

STUDENT NOTE

ADMINISTRATIVE GOVERNANCE AS CORPORATE GOVERNANCE: A PARTIAL EXPLANATION FOR THE GROWTH OF CHINA'S STOCK MARKETS

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Every developing country wants its own stock exchange, and perhaps this exuberance is well founded.¹ Indeed, if capital markets contribute to economic growth, then the question of how to establish equity markets should occupy a central position in the economic development field.² There are, of course, no authoritative directions on how to go about establishing and developing a stock market. One highly influential strand of literature authored by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny (hereinafter LLSV) has considered the importance of legal system origin.³ This line holds that investor protection is the key to vibrant and efficient capital markets, and countries of common law legal origin have corporate governance institutions that

1. Developing countries' desire for their own stock exchanges is sometimes attributed to economic nationalism or sovereignty concerns. Promising companies can always list on overseas exchanges and many do. However, recent findings show that investors display a "home bias" by allocating a relatively large fraction of their wealth to equities issued by domestic firms. This offers some validation to a country's impulse for its own domestic exchange. See Kalok Chan et al., *What Determines the Domestic Bias and Foreign Bias? Evidence from Mutual Fund Equity Allocations Worldwide*, 60 J. FIN. 1495 (2005).

2. While studies have not conclusively established whether economic growth causes stock market development or whether stock market development causes economic growth, certainly there seems to be a positive relationship between the two. Findings suggest interdependency: economic growth feeds off of stock market development and vice versa. See Ross Levine & Sara Zervos, *Stock Markets, Banks, and Economic Growth*, 88 AM. ECON. REV. 537 (1998) (showing that stock market liquidity and banking development positively predict growth); Raghuram G. Rajan & Luigi Zingales, *Financial Dependence and Growth*, 88 AM. ECON. REV. 559 (1998) (setting forth a reasonable thesis to prove a causal relationship between stock market development and economic growth).

3. The key LLSV articles are Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *What Works in Securities Laws?*, 61 J. FIN. 1 (2006); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POLIT. ECON. 1113 (1998) [hereinafter La Porta et al., *Law & Finance*]; Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, & Robert W. Vishny, *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) [hereinafter La Porta et al., *Legal Determinants*].

provide superior investor protection.⁴ Countries of civil law legal origin, on the other hand, generally have lower levels of investor protection and less vibrant capital markets.⁵ While the findings of LLSV reveal correlation between investor protection indicators and stock market performance, their methodology neglects any real consideration of causal links. In a similar vein, Professor Bernard Black has offered a list of “core” institutions necessary for well-functioning stock markets, and he explains how these institutions contribute to the efficient allocation of capital.⁶ The emphasis on institutions in these seminal articles operates on a highly abstract level. Much of the law and finance literature draws generalizations based on the experiences of developed, capitalist economies, positioned in democratic, rule-of-law-based political systems. The most glaring omission is a general failure to address “transition economies.”⁷ These studies have excluded two of the most consequential economies in the world: China and India.

Disregarding China is immensely convenient for law and finance scholars. China is not a common law country—nor is it reliably categorized as a civil law country. It has a political system which is neither democratic nor characterized by rule of law. However, given its increasing importance in the global economy, worldwide capital markets, and world trading system, China is simply too important to dismiss as an inconsequential outlier.

China has seen extraordinary economic growth over the past three decades, the development of booming equity markets, and high value participation by Chinese issuers in offshore capital markets. According to one estimate, market capitalization of companies listed on China's domestic exchanges increased at an average rate of 63.3 percent per year between 1992 and 2003.⁸ In 2003, total market capitalization was 36.4

4. See La Porta et al., *Legal Determinants*, *supra* note 3, at 1137 (showing that anti-director rights measures are highest in common law countries, intermediate in Scandinavian and German civil law countries, and lowest in French civil law countries).

5. La Porta et al., *Law & Finance*, *supra* note 3, at 1116 (finding a strong negative correlation between concentration of ownership, as measured by the combined stake of the three largest shareholders, and the quality of legal protection of investors); La Porta et al., *Legal Determinants*, *supra* note 3, at 1137 (showing that low shareholder protection may be the reason why some legal origins have smaller equity markets as well as lower access to equity finance).

6. See Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 *UCLA L. REV.* 781 (2001).

7. La Porta et al., *Law and Finance*, *supra* note 3, at 1117 (“There are no socialist or ‘transition’ economies in the sample.”).

8. Lihui Tian & Saul Estrin, *Debt Financing, Soft Budget Constraints, and Government Ownership: Evidence from China*, 15 *ECON. TRANSITION* 461, 464–65 (2007). Any measure of market capitalization for Chinese listed companies during this timeframe is problematic. See *infra* Part III.C.

percent of China's gross domestic product (GDP).⁹ The number of Chinese-listed companies grew from fifty-three companies in 1992 to 851 in 1998 to 1,287 in 2003.¹⁰ Notably, the largest IPO in history was the dual listing of a Chinese company on the Shanghai and Hong Kong stock exchanges.¹¹ Until quite recently, however, China's law and institutions, including investor protection and corporate governance, were significantly less developed than almost all countries in the LLSV sample.¹² Enforcement of law and governance norms has been problematic, as is common in developing countries.¹³ In the Chinese case, robust stock market development has been coupled with underdeveloped securities law and regulation, weak legal institutions, and spotty enforcement. China's experience therefore represents a puzzle.¹⁴

9. *Id.*

10. *Id.* There has been a good deal of debate about the relevance of China's capital markets to the country's economic growth, with many arguing that they are not nearly as important as bank financing. *See, e.g.,* Franklin Allen et al., *Law, Finance and Economic Growth in China*, 77 J. FIN. ECON. 57, 73 (2005) ("Both the scale and relative importance (compared with other channels of financing) of China's external markets are not significant."); Donald C. Clarke, *The Ecology of Corporate Governance in China* 17 (George Washington Univ. Law Sch. Pub. & Legal Theory, Working Paper No. 433, 2008), available at <http://ssrn.com/abstract=1245803> (last visited June 28, 2009) ("[M]uch writing on them unsurprisingly assumes that [China's stock markets] are critical to the Chinese economy. At least until recently, this assumption is questionable."). The loans made by Chinese banks are hardly exemplars of efficient capital allocation. Thus, the capital markets have an important role to play in sustaining China's record-setting growth rate.

11. In 2006, the Industrial and Commercial Bank of China (ICBC) was simultaneously listed on both the Hong Kong Stock Exchange and Shanghai Stock Exchange. ICBC raised at least USD \$14 billion in Hong Kong H-shares and another USD \$5.1 billion in Shanghai A-shares, making it the largest IPO in world history. *See* Richard McGregor et al., *China's Biggest Bank Goes to Market*, FIN. TIMES, Oct. 24, 2006, available at http://us.ft.com/ftgateway/superpage.ft?news_id=fto102420061415242175&page=2 (last visited July 24, 2009).

12. *See infra* app. tbl.1.

13. *See* DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 35 (1990). "[T]he inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third World." *Id.* at 54; *see, e.g.,* Nicholas Bloom et al., Contract Enforcement and Firm Organization: Evidence from the Indian Textile Industry (Mar. 4, 2009) (unpublished manuscript, on file with the author) (detailing how poor law enforcement in India discourages executives from delegating responsibilities to middle management, which directly limits firms' productivity and expansion); Dhammika Dharmapala & Vikramaditya Khanna, *Corporate Governance, Enforcement, and Firm Value: Evidence from India* (Univ. of Mich. Law & Econ., Olin Working Paper No. 08-005, 2008), available at <http://ssrn.com/abstract=1105732> (last visited June 28, 2009) (showing that substantive corporate governance reforms contributed to the value of listed companies in India but only after the enactment of severe sanctions for non-complying firms).

14. This puzzle is in a sense subsidiary to the broader Chinese exception to the "rights hypothesis," an influential theory in institutional economics that economic growth requires stable and predictable contract and property rights. *See generally* Donald C. Clarke, *Economic*

This Note offers a partial explanation to this puzzle. I argue that during the first decade of stock market development (roughly 1990–2000) Chinese institutions, which emphasized administrative direction and control, functioned in lieu of legal and financial institutions. Preexisting modes of administrative governance introduced incentives that mitigated information asymmetry problems inherent in initial public offerings (IPOs) and contributed to enhanced market valuation during the post-IPO phase.¹⁵ I focus on two *sui generis* Chinese institutions employed during this time period: the quota system for equity share issuance and the Special Treatment (ST) system for underperforming issuers. In short, my thesis is that administrative governance substituted for corporate governance.

I do not suggest that the incentive structures surrounding the quota system and the ST system constitute a superior method of securities regulation and corporate governance compared with the mechanisms of investor protection emphasized in the LLSV literature or the well-known institutions outlined by Professor Bernard Black. I would question the utility of Chinese administrative governance for efficient allocation of capital in the medium to long term. During the early years of China's experiment with stock markets, however, these institutions filled a void and jump-started the markets in a way that newly introduced laws (mandatory disclosure and criminal and civil liability) and immature institutions (courts, market regulators, and intermediaries) could not. My Note pushes back on the notion that developing countries should embrace any set of predetermined institutions wholesale—certainly not Anglo-American common law institutions transplanted from a radically different political-legal context.¹⁶ Any program designed to build a stock market should first look to integrate indigenous institutions and practices. Even institutions born of socialist-era, centralized state planning—at first blush the very antithesis of market-based development—may contribute to the growth of viable capital markets.¹⁷

Development and the Rights Hypothesis: The China Problem, 51 AM. J. COMP. L. 89, 89 (2003) (refining the rights hypothesis through discussion of the Chinese case).

15. My analysis draws directly upon the excellent empirical work done by Katharina Pistor & Chenggang Xu, *Governing Stock Markets in Transition Economies: Lessons from China*, 7 AM. L. & ECON. REV. 184 (2005) (examining the impact of China's quota system for equity shares), and Julian Du et al., *Special Treatment (ST) Firms and Administrative Governance of Capital Markets in China*, in *ECONOMIC ANALYSIS OF LAW IN CHINA* 164 (Thomas Eger et al. eds., 2007) (examining the impact of the ST system and delisting).

16. For these reasons, generic recommendations, such as the Organisation for Economic Co-Operation and Development's (OECD) Principles of Corporate Governance, may have only limited utility. See OECD, *PRINCIPLES OF CORPORATE GOVERNANCE* (2004), available at <http://www.oecd.org/dataoecd/32/18/31557724.pdf> (last visited June 28, 2009).

17. Professor Black and his co-authors have admitted that "enterprise leasing," a home-grown, Russian plan whereby the State retains ownership of the enterprise yet managers are

This Note proceeds in four parts. Part I provides an overview of the so-called “core” institutions necessary for functioning stock markets. Part II introduces the Chinese case and outlines several relevant features of China’s financial markets, many of which arise from the legacy of state-ownership and the planned economy. Part III frames the Chinese puzzle by examining the record of robust stock market performance alongside clearly dysfunctional legal and financial institutions. Part IV details two examples of administrative governance as corporate governance: the quota system and the ST system.

I. CORE INSTITUTIONS

Information asymmetry and self-dealing are the two major threats to strong financial markets.¹⁸ Core institutions counter these threats.¹⁹ This Part discusses the ways in which information asymmetry and self-dealing manifest in the market. The Part also introduces five core institutions that ideally assure investors that the information they receive is accurate and that company insiders are looking to create value for the issuer firm.

Securities represent claims to a company’s future income. The present value of a company’s securities depends on that company’s future prospects.²⁰ Past performance often indicates future performance.²¹ Insiders, such as managers and controlling shareholders, are intimately familiar with their company’s past performance and future prospects. They must share this information in order for investors to value the company’s securities accurately.²² Since investors cannot directly verify the accuracy of the company reported information, insiders are incentivized to exaggerate the issuer’s prospects and divert company capital for their personal consumption.²³ In the context of an initial public offering, this incentive to misappropriate the cash raised by the sale of stock is known as the “promoter problem.”²⁴ The promoter problem is a classic out-

given material incentives to improve performance, might very well have led to a better solution for Russia. See Bernard Black et al., *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731, 1784 (2000) (“The privatizers killed enterprise leasing in 1992, so we don’t know how it would have turned out. But we know how it started, and the start was promising.”).

18. See Black, *supra* note 6, at 783.

19. *Id.* at 789 (introducing the concept of “core” institutions).

20. *Id.* at 786.

21. *Id.*

22. *Id.*

23. *Id.*

24. See Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1049 (1995).

growth of “vertical agency costs” between company insiders and outside investors, where the insider is the agent of the capital-providing investor.²⁵

Similarly, insiders may use their influence over company decision-making and misappropriate company value to themselves, their relatives, or another insider-controlled company.²⁶ They typically do this by engaging in non-arm's-length transactions (direct self-dealing) or by using insider information to trade with less informed investors (indirect self-dealing or insider trading).²⁷ Self-dealing, also known as the “controller's problem,” is a consequence of “horizontal agency costs” between the dominant and minority shareholders, where principal and agent are, under law, co-equals.²⁸

Problems arising from agency costs can undermine the viability of a country's financial markets.²⁹ If investors cannot trust a company's reported information or the insiders who control the company, they will discount the prices that they are willing to pay for those companies' securities to reflect that risk.³⁰ Under these circumstances, honest issuers will not receive fair value for their shares and, consequently, they will look to sources of financing other than the equity markets. High quality issuers will exit and leave the market populated by low-quality issuers.³¹ Investors will further discount the prices they are willing to pay, causing more of the quality firms to flee and creating a “death spiral.”³²

25. For a discussion of the “horizontal” and “vertical” dimensions of corporate governance, see Mark J. Roe, *The Institutions of Corporate Governance* (Harvard Univ. John M. Olin Ctr. for Law, Econ. & Bus., Discussion Paper No. 488, 2004), available at <http://ssrn.com/abstract=612362> (last visited July 12, 2009).

26. The insiders' incentive to act opportunistically is an example of “moral hazard.” See PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION AND MANAGEMENT* 195 (1992) (defining moral hazard as “any behavior under a contract that is inefficient, arises from . . . differing interests . . . and persists only because one party to the contract cannot tell for sure whether the other is honoring the contracting terms”).

27. Black, *supra* note 6, at 804 (distinguishing between direct and indirect self-dealing).

28. See Roe, *supra* note 25, at 2. The problem of horizontal agency costs is the central concern of corporate governance throughout most of the world, where equity ownership is generally concentrated and external finance is oriented toward bank-provided credit. The United States, where public company ownership is more dispersed and the problem of vertical agency costs predominates, is an outlier.

29. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 276, 280 (1991) (noting that unless investors can discern the relative quality of securities, there will be too little investment in good ventures and “lemons” will dominate the market).

30. *Id.*

31. *Id.*

32. In the economist jargon, this downward spiral is known as a “market for lemons” problem. See generally George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

Disclosure, reputational intermediaries, liability standards, courts, and a public regulator serve to mitigate this threat.

A. Disclosure

Disclosure generally refers to two distinct concepts: to the corporate law notion of disclosure to shareholders prior to their approval of corporate actions, such as a merger; and to initial and ongoing public disclosure of corporate information as required by the securities laws.³³ Disclosure is probably the least controversial of the five core institutions. Traditionally, proponents stressed fairness rationales for mandating disclosure, but perhaps the strongest rationales are efficiency-based.³⁴ The analysis below sketches out the five main policy arguments that underpin a mandatory disclosure regime.

1. Information as a Public Good

The efficiency-based rationales for mandatory disclosure hinge on the fact that information about public companies displays many of the characteristics of a public good.³⁵ The key characteristic of a public good is non-excludability.³⁶ People benefit from public goods regardless of whether or not they contributed to the cost of acquiring the good. Moreover, consumption of a public good does not diminish the good's availability to others.³⁷ This leads to a situation where people can free-ride on the contributions of others. The potential for free-riders discourages anyone from paying for the public good. The paradoxical result is that goods that most people would consider to be vital are woefully underprovided absent regulation.³⁸

Since market forces are inadequate to produce a socially optimal supply of information about public companies, a regulatory response is justified. By mandating that issuers disclose key information, society

33. EASTERBROOK & FISCHER, *supra* note 29, at 276 (referring to disclosure "before collecting proxies from investors" regarding a corporate action and "before selling securities" to the investing public).

34. For a repudiation of fairness-based justifications for mandatory disclosure, see *id.* at 296–300.

35. Public goods include public parks, clean air, and national defense. For an important discussion of this concept, see MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* 14 (1965) (defining public good as a benefit or good accruing to all of a group's membership).

36. *Id.* at 15.

37. *Id.* at 14.

38. See RICHARD A. MUSGRAVE, *THE THEORY OF PUBLIC FINANCE* 133–34 (1959) ("The basic problem in the theory of public economy . . . is that the same amounts of [public] services are consumed by all, so that (1) true individual preference for such wants are not revealed at the market, and (2) there is not a single solution that is optimal in the Pareto sense.").

effectively subsidizes securities analysts.³⁹ Analysts' marginal cost of acquiring and verifying information decreases, and for their part, analysts rationally increase the quantity of information they disclose.⁴⁰ With mandatory disclosure as a cost-saving measure, over time, new analysts should enter the market, and competition among analysts should also lead to greater quality of information.⁴¹ Ideally, the end result is improvement in the capital market's allocative efficiency and increased investment in productive firms.

2. Reducing Agency Costs

Agency cost problems can push a country's capital markets toward a death spiral. Outside investors have difficulty monitoring the performance of managers and insiders. However, mandatory disclosure can moderate corporate misfeasance.⁴² Agency costs are reduced when insiders disclose shareholdings, executive compensation, and, most importantly, related-party transactions.

Disclosure does not eliminate the ability of insiders to profit from direct or indirect self-dealing. Rather, mandatory disclosure alters the relationship between outside investors and insiders whereby information about related-party transactions comes to light on an ongoing basis, and inefficiencies associated with these questionable transactions become embedded in the company's share price.⁴³ Mandatory disclosure is "contract inducing."⁴⁴ The rule saves parties from incurring transaction costs while negotiating disclosure content in every particular corporate instance.

3. Resolving Coordination Problems

Misleading information often enters financial data. Absent contracting costs, investors would require all firms to identify and use one optimal format of disclosure.⁴⁵ However, no one firm could justify the costs of doing so.⁴⁶ Free-rider firms would use the format, and so the

39. John C. Coffee, Jr., *Market Failure and the Economic Case for Mandatory Disclosure*, 70 VA. L. REV. 717, 728 (1984).

40. *Id.* at 729.

41. *Id.*

42. See Mahoney, *supra* note 24, at 1048 (arguing that the "principle purpose" of mandatory disclosure is addressing the misalignment of interests between promoters and investors or managers and shareholders).

43. Under this contractual formulation, Mahoney posits that the promoter (or insider) "sells" his expertise to investors. *Id.* at 1091.

44. See Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 444 (1993).

45. See EASTERBROOK & FISCHEL, *supra* note 29, at 290–92.

46. *Id.*

creator company's efforts would go under-compensated. Such a language would essentially be a public good.

State intervention and imposition of a set of regulatory schedules and accounting standards resolves the problem of coordinating a common language of disclosure. Introducing a uniform system of reporting allows for comparisons among similar companies and limits managers' abilities to cherry-pick reporting and accounting practices to make their firm appear more profitable.⁴⁷

4. Minimizing the Cost of Duplicative Research

When information about public companies is easily accessible and accurate, investors will gravitate toward good companies, the market will allocate capital efficiently, and entrepreneurs will be able to raise capital for wealth-creating projects. This is beneficial from a social welfare perspective. Trading gains made in the secondary market, however, generally do not create additional wealth,⁴⁸ as one party's gain is another's loss.⁴⁹ The resources expended by either party in determining whether to make a trade constitute social waste.⁵⁰ Mandatory information disclosure reduces these costs. Rival investment firms do not incur duplicative data banks on a certain stock; instead, they can access a state-maintained central information depository.⁵¹

5. Positive Externalities

The analysis thus far has hinted at the beneficial externalities when one firm commits to information disclosure. However, disclosure is costly, and, absent rules mandating it, free-rider problems discourage disclosure and exacerbate information asymmetries between firms and investors. This reduces firm value.⁵² The first positive externality is that mandatory disclosure allows each firm's results to inform the market about other firms' values and by extension improves liquidity for a population of firms.⁵³ Admati & Pfleiderer have argued that a related but distinct externality arises when a company improves its liquidity through disclosure: if firm A lowers the cost of trading its stock, it may increase

47. *Id.* at 289–90.

48. Coffee, Jr., *supra* note 39, at 733.

49. *Id.*

50. See generally Jack Hirschleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561 (1971).

51. Coffee, Jr., *supra* note 39, at 733–34.

52. See Anat R. Admati & Paul Pfleiderer, *Forcing Firms to Talk: Financial Disclosure Regulation and Externalities*, 13 REV. FIN. STUD. 479, 479–80 (2000) (demonstrating that the Nash equilibrium of a voluntary disclosure game is often socially inefficient).

53. *Id.* at 513.

the willingness of investors to buy firm *B*'s stock by decreasing the cost of adjusting a portfolio to account for changes in firm *B*'s risk profile.⁵⁴ The beneficial effects of mandatory, ongoing disclosure therefore percolate throughout the market.

B. *Reputational Intermediaries*

Reputational intermediaries, such as investment banks, accounting firms, and law firms, perform a crucial role in combating information asymmetry and assuring investors that they will not be defrauded.⁵⁵ The problem is "particularly acute" when dealing with an initial issuance of securities.⁵⁶ Buyers must be convinced of the information's accuracy and the issuer's good faith. However, pre-sale verification is costly, and complete verification is probably impossible. From a one-time seller's perspective, the gains from opportunism may exceed the cost of a reputation for thievery.

Reputational intermediaries can credibly vouch for issuers because the intermediaries are repeat players.⁵⁷ A reputable investment bank, for example, has accrued reputational capital by bringing different firms to the public over many years. In theory, a bank would not aid in fraud and sacrifice such reputational capital for a one-time, relatively modest fee.⁵⁸ Thus, the underwriter in a securities issuance transaction effectively "rents" its reputation to the issuer.⁵⁹ The investment bank may purchase an issuer's entire offering, as part of a "firm commitment" underwriting, before reselling the securities to investors. Alternatively, it may engage in a "best efforts" style underwriting receiving a commission on each security sold but without taking true ownership risk.⁶⁰ In either case, the name of the underwriter (or syndicate of underwriters) inspires confidence and helps ensure the success of the offering. Knowledge that a reputable law firm has compiled the prospectus and that a reputable accounting firm has audited the financial statements similarly assures

54. *Id.* The "argument assumes that investors are heterogeneous. Otherwise, they would have no reason to trade." *Id.* at 513 n.28.

55. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 619–21 (1984).

56. *Id.* at 620.

57. *Id.*

58. *But see* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 BUS. L. 1403 (2002) (exploring why reputational intermediaries sometimes acquiesce in managerial fraud, even though the potential reputational loss obviously exceeds the gains made from the individual client).

59. Gilson & Kraakman, *supra* note 55, at 620.

60. STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION: CASES AND ANALYSIS* 419–20 (2d ed. 2008).

investors.⁶¹ By lowering investor verification costs, reputational intermediaries allow the issued securities to fetch a higher price than they might otherwise.

C. Liability Standards

Markets cannot work properly if they are not informed about wrongdoing. If offering documents routinely misstate or omit important details about a company's performance, investors will be unable to rationally distinguish high-value companies from low-value companies. This will trigger the adverse selection or death spiral effect. Law-based institutions must force dissemination of information.⁶² To combat the impulses to cheat among issuers as well as secondary actors, a mandatory disclosure regime must impose calibrated penalties for misrepresentation or manipulation. The threat of liability provides credibility to disclosure.

1. Issuer and Insider Liability

Issuer and insider liability is the first line of defense against fraud.⁶³ Mandatory disclosure is not always completely truthful, accurate, or comprehensive. The market provides some minimal checks on insiders' behavior. Although insiders will be tempted to conceal the truth about their company during a public offering or renege on promises made at the time of issuance (*e.g.*, use of proceeds), the company will probably want to re-access the capital market to issue more securities.⁶⁴ Furthermore, insiders will probably want to sell their own shares in the future. Market-imposed constraints alone, however, do not adequately deter misbehavior for three reasons. First, depending on enforcement capacity of the market regulator and prosecutor, the probability of detection may be quite low.⁶⁵ Second, the misappropriated value may not be large rela-

61. Black, *supra* note 6, at 787.

62. Roe, *supra* note 25, at 13.

63. Black, *supra* note 6, at 796. To the extent that corporations may purchase insurance coverage and pass the cost of securities fraud along to shareholders, insider liability is particularly important for deterrence purposes. Of course, insiders may contract to be indemnified by the corporation or purchase director's and officer's insurance, similarly imposing the cost of their misfeasance on shareholders. For a discussion on remedying these conundrums in the U.S. context, see John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1572–85 (2006).

64. Black, *supra* note 6, at 796.

65. Even the SEC, widely considered a robust and well-funded regulator, "does not have the resources to investigate every instance in which a public company's disclosure is questionable. . . [t]his would continue to be the case even if the Commission's resources were substantially increased." See *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking Housing & Urban Affairs*, 103d Cong. 5 (1993) (statement of William R. McLucas, Dir. of Enforcement, Sec. Exch. Comm'n); see also *Berner v. Lazzaro*, 730 F.2d 1319, 1322 (9th Cir. 1984) ("The re-

tive to the firm's size and therefore may have only a negligible impact on share price.⁶⁶ Finally, insiders may be desperate for funds, and if they do not lie or cheat, there will be no subsequent financing.⁶⁷ In sum, reputational sanctions do not effectively police the moral hazard faced by insiders.⁶⁸

The standard of liability directly affects the ease and frequency whereby the public regulator or private litigants (if they are so empowered) can bring enforcement actions.⁶⁹ The standard may require mere proof of a material misstatement or omission in the offering documents. Substantive law may go further and require that investors show reliance on that statement or omission, and that it caused them a loss. Finally, the law may require showing that insiders' acts constituted negligence or gross negligence.⁷⁰ Civil liability contributes to deterrence, but without more it is inadequate because "insiders often have little wealth outside their firm."⁷¹ Insiders can also hide or spend most of their gain.⁷² For these reasons, criminal and administrative sanctions have a significant role to play.

In addition to deterrence, liability also serves a compensatory role. Civil liability functions to "make whole" the investors that have been cheated. As a starting point, the damages calculation might begin as the difference between what the investor paid for the security and the security's "true" value (absent the fraud) at the time of the purchase.⁷³ However, depending on the concentration of an individual shareholder's equity ownership, this loss may seem relatively insignificant in comparison to the costs of litigation. Moreover, to adjust for the movement of the market as a whole, the quantum of this loss is generally narrowed by the percentage decline of a market index during the relevant time period.⁷⁴ If the parties decide to settle, investors will recover an even smaller share of their losses. Although the civil litigation costs may

sources of the Securities Exchange Commission are adequate to prosecute only the most flagrant abuses.") (internal citation omitted).

66. Roe, *supra*, note 25, at 13.

67. As a matter of game theory, this third scenario describes the final round of a repeat game. See generally ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* (1984).

68. See MILGROM & ROBERTS, *supra* note 26, at 166–204.

69. See Katharina Pistor & Chenggang Xu, *Incomplete Law*, 35 N.Y.U. J. INT'L L. & POL. 931, 941 (2003).

70. *Id.* ("Requiring intent or negligence or imposing strict liability can further circumscribe the scope of liability . . .").

71. Black, *supra* note 6, at 797.

72. *Id.*

73. This measure has been described as "net out-of-pocket" (NOP). See Mary E. Calhoun et al., *The Calculation of Damages in Securities Arbitration*, in SECURITIES ARBITRATION 2001: HOW DO I DO IT? HOW DO I DO IT BETTER? 1060, 1069 (2001).

74. *Id.* at 1083–84.

sometimes exceed recovery, shareholders' suits also have an important role to play.

2. Secondary Actor Liability

Liability for secondary actors (reputational intermediaries) provides a second line of defense against fraud. Intermediaries have an incentive to gamble their firm's reputation to gain or keep a client or, if paid enough, to win fees.⁷⁵ As with issuers, intermediaries will weigh the probability of getting caught times the cost of punishment against the benefit of the client's business. The "risk of liability reinforces [an intermediary's] concern for reputation."⁷⁶ Liability can persuade an investment bank, for example, to turn away an issuer of marginal credibility: risk of liability supplies accountants with a response to clients that want less intrusive audits, and lawyers with a response to clients that want more favorable disclosure than the law allows.⁷⁷ The same liability standards that apply to issuers and insiders may also apply to secondary actors.

3. Procedural Support Mechanisms

Meaningful liability depends upon rules of procedure.⁷⁸ The law will deter bad actors only if they are held accountable for their violations. The analysis below briefly sketches three procedural arrangements that work together to support a plaintiff's ability to bring suit.

a. A Mechanism to Combine Shareholders' Claims

A group action mechanism enables shareholders that have been harmed to join their claims and have them resolved together. The aggregation of losses makes it possible to compensate numerous victims who individually have been harmed in amounts too small to warrant an individual suit. Without such a mechanism, shareholders are beset by a collective action problem and, in the unlikely event that a shareholder makes it to the courthouse, individual suits are administratively inefficient.⁷⁹

75. See Black, *supra* note 6, at 794.

76. *Id.* at 794–96.

77. See *id.* For example, the Sarbanes-Oxley Act of 2002, 17 C.F.R. § 205.3(b) (2003), imposes a higher standard of liability upon securities lawyers that fail to "report up the ladder" nondisclosure that would constitute a material violation.

78. Black, *supra* note 6, at 791.

79. *Id.* ("It's important to have class actions or another way to combine many individually small claims.").

b. Contingency Fee Arrangements

The contingent fee drives private enforcement and group action litigation. A contingency fee has two components: payment is contingent on the outcome of the litigation, and the fee is a percentage deducted from the clients' recovery.⁸⁰ A contingent fee contract's primary purpose is to allow plaintiffs who cannot afford a lawyer to obtain legal services by compensating the lawyer with the proceeds of any recovery.⁸¹ Individual investors generally will not be willing to incur the costs of a complex lawsuit to recover only a small private loss. Coupled with the group action mechanism, the prospect of a percentage of all investors' aggregated losses incentivizes plaintiffs' lawyers to pursue the litigation.

c. Broad Civil Discovery

Proving false disclosure often requires uncovering evidence buried in an issuer's records.⁸² A false disclosure in the prospectus or a periodic report provides a natural starting place for the paper trail. Cases of self-dealing, however, are typically more difficult to prove.⁸³ Broad civil discovery allows for aggrieved shareholders to credibly threaten action and succeed in civil litigation and, in either case, play a private enforcement role.

D. Courts

Every legal system must allocate power to make and enforce the law. Lawmaking is typically conducted by legislatures and, particularly in common law countries, by courts. Law pronounced by either of these institutions cannot anticipate all possible permutations of human conduct. Liability standards, such as negligence, still leave open the question of what actions will trigger a breach.⁸⁴ New and unforeseen cases continually arise.⁸⁵ Since the standards' precise contours are ambiguous, an individual contemplating the legal ramifications of his conduct has two options: to proceed anyway, assuming that the law will not apply, or not to act, believing that the mere possibility of punishment justifies inaction.⁸⁶ Either case embodies suboptimal levels of

80. See generally Task Force on Contingent Fees, Tort Trial and Insurance Practice Section of the American Bar Association, *Report on Contingent Fees in Class Action Litigation*, 25 REV. LITIG. 459 (2006).

81. See *id.* at 464.

82. Black, *supra* note 6, at 791.

83. *Id.* at 807.

84. Pistor & Xu, *supra* note 69, at 941.

85. See *id.* (describing so-called "Type I incomplete law").

86. See generally Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992).

deterrence.⁸⁷ Because law is often inherently “incomplete,” the power to interpret and develop law so that it applies to new cases must also be allocated.⁸⁸ Courts, and at times a public regulator, may take on this residual “lawmaking” role.⁸⁹

In common law systems, courts are vested with original lawmaking power, while in civil law systems, judges are said to interpret and not “make” law.⁹⁰ The notion of residual lawmaking implies that the wording of the relevant statute does not directly apply to a particular set of facts. A civil law judge who “interprets” the statute to apply essentially serves a residual lawmaking function. In theory, civil law judges are less constrained than common law judges in their application of law because they are not bound by the rule of precedent.⁹¹ However, in civil as well as common law courts, the formal distinction between lawmaking and law interpretation often breaks down. Courts in both systems fill the gaps not expressly codified in law.

Courts differ from regulators in the process and timing of their residual lawmaking power.⁹² Under the general principle of equality before the law, courts are designed to be “neutral arbiters.” They are passive and only adjudicate claims brought by private parties or the State in a criminal prosecution.⁹³ Plaintiffs may ask a court to prevent harmful actions from taking place by filing for a preliminary injunction. However, generally, courts function as lawmakers *ex post*, reacting only after the harm has occurred.

87. Precisely for this reason, some commentators have provocatively argued that in an environment with weak enforcement “no law is better than good law.” The “suboptimal level of deterrence” alluded to here is akin to the enforcement Prisoner’s Dilemma illustrated in Utpal Bhattacharya & Hazem Daouk, *When No Law Is Better Than Good Law*, 13 REV. FIN. (forthcoming 2009), available at <http://ssrn.com/abstract=558021> (last visited June 28, 2009).

88. Pistor & Xu, *supra* note 69, at 933–34.

89. *Id.* at 947.

90. There is considerable debate about whether common law judges “make” law or merely “find” law based on legal principles. See, e.g., Robert D. Cooter & Tom Ginsburg, *Comparative Judicial Discretion: An Empirical Test of Economic Models*, 16 INT’L REV. L. & ECON. 295 (analyzing the “daringness” of judges in different legal systems); Jack G. Day, *Why Judges Must Make Law*, 26 CASE W. RES. L. REV. 563, 563–65 (1976).

91. In practice, lower courts, even in a civil law system, usually adhere to prior rulings of superior courts to avoid being overruled. Nonetheless, the LLSV literature suggests that civil law countries’ courts are less helpful to investors than their common law counterparts. See La Porta et al., *Law and Finance*, *supra* note 3, at 1140 (“[A] strong system of legal enforcement could substitute for weak rules since active and well-functioning courts can step in and rescue investors abused by the management.”).

92. Pistor & Xu, *supra* note 69, at 948.

93. *Id.*

E. *The Public Regulator*

In contrast to courts, the public regulator can make and enforce law proactively.⁹⁴ While courts must remain passive and wait for private parties to bring suit, the regulator may intervene on its own initiative to control market entry, monitor and investigate market actors, and enjoin and sanction violators. The regulator employs its residual law-making power (*i.e.*, rulemaking) and its enforcement power “both *ex post* and *ex ante*.”⁹⁵ So long as the regulator stays within the scope of its statutory powers, it retains a high degree of flexibility.⁹⁶ Legislatures, in contrast, face procedural constraints and higher costs when changing the law.⁹⁷

Public regulation comes with significant costs. An administrative agency requires funding to hire monitors and investigators, maintain a filing system, and launch enforcement actions if so empowered.⁹⁸ Over or under-regulation by the regulator also imposes indirect societal costs.⁹⁹ Over-regulation exists when the costs of proactive *ex ante* law enforcement outweigh the benefits. Regulation may, for example, enjoin too many potentially beneficial actions and stifle economic activity.¹⁰⁰ Under-regulation exists when the regulator, often as a result of resource constraints or misallocation, fails to respond to harmful actions. Finally, agencies are more susceptible to capture because agencies deal with the same industry players on a daily basis while courts deal with a more dispersed population. A regulator may favor certain influential entities (*e.g.*, future employers), extract bribes from regulated parties, and punish political opponents.

F. *A Web of Institutions*

Part One has described an integrated set of institutions designed to check the negative effects of information asymmetry and self-dealing. Multiple reputational intermediaries vouch for different aspects of a company's disclosure. A public regulator and private investors, assisted by the courts and through enforcement actions, police issuers and secondary actors. The complexity of this web helps explain the difficulties

94. *Id.*

95. *Id.* at 949.

96. *Id.* at 950.

97. *Id.*

98. For this reason, Jackson & Roe have argued for a “resource based” measure of public enforcement. See Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence* (Harvard Pub. Law Working Paper No. 08-28, 2009), available at <http://ssrn.com/abstract=1000086> (last visited June 28, 2009) (settling on staffing levels and budgets as proxies for oversight of capital markets in an inter-country comparative study of public versus private enforcement).

99. *Id.* at 5-6.

100. Pistor & Xu, *supra* note 69, at 951.

faced by countries such as the Czech and Slovak Republics, Lithuania, and Romania, all of which attempted to create capital markets by transplanting these institutions post-socialism.¹⁰¹ “Shock therapy”—the dominant policy prescription for transition economies of the 1990s—called upon countries to privatize and, frequently, to list all former state-owned enterprises (SOEs) on national exchanges in a highly accelerated fashion.¹⁰² The Western advocates of mass privatization did not sufficiently appreciate the enormity of the institution-building task before them or whether, in fact, “core” institutions fit the target country’s pre-existing institutional mix.¹⁰³ With these experiences in mind, the remainder of this Note discusses the Chinese case and the indigenous institutions that have helped China develop increasingly vibrant capital markets and issuers able to raise capital across the globe.

II. CHINESE CHARACTERISTICS

There is something about stock markets—archetypal symbols of capitalism—in an ostensibly Communist China that presents an intellectually tantalizing riddle. Officially constituted as the Shanghai and Shenzhen stock exchanges in 1990 and 1991 respectively, national-level stock markets arrived in China more than a decade after the initiation of Deng Xiaoping’s Opening-up and Reform Program.¹⁰⁴ The advent of China’s stock markets did not coincide with privatization; far from it, “until 2000 about two-thirds of all listed company shares were owned by various government entities.”¹⁰⁵ In the late 1990s, the government was the dominant shareholder in 43.9 percent of listed firms, and in about one-third of these, the government owned a stake greater than 50 percent.¹⁰⁶

These numbers suggest that China’s stock market was created first and foremost as a tool for SOE financing and reform, and not as a means of offering members of the general public a way to diversify their in-

101. Anete Pajuste, *Corporate Governance and Stock Market Performance in Central and Eastern Europe: A Study of Nine Countries, 1994–2001*, at 3–4 (Apr. 15, 2002) (unpublished manuscript, available at <http://ssrn.com/abstract=310419> (last visited June 28, 2009)).

102. See Black et al., *supra* note 17, at 1739–42 (reexamining the pitfalls of mass privatization and share consolidation in the Russian and Czech contexts).

103. See source cited *infra* note 158.

104. See generally STEPHEN GREEN, *CHINA’S STOCKMARKET: A GUIDE TO ITS PROGRESS, PLAYERS AND PROSPECTS* 9–36 (2003) (providing an important account of the events leading up to the establishment of the exchanges in 1990 and 1991).

105. Cheng Guo et al., *Understanding the Chinese Stock Market*, 18 J. CORP. ACCT. & FIN. 13, 14 (2007).

106. Lihui Tian, *Government Shareholding and the Value of China’s Modern Firms* 33 (Univ. of Mich. William Davidson Instit., Working Paper No. 395, 2001).

vestment portfolios and hedge future risk. This section will review the reform processes that led to the creation of China's equity markets and highlight certain unique characteristics that have and will likely continue to color the markets' evolution. While the future evolution of Chinese corporate governance remains to be seen, the firms that populated China's financial markets at their inception offered a significant contrast to the "standard" shareholder-oriented model characteristic of developed world, capitalist economies.¹⁰⁷

A. *The SOE Problem*

The failure of the state-owned sector constituted the main challenge motivating the architects of China's "gradualist" approach to economic reform. Although the first signs of a market economy bubbled up from local initiatives in the agricultural sector,¹⁰⁸ central authorities recognized at an early stage that the reform program had to address the underperformance of the state-owned sector.¹⁰⁹ The state-owned sector was too large, and its social and political significance too great, to allow the long-run trend of declining efficiency to persist.

The SOE problem has dominated Chinese law and policymaking during the reform era (1978 to the present).¹¹⁰ Until 1998, the Communist Party Central Committee or provincial committee determined the appointment, promotion, or dismissal of senior managers of large SOE and enterprise groups.¹¹¹ Managers rotated through a revolving door between enterprise and government postings as they moved up the political ranks.¹¹² Traditionally, under the planned-economy, SOEs received all

107. See John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641 (1999) (positing that globalization may effect a high degree of convergence through corporate migration and stock exchange harmonization); Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329 (2001) (distinguishing between "formal" convergence and "functional" convergence); Henry Hansman & Reiner Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2000) (arguing for convergence toward a single standard model of corporate governance). *But see* Lucian Arye Bebchuck & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999) (presenting a theory of "path dependence" of corporate governance structures).

108. See generally BARRY NAUGHTON, *GROWING OUT OF THE PLAN: CHINESE ECONOMIC REFORM, 1978–1993*, at 137–68 (1995).

109. *Id.* at 100 (describing the initial enterprise reform plan as conceived by Xue Muqiao and his cohorts as early as December 1979 and August 1980).

110. Some commentators have even called the traditional SOE "the most important form of economic organization in modern Chinese history." See Clarke, *supra* note 10, at 8.

111. STOYAN TENEV ET AL., *CORPORATE GOVERNANCE AND ENTERPRISE REFORM IN CHINA: BUILDING THE INSTITUTIONS OF MODERN MARKETS* 23 (2002).

112. Beginning in the late 1990s, certain municipalities and provinces began to experiment with various levels of indirect state control, largely exercised by state-authorized

funding from various government bureaus, and banks allocated the funds to firms according to government direction.¹¹³ Money received directly from its government administrative unit was called a grant; money received from a bank was called a loan. Regardless of whether grant or loan, firms operated under a soft budget constraint and were under no real pressure to demonstrate a profit or repay.¹¹⁴ Insofar as there was a “capital market,” firms competed for capital in political and bureaucratic fora.

Ideological and institutional constraints, including the absence of property rights and a rule of law tradition, ruled out a program of mass privatization for China.¹¹⁵ Rather than immediately undertake the complex task of importing and implementing Western-style market institutions, the policy response was to preserve the state-owned sector but implement a leaner, more market responsive variant of state ownership. For example, SOE reform during the 1980s focused on delegating more managerial authority to the enterprise level.¹¹⁶ The reforms also reduced the share of output from the state plan. Production in excess of certain fixed targets could be sold at market prices at management’s discretion.¹¹⁷

While these initial reforms sensitized enterprise management to market forces, significant problems still remained. First, the reforms failed to establish uniformly market-determined prices.¹¹⁸ Continuing price controls forced many firms to operate at a loss. Moreover, the dual-track price system created enormous incentives for corruption.¹¹⁹ Transferring a good outside of the plan could exponentially raise its price.¹²⁰ Separately, the insistence that financial contracts with relevant ministries be negotiated on an enterprise-by-enterprise basis precluded the development of a modern tax system with rates applied uniformly and

municipal or provincial-level holding companies. *See id.* at 25–26 (describing the so-called “Shenzhen-Shanghai Model”).

113. NICHOLAS R. LARDY, CHINA’S UNFINISHED ECONOMIC REVOLUTION 60 (1998) (“[I]nvestment was financed predominantly from interest-free budgetary grants [and to a lesser extent] . . . loans to state-owned firms to finance their investment in fixed assets and . . . working capital needs.”).

114. *See* JANOS KORNAI, ECONOMICS OF SHORTAGE 302–14 (1980); Janos Kornai, *The Soft Budget Constraint*, 39 KYKLOS 3 (1986).

115. *See* LARDY, *supra* note 113, at 21. For an in-depth account of the debates on reform strategy, *see* NAUGHTON, *supra* note 108, at 187–96.

116. *See* LARDY, *supra* note 113, at 22.

117. NAUGHTON, *supra* note 108, at 202.

118. LARDY, *supra* note 113, at 23; *see* NAUGHTON, *supra* note 108, at 228.

119. NAUGHTON, *supra* note 108, at 230 (“The dual-track strategy . . . present[ed] a particularly rich menu of temptations to corruption.”).

120. *Id.* at 230–31.

impartially.¹²¹ Furthermore, between 1977 and 1993, employment in the state sector rose by almost 40 million and finally stabilized at just over 110 million.¹²² Throughout this period, total factor productivity declined and profits fell.¹²³ By 1996, the state-owned sector profits as a percent of GDP was less than one percent.¹²⁴

The low level of profits translated to meager retained earnings, and consequently, SOEs relied heavily on credit to finance working capital needs.¹²⁵ Under these circumstances, the four large, state-owned banks refused to hold SOEs accountable for their debts, and the *status quo ante* soft budget constraint and failure to monitor perpetuated.¹²⁶ The Provisional Enterprise Bankruptcy Law passed in 1986 and, although specifically applicable to SOEs, was rarely applied.¹²⁷ Political concerns about unemployment and social stability led to reluctance to allow liquidation of loss-making state-held firms. China's banks held a massive portfolio of non-performing loans and became technically insolvent.¹²⁸

B. Corporatization (Not Privatization)

In the midst of this crisis, economic reformers turned to the stock markets as an alternative to bank lending to provide new sources of capital to the state sector. Chinese domestic savings represented a tremendous capital resource. The stock markets could serve as a conduit to channel domestic savings and passive foreign investment into the ailing SOEs. Traditionally, banks functioned as the worst kind of intermediary. Savings were deposited in state banks, and the banks in turn channeled the money to underperforming SOEs as loans. With no monitoring, most of these loans became bad debts. The hope was that the stock market as a new kind of intermediary could induce an efficient allocation of capital.¹²⁹

These ideas arose in tandem with a new round of reforms designed to separate the business and administrative functions of SOEs. In 1993, the Standing Committee of the National People's Congress passed the

121. *Id.* at 228–29.

122. LARDY, *supra* note 113, at 26.

123. *Id.*

124. *Id.* at 34.

125. *Id.* at 39–43.

126. *Id.*

127. *Id.* at 23.

128. In 2006, an audit by a major international accounting firm estimated China's non-performing loans (NPLs) as over USD \$900 billion. See Tian & Estrin, *supra* note 8, at 464. These bad loans were a legacy of the reform period—not of the planned economy. *Id.*

129. See generally LARDY, *supra* note 113.

Company Law.¹³⁰ The stated intent of the 1993 Company Law was to introduce “diversified” forms of ownership and thereby impose a framework of modern corporate governance on state-owned firms.¹³¹ An SOE could be converted into a joint stock company (*gufen youxian gongsi*), a limited liability company (*youxian zeren gongsi*), or classified as a wholly state-owned company (*guoyou duzi gongsi*)—the latter essentially an SOE holdover and subgenre of the limited liability company. Symbolic pillars of Chinese industry, “enterprises owned by all the people” (*quanmin suoyouzhi qiye*) were transformed into enterprise legal persons formed as companies.

The ideological limitations embodied in the Company Law are worth emphasizing.¹³² Critically, corporatization was never privatization.¹³³ Ownership of SOEs was disaggregated into share participation in newly established legal persons. With the relevant approval, a small percentage of those shares might be issued to the public on a national or overseas stock exchange for corporate finance purposes. The State, however, insisted upon maintaining a controlling stake—usually as much as 75–85 percent.¹³⁴ Corporatization was specifically designed to avoid privatization. Non-state investors could not easily obtain control of corporatized, listed SOEs because the State retained an overwhelming majority of shares in the company. These state-held shares carried restrictions on ownership and transferability.¹³⁵ Shares retained by the State in an IPO or owned by the State in non-public joint stock companies were designated “state shares” (*guoyou gu*).¹³⁶ Similarly, “legal person shares” (*faren gu*) were typically held by the SOEs and financial institutions that contrib-

130. Zhonghua Renmin Gongheguo Gongsi Fa [Company Law of the People’s Republic of China] (promulgated by the Standing Comm. Nat’l People’s Cong., Dec. 29, 1993, effective July 1, 1994) ZHONGGUO FALÜ NIANJIAN [1994 LAW YEARBOOK OF CHINA]. The Company Law was substantially amended in 2005. See Zhonghua Renmin Gongheguo Gongsi Fa [Company Law of the People’s Republic of China] (amendments promulgated by the Standing Comm. Nat’l People’s Cong., Oct. 27, 2005, effective Jan. 1, 2006), 2006 ZHONGGUO FALÜ NIANJIAN [2006 LAW YEARBOOK OF CHINA].

131. LARDY, *supra* note 113, at 24.

132. TENEV ET AL., *supra* note 111, at 5 (noting the “important shift in ideology” that accompanied China’s market-oriented reforms and concomitant corporatization strategy).

133. See Nicholas C. Howson, *The Doctrine that Dared Not Speak Its Name: Anglo-American Fiduciary Duties in China’s 2005 Company Law and Case Law Intimations of Prior Convergence*, in TRANSFORMING CORPORATE GOVERNANCE IN EAST ASIA 209 (Hideki Kanda et al. eds., 2008) (describing China’s adoption of the corporate form as “mere corporatization rather than privatization”).

134. For an excellent analysis of the (conflicting) goals of the Company Law and the corporatization project, see Donald C. Clarke, *Corporate Governance in China: An Overview*, 14 CHINA ECON. REV., 494, 497–500 (2003).

135. *Id.*

136. CARL E. WALTER & FRASER J.T. HOWIE, PRIVATIZING CHINA: THE STOCK MARKETS AND THEIR ROLE IN CORPORATE REFORM 77–78 (2003).

uted capital to the restructuring before the IPO.¹³⁷ State shares could not be traded on the stock exchanges, and legal person shares could only be traded between legal persons.¹³⁸ Until recently, the typical shareholding pattern in listed companies was about 30 percent each for the State, legal persons, and domestic shareholders (holders of RMB-traded public shares), and 10 percent for foreigners and employee shareholders.¹³⁹

C. Corporate Governance with Chinese Characteristics

This history brings into sharp relief several characteristics particularly relevant to the Chinese case. While a high level of ownership concentration is actually the norm outside the context of Anglo-American common law systems, the identity of the controlling shareholder in China—the State—is distinctive.¹⁴⁰ This fact has had important second order implications. Large shareholders under certain circumstances will monitor firm managers, since it is in their economic interest to ensure that managers maximize profits.¹⁴¹ When the large shareholder is a state body, however, the absence of an ultimate human principal with rights to residual earnings makes for an ineffective monitor.¹⁴² The State may have social or political goals that take priority over profit-maximization, e.g., preventing unemployment or developing a strategic industry sector.¹⁴³ Even if the State did prioritize profit-maximization, the agents of the State delegated with the actual monitoring responsibility often have interests that diverge from their principal—they may be subject to local influences, and bureaucratic command structures may not be clearly defined.¹⁴⁴

Other conventional pressures toward achieving the profit-maximization norm include a reasonably efficient capital market and an active market for corporate control, but particularities of the Chinese case substantially undermined these pressures.¹⁴⁵ In countries with high ownership concentration, controllers invariably enjoy certain private benefits of control, such as “the perquisites enjoyed by top executives” or the “psychic” value some shareholders attribute to simply being in

137. *Id.*

138. *Id.* at 80.

139. Xiaonian Xu & Yan Wang, *Ownership Structure and Corporate Governance in Chinese Stock Companies*, 10 CHINA ECON. REV. 75, 76 (1999).

140. See La Porta et al., *Law & Finance*, *supra* note 3, at 1146–48.

141. See Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 754–55 (1997) (discussing how large investors reduce agency costs).

142. Donald C. Clarke, *The Role of Non-Legal Institutions in Chinese Corporate Governance*, in TRANSFORMING CORPORATE GOVERNANCE IN EAST ASIA 168, 179 (Hideki Kanda et al. eds., 2008) (describing the “absent owner” (*suoyouzhe quewei*) phenomenon).

143. *Id.*

144. *Id.* at 179–80.

145. See *id.* at 180.

control.¹⁴⁶ Controllars should want to assure investors that they will not engage in tunneling or other corporate misfeasance since such conduct will lead to discounted share prices. If share prices decline, then the company will have to issue more shares in order to raise capital, and this will lead to dilution and loss of control. Discounted share prices may also leave the company vulnerable to a takeover. However, Chinese state-controlled firms could readily obtain financing from the state-controlled banks,¹⁴⁷ so they did not need to rely upon the equity markets. Furthermore, because typically over three-quarters of the firm's equity holdings were illiquid state-held blocks, independent parties were hard-pressed to mount a successful takeover.¹⁴⁸

Courts and administrative agencies might also play a disciplining role. As in all cases of high ownership concentration, a crucial challenge of corporate governance is combating horizontal agency costs. However, since the large shareholder engaging in opportunistic behavior was a state actor, impartial disciplining was exceedingly difficult. The state shareholder typically received preferential treatment from the courts.¹⁴⁹ The intermediate people's court in the jurisdiction of the defendant's domicile generally adjudicated securities fraud cases.¹⁵⁰ The

146. See Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 540–43 (2004) (introducing a theoretical framework to measure private benefits of control).

147. See *supra* Part II.A. Interestingly, "private benefits of control are highest in former communist countries . . ." Dyck & Zingales, *supra* note 146, at 588.

148. See Clarke, *supra* note 142, at 180 ("So far, at least, there is no hostile takeover activity to speak of in China").

149. The flaws of the Chinese judiciary—most notably, a lack of independence—are well documented. See, e.g., TENEV ET AL., *supra* note 111, at 21 ("[L]ocal authorities have appointive and financial power over judicial and law enforcement departments and may obstruct enforcement of court judgments."); see also Clarke, *supra* note 134, at 503 ("Chinese courts are not politically powerful and are hence reluctant to take cases involving large sums of money and powerful defendants."). But see Howson, *supra* note 133, at 198 ("Chinese courts have proven perfectly willing and technically able to invoke and enforce, on their own and without statutory authorization . . . basic corporate fiduciary duty norms.").

150. Zhonghua Renmin Gongheguo Minshi Susong Fa [Civil Procedure Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 9, 1991, effective upon promulgation) art. 22 (geographical jurisdiction); Zuigao Renmin Fayuan Guanyu Shouli Zhengquan Shichang Yin Xujia Chenshu Yinfa de Minshi Qinquan Jiufen Anjian Youguan Wenti de Tongzhi [A Notice by the Supreme People's Court on Issues Related to the Pleading Requirements of Private Right of Action Involving False or Misleading Statement on the Securities Markets] (issued by the Sup. People's Ct., Jan. 15, 2002) art. 5, TIANYA FALÜ WANG, available at <http://www.hicourt.gov.cn/law/show.asp?fileno=1045> (last visited June 28, 2009) [hereinafter SPC Second Circular]; Zuigao Renmin Fayuan Guanyu Shenli Zhengquan Shichang Yin Xujia Chenshu Yinfa de Minshi Peichang Anjian de Ruogan Guiding [Several Rules by the Supreme People's Court on the Adjudication of Civil Damages Cases Arising from False Disclosure Involving Securities] (issued by the Sup. People's Ct., Feb. 1, 2003) art. 9 translated in 2004 ZHONGGUO FALÜ NIANJIAN [2004 LAW YEARBOOK OF CHINA] [hereinafter SPC Rules].

listed corporation was generally owned and controlled by the local government where the court sat, and judges owed their positions to these very same authorities.¹⁵¹ Finally, the public regulator was put in the awkward position of having to pose as “policeman” and “cheerleader” of the market at the same time. On the one hand, the regulator served to make rules, monitor market players, and carry out enforcement actions to ensure that information disclosures were credible and the market functioned efficiently. On the other hand, it was politically important that SOE stock continued to trade at a high price. The securities markets were conceived to facilitate transfers of capital to the state-sector and to advance the State’s political and social objectives. Clamping down on self-dealing, or obstructing the flow of funds into the markets from illegal sources (*e.g.*, market manipulation), thus often harmed the interests of state actors.

III. THE CHINESE PUZZLE

Given the accepted institutional preconditions for strong securities markets and the particular motivations for securities markets in China, China’s success appears counter-theoretical. Chinese legal institutions were weak and enforcement was unpredictable. Disclosure requirements were violated with some frequency.¹⁵² High profile media exposés revealed reputational intermediaries’ involvement in schemes to defraud investors.¹⁵³ In the IPO context, the circumstances were ripe for promoters to abscond with their newly acquired equity capital, which happened with some frequency. Indeed, the promoter’s problem was basically institutionalized.¹⁵⁴ SOEs underpriced their shares, allowing

151. See STANLEY B. LUBMAN, *BIRD IN A CAGE: LEGAL REFORM IN CHINA AFTER MAO* 263–66 (1999) (discussing the influence that the local party-state wields over courts).

152. See ZHU SANZHU, *SECURITIES REGULATION IN CHINA* 107–10 (2000) (discussing enforcement of disclosure requirements).

153. See, *e.g.*, Peter Montagnon, *China Blames Two Firms for Bonds Scandal*, *FIN. TIMES*, Sept. 22, 1995, at 5 (reporting that China’s second largest securities firm was found to have willfully violated trading rules by rigging prices and manipulating the treasury bond futures market); Tony Walker, *China Plans to Resume Bond Futures Trading*, *FIN. TIMES*, Apr. 24, 1996, at 26. Market manipulation was known to be widespread in the equities markets. For a thorough analysis by the Chinese-language media outlet at the forefront of investigative reporting for financial news, see Ping Hu & Li Qing, Jijin Heimu, *Guanyu Jijin Xingwei de Yanjiu Baogao Jiexi* [*Behind the Dark Curtain: Research Report and Analysis on Fund Behavior*], *CAIJING*, Oct. 2000, available at <http://news.hexun.com/2008-09-14/108855569.html> (last visited June 28, 2009).

154. Professor Barry Naughton cogently characterizes this “institutionalized corruption” in terms of a “triangle of interests” including the SOEs and their patrons, the securities companies, and the China Securities Regulatory Commission (CSRC) itself. See Barry Naughton, *The Politics of the Stock Market*, *CHINA LEADERSHIP MONITOR*, Summer 2002, at

favored insiders to buy low and sell quickly at the higher market price. An initial price “pop” was generally assured because the government limited the annual share issuance (through the quota system).¹⁵⁵ In the post-IPO stage, self-dealing by a state-affiliated dominant shareholder was similarly easy. Large shareholders of corporatized SOEs diverted cash for their own personal consumption by siphoning off and selling assets or utilizing bankruptcy to liquidate while leaving priority creditors’ claims unsatisfied.¹⁵⁶

Nonetheless, asset stripping in China never reached the degree of egregiousness as in Russia or other former Soviet Union countries,¹⁵⁷ and the adverse selection death spiral never really occurred. Instead, China’s stock markets showed exceptional growth during the 1990s according to the World Bank.¹⁵⁸ While Part IV will offer a partial explanation for China’s success, this Part first lays the foundation through a more rigorous analysis of the performance of China’s stock markets and of the impact (or lack thereof) of China’s “core” institutions.

A. Interlude: The Former Soviet Union Cases Considered

According to conventional wisdom, the conditions in China should have sapped the vitality of the financial markets. Widespread “tunneling” in the Czech Republic—once a darling of Western legal academia¹⁵⁹—decimated the Prague Stock Exchange within five years following that country’s privatization overhaul.¹⁶⁰ Perhaps more famously, the Russian financial markets, notwithstanding a corporate law that was reputedly “self-enforcing,”¹⁶¹ fell prey to a cadre of klep-

6–7, available at <http://www.hoover.org/publications/clm/issues/2906711.html> (last visited June 28, 2009).

155. GREEN, *supra* note 104, at 162–64 (arguing that controlling share volume and systematic underpricing assured the success of SOE IPOs).

156. See TENEV ET AL., *supra* note 111, at 22.

157. *Id.* at 23.

158. See China: The *Emerging Capital Market* 1 (World Bank, Rep. No. 14501-CHA, 1995) [hereinafter World Bank].

159. See, e.g., John C. Coffee, Jr., *Institutional Investors in Transitional Economies: Lessons from the Czech Experience*, in 1 CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA: BANKS, FUNDS, AND FOREIGN INVESTORS 111 (Roman Frydman et al. eds., 1996).

160. See Black et al., *supra* note 17, at 1790–97.

161. For the seminal article outlining this model, see Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911 (1996). Professors Black & Kraakman offer a sobered analysis a few years later:

The privatizers, ourselves included, underestimated the extent to which functioning law requires honest courts and prosecutors that can redress gross violations. We called the Russian company law that we helped draft a “self-enforcing” model because we thought that stating sensible rules could encourage corporate norms to coalesce around those rules (even with minimal enforcement) Instead, self-

tocrats.¹⁶² These kleptocrats acquired the largest Russian SOEs from the government for astonishingly low prices and then looted the companies' assets.¹⁶³

Like corporatization in the Chinese setting, privatization in former Soviet States was designed to align the incentives of company managers and large shareholders with the company as a whole. Theoretically, insiders would advance profit-maximization for the firm to maximize their own personal returns. Of course, it did not turn out this way, and at least two forms of adverse selection besieged the Russian market. On one level, an unfriendly government bureaucracy resorted to punitive taxation and corruption.¹⁶⁴ Moreover, since the threat of expropriation or re-nationalization loomed large, managers looked to maximize short-term gains.¹⁶⁵ In a hostile and uncertain environment such as that, a controlling stake was worth more to a dishonest owner, who would extract all of the firm's value, than to an honest owner, who would gradually build value and share it with minority shareholders.¹⁶⁶ Managers would hide whatever earnings the firm did accrue, thereby contributing to a severe lack of transparency and overall information asymmetry.¹⁶⁷ Consequently, government revenues did not improve, bureaucrats continued their predatory practices, and the downward spiral continued. On a second level, the fact that corporate financial statements did not reflect a company's true health discouraged outside

dealing transactions were hidden, courts were of little help . . . and managerial culture coalesced around concealing self-dealing instead of disclosure

Black et al., *supra* note 17, at 1756.

162. *E.g.*, Black & Kraakman, *supra* note 161, at 1924–25 (describing how between summer 1994 and late 1995 Russian share prices fell roughly 75 percent).

163. The Russian government bundled controlling stakes in many of the largest industrial enterprises—in the oil and gas, electric power, and telecom sectors—into several holding companies and then sold controlling stakes in those holding companies to a favored few. Black et al., *supra* note 17, at 1741.

164. *See id.* at 1757–62 (discussing the various forms of punitive taxation and corrupt practices by tax inspectors in Russia).

165. *See id.* at 1763–64.

166. *See id.* at 1737. *But see* Diana Yousef-Martinek et al., *Yukos Oil: A Corporate Governance Success Story?*, CHAZEN WEB J. INT'L BUS. 3 (2003), http://www1.gsb.columbia.edu/mygsb/faculty/research/pubfiles/715/Yukos_proof.pdf (last visited June 28, 2009) (describing the rise of Yukos CEO, Mikhail Khodorkovsky, and his transformation “from ‘corporate governance nightmare’ to poster child of the Russian market”). Not unlike the Russian stock market, Mr. Khodorkovsky's rise was followed by a tumultuous fall: he was sentenced to eight years in prison for fraud and tax evasion in 2005. *See Times Topics: Mikhail B. Khodorkovsky*, Last Updated Mar. 3, 2009, http://topics.nytimes.com/top/reference/timestopics/people/k/mikhail_b_khodorkovsky (last visited July 16, 2009).

167. The threat of expropriation in Russia during the 1990s was so dire that managers resorted to extensive barter chains rather than leave a record of financial transactions. Black et al., *supra* note 17, at 1757.

investment.¹⁶⁸ Outside investors who bought shares saw their shares' value decline as a result of rampant self-dealing and quite rationally sold their shares hoping to cut their losses.¹⁶⁹ An environment of acute risk aversion such as this gave little reason to issue shares on the exchanges, and so the viability of the market spiraled downward in lockstep.

True, China corporatized, and has been privatizing gradually, while the former Soviet Union countries typically engaged in accelerated privatization. However, these two divergent paths cannot be reduced to mere speed of privatization. Professor Black and his co-authors suggest that a poor institutional environment, regardless of the pace of privatization, will lead to crippling self-dealing. They point to Ukraine, which has been slow to privatize but has suffered an economic fate even worse than that of Russia.¹⁷⁰ Decoding the forces that made China's stock markets work requires an in-depth look at China's institutional environment.

B. China's Development of "Core" Institutions

China's development of the so-called "institutional preconditions"¹⁷¹ for strong securities markets started late and evolved in a series of (sometimes violent) fits and starts. State intervention in the economy is a deep-seated intellectual current going back millennia.¹⁷² In the 1870s, China's first wave of modern, profit-oriented private enterprise was sponsored and supervised by provincial governors-general.¹⁷³ Local governments could be considerably intrusive toward business. For example, they might enforce a range of licensing and tax requirements to extract fees and rents. Officials' involvement in early joint-stock experiments provided shareholders with property protection.¹⁷⁴ For the most part, businesses were suspicious of the public as shareholders¹⁷⁵ and preferred

168. *Id.* at 1763.

169. *Id.*

170. *Id.* at 1736.

171. Black, *supra* note 6.

172. The Legalists, a philosophical school that influenced the ruling elite during the Qin Dynasty (221 BC–207 BC) and afterward, articulated the primary concern of the State as the accumulation of wealth and power. See WELLINGTON K. K. CHAN, *MERCHANTS, MANDARINS, AND MODERN ENTERPRISE IN LATE CH'ING CHINA* 67 (1977).

173. *Id.* at 69–70 (providing an account of the China Merchant's Steam Navigation Company sponsored by Governor-General Li Hongzhang); see also CHI-KONG LAI, *The Qing State and Merchant Enterprise: The China Merchants' Company, 1872–1902*, in *TO ACHIEVE SECURITY AND WEALTH: THE QING IMPERIAL STATE AND THE ECONOMY, 1644–1911*, at 139–55 (Jane Kate Leonard & John R. Watt eds., 1991) (showing that while the State provided financing through loans and forgiveness of debt, the two large shareholders wielded a significant degree of autonomy in running the firm).

174. See William C. Kirby, *China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China*, 54 *J. ASIAN STUD.* 43, 50 (1995).

175. As late as the second decade of the twentieth century, Chinese industrialists resisted the formation of joint-stock companies. Competitive pressures from British-American To-

mortgages, collection of rents, and land speculation over issuance of shares as methods of raising capital.¹⁷⁶ This was notwithstanding the promulgation of the Company Law in 1904 and the Ordinance Concerning Commercial Organizations in 1914, which drew heavily on German commercial law and allowed for limited liability joint-stock companies.¹⁷⁷ For at least a decade before 1914, when the Shanghai Securities Dealers Association was founded, company stock was traded in Shanghai teahouses with no standards of accounting or disclosure whatsoever.¹⁷⁸

The 1920s witnessed a golden age for the development of China's securities markets. Self-regulating industry organizations such as the Shanghai Native Bankers Association, the Shanghai Securities Brokers/Dealers Association, and others emerged to bolster contract enforcement, market conduct, and property rights and to fill the gaps left by the struggling Guomindang State.¹⁷⁹ By 1921, more than 140 securities exchanges were in Shanghai, and 52 exchanges were scattered throughout China's other major commercial hubs.¹⁸⁰ Standardized rules and viable networks of financial intermediaries had begun to gel.

This foundation was summarily disassembled when Mao Zedong came to power in 1949. The Cultural Revolution (1967–77) went further and led to the dismantling of the formal legal system.¹⁸¹ Unlike other transition countries, China's market reforms during the last two decades of the twentieth century did not establish a legal framework based on private property rights.¹⁸² The 1994 Company Law was clearly geared toward enterprises with state-held ownership structures, and the *raison de être* of the stock markets and the 1999 Securities Law was to obtain financing for the ailing state sector.

1. Disclosure

Not long after the establishment of the national stock exchanges in the reform era, the letter of the law reflected a fairly comprehensive

bacco finally forced the most prominent Chinese cigarette manufacturer of the time to accept begrudgingly the corporate form and issuance of equity shares. See SHERMAN COCHRAN, *BIG BUSINESS IN CHINA: SINO-FOREIGN RIVALRY IN THE CIGARETTE INDUSTRY, 1890–1930*, at 96–102 (1980) (detailing the intra-familial debate surrounding the decision to incorporate the Nanyang Brothers Tobacco Company).

176. Kirby, *supra* note 174, at 50.

177. *Id.* at 49.

178. Zhiwu Chen, *Stock Market in China's Modernization Process—Its Past, Present, and Future Prospects* 15 (June 1, 2006) (unpublished working paper, on file with author).

179. *Id.* at 17.

180. *Id.* at 15–16.

181. See generally LUBMAN, *supra* note 151.

182. Protection of private property was not guaranteed by the Constitution until 2004. See XIAN FA arts. 6, 13 (2004) (P.R.C.).

disclosure regime;¹⁸³ the difficulty has been enforcement. By 1993, the regulatory framework provided for disclosure concerning initial public offerings as well as continuing disclosure in annual and interim reports.¹⁸⁴ In theory, a listed company that failed to comply with these disclosure rules faced tough penalties. The rules called for administrative sanctions ranging from fines to delisting.¹⁸⁵

Regulators, however, struggled to effectively implement these disclosure requirements. The record of disclosure was particularly abysmal during the 1990s. Listed companies frequently got away with ignoring the rules. According to a 1994 report by the China Securities Regulatory Commission, of the 183 companies listed on the domestic exchanges, thirty-four companies submitted only abstracts of their annual report, and fourteen companies did not submit annual reports at all.¹⁸⁶ The reports that were submitted contained substantial omissions and irregularities.¹⁸⁷

The emphasis on administrative regulations may have been part of the problem. By mandating disclosure of a discrete list of items, lawmakers may have led issuers to believe that information not expressly stipulated in the regulations did not need to be disclosed. Of course, formulating a list of all information relevant to investors is impossible—hence the utility of an undefined “materiality” standard. The situation improved somewhat with the promulgation of the Securities Law in 1998, which stated that otherwise unknown “major events” (*zhongda shijian*) that could have a “material effect” (*chansheng jiao da yinxiang*)

183. The Company Law required listed companies to publish a financial accounting report every half year. See *Zhonghua Renmin Gongheguo Gongsifa* [Company Law of the People's Republic of China] art. 156 (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1993, effective July 1, 1994) 1994 ZHONGGUO FALÜ NIANJIAN [1994 LAW YEARBOOK OF CHINA]. Provisional regulations set out more detailed requirements, mandating the reporting of price sensitive information in interim reports and annual reports. See, e.g., *Gupiao Faxing yu Jiaoyi Guanli Zanzing Tiaoli* [Provisional Measures for the Administration of the Issuing and Trading of Securities] (promulgated by the State Council, Apr. 20, 1993, effective immediately upon promulgation) arts. 57–67, 1994 ZHONGGUO FALÜ NIANJIAN [1994 LAW YEARBOOK OF CHINA] [hereinafter 1993 Provisional Measures on Share Issuing].

184. 1993 Provisional Measures on Share Issuing, *supra* note 183, art. 57.

185. *Id.* art. 74. Moreover, with the amending of the Criminal Law in 1997, company managers directly responsible for false reporting could serve up to seven years in prison. See *Zhonghua Renmin Gongheguo Xingfa* [Criminal Law of the People's Republic of China] (amended Mar. 14, 1997, effective Oct. 1, 1997) arts. 158–69, 1998 ZHONGGUO FALÜ NIANJIAN [1998 LAW YEARBOOK OF CHINA] (imposing criminal liability for violations of the Company Law).

186. Xin Zhen, Cushi Shangshi Gongsifa Guifanhua Yunzuo: *Zhengjianhui Jiaqiang Zhengquan Shichang Xinxi Pilu Guanli* [Encouraging Regulatory Compliance for Listed Companies: CSRC Strengthens Oversight over Information Disclosure for the Securities Markets], RENMIN RIBAO [PEOPLE'S DAILY], July 19, 1994, at 2.

187. *Id.*

on a listed company's share price should be promptly reported.¹⁸⁸ In any case, uncertainty on the part of issuers over what constituted a "major event" still probably contributed to the high level of noncompliance which, in turn, made consistent enforcement administratively difficult.¹⁸⁹

2. Reputational Intermediaries

Many commentators have suggested that, in the Chinese context, the classic reputational intermediaries are ill-suited to serve as gatekeepers.¹⁹⁰ A series of scandals rocked the markets during the 1990s, and the role of bankers, accountants, and lawyers in aiding and abetting fraud and market manipulation left these intermediaries with precious little reputational capital.¹⁹¹ The major state banks were the promoters of the three national brokerages, which were all implicated in collaborating with manipulators by taking up shares on inside information and taking parallel proprietary positions.¹⁹² Even joint venture and foreign accounting firms, apparently, were not innocent.¹⁹³ While there have been very few publicized cases of lawyers aiding and abetting fraud, this likely

188. Zhonghua Renmin Gongheguo Zhengquan Fa [Securities Law of the People's Republic of China] adopted Dec. 29, 1998, effective July 1, 1999, art. 61 in 1999 ZHONGGUO FALÜ NIANJIAN [1999 LAW YEARBOOK OF CHINA].

189. For a number of scholarly views on the definition of "false statement," see generally Huan Xiding & Xu Qinzhong, *Shilun Zhengquanfa Zhong de Xujia Chenshu* [On False or Misleading Statements in the Securities Law], 18 ZHENGFA XUEKAN [J. POL. SCI. & LAW] 22 (2001) (P.R.C.); Song Yixin, *Xujia Chenshu Minshi Peichang Susong Zhidu Ruogan Wenti de Sikao* [Thoughts on Several Issues Regarding Rules Related to Securities Litigation Involving False or Misleading Statements], 4 FALÜ SHIYONG 9 (2003).

190. See, e.g., Allen et al., *supra* note 10, at 70 ("[T]he most glaring problem in China's accounting system is the lack of independent, professional auditors, similar to the situation for the legal profession."); Clarke, *supra* note 142.

191. Early on in the capital markets' development, China's second largest securities firm was found to have willfully violated trading rules by rigging prices and manipulating the treasury bond futures market. Such behavior was surely prevalent in the equities markets as well. See Peter Montagnon, *China Blames Two Firms for Bonds Scandal*, FIN. TIMES, Sept. 22, 1995, at 5; Tony Walker, *China Plans to Resume Bond Futures Trading*, FIN. TIMES, Apr. 24, 1996, at 26.

192. In perhaps the most infamous example, a CSRC investigation revealed that market manipulation by Lü Liang was facilitated by 125 securities firms. See WALTER & HOWIE, *supra* note 136, at 156–58. For the Chinese media exposé, see Hu Shuli et al., *Zhuangjia Lü Liang Zhi Yi* [Speculator Lü Liang, Part 1] CAIJING, Feb. 5, 2001; Hu Shuli et al., *Zhuangjia Lü Liang Zhi Er* [Speculator Lü Liang, Part 2] CAIJING, Feb. 5, 2001. For a useful depository of articles on Lü Liang, see generally <http://business.sohu.com/35/13/column200331335.shtml> (last visited June 28, 2009).

193. A joint venture accounting firm and a Hong Kong accounting firm were named defendants in a B share case filed in the Intermediate People's Court of Shenyang for their role in false statements made by a Shanghai-listed company. See *Shenyang Zhongyuan Shenli Jingtang B Gu An, Bimawei Fenzhi Jigou Cheng Beigao* [Shenyang Intermediate People's Court Hears Jingtang B Share Case, KPMG Branch Office to Be Named Defendant], ZHONGGUO ZHENGQUAN BAO HUDONG BAN [CHINA SECURITIES INTERACTIVE], Feb. 11, 2003, <http://www.cs.com.cn/csnews/20030211/327462.asp> (last visited June 28, 2009).

reflects the low probability of sanctions rather than a clean record.¹⁹⁴ Overall, the conduct of intermediaries hardly inspired confidence in investors.

The dysfunctional performance of reputational intermediaries is partly explained by a number of historical, “soft” factors. Independent bankers, auditors, and lawyers had few real antecedents in the pre-reform era. After being disbanded during the Cultural Revolution, the Ministry of Justice had to be reestablished in 1979. After little more than a decade, the educational standards for professionals remained low.¹⁹⁵ More fundamentally, a deeply held suspicion of autonomous organizations and monitoring by internal party apparati left intermediaries, and especially lawyers, with a conflicted sense of their role in society.¹⁹⁶

Reputational intermediaries also failed to police the market because the law did not incentivize them to do so. Chinese lawmakers have struggled to articulate a workable liability standard for accountants. The State Council introduced a vague general tort for certification of false financial information during the late 1980s.¹⁹⁷ The 1994 package of reforms, which included the Company Law, also contained the Law on Registered Accountants. Undefined terms and ambiguities in the language, however, have made courts reluctant to accept financial fraud cases and, if accepted, generally unwilling find in the plaintiffs’ favor.¹⁹⁸ The 1993 Provisional Regulations for the Administration of the Issuing and Trading of Securities, the precursor to the Securities Law, provided for fines and administrative sanctions for accountants and lawyers,¹⁹⁹ and the 1999 Securities Law contained provisions imposing both administrative sanctions and civil liability for false or misleading representations or certifications in the course of securities issuance or trading.²⁰⁰ Intentional or grossly negligent false certification of facts by lawyers, accountants,

194. Clarke, *supra* note 10, at 31.

195. See LUBMAN, *supra* note 151, at 151–60 (1999) (on the legal profession); TENEV ET AL., *supra* note 111, at 120–23 (on the accounting profession).

196. See LUBMAN, *supra* note 151, at 159.

197. See Zhonghua Renmin Gongheguo Zhuce Kuaijishi Tiaoli [People’s Republic of China Regulations on Registered Accountants], issued by the State Council, July 3, 1986, arts. 11, 27, in 1987 ZHONGGUO FALÜ NIANJIAN [1987 LAW YEARBOOK OF CHINA].

198. Clarke, *supra* note 10, at 28–29; Xin Tang, *Protecting Minority Shareholders in China: A Task for Both Legislation and Enforcement*, in TRANSFORMING CORPORATE GOVERNANCE IN EAST ASIA, 141, 147 (Hideki Kanda et al. eds., 2008).

199. 1993 Provisional Measures on Share Issuing, *supra* note 183, art. 73.

200. Zhonghua Renmin Gongheguo Zhengquan Fa [Securities Law of the People’s Republic of China] adopted Dec. 29, 1998, effective July 1, 1999, arts. 161, 189, 202, in 1999 ZHONGGUO FALÜ NIANJIAN [1999 LAW YEARBOOK OF CHINA]; see also Zhonghua Renmin Gongheguo Zhengquan Fa [Securities Law of the People’s Republic of China], as amended Oct. 27, 2005, effective Jan. 1, 2006, arts. 173, 223, in 2006 ZHONGGUO FALÜ NIANJIAN [2006 LAW YEARBOOK OF CHINA].

and other intermediaries could, in theory, also lead to criminal prosecution.²⁰¹ However, a recent inquiry affirmed that civil remedies and administrative sanctions have been rarely imposed, and criminal proceedings have been only marginally more frequent.²⁰²

3. Liability Standards and Private Enforcement in the Courts

Chinese securities laws have traditionally provided a weak basis for civil liability.²⁰³ Courts have been wary of accepting securities cases because of the questionable legal foundation of investors' claims and the politically sensitive nature of fraud perpetrated by state-affiliated dominant shareholders.²⁰⁴ Not until the 2005 amendments to the Securities Law did a statute acknowledge a private right of action for misleading statements or omissions in issuance-related disclosures.²⁰⁵ After a spate of high profile corporate scandals, investors responded with a surge of securities fraud claims between 1999 and 2001.²⁰⁶ None of the claims brought and filed in the people's courts as a result of insider trading, market manipulation, or false statements were allowed to progress to the hearing phase.²⁰⁷ The popular upsurge, however, compelled the Supreme People's Court (SPC) to issue three statements concerning shareholder litigation.²⁰⁸ The SPC

201. See *Zhonghua Renmin Gongheguo Xingfa* [Criminal Law of the People's Republic of China] (amended Mar. 14, 1997, effective Oct. 1, 1997) art. 229.

202. See Clarke, *supra* note 10, at 29–30.

203. As a general matter, China has historically favored administrative and criminal punishments. Zhiwu Chen, *Capital Markets and Legal Development: The China Case*, 14 CHINA ECON. REV. 451, 454 (2003). Even in the 2005 Securities Law, there are over thirty administrative liability provisions, eighteen criminal liability provisions and only four provisions that deal with civil liability. See *Zhonghua Renmin Gongheguo Zhengquan Fa* [Securities Law of the People's Republic of China], as amended Oct. 27, 2005, effective Jan. 1, 2006, arts. 173, 223 in 2006 ZHONGGUO FALÜ NIANJIAN [2006 LAW YEARBOOK OF CHINA].

204. Tianya Falü Wang, *Gaofa Fuyuanzhang Li Guoguang Xishuo Guojia Jinrong Anquan de Sifa Baozhang* [Deputy President of the Supreme People's Court Li Guoguang Talks in Detail About Judicial Protection of State Financial Safety], July 23, 2002, http://www.hicourt.gov.cn/news/news_detail.asp?newsid=2002-7-24-9-20-38 (last visited June 28, 2009) [hereinafter *SPC President Talk*].

205. *Zhonghua Renmin Gongheguo Zhengquan Fa* [Securities Law of the People's Republic of China], as amended Oct. 27, 2005, effective Jan. 1, 2006, art. 69, in 2006 ZHONGGUO FALÜ NIANJIAN [2006 LAW YEARBOOK OF CHINA]. The 1998 Securities Law provided for joint and several liability for directors, officers, and supervisory board members of an issuer as well as underwriters but failed to state affirmatively that investors could sue to obtain damages. See Nicholas C. Howson, *Private Shareholders' Suits in the People's Republic of China—Making “Rule of Law” from the Bottom Up* 17–18 (2007) (unpublished manuscript, on file with the author).

206. Howson, *supra* note 205, at 7 (citing an unofficial statistic of “more than 5,000” shareholder lawsuits filed between mid-1999 and mid-2001).

207. See generally *SPC President Talk*, *supra* note 204.

208. Zuigao Renmin Fayuan Guanyu She Zhengquan Minshi Peichang Anjian Zan Buyu Shouli de Tongzhi [Notice on the Temporarily Ban on Securities Related Civil Damages Cases] (issued by the Sup. People's Ct., Sept. 21, 2001), TIANYA FALÜ WANG, *available at*

statements allowed aggrieved minority shareholders to sue issuers, dominant shareholders, and secondary actors under the following procedural framework.

a. The Limited Scope of the Private Right of Action

The SPC's Second Circular and the SPC Rules (chronologically, the SPC's third statement) introduced a limited private right of action. The Court determined that the lower courts could only accept false or misleading disclosure cases.²⁰⁹ Other actions, such as insider trading, market manipulation, and breaches of fiduciary duty remained "temporarily" suspended.

b. The Prerequisite Requirement

The SPC Rules required that plaintiffs base their claims on a prior administrative action or criminal judgment.²¹⁰ The China Securities Regulatory Commission (CSRC), the Ministry of Finance (MoF), or another empowered government agency would first have to issue a decision regarding the conduct of directors, officers, supervisory board members, or secondary actors.²¹¹ Alternatively, investigation by the People's Procuratorate, China's criminal prosecutor, could fulfill the prerequisite requirement.²¹² The courts could hear a private shareholders' suit only after such administrative action or criminal conviction.

The prerequisite requirement also had an evidentiary dimension. Civil discovery was limited, and the evidentiary record in the civil trial was derived from the prior proceedings.²¹³ This was particularly troublesome because it allowed defendants to strike a settlement bargain with the CSRC, the MoF, or the Procuratorate whereby the defendant company would not submit to extensive discovery. Consequently, the plaintiffs in the civil trial would have no basis upon which to state a claim.

<http://www.hicourt.gov.cn/law/show.asp?fileno=853> (last visited June 28, 2009) [hereinafter SPC First Circular] ("temporarily" suspending the hearing of private shareholders' suits by all Chinese courts); SPC Second Circular, *supra* note 150 (partially lifting the ban and so allowing the first large representative action, to go forward); SPC Rules, *supra* note 150 (providing a more comprehensive set of rules for shareholder litigation that clarified a number of the ambiguities).

209. See SPC First Circular, *supra* note 208 (effectively banning all securities-related civil claims); SPC Second Circular, *supra* note 150, art. 1 (allowing the courts to accept false disclosure claims but not those arising from insider trading or market manipulation).

210. SPC Rules, *supra* note 150, arts. 5–6.

211. *Id.*

212. *Id.*

213. Song Yixin, *supra* note 189, at 9.

c. Contingency and Other Fees

Chinese law allowed for a contingent fee arrangement.²¹⁴ Law firms could calculate fees as a percentage of the client's net recovery.²¹⁵ Plaintiffs would also have to pay a filing fee, determined according to the amount in controversy.²¹⁶ Article 107 of China's Civil Procedure Law (CPL) permitted courts to reduce or waive the filing fee where appropriate.²¹⁷ For group actions brought pursuant to Article 55 of the CPL, the losing party would pay (or reimburse, in the case of a plaintiff victory) the filing fee.²¹⁸ As a result of the "loser pays" rule, small investors were reasonably reluctant to serve as the class representatives since those people might be left to bear the full cost of any unsuccessful litigation.

d. The Representative Action Mechanism

Although the SPC statements prevented even this narrow world of shareholders' actions to proceed on a true "class action" basis, the rules did provide for "opt-in" representative actions.²¹⁹ In cases in which numerous parties had similar claims, courts would issue a public notice describing the substance of the case and informing affected parties of their right to register with the court within a specified period. Given the

214. However, as of 2006 contingent fees were no longer permitted for multiparty litigation. See Lüshi Fuwu Shoufei Guanli Banfa [Measures on the Management of the Collection of Legal Fees] (issued by the State Development and Reform Comm'n & the Ministry of Justice, Apr. 13, 2006, effective Dec. 1, 2006), available at http://www.chinacourt.org/flwk/show1.php?file_id=109584 (last visited June 24, 2009).

215. See *id.* arts. 11, 13.

216. See Renmin Fayuan Susong Shoufei Banfa [Provisions for the Collection of Litigation Fees] (issued by the Sup. People's Ct., July 12, 1998), art. 5., available at <http://www.people.com.cn/zixun/flfgk/item/dwjf/falv/9/9-1-1-06.html> (last visited June 28, 2009).

217. See Zhonghua Renmin Gongheguo Minshi Susong Fa [Civil Procedure Law of the People's Republic of China] (promulgated by the Nat'l People's Cong., Apr. 9, 1991), art. 107, translation in <http://en.chinacourt.org/public/detail.php?id=2694> (last visited June 28, 2009).

218. See Zuigao Renmin Fayuan Guanyu Shiyong Zhonghua Renmin Gongheguo Minshi Susong Fa Ruogan Wenti De Yijian [Opinion of the Supreme People's Court on Questions Concerning the Implementation of the Civil Procedure Law of the People's Republic of China] (issued by the Sup. People's Ct., July 14, 1992), art. 129, in 1993 ZHONGGUO FALÜ NIANJIAN [1993 LAW YEARBOOK OF CHINA] (the loser pays the filing fee).

219. Plaintiffs could proceed on a direct action (*dandu susong*) or joint action (*gongtong susong*) basis. See SPC Second Circular, *supra* note 150, art. 4 (expressly forbidding "class actions" (*jituan susong*)). Under Article 55 of China's CPL, joint action may accommodate a potentially large number of plaintiffs, but a plaintiff must affirmatively opt-in to the representative class, and the group is generally fixed during a pretrial hearing. Zhonghua Renmin Gongheguo Minshi Susong Fa [Civil Procedure Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 9, 1991, effective upon promulgation), arts. 53–55; *cf.* FED. R. CIV. P. 23 (allowing, in the United States, for inclusive representation of all affected parties except for individuals who affirmatively opt-out); Tang, *supra* note 198, at 156 (arguing that a true class action mechanism in China is both "necessary and possible").

large number of plaintiffs in a typical securities action, such a requirement posed serious coordination problems. The SPC made a lukewarm attempt to deal with this by requiring that plaintiffs authorize special authority to their representative to amend, discontinue, or settle the claim.²²⁰

Given the uncertainty and costs associated with civil actions, the evidence strongly suggests that private enforcement has had little deterrence value. Since the first legal action filed in 1996, the number of punishment decisions for disclosure violations has remained low.²²¹ In 2003, for example, the number of punishment actions was less than one percent of the number of listed companies.²²²

4. The Market Regulator and Public Enforcement

Public enforcement has been only moderately more effective in regulating the markets. Since as early as 1993 the CSRC has been investigating market actors and issuing regulations relating to the issuance and trading of securities. Until the promulgation of the 1999 Securities Law, however, its authority was contested by rival agencies.²²³ A Chinese-language study covering the period from 1993 to 1998 shows scant enforcement against misleading disclosures.²²⁴ During that period, the CSRC reportedly issued a total of sixty punishment decisions relating to securities issuance and trading (excluding futures).²²⁵ Only 26.7 percent of these cases were against issuers, 43.3 percent were against securities firms, and 8.3 percent were against other intermediaries.²²⁶

The 1999 Securities Law vested the CSRC with the primary power to regulate the markets. In 2000 its nominal enforcement powers were strengthened by a central enforcement bureau in Beijing and corresponding enforcement offices in its regional branches.²²⁷ The number of enforcement actions which have actually involved punishment by the CSRC show that public enforcement has played only a marginal role in China's stock market development.²²⁸ Anecdotal evidence supports the

220. See SPC Rules, *supra* note 150, arts. 14, 15.

221. According to one prominent securities lawyer, the number of investors that have initiated securities-related suits is probably fewer than 10 percent of all those who have been damaged and have standing to sue. Tang, *supra* note 198, at 147.

222. Clarke, *supra* note 10, at 59.

223. WALTER & HOWIE, *supra* note 136, at 60–62.

224. See Bai Jianjun, *Zhengjianhui 60 ge Chufa Jueding de Shizheng Fenxi*, [An Empirical Analysis of 60 CSRC Punishment Decisions], 11 FAXUE [LEGAL STUD.] 55, 62 (1999).

225. *Id.* at 55.

226. *Id.* at 58.

227. See GREEN, *supra* note 104, at 60.

228. See *infra* app. tbl.2 (summarizing enforcement data from 1998 to 2003).

contention that CSRC enforcement actions have been susceptible to political influence.²²⁹

On the whole, it is clear that many core institutions that are supposedly prerequisites for strong securities markets do not function "properly." In terms of the LLSV shareholder rights index, China shows up well below the average of other transition economies during the 1990s; in 1998, China scored a 3, compared to the average score of 3.61 for all other transition economies.²³⁰

C. China's Stock Market Performance

A comparison with other transition economies helps to fairly appraise the performance of China's financial markets. These countries share a legacy of central planning and extensive state ownership, and most of them began to develop stock markets in the early 1990s. The sheer size of China as measured in population and GDP poses challenges when using the nation-state as a unit of comparison, but this can be partially overcome by breaking out data on certain Chinese cities and provinces. Several studies, including LLSV, utilize market capitalization, number of listed firms, and number of IPOs as variables in measuring firms' ability to raise capital on the market.²³¹ Other scholarship on the nexus between stock market development and economic growth has focused on liquidity measures.²³² Particularly for transition economies, each of the standard measures of stock market development should be understood with some caveats in mind.

With regard to market capitalization, stock prices in transitional economies often do not bear a direct relationship to company value. Although a listed company's financial records may have been translated from socialist-era into market-based accounting standards, the information content often remains problematic. Restrictions on the transferability of a large number of shares further distorts share price. This is clearly the case

229. For example, in the well-known case of Hainan Minyuan Modern Agricultural Company, Minyuan effectively stonewalled the CSRC's investigation of that company's five directors. The reason: Deng Xiaoping's son, Deng Pufang, headed the China Welfare Fund, which owned 1.45% of the company's shares. See Daniel M. Anderson, *Taking Stock in China: Company Disclosure and Information in China's Stock Markets*, 88 GEO. L.J. 1919, 1935 (2000).

230. See *infra* app. tbl.1.

231. See, e.g., La Porta et al., *Legal Determinants*, *supra* note 3; Stijn Claessens et al., *The Future of Stock Exchanges: Determinants and Prospects*, 3 EURO. BUS. ORG. L. REV. 403 (2002); Katharina Pistor et al., *Law and Finance in Transition Economies*, 8 ECON. TRANSITION 325 (2000).

232. Levine & Zervos, *supra* note 2, at 537.

in China where the effects of the huge overhang of non-tradable state shares are well documented.²³³

The number of listed firms says little about the size of those firms and thus says little about the value of the stock market to the economy as a whole. Moreover, in transition economies, the number of listed firms and the number of IPOs may be misleading because of the use of the stock market for privatization. For example, the Czech Republic mandated that all SOEs list on the Prague Stock Exchange. Over 1,700 firms were listed in 1994, yet illiquidity and corporate misfeasance continued²³⁴ and by 1997 most of these firms were effectively delisted.²³⁵ Turnover velocity, defined as the total turnover for the year expressed as a percentage of total market capitalization, may be a good measure of liquidity,²³⁶ but a high turnover ratio may indicate speculation on the market.²³⁷

Considering all of these measures, China's stock markets display strong performance when viewed in a comparative perspective. Data on fifteen transitional economies compiled by Pistor & Xu confirm this.²³⁸ In terms of number of listed firms, China surpasses all of its competitors save Romania, where the turnover ratio suggests a highly illiquid market. Only two transition economies, Estonia and Russia, have a higher market capitalization as a percentage of GDP, yet the figures of both of these economies are dwarfed by the turnover figure for Shanghai alone. Overall, China's stock markets display the highest levels of liquidity, though the high turnover ratios for Guangdong and Shanghai likely reflect speculation. Finally, additional data shows that no country comes close to China when judged in terms of total number of IPOs. In the period from 1998–2001 alone, 414 IPOs took place in China, raising the equivalent of US\$ 61.6 billion,²³⁹ and this figure does not include the numerous listings of Chinese companies on overseas exchanges.²⁴⁰ These

233. See, e.g., Allen et al. *supra* note 10, at 70; WALTER & HOWIE, *supra* note 136, at 77–87.

234. Pistor & Xu, *supra* note 15, at 187.

235. *Id.* at 187–88; see also Katharina Pistor, *Law as a Determinant for Stockmarket Development in Eastern Europe*, in *ASSESSING THE VALUE OF LAW IN TRANSITION ECONOMIES* (Peter Murrell ed., 2001).

236. Allen et al., *supra* note 10, at 73.

237. Pistor & Xu, *supra* note 15, at 188.

238. See *infra* app. tbl.3.

239. Pistor & Xu, *supra* note 15, at 189–90; Anete Pajuste, *Corporate Governance and Stock Market Performance in Central and Eastern Europe: A Study of Nine Countries, 1994–2001* (Apr. 15, 2002) (unpublished working paper, available at <http://ssrn.com/abstract=310419> (last visited June 28, 2009)).

240. See Jamil Anderlini, *Chinese Overseas Listings Set to Increase*, *FIN. TIMES*, May 11, 2007, at 27, available at <http://www.ft.com/cms/s/0/f0556bf6-ff5c-11db-aff2-000b5df10621.html> (last visited June 28, 2009).

observations support the contention that China has outperformed all other transition economies in its ability to raise capital.

IV. ADMINISTRATIVE GOVERNANCE AS CORPORATE GOVERNANCE

Disclosure rules ineffectively resolve information asymmetry when they are not credibly enforced and when there is no reasonable relationship between the information disclosed and the firm's actual operation. Like most transition economies, China has exhibited under-enforcement of its securities laws, and companies have operated under non-market standards. The reputational intermediaries that theoretically served to collect and verify information often participated in rather than prevented fraud. For the market to function, some mechanism was needed to induce insiders to reveal critical information usable to select decent companies for public offerings.

Two indigenous Chinese institutions brought about such a mechanism: the quota system for equity share issuance and the ST system for underperforming issuers. The quota system served two important functions. First, it mitigated the serious information problems faced by regulators and investors. Second, it incentivized local bureaucrats to select viable companies (or restructure companies to make them viable) at the IPO phase. The ST mechanism built upon this same incentive structure to improve or sustain corporate performance in the post-listing phase.

The economic reforms of the 1980s brought political decentralization in an increasing number of decision-making areas. Local officials became powerful political players able to bargain with the central government over the terms of their interactions.²⁴¹ Localities lobbied for exemptions to taxes and labor regulations in a "race to the bottom" to attract foreign investment.²⁴² Political power was "fragmented" and local

241. See DALI L. YANG, *BEYOND BEIJING: LIBERALIZATION AND THE REGIONS IN CHINA* (1997) (offering a thorough account of regional relations and "competitive liberalization"); see also YASHENG HUANG, *INFLATION AND INVESTMENT CONTROLS IN CHINA: THE POLITICAL ECONOMY OF CENTRAL-LOCAL RELATIONS DURING THE REFORM ERA 1* (1999) (detailing central and local controls over investment in plants and equipment to expand the productive capacity of the economy).

242. See MARY ELIZABETH GALLAGHER, *CONTAGIOUS CAPITALISM: GLOBALIZATION AND THE POLITICS OF LABOR IN CHINA 6* (2005) ("In order to attract even greater amounts of FDI, regions granted enterprises increasing managerial control and autonomy over labor practices.").

governments were “entrepreneurial.”²⁴³ The quota system for equity share issuance and the ST system for underperforming issuers reflected this dynamic of competitive liberalization in the financial sector.

A. *The Logic of Indigenous Institutions*

Quota systems were a basic feature of regional economic management prior to and during the reform era.²⁴⁴ The central government allocated quota for certain critical resources, such as energy,²⁴⁵ to the provincial and municipal governments.²⁴⁶ Quota was applied to the financial markets from late-1991 to mid-2001,²⁴⁷ although in important ways the system’s legacy endures.²⁴⁸ In the tradition of economic planning and administratively driven growth, the total value of new shares issued each year was part of the national investment and credit plan.²⁴⁹

During the early years, the provincial-level branches of the People’s Bank of China (PBoC) liaised with their corresponding locality to reach an estimate for the annual quota of equity shares issuance.²⁵⁰ The main branch of the PBoC fixed the final quantity of quota in conjunction with other central government organs, and then allocated it among the localities via the PBoC provincial-level branches.²⁵¹ While, formally, enterprises “applied” to the local governments for the opportunity to issue shares on the exchanges, in practice the local governments chose whatever companies they wished—invariably local government-owned or government-controlled enterprises.²⁵²

243. See Kenneth G. Lieberthal, *Introduction: The “Fragmented Authoritarianism” Model and Its Limitations*, in BUREAUCRACY, POLITICS, AND DECISION MAKING IN POST-MAO CHINA I (Kenneth G. Lieberthal & David M. Lampton eds., 1992).

244. See Zhiwu Chen, *supra* note 203, at 456 (arguing that planned growth has been at the heart of the Chinese modernization process for over the past 150 years).

245. Pistor & Xu, *supra* note 15, at 196.

246. I refer to provinces and provincial-level municipalities as “localities,” and to provincial government and provincial-level municipal government as “local governments.” I refer to the central government in Beijing as “the center.”

247. Fang Liufang, *China’s Corporatization Experiment*, 5 DUKE J. COMP. & INT’L L. 149, 178 (1995) (describing the 1991 first stock issue quota to nine Shanghai companies for a total of 130 million shares). By 1993, the system of allocating quota had become standardized. *Id.* at 181.

248. Since companies selected for IPO under the quota system entered a queue, which typically involved a two-year waiting period, the quota system *de facto* endured until at least 2002. Moreover, rather than moving to a registration system (as is common in developed markets), the quota system was replaced with an approval system whereby the CSRC screens all applicants. Ministries and local governments continue to play a role in identifying and approving the selection of companies. Politics figures prominently in the process. See WALTER & HOWIE, *supra* note 136, at 115.

249. World Bank, *supra* note 158, at 89.

250. Fang Liufang, *supra* note 247, at 179.

251. *Id.*

252. World Bank, *supra* note 158, at 89.

By 1993, the PBoC no longer played the lead role, but the process largely remained the same. The State Council Securities Policy Committee, the State Planning Commission, and the CSRC—the latter playing an increasingly active role as time went on—determined the quota figure, subject to final approval from the State Council (China's executive cabinet).²⁵³ These central government organs allocated quota among the localities via the CSRC provincial-level branches.²⁵⁴

The apportionment of quota represented only the first tier of a multi-tiered approval process.²⁵⁵ Once each locality had received its share of quota and awarded it among its favored SOEs, the SOEs would have to submit offering documents and financial statements for the past three years to the CSRC for review in order to verify compliance with standards for assets, management, and profitability.²⁵⁶ The process of compiling the offering documents in the lead-up to the IPO notoriously entailed funny accounting to meet listing criteria.²⁵⁷ Finally, after CSRC acceptance, the exchanges themselves would have to approve the issuance.²⁵⁸

The rationale of the quota system appeared appropriate during those early years. The quota mechanism facilitated ordered market entry and allowed the government to maintain some control over the size and stability of the stock markets. Pent-up demand for investment capital would have otherwise swamped the market with shares and populated the exchanges with bad issuers, which would likely have led to a death spiral.²⁵⁹ Consistent with development goals, the quota mechanism also allowed authorities to channel funds into certain sectors, such as natural resources and utilities, and away from others, such as light industry and real estate.²⁶⁰ Perhaps most importantly, the quota mechanism allowed the government to restrict the flow of issued shares to keep IPO prices high—which assured a suitable level of equity financing for the state sector.²⁶¹

253. Fang Liufang, *supra* note 247, at 180.

254. *Id.*

255. Here I am referring to domestic A and B shares. The latter also required approval by the Ministry of Foreign Technology and Economic Cooperation (MOFTEC). Overseas listings were not subject to quota. They required case-by-case approval by central authorities. *See GREEN, supra* note 104, at 160–61.

256. *See* Zhiwu Chen, *supra* note 203, at 457.

257. *Id.*

258. *Id.*

259. *See GREEN, supra* note 104, at 161.

260. Political bias has endured today because of the CSRC's screening role of applicant firms. *See id.* at 161–62.

261. *But see* Naughton, *supra* note 154, at 6–7, for a more nefarious interpretation of IPO pricing.

A quota system, however, has obvious distortionary effects on the market, and China's quota system was damaging for at least two reasons. First, the central government unabashedly used quota to manipulate the market. To give a more benign example, to deflate what he believed to be a speculative bubble in 1996, Premier Zhu Rongji simply announced an increase in the following year's quota, and the market adjusted accordingly.²⁶² Second, the quota system created tremendous opportunities for rent-seeking and corruption. The limited supply of permits to issue shares inflated the value of each permit. Companies would bribe local officials to gain access to quota. Chinese media reports have subsequently revealed that a number of companies avoided the quota selection process altogether by bribing central officials.²⁶³

B. Quota and Incentive Structures During the IPO Phase

Despite its unconventionality, a growing body of empirical evidence has shown that the quota system, on the whole, created incentive structures that benefited the financial markets.²⁶⁴ Responsibility for collecting and verifying the relevant information about listing firms was assigned to the local government.²⁶⁵ Local government ownership of these firms gave local bureaucrats the power to appoint management and request information from management.²⁶⁶ Neither central authorities nor investors, however, could check the accuracy of this information. Furthermore, critics rightfully have pointed out how the local government owners routinely "cooked the books," since they had a direct interest in the generation of equity financing.²⁶⁷ On average, however, the system worked to partially negate the promoter's dilemma.

The localities were players in a "repeat game" where the central government offered carrots and wielded a stick. Positive performance on one of the national stock exchanges brought tangible benefits for the local government/owner beyond a one-time windfall gain of equity capital. The CSRC rewarded the localities whose companies performed well on the national exchanges with future quota.²⁶⁸ Controlling for regional size, Pistor & Xu have found a positive correlation between performance indicators of listed firms and the size of quota allocated in subsequent

262. GREEN, *supra* note 104, at 161.

263. The Chinese financial media reported that at least twelve companies from Jiangsu Province, including Shanghai-listed Jiangsu Sunshine and Shenzhen-listed Wuxi Little Swan had bribed regulators to gain market access during the 1990s. *Id.*

264. See, e.g., Pistor & Xu, *supra* note 15 (on the quota system); Du et al., *supra* note 15 (on the ST system).

265. Pistor & Xu, *supra* note 15, at 198–99.

266. *Id.*

267. For this sort of critique, see Zhiwu Chen, *supra* note 203, at 457.

268. See Pistor & Xu, *supra* note 15, at 200–03.

periods.²⁶⁹ Even powerful provinces such as Guangdong and Jiangsu received comparatively low quota in the periods after their firms performed below the national mean and median.²⁷⁰

Moreover, career advancement required that party cadres meet their region's economic development targets.²⁷¹ Good performance of regional companies on the two major stock exchanges reinforced key social and economic indicators.²⁷² Thus, a local bureaucrat's political fortune was wedded to the performance of local SOEs. Equity financing made local enterprises less dependant on regional budgets. On the other hand, when its listed companies underperformed, local government/owners were penalized. The CSRC might order delisting or force the local government/owner to bailout and restructure the company.²⁷³ Delisting amounted to a retroactive reduction of previously allotted quota; no new company could use that quota to issue shares.²⁷⁴ Lower quota would generally be allocated to that locality in the future. After 1998, underperforming firms were required to file for ST status, which constrained the firm and subjected it to the possibility of takeover.²⁷⁵ In sum, the incentive structure created by the quota system functioned on two levels. First, on a "vertical" level, the central government, generally embodied by the CSRC, rewarded and punished local governments based on the performance of their firms listed on the exchanges. Second, on a "horizontal" level, the local governments competed for a finite quantity of quota on an annual basis and sought to distinguish themselves in the eyes of the CSRC and other influential central government actors.

The quota system effectively utilized state and party administrative governance to select companies for listing on the national stock exchanges. It extended preexisting inter-locality competition into the area of equity market entry. The system incentivized informed company insiders to list the better performing SOEs in their jurisdiction.²⁷⁶

269. *Id.* at 200.

270. *See id.* at 201–02.

271. For an excellent account of the evaluation system (*kaohe zhidu*) for local cadres, see Susan H. Whiting, *The Cadre Evaluation System at the Grass Roots: The Paradox of Party Rule*, in *HOLDING CHINA TOGETHER* 101 (Barry J. Naughton & Dali L. Yang eds., 2004); *see also* TENEV ET AL., *supra* note 111, at 8 (referring to the bureaucracy as a "helping hand" for economic development).

272. *See* TENEV ET AL., *supra* note 111, at 8.

273. Pistor & Xu, *supra* note 15, at 203–05.

274. *Id.* at 203.

275. *See infra* Part IV.C.

276. I am not suggesting that the companies ultimately chosen to list on the domestic exchanges were ideal investments by any means. As I have argued, the whole point of corporatization was to gain equity financing for failing SOEs. Clearly, the firms chosen to list were the most politically privileged of firms. My point is simply that they were also often the best of that lot, and restructuring made these firms relatively better still.

Indigenous Chinese administrative governance served to mitigate the severe information problems and reduced adverse selection during the IPO. It is likely that administrative governance also helped to solve the controller's dilemma in the post-IPO phase since seasoned equity offerings also depended on a locality's apportionment of quota.

C. *ST and Incentive Structures During the Post-IPO Phase*

An important objection to a theory of administrative governance based solely on the quota system is that, even if it did partially mitigate the effects of information asymmetry, that success was short-lived. As Pistor & Xu acknowledge, the evidence does not show that the quota system curbed the moral hazard problem very far into the post-listing phase.²⁷⁷ More than 90 percent of the violations on the Shanghai and Shenzhen exchanges concerned post-IPO continuing disclosure; of these, 64 percent concerned *ad hoc* disclosure requirements violations.²⁷⁸ In 1998, the CSRC answered this apparent failure of post-listing governance with the ST delisting mechanism.²⁷⁹ Like the quota system, the ST mechanism was an administrative governance tool. Utilizing a similar set of preexisting incentive structures, it sought, with some success, to motivate local governments to rescue ailing firms.

A listed company qualified for special treatment and would have "ST" inserted in front of its listing number, if it displayed either: (1) net losses for two consecutive fiscal years; (2) shareholder equity lower than registered capital (the par value of the shares); (3) a negative opinion (or inability to issue an opinion) by the auditors of the company's financial statements; or (4) an abnormal financial condition, determined by the stock exchanges or the CSRC.²⁸⁰ The ST designation imposed serious constraints. The company's interim report would be audited, and daily share price fluctuations would be limited to 5 percent to prevent market manipulation.²⁸¹ If an ST company continued to incur losses for more than one year, it would be delisted.²⁸²

Local governments zealously resisted any effort to delist even their poorest performing companies for two reasons. First, a locality typically

277. Pistor & Xu, *supra* note 15, at 207 ("The quota system has been less effective in monitoring postlisting violations than ensuring prelisting selection.").

278. *Id.* at 207; Du et al., *supra* note 15, at 165. "Continuing disclosure," refers to annual, quarterly, and current reports. "Ad hoc disclosure" refers to current reports announcing major events.

279. Pistor & Xu, *supra* note 15, at 204.

280. Du et al., *supra* note 15, at 166.

281. See Anderson, *supra* note 229, at 1933.

282. This was the policy as of January 1, 2002. Before that date, losses in excess of one year would lead to a further downgrade to "particular transfer" treatment, which dictated even more restrictive measures. Du et al., *supra* note 15, at 166.

bargained hard with the central government for its listing quota; second, the very existence of quota and the restrictions on market entry meant that a listed company commanded substantial “shell value.”²⁸³ Companies otherwise excluded from the market would pay a premium to obtain control of a listed company and thereby gain access to coveted post-IPO equity financing. The local governments for their part relied upon periodic equity capital infusions and the huge economic rents brought by the firm’s shell value. Delisting would also constitute a substantial embarrassment (*diu mianzi*) for the local government-affiliated company managers.²⁸⁴ By threatening to delist a local government’s underperforming firm, the CSRC was threatening to kill the local government’s golden goose. The ST mechanism served in part to make that threat credible. By making an ST designation, the CSRC also put itself under public scrutiny to fulfill its promise to hold the company’s managers accountable. Delisting served both specific deterrence and general deterrence aims.

For these reasons, local governments faced tremendous pressure to rescue their ST firms. The local government-affiliated controlling shareholder would present its firm management with a choice: develop a workable restructuring plan or relinquish control to another party with a more convincing plan. Local governments could be expected to make a total effort. They might put administrative pressure on major creditors or on state banks to forgive the ST firm’s debts, indirectly subsidize the ST firm by using fiscal revenues to purchase the firm’s products, directly grant the ST firm subsidies, or act as an intermediary to arrange an acquisition deal.²⁸⁵

Attempting to escape the threat of delisting, most ST firms underwent asset or share restructuring.²⁸⁶ In an asset restructuring, the ST firm typically exchanged with large shareholders inferior assets for superior assets. Value differences arising from the asset swap were exempted by the large shareholders, allowing the ST firm to obtain the superior assets at a highly discounted rate or without charge.²⁸⁷ In contrast to an asset

283. Pistor & Xu, *supra* note 15, at 207 (“Firms that had been excluded from the market have discovered that buying up moribund shells of listed companies and inserting their own assets can give them access to the financial markets.”); Du et al., *supra* note 15, at 169 (“[T]he stringent quota and quantity restrictions that the central government imposed . . . created huge economic rents for incumbent listed firms . . .”).

284. See Du et al., *supra* note 15, at 168.

285. *Id.*

286. *Id.* at 169.

287. Du et al. report the case of ST Zhang Jia Jie, designated an ST firm in 2002, as an example of asset restructuring. *Id.* The firm swapped 140 million yuan of accounts receivables, other receivables, prepayments, and investment securities (*i.e.*, bad assets) for 227 million yuan of superior assets from its controlling (state) shareholder without paying the price difference. *Id.* The controlling shareholder forgave Zhang Jia Jie the 20 million yuan of

restructuring, share restructurings involved an ownership change. Incumbent shareholders sold their shares to another company to cash out the firm's shell value. Data from 1998–2003 shows that share restructurings predominated for both Shanghai- and Shenzhen-listed ST companies.²⁸⁸ Restructurings and related corporate governance modifications, such as CEO changes, improved companies' operational performance and in a significant number of cases allowed companies to shed their ST status.²⁸⁹ The market responded to the ST system. In their studies of company performance, Du, Liu, & Wong have found significant, negative abnormal returns in the twenty-day period surrounding a ST designation, but positive cumulative abnormal returns in the ten months after ST designation.²⁹⁰

In sum, state control and institutions of administrative monitoring buttressed share value in at least three ways. First, corporatization necessarily involved large blocks of non-tradable state shares. The limited supply of freely floating shares ensured that demand would be sufficient for high initial returns. Second, in a sense, the State functioned as a reputational intermediary: state control signaled to investors that their investment was safe, and labeling a company "ST" intimated that a local government bailout was on the way. Most interestingly, an elaborate system of intra-government incentive structures, with both vertical and horizontal dimensions, led to actual improvements in corporate governance and in the financial health of ailing firms. While Russian owners rationally chose to loot rather than to restructure, Chinese owners faced incentives that lured them in the opposite direction.

D. *The Role of the CSRC*

The CSRC was the nucleus of the administrative governance structure. The thesis of this Note depends largely upon the CSRC's role consistently rewarding and punishing through quota distribution. Such tremendous discretion concentrated in the hands of a regulator might foster an environment where agency capture and corruption flourish. The CSRC's powers, however, were subject to oversight. The State Council directly monitored the CSRC, and as the highest executive organ, the State Council was sensitive to the economic and social instability that could result from mismanagement of the financial markets.²⁹¹ Indeed, the

debt. *Id.* In essence, the restructuring led to 17.38 million yuan of net profits with earnings per share of 0.095 yuan. This resulted in removal of the ST "hat" in 2003. *Id.*

288. *Id.*

289. *Id.* at 172–73.

290. *Id.* at 166.

291. For example, the new Securities Law requires State Council approval of all CSRC imposed conditions for listing. See *Zhonghua Renmin Gongheguo Zhengquan Fa* [Securities

CSRC assumed its role as preeminent market regulator in 1999 after market mismanagement and insider-dealing by the People's Bank of China led to shareholders' riots in Shenzhen and elsewhere.²⁹² In addition to oversight from the State Council, the CSRC has also had to struggle with the demands of the localities and the courts. As adversaries of the CSRC in negotiations over quota, the local government recipients had strong incentives to carefully monitor CSRC allocations and approvals each year. When agency action appeared arbitrary, individual companies occasionally challenged CSRC decisions in the courts. In one publicized case, the Beijing High People's Court affirmed an intermediate court holding that a CSRC rejection of a particular company's listing application had no legal basis.²⁹³ The court ordered the CSRC to approve the listing.²⁹⁴ These factors have not rendered the CSRC immune from favoritism and corruption, but they illustrate the reality that the CSRC has had to contend with certain checks and balances.

CONCLUSION

This Note has offered a partial explanation for the improbably robust development of China's equity markets. I have argued that during the first decade of stock market development institutions of administrative governance mitigated information asymmetry, casting local governments as intermediaries that vouched for the quality of issuer firms. Local government sponsorship was an important signal for relevant central government organs and for the investing public. When issuers performed so poorly that their stock qualified for ST status, the localities were motivated to restructure or allow takeover by new owners with a plan for the business that would raise the stock price. Taken together, these structures staved off the adverse selection problem that crippled the former-soviet transition economies. Indigenous Chinese institutions and practices filled gaps left by substantive law, administrative regulation, and legal institutions that had not yet completely taken root and, therefore, could not be depended upon to provide real investor protection.

Law of the People's Republic of China], as amended Oct. 27, 2005, effective Jan. 1, 2006, arts. 12, 13, in 2006 ZHONGGUO FALÜ NIANJIAN [2006 LAW YEARBOOK OF CHINA].

292. See WALTER & HOWIE, *supra* note 136, at 59 (detailing the CSRC's "domestic struggle").

293. In the Hainan-Kaili case, a company designated by Hainan Province to issue shares was rejected by the CSRC. The Commission cited fraudulent financial reports and implied that the company would not be able to apply again. The company brought suit. Pistor & Xu, *supra* note 15, n.23.

294. *Id.*

The Chinese experience provides some useful insights for developing and transition economies seeking to establish capital markets. Before adopting a catalogue of “core” institutions that make stock markets work in developed economies—generally characterized by the common law legal origin—policymakers in the developing world may do better by first looking to cultivate and build upon indigenous institutions. Often, the most viable institutions in transition economies are institutions of state-guided growth and administrative governance. During the initial period of market development, these state structures may offer a foundation upon which to erect a stock market. Ideally, these indigenous institutions provide the initial support so that “core” legal institutions can gradually share the burden of regulating the market and can grow into their proper place, effectively combating the dual-threats of information asymmetry and self-dealing. China’s experience provides a modicum of promise that this hope may yet become a reality.

APPENDIX

TABLE 1
LEGAL SHAREHOLDER PROTECTION 1998

Country	Formal Law (LLSV) [*]	Regulatory Quality ^{**}
Bulgaria	4	39.9
China	3	57
Croatia	2.5	46.4
Czech Republic	4.5	73.2
Estonia	3.75	76.5
Hungary	3	79.8
Latvia	3.5	61.7
Lithuania	3.75	67.8
Poland	3	77
Romania	3	44.3
Russia	5.5	26.8
Slovakia	2.5	62.8
Slovenia	2.5	82.5
Ukraine	2.5	12
Average	3.61	62.3

* A higher number indicates more developed formal law.
** A higher number indicates more developed regulatory quality.

Source: Pistor & Xu, *supra* note 15, at 191. Formal law is based on a "rule of law" indicator. See LLSV, *Law and Finance*, *supra* note 3, at 1124. Regulatory quality is a World Bank governance indicator. See Governance Matters, Worldwide Governance Indicators, <http://info.worldbank.org/governance/wgi/index.asp> (last visited July 29, 2009).

TABLE 2
ENFORCEMENT ACTIONS BY
REGULATORS (1998–2003)

Year	Enforcement actions taken by regulatory agencies [*]	Followed by punishment	Number of companies listed on Shanghai and Shenzhen Stock Exchanges
1998	3	3	853
1999	12	9	950
2000	16	7	1088
2001	71	9	1160
2002	62	8	1235
2003	51	11	1287

* "Regulatory agencies" include the CSRC, the Shanghai and Shenzhen Stock Exchanges, and other government agencies.

Source: Pistor & Xu, *supra* note 15, at 195.

TABLE 3
 STOCK MARKET INDICATORS: CHINA AND TRANSITION ECONOMIES
 IN CENTRAL AND EASTERN EUROPE COMPARED (2002)

	Population (in 1,000)	Listed Firms	Total Market Cap/GDP	Tradable market Cap/GDP	Turnover Ratio
Bulgaria	7,707	354	.05	.03	28.4
Croatia	4,334	66	.2	.12	4.2
Czech Republic	10,264	78	.28	.17	48.7
Estonia	1,423	14	.44	.26	5.5
Hungary	10,106	48	.25	.15	52.2
Latvia	2,385	62	.09	.06	17.6
Lithuania	3,611	51	.12	.07	13.5
Poland	38,634	216	.16	.1	22.4
Romania	22,364	4,870	.12	.07	12.2
Russia	290,349	196	.4	.24	36.1
Slovakia	5,415	354	.09	.06	46.1
Slovenia	1,930	35	.24	.15	27.9
Ukraine	48,760	184	.08	.05	5.7
China	1,275,389	1,235	.4	.16	67.6
Chongqing	30,513	26	.41	.14	65
Guangdong	85,225	138	.52	.16	331.7
Shanghai	16,408	144	1.61	.41	391.8
<i>Source: Pistor & Xu, supra note 15, at 189.</i>					