). The former officials used their influence and connections to operate fund management firms and affect the regulation of the fund industry. This also evidenced the “capture theory” (Newman, 2005).

Rong Hong (2014), on his weibo, showed his disappointment about the role of securities firms in the Chinese stock market. As he stated, apparently the biggest problem of the Chinese stock market was abnormal pricing of stocks (high issuance prices and high price-earnings ratios), which resulted from the unequal status of stock buyer and seller. Securities firms, as intermediaries between seller and buyer, did not make efforts to solve this problem of abnormal pricing, but rather, aggravated the problem. They packaged the company to be listed and helped the stock seller set the IPO price, and investors in the secondary market bought the stock at the high price. This is a model for

how participants in the primary market grabbed huge profit from investors in the secondary market. The problem of abnormal pricing bred corruption and caused unfair treatment of public investors.

Rong Hong (2014) suggested reshaping the role of securities intermediaries to be active and responsible market participants. He opined that securities firms and fund management firms should be strong representatives for public investors in the secondary market and protect their interest. But in the past, securities firms and funds were state-owned agencies and lacked incentives and strengths to speak for investors. This situation is expected to change after a series of mechanisms are to be taken to reform the IPO and listing system. Invitation of qualified foreign institutional investors (QFII), RMB qualified foreign institutional investors (RQFII), private equity (PE), and Shanghai-Hong Kong Connect into the Chinese stock market have improved the role of securities intermediaries and strengthened the function of value discovery of the stock market. In 2014, upon resuming IPOs after one year's suspension, the CSRC adopted measures to suppress stock issuance prices, allot shares at market prices, and forcibly grant price differentials between primary and secondary markets to investors in the latter. Hong Rong suggested that securities firms should see the market trend in the future and adjust their way of thinking, enhance their competency, and realize their own value to meet the needs of development of the Chinese capital market.

The disadvantaged group of public retail stockholders. Currently in the Chinese stock market, the majority of stockholders are retail stockholders. On 27 December 2013, the General Office of the State Council published the Opinions Regarding Further Strengthening the Protection of Legal Interest of Medium and Small

Investors in the Capital Market, officially admitting that public retail stockholders were in a disadvantaged position in obtaining information and resisting risks, and protection of their interest was far from reaching the goal of equality and fairness³³. As the Opinions proposed, intermediary agencies should recommend appropriate financial products and provide appropriate services to investors. Listed companies should increase investment return and provide investors with a voting system to supervise majority shareholders and corporate controllers. The regulatory department should improve dispute resolution and compensation mechanisms for investors, strengthen regulation and increase severity of penalties, and at the same time educate investors on market risks.

As the CSRC suggested, it needs to introduce large institutional investors, e.g., insurance, pension, and housing funds, to change the current stockholder structure (Securities Daily, 2012). The large institutional investors would balance one another and create forces to check market manipulation and excessive speculation. But as scholars criticized, institutional investors in China currently also like to speculate just like irrational retail stockholders do (F. Cao, 2014e). The prerequisite for the development of institutional investors is to train financial experts with professional knowledge and rational analyses to run institutional investors. Education of ethics and disciplines should not be ignored in cultivating financial experts. In addition, as the interviews discussed in the prior chapter revealed, retail stockholders tend to ask for advice from experts, so the demand for financial consultants is great.

Discussions on the Adoption of the Registration System in the Near Future

³³See at http://www.360doc.com/content/14/0527/08/247661_381317849.shtml

As Fengqi Cao (2013a, September 14) summarizes, the new stock issuance and listing system in the Chinese stock market evolved from the quota management system (1993-1995), the index management system (1996-2000), the channel system (2001-2003), to the current sponsorship system (2004-present). In 2014, the State Council's New Nine Opinions confirmed that a registration system would be adopted in the near future. Baisan Xie (2014, April 30) discussed the registration system in the US and other countries. In 1933, the US Securities Act confirmed the adoption of the registration system for stock issuance and listing. Under the registration system, if a company meets the relevant standards and sufficiently discloses information required by the law, it will be allowed to issue and list stock; the regulatory departments exert general supervision over stock issuance and listing, for which material reviews of application documents in some important processes are still needed. The registration system takes different forms in different countries, but the common ground is that companies as applicants for IPO and listing should sufficiently disclose information required by the law, securities firms as intermediaries are responsible for the truthfulness and completeness of the information applicants submit, and the regulatory department takes charge of reviewing and checking the legal compliance of application documents. Sufficient information disclosure is the basis of the registration system. Based on the information companies disclose, investors evaluate the companies' values and risks and make decisions about their investments (Liu Jipeng, 2013b, December 2).

Some scholars and financial experts showed their support for the adoption of the registration system in China. Currently in China, the demand for stocks exceeds the supply, which causes the stock prices to deflect from their real values. The adoption of

the registration system would allow more companies to be listed on the stock market, and would lead to a better balance of demand and supply of stocks. Thus, stock prices would reflect the real values of listed companies (Daxiao Li, 2014b, November 29). As being listed on the stock market is not a rare resource, the cost for being listed will decline, and companies would have less reason to seek back door listings. Fengqi Cao (2014c) also argued that the registration system would contain excessive administrative intervention into stock issuance and listing and reduce the room for power-money trading. Thus, the registration system would curb the “three high” phenomena and make the stock market follow market principles. The critical point of the adoption of the registration system is to adjust the role and function of the regulatory departments. Thus, this transformation indicated a change from a government-directed system to a more market-oriented system for stock issuance and listing.

Not all experts agree that this change is for the best, however. Zuo Xiaolei (2013, March 10) argued that the registration system is just a form to govern stock issuance and listing. If the regulator had strictly enforced the law and fulfilled its obligations, the approval system could have been sufficient to curb the listing of low-quality companies and misrepresentation. Pingbo Lu (2014b, June 30) stated that it won’t be helpful for China to copy the US experiences blindly since the Chinese stock market is a primitive market just focusing on fundraising, while the US stock market is a mature market based on value discovery. Pingbo Lu (2014b, June 30) argued that it is more feasible to exert stricter supervision over the activities of companies in the process of stock issuance based on the current approval system. He thinks that high prices, high price-earnings ratios, and high excessive funds raised were due to lax control. He said the CSRC should control the

total amount of fundraising in IPOs of the whole stock market and control the amount of fundraising of individual stocks. Since the CSRC checks on the necessity and feasibility of financing for investment projects of companies, companies should raise funds through stock issuance according to the amount approved by the CSRC. The CSRC does not need to set IPO prices, but should supervise listed companies in order to avoid high excessive funds raised (P. Lu, 2013, September 13th). Pingbo Lu (2014b, May 20th) argued that the CSRC should conduct macro-control of the total amount of financing, which is not administrative intervention, but applying economic tools to set boundaries for financing through the stock market.

Suiqi Lu (2014, January 22) also warns of high expectations for the registration system. S. Lu argued that the registration system and the approval system are just the forms, rather than the essence, of the stock market regulation. The prerequisites for the effective operation of the registration system are a market with thorough competition, self-disciplinary securities firms and listed companies, the regulator's full enforcement of the laws, and strong protection of investors. But the Chinese stock market lacks these prerequisites for the registration system. Suiqi Lu states that if the nature of the Chinese stock market as a platform for fundraising does not change, the adoption of the registration system will be a cover-up for money collection. Jipeng Liu (2014b, November 20th) also argued that China lacks the basic conditions for the adoption of the registration system. Liu Jipeng took the US as an example. As he stated, the US has a strong litigation culture, close connections between administrative and criminal penalties, strict recovery mechanisms, and a high percentage of institutional investors, which lay a solid foundation for the successful operation of the registration system. Han Zhiguo

(2014, December 2nd) argued that the adoption of the registration system would be a desirable future trend for the Chinese stock market, but it is not appropriate to adopt this system right now. Due to the absence of a credit system and the lack of effective civil compensation mechanisms for investors (e.g., class action), the adoption of the registration system would cause more risks to public investors.

As summarized by Baisan Xie (2014a), the adoption of the registration system needs relevant supporting mechanisms and should adapt to the real conditions of the country. Xie Baisan asserts that the registration system sets a low threshold for stock issuance and listing, but there are supporting mechanisms for strong regulation. The relatively successful operation of the registration system in the US is based on supporting mechanisms centering on strong protection of investors. One such mechanism is the advanced litigation system and associated civil compensation, especially the class action system, providing strong protection for public medium and small investors. Another is the severe penalties against securities offenders including listed companies, intermediaries, and related parties. In addition, the majority of investors in the US stock market are institutional investors, more professional and rational than individual investors. Baisan Xie (2014a) argued that China has not yet established economic and legal requisites for the registration system, e.g., the Chinese stock market is still a closed market, state or institutional shares are not fully circulated, and the regulation of the market is still poor. One of the biggest problems is that penalties against securities fraud and crimes are still too light. If the registration system is adopted in the near future, without effective supporting mechanisms for the market regulation, it might cause more problems, e.g., companies and securities intermediaries conspire to fabricate application

documents for listing, listed companies with poor performances make false financial reports, and so on. Xie Baisan suggests adopting a mix of registration and approval systems in the transition to establishment of a registration system.

As Fengqi Cao (2013c) suggested, in the transition to the registration system, the functions of the CSRC and the stock exchanges should be transformed, and the review and regulation for stock issuance and listing should be separated. As Fengqi Cao describes, the stock exchanges currently are an extension of the CSRC, and their executives are appointed by the CSRC. Thus, they actually are not independent of the CSRC. For example, the current Chinese Securities Law provides that the CSRC is responsible for stock issuance while the stock exchanges are responsible for stock listing and trading, but in actuality, if the CSRC approves the stock issuance, the stock exchanges will approve the stock listing and trading. The CSRC and the stock exchanges did not form a relationship of checks and balances. To meet the need of the registration system, the stock exchanges should be transformed to be independent and self-disciplinary organizations. Liu Jipeng (2013b, December 2) expressed that the Stock Issuance Review Committee should be dismissed, and the CSRC should change the current status as one having power but without responsibility.

The president of the CSRC, Xiao Gang, confirmed that the CSRC should transform its function from paying more attention to ex-ante review and approval to focusing on post-hoc regulation (China.com, 2013). In the past, the CSRC made more efforts to review applications of stock issuance and listing, and were concerned less about the market regulation. To adopt the registration system, the stock exchanges will be assigned the power to review the material content of applications for stock issuances and

listing, and to establish listing and delisting mechanisms, while the CSRC will check the legal compliance of application documents. Fengqi Cao (2013b, November 30) emphasized that the CSRC should focus on supervising listed companies and securities intermediaries, protecting investors, fighting securities irregularities, and maintaining the market order. The critical point of the adoption of the registration system is to invite market-driven mechanisms to transform the role of the government in the stock market. To reduce the room for corruption by the collusion of the government and the economically powerful, scholars suggested introducing relevant mechanisms to invite public supervision and strengthen investor protection.

Whistleblower Program

In the wake of the 2008 Financial Crisis, US scholars raised heated discussions on fighting against securities fraud and irregularities that contributed to the collapse of the financial market. To strengthen the regulation of the financial market, in 2010, the US Congress published the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which added Section 21F “Securities Whistleblower Incentives and Protections” to the Securities Exchange Act of 1934 (US SEC, 2014). The whistleblower program provides monetary awards, anti-retaliation protection, and identity confidentiality protection for individuals who offer the SEC important information about securities violations that leads to successful actions against the violations and the resulting monetary sanctions of more than one million USD. For any action, the whistleblower (one or more individuals) aggregately could receive awards equal to 10% to 30% of the amount of the funds collected from monetary sanctions against the securities violations (US SEC, 2014).

The US SEC made a broader interpretation of whistleblowers to include those who report violations to the corporate authority internally and then to the SEC, which encourages corporate internal regulation and extends the scope of anti-retaliation and identity confidentiality protection. The US SEC established the Office of Whistleblower (OWB) to administer the whistleblower program. The whistleblower monetary awards are paid from the Investor Protection Fund established by the US Congress, which ensures that the funds collected from the monetary sanctions would be paid for the victims of securities violations. In 2014, the US SEC received 3,620 tips from whistleblowers in many other countries, including China. A whistleblower living outside the US received an award exceeding 30 million USD (US SEC, 2014).

Given the difficulties of evidence discovery and collection for securities violations, a whistleblower system should be established in China (Liu and Wang, 2014). Usually, only the corporate insiders, employees, or related parties could know important information about violations of securities laws. The high monetary incentives with anti-retaliation and confidentiality protection provided by the whistleblower program could drive them to report the violations, since the monetary awards they could get from the whistleblower program would be much higher than the expected profit they could obtain from securities violations. A whistleblower program could divide corporate insiders and make it more difficult to complete fraudulent schemes. As a result, a whistleblower program would increase the cost for crime and provide great deterrence to potential offenders.

Class Action

Many Chinese scholars appealed for the adoption of class action to build effective civil compensation mechanisms for investors damaged by securities irregularities and crimes. Class action³⁴ is a form of lawsuit in which one or a few persons or a small group representing a larger group sues against violations of the laws. Class action is often applied to cases consisting of numerous claimants with the same kind of cause, such as cases on labor disputes, environmental pollution, product quality, and securities fraud, involving compensation for victims damaged by violations of the laws. Class action was first seen in 1848 as a statutory law provision in the NY Field Code. In 1938, the US Federal Civil Procedures provided specific procedures and categories of class action. In 1966, the “opt-out” rule was adopted for class action, which provides that the plaintiff class includes victims of the violation being sued, except those who specifically confirm that they give up the suit (Ren 2008). The laws and related mechanisms caused the rise of class action in the US, especially suits against violations of the securities laws (Ren, 2008).

As a class action case often consists of small claims from a large number of individuals, the violation may cause massive losses across numerous victims, but the claims might be small for each individual victim. If an individual victim brings a suit, the litigation cost will be high compared to the claim. The high litigation cost often prevents an individual victim from bringing a suit to recover the loss caused by the violation. The US Federal Judicial Center studied class action cases in four federal district courts, finding that the members of the plaintiff class obtained compensations of 315 to 528 USD on average; if each of them brought an individual suit, the litigation cost would have

³⁴ See at https://www.law.cornell.edu/wex/class_action.

exceeded 10 times the compensation awarded (Willing, Hooper, and Niemic, 1996). The system of class action reduces the litigation cost for individual claimants and encourages victims to claim their rights through legal proceedings. In addition, it also decreases the judicial cost for handling the issues involving numerous claimants. This provides investors with economic and efficient mechanisms for civil compensation and strengthens the protection of their interests.

It was said that Chinese legislators used the US class action as the reference in developing Article 54 of the Chinese Civil Procedure Law (Jiang, 2008). As this article provides, “with respect to a case in which the subject matter of action is of the same category and one party consists of numerous persons or of an uncertain number upon initiation of the lawsuit...Claimants who have filed at the people’s court may select representatives from among themselves to engage in litigation...The act of litigation of such representatives shall be effective for the party they represent...The judgments or orders rendered by the people’s court shall be effective for all the claimants who have filed at the court...”³⁵. For securities civil compensation cases with numerous victims, the form of representative action should have been suitable. But the Chinese Supreme Court in its 2003 Notice Regarding Issues on the Acceptance of Civil Compensation Cases Caused by Misrepresentation in Securities Markets specifically forbids the application of representative action for these kinds of cases. To restrict lawyers from participating in actions for numerous claimants, in 2006, the Chinese judicial departments specifically forbade the application of contingent fees in securities civil compensation cases and other actions. The Chinese Supreme Court’s restriction of representative action arose out of

³⁵See at http://china.findlaw.cn/jingjifa/shewaifalv/swflfg/20110414/91492_5.html.

concern that mass activities would cause social unrest; in addition, the courts lacked experience to handle group litigations (Z. W. Chen, 2003).

According to the Chinese Supreme Court's Notice, claimants for securities civil compensation can bring individual or joint actions (for not more than 10 individuals in a party). This arrangement created high litigation costs for individual claimants, which is the main factor that halted most victims of securities violations from claiming compensation through legal proceedings. For example, in the Zhong Ke Venture case and the Lan Tian case, the number of victims reached 7.83 million to 7.92 million, and they were living in different districts of the country (Ren, 2008). The total amount of the losses caused by a violation was huge, but the loss of an individual investor was comparatively small. The high cost for litigation kept the victims from bringing suits to recover losses. In addition, the court could not handle such a huge volume of cases if all the victims brought individual or joint actions. Even if the courts accept and try the cases, different courts would make different judgments toward the same cause. The inconsistency in judgments would hurt the judicial authority and could not ensure a fair judgment to each victim (Ren, 2008). The adoption of class action can concentrate numerous claims to a court, and thus will save judiciary costs and enhance judicial efficiency.

While the class action system in the US strengthened the recovery mechanisms for victims and increased the cost for crimes, it also led to abusive litigations and caused a waste of social resources (Kreese and Rosenbaum, 2005; Ren, 2008). For example, the related laws provided rules advantageous to the plaintiff class, e.g., the plaintiff need not provide sufficient evidence before initiating a suit. Some took advantage of the class

action mechanisms to make troubles for companies (Kreese and Rosenbaum, 2005). In addition, driven by strong incentives, such as contingent fees, lawyers made great efforts to increase class actions against companies. In some cases, lawyers placed their benefits above the interest of plaintiffs and made the cases end in ways that would be the most beneficial for them (Phillips and Miller, 1996). To avoid the high cost and long process of litigations, the defendant had to reach a settlement with the plaintiff class even though they knew the claims lacked solid foundations. In response to the phenomena of abusive litigations, the US Congress enacted the Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998. The US Congress enacted the Class Action Fairness Act in 2005, which aims to adjust the imbalance between plaintiff and lawyer, reduce excessively high cost for the defendant, and pay more attention to due process in class actions (Kreese and Rosenbaum, 2005). These laws and measures reduced abusive litigations of class action in the US.

The potential negative effects of a class action system are not a concern in China currently. China has not yet reached a stage of strong civil rights for citizens, active lawyers, and independent judges, like those in the US. And Chinese scholars and legislators should learn from the US lessons to avoid potential negative effects of class action.

Conclusion

In summary, the Chinese stock market is an emerging market during the economic transitional period. It was initiated to raise funds to solve the capital shortage of state-owned enterprises. This character made it a market focusing more on fundraising

than investment. As a result, the Chinese stock market became a market for more speculation than investment, and a policy-oriented market rather than a market-driven market. The regulatory department did not pay enough attention to the interests of investors. With lax regulation, companies and securities collaborated to cause high stock issuance prices, high price-earnings ratio, and high excessive funds raised (“three high” phenomena), grabbing huge profits from the stock market and causing high risks to investors. Furthermore, without effective supervision, institutional defects created room for power-money trading and lured potential offenders. Consequently, the Chinese stock market was plagued with IPO fraud, insider trading, market manipulation, and other securities irregularities, intertwined with government corruption. The collusion of the politically and economically powerful made the Chinese stock market a channel for looting huge profits from the majority of public retail investors.

To curb rampant securities crimes and irregularities, a regulator should increase the cost for crimes through adoption of more severe penalties, combining criminal and administrative penalties and monetary sanctions, improving the delisting system, improving civil compensation mechanisms, shifting the burden of proof to defendants in civil compensation cases, strengthening external regulation over listed companies and intermediaries, and strengthening corporate governance. Institutional investors, consultation firms, and financial experts should be developed to help change the investor structure and foster rational investors. In the near future, a registration system will be adopted to curb the “three high” phenomena that resulted in serious securities fraud. Actually, the core of the establishment of the registration system is to transform the role of the government in the Chinese stock market. Supporting institutions should be

established to effectively run the registration system and strengthen market regulation and investor protections. The critical point for supporting mechanisms for investor protection is to increase the cost for crime, reduce the cost for regulation, and exert great deterrence to potential offenders.

The establishment of a whistleblower program is feasible and urgent in China. Economically, a whistleblower system could save the regulatory department the costs of detecting and investigating securities irregularities, help enforce monetary sanctions against securities offenders, curb ongoing securities fraud to avoid causing further losses to investors, and increase the resources for victim compensation. The adoption of class action will also have great significance in China. A class action system could unite public investors to form a force which could press the powerful offenders to pay high prices for their violations and strongly deter potential offenders. In addition, the application of class action will shape the legal culture and promote rights consciousness among the common people.

CHAPTER VII

CONCLUSIONS AND RECOMMENDATIONS: REBUILDING SOCIAL VALUES AND ADJUSTING THE RELATIONSHIP AMONG THE GOVERNMENT, MARKET, AND PUBLIC STOCKHOLDERS

Conclusions and Recommendations

As the 2014 State Council's New Nine Opinions proposed, a registration system would be adopted for stock issuance and listing, with the goal of further expanding the Chinese stock market; correspondingly the Securities Law and other laws would be revised, and supporting mechanisms would be established to achieve this goal. This arose from the need to develop the real economy. Currently, the Chinese economy faces pressure from local debts, potential housing bubbles, and excessive production capacity in the manufacturing industry, which forces the Chinese government to turn to the stock market for more capital to support the real economy (Xu and Liu, 2014). Actually, the Chinese stock market still has great room for expansion. Compared to bank deposits, only a small amount of funds entered the stock market. In China, bank deposits reached 116 trillion yuan, among which individual deposits were about 50 trillion yuan in 2013; but the stock market raised only 400 billion yuan, while the whole social financing was 17 trillion yuan (F. Cao, 2014b). However, rampant securities fraud and crimes ruined public confidence in the Chinese stock market. This necessitates further reform to correct the failure of Chinese stock market regulation and strengthen investor protection. Sustainable development of the Chinese stock market cannot be accomplished without protecting the interests of investors, especially large numbers of retail stockholders

Centering on the theme of stockholder protection, this study examines the social contexts and institutional factors that shaped the development of the Chinese stock market and the evolution of the market regulation during the last two decades. To explore the construction of regulatory mechanisms and the roles of the government and other players in the stock market, this study applies relevant socio-legal theories, especially “law and finance” theories, which were based on historical and comparative studies of financial market regulation across various countries. For stock market regulation, the critical task is to curb securities irregularities and crimes. In this study, white-collar criminological theories, especially crime-as-choice theory, are applied to interpret the causes of securities irregularities and other offences related to the Chinese stock market. Through historical review, policy analyses and case studies, this study examines the effects of relevant policies and laws on the regulation of the Chinese stock market in reality.

The role of the Chinese government in the stock market was a source of public criticism. Inviting investors into the stock market while not implementing effective regulation, the Chinese government became a provider of temptations. Also, the Chinese government was involved in some securities irregularities, e.g., insider trading in the 327 event and manipulation in the 5/19 market rise as discussed in Chapter 3. These kinds of government actions damaged its authority and blurred the boundaries between lawful activities and violations. The role of the government as both a referee and player in the stock market at the same time made external regulation ineffective and discredited its claim of investor protection. As discussed in Chapter 3 and 4, IPO fraud, misrepresentation, insider trading, manipulation, and other securities irregularities,

intertwined with government corruption, plagued the Chinese stock market. Due to their disadvantages in terms of capital, information, and expertise, public retail stockholders were exposed to high risks of becoming victims of securities irregularities and crimes. The Chinese stock market became a platform for the politically and economically powerful to loot huge profits from the majority of public retail investors.

A series of scandals led to calls for new legislations and other reforms. As discussed in Chapter 4, the Chinese State Council issued the Nine Opinions, adopting measures to refine regulatory mechanisms. Subsequently, the sponsorship system replaced the principal underwriter recommendation system for stock issuance and listing. But it turned out that the sponsorship system did not enhance the administrative transparency and better protect investors. Instead, sponsors often traded their power for money and colluded with companies to perpetrate fraud. The SME and ChiNext were established to form a diversified capital market in order to reduce speculation in the stock market. However, rampant securities fraud quickly plagued the relatively new markets, the SME and ChiNext. Recurring irregularities and crimes showed the weaknesses in laws and their implementations. The critical problem was that penalties provided by the laws against securities fraud and crimes were still too light. Meanwhile, poor enforcement of laws made the market regulation largely ineffective. As the cost for crime was low, expected high profits attracted potential offenders.

As summarized in Chapter 6, the Chinese stock market was initiated to collect funds for state-owned enterprises. This character led it to a market focusing more on fundraising than investment. Without changing this character, the Chinese market became a policy-oriented market flooded with speculation. Accordingly, investors, especially

public retail stockholders, were not provided with sufficient protection. Institutional defects created room for relevant government officials to trade power for money, and this lured potential offenders. In the near future, the registration system will be adopted to transform the role of government in the Chinese stock market. But we should not be blindly optimistic about the registration system as the Chinese stock market learned many lessons from reforms in the past as discussed in prior chapters. Supporting mechanisms should be established to realize the effective operation of the registration system. The critical point for supporting mechanisms is to increase the cost for crime and reduce potential profits from the crime, thus strengthening market regulation and investor protection.

Based on the exploration of causes for rampant securities offences in the Chinese stock market, this study recommends the regulatory departments adopt more severe penalties, combining criminal, administrative penalties and monetary sanctions against securities offenders. Effective civil litigation system (e.g., class action, civil compensation mechanisms, shifting the burden of proof to defendants in civil cases, and so on) should be established to make offenders pay high prices for their misconduct and ensure investors are compensated for their losses. To improve the quality of listed companies, the regulator should improve the delisting system and strengthen external regulation over listed companies and intermediaries. This study also recommends adoption of a whistleblower program to strengthen external and internal regulation and greatly deter potential offenders.

To reduce speculation in the stock market, more channels for investment should be established to spread investors to different markets. The interviews showed that

investors crowded into the stock market because they had no other or better options for investment. The government should allow financial institutions to make more financial products for investment and build a diversified capital market. In addition, the government should develop institutional investors, consultation firms, and financial experts to help change the investor structure and foster rational investors. At the same time, the government must make relevant laws and rules to regulate markets for new financial products and strengthen supervision over financial institutions. In recent years, shadow banks engendered high risks to the financial market. Shadow banks refer to the financial institutions that do some business like banks but are not included in the scope of regulation of banks and thus lack strict supervision.

As this study indicates, law and finance theories shed light on the development of the Chinese stock market and the evolution of market regulation. The themes of investor protection, comprehensive regulatory mechanisms, effective law enforcement, the crash-then-law pattern, and so on addressed in the law and finance literature provide inspirations for further political and legal reforms of the Chinese stock market. This study presents brief comparative analyses of broader regulatory patterns and the roles of governments and other actors in financial markets of China and other countries. Future comparative study of specific financial regulatory mechanisms of China and other countries will add valuable contributions to the field of socio-legal studies on financial market regulation.

This study also shows that white collar criminological theories, especially crime-as-choice theory, provide important perspectives for interpreting the causes of securities irregularities and crimes in China. Although Chinese contexts are different from those of

Western countries where white-collar criminological theories were developed, the Chinese stock market has seen and will confront problems that occurred in Western countries. The concepts of state and elite deviance and the government as supplier of lures are very helpful for exploring the role of the government and institutional defects that bred rampant securities crimes in China. China can learn from the experiences of other nations that have confronted the need to regulate stock markets and fight white-collar crime. Applying the theoretical framework, this study explores the causes of securities crimes and violations associated with the Chinese stock market within historical, social, and political contexts which were not systematically addressed in prior research on securities crimes in China. Future study on specific types of securities crimes or specific cases would help further understanding of relevant laws and their enforcements.

The theories reviewed in this study, e.g., Dorn's (2010) claim of a democratic approach to financial regulation, Coffee's (2001) historical discourse of shareholder democracy, and white-collar criminologists' emphases to contain elite deviance, pointed to the significance of common public in fostering political and legal reform. The Chinese stock market invited a vast number of stockizens into the market-oriented frame. This group of stockizens has potential to become an important force to foster reform for investor protection and market regulation. But prior research on rights consciousness or research on securities crimes in China did not pay enough attention to the views of the group of public retail stockholders. This study begins to address this limitation. Chapter 5 describes the interviews of public retail stockholders and analyzes their experiences in stock investment and views about stock market regulation. The interviews showed the

growth of rights consciousness among public retail stockholders. Future study on public retail stockholders in specific cases would help further understanding of how they would react to specific securities frauds causing damage to them.

Rebuilding Social Values and Adjusting the Relationship among the Government, Market, and Public stockholders

Recent noteworthy arrests of corrupt high-ranking officials exposed the collusion of the politically and economically powerful in looting public stockholders and indicated the growth of crony capitalism in China (China Funds Daily, 2014). As this study shows, the series of securities fraud and irregularities have roots in institutional factors and social contexts during the transitional period in contemporary China. In the current stage of the Chinese stock market, fights against securities irregularities are actually about the interest distribution between the political and economic elite and common stockholders. The political and social atmosphere that provides fertile ground for the growth of securities irregularities and crimes needs to change. As the political economy is in a transitional period, China's primary task is to build social values and standards to govern and adjust the relationship among the government, the market, and common people, as well as lay the ideological and cultural foundation for further political reform. Rediscovering Chinese classics and learning experiences from other countries would inspire the government to go beyond ideological contentions and adapt the implanted laws and mechanisms into the local environment, thus laying the social and institutional foundations for further political reform.

Capitalist spirits vs. socialist reform. The Chinese stock market has been plagued with insider trading, manipulation, and other securities irregularities, often involving the collusion of government officials and businessmen, which seems like repeating the early history of Western stock markets. In Western countries, the stock market was originally created by the government (the king and the Houses) to sell bonds that the government was not able to pay (Lang and Yang, 2012). But a series of scandals, e.g. the South Sea Bubble, the Mississippi Bubble, and so on revealed the collusion of the government (the king) and the businessmen, and led to the collapse of stock markets in Europe in the seventeenth century (Gray, Clark, and Frieder, 2005; Lang and Yang, 2012). After the South Sea Bubble, share-holding companies were forbidden for about 100 years in the United Kingdom; the relevant functions of banks in stock investments were not allowed by the French government for 150 years (Lang and Yang, 2012). In 1720, the United Kingdom enacted the Bubble Act to regulate the stock market (Harris, 1994). The 1929 US stock market crisis also saw scenes similar to the South Sea Bubble (Gray et al., 2005). Consequently, the US government passed the 1933 Securities Act and the 1934 Securities Exchange Act, applying strict laws to enforce information disclosure and fiduciary duty to strengthen the regulation of the stock market.

In their book *The Capitalist Spirits and the Socialist Reform*, Lang and Yang (2012, p. 76) used the history of stock market regulation in Western countries as one example to support their conclusion that “the history of all hitherto existing society is the history of class struggles to contain corruption by enhancing democracy and rule of law.” Lang and Yang (2012) contend that during the Chinese economic reform the disputes between the left (followers of Karl Marx) and the right (followers of Adam Smith) in fact

ignored the goals of these two thinkers. According to them, both Smith and Marx showed great compassion for workers and poor people and severely attacked corruption by the politically and economically powerful. In *The Wealth of Nations* published in 1776, Adam Smith (1934) views the market as an invisible hand to regulate activities of individuals in seeking their own interest and then benefit the whole society. This notion of an invisible hand is the basis for adoption of a liberal economy to limit the power of the government in the economic sphere and curb the collusion of the government and businessmen. In contrast, Marx tried to adopt another way, that is, abolishing private ownership, to curb the corruption and to seek a just and harmonious society. As Lang and Yang (2012) contend, both Smith and Marx had in common a goal of realizing a just and harmonious society.

Lang and Yang (2012) review that Europe went from oral commitments to the Magna Carta, the Reform Act, to the democratic system adopted for the political regime, and state power shifted from the hand of the king, nobility, bourgeoisie, to the common people; the high cost for violation under the rule of law ensured the implementation of democratic politics to curb corruption resulting from the collusion of the government and the economically powerful. In other words, the cost for violating the democratic politics would be proletarian revolution. Lang and Yang (2012) state that Marx's theory in *Capital*, published in 1867, greatly influenced the development of political and legal systems in Western countries. According to Lang and Yang (2012), the primitive capitalism in Marx's age had collapsed, as Western countries adopted a democratic political system to curb corruption of the government and bourgeoisie to preclude the outbreak of proletarian revolution. This interpretation showed their well-intentioned

efforts to advise the Chinese government to go beyond the ideological contentions and further political reform to develop democracy and the rule of law in China.

Lang and Yang (2012) emphasized the principles for further economic and political reform: allow some people to become rich while other people do not become poorer, apply strict laws to curb collusion of government and businessmen to prevent insider trading and ensure fundamental social equality, allow all people to have potential to become rich. This seemed a response to Deng Xiaoping's adage "allow a portion of the people to become rich first" brought forward when he initiated the economic reform. Deng Xiaoping's point was significant in providing incentives for people to create wealth and emancipating people from egalitarianism under a planned economy. However, "allow a portion of the people to become rich first" became the justification for some people to earn money by violating laws or taking advantage of loopholes in laws and policies. This also became the justification for those who grabbed huge profits from the stock market through securities irregularities at the expense of other stockholders. But the emergence of serious wealth disparity and inequality in today's China urges people to reflect on this point. Lang and Yang (2012) use the example of the current US stock market as a contrast to the Chinese stock market. In the US stock market, the majority of listed companies were not controlled by big families, as the common public holds the majority of their shares; strict laws are applied to regulate the stock market, and the US SEC has a huge power in law enforcement. The institutional arrangements made the US stock market realize the function of wealth redistribution for common people. But the Chinese stock market formed interest groups or even crony capitalism, where the majority of

stockholders bore the cost for financial reform but did not share the economic achievements. This violated the basic principles of equality, justice, and fairness.

Morality and the idea market. In *How China Became Capitalist*, Coase and Wang (2012) draw attention to the great work of Adam Smith, the *Theory of Moral Sentiment*, and note the importance of morality in the economic world. They emphasize that Adam Smith's classic works, *The Wealth of Nations* and *The Theory of Moral Sentiments*, constituted the theoretical bases for liberal economy, that is, market and morality are the two invisible hands to regulate economic players. But the latter is often neglected by economists. Coase and Wang (2012, p. 206) criticized the embarrassment of the current economics community in that "the stupendous loss in the depth and richness of human nature is a noticeable part of the price we have paid in transforming economics from a moral science of man creating wealth to a cold logic of choice in resource allocation."

Coase and Wang (2012) also brought out some important Chinese ancient classics that are still meaningful and relevant to improving the political and legal system in today's China. For example, they quoted the words of *The Book of Lord Shang* to address the importance of definite provisions of rights and duties. Lord Shang was an important representative of Legalism, which emerged during the Warring States (475-221 B.C.) and became the predominant political philosophy in the Qin Dynasty. As *The Book of Lord Shang* stated,

Now if laws and mandates are not clear, nor their titles definite, the men of empires have opportunities for contention; in their contentions people will differ

and there will be no definiteness... When rights and duties are indefinite, even men like Yao and Shun (superior men as moral models) will become crooked and commit acts of wickedness, how much more then the mass of the people! This is the way in which wickedness and wrong-doing will be greatly stimulated. The ruler of men will be despoiled of his authority and power, will ruin his country...” (Yang Shang, 1928, p. 332-333)

Coase and Wang (2012) emphasized that if the government is not subject to the rule of law, the rights and duties for state-owned enterprises would be indefinite, which would invite corruption and cause market disorder and political risks. The problems of indefinite rights and duties were also shown in the Chinese stock market, as state-owned listed companies often enjoyed the government’s biased policies and violated the laws and market principles. The stock market needs to introduce mechanisms to confirm corporate ownership and enhance the transparency of activities of market participants, which would clarify rights and duties for market players and place them under public supervision.

After reviewing the process of China’s transformation, Coase and Wang (2012) point out that the lack of a free, open, and active market for ideas would be the biggest obstacle for the further development of the Chinese economy and politics. As they criticize, in China, universities currently lack autonomy, and the government still employs strict ideological control and state surveillance. This is not helpful to enhancing innovation in science and technology, to maintaining a healthy social order, and to developing cultural renovation and spiritual civilization. They give great hope to Chinese intellectuals that have the traditional spirit of “*shi*.” This refers to the literati class who

were creators of ideas in traditional Chinese society and were regarded as the representatives of moral standards. The spirit of *shi* was described by Mencius when he defined “a great man” as “he cannot be led astray by riches and honor, moved by poverty and privation, or deflected by power or force” (Mencius, 2009, p. 62). As Coase and Wang (2012, p. 197) suggest, “a critically minded public, willing to challenge authority, but tolerant and open-minded, offers circumstances conducive to a free market for ideas.”

Rediscovery of Chinese classics. Since the initiation of the economic reform, scholars have made great efforts to introduce Western thoughts and culture into China, which greatly influenced the government and common people. The government made laws and relevant mechanisms learned from advanced countries to foster economic development. Although the government exerted ideological control in order to maintain its ruling, most people admired Western advanced economies, politics and culture and thought that full westernization might be the future way for the world. But in recent years, scholars turned to rediscover Chinese traditional thoughts and culture for rebuilding national spirit. The enthusiasm for Chinese classical studies emerged within the context that China achieved some economic progress while Western countries experienced a slowdown in economic growth and confronted some social problems. As discussed in Chapter 4, the occurrence of serious frauds, e.g., the Enron case, the Madoff case and so on, ruined the Chinese public’s admiration of the Western regulatory patterns. Especially, the exposure of irregularities by international investment banks (e.g., Goldman Sachs) toward the Chinese capital market seemed to indicate the greed of financiers and caused calls for strong regulation of the financial market.

Rediscovery of Chinese traditional culture showed the resumption of self-confidence and national dignity. In addition, this is also a good way to reconsider the Western patterns and reflect the adaptation of the implanted cultures and mechanisms. When it comes to the implantation of thoughts, laws, and mechanisms, the most important issue is how to adapt them into the local environment. Excellent Eastern and Western thoughts have great things in common. Finding or cultivating intellectual soil to support the implanted mechanisms would be an effective and efficient way for their adaptation into the local societies. This would exert positive impacts on the government and lay a social foundation for further political and economic reform. For example, as the online comments showed, some Chinese government leaders would like to disseminate universal values, but universal values were attacked as Western tools for imperialism by their opponents; in contrast, Confucian and other traditional classics advocating benevolence, equality, freedom, and so on would be accepted more readily by the Chinese government and common people. For China, how to go beyond the ideological contention and cultivate a democratic system (perhaps without a multi-party system) for public benefit is a primary task.

Rereading the traditional Confucian classics, we could find great values that are of significance to a modern society. Traditional Confucianism emphasizes moral cultivation and self regulation. It brought forward a conception of *Jun Zi* (the superior man) that referred to a man of complete virtue and used it as the goal for moral cultivation. For Confucianism, filial piety, fraternal submission, faithfulness, truthfulness, propriety, righteousness, and sense of shame constitute the core of moral standards. People should perform their social roles in compliance with moral standards. The

Analects of Confucius record the philosopher Tsang saying, “I daily examine myself on three points: whether, in transacting business for others, I may have been not faithful; whether, I may have been not sincere to my friends; whether I may have not mastered and practiced the instructions of my teacher” (Confucius, 1971, p. 139). Another famous saying, “What you do not want done to yourself, do not do to others” (Confucius, 1971, p. 301) became a basic rule on how to deal with other people in society. But nowadays China is plagued with fraud and cheating in many fields. As discussed in earlier chapters, misrepresenting companies became normative for the circle of businessmen who wanted to list their companies. Self examination or self regulation is critical to the healthy development of individuals and for maintaining social order. For example, businessmen should often perform self examination and regulation in compliance with the principles of faithfulness and truthfulness. But this moral touchstone has been ignored for a long time, which to a great degree might account for the moral crises in the business circle of present-day China.

In the field of economic operation, the traditional Taoist values should be used in reference to government actions. The Taoist notion of “nature order” or naturalism is regarded as the ideological foundation for economic laissez-faire (Gernet, 1985; Spengler, 1964). Adam Smith adopted the Taoism’s notion as the basis for a liberal economy which aimed to curb a government controlled by interest groups from intervening in economic operations (Lang and Yang, 2012). The conception of “invisible hand” fostered the development of non-interventionism or a free economy. As a liberal economy was established, the collusion of the government and interest groups was greatly curbed from economic operations. In recent years, some Chinese scholars, represented by Zhang

Weiying, criticized Keynesianism that argues for the government as the visible hand to affect economic activities (W. Zhang, 2010). This was actually in response to the Chinese government's excessive intervention into the economic sphere. The scholars argued that government intervention should be the last resort under the circumstance of market failure, and the government should not use Keynesianism to justify its excessive intervention (W. Zhang, 2010). Although there is no agreement on which economic view is better, the government should subject itself to the rule of law to avoid corruption resulting from power-money trading and should not relax law enforcement. As for the Chinese stock market, the government's excessive intervention was criticized as the "restless hand" that violated market principles and bred serious corruption (Y. Lu, 2008). The Chinese government should control its restless hand and adjust its role to the regulator of the stock market and provide stronger protections for investors.

The government should not excessively intervene in the stock market and violate market principles. It does not mean that the government should relax the regulation of the stock market. Instead, scholars and public opinion appealed for government to apply more severe penalties to punish offenders, strengthen oversight of the stock market, and even strengthen regulation of the wider society. This also reflected the culture trait of Legalism. Legalism emphasizes setting definite rights and duties and using strict laws and severe penalties to govern the state. Han Feizi, the most important representative of legalism, claimed that since human nature is evil, strict laws, harsh penalties, and rewards should be applied to govern a country (Han, 2003). According to Legalism, the system of law (*Fa*) rather than the ruler ran the state; successful enforcement of the law would lead to a strong state, no matter whether the ruler is weak or strong. In the long history of

China, the ruling class applied the mainstream Confucianism combined with some legalist ideas to govern the country. The political philosophy of legalism served the monarchical totalitarianism and was different from the Western notion of “rule of law,” but the social context of China has changed greatly. Eventually, the rule of law can be realized only by a government that is willing to subject itself to the law. This needs strong supervision and pressure from a public possessing rights awareness and legal consciousness.

Legalism and Confucianism are based on different assumption of human nature. While Legalism assumes that human nature is evil, Confucianism thinks that human nature is good and prefers the rule of morality. Confucius says, “If the people be led by laws, and uniformity sought to be given them by punishments, they will try to avoid the punishment, but have no sense of shame; If they be led by virtue, and uniformity sought to be given them by the rules of propriety, they will have the sense of shame, and moreover will become good” (Confucius, 1971, p. 146). Although Confucianism seemed too optimistic about human nature and rule of virtue could hardly handle the more complex social relations in modern societies, the significance of forming the inner sense of shame and moral cultivation should not be ignored. As Adam Smith (1969) also indicates in *The Theory of Moral Sentiments*, the rule of law could not be fulfilled without the rule of morality. The rule of law (visible regulation) and rule of morality (invisible regulation) should work together to govern the state and regulate social relations. The Chinese government should put its visible hand more on the enforcement of rule of law and should not intervene too much into economic activities, as Taoism suggests.

Furthermore, common people should actively supervise the government. The proverb “while water can carry a boat, it can also overturn the boat; the ruler (the government) is the boat, while common people is water,” said by Confucius, was often mentioned by the Chinese rulers in dynasties, and even today the Chinese government often emphasizes it. Chinese culture encouraged common people to resist the bad ruler/government. This was shown in the popular Chinese saying, “Do those kings and the gentry certainly have blue blood (*Di Wang Jiang Xiang, Ning You Zhong Hu?*)?” In Chinese culture, blood does not determine the future of people, and the social upward mobility has been invigorated. As Yu Yingshi (2013) argues, in history, China did not lack democratic thought elements, but did not form democratic systems. Fukuyama (2012) points out that contemporary China represents responsive authoritarianism, but it would be hard to prevent it from falling into a vicious circle of “bad emperor.”

In today’s China, the rapid growth of the middle class is regarded as a huge potential force to foster further political reform in China. As mentioned above, public stockholders were primarily members of China’s middle class. Public stockholders could become a force to be reckoned with in further economic and political reform in China. The Chinese stock market has introduced market mechanisms to define rights and duties of market players, invite public stockholders into the game with the government in a market-oriented framework, enhance transparency of market players, and now urge transformation in the role of the government. It’s critical to establish relevant mechanisms to realize civic participation in supervising the government and strengthening protection of common public investors. For example, this study recommends the establishment of a whistleblower program, which, in a broader sense,

will also promote individuals' social responsibility to maintain justice and provide a means of supervising the political and economic elite. The adoption of class action will touch the allocation of profit and resources and test the resolution of reformers. The critical point for the adoption of class action is to establish a legal framework to invite public stockholders to fight against securities violations and shape a new relationship of administrative departments and individual stockholders in maintaining market order and public interest. More importantly, the adoption of the class action could help place the court at the center of regulation, motivate lawyers, and further the rule of law in the Chinese stock market.

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APPENDIX A

TABLE OF DESCRIPTIONS OF INTERVIEWEES

Table 1

Description of Interviewees in Shenzhen and Haikou

		Shenzhen (Total: 20)		Haikou (Total: 20)	
		Female Total: 8	Male Total:8	Female Total: 10	Male Total: 10
Age	Under 30		1		1
	30-40	3	3	3	2
	40-50	4	5	5	6
	50-60	1	2	1	
	Up 60		1	1	1
Education Level	Under College		1	2	
	College	4	8	8	9
	Graduate	4	3	1	
Profession	Government Employee	2	3	3	2
	Doctor	1			
	College/Technical School Teacher				2
	State-Owned Company Employee	2	2	3	3
	Bank Employee			3	1
	Foreign/Private Company Employee	1	4		
	Small Business Owner	1	2		1
	Self Employed	1			
	Retired		1	1	1

APPENIX B

INTERVIEW QUESTIONS

This is an English Translation of the Questions I will ask in the interviews. The interviews will be conducted in Chinese (Mandarin).

1. When did you enter into the stock market?
2. What was the primary reason why you entered into the stock market? (to make a living, investment, interest, entertainment, to kill time)
3. What has been the effect of your participation in the stock market on your life?
4. Could you please describe your most unforgettable experience as a stockholder?
5. Overall, have you earned money from the stock market? If not, why have you still stayed in the stock market?
6. Have you had professional knowledge about how the stock market operates?
7. Have you paid close attention to changes in laws and policies regarding the operation and regulation of the stock market?
8. How have you chosen stocks to purchase? How have you decided to sell stocks (according to recommendations, your own analysis, or at will)?
 - a. If according to recommendations, whose recommendations or advices have you taken?
 - b. If according to your own analysis, how have you analyzed the stocks?
 - c. Have you taken both others' advice and your own analysis?
9. Have you cared about the performance of the listed companies whose stocks you bought?
10. Have you paid attention to the misconduct of listed company executives that were announced by regulatory agencies? Have those announcements impacted your choices of stocks?
11. Could you please talk about your views on the rise of corporate scandals? Have they impacted your stock trading activities?

12. Could you please talk about your views on the corporate executives that accounted for the scandals? Do you view them as criminals, bad persons, or smart guys, ambitious enterprisers?
13. Could you please talk about your views on China's stock market? Do you view it as a casino?
14. Could you please talk about your views on the regulation of the stock market? Please evaluate the external and internal oversight of the stock market.
15. Could you please talk about your views on the protection of retail stockholder' interest in China? Do you think Chinese retail stockholders are vulnerable?
16. I have a few questions about insider trading:
 - a. Are they common practices in stock trading?
 - b. Are they criminal activities?
 - c. Is it necessary to adopt more severe measures to prevent these activities?
 - d. Is it possible to reduce these activities in the current Chinese contexts?
17. I have a few questions about illegal manipulation of stock prices:
 - e. Are they common practices in stock trading?
 - f. Are they criminal activities?
 - g. Is it necessary to adopt more severe measures to prevent these activities?
 - h. Is it possible to reduce these activities in the current Chinese contexts?
18. I have a few questions about the cases of "Stock Sages" which refer to illegal provision of consultations on stock trading:
 - a. Have you ever seen this kind of so-called insider information from "stock sages?" If yes, where have you seen it? (online, newspaper, magazine)
 - b. What accounted for the emergence of this kind of cases?
19. From your perspective, what are the primary causes of securities fraud and other white-collar crime associated with China's stock market?

20. Do you think the criminal laws provide appropriate penalties against securities crime?
21. What measures do you think should be taken to strengthen the protection of stockholders' interest?

Thank you!