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EXPERIMENTATION IN SECURITIES MARKET STRUCTURE AND REGULATION IN CHINA: FROM STATE TO MARKET

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A key feature of the socialist market economy in China is the development of securities markets so as to facilitate entrepreneurship. With the national securities market now well established attention has shifted to the development of lower tier markets that may be able to meet the financing needs of smaller scale enterprises. In this article we examine how the concept of experimentation has been applied to the process of developing such markets and the regulatory framework in which they operate. We begin with a survey and critique of the policy and regulatory framework within which lower-tier markets have evolved. We argue that experimentation has been important in China but that it operates in a unique way as a result of the institutional structure in which securities markets are located. We then focus more specifically on the regulatory framework for lower tier markets and present two case studies focused on the establishment and operation of two local equity exchanges in a single province (LiaoNing). While this evidence supports our view on the significance of experimentation it also highlights the problems associated with developing lower-tier securities markets within the current policy framework.

A. INTRODUCTION

One outcome of the recent financial crisis has been the prioritisation of financial stability as a regulatory objective by international and national regulators.¹ Financial stability can be

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¹ While financial stability was omitted in the regulatory objectives of the Financial Services Authority (FSA) in the UK, it is now one of the legislative objectives for the FCA and PRA. In the US, a Financial Stability Oversight Council was introduced in 2010. An international body on financial stability, the Financial Stability Board (FSB) was established in 2009, as a successor to the Financial

defined as the dynamic ability of the financial market to “facilitate and enhance economic processes, manage risk, and absorb shocks.”² To achieve this objective requires a proper understanding of risks and uncertainty. In a Knightian world, risk is different from uncertainty in that the former is quantifiable and measurable whereas the latter not.³ For Minsky, such overlooked uncertainty, which he characterized as the endogenous instability problem of the financial market, may contribute to recurrent financial crises.⁴ This is because false confidence in the measurable future among market participants results from projecting future trends on the basis of past experience.⁵ As uncertainty is unavoidable and immeasurable, the simple oversight of the difference between risk and uncertainty may invalidate any claim of adequacy and effectiveness of a predetermined regulation.

The issue is then how we deal with a dynamic world of uncertainty. The risks of both over- and under- regulation are real. Overregulation may be good for market stability but at a cost of inhibiting competition and financial innovations or the creative destruction which is indispensable to the development of capitalism.⁶ Alternatively, under-regulation may contribute to free competition and financial innovation but increase the risk exposure of the whole financial system. Both will ultimately impose costs on taxpayers. A balance must be reached to achieve financial market stability and the sustainable development of the economy as a whole. However, the correct balance is difficult to achieve, especially since social and political pressure may drive regulators to adjust the risk tolerance of the entire financial system.⁷

In the light of the priority now given to financial market stability and the fact that financial regulations almost always lag behind financial innovations, a sensible regulatory

Stability Forum (FSF). The Board of the FSB includes representatives of the G-20 major economies, FSF members and the EU. For more information on the FSB, see <http://www.financialstabilityboard.org/> accessed 19 November 2015.

² See Garry J. Schinasi, ‘Defining Financial Stability’ (2004), IMF Working Paper WP/04/187.

³ See Frank H. Knight, *Risk, Uncertainty, and Profit* (Boston, MA: Houghton Mufflin 1921), 197–232.

⁴ See Hyman P. Minsky, *Stabilizing an Unstable Economy* (first published 1986, New York: McGraw-Hill 2008) especially at 219–245.

⁵ Alessio M. Paces, ‘Consequences of Uncertainty for Regulation: Law and Economics of the Financial Crisis’ (2010) 4 *ECFR* 479.

⁶ Joseph Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper & Bros. 1942).

⁷ See Iain MacNeil, ‘The Trajectory of Regulatory Reform in the UK in the Wake of the Financial Crisis’ (2010) 11 *EBOLR* 483, discussing the role of so-called “light touch” regulation in the UK.

goal is not to search for an optimum end-point for regulation but rather to pursue a new governance institution which accommodates never-ending recursive feedback loops between market practice and regulation. Indeed, the concept of financial stability itself is a dynamic and contextual one, as “it is considered a continuum: changeable over time and consistent with multiple combinations of the constituent elements of finance.”⁸ Such an intensive concern for financial stability thus entails a reform of the regulatory framework as it is increasingly accepted that the management of financial risks is no longer a private matter but a public concern.⁹

One approach to achieve this objective is to promote experimental governance. As will be discussed in further detail in the following sections, experimentation from local points to a wider scope under the hierarchical state structure with a strong central control has long been informing the decision making process of the central government in China.¹⁰ The fact that China faced a very unusual problem when it created its securities market in the 1990s from a planned economy has important implications on the later evolution of the Chinese securities market. China may accordingly follow an evolutionary path different from the west. The transition of the Chinese economy from a planned economy with a strong central control to the current socialist market economy is unprecedented. A strictly planned economy suffered from information asymmetry and distorted incentive mechanisms arising from the centrally controlled pricing system and resource allocation system. The market had no real role to play in resource allocation and so the traditional technique of developing regulatory rules (in the west) through market failure and cost-benefit analysis could not be applied since there was no market in place and therefore no concept of market failure. In that kind of environment experimentation has stronger attractions than in a system where there is already some form of market system in place (for capital as well as the underlying markets for other factors of

⁸ See Schinasi, ‘Defining Financial Stability’ (*supra* n 2) at 1.

⁹ Mads Andenas and Iris H-Y Chiu, ‘Financial Stability and Legal Integration in Financial Regulation’ (2013) 38 *E.L. Rev.* 335; Mads Andenas and Iris H-Y Chiu, *The Foundations and Future of Financial Regulation – Governance for Responsibility*, (Routledge, 2014); Christian Kopf, ‘Restoring Financial Stability in the EURO Area’, CEPS Policy Brief No.237 (2011).

¹⁰ It is noted that experimentalist governance promoted in the west however is of a polyarchic nature and thus is different from the experimentation conducted in China, where strong central control under the Nomenklature System and a hierarchical administrative system is apparent. Moreover, experimentation in China usually begins without corresponding laws. Instead, administrative policies from different levels in the administrative system are the norm. See Charles F. Sabel, Jonathan Zeitlin, ‘Experimentalist Governance’ in David Levi-Faur (ed.), *The Oxford Handbook of Governance*, (OUP 2012) 169-186,.

production such as land, labour, and natural resources).

Given that China has been enjoying the benefits arising from experimentation with economic development policies it is not surprising that experimentation on the regulation of the securities market has also been attempted. However, partly because the central government underestimated the negative impacts or was overconfident in controlling the securities market, the initial connivance from the central government on the development of local securities markets only led to a race to bottom among segmented local securities markets, which seriously undermined the stability of the national securities market. The notorious incident of 10 August 1992 in Shenzhen finally pressed the central government to strangle the rampant growth of local securities markets and to introduce the sole national regulator for the national securities market, the China Securities Regulatory Commission (CSRC).¹¹ The government has since then focused its efforts on the development of the two national stock exchanges. Gradually, the incremental keen demand for financing of SMEs was also recognized and considered in this process by introducing the SME Board and the Growth Board, or Chinext, onto the ShenZhen Stock Exchange (SZSE). However, the overly stringent listing standards on both the SME Board (which are almost similar to those on the two national stock exchanges) and the Chinext (which are still too harsh for SMEs even though they are more lenient in comparison with those of the SME Board) may in fact close the door of the two national stock exchanges to most SMEs who require financing.¹² This situation, in combination with the fact that both the formal stock exchanges and the existing banking system have historically been focused on the SOE-dominated national economy, severely constrains the financing for private enterprises, especially local SMEs.¹³ Within such a context, the development of the multi-tier securities market thus attracted the attention of the central government.¹⁴

¹¹ See *infra*, section B.

¹² This can be observed by the difference among the listing rules on the different boards.

¹³ Non-performing loans extended to SOEs have constrained the capacity of the banking system to finance SMEs. See World Bank and International Monetary Fund, 'China: Financial Sector Assessment' Washington, DC: World Bank and IMF Financial Sector Assessment Program, 2011, available at <http://www.worldbank.org/content/dam/Worldbank/document/WB-Chinas-Financial-Sector-Assessment-Report.pdf> accessed 19 November 2015

¹⁴ Decision of the CCCPC on Some Major Issues Concerning Comprehensively Deepening the Reform, passed on 12 November 2013 at the 3rd plenary session of the 18th Central Committee of the Communist Party of China (CCCPC) The development of the multi-tier capital market in general has been emphasized in both the 12th and the recent (framework for) 13th 5-year plan for national economic and social development. See Premier LI Keqiang: Promoting the Healthy Development of Multi-tier

While there are a large number of articles on the contribution of experimentation to economic development in China, we focus on a specific segment of China's financial market – the local securities exchanges established at the provincial level. It is worth noting to begin with that local securities markets may serve several purposes. First, they provide additional financing channels for locally established enterprises. This may be achieved not only by providing the local SMEs with equity financing via improving liquidity of shares of quoted companies but also by providing alternative financing sources, for instance, private placement, secondary equity offering, credit enhancement and loans on equity. Second, local securities markets offer more investment opportunities for investors who are less risk averse. Third, local securities markets may create pools of seed enterprises to be listed on trading centres or exchanges at higher levels. The development of a multi-tier capital market to facilitate financing for enterprises with different financial demands is thus an impending and indispensable requirement for the sustainable development of the Chinese national economy.

We aim to provide a timely study of how experimentation has been and is being conducted, focusing on the institutional dynamics of the process and its implications for the future evolution of the Chinese securities market. Viewed from that perspective, China is a meaningful reference point for the EU and the wider international community. However, China is also unique in several aspects. First, state intervention has long been established while in the west the recurrent financial crises and their implications for the economy as a whole have already led to calls for more effective government intervention in financial markets that have historically been less intensely regulated.¹⁵ How can the financial regulatory framework evolve as China's economy, including the financial market, becomes increasingly integrated with the international community? Second, compared with other jurisdictions, the financial market in China is still in its incipient stage. Given the de facto federalism¹⁶ in China, it is interesting to review the evolution of regulation of the financial

Capital Market, 7 March 2016, *Securities Times*,

<<http://kuaixun.stcn.com/2016/0307/12613826.shtml#>> accessed 15 June 2015.

¹⁵ Joseph E. Stiglitz, Jaime Jaramillo-Vallejo, and Yung Chal Park, 'The role of the state in financial markets' *World Bank Research Observer*, Annual Conference on Development Economics Supplement (1993) 19-61.

¹⁶ Yongnian Zheng, *De Facto Federalism in China Reforms and Dynamics of Central-Local Relations* (Beijing: World Scientific 2006).

markets. As the current regulatory scheme grants local governments an important role in local equity markets, our research will contribute to the understanding of de facto federalism in China and further elaborate the new characteristics of local-central relations in the financial market as the legal system matures. A prominent feature is competition between local governments for comparative advantage in their relations with the central government. Third, in the light of the recent focus on experimentation in the US and the EU¹⁷, the evolution of the regulatory framework of the local equity markets in China may better help us understand the relationship between “minimalism and experimentalism in the administrative state.”¹⁸

In contrast with the conventional focus on economically developed areas, we focus in particular on regional/local equity markets in one economically less developed province – LiaoNing in north-eastern China.¹⁹ While national strategies on regional economic development have long been in place, positive results remain elusive.²⁰ In fact, local governments in economically less developed areas may be doubly constrained. For one thing, their enterprises may suffer a more severe demand for financing due to a shortage of funding from banks, which may press the local governments to be bolder to explore riskier methods of financing. For another, due to the inertia of the local political and economic context and the concern for career development on the part of local governors, they may simply be rule-transplantees or passive followers of other leading provinces. In other words, local governments of economically less developed areas may have more convoluted motives to compete and/or collaborate with their peers to maximize their individual local interests either directly or indirectly by having a share of the interests of a larger region at provincial or even regional level. Alternatively, it is also interesting to observe how the central

¹⁷ See *supra* n 10 and accompanying text.

¹⁸ Charles F. Sabel and William H. Simon, ‘Minimalism and Experimentalism in the Administrative State’, (2010). Columbia Public Law & Legal Theory Working Papers, Paper 9187, available at <http://lsr.nellco.org/columbia_pllt/9187> accessed 19 November 2015.

¹⁹ We mainly deal with two local exchanges in this article, i.e., the LiaoNing Equity Exchange (LNEE) and the DaLian Equity Exchange (DLEE), both in LiaoNing province.

²⁰ The working group on the development of western China started in 2000 and the policy was approved in Fifth Session of the Fifteenth Central Committee of the Chinese Communist Party. The National Strategy to Rejuvenate Old Industrial Bases of north-eastern China was introduced in 2006 by the central government.

government promotes the development of local financial markets whereas at the same time it seeks to avoid the serious concern of a “race to the bottom” in terms of market integrity and investor protection.

It might well be argued that an empirical research of LEEs is premature at this stage. However, the shortage of rules on the regional/local equity markets at the national level provides a valuable opportunity to detect and map the evolutionary path of regulations for those markets in the coming years. Indeed, as Karl Polanyi pointed out, markets do not occur naturally but require to be supported by the state in some way (even if not formally regulated).²¹ The role of the state is particularly evident in China since the capacity for the spontaneous emergence and private-ordering of markets envisaged by Hayek²² is constrained by the central government. The development of the multi-tier capital market was inserted in the 12th national 5-year plan and several important and concrete measures have been introduced to promote the objective.²³ In comparison with the regulatory approach to the national New Third Board,²⁴ the central government and the CSRC have already opined that trading of shares of non-listed local companies shall be regulated by local provincial governments and that local provincial governments shall assume a larger role in promoting regional equity markets.²⁵

²¹ Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Boston: Beacon Press 2001 [1944]).

²² Hayek claimed that markets are capable of creating spontaneous order and that state interference will disrupt the just outcomes that would otherwise result from the operation of the market. See F A Hayek, *The Mirage of Social Justice*, vol 2 of *Law, Legislation and Liberty*, (Routledge 1979) at Ch 2.

²³ The General Office of the State Council (SCGO) issued Implementation Opinions on Financial Support to Develop Small and Micro Enterprises (SCGO [2013] Circular No. 87), in which the development of Regional Equity Market has been identified among the measures to provide direct financing channels to small and micro-sized enterprises. See SCGO [2013] Circular No. 87, *Implementation Opinions on Financial Supports to Develop Small and Micro Enterprises*.

²⁴ See *infra* section D 4.

²⁵ CSRC [2001] Circular No.5 Opinions on the Trust of Securities of Non-listed Public Companies, stating that: “due to the complexity and the wide scale of the issue, the redress work shall be carried out by local governments.”

Our article is structured as follows. In Part B we provide a high-level account of the role of experimentation in the development of securities markets in China. In Part C we link that process to the unique features of the institutional structure in China. The policy and regulatory framework surrounding the development of the local securities trading centers is set out in Part D. In Part E we focus on two case studies of formation and operation of Local Equity Exchanges (LEEs) in Liaoning Province. Part F concludes.

B. EXPERIMENTATION ON CHINA'S SECURITIES MARKET

At the time when the Communist Party of China (CPC) announced the reform and opening-up policy in the Third Plenary Session of the 11th Central Committee of the CPC in 1978, a decision which triggered the long phase of economic development in the following years, the concept of market economy was still of utmost ideological importance.²⁶ A common recognition as a result of heated debates on this issue was that both market and plan were merely methods to achieve high efficiency in resource allocation.²⁷ In other words, socialist countries can also develop the market economy to improve productivity.²⁸ Nevertheless, there was no predetermined itinerary when Deng announced to his citizenry that “To get rich is glorious” and “It is permitted to make a group of people to get rich first.”²⁹

²⁶ This was the well-known debate which persisted until the early 1990s over whether the surname of the Chinese economy was capitalist or socialist. See Shaoguang Wang, ‘Learning by Debating: The Changing Role of the State in China’s Economy and Economics Theories’ (1995) 23 *Policy Studies Journal* 11.

²⁷ This was especially the case when the Tiananmen Square incident happened in 1989. Deng Xiaoping stated clearly in several talks that both market and plan are tools or methods to achieve the development of economy. See Guangxiang Wu, ‘The Herald to Deng’s Talk in his Southern Trip, The Four Comments on Reform’, available at <<http://cpc.people.com.cn/GB/85037/8167608.html>> accessed 19 November 2015.

²⁸ The concept of socialist market economy did not emerge until the 14th National Congress of the CPC in 1992, ‘China’s central government decision on resolving several problems concerning the establishment of a socialist market economic system,’ *Renmin Ribao (People’s Daily)* (17 November 1993).

²⁹ The paradox in the claim with the established understanding of communism was later revealed in an interview with Deng in his eighties, who said:

“The main task in the socialist stage is to develop the productive forces, keep increasing the material wealth of society, steadily improve the life of the people and create material conditions for the advent of a communist society. There can be no communism with pauperism, or socialism with pauperism.

So to get rich is no sin. However, what we mean by getting rich is different from what you mean. Wealth in a socialist society belongs to the people. To get rich in a socialist society means prosperity for the entire people. The principles of socialism are: first, development of production and second,

One scholar observed that “Even the slogan *mo shitou guohe* (crossing the river by stepping from stone to stone) exaggerates the systemic component of China’s early reforms by suggesting a firm objective – the far bank of the river – where none existed.”³⁰

To explore the uncharted sea under the socialist canopy, China first separated several special economic zones (SEZs), where Township Village Enterprises (“TVEs”) were highly promoted.³¹ A generally accepted practice among TVEs in this period was that promoters made contributions in both capital and labour, an indicator of shareholding in its embryonic form.³² Such a method to pool capital was then accepted and promoted by the central government among other private enterprises.³³

With the success of these initial shareholding explorations in SEZs and villages, the CPC announced its “Decision on the Reform of the Economic System” in 1984 to promote a mixed economy with a role for both private and state-owned enterprises (SOEs) in the economy. Subsequently, the shareholding experimentation in villages was extended to cities, where SOEs joined to pilot the shareholding experimentation as an alternative route to reorganization of SOEs.³⁴ In adherence to the philosophy of gradualism, reorganizations via shareholding experimentation were first carried on among small and medium sized SOEs. It

common prosperity. We permit some people and some regions to become prosperous first, for the purpose of achieving common prosperity faster. That is why our policy will not lead to polarization, to a situation where the rich get richer while the poor get poorer.”

See Patrick Whiteley, ‘The Era of Prosperity is upon us’, *China Daily*, (19 Oct 2009), available at <http://www.chinadaily.com.cn/opinion/2007-10/19/content_6243676.htm> accessed 19 November 2015.

³⁰ Thomas Rawski, ‘Implications of China’s Reform Experience’, 1995 *China Quarterly* 1150, 1151-2.

³¹ The first public offer of share-like certificate (share certificate) was made by a Shenzhen TVE, the Baoan County Joint Investment Company in 1983. In the following year, an SOE in Beijing – Beijing Tianqiao Department Store - was converted into a company limited by shares.

³² Some would only contribute labour whereas others only capital.

³³ The Central Committee of the CPC, The Notification on the Work of Village by the Central Committee of the CPC 1984, even promoted such activities. Peasants and collectives were permitted to circulate their capital freely without boundary restrictions. Peasants were encouraged to invest in different enterprises via shares and to pool their capital to set up different organizations, especially those with a developmental objective. The State committed itself to protect the legal interests of such investments. See Guangyao Shi, Qi Zhang, Guofang Liu, and Haifeng Hu, *The Miracle of Capital – the Review and Envision of the 20 Years of Chinese Securities Market*, (Beijing: Economic Science Press 2010) at 26-7.

³⁴ As a result of SOE restructuring, the company as an organizational form was introduced when Beijing Tianqiao Department Store and Shanghai Feile Acoustics Company came into being in 1984.

was not until December 1986 when the State Council promulgated the Several Stipulations on Deepening the Reform and Enhancing the Vitality of Enterprises that shareholding experimentation was explored among big and medium sized SOEs.

Another reason contributing to the wide experimentation among SOEs was that banks had already been heavily burdened with a large amount of bad debts of SOEs in this restructuring period.³⁵ Given such an embarrassing financial situation, alternative financing sources had to be located by the government to alleviate the financing concern of its SOEs. Despite this, the acceptance of shareholding was not easy. Indeed, given that the assets of SOEs belong to the people collectively, the concept of shares as a form of private property was ideologically in conflict with the then widely established understanding of property ownership under the centrally planned economy. It is thus no wonder to read in one document issued by the State Council (SC) in 1986:

Enterprises wholly owned by the people shall not offer their shares to the public. For those big and mid-sized SOEs which have already been approved to explore the shareholding, the local governments in concern shall have a detailed review and purge, and for those which still need to continue issue shares to the public, local branches of the PBOC must review strictly.³⁶

In addition, the concept of share was not clear. Shares were not equity in the western legal sense but merely an alternative choice to energize the then moribund SOEs. In fact, shares issued during this period of time were more like bonds with variable dividends. Moreover, even if shares were bought, they were held for the long-term rather than for the purpose of being traded. Given the stronghold of SOEs and the belief among investors in the creditworthiness of the government in the past, this understanding was acceptable as the government was expected to pay the unpaid capital and dividends in the event of bad operating performance. However, such debt-like shares were still riskier than Treasury bonds backed explicitly by the State and thus unpopular among risk-averse investors even if they were provided with interest rates higher than that provided by bank deposits. The evolutionary path changed abruptly when investors of the Shenzhen Development Bank, the

³⁵ It is observed that fiscal subsidies to bad performing SOEs exceeded RMB140 billion in 1980. This led to the dominant financing role of banks who struggled to meet demand for loans despite growth in their deposits. See further Shi, et al, *The Miracle of Capital* (*supra* n 33) at 27-8.

³⁶ Art 2 of the Notification on Enhancing the Administration of Stocks and Debentures, SC No.22 [1987].

first Chinese financial institution limited by shares, found that a share for which they paid RMB20 could reap a cash dividend of RMB7, a two for one stock dividend, and a one-for-one stock split at the year end.³⁷ Similar exhilarating announcements of companies in other areas began to attract speculative investors despite the government's warning of the investment risk. China then experienced a share fever at the end of the 1980s.

During this period of time the People's Bank of China (and its local branches) was the main regulator. Without a clear regulatory framework from the centre, such spontaneous experimentations with the corporation as an organizational form and the issuance and trading of securities were energetically promoted by local governments in this period with support from local branches of the PBOC.³⁸ Securities companies also began to develop in this period of time. In 1985, Shenzhen established with the approval of the People's Bank of China the first professional securities company in China, Shenzhen Securities Inc., to engage in the trading of securities issued by Shenzhen enterprises. With the approval of the local branches of the PBOC,³⁹ more than 20 provinces, autonomous regions and special municipalities established their own securities companies afterwards, which further contributed to the development of the securities market.⁴⁰

The June 4th Tiananmen Square Incident in 1989 reverted the trajectory of economic reform to the ideological debate on whether the reform would ultimately lead China to capitalism.⁴¹ However, this incident only held up rather than setback the shareholding

³⁷ See Carl E. Walter and Fraser J. T. Howie, *"To Get Rich is Glorious!" – China's Stock Markets in the '80s and '90s* (NY: Palgrave, 2001) at 6-7. The authors observe (at 7) that "its shares skyrocketed from a year end price of RMB40 to RMB120 just before June 4 and ended the year at RMB90, the June interruption notwithstanding. In the late 1980s these sums were very big money".

³⁸ Informal (OTC) trading of shares was first observed in Shenyang in 1986 and then followed by other areas.

³⁹ According to (xi) of Article 5 the Provisional Regulation on the Administration of Bank of PRC promulgated by the SC on January 7 1986, "the PBOC has the power to administer such securities as enterprise bonds and stocks, administer the financial market." It should be noted that local branches of the PBOC have stronger ties with local governments than with their common headquarter in Beijing.

⁴⁰ See Shi, et al, *The Miracle of Capital* (*supra* n 33) at 26-27.

⁴¹ While this ideological debate is no longer a serious concern, the development of the socialist market economy in China has been shaped primarily "through elite disagreement over the appropriate relationship between state and market, and resembles an ad-hoc series of compromises between neo-liberal reformers on the right and the socialist left rather than a coherent "China model" of development." See Orion A. Lewis and Jessica C. Teets, 'A China Model? - Understanding the Evolution of a "Socialist Market Economy"', August 2009, Glasshouse Forum.

experimentation, which was tactically employed to introduce a modern enterprise system albeit that the function of the securities market in terms of public offering and trading securities was intentionally marginalized. Indeed in February 1989, State Committee for the Restructuring of the National Economic System (SCRES) emphasized that public offering of shares was not the focus of the shareholding reform⁴²; rather, the purpose of shareholding experimentation was to introduce the modern enterprise system by clarifying rights and responsibilities of the management. Six months later, the State Council promulgated the Notification on Public Offering Shares, which constrained, rather than prohibited, the public offering of shares within Shanghai and Shenzhen only. As a result, shareholding experimentation in other provinces almost all came to a stop. In parallel, another document issued in May 1990 by the SCRES also expressed a conservative attitude towards the development of the shareholding system at this specific juncture. After emphasizing the importance of the Contract Responsibility system,⁴³ the SCRES stated at the end of the document that the shareholding experimentation shall be carried on but three situations should be differentiated: 1) cross shareholding among enterprises shall be promoted; 2) employee shareholding programs shall be limited to their existing scale and no more experimentation of employee shareholding shall be promoted; and 3) no more experimentation of public offering can be accepted.⁴⁴ The upshot of these policies was that OTC⁴⁵ trading was permitted within Shanghai and Shenzhen only, which however paved the way to the establishment of the two formal stock exchanges months later.

⁴² See State Committee for the Restructuring of the National Economic System, The Notification on Enhancing the Supervision of the Organization to Safeguard the Healthy Development of the Explored Shareholding, (Telegram 15 February 1989).

⁴³ This refers to the extension of the contracting out system in the rural areas to the SOEs. In rural areas, peasants were allowed accordingly to produce and sell freely once they sold a given amount at the prices fixed by the state, a system which produced the high growth rate of the rural economy. Such experimentation was later extended to industrial enterprises. According to the Contract Responsibility System, the state held ownership whereas the management team was incentivized to improve performance: see Anthony Koo, 'The Contract Responsibility System: Transition from a Planned to a Market Economy' (1990) 38 *Economic Development and Cultural Change* 797.

⁴⁴ Art 29 Opinions on Deepening Enterprise Reform and Enhancing Enterprise Administration in the Process of Improvement and Rectification April 10 1990, approved and promulgated by the SC on 23 May 1990.

⁴⁵ OTC ("over the counter") refers to trading outside formally constituted markets. In China, however, OTC refers to any trading outside the national market system. In the west, OTC is primarily associated with derivatives, Eurobonds and wholesale money markets in which bilateral rather than exchange-based trading is the norm.

An unintended consequence of the June 4th incident was that the government merely gave up the initial choice of Beijing as the venue of its first stock exchange in China.⁴⁶ In the light of the political environment, “[t]he prospect of having socially sensitive securities trading located throughout the country, much less Beijing, was unacceptable to the government at this point.”⁴⁷ The introduction of formal stock exchanges and then constraining rather than suffocating the experimentation of the securities market was thus a choice of a lesser evil. The Shanghai Stock Exchange (SHSE) was finally recognized in December 1990 and the Shenzhen Stock Exchange (SZSE) in July 1991, albeit that the SZSE had already started to operate at the beginning of 1990.⁴⁸

Notably, both stock exchanges were regulated by the local branch of the PBOC and the local government of each city. Stocks issued and traded on these two exchanges were also those of local companies.⁴⁹ Viewed from this perspective, the stock exchanges were established with a strong local nature. Nevertheless, the commitment of the central government to further promote the shareholding experimentation could still be observed when it issued its Opinions on Standardization of Joint Stock Companies in May 1992.⁵⁰ However, an incident in Shenzhen on 10 August 1992 might well have aborted the initial efforts to introduce securities markets into China. As a practice in those days, investors who wanted to subscribe for shares were required first to acquire necessary forms for such subscription. However, when tens of thousands of investors who had lined up overnight were told in the morning that such forms had run out, a riot erupted in the city despite a subsequent release of more such forms. With the memory of the Tiananmen Square incident still fresh, the August 10 incident in Shenzhen drove the country into a heated ideological

⁴⁶ This was suggested by the Joint Office of Research and Design of Stock Exchange (established by students who studied abroad) on 15 March 1989. See Shi, et al., *The Miracle of Capital* (*supra* n 33) at 39.

⁴⁷ See Walter and Howie, *“To Get Rich is Glorious!”* (*supra* n 37) at 8.

⁴⁸ This is not to say that Shenzhen did not apply to establish the first Stock Exchange. However, no public information is available as to why the application from the Shenzhen Municipal government was postponed. However, it seems that Shenzhen may have suffered from starting operations prior to official approval whereas the Shanghai exchange was envisaged as a formal process of experimentation endorsed by the central government. See Zhangze LI, ‘The Exploration and Operation of the SZSE’, *Securities Times* 22 Oct 2010, available at http://zt.stcn.com/content/2010-10/22/content_1459856.htm accessed 10 June 2015

⁴⁹ There were 30 securities listed on the SHSE, i.e., 5 treasury bonds, 8 enterprise bonds, 9 finance bonds, 8 stocks (7 from Shanghai companies and 1 from Zhejiang). All companies listed on SZSE were local companies.

⁵⁰ SCRES, Opinions on Standardization of Joint Stock Companies, 15 May 1992.

debate.

However, it was again Deng (this time on his southern trip to Shenzhen) who expelled any doubt hanging over the development of the securities market in China.⁵¹ Encouraged by the decisiveness of the central government, the State Council extended the exploration of public offering of shares and trading of securities on Exchanges in three provinces (Guangdong, Fujian and Hainan) and two cities (Shanghai and Shenzhen) to thirty provinces and fourteen cities under separate plans.⁵² A quota system and a review and approval system were also introduced at the same time.⁵³ The two original stock exchanges with a strong local nature thus began their metamorphosis into national exchanges.

It should be noted that at the time when the two stock exchanges were established, there was no company law much less securities law in China: the relevant legal frameworks only took effect in 1993 and 1999 respectively. The regulatory framework was established through decisions, opinions of the Central Committee of the CPC (CCCPC), the SCRES at the centre, the local branches of PBOC or the local governments. The rampant growth of OTC trading in discrete localities and the notorious August 10 incident thus pressed for a strong central regulator. For that purpose, the SC established the Securities Committee of the SC and the CSRC in 1992. As a newly-born institution the CSRC's legitimacy was first established with help from the central government (the Securities Committee of the SC) to coordinate with the then existing multiple regulators.⁵⁴ With the promulgation of the Provisional Regulations on the Administration of Securities Exchanges in 1993 and the adoption of its

⁵¹ Deng said: 'Are such things as securities and stock markets good or not? Are they dangerous? Do these things exist only in capitalist system and can socialist ones use them too? It is permitted to try them out, but it must be done in a determined fashion'. See Changjiang Li, *The History and Development of China's Securities Markets*, (Beijing: Zhongguo Wuzi Chubanshe, 1998) at 86.

⁵² The SC promulgated the Notice of Further Strengthening the Macro-Administration of the Securities Market on 17 December 1992.

⁵³ Accordingly, JSCs which applied for public offering of their shares should first secure approval from these local governments, and then go through the review and approval of the CSRC and the review and approval of the stock exchanges.

⁵⁴ Walter and Howie identified three stages through which the CSRC established its authority as the sole regulator of the securities market: 1992-93 marked the establishment and consolidation of authority over the securities and future markets and extension of investigatory and enforcement powers; 1996 marked the CSRC's assumption of full control over the two securities exchanges; and in 1998 the CSRC became a full ministry-level organization empowered by the 1999 Securities Law. See Walter and Howie, *"To Get Rich is Glorious!"* (*supra* n 37) at 11.

final version in 1996,⁵⁵ the CSRC began to enjoy sole-regulator status. The Provisional Regulations vested in the CSRC the power to supervise exchanges within the country, which included 1) the power to nominate and remove directors and the general manager of the exchanges; 2) the power to investigate matters related to the exchanges and the settlement companies; 3) the power to review and approve the products and services to be provided on the exchanges; and 4) the power to review, and demand to change if it thinks necessary, the operation of the stock exchanges and related services.⁵⁶ The status and power of the CSRC was later confirmed in 1999 when the Securities Law of the PRC came into power.

During this evolutionary process, the Chinese securities market experienced the single regulator model under the control of the PBOC in its initial stage, then the multiple-regulator model in the transitional period, and finally the national sole-regulator model under the control of the CSRC. Viewed retrospectively, this evolution is in tune with the development of the Chinese securities market. In the initial stage, when there were merely spontaneous explorations at the local levels, the PBOC held the power to supervise the financial market as a whole. With the emergence of the securities market, the intervention of the local governments and the regulation of the local branches of the PBOC were necessary in the absence of national regulatory rules. Once the national regulators came to intervene, we observe the involvement of the PBOC, the Ministry of Finance, the Central Committee of the CPC, the State Committee of Restructuring National Economy and the State Administration of Foreign Exchange. The process was one of partitioning the emerging administrative power over an increasingly important market. However, the unregulated local markets, the inefficiency of the multiple-regulator model, the systemic importance of the securities market for the financial system and the experience from other countries all contributed to the ultimate single regulator model that now operates in the securities market in China.⁵⁷

⁵⁵ Securities Committee of the SC, Regulations on the Administration of Stock Exchanges, 21 August 1996.

⁵⁶ The rules thus required the stock exchanges to be subject to the regulation of the CSRC rather than the local government and the local branch of the PBOC. However, while SZSE undertook proactive compliance by referring to the CSRC directly, SHSE did not. For the different responses from the SHSE and SZSE to the adjustment to be made to their Articles of Association, see Walter and Howie, *"To Get Rich is Glorious!"* (*supra* n 37) at 77-8.

⁵⁷ The single regulator for the securities market (the CSRC) operates within a system in which regulatory responsibility for banking lies with the PBOC and for insurance with the CIRC. See generally Hui Huang, 'Institutional Structure of Financial Regulation in China: Lessons from the Global Financial Crisis' (2010) 10 *JCLS* 219.

C. EXPERIMENTATION IN THE SUI GENERIS CONTEXT OF CHINA

In a rule of law jurisdiction, path dependence in the legal system and the priority given to legal certainty may in fact frustrate experimentation in rule making.⁵⁸ In such a jurisdiction, the stickiness of the institutions, especially the legislative and political framework, means that small scale discrete experimentations and *ex post* automatic reviews of existing legislation designed to improve the adaptability of the regulatory system to the development of the real world may be favoured over introducing new laws driven by political pressure.⁵⁹ Romano therefore advocates that legislative tools such as sunset clauses and experimentation be adopted so as to provide “a feedback loop measuring and remedying regulatory errors.”⁶⁰

In comparison, China may not suffer from such institutional stickiness as the lack of a sound rule of law system in China provides a conducive environment for discretionary and experimental administrative policies before laws and regulations are enacted.⁶¹ Still, the approach conducted in China can only be properly understood within its special institutional environment, of which the following are of special importance. The first is the *de facto* federalism,⁶² or the regionally decentralized governance system, which is defined as “a combination of political centralization and economic regional decentralization.”⁶³ The *de facto* federalism is different from the federalism in the US, where each state has its own legislative power and where legal rule competition is an inherent nature of state competition. Local governments in China enjoy only limited legislative power of making regulations

⁵⁸ See Zachary J Gubler, ‘Experimental Rules’ (2014) 55 *B.C. L. Rev.* 129, at 139-141. While the federalism in the US may provide a favourable environment for large scale experimentation, the promotion of experimental rules became widespread in the UK only since 1997: see Performance and Innovation Unit ‘*Adding It Up: Improving Analysis and Modelling in Central Government*’ (London: Cabinet Office 2000); Roger Jowell, ‘Trying It Out – The Role of ‘Pilots’ in Policy-Making’, (Government Chief Social Researcher’s Office 2003), at 8-9.

⁵⁹ Roberta Romano, *Regulating in the Dark*, in Cary Coglianese, ed., *Regulatory Breakdown: The Crisis of Confidence in U.S. Regulation* (University of Pennsylvania Press, 2012), at 4-5.

⁶⁰ Roberta Romano, ‘Further Assessment of the Iron Law of Financial Regulation: A Postscript to *Regulating in the Dark*’, ECGI Working Paper N°. 273/2014, available at: <http://ssrn.com/abstract=2517853> accessed 19 November 2015, at 1.

⁶¹ Sebastian Heilmann, ‘Experimentation under Hierarchy: Policy Experiments in the Reorganization of China’s State Sector, 1978-2008’, (2008) Working Paper No.172 of the Center for International Development at Harvard University.

⁶² See Zheng, *De Facto Federalism* (*supra* n 16).

⁶³ Chenggang Xu, ‘The Fundamental Institutions of China’s Reforms and Development’ (2011) 49 *Journal of Economic Literature* 1077.

(rather than laws) which can neither be in conflict with the laws nor exceed the boundaries established in laws or regulations created by a legislative agency at a higher level.⁶⁴ It is true that when the target sector is unregulated, local governments may enjoy discretion in the initial stage of the reform. However, the strong central government within such a de facto federalism may easily control the timing, the substance and the progress of experimentation at local levels.⁶⁵ Accordingly, free competition among different rule providers is seriously constrained in China.

The second feature is the Nomenklatura system, which was transplanted from the Soviet Union but well maintained in China until today. The Nomenklatura system refers to the institutional arrangements on personnel management, through which the Party has the power to make appointments to and decides the list of potential candidates for key positions both in the government and the party's own hierarchy.⁶⁶ The Nomenklatura system covers a wide range of personnel from political positions to positions in judiciary organs, academic institutions and enterprises, including all top staff on the regulatory bodies and the senior staff on the two national stock exchanges.⁶⁷ The Nomenklatura system may in fact establish a set of strong and effective norms constraining behaviour of agents, which is important for a jurisdiction without a sound legal system but may tend to prioritise consensus over consistent policy-making.⁶⁸

Figure 1. The Nomenklatura System in China

⁶⁴ Legislation Law of the PRC 2015, Article 72 and 73

⁶⁵ See Heilmann, *Experimentation under Hierarchy* (*supra* n 61) at 4.

⁶⁶ See generally John Burns, 'China's Nomenklatura System' (1987) 33 *Problems of Communism* 36.

⁶⁷ For a list of the job titles covered, see Burns (*supra* n 66). A related concept is BianZhi, which is usually translated into "establishment." The two concepts are different. BianZhi is intended to clarify what departments and positions are included in an administrative setup whereas the Nomenklatura system determines which job titles are under the party control. Since 1980, the system has already been extended to party committees at lower levels. See Kjeld Brødsgaard (2012) 'Cadre and Personnel Management in the CPC', 10 *China: An Int'l J.* 69.

⁶⁸ See Heilmann, 'Experimentation under Hierarchy' (*supra* n 61) at 2.

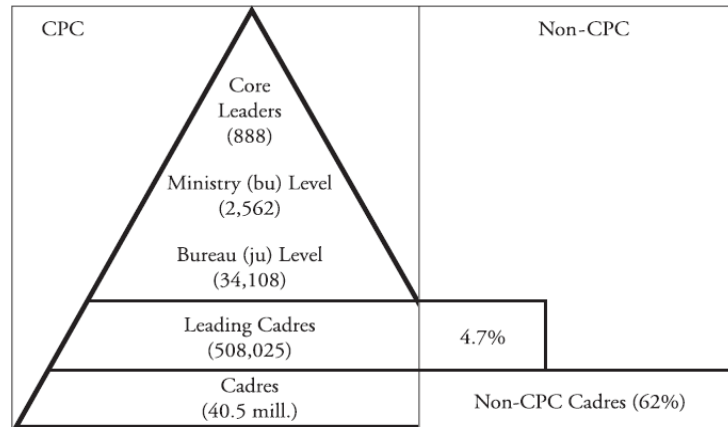


Figure reproduced from Kjeld Brødsgaard, ‘Cadre and Personnel Management in the CPC’⁶⁹

Experimentation in China must therefore be understood as “experimentation under hierarchy,” a policy experimentation process within the *de facto* federalism and the strong hierarchical Nomenklatura system.⁷⁰ Within such a world, the centre enjoys an incomparable advantage, by comparison both with other jurisdictions and local governments within China, in understanding and constantly monitoring the non-linear feedback dynamics that follow the introduction of a policy by the local governments.⁷¹

The third feature is that, in comparison with the West, China is a Party-controlled state where there is no concern for recurrent electoral campaigns. It may accordingly have a longer-term view and more capacity to accumulate experience before reaching conclusions about financial market experiments and appropriate regulatory frameworks. The longer time-frame and secure political position of policy makers in China thus facilitated institutional transformation.⁷²

The fourth feature is the almost uniform economic, political and governance structure of

⁶⁹ Figure reproduced from Kjeld Brødsgaard, ‘Cadre and Personnel Management in the CPC’, (*supra* n 67), at 75

⁷⁰ Sebastian Heilmann, ‘Policy Experimentation in China’s Economic Rise’ (2006) 43 *St Comp Int Dev* 1.

⁷¹ For a good description of the central-local relations, see Lisheng Dong, ‘Central-Local Relations in China: Retrospect and Prospect’ (2007) Discussion Paper 16 China Policy Institute University of Nottingham. Deng Xiaoping announced publicly that the centre must have authority over local governments. See Deng Xiaoping, ‘The Centre Must Have Authority’, in *The Works of Deng Xiaoping*, (Beijing: Renmin Publishing House, 1993).

⁷² See Heilmann, ‘Experimentation under Hierarchy’ (*supra* n 61) at 16.

local governments. While it is true that different provinces may enjoy different natural endowments and different heritage from history, the governance structure is almost identical across provinces.⁷³ In fact, provincial economies were more self-sufficient than their counterparts in the west since Mao, fearing military invasion from the outside, encouraged local self-sufficiency and devolved much planning and administration to provincial cadres.⁷⁴ Explorations within such a context may therefore be more meaningful in terms of evaluating the effectiveness of the policies. Also, given the variation in the economic power of individual provinces, policies that have failed in one province may well be effective in another province or policies becoming redundant in one province may well start a new life in another province; and both situations may well mitigate the exploration costs.

Figure 2. Stylized Governance Structure of China

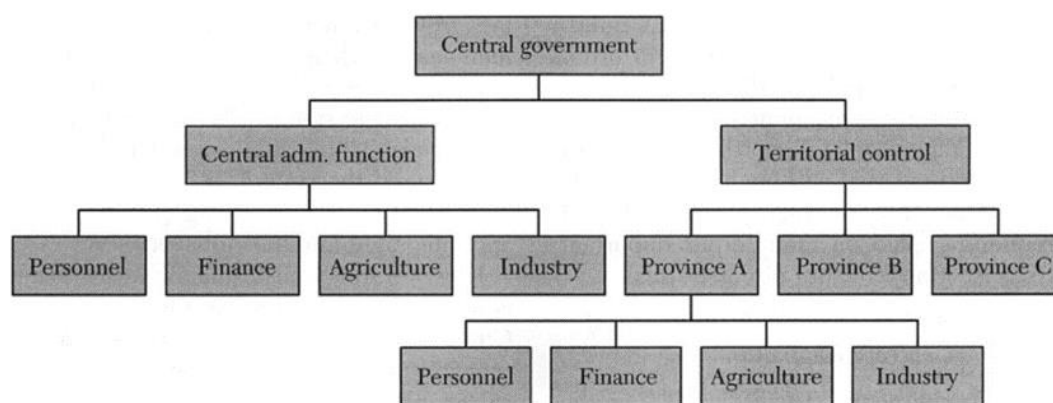


Figure reproduced from Xu, ‘The Fundamental Institutions’⁷⁵

Finally, despite the use of the terminology “Over the Counter (OTC)” to describe informal markets in China, the absence of a clear regulatory perimeter comparable to western systems means that the term OTC cannot be understood in the same way in China. In the west, the regulatory perimeter clearly delineates regulated activities from those that are not regulated, albeit that the perimeter may be adjusted over time through legislation in line with the prevailing political view of the appropriate balance between market freedom and state intervention.⁷⁶ In China, there is no such clear demarcation, albeit that the OTC market has

⁷³ See Xu, ‘The Fundamental Institutions’ (*supra* n 63).

⁷⁴ See Yingyi Qian and Barry R. Weingast, ‘China’s Transition to Markets: Market-Preserving Federalism, Chinese Style’ (1996) 1 *Journal of Policy Reform* 149.

⁷⁵ See Xu, ‘The Fundamental Institutions’ (*supra* n 63).

⁷⁶ For example, the regulatory perimeter has expanded in Europe and the US in the wake of the financial crisis.

been more clearly defined in a recent administrative measure as securities trading outside the national market system (SHSE and SZSE) and the New Third Board (NEEQ).⁷⁷ The nature of the socialist market economy (and the role of law within such a system) leaves the state (the central government and its agencies as well as local governments) with considerable discretionary powers of intervention. Thus, innovation and experimentation in such a system occurs in the shadow of the state in a much more direct manner than occurs in the west and the characterization of the OTC market as a self-regulating domain is much less relevant.

Experimentation within such a *sui generis* Chinese context can therefore be characterised as diagnostics before prescription, according to which local incentives are generated for policy competition and institutional innovation.⁷⁸ On the other hand, communication between the local and the central government is also safeguarded. The central government can in this process garner information on both failure and success through reports and paroling officials from the central authority and thus constrain the negative effects of bad policies and expand the benefits of good ones.⁷⁹ To a large extent, political opposition to new reforms has also been pacified by the learning processes generated through the regional experimentation.⁸⁰ This process cannot be simply labelled as top-down or bottom-up. Rather, it is a dynamic adaptation given the specific local situation.⁸¹ On this, Bakhshi *et al* aptly articulate that “any experiment is a hypothesis test” and “the point is not to prove that something is correct,, but rather to discover what was not known, and then

⁷⁷ See the National Securities Association, Administrative Measures on File for Record of OTC Securities Business, effective 1st September 2015. This definition does not in itself adjust or clarify the regulatory perimeter, nor does it protect OTC activity from retrospective regulatory intervention.

⁷⁸ Dani Rodrik, ‘Diagnostics before Prescription’ (2010) 24 *J Eco. Perspectives* 33; Sebastian Heilmann, ‘From local experiments to national policy: the origins of China's distinctive Policy Process’ (2008) 59 *The China Journal* 1; Max Boisot and John Child, ‘From Fiefs to Clans and Network Capitalism: Explaining China's Emerging Economic Order’ (1996) 41 *Administrative Science Quarterly* 600; Max Boisot and John Child, ‘The Iron Law of Fiefs: Bureaucratic Failure and the Problem of Governance in the Chinese Economic Reforms’ (1988) 33 *Administrative Science Quarterly* 507.

⁷⁹ Xiao Li, ‘Legal and Economic Development with Sui Generis Chinese Characteristics: A Systems Theorist's Perspective’ (2014) 39 *Brooklyn Journal of International Law* 159.

⁸⁰ See Xu, ‘The Fundamental Institutions’ (*supra* n 63).

⁸¹ Xufeng Zhu, ‘Mandate versus Championship Vertical Government Intervention and Diffusion of Innovation in Public Services in Authoritarian China’ (2014) 16 *Public Management Review* 117'. Such adaptation also happens in the political system: see Wen-Hsuan Tsai and Nicola Dean, ‘Experimentation under Hierarchy in Local Conditions: Cases of Political Reform in Guangdong and Sichuan, China’ (2014) 218 *China Quarterly* 339.

to use that new knowledge for further exploration.”⁸²

Despite the largely successful experience in the past, one side effect of such an institutional background is that the sequence of reform in different aspects of economic life is largely the intentional choice of the central government. For instance, in comparison with other sectors of the economy, reforms on the financial market and the market for land have long been intentionally delayed.⁸³ Nevertheless, it is understood that the development of the financial market must be adaptable to the national economy as a whole and in turn, financial market regulation can only be deemed as means to achieve the macro objective of economic and social development.⁸⁴ Thus, due to the increasing importance of small and medium sized enterprises in the sustainable development of the Chinese economy, the development of a multi-tier capital market, which is the key to provide multiple financing channels to different types of enterprises and multiple investment opportunities for investors with different risk preferences, has gradually attracted the attention of the central government.

D. REGULATION OF LOCAL EQUITY EXCHANGES

1. History

The initial rampant growth of local stock exchanges (LSEs) has been characterised as an experiment of local governments in the mid-1980s to “circumvent conservative opposition from Beijing.”⁸⁵ The upshot was a largely unregulated market overseen by local governments, whose regulatory concerns were primarily to require local firms to be quoted on LSEs and to cultivate local securities trading companies.⁸⁶ While the initial efforts of local governments

⁸² Hasan Bakhshi, Alan Freeman and Jason Potts, 'State of Uncertainty – Innovation Policy through Experimentation', NESTA Provocation 14 April 2011, https://www.nesta.org.uk/sites/default/files/state_of_uncertainty.pdf, accessed 19 November 2015 at 11.

⁸³ The reform of the financial market has been ongoing but slowly and carefully, see Barry Naughton, *The Chinese Economy: Transitions and Growth* (Cambridge, MA: MIT Press 2007). The reform of the land market is just starting.

⁸⁴ See Yifu LIN, *New Paradigm for Interpreting the Chinese Economy: Theories, Challenges and Opportunities*, (Singapore; Hackensack, N.J.: World Scientific Publishing Company 2014).

⁸⁵ Stephen Green, *China's Stock Market: A Guide to Progress, Players and Prospects* (London: Profile Books Ltd 2003) at 154.

⁸⁶ Qingshan Tan, 'State, Institution Building, and Emerging Stock Markets in China' (2004) 37 *Communist and Post-Communist Studies* 373, at 374, 378-381.

resulted in the establishment of 25 securities trading centres without opposition from the central government (under the ideology of Deng Xiaoping), the arrival of Zhu Rongji as Premier in 1991 deflected the evolutionary path to that of developing the two national stock exchanges on the model of a national securities market.⁸⁷

During this period local stock exchanges (LSEs) functioned more like brokerage offices as the shares traded on these exchanges were those already listed on the SHSE and SZSE. In the main, this pattern corresponded with the evolution of local stock exchanges in the UK⁸⁸ although it was noted that in addition to Treasury Bonds and local investment funds, no less than 12 LSEs also listed the shares of local companies.⁸⁹ At this stage however LSEs were not recognised by the central government and the legal status of LSEs was also dubious. Without regulations, many LSEs became highly indebted and the national financial system was also seriously segmented into discrete parts.⁹⁰ Further exacerbated by the Asian financial crisis in 1997, all the LSEs were required to be purged or closed down according to one Notification from the General Office of the State Council (SCGO).⁹¹

In fact, the SCGO issued a series of circulars in 1998,⁹² which outlawed any then existing property trading centres operating without prior approval from the SC. Such trading centres ranged from property rights trading centres, securities trading centres, automatic quotation systems for securities trading to other centres where transactions of shares of non-listed companies, equity certificates and other equity-like products were conducted. This campaign to purge or close down LSEs came to an end when the life of the last LSE (The HaiNan Stock Exchange) was terminated in June 2003.

⁸⁷ See Green, *China's Stock Market* (*supra* n 85) at 155-6.

⁸⁸ See Andrew Leyshon, Nigel Thrift and Caroline Tommey, *The Rise of the British Provincial Financial Center*, (Oxford Pergamon Press 1990).

⁸⁹ See Green, *China's Stock Market* (*supra* n 85) at 156.

⁹⁰ *Ibid*, at 155-7. Noticeably, local stock exchanges could still be called as such in this period of time as the law did not prohibit such titles. In the later stage, local stock exchanges were all designated as Local Equity Exchange or Equity Custody Centre.

⁹¹ The SCGO forwarded the Notification by the CSRC of Measures on Purging and Closing down Illegal Transactions of Securities on OTC Market, (SCGO [1998] No.10) hereafter SCGO Circular No.10.

⁹² In addition to SCGO Circular No.10 (*supra* n 91) in March, the SCGO forwarded the Notification by the CSRC of Measures on Purging and Closing down Securities Operation Institutions, (SCGO [1998] No.78) in June; SCGO forwarded the Notification by the CSRC of Measures on Purging and Closing down Securities Trading Centers, (SCGO [1998] No.135) in September.

However, the demise of the LSEs did not remove the underlying demand for shares of non-listed companies to be traded on the OTC market. Indeed, with the support of local governments and as a by-product of the SOE reform, local property rights trading centres never entirely disappeared from the market. But the main clients of these local property rights centres were local SOEs despite the then already developed private economy. Generally, transactions were conducted on open markets without a competitive bidding process but with a limitation of the listing period on the local property rights trading centres.⁹³ Products transacted on these local property rights centres however were not limited to the shares of local SOEs but also include precious metals, cultural products⁹⁴ and other properties.

In spite of such a prohibitive environment, some courageous local property trading centres began to experiment with a centralized competitive bidding process and continuous trading of products. However, these initiatives only courted more intensive constraints from the central government. In 2011, the SC issued Circular No.38 and the SCGO later issued Circular No.37.⁹⁵ With an objective to develop a multi-tier capital market while at the same time to mitigate system risks, these two circulars, the drafting of which was dominated by the CSRC, were framed as principles with a prohibitive nature. In essence, these latter documents establish that only one equity exchange may be established within each province.⁹⁶ The establishment of Local Equity Exchanges (LEEs) must be approved by provincial governments. LEEs are expected to function as private placement markets to

⁹³ For example, Art 21 of the Measures of Administering the Transactions of State Owned Property Rights of Shandong Province stipulates that the listing period shall not be less than 15 days. The Measures are available at <http://www.wfcqjy.com/newsinfo.asp?topid=L21&f=%E6%9C%8D%E5%8A%A1%E6%8C%87%E5%8D%97&s=%E5%B1%B1%E4%B8%9C%E7%9C%81%E7%9B%B8%E5%85%B3%E6%B3%95%E8%A7%84&img=ibanner04.jpg&newsId=L310310957264564&classid=L2102> accessed 19 November 2015.

⁹⁴ Intellectual property rights were subject to a formal legal regime before securities: Trademarks in 1982, Patents in 1984 and Copyright in 1990. These rights could be traded on the LSEs.

⁹⁵ Decision of the State Council Concerning the Screening and Rectification of Various Types of Trading Venues to Effectively Prevent Financial Risks (Circular No. 38 [2011] of the SC) and Implementation Opinions of the SCGO Concerning the Screening and Rectification of Various Types of Trading Venues (SCGO Circular No. 37 [2012]).

⁹⁶ It is noticeable that local securities trading centers employ the title “Equity Exchange” rather than Stock Exchange: the latter is under the coverage of the Securities Law, which stipulates that Stock Exchanges must be established with prior approval from the State Council and the CSRC. Some interviewees expressed the view that the title “Equity Exchange” may theoretically provide support to local governments to evade CSRC regulations.

provide financing services to local enterprises by facilitating equity and debenture transfer and other financing services. In principle, an LEE cannot establish subsidiaries or branches in other provinces nor can it accept quoting applications from companies outside the local province. In cases where there is such a demand, the relevant provincial governments shall co-monitor the activities if they approve such cross-boundary transactions. LEEs are also required to establish administrative systems regulating members of LEEs and rules on the admission of investors to the market. In addition, with the approval of the provincial government, LEEs are required to make rules on quoting (and de-quoting), rules on information disclosure, rules on registration, custody and settlement.

In the following year, the CSRC issued the Guiding Opinions on Regulating Securities Companies' Participation in Regional Equity Trading Markets (Provisional),⁹⁷ which further affirmed that the regional OTC markets were an important part of the multi-tier capital market. The resolve of the central government to establish local equity exchanges to support the multi-tier capital market has since been further reinforced in a series of documents promulgated by the SC.⁹⁸

2. Central Control of LEEs through Regulation of Intermediaries

Intermediaries on the multi-tier capital market include securities companies, accounting firms, law firms, investment consultancy services firms and credit rating agencies. Among those intermediaries, securities companies play a central role in listing, executing transactions and advising investors and so we focus on them in this discussion.

According to Circular No.20, securities companies may also participate in share transfer, private placement, debenture financing and provide investment consultation services on LEEs. Due to the adoption of a “centralized competitive pricing system” on the two national stock exchanges, the securities companies act only as agency brokers in securities transactions. Laws and administrative regulations prohibit employees of securities

⁹⁷ CSRC Circular No. 20 [2012] Guiding Opinions on Regulating Securities Companies' Participation in Regional Equity Trading Markets (Trial).

⁹⁸ The SCGO, Opinions on Promoting Micro and Small Enterprises Financially, SCGO No.87 [2013]; The CCCPC and the SC, Several Opinions on Deepening the Reform of Institution and Hastening the Implementation of Development Strategy Driven by Innovation, in March 2015 and the SC, Opinions on Promoting Entrepreneurship and Innovation among Populace, SC No.32 [2015].

companies from participating in securities trading. The market maker system, which plays a prominent role in the in the US and UK securities markets, did not have a root to bloom in China as it was not favoured in the initial phase of financial development. However, the policy changed when the central government started to promote financial innovation and the market-maker system was permitted for the New Third Market (NEEQ).⁹⁹ It remains unclear whether or not securities companies can be market makers on LEEs.¹⁰⁰ But considering the potential contribution of market-makers in improving liquidity of the securities market, it is possible that the market-maker system will be launched to revitalize the regional LEEs. Indeed, if the market-maker system is introduced into the LEEs, securities companies may play a more important role of improving market liquidity by either quoting to both sides of the transaction, or seeking and accepting requirements from both transaction parties to reach deals,¹⁰¹ or entering into transactions with either side of the transactions using its own capital on a continuous basis.¹⁰²

Apart from securities companies, accounting firms, law firms and other firms which offer investment consulting services are usually called securities trading service organizations and can provide professional services but are prohibited in securities transactions from acting as

⁹⁹ The Rules of the National Equities Exchange and Quotations for the Sponsoring Brokers Management (Trial) (2013), Article 7 lists the general conditions for securities companies to be a market maker on New Third Board (NEEQ). The NEEQ then officially recognized the legality of market maker business through the announcement of The National Equities Exchange and Quotations Market Maker Business Management (Trial) (2014).

¹⁰⁰ The only LEE which introduced the market maker system is the Tianjin EE which benefits from less intervention from the CSRC. See *infra* section D5 for further information.

¹⁰¹ According to Article 143 of the Securities Law of PRC 2014, a securities company shall not accept the entrustment of discretionary power by a client to decide on the timings, types, quantities and prices of securities transactions when conducting brokerage business. This means the securities companies could only do what the clients ask them to do, but can't automatically seek and reach deals by representing both transaction parties.

¹⁰² As a result of the three circulars issued by CSRC but forwarded by the SCGO in 1998 (*supra* n 92), the norm of three prohibitions, *i.e.*, prohibition on division of an order, prohibition on standardization of an order, and prohibition on continuous trading, had been soundly established on the equity market. Ever since then, market making business on the securities market has largely been prohibited without prior permission from the CSRC. The prohibition was further enhanced by an order co-issued by the SASAC and the Ministry of Finance, The Provisional Measures on the Administration of Transfer of State Owned Property of Enterprises, SASAC Circular No.3, on 31 December 2003. The market maker model only became accepted by the central government in its recent efforts to promote mixed ownership to revive the SOE dominated national economy: see State Council, Opinions on Developing Mixed Ownership by SOEs, SC Circular No. 54 2015 on 24 September 2015.

agents, or purchasing or selling securities by themselves.¹⁰³ This however can be modified to adapt to the development of the LEEs. For instance, qualified accounting firms and law firms may secure a licence as a recommendation member, which may entitle the law firm or the accounting firm to participate in equity transfer, private placement of bonds, debenture financing and to provide investment consultation services on the LNEE.¹⁰⁴ Thus, accounting firms and law firms may have a broader business scope on the LEEs.

In China, securities business is separated from banking business, trust business and insurance business with the result that these activities cannot be combined within the same entity.¹⁰⁵ However, trust companies, small loan companies, financing guarantee companies and other banking institutions are all qualified to be a special member or strategy cooperation member of LEEs and can thereby offer support services for the quoted companies across the range of activities of the LEEs (including both debt and equity financing).

Table 1. Intermediaries on the Multi-tier Capital Market

	SHEE and SZEE	The Third Board (NEEQ)	LEE
Securities companies	√	√	√
Accounting firms and law firms, etc.	√	√	√
Trust companies, small loan companies, financing guarantee companies, banking institutions, etc.			√

¹⁰³ Securities Law of the PRC 2014 Art 171.

¹⁰⁴ The Rules of the Liaoning Equity Exchange Membership Management (Trial) Article 5 and 8.

¹⁰⁵ Securities Law of the PRC 2014 Article 6.

3. Local Regulation of LEEs

With the evolution of the LEEs, it is worth noting the increasingly important role played by the Local Financial Office (LFO) in this dynamic evolutionary process.¹⁰⁶ The first LFO was established in Shanghai in 2002. Today, all 31 provinces and 222 local prefectural cities have already set up their own Financial Offices.¹⁰⁷ LFOs were initially established with a function of liaison and coordination with the PBC, CSRC, CBRC and CIRC and other financial institutions. Nowadays, the LFOs have already played an important role in introducing local regulations on financial markets, facilitating corporate financing for local enterprises, and monitoring local state-owned financial institutions.

As the LFOs are within the organizational chart of local governments, there is no vertical hierarchical structure among LFOs at different levels. This may pose a serious concern on the power of the central government and accordingly the coherence of regulations on the LEEs, rules which are designed by different local governments.¹⁰⁸ This concern may however be alleviated by developing regional securities markets across provincial boundaries. In history, similar efforts to develop regional financial markets can be observed in the evolution of the banking industry.¹⁰⁹ However, it is still too early to tell whether the regional equity centres will follow the trajectory of the banking industry.

In practice, the strong hand of the sole regulator CSRC has seriously limited the discretion of local governments in regulating local financial matters.¹¹⁰ However, to facilitate

¹⁰⁶ On 30 March of 2009, the LFO of Beijing was renamed as the Finance Bureau, a governmental bureau level department, directly under the control of the local government.

¹⁰⁷ The first LFO was established in Shanghai in 2002. See Yonggang Liu and Hua Wei, 'The History of Local Financial Office' (2013) *China Economic Weekly* 23 at 26.

¹⁰⁸ This may give rise to "the provinces' relative independence from the central government on the one hand, and being independent from each other on the other hand." See Zheng, *De Facto Federalism in China*, (*supra* n 16) at 366.

¹⁰⁹ Historically, the nine branches set up by the PBOC across the country (Tianjin, Shanghai, Nanjing, Shenyang, Wuhan, Guangzhou, Chengdu, Xian, and Jinan) can be viewed as a forerunner of the regional financial markets in China.

¹¹⁰ The history of the (so-called) Chinese OTC stock market is marked by two clean-up initiatives, which terminated all the non-stock exchange stock trading activities: see Caili Yang and Yiqun Cao, 'Review of the Development of China's OTC Market in 1990s', in Luan Gao and Guanhua Zhong (ed), *Annual Report on China's OTC Market Development 2009-2010* (Beijing: Social Sciences Academic Press 2009), 62-93, at 90. Despite the fact that Local Property Rights Centres filled the gap, it should be noted that it is not securities but the property rights (of SOEs in general) that are traded on LPTCs: see also Fengjun He, 'The Game on the Allocation of Financial Resources between the Central

the development of a multi-tier capital market, regulatory authority may have to be delicately distributed between the CSRC and the local governments so that the local/regional securities markets may both provide additional financing sources to SMEs and secure the intended market stability and integrity. On the one hand, local governments may be better suited than a short-staffed CSRC to monitor the local situation. First, if local companies are the main candidate companies to be quoted on regional/local equity markets, local governments may have a better understanding of such companies and a stronger power to make and enforce local regulations.¹¹¹ Second, if local governments have more opportunities to experiment with new policies, competition among local regulations may produce rules with better qualities in terms of market integrity and investor protection.¹¹²

On the other hand, unconstrained discretion of local governments may also engender ill-effects undermining the stability of the whole securities market. Researchers have already demonstrated that it is the intervention from local governments at different levels that leads to widely observed abuses such as tunnelling, holding-back of cash dividends, distorted refinancing on the stock market and the malfunction of the delisting system.¹¹³ Also, a regulatory race to the bottom between local governments may still be a real serious concern, the gravity of which may be more precarious due to the almost homogenous financial structures of different provinces.¹¹⁴ Again, this is another delicate balance the central

Government and Local Governments' (2005) 11 *Chongqing University Academic (Social Science Section)* 42.

¹¹¹ This may also be beneficial to potential investors, who may have special knowledge of local business.

¹¹² Expressing this in terms of the theory of complex adaptive systems, chaos at local levels in this situation is beneficial to stability at higher levels. For the application of the CAS theories to financial market regulation, see Edoardo Gaffeo and Roberto Tamborini, 'If the Financial System is Complex, How Can We Regulate It?' (2011) 40 *International Journal of Political Economy* 79; William White, 'The Prudential Regulation of Financial Institutions: Why Regulatory Responses to the Crisis Might Not Prove Sufficient' (2013) 6 *University of Calgary The School of Public Policy Research Papers* 1. For experimental rules in financial markets from the perspective of public choice theory, see Zachary Gubler, 'Experimental Rules', *supra* n 58.

¹¹³ Local governments with a strong inclination to serve local interests may well tunnel assets of those limited number of listed companies, which seriously undermines the confidence of the investors on the market. In addition, the reason why it is hard to delist listed companies with ST status from the national stock exchanges is that the ultimate shareholder (local governments) of those ST companies may well take advantage of the current accounting rules to give ST companies a break; this is the notorious "phoenix nirvana" on the Chinese stock market. ST means special treatment. In China, when a listed company triggers one of several financial distress indicators its shares will be labelled "ST". See Rule 13.1.4 of the Listing Rules of SHSE (2015) and Rule 13.1.3 and 13.1.4 SZSE (2015).

¹¹⁴ Jie Zhang, 'The Intervention of Local Governments and Mutation of the Financial System',

regulator has to strike.

That said, we must be cautious about the efficacy of regulatory experimentation in helping the central government to achieve the intended objective. It is true that the typical regulatory approach by exploration, evaluation and then extension has been employed successfully in history. However, the legitimacy and legality of such an approach are increasingly open to doubt. Indeed, due to the gradual movement towards a “rule of law” legal system in China, the uncertainty and the accompanying risks in law and politics inherent in the process of experimentation may well constrain the continuing adoption of a similar approach in the future.¹¹⁵ For one thing, innovation cannot easily be protected in law and so emulation by other provinces may well limit any “early mover” advantage. For another, the increasingly developed legal system may limit the discretion of local governments to innovate.

The uncertainty surrounding the operation of the LEEs is evident in their lack of formal legal status. Since the relevant circulars are of an administrative nature, LEEs do not enjoy a legal status in law,¹¹⁶ which entails further clarification from the central government and ultimately in law. Given that Circular No.37 of the SCO and No.38 of the CSRC provide that the establishment and the operation of the LEEs fall within the competence of local governments, we may expect that the LFOs, with power delegated from the provincial government, will play an increasingly important role in coordinating different stakeholders, setting up LEEs, and even inculcating a favourable culture of equity financing for SMEs.

(1996) 3 *Economic Research* 21.

¹¹⁵ See Gao and Zhong (ed), *Annual Report*, (*supra* n 110) at 89; Yongnian Zheng, *De Facto Federalism in China – Reforms and Dynamics of Central-Local Relations* (Daolong Qiu tr, Beijing: The Oriental Press 2013) at 9-10.

¹¹⁶ Article 7 of the Legislation Law of the PRC 2015 states that only The National People’s Congress and its Standing Committee have the legislative power of the State. Articles 65, 72 and 80 provide for the legislative power of the State Council, the people’s congresses or their standing committees of the provinces, autonomous regions and municipalities. For the LEEs, there are no clear laws, regulations or rules to regulate them, thus we say that they do not enjoy formal legal status. The most relevant rules are the Provisional Rules on the Supervision and Administration of Local Equity Exchanges (Draft for Opinions).

4. Regulation of Issuing and Trading on LEEs

Admittedly, the LEEs in China will be subject to less intense regulation than the national market because they are focused on providing finance to early-stage enterprises and SMEs rather than mature companies. However, regulation of the LEEs is still necessary mainly for two reasons: to control transaction costs and to mitigate or at least control the externalities arising from the operation of the markets.¹¹⁷ Due to the incipient stage of the LEEs, an immediate regulatory concern for local governments is how to lower transaction costs, which have “significant and dependable” implications on equity market volatility and in turn the survival of the LEEs.¹¹⁸ Moreover, the price discovery function of the LEEs should also be emphasized for the sustainable development of LEEs. Local regulators should accordingly be attentive to “the method by which prices are determined and the susceptibility of the price-setting process to abuse by dealers.”¹¹⁹ In terms of trading rules, the current rules are principles-based but with a restrictive nature.¹²⁰ For instance, LEEs are prohibited under the Circular No.37 from adopting any centralized trading methods, including the call auction, continuous auction, electronic matching, anonymous trading and acting as a market maker. LEEs wishing to operate financial products, like insurance, credit or gold, must secure prior permissions from the relevant administrative departments.¹²¹

Furthermore, several barriers in the current regulatory scheme may have to be removed before LEEs can play their due role in facilitating financing for local SMEs. One immediate concern is that the current law makes the public capital market almost an impossible alternative for SMEs. This is because most SMEs are not joint stock companies but limited liability companies (LLCs), which are not qualified for equity financing on the public capital market.¹²² Even if a SME has been converted from a limited liability company into a joint stock company, the current regulatory scheme on public offers may still frustrate SMEs from entering the public capital market. According to the current law, any offer to unspecified

¹¹⁷ See generally Jonathan R. Macey, and Maureen O'Hara, 'Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective' (1999) 28 *Journal of Legal Studies* 17.

¹¹⁸ Ibid.

¹¹⁹ Christopher Green, Paolo Maggioni, Victor Murinde, 'Regulatory Lessons for Emerging Stock Markets from a Century of Evidence on Transactions Costs and Share Price Volatility in the London Stock Exchange' (2000) 24 *J. Banking and Finance* 577.

¹²⁰ This can be understood from the largely prohibitive stance of Circular 37 and Circular 38.

¹²¹ See *supra* n 95.

¹²² Only JSCs are qualified for listing and trading on stock exchanges: see Art 50 of the Securities Law 2014.

investors or, in cases of issuing to specified investors the number of investors exceeds 200, will be deemed as a public offer requiring prior approval from the CSRC.¹²³ In other words, a private placement which leads to the shareholders of a SME exceeding 200 will require prior approval from the CSRC. Since this approach drives LEEs to function as private placement markets only, SMEs are thus deprived of public financing.

The second concern is about the registration and custody of shares to be transferred or newly issued on the LEEs. Registration falls within the remit of the local bureau of Administration of Industry and Commerce (LAICs) while custody is within the business scope of the LEE. A transfer of the shares completed on the LEE without a corresponding change to the articles of association at the LAIC is legally ineffective,¹²⁴ a situation which may further undermine the legitimacy of the LEE at such an incipient stage. The overlap of the power between the intended function of LEE and the legally established power of the LAICs thus hinders share transfers on LEEs.

The third concern is the trading system permitted on the LEEs. Pricing via individual negotiations between transaction parties is still the norm among LEEs. Although both TianJin EE and ChongQing EE introduced the competitive bid system and pricing via negotiations, TianJin EE is the only LEE which has introduced the market maker system.¹²⁵ Nevertheless, due to the lack of liquidity on most LEEs, the introduction of the market maker system will not make too much difference to the liquidity of the LEEs.

¹²³ Securities Law 2014 Art 10 and SCGO [2006] Circular No.99 Notification on the Relevant Issues on the Strict Crackdown on Unlawful Issuance of Stocks and Unlawful Operation of Securities Business.

¹²⁴ Registration of a change to the shareholder list is required of LLCs (Art 32 of the Company Law 2014) and JSCs (Art 139 of the Company Law 2014). In addition, the Regulations of the PRC on the Registration and Administration of Companies (2014) have clear rules for modification of registration. No company may, without authorization, change any registered items without going through the modification registration (Art 26, 34). Where a change is to be made to the list of shareholders filed for record at the AIC, the company shall apply for a change of registration within 30 days of such changes, and submit the capacity eligibility proof of the new shareholder or the identity proof of the natural person concerned. However, the law is not clear on whether it is the directors, the company or the legal representative who will bear the corresponding legal liabilities when the company fails to go through the relevant change registration.

¹²⁵ China OTC Market Report
<http://file.chinascopfinancial.com/website/reports/chinascope_otc_report_201401_en.pdf>
accessed 19 November 2015.

The fourth concern is that the lack of conversion rules between different tiers of the securities market may place the LEEs in a dilemma. For one thing, due to the low liquidity and the underperformance of LEEs, they may have to serve as seed pools of qualified SMEs which are to be converted to securities markets at higher levels if they are to have any useful role as conduits for equity financing. For another, given the current fervour and the strong performance of the New Third Board (NEEQ), qualified SMEs may select to be quoted directly on the New Third Board (NEEQ) without bothering to spend more money and time to be quoted and remain dormant on LEEs. Therefore, the lack of conversion rules between different tiers of the securities market only exacerbates the limited strategic options open to LEEs.

Due to the underperformance of LEEs, policy innovations under the strong monitoring of the central regulator may not be easy. To a large extent, most innovations can only be termed as improved co-ordinations. Competition among local securities trading centres is thus more akin to competition among piano players rather than among innovative musical instrument makers. Given such a regulatory framework, collaboration among LEEs is a much better choice for local governments to retain their regulatory power over LEEs. For example, the LiaoNing Equity Exchange (LNEE) has already made investment into the Inner Mongolia EE and a coalition with Jilin and Heilongjiang Securities Trading Centres is also in progress. The central government however keeps an attentive eye on the development of local securities trading centres.

5. Competition

The objective of regulation of securities market service providers is to achieve a free market which does not inhibit competition. In the west, the evolution of a multi-tier securities market is partly a result of natural evolution, which promotes competition among different service providers, exchanges, brokers-dealers, and other trading systems.¹²⁶ While such competition has sometimes been thwarted by restrictive practices, the MiFID regime in the EU, for instance, has opened up competition between established exchanges and alternative

¹²⁶ In the UK, provincial stock exchanges were set up to compete with the then London Stock Exchange and when that failed to supplement the transactions on the London Stock Exchanges. Provincial stock exchanges in the UK were almost all occupied with local government debts and functioned as extension of the London Stock Exchanges. See Leyshon et. al., *The Rise of the British Provincial Financial Center*, *supra* n 88.

trading venues in recent years.¹²⁷

However, competition among different service providers so as to engender a sustainable securities market has not yet become a reality in China. It should be noted that Circulars No.37 and No.38¹²⁸ may intentionally place the LEEs outside the public equity market.¹²⁹ A detailed reading of the two Circulars tells us that the central government intends to develop the multi-tier securities market in sequence. Indeed, despite the juxtaposition of both debt financing and equity financing in the circulars with regard to their function, the LEEs are designed (and also as iteratively emphasized by the governor of the CSRC¹³⁰) mainly as markets for debt products, which intentionally marginalizes their equity funding function. In addition, the current law strictly prohibits public offering of shares on the LEEs despite the recent promulgation of rules on public offering of non-listed shares by the CSRC.¹³¹ In other words, the strong central control administratively constrains the development of the LEEs, especially in their role as conduits for equity financing.

Accordingly, the reality is that the multi-tier capital market is being built within China with a clear intention to prioritize the national systems, including both national stock exchanges and the national New Third Board (NEEQ). LEEs are intentionally frustrated by

¹²⁷ See further G Ferrarini and P Saguato, *Regulating Financial Market Infrastructures*, chapter 19 in N Moloney, E Ferran and J Payne (eds) *The Oxford Handbook of Financial Regulation* (OUP, 2015).

¹²⁸ See *supra* n 95.

¹²⁹ The private placement function of the LEEs has also been clarified in the Draft for Consultation by the CSRC in June 2015.

¹³⁰ While there is no clear roadmap for the development of local securities trading centers, the Chairman of the CSRC expressed in one meeting after his intensive investigation of three equity trading centers the vision of how to develop local securities trading centers:

“local equity trading markets are markets for non-publically issued shares, which are administered by local governments. The business scope of such markets shall focus on local enterprises, products shall center around further financing through credit enhancement and M&A transactions while at the same time gradually improve equity financing. The itinerary for the evolution of local equity markets shall not follow the old track of national securities exchanges. The pursuance of the number of listed cases and the activeness of equity trading are not the targets of these trading centers.”

See Baochen Zhu and Xiao Gang, ‘Drawing the Itinerary for the Reformation of Chinese Capital Market from Multiple Perspectives’, *Securities Daily*, 24 Dec 2014, available at <<http://www.ccstock.cn/stock/gupiaoyaowen/2014-12-24/A1419356673282.html>> accessed 19 November 2015

¹³¹ See CSRC, *Measures for the Supervision and Administration of Non-Listed Public Companies* (2012, revised 2013)

the central regulator from playing their due role of facilitating equity financing for SMEs in the multi-tier capital market. The dominant position of the national system is accordingly an outgrowth of a carefully designed evolution supported by the central government and the CSRC rather than that of a natural evolution process.

The intentional segregation between the national market and the local markets and between different local markets (according to administrative boundaries) may in fact preclude competition among different service providers. Indeed, the rather dim and opaque picture of LEEs is in stark contrast with the bright and highlighted New Third Board (NEEQ). Local securities markets are on the agenda of the central regulator but are subordinated to the needs of the national market. Viewed from that perspective, the quota of one LEE for each province may better be deemed as a political compromise from the central government to cater for the local governments. It is possible that the failure of exploration of LEEs in some provinces may have already been taken into consideration when the central regulator issued the two circulars constraining the development of LEEs.

In reality, competition among LEEs is not a serious concern as the companies to be quoted on LEEs are mainly local SMEs and potential investors will be either local investors or else investors who are familiar with those applicant companies. Such a regulatory approach adopted by the central regulator may help economically less developed provinces to retain those qualified local SMEs on the LEE without seeking finance from another active LEE outside the province. Even though such an approach may cater for the impulse of local governments to develop their own Equity Exchanges, it conflicts with the fundamental function of the capital market in terms of efficiently distributing financial sources. In addition, local provincial governments may have to design favourable rules in alignment with the performance of local applicants and the investment preference of local investors. As a result, a market for lemons may have little chance to develop into a more efficient market with broader appeal to issuers and investors.

That said, competition among provincial governments can still be observed but to serve a purpose to secure favourable policies from the central government, which further strengthens the strong position of the central government in its negotiation with local governments. Reference to the independent governance model of TianJin EE can help us better understand

this issue.¹³² Compared with governance models of the other LEEs, TianJin EE enjoys more independence in terms of trading rules and less intervention from the CSRC. This model however was approved by the SC as early as 2009.¹³³ Given the earlier development of the TianJin EE in comparison with the other LEEs, Tianjin apparently enjoyed the advantage of a head start by securing favourable policies from the central regulator.

In comparison, the major concern for LEEs is the competition from the New Third Board (NEEQ), where SMEs can access a bigger and better-informed pool of investors and can be easily converted to the main board of the national exchanges. In addition, compared with the much larger subsidy provided by local governments to each candidate company to be quoted on the New Third Board, the one-off small subsidy granted to the LEEs may better be deemed as a courtesy service by the local governments – to ignite the interest of *other players* in the local securities market.¹³⁴ In combination, the shortage of conversion rules, the limitation imposed on the products and applicants on the LEEs and the meagre subsidy provided by the local governments may in fact make the LEEs superfluous in terms of facilitating equity financing for SMEs.¹³⁵ Blue chip SMEs will seek financing directly on the New Third Board (NEEQ) without bothering to stay dormant on the LEEs. The shortage of such rules unfairly disadvantages LEEs on the public capital market. In the words of our interviewees: “There is little chance that local teams can win a game with the national team.”

The upshot is that the options available to applicant companies and potential investors

¹³² Jianrong Jiang, Gang Zeng, Kangning Qian, Fang Gong, and Bei Liu, ‘The Regulation of Quotation, Financing, Transfer, and Registration of the Regional OTC market and The Measures of the Stock Exchanges to Support the Development of the Regional Equity Exchange’ (2013) a co-sponsored project by Shanghai Stock Exchange and Institution of the Shenying Wanguo Securities Companies, SSE Assembly Report No.24, http://2015.sse.com.cn/researchpublications/jointresearch/c/c_20140414_3790771.pdf, accessed 19 November 2015

¹³³ The State Council issued the Reply to the Framework Measures on the Exploration of the Comprehensive Complementary Reform of the BinHai New Zone of Tianjin, which was further implemented by The Specific Plan for the Exploration of Financial Innovation in the Comprehensive and Complementary Reform of the BinHai New Zone of Tianjin issued by the Tianjin Government.

¹³⁴ See *infra* Section E.

¹³⁵ The standard itinerary for a company to be listed is typically as follows. Once a company issues shares to the public, they will first be listed on OTC markets. They might then move to a regional exchange. And most would convert to the formal exchanges, selected according to the stringency of the listing requirements of those markets. See Michael Simon and Robert Colby, ‘The National Market System for Over-the-Counter Stocks’ (1986-7) 55 *Geo. Wash. L. Rev.* 17, at 21-22.

are not different national trading systems in competition but rather an intentionally designed multi-tier securities markets with each tier of the capital market serving companies from different administrative localities. Such a regulatory intention may suit the existing administrative hierarchy, where local governments compete for favours from the central government. Among and between LEEs, we can observe an intensification of lobbying efforts by local officials who strive to obtain official “experimental point” status¹³⁶ to gain access to central preferential treatment and to improve their career prospects, just like the TianJin EE which enjoys the advantage of a head start. The ambition to develop a multi-tier capital market so as to serve companies with different financial needs has thus been subordinated to the constraints of the existing administrative framework.

Given that market participants have few markets to select from and that the availability of securities market institutions is strictly under control of the central government, market participants may find it hard to avoid or sidestep the cumbersome regulations by directing the trade to less or non-regulated securities markets. The regulatory scheme of LEEs is framed neither to adapt to the “different services designed to respond to the needs of different clientele”¹³⁷ nor to “serve public policy goals of promoting fairness and efficiency without restricting the ability of market participants to offer precisely the bundle of products that they choose to offer their respective clientele and no more.”¹³⁸ The ultimate results however are markets without investors.

E. MARKETS WITHOUT INVESTORS – TWO CASE STUDIES

1. Context and Methodology

To understand the institutional setup process for LEEs, we undertook personal interviews with diverse market participants, such as regulators, intermediaries and investors connected with the two LEEs in LiaoNing province.¹³⁹ The interviews helped us to fill gaps in the public information relating to the LEEs as well as to clarify the dynamics of their

¹³⁶ See Heilmann, ‘Policy Experimentation in China’s Economic Rise’ (*supra* n 70), at 10.

¹³⁷ See Macey, and O’Hara, ‘Regulating Exchanges and ATS’ (*supra* n 117) at 54.

¹³⁸ *Ibid.*

¹³⁹ Semi-structured interviews were conducted subject to the condition that observations could be reported but not attributed. We employed both in-person interviews and interviews by telephone, the latter mainly for follow-up questions.

operation and regulation. In order to integrate the interview results with the experimentation theory introduced in Parts A and B we differentiate experimentation at three different levels, each of which has a bearing on the manner in which the LEE form of experimentation is framed and executed.

1. Experimentation at national level: the ultimate objective of experimentation is to achieve a healthy national securities market. Experimentation at this level is conducted to determine an appropriate structure for China's securities market by creating different levels and setting an appropriate relationship between them. For that purpose, the results of experimentations at lower levels, for instance the failure of the regional trading centres, could result in overall success for the experiment at the national level. In more specific terms this approach could lead to the conclusion that only the New Third Board is required and that the LEE experiment may be ended.

2. Experimentation at the intermediary level: intermediary experimentation is conducted to set the correct parameters for over-lapping regulations between the CSRC (intermediary regulation) and provincial governments (local exchanges).¹⁴⁰ This issue is, however, complicated by the absence in China of a conventional regulatory perimeter, which means in effect that all activities conducted on and all products introduced to the securities market require prior approvals to limit risk prima facie from provincial governments but ultimately from the central government. This makes the concept of policy innovation very tricky because it is a government controlled process rather than spontaneous development in response to market signals.¹⁴¹ However, this just echoes what Polanyi argued

¹⁴⁰ In addition to provinces, this concept also covers those four cities under the direct control of the central government (Beijing, Tianjin, Shanghai, and Chongqing). All these administrative units are at provincial level in the administrative hierarchy of the PRC.

¹⁴¹ One of the interviewees referred to "innovation under the norms".

decades ago that the shadow of the state is present even without formal regulation.¹⁴²

3. Experimentation at local levels or more specifically explorations to set disclosure and corporate governance rules on the Local Equity Exchanges (LEEs). It is this form of experimentation which has the largest private input from stakeholders in the LEEs (as well as some high-level input from the provincial governments). There appears to be a strong self-regulatory element in this process (e.g. model articles for candidate companies developed by the LEEs) while local governments also have incentives to facilitate share transfer by providing local regulations within the existing boundary of laws and state regulations.

Experimentation across these three dimensions must, however, be understood within the specific context of the overarching regime of financial regulation in China. The nature of state control in China (both indirectly through state shareholding by the State-owned Assets Supervision and Administration Commission (SASAC) at different levels and the Nomenklatura system; and directly through regulations) means that there is no direct counterpart of the western concept of the “regulatory perimeter”. Thus, the concept that individuals, transactions and markets may be located beyond the oversight and control of the government and its administrative agencies is simply alien to the existing Chinese system.¹⁴³

A consistent observation from our interviewees was that even in the absence of any legal or regulatory prohibition any action in the form of financial innovation could be subject to ex post intervention by the government in the form of regulation or even prohibition. In that sense, there can be no direct counterpart in China to the OTC market in the west since the OTC market relies on a clear demarcation between regulated activity and unregulated

¹⁴² See Polanyi, *The Great Transformation* (*supra* n 21).

¹⁴³ See *infra* Section D 1.

activity.¹⁴⁴ Thus, innovations in the Chinese context must be understood as a process that is driven more by testing and extending official tolerance for new techniques rather than the process of competitive evolution that is envisaged in western systems. Alternatively, economic agents will also be frustrated by the regulatory norms in the sense that the applicability of the general rule that actions not prohibited by law are permitted will be seriously constrained by the regulatory norm of ex post review. In turn, economic agents in less developed provinces may be further handicapped in promoting financial innovation in comparison with their counterparties in economically developed provinces, who may have more bargaining chips to negotiate with the central government to mitigate unintended ill-effects arising from the ex post reviews.

2. Government Involvement

Following the establishment of LEEs in Shanghai and Zhejiang in 2013, LiaoNing Equity Exchange (LNEE) and DaLian EE (DLEE) were established in sequence in the same year. While both the national stock exchanges and the LEEs were established as joint stock companies, they are neither independent companies with their own interests to pursue nor mutual exchanges, which are of and for their members.¹⁴⁵ The following characteristics demonstrate that the operation of the LEEs are under the strict monitoring of the CSRC, especially in terms of the intended function of providing equity financing for SMEs.

Both the LNEE and DLEE were established to play both a governmental/ administrative role of developing the local securities market and a profit-seeking role for their own sustainability. The dual objectives imply intensive involvement on the part of the local

¹⁴⁴ That remains so even if it is conceded that the regulatory system may at times reach into the OTC market, for example through intermediary regulation or rules relating to trade reporting. See further text at *supra* n 45 referencing the definition of the OTC market in China.

¹⁴⁵ Jingyun Ma, Fengming Song and Zhishu Yang, 'The Dual Role of the Government: Securities Market Regulation in China 1980-2007' (2010) 18 *Journal of Financial Regulation and Compliance* 158, at 162-4.

governments. Both the LNFO and DLFO played an important coordination role among different authorities in the development of the local EEs. They also helped to introduce funds for market development (e.g., governmental guiding fund and afterwards perfection funds) and funds for investor protection (the latter requires pro rata contribution of promoters).¹⁴⁶ The Liaoning government provided a one-off fiscal subsidy of 5m RMB for qualified LLCs to be converted into JSCs.¹⁴⁷ A similar sized one-off subsidy was also provided by the Dalian municipal government. However, this sum of money may only be sufficient to pay for the intermediary fees for 20-30 necessary conversions.

While both EEs in Liaoning were set up in 2013, the DLEE has proven to be unsuccessful with the operation almost coming to a stop. The DLEE is now merely a separate office with an independent logo. A group of staff from the Dalian Property Rights Trading Centre now operate the DLEE. Even though the government of Dalian devoted extensive and intensive efforts into the development of the DLEE, the result is unsatisfactory with liquidity and trading volume being lower compared with the LNEE.

For both the LNEE and the DLEE, local government involvement is necessary for other reasons. Interviewees repeatedly mentioned that the environment of the local financial market is not favourable for developing a public securities market. It is widely understood that people from North Eastern China are conservative and reluctant to make deals. In comparison, people from Jiangsu and Zhejiang (adjacent to Shanghai) areas are much more oriented towards commerce. The awareness of the local governments of the function of the securities markets is therefore of special importance in the North Eastern area to provide favourable rules on evaluation criteria regarding qualified companies. Second, the lack of a credit rating system also inhibits the development of LNEEs. It is known that the credit rating system for individuals is still under construction whereas that for enterprises has not yet

¹⁴⁶ Information secured from our interviews.

¹⁴⁷ The subsidy from Liaoning was provided for qualified limited liability companies in seven cities within the province. No subsidies are now available for enterprises to be listed on the LNEE although micro and agricultural enterprises may still access such subsidies.

been put on the table at either national or local level. This is a serious concern for the enterprises providing guarantees associated with the listing of securities (especially securitized debt) on the LEEs. In the absence of credible private sector credit rating agencies, the involvement of local governments is crucial to build norms and enhance the creditability of transactions conducted on the LEEs.

3. Shareholders

Despite the intensive monitoring of the financial office of the local government, the operation of the LEEs has largely been placed in the hands of the shareholders of the EE. For the LNEE, the nature of the shareholders indicates that the governance of the LNEE can be viewed as a government dominated model. The LNEE was set up as a joint stock company with five shareholders.¹⁴⁸ The two large shareholders play an important role in the governance of the LNEE. Cinda controls almost all the staffing of the LNEE, except for the vice CEO, which was dispatched by the SHSE and approved by the LNFO. The other blockholder (Shenyang Equity Registration and Custody LLC) represents the Liaoning provincial government. In combination, the SASACs of Liaoning, Dalian and ShenYang control 47% of the LNEE. Moreover, since the securities companies are all under close monitoring of the CSRC, it also has an important say in the control of the LNEE. Such a shareholding structure may better be deemed as a balance reached between the central regulator and the local government in the case of LNEE.

For the DLEE, we observe a largely similar picture. However, in comparison with the 20% shareholding of the SHSE in the LNEE, the SZSE only controls 5% of the DLEE.¹⁴⁹ DaLian

¹⁴⁸ Cinda Venture Capital Investment LLC, which is a subsidiary of Cinda Securities Company (33%); Datong Securities Investment Co. (10%), of which the DaLian SASAC is the supermajority shareholder; Zhongtian Securities Investment Co (4%), of which Liaoning SASAC is the 88% shareholder; SHSE Information and Network LLC (20%), which is a subsidiary of Shanghai Stock Exchange; and Shenyang Equity Registration and Custody LLC (33%), which is a subsidiary of Shenyang United Property Right Exchange.

¹⁴⁹ There is no clear indication why the two exchanges followed different investment policies. A

municipal government itself ultimately controls almost 95% of the DLEE as DaLian SASAC either controls or dominates the shareholding of the other four shareholders apart from the SZSE. The predominant shareholding by the DaLian municipal government may indicate that a more intensive impetus of the local government to develop its own local securities market, which may partly be attributed to the benefits DaLian has been enjoying from the DaLian Commodity Exchange and the ambition of DaLian to compete, especially with the LN provincial government, for the financial centre of North East China. However, the disproportionate dominance of the local government may also place the DLEE into a dangerous situation due to the lack of external expertise. In fact, the precarious financial situation of the DLEE may have already seriously dampened the initial fervour of the DaLian government.

Due to the close relationship between the CSRC and the two national Stock Exchanges, and the close monitoring of the investment activities of the securities companies investing in LEEs,¹⁵⁰ the birth and operation of the LEEs can be viewed as the result of coordination between the CSRC and the local governments, with the former playing a more important role especially in developing the local equity markets. Even though it is the shareholders who design the first set of rules, it is still safe to say that these rules are also constrained by the CSRC, which closely monitors the operation of securities trading companies and their involvement in LEEs. The institutional control on the securities market by the central authority is also apparent from several other perspectives. First, approval of the new trading venues, including LEEs, and new products to be traded on such markets, can only be secured from the State Council, or more specifically, the Joint-Conference of Ministries in which the

possible explanation is that the two exchanges do not want to lose in the competition for the shares of local markets. It is also noticeable that SHSE only made investment in three LEEs, i.e., ShangHai EE, ZheJiang EE, and LNEE, all with 20% shareholding. In comparison, SZSE made investment in 10 LEEs, with shareholding diverging from 4.16% to 15% in each LEE: specifically; Beijing and ChongQing 15%; ChengDu and WuHan 10%; QianHai 9.52%; QiLu 6%; DaLian, GuangDong and QingHai 5%; ShanXi 4.16%.

¹⁵⁰ CSRC Announcement [2012] No.20, Guiding Opinions on Regulating the Involvement of Securities Companies in Regional Equity Trading Markets (provisional), 23 August 2012.

CSRC plays a dominant role. Second, it is true that the implications of the Nomenclature system on the staffing of the LEEs are not apparent in our project. However, given the dual objectives of LEEs and the intensive participation in approving the board members by the LFO in their incipient stage, the shadow of the Nomenclature system still hangs over the operation of LEEs.

Such intensive involvement of the governments thus implants a gene of public interest into the LEEs. However, shareholders ultimately have to decide how to improve the performance of LEEs given the continuing underperformance of the LNEE and DLEE. Indeed, our interviewees expressed serious concerns that the majority shareholders of both EEs are increasingly losing interest in supporting the development of LEEs as the continuing underperformance only entails burning the deep pocket of the shareholders of the LEEs to achieve a public interest of the local governments, an objective which does not serve the commercial interests of the shareholders.¹⁵¹

4. Regulatory Control of Membership

Licensed membership has been widely used on exchanges as a means to control the type of business that can be conducted and the nature of competition between members. We discuss types of licensed memberships available on the exchanges, qualified candidates for such memberships, the business scope of each different type of licensed membership and the requirement of the registered capital for different types of members. As membership is closely linked with the business scope of the license accorded, we discuss them together. In addition, given the importance of securities companies on exchanges, we discuss the business scope of securities companies on LEEs separately. We conclude the section with a discussion of relevant capital requirements for membership.

¹⁵¹ Even though most shareholders are owned by local governments, they are independent legal persons with their own sustenance as the major concern.

In order to facilitate our discussion we compare the types of membership available on the LEEs by comparison those on the national New Third Board (NEEQ). This serves the purpose of clarifying the nature of the experimentation that is taking place on the LEEs and the manner in which they fit into a segmented national securities market. We find that experimentation is taking place at all three of the levels mentioned earlier (national, intermediary and local). While the scope for experimentation at the local level is explicitly constrained within the segmented national securities market, we observe that there are ownership, regulatory and operational differences between the two LEEs in Liaoning province that may help to explain their evolution and viability.

a) Types, Candidates and Business Scope of Memberships

Both the LNEE and the DLEE separate their members into three categories: members who are entitled to recommend companies to be quoted; members who can only provide professional services; and members who only enjoy the status of Strategic Co-operator. In terms of qualifications for recommendation members, both the LNEE and the DLEE introduce financial performance and relevant experience as relevant thresholds. However, the LNEE further expressly identifies that accounting firms, law firms and even industrial analysts, who are not allowed to deal with securities transactions according to the Securities Law 2014, can be candidates for recommendation members on the LNEE.¹⁵² In terms of professional member, the LNEE may accredit a larger group of professionals to be professional members by merely requiring of such firms a good reputation and business performance. In comparison, the DLEE prescribes a much stricter set of qualifications. There are no stipulations on strategic co-operator members on the DLEE whereas the LNEE stipulates that as long as a partner has a sound internal control system, with specialists and good information technology, and importantly the capacity for financial innovation, a partner can be a potential candidate for strategic co-operator membership on the LNEE.

¹⁵² Securities Law of the PRC 2014 Art 171 and The Rules of the Liaoning Equity Exchange Membership Management 2013 (Trial) Article 8

As shown in Table 2, the LNEE provides more choices than the DLEE. Such “innovation” may accordingly help to access a broader range of stakeholders to participate in the development of the LNEE. Our interviews show that members on the LNEE also enjoy important regulatory powers. The review committee¹⁵³ set up by selected members of the LNEE enjoys a decisive power in terms of deciding whether an application for quotation is successful, and of reviewing any revision made to the existing rules though the revision must be approved by the LNFO before they come into effect. In the light of the moribund situation of the DLEE it is not possible to compare the role of members in the operation of the DLEE.

We provide the following tables for the sake of clarity.

Table 2: Membership on LNEE and DLEE

	LNEE	DLEE
Categories of Membership	<ol style="list-style-type: none"> 1. Member for recommendation 2. Member for professional services 3. Others (Member for Strategic Cooperation; Special Member) 	<ol style="list-style-type: none"> 1. Member for recommendation 2. Member for professional services
General Requirements	<ol style="list-style-type: none"> 1. No violation of laws within 12 months 2. Good reputation and business performance 3. Compliance with rules and regulations of the equity exchange 	<ol style="list-style-type: none"> 1. No violation of laws within 3 years 2. Good reputation and business performance 3. Compliance with rules and regulations of the equity exchange
Special Requirements for Recommendation Member	<ol style="list-style-type: none"> 1. Should be securities company, or other approved financial institutions, qualified accounting firm or law firm 2. No reserved/negative opinions 	<ol style="list-style-type: none"> 1. No reserved/negative opinions within the latest (or current annual) financial statement 2. Relevant experience in quoting, investment

¹⁵³ An organ corresponding to the Review Committee of Issuance of the CSRC.

	<p>within the latest (or current annual) financial statement</p> <p>3. Relevant experience in quoting, investment counselling and due diligence</p> <p>4. Specialists in accounting, law, and securities analysis</p>	counselling and due diligence
Special Requirements for Professional Services Members	<p>1. Qualified accounting firm and law firm with good reputations and business performance</p>	<p>1. Operating more than 5 years</p> <p>2. ≥ 10 professionals with qualification</p> <p>3. Relevant experience in quoting, investment counselling and due diligence</p> <p>4. Good organizational structure and sound internal control system</p>
Special Requirements for Members: Strategic Co-operator and Others	<p>1. Sound internal control system</p> <p>2. Having specialists and good information technology</p> <p>3. Having financial innovation ability</p>	

By way of comparison, the New Third Board (NEEQ) has its own list of qualified members for intermediaries, including 88 nominated brokers and advisers (securities companies), 39 accounting firms and 412 law firms.¹⁵⁴ The relevant rules¹⁵⁵ list three types of business licenses for nominated securities companies to apply: license of recommendation business, brokerage business and market maker. In addition, the New Third Board (NEEQ) also issues licenses to securities companies which provide brokerage and market making

¹⁵⁴ Data drawn from the New Third Board (NEEQ) website, <<http://bpmweb.neeq.org.cn/xxpl/web/securityList.infor>> accessed 19 November 2015.

¹⁵⁵ Article 4 of the Rules of the National Equities Exchange and Quotations for the Sponsoring Brokers Management (Trial).

services whereas the LEEs issue licenses for special membership or strategic partners.¹⁵⁶ And the New Third Board (NEEQ) makes specific provisions to regulate the securities companies' conduct.¹⁵⁷ There are however no rules on what kind of business accounting firms and law firms can run on the New Third Board (NEEQ), though these intermediaries are subject to the general rules of the Securities Law, which does not allow them to do what nominated brokers can do.¹⁵⁸

The members licensed on LEEs are different. While securities companies, investment management companies, accounting firms and law firms are all permitted to apply for licenses for recommendation business, licenses for professional services are only for accounting firms, law firms and asset appraisal institutions, most of which are experienced players on the public capital market. Trust companies, small loan companies, financing guarantee companies and other banking institutions, which cannot perform in other tiers of the securities market, can run all kinds of business with their licence as special members except for recommending quoted companies.¹⁵⁹ This situation may partly be attributed to the lack of confidence of the LEEs in the services provided by the latter group especially in terms of sponsoring business.

In common with the New Third Board, the LEEs also issue recommendation licenses and professional service licenses.¹⁶⁰ Members holding recommendation licenses can only recommend applicants on the New Third Board, but their counterparts on the LNEE can also

¹⁵⁶ The Rule of National Equities Exchange Quotations Business Management (Trial) 3.1.4; The Rule of National Equities Exchange Quotations Nominated Broker Management (Trial) Article 4 and 7; The Rules of the Liaoning Equity Exchange Membership Management (Trial) Article 4, 7 and 10. No rules on special membership or strategic partners can be found in The Rule of DaLian Equity Exchange Quoting Business (Trial).

¹⁵⁷ The Rule of National Equities Exchange Quotations Nominated Broker Management (Trial) Article 2 (requirement of file for record so as to be Nominated Broker) and 4 (Business Scope by the Nominated Broker), the New Third Board (NEEQ) Rules on Business (Trial) Art 1.6 (the obligation of continuing supervision by the Nominated Broker)

¹⁵⁸ Securities Law of the PRC 2014 Article 171.

¹⁵⁹ The Rules of the Liaoning Equity Exchange Membership Management 2013 (Trial) Article 7

¹⁶⁰ This leaves out the market making license.

provide other services, such as participating in equity transfer, private placement of bonds, debenture financing and providing investment consultation services. The LNEE expressly requires that recommendation by a recommendation member is necessary in application for quotation,¹⁶¹ while the DLEE only requests the applicants to discuss with recommendation members before they start the process of quotation.¹⁶² It is worth noting that, in addition to the requirement of recommendation by a licensed recommendation member,¹⁶³ the New Third Board (NEEQ) also requires continuous supervision of the nominated broker.¹⁶⁴ The absence of such an agreement with sponsors or the nominated broker for candidate companies to be listed on LNEE and DLEE may expose these two LEEs to substantial risks of governance practices especially in terms of continuing governance practices after the quotation.

Table 3: Qualified Companies Serving as Members and Their Business Scope on the LNEE and DLEE

	Recommendation		Professional		Others (Only in LNEE)	
	LNEE	DLEE	LNEE	DLEE	Strategic	Special
Type of Companies	Securities Companies, Qualified accounting firms and law firms Investment organizations	Banks; Securities Companies;	Accounting firms, Law firms, Asset evaluation firms	Accounting firms, Law firms, Asset evaluation firms	Trust companies, Banking financial institutions	Financing guarantee companies, Small loan companies

¹⁶¹ Rules of The LiaoNing Equity Exchange Quoting Business 2014 (Trial) Article 2.

¹⁶² Rules of The DaLian Equity Exchange Quoting Business 2014 (Trial) Article 2.

¹⁶³ Rules of The National Equities Exchange Quotations Business Management 2013 (Trial) 2.1.

¹⁶⁴ Rules of The National Equities Exchange Quotations Business Management 2013 (Trial) 1.6.

Business Scope	Recommending, Equity financing, Equity quotation, Brokerage (purchasing and selling for clients), Private placement of bonds, Investment consulting	Recommending, Private Placement of Equities, Private Placement of Bonds, Pledge of equity for financing	Recommending, Private placement of bonds, Equity financing, Legal service, Auditing, Asset evaluation	Accounting, Legal service, Asset evaluation	Equity quotation, Private placement of bonds, Brokerage,(purchasing and selling for clients) Private Placement of Equities, Investment consulting
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In comparison with the rules of the New Third Board (NEEQ), which clearly differentiate the different business scopes for each type of licenses, the rules of the LEEs are not clear cut. For example, the LNEE's rules of membership management allow the special members to participate in equity transfer, private placement of bonds, debenture financing and providing investment consultation services when opportunities mature in the future. In effect, there is a possibility that all members on the LEEs may have a similar business scope in the future.

Overall, by comparison with the rules on the New Third Board, the rules on members and their business scope on the two LEEs are rather ambiguous. This ambiguity may reflect the incipient stage of the evolution of these two LEEs, which are struggling to strike a balance between attracting the attention of institutional players and safeguarding a transparent and liquid local securities market. When we examine the two LEEs in detail, we find that the rules of the LNEE are more in alignment with the New Third Board regulatory framework, which has been accepted by the CSRC. This comparative proximity may give the LNEE a head start in its ensuing evolution.

b) *Business Scope of Securities Companies*

The overall business scope of securities companies under the Securities Law 2014 covers seven different activities including an open-ended category of “any other business operation concerning securities”.¹⁶⁵ As shown in table 4 below securities firms have a broader role at the two lower tiers by comparison with the national market. This approach evolved from the CSRC’s 2012 statement setting out how securities companies may participate in LEEs.¹⁶⁶ First and foremost, the securities companies should evaluate the LEE and file a report before participating. Then, the securities companies can negotiate with the LEE about the way they participate. In addition to the standard business such as recommending companies to be quoted, brokerage business, bond financing, and equity financing, the CSRC also allows the securities companies to invest in LEEs.

Table 4: Business Scope of Securities Companies

	SHSE and SZSE	The New Third Board (NEEQ)	LNEE	DLEE
Recommendation	√	√	√	√
Brokerage business	√	√	√	√
Securities business on its own account	√			
Securities underwriting business	√	√	√	√
Market maker		√		
Equity financing			√	√
Investment consulting			√	√
Investing in the			√	√

¹⁶⁵ Securities Law Article 125 (see *infra* n 171 below for more detail).

¹⁶⁶ CSRC Circular No. 20 [2012] Guiding Opinions on Regulating Securities Companies' Participation in Regional Equity Trading Markets (for Trial Implementation).

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An interesting question is whether securities companies can function as market makers on different tiers of the multi-tier capital market. Market making business is now only permitted on the New Third Board (NEEQ) and TianJin EE. The case for market-making as a form of trade execution is that it can help quoted companies raise their reputation, promote stock liquidity, and improve the transparency of the equity market.¹⁶⁷ Indeed, the market makers on the New Third Board (NEEQ) have already contributed to the recent strong performance on the New Third Board (NEEQ).¹⁶⁸ However, it remains unclear whether market making is permitted on the other LEEs.

c) Registered Capital

The Securities Law 2014 provides that prior approval from the CSRC must be given for any securities company to come into existence.¹⁶⁹ It also regulates securities companies according to their business scope: a securities company must acquire prior approval from the CSRC for its intended business scope before it can start its activities.¹⁷⁰ There are seven categories of businesses of securities companies: brokerage, investment consultation, financial consultation related to securities transactions, underwriting and sponsoring, securities business for its own account and securities asset management business and others.¹⁷¹ Different sizes of registered capital are required for different businesses or different combination of businesses.¹⁷² In cases of expansion of businesses scope, no more

¹⁶⁷ See generally Frank J. Fabozzi and Franco Modigliani, *Capital Markets: Institutions and Instruments* (4th edn, N. J.: Person Prentice Hall 2009); Zirui Lv, 'Analysis of the Civil Laws on the Market Maker' (2012) 33 *Northern Legal Science* 151.

¹⁶⁸ Chen Xia, 'Market makers to add much needed liquidity to NEEQ', *Global Times* (China, August 24, 2014) <www.globaltimes.cn/content/877820.shtml> , (accessed 2 June, 2015).

¹⁶⁹ Securities Law 2014 Art 122.

¹⁷⁰ CSRC Announcement No. 42 [2008] Interim Provisions on the Examination and Approval of the Business Scope of Securities Companies

¹⁷¹ Securities Law 2014 Art 125.

¹⁷² Securities Law 2014 Art 127.

than two categories of businesses can be applied for in one application. In addition, on the basis of evaluation in terms of six indicators¹⁷³, securities companies are also classified into 11 different levels ranging from A to E.¹⁷⁴ The results of classification however are not accessible to the public but available to the CSRC for the purpose of monitoring and to the China Securities Investor Protection Fund Company for the purpose of setting contributions to its investor protection fund. However, no reference to such classification has been made for securities companies intending to operate on LEEs. Since the law has already provided mandatory requirements for securities companies,¹⁷⁵ The New Third Board (NEEQ) doesn't request additional registered capital. But for securities companies that intend to be market makers, they need to provide additional financial documents for approval from the New Third Board (NEEQ).¹⁷⁶

Since there are no uniform regulations for LEEs, each LEE may design requirements for the registered capital on the basis of the quality of securities companies in their region. In general, the minimum net asset requirement of a recommendation member is 10 million RMB, a number much lower than that for securities companies according to the Securities Law 2014.¹⁷⁷

¹⁷³ Capital adequacy, corporate governance, regulatory compliance management, dynamic risk control, information system safety, protection of the interests of the clients, and information disclosure.

¹⁷⁴ CSRC Announcement No.12 [2009] Provisions on the Classified Supervision and Administration of Securities Companies (on May 26, 2009).

¹⁷⁵ According to Art 127 of the Securities Law 2014, a minimum registered capital of RMB50 million is required of securities companies engaging in 1) securities brokerage business; (2) securities investment consulting; and (3) provision of financial advisory services relating to securities trading and securities investment activities.

¹⁷⁶ The Rule of National Equities Exchange Quotations Market Maker Business Management 2014 (Trial) Article 6.

¹⁷⁷ Art 124 of the Securities Law 2014 stipulates that securities companies shall have net assets no less than 200 million RMB.

5. Quotation and Trading Rules

The quotation and trading rules of the LEEs provide a form of experimentation that serves to delimit the respective roles of the New Third board and the LEEs as conduits for finance to SMEs. While the LEEs cannot compete directly with the national market in trading the securities of companies listed on the national market, the New Third Board was granted national market status in September 2015, thereby enabling it to trade securities listed on the national market. Thus, we observed in our field research that the LEEs and the New Third Board are in competition with each other. At the local level, experimentation in quotation and trading also serves the purpose of determining whether there is a role for LEEs by comparison with the more traditional sources of finance such as bank loans and family funding.

Most companies quoted on the LEEs are joint stock companies. This is especially the case for those quoted on the LEEs of economically developed provinces. Indeed, the quoting standards of the ShangHai EE (SHEE) are almost similar to those of the New Third Board (NEEQ). In addition to providing a one-off grand sum of fiscal subsidy to support the development of LEEs, QianHai EE (QHEE) in Shenzhen even provides such facilities as “low threshold, no prior approval, no registration and custody fees,” which in fact led to a surge of the number of companies quoted on the QHEE.¹⁷⁸ Without such favourable standards for quotation, the LNEE and the DLEE can only quote a much lower number of companies. Even though both JSCs and LLCs are permitted to be quoted on the LNEE and the DLEE, they are quoted on different boards.¹⁷⁹ Such treatment can be attributed to the difference in the

¹⁷⁸ In comparison with typically hundreds of companies quoted on other LEEs, the QianHai Equity Exchange (QianHai EE) started with 1,200 firms making their debut in 2013. For more information, see <www.scmp.com/business/money/markets-investing/article/1250932/shenzhen-sme-share-market-starts-1200-firms> accessed on 15 June 2015. After 2 years of operation, there are now 6163 companies from 229 cities quoted in QianHai EE. For more information, see <www.qhee.com> (accessed on 15 June 2015).

¹⁷⁹ There are four boards in LNEE and two in DLEE. In LNEE, no specific capital requirements can be found in the board of financing transactions and the board of small and micro companies. The

potential conversion to the New Third Board or the Main Board as all companies to be quoted on the former or to be listed on the latter must be JSCs.¹⁸⁰

In general, the companies applying for quotation on the LNEE and the DLEE should have been operating for at least one year, with good reputation and business performance.¹⁸¹ Both the LNEE and the DLEE request a clear shareholding structure and good corporate governance as well as compliance with laws and regulations for a year prior to application. Of course, the decision to apply for quotation on the LNEEs should be approved by the general shareholder meeting or the board of the applicant company. Capital requirements can be found in the quoting requirements of the LNEE, but none in those of DLEE. Both the LNEE and DLEE separate the companies by their characteristics and put them into different boards.

Table 5: Quotation Requirement on the LNEE and DLEE

	LNEE	DLEE
Business place	No restriction on the place of registration of candidate companies ¹⁸²	Registered in Dalian
Types of	1. Unquoted JSC 2. Limited liability company	1. Unquoted JSC 2. Limited liability company

capital requirements of the board of financing service for technology companies and the board of SMEs innovation are the same (see Table 4). The DLEE established two boards: one for unlisted companies limited shares and the other for limited liability companies. However, there do not appear to be any capital requirements.

¹⁸⁰ Only JSCs are qualified for listing and trading on stock exchanges: see Art 50 of the Securities Law 2014.

¹⁸¹ The Rule of Liaoning Equity Exchange Quoting Business (Trial) Article 10; The Rule of Dalian Equity Exchange Quoting Business (Trial) Article 7.

¹⁸² According to the Provisional Rules on the Supervision and Administration of LNEEs (Draft for Opinions) (2015) Article 4, cross-provinces listing is permitted on the condition that an agreement between the two provinces has been reached. In our case, as LNEE has already been a shareholder of Inner-Mongolia EE, it is no surprise that the LNEE has such a regulation whereas the DLEE does not.

companies ¹⁸³	3. No clear rules for partnership firm and others	3.Partnership firm 4.Other economic organization
Period of operation	≥ 1 year	≥ 1 year
File for Application	Two types: Simple and Explicit	N/A
Capital requirements	Board for financing services (technology) and SMEs: ¹⁸⁴ 1. Operating profit ≥ 1 million RMB within 12 months, or 2. Operating revenue ≥ 20 million RMB within 24 months, or 3. Net asset ≥ 5 million RMB, and operating revenue ≥ 5 million RMB within 12 months, or 4. Good loan records, or investment from financial organizations within 12 months	No clear capital requirements can be found in any official documents
Registration and Custody of Shares	Register within 2 days after getting the abbreviation and code	Before applying to be quoted
Other requirements	1. Clear shareholding structure 2. Good corporate governance 3. No serious violation of laws and regulations within 1 year 4. The shareholders' agreement on permitting the company to be quoted	

Even though the quotation standards in terms of operating profits, operating revenue and net assets are much lower than those on the national New Third Board, they are still

¹⁸³ It should be noted that, in contrast with the bifurcation of private and public companies limited by shares in the EU, companies limited by shares in China are categorized into Limited Liability Company (LLC) and Joint-Stock Company (JSC) and that only the qualified JSC can be listed on the main board. “Unquoted” refers here to JSCs not being listed on the main board and not quoted on the New Third Board.

¹⁸⁴ This information cannot be found in the Quotation Rules but on the official websites. For the board for financing service (technology), see <http://www.lneec.com/center/channel_wygp.jhtml?fmode=1>; for the board for financing for SMEs, see <http://www.lneec.com/center/channel_wygp.jhtml?fmode=2> accessed 10 June 2015.

high thresholds for SMEs or micro-enterprises who seek equity financing on the LEEs.¹⁸⁵ In addition, the concern of entrepreneurs over losing control may also frustrate them from seeking equity financing on the LEEs. An additional hurdle for the development of the equity financing function of the LEE may be the lack of commercial entrepreneurism in the North-eastern provinces among investors, entrepreneurs and government officials. Last but not least, the T+5 trading scheme also undercuts the liquidity of the market. On the SHSE and the SZSE, the T+1 (or T+3 for B shares) trading system enables shares bought on the transaction date to be sold out on the following day whereas payment received for shares sold on the transaction date can still be employed to buy further shares.¹⁸⁶ In comparison, the T+5 trading system is the norm on LEEs, meaning that the investors can't sell the equity within 5 days after share purchase from the same company or use the consideration to purchase new equity within 5 days after the sale of the shares. The T+5 operation mode on the LNEE and the DLEE¹⁸⁷ may in effect be identified with a lock up period of 5 days as no transaction is possible during the 5 days of settlement. While that might not be an impediment for long-term investors, China's stock markets are characterised by speculative and short-term trading and therefore this lockup period can be viewed as a barrier to the initial development of the LEEs as an alternative for investors.

Efforts to facilitate the equity financing function of the LNEE have already been made. For instance, the LNFO coordinated with the Liaoning Administration of Industry and Commerce (LNAIC), the SYAIC and the LNEE to enter into a cooperation agreement according to which the LNAIC will automatically accredit the registration of new share transferees once share transfers are completed on the LNEE. While that initiative may enhance liquidity, it is not clear that the sort of short-term trading that dominates the

¹⁸⁵ Note in particular the requirements of profits, revenue and net assets.

¹⁸⁶ The settlement rules of both the Shanghai Company and the Shenzhen Company of The China Securities Depository and Clearing Corporation Limited (CSDC) adopt the T+1 trading system: see section 3 of the Settlement Rules of Shanghai and section 4 of Ch 1 of Settlement Rules of Shenzhen.

¹⁸⁷ The Rules of The Liaoning Equity Exchange Trading Business 2014 (Trial) Article 16; The Rule of Dalian Equity Exchange Quoting and Trading Business 2014 (Trial) Article 17.

national exchanges is an appropriate model to meet the financing and governance requirements of SMEs traded on the LEEs since qualified investors may well envisage a more active role as a route towards generating value in contrast with the more passive role of shareholders in large companies listed on the national exchanges.

Given the fierce competition from the New Third Board (NEEQ), LEEs are pressed, for the sake of their own sustainable development, to develop their debt financing function. This alternative mode of operation was clearly the intentional design of the CSRC and the SC.¹⁸⁸ It was much less clear, however, that the private contractual process in the debt market could redress the institutional gaps on the local equity market in the manner that has occurred. The process works through the lender taking advantage of its negotiating power to require the borrower to disclose information on corporate governance as required on the public equity market and then lending according to the governance practices of the debtor. The debt is then distributed to investors in securitised form through the LEE.¹⁸⁹ Such arrangements indicate that market participants can use all the available possible means to achieve good governance practices which cannot be secured under the current regulatory framework of LEEs. The complementary role of private contracting is thus very apparent in terms of improving the governance practices not by way of legalized rules but rather through a private contractual process prior to the stage when the market is ready to have a set of sophisticated regulatory rules.¹⁹⁰ In that sense experimentation at the local level indicates that good corporate governance is valued in the market by investors whether or not it is required by the LEE or other regulatory authorities.

¹⁸⁸ As reflected in Circular No.37 by the SCGO and Circular No.38 by the CSRC.

¹⁸⁹ Interviewees indicated that this type of business formed the majority of the business of the LNEE.

¹⁹⁰ A similar trend had already been evident in Russia's transition to capitalism: see Doreen McBarnet, 'Transitional transactions: legal work, cross-border commerce and global regulation' in Michael Likosky (ed) *Transnational Legal Processes* (London: Butterworths, 2002) discussing the use of contractual terms in public offers of shares in Russia in respect of the liability of the issuer for the accuracy of its share register.

6. Qualified Investors

The requirements for qualified investors are similar in the LNEE and DLEE. Both separate investors into institutional and individual investors, and design the requirements accordingly. In general, as shown in Table 5, the LNEE has relatively higher requirements for investors, indicating a preference for a higher degree of investor protection by limiting access to the relatively unproven enterprises likely to seek a quotation on the LNEEs. Institutional investors should have at least 1 million RMB registered capital or the total actual capital contribution by partners should be no less than 1 million RMB if it is a partnership. A similar capital requirement for institutional investors can't be found in DLEE. For the individual investors, the LNEE deems individual investors with total assets no less than 0.5 million RMB as qualified individual investors whereas the counterpart for the DLEE is lower than half of this figure, i.e., merely 0.2 million RMB in terms of total financial assets.

Table 6: Qualified Investors on LNEE and DLEE

	Institution		Individuals	
	LNEE	DLEE	LNEE	DLEE
Type	Qualified financial institutions	Person with full capacity for civil conduct	Qualified Legal institutions, partnership companies, financial institutions	1. ≥ 18 years old 2. Person with full capacity for civil conduct
Capital requirements	1. Register capital ≥ 1 million RMB 2. Total actual investment by partners ≥ 1 million RMB		Total financial asset ≥ 0.5 million RMB	Total financial asset ≥ 0.2 million RMB
Other			1. Understand	1. Understand

requirements			<p>the risk of investment</p> <p>2. Pass the exam of equity investment and risk identification</p> <p>3. Enter into An Agreement of Risk Disclosure with the EE or the Agencies</p>	<p>the risk of investment</p> <p>2. Pass certain exams</p> <p>3. Having experience in securities investment, and no bad records</p>
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7. Explaining the Failure of the LEEs as a Conduit for SME Financing

The main purpose in developing the LEEs is to encourage the growth of SMEs through expanding their financing options. Investigations through our project suggest that neither LiaoNing nor DaLian has been able to develop the equity funding function of the LEE successfully. The LNEE has developed trading mainly in bonds backed by trade debts whereas DLEE has largely been limited to "showcasing" quoted companies with almost no trading or capital raising having taken place. Both equity exchanges face the problem of "markets without investors".

There are several explanations for this outcome. First, the equity financing function of the LEEs has intentionally been marginalized by the central regulator. The current promotion of the national New Third Board and the LEEs must be understood within a context where the two national stock exchanges have already been in existence for over two decades and the legitimacy of the national regulator (the CSRC) has already been established. With the well-established national stock exchanges and the currently feted national New Third Board, LEEs coveted by the local governments may have to fit their feet to the shoes

made by the central government. We can accordingly observe a guided evolution of the securities market in China with control from the central government on the sequence of development and the interaction of markets at different levels. The national markets are without doubt given priority. We thus experienced the super priority of the two national exchanges and then the national New Third Board. The campaign to promote the multi-tier capital market was accordingly not a random, unorganized evolution. The Chinese approach is very different from the challenge that the SEC saw itself facing in 1997 to promote competition among different trading systems so as to “develop a forward-looking and enduring approach that will permit diverse markets to evolve and compete while preserving market-wide transparency, fairness and integrity”.¹⁹¹

Our project also shows that the dividing line between the administrative and judicial hierarchy is not clear. When no laws exists, for instance in our case of the LEEs in the late 1990s, we see strong intervention from the administrative hierarchy. While Chinese Administrative Law and the Law on Legislature do stipulate that regulations cannot be in conflict with laws or regulations at higher levels, the possibility of a judicial review of local regulations when no law exists is still slight. It is accordingly unlikely that a judicial review of administrative policies by reference to deficiencies in cost-benefit analysis in rule-making is possible in China.¹⁹² In addition, even though the development of China’s securities market is still a government controlled but incrementally government induced process, the nonlinear feedback loop between the experimentation and the central policy making may still provide opportunities for “political lightning” that could “transform a long-dead policy proposal and push it to the top of the agenda.”¹⁹³

¹⁹¹ SEC Concept Release, 62 Fed. Reg. 30,486 (1997). A similar focus on competition and market integrity was later evident in the EU’s approach to the emergence of alternative trading venues: see preamble 5 to MiFID (Directive 2004/39, [2004] OJ L 145/1).

¹⁹² For a discussion of this issue in the context of the US courts striking down SEC regulation as a result of failures in cost-benefit analysis see Matthew Spitzer and Eric Talley, ‘On Experimentation and Real Options in Financial Regulation’ (2014) 43 *Journal of Legal Studies* 121, arguing that the benefits of field experimentation tend to be over-estimated by regulators and undervalued by the courts.

¹⁹³ Sebastian Heilmann, ‘Experimentation under Hierarchy’, *supra* n 61, at 17.

Such confusion over the appropriate roles for administrative and judicial authority leads to a situation in which there is no clear concept of a regulatory perimeter in China. Thus, the western understanding of an OTC market in which innovative financing, intermediation and execution techniques can be developed beyond the scope of regulatory oversight cannot be applied to China. The possibility of ex post regulatory intervention and the imperative of preserving good relations with provincial governments mean that innovation can only be approached in a cautious and incremental manner.

Second, the lack of product variety is another reason for the lack of investors on the market. Products available on exchanges at higher levels are still not available to investors on the LEEs. Cross-quoting of or co-recognition for a quoted share on local exchanges is still restricted and competition between markets at different levels (regional/national) so as to achieve a competitive healthy national market system is still not possible at this time.¹⁹⁴ In addition, bank-credit based products, gold, insurance and related products are also not available on LEEs, much less the trading of structured products or derivatives at this stage. All these contribute to the lack of variety of products permitted to be traded on the LEEs. While debt financing has enjoyed relatively greater success on the LNEE, it has also been constrained by the lack of an efficient credit rating system for both individuals and enterprises.

Thus, introducing more products to the LEEs may help to alleviate the current moribund situation. New products such as a structured equity product based on an index for the region might well be considered as useful innovations for LEEs. Moreover, lobbying for mutual recognition across regional boundaries so as to permit cross-quoting into another province may also be useful at this stage. Passive investment products (indexation) might also be promoted by the LEEs for the purpose of increasing product variety.

¹⁹⁴ See the Provisional Rules on the Supervision and Administration of LEEs (Draft for Opinions) Article 4 (2015) in general.

Third, the trading scheme of T+5 (with its purpose of providing safety to transaction parties) may undermine the liquidity of the market, thereby limiting its attraction relative to the National Market and the Third Market. In addition, the failure to introduce a market-maker system to the LEEs may also further undermine the liquidity of the market.

Fourth, our interviewees indicated that the local culture and recent economic stagnation also contribute to the lack of investors on the market. The less developed private economy, the comparatively weaker initiatives of local governments to develop the private economy, and the lack of confidence of the investors in the local economy all contribute to the outcome of a market without investors. That outcome however largely reflects the institutional context, which deserves long term efforts and possibly favourable policies from the central government. Progress on that front is linked to the dynamic of the relationship between central and local governments and the struggle for comparative advantage between and even inside the provinces.¹⁹⁵

Both LNEE and DLEE can be characterised as thin markets with a low degree of liquidity, and a low level of efficiency in the pricing process and in turn it is hard for them to play their expected function of pricing of the shares traded on the centres. Without a favourable regulatory environment, the low trading volume and the inactive trading activities on the LEEs may in turn further exacerbate their moribund situation. This is because for candidate companies only marginal reputation can be reaped for being quoted and traded on LEEs and for intermediaries support may only be provided with a high risk.

It is reasonable to project that this situation may however stimulate the development of

¹⁹⁵ For instance, DaLian has been striving for the financial centre of the Northeast and DaLian took advantage of the ambiguous effect of the rules of the CSRC and the SCO to further enhance its existing financial status within the region. See further Lam Tao-Chiu, 'Central-Provincial Relations amid Greater Centralization in China' (2010) 24 *China Information* 339.

the private equity industry, which can inject new capital and contribute to more buyout transactions. It is likely that private equity firms may be more efficient investors in SMEs and can draw indirect investors into their funds. The transaction costs involved however will be high and the entrepreneurs will usually have to give up their control of the company to the PE firms. However, given that PE firms are systematically controlled by the CSRC, the role of PE firms in promoting the liquidity of LEEs should not be exaggerated since the same priorities that led to the demise of the LEEs can be expected to emerge in that process.

The regulatory framework for LEEs may raise questions as to whether information disclosure on corporate governance is preferred by potential investors. Our interviews reveal that some credit enhancement companies have already required such information, indicating that information necessary for equity investors can in principle be made available on the market. However, moving towards a stronger disclosure regime for lower tier markets such as the LEEs is inevitably a finely-balanced process. For instance, stringent requirements of disclosure may engender good governance practices but at the same time may increase quotation costs and in turn handicap prospective applicant companies.

F. CONCLUSION

In this article, we evaluated the role of experimentation in the process by which China has established and expanded its securities market in recent years. We noted that several characteristics of the Chinese system meant that the process of experimentation should be regarded as *sui generis*. One overriding consideration is that the relative weakness of the rule of law in China provides a conducive environment for adopting discretionary and experimental administrative policies before law and regulations are enacted. Beyond that we noted that several elements of the political structure were influential: a form of *de facto* federalism which combines political centralization with economic regional decentralization; the capacity for a longer-term view to be adopted in a one-party state where short-term electoral concerns are absent; and the direct influence of the Communist Party on

policy-making, enterprise management and securities market regulation through the Nomenklatura system. A more direct influence at the level of securities market regulation is the absence of a formal concept of “regulatory perimeter” comparable to western systems of regulation. The effect is that all financial sector activity is undertaken on the understanding that the state has discretionary power to intervene and may even do so on a retrospective basis.

All these factors have played a part in the most recent phase of development of the Chinese securities market in which efforts have been made to establish local (provincial level) equity exchanges (LEEs) so as to support entrepreneurship and SMEs. The legal status of the LEEs remains unclear even if it is now clear that it is for Local Financial Offices rather than the CRSC to regulate their establishment and operation. However, the CSRC retains a significant influence over the operation of the LEEs through its role in regulating securities firms. Regulation of issuing and trading on the LEEs makes it difficult for them to meet their objective of supporting SMEs. There is no scope for the LEEs to compete with the national market nor can companies listed on the LEEs easily convert to the New Third Board or The National Market.

Case studies of the LNEE and DLEE show that the LEE initiative has largely failed as it survives only by quoting and trading non-equity products. Several factors may have contributed to this unfortunate outcome. First, the strong control of the central government and the CSRC is apparent in exploring the LEE initiatives. The intentional segmentation of the local securities market and constraints imposed on local governments in promoting local securities market show that the central government is still reserved in granting full discretion to local governments. The evolutionary path to achieve a healthy national securities market by promoting free competition among local securities markets has accordingly been disfavoured. Instead, a guided and closely monitored evolutionary path has been selected.

The promotion of the New Third Board has occurred in parallel with the development of the LEEs and a series of strict quotation rules have since been promulgated on the New Third Board with the intention of attracting investors. The LEEs may be doomed to fail in this competition between the local teams and the national team. Third, constrained by the limited sources in terms of professionals, technology and administrative control, the LEEs may have to strike a hard balance between attracting candidate companies and long term investors. The empirical evidence up to now shows that lenient quotation rules, in comparison with those of the New Third Board, do not attract long term investors and fail to improve the liquidity of the market. In turn, the price discovery function of the LEEs has been handicapped.

Nevertheless, benefits can still be observed as a result of the experimentation process with LEEs. Despite the strong control of the centre, both LiaoNing and DaLian governments still enjoy some discretion in designing local rules, which leaves scope to develop rules according to the needs of local markets. Indeed, our case studies show clear indicators of market development of corporate governance, market-led development of quotation and conduct rules, and development of regulatory expertise in the LNFO as a counterbalance to CSRC orthodoxy.

It is possible to conclude from the perspective of national experimentation that the LEEs are simply not required, or at least not in their current configuration. But we need to look beyond LiaoNing before we can reach that conclusion. And we need to take into account the revitalisation of the objective of a multi-tier capital market that has been articulated by the incoming Chairman of the CSRC, Liu Shiyu.¹⁹⁶ In that sense our conclusions are provisional at this stage.

¹⁹⁶ See 'China dismisses top market regulator' *Financial Times* (London 20 February 2016)