THE ROLE OF CHINA'S SECURITIES MARKET IN SOE REFORM AND PRIVATE SECTOR DEVELOPMENT

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China's securities market took off after the early 1990s when exchanges were established in Shanghai and Shenzhen. During most of the 1990s, the dominant philosophy was that securities markets are supposed to serve large state-owned enterprises (SOEs). As a result, most companies listed on exchanges in China are SOEs. Moreover, the state owns more than fifty percent of the shares of these enterprises and these shares are not tradable. Since the late 1990s, however, more and more private companies have entered the securities market. As of the end of April 2001 private firms or individuals controlled 10.5 percent of the companies listed on the Shanghai and Shenzhen exchanges.

The securities market in China is plagued with corporate governance problems. Self-dealing between listed companies and their state-owned parent companies is quite common as a way to transfer profits to the parent. Many companies fall into financial distress as a result of this practice two or three years after they are listed. China must improve corporate governance in order to contain the risk of the growing reliance on the securities market to finance economic development.

HISTORY AND OVERVIEW OF CHINA'S SECURITIES MARKET

The securities market in China has a very brief history. Some enterprises issued stocks and bonds to obtain funds for business expansion in the late 1980s, but these issues were odd and irregular and there was no legal market for secondary trading. The modern securities market began with the launching of exchanges in Shanghai and Shenzhen in 1990. Since then, the securities market has played an increasing role in the financing of enterprises in China, with stocks the main instrument traded in the securities market. For the eleven years from 1991 through 2001 China's enterprises raised a total of 772.7 billion RMB yuan on the two markets through IPOs, additional flotation by listed companies, and convertible bond issues by listed and non-listed companies. Since 1997 enterprises raised between 84.2 billion and 210.4 billion RMB yuan a year in the securities markets (Figure 1).

The number of enterprises listed on the Shanghai and Shenzhen exchanges increased rapidly, from only 10 in 1990 to 1,153 at the end of 2001 (Figure 2). The number of registered stockholders reached about 65 million in 2001. Market value also increased enormously. The total capitalisation of the Shanghai and Shenzhen markets rose from 35.3 billion RMB yuan in 1993 to 4,376.3 billion at the end of 2001 (Figure 3). Securities market capitalisation exceeded fifty percent of GDP for the first time in 2000, and China's stock market is now the second largest in Asia after Japan's.

With the adoption of the corporatisation or 'modern enterprise system' policy in 1995 many SOEs were reorganised into shareholding corporations and in consequence the majority of companies listed on China's stock exchanges are SOEs. Most companies that transformed from pure state-ownership to shareholding enterprises have three types of shares, state shares which are non-negotiable (that is, they cannot be sold in the market), shares held by employees, and shares held by legal entities including other companies and financial institutions. Usually, the non-negotiable state shares comprise the majority of a listed company's shares, and thus the state retains control of these listed enterprises.[1]

During most of the 1990s, regulators and government and enterprise officials viewed the securities market mainly as an instrument to serve SOEs and even to rescue them from financial difficulty. Since the late 1990s, though, the situation has changed. More and more listed companies have been restructured with private companies purchasing their shares and becoming controlling shareholders. Furthermore, the underlying philosophy changed since the China Securities Regulatory Commission (CSRC) was reorganised in 1998 and the Securities Law took effect in 1999. The examination and approval system and the quota systems for issuing securities, which tended to favour SOEs and give government agencies a large say, were replaced. Under the new verification system for public offerings, private companies have more equal access with SOEs to funding from the securities market. More private companies have been listed and the securities market is playing an increasing role in the development of private companies.

IMPACT ON THE SHAREHOLDING STRUCTURE AND CORPORATE GOVERNANCE OF SOEs

It is fair to say that at the beginning, the securities market was developed essentially as a means to transform traditional large and medium-sized SOEs from enterprises solely owned by the government into enterprises with hybrid ownership. As these enterprises listed and sold some shares in the securities market non-state shareholders, including the general public, were introduced. From 1997 to 2000 the proportion of public shareholding on the Shanghai and Shenzhen markets rose from 29.7 percent to 33.5 percent (Figure 4).

A more significant impact of the development of the securities market has been to diversify the ownership of companies after they have been listed. When SOEs have been corporatised and their shares listed in the securities market, it becomes easier to reduce the extent of state ownership. In fact, since 1997 other firms, including private firms have even acquired control of some of the state shares of listed SOEs. In particular, the government has allowed ownership of the (previously non-negotiable) state shares of so-called “shell” companies, which are listed companies that have essentially no net assets, to be transferred to other enterprises. At the end of 2001, for example, the CSRC approved a plan for transferring the state shares of financially troubled retailer, Zhengzhou Baiwen, to a private enterprise, the Sanlian Group, in exchange for Sanlian's taking over Baiwen's debt. Baiwen, which had three successive years of losses, became a shell company when the Sanlian Group took over its capital, debts, and staff. (This transaction also brought Sailian a "backdoor listing" on the exchange and hence access to securities market financing.)[2]

In addition, the development of the securities market has made possible a new type of transaction, a management buy-out (MBO), which has started to attract a lot of attention as a way to diversify ownership of SOEs. In such a transaction, the managers of a listed SOE set up a private firm which then acquires some of the state shares of the listed company. For example, in 2001 state shares of vehicle manufacturer, Yutong Ke Che, in Henan Province were sold to a private investment company that had been established especially for the deal. Since an MBO usually means the managers of a listed SOE can become owners at a discounted cost, many more such deals are expected to take place.

Diversification in the ownership of SOEs has a positive impact on their governance. For most listed companies in which the state share is still the majority, boards of directors are controlled by the government, and nomination of directors and appointment of officers as well as significant business decisions are subject to statutory procedures. For listed companies in which non-state ownership predominates, on the other hand, government interference is more restrained. Thus, development of the securities market in China has promoted the reduction of government influence over enterprise activities. Disclosure and auditing requirements for listing on the securities market also helped to improve corporate governance to some extent. In 2001, for example, regulators punished Yin Guang Xia and its auditing firm for making false disclosures.

THE PRIVATE SECTOR AND THE SECURITIES MARKET

In the early 1990s, China had very few listed private enterprises because of the listing policies of the exchanges, and listing quotas favoured SOEs. The number of listed private firms increased since 1998 with the reform of the CSRC and the adoption of the Securities Law. From only three in 1993 the number of new listings of private enterprises increased to over 30 in 1999 and 2000 (Figure 5). As of the end of April 2001, 10.5 percent of the companies listed on the Shanghai and Shenzhen exchanges, a total of 118 companies, were controlled by 113 private enterprises. Fifty-two of these private enterprises were listed in Shenzhen and sixty-six in Shanghai.

Milestones in the development of China's securities market were the listing of the first private enterprise, New Hope Group, in 1998 and the first listing of a private bank, MinSheng Bank in 2000. In 2001, the Shanghai exchange became the first to list a company promoted and controlled by a "natural person" (as opposed to a "legal person").

There are two ways in which a private enterprise to can have its shares traded. One is to go through an IPO and then have the shares listed on an exchange. The other, and most common way, is to acquire a shell company which is already listed on one of the exchanges. Of the 113 private companies listed on the two exchanges in 2001, 48 had gone through IPOs and 65 had acquired a shell company. Acquisitions of shell companies became more frequent in 1998 (15 firms acquired), 1999 (22 firms acquired), and 2000 (22 firms acquired) because of the intensified restructuring of listed SOEs (Figure 6). (There were no such acquisitions during the first four months of 2001, however.)

The listing of private enterprises has had a positive impact on the development of both the securities market and enterprises. Private enterprises make more attractive investments than SOEs because they do not have the same burden of social welfare expenses and they are less subject to government interference. Thus, with the listing of private enterprises investors became more interested in trading in China's securities markets than when only SOE stocks were available. At the same time, listing on the securities market gave private enterprises access to a new source of funds, which was conducive to their own further development. Although the private sector contributed 20 percent of GDP in 2000, up from 15 percent in 1997, (Figure 7) only 0.6 percent of bank loans went private sector firms that year. Thus, to some extent, being able to access the securities market made up for a shortage of bank funds for business development in this growing sector. Some private listed companies are growing rapidly and becoming large conglomerates. For example, Delong Group, a well-known private conglomerate, expanded quickly after entering the securities market in 1999 and it now owns three other listed companies. The Dong Fang Group, which is a listed private enterprise, also controls another listed company, Xinjiang Tun He.

For private enterprises, having shares traded in the securities market also improves their governance. In China most private enterprises are family-controlled and their shareholdings and operations are usually closed. Becoming listed introduces public stockholders and transparent accounting to these enterprises, and both of these governance factors will have a good influence on business in the long run.

SELF-DEALING AND TRANSFERRING PROFITS: A BIG PROBLEM WITH CHINA'S LISTED COMPANIES

Although listing on the securities market has a positive effect on governance both for SOEs and for private enterprises, listed companies in China still have very serious problems and the number of listed companies involved in scandals has increased in recent years. In fact, quite a few companies have fallen into financial difficulty two or three years after becoming listed. The main cause of their financial downturn is self-dealing and the transfer of profits, which are common practices among listed companies.

For the SOEs that make up the majority of listed companies self-dealing and profit transfer are almost a necessity, since they cannot raise funds by issuing their own shares through an IPO because of the poor quality of their assets and their heavy social welfare obligations. Thus, they are motivated to put their good assets in a newly established corporation, which then does an IPO. The bad assets remain in the old SOE, which is the parent of the newly listed company. Unlike its parent, the listed spin-off has both profit potential and access to funds from the securities market. Since the parent usually holds 50 or 60 percent of the spun-off company, giving it control, it naturally tends to extend its hands to the funds of the newly listed company. Furthermore, business relations between parent companies and spin-offs facilitate the transfer of funds. Usually, a parent company is engaged in supporting business for the listed spin-off, which uses the tangible and intangible assets of the parent. So, self-dealing transactions between parent companies and listed spin-offs occur each and every day. With such transactions made at non-market prices profits tend to be transferred from the listed company to the parent.

Private companies listed on the securities market are also interested in this trick of self-dealing and profit transfer. A private entrepreneur may set up a group of firms and manage to list one while the others remain unlisted. Arranging self-dealing transactions among these firms will convey profits and funnel funds from the securities market to the unlisted firms in the group. Private enterprises do not engage in transferring profits to the same extent as SOEs because they do not have as large a burden of welfare expenses to distribute among related companies.

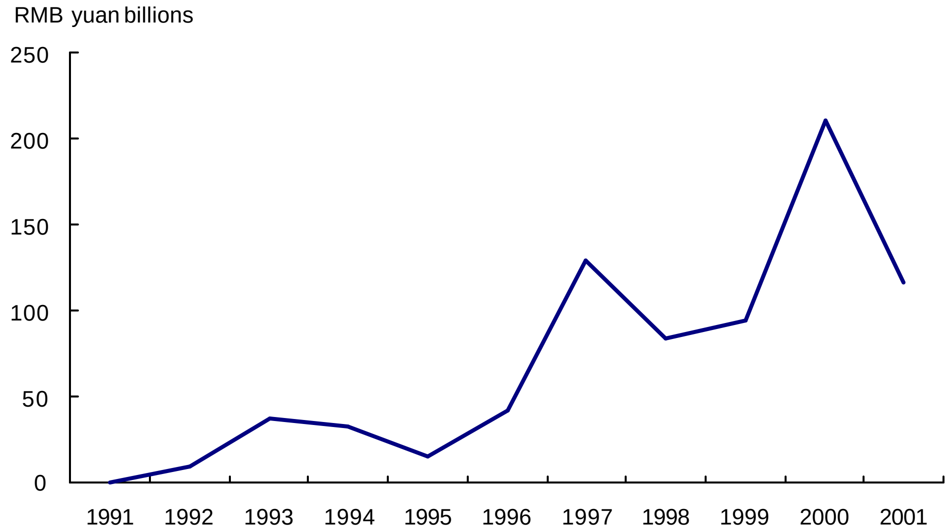
Self-dealing and profit transfer between parent SOEs and listed companies is gaining attention as a serious problem in China, with listed companies often referred to as "ATMs"—automated teller machines. One way to address this problem is to restructure the SOEs to give them direct access to funds from the securities market. In 2001 some parent SOEs were transformed into shareholding corporations or even privatised. Yutong Ke Che, which was mentioned previously, underwent an MBO. This trend is expected to continue over the next few years.

Although the CSRC is relaxing restrictions on the entry of private firms to the securities market, some obstacles will exist for a while longer. One of these is the statutory conditions for listing under the Company Law. These conditions include minimum capital of RMB50 million and three consecutive years of profitable operation. It is not possible for new start-ups to meet these conditions. For this reason, many economists are calling for the establishment of a second board for growth enterprises in order to give new private firms in China access to securities market financing.

Notes

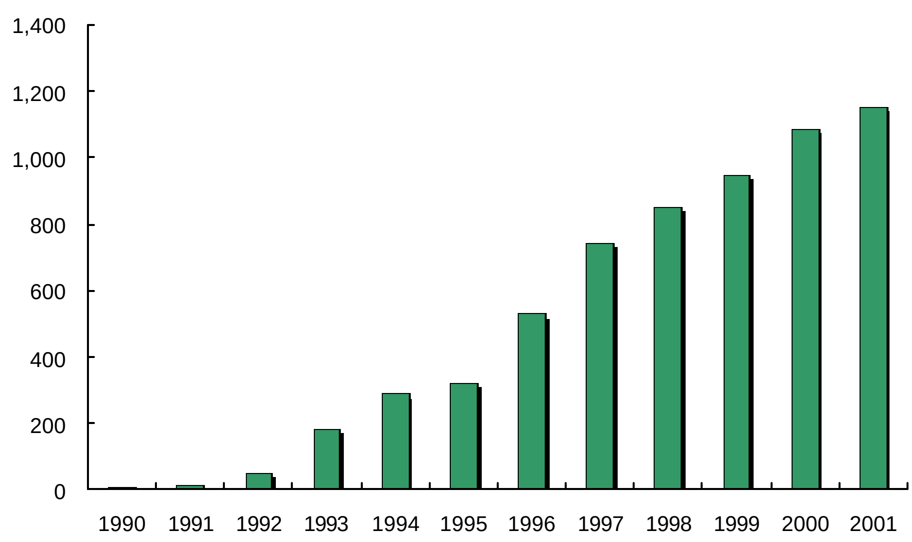
1. Although state shares are not negotiable on the Shanghai or Shenzhen markets, they may be transferred in negotiated purchases with government approval.
2. http://english.peopledaily.com.cn/200012/07/eng20001207_57156.html.

FIGURE 1
Funds Raised in the Shanghai and Shenzhen Markets, 1991-2001



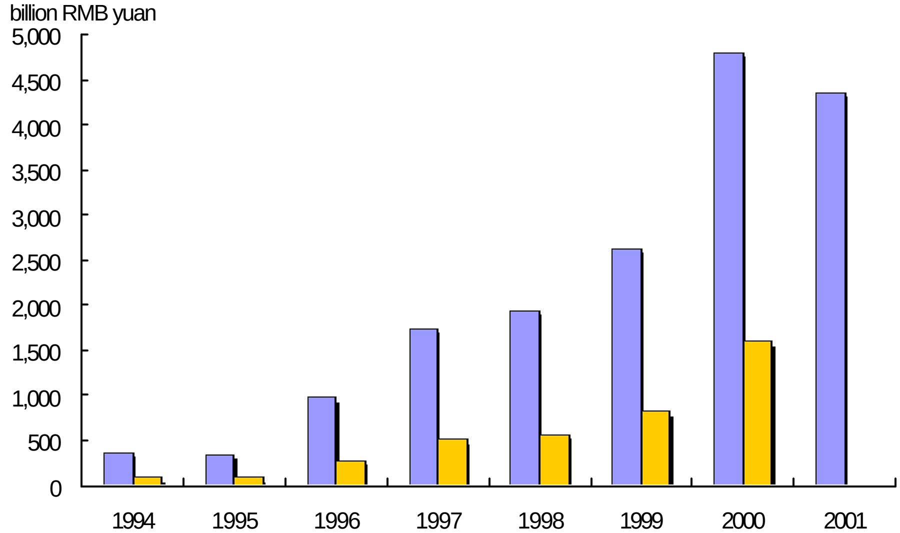
Source: Yearbook of People's Bank of China (2000) and http://drcnet.com.cn. 1991-96 from *China Statistical Yearbook* 2001. Table 19-13.

FIGURE 2
Number of Enterprises Listed on the Shanghai and Shenzhen Securities Exchanges, 1990-2001



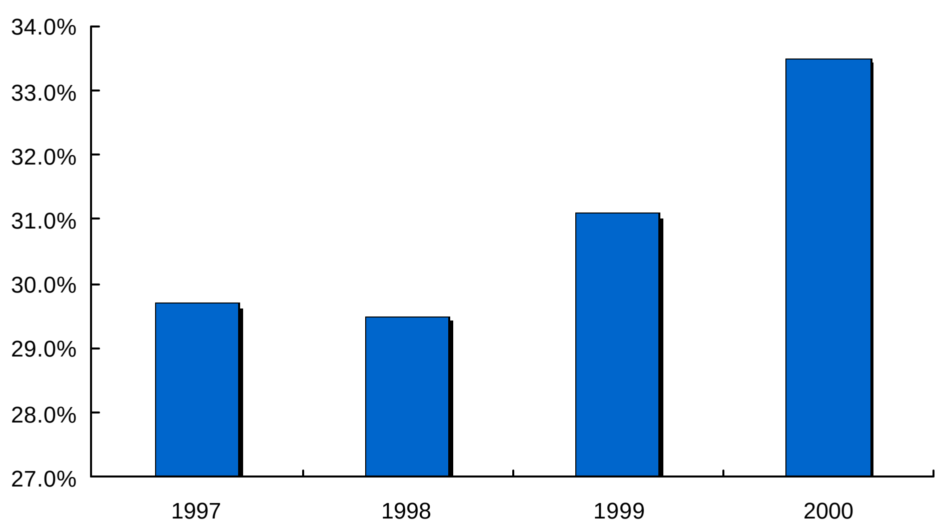
Source: Yearbook of People's Bank of China (2000) and http://drcnet.com.cn.

FIGURE 3
Total and Negotiable Capitalisation of the Shanghai and Shenzhen Markets, 1994-2001



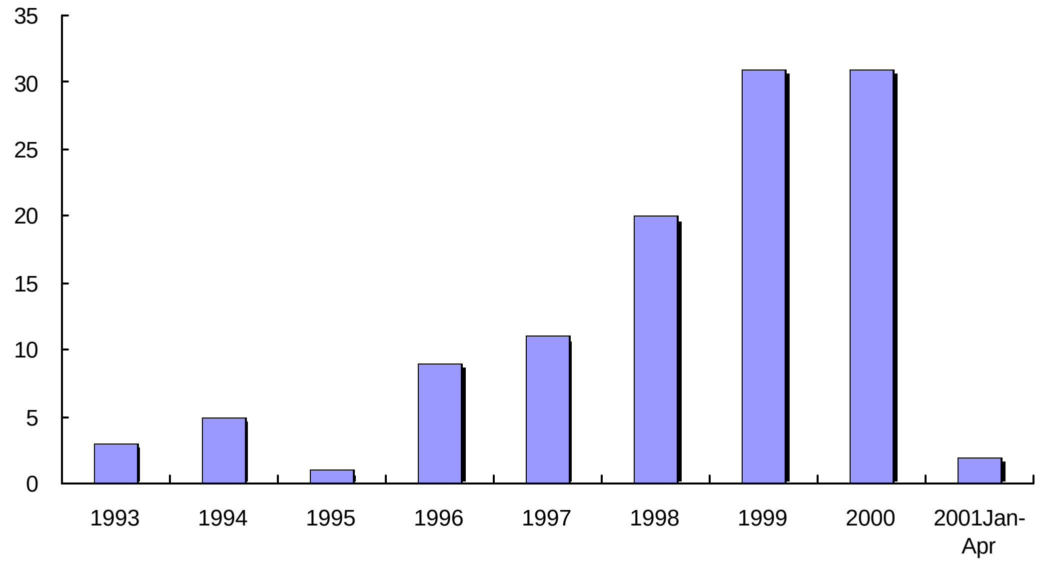
Source: Yearbook of People's Bank of China 2000 and http://drcnet.com.cn. 1994-96 from *China Statistical Yearbook*, 2001 Table 19-14.

FIGURE 4
Public Shareholding of Listed Companies, 1997-2000



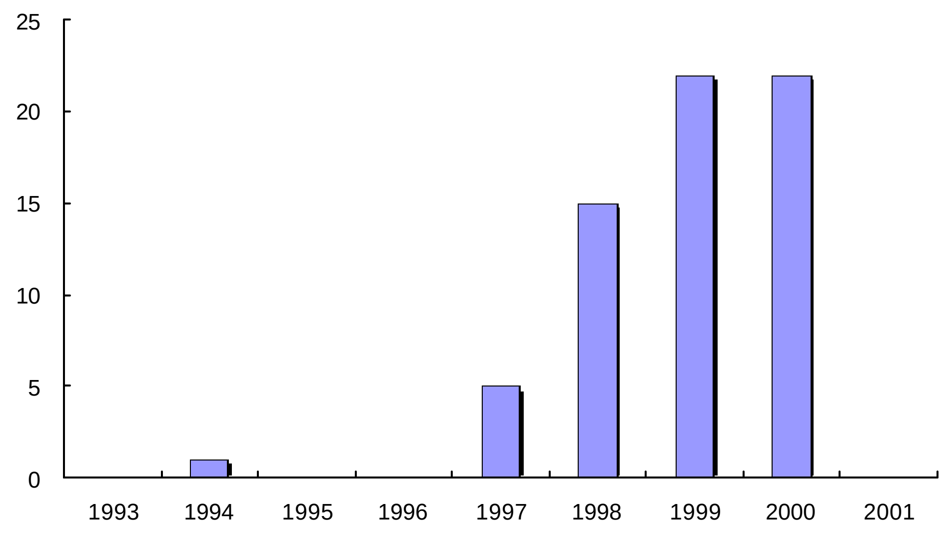
Source: Yearbook of People's Bank of China (2000) and http://drcnet.com.cn.

FIGURE 5
Number of Private Enterprises Entering Securities Markets, 1993-2001



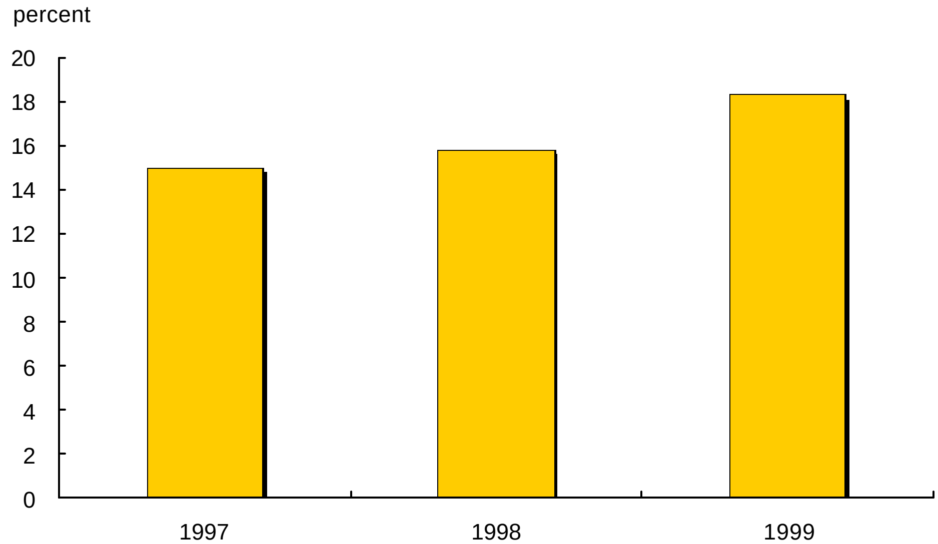
Source: Anhui Securities Corporation.

FIGURE 6
Acquisitions of Shell Companies by Private Enterprises, 1997-2001



Source: Anhui Securities Corporation.

FIGURE 7
Private Sector's Share of GDP, 1997-1999



Source: China State Statistics Bureau.