AN ANALYSIS OF THE CHINESE STOCK MARKET

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ABSTRACT

With the introduction of a market economy, China is experiencing rapid economic development. As an indispensable component to its economic system, China's stock market came through its initial set-up period, overcame challenges, suffered pains, and is currently progressing towards to an internationalised direction. However, its immaturity hinders its continuous development and the country's economic expansion. This paper focuses on the status quo of Chinese stock market and centres on problems that have greatly contributed to the capital market's inefficiency. With its main objective, this paper begins with a brief introduction of Chinese stock market. Then, it analyses Chinese stock market's fundamental problems of its structure, shares, regulations, and listed companies. Next, regulations and key solutions to the problematic market are presented. Finally, the paper ends with general suggestions on Chinese stock market's further development direction.

Keywords: Chinese Stock Market; Economic System; Tradable and Non-Tradable Shares; Political Impact; Capital Market Regulation

DEDICATION

生命的可贵并不在于金钱上的富有和身份上的显赫；
对我来说其的价值在于拥有慈祥的父母并拥有他们给予的无限亲情；
我感谢上天给我机会能拥抱这样的善良父母！
我的父母朴实平凡，
但他们的伟大却在于给了我美丽的生命，无价的亲情，富足的生活……
为了珍惜他们的付出，回报他们的恩情，我一刻也没停息的努力着自己的人生：
戴上学士帽和爸妈相拥庆祝的瞬间犹如昨日的画面还历历在目，
今日我又再次拥有硕士的光环，
这份荣誉是完全属于你们---我亲爱的父母！
在过去7年我独自在异国求学的的日子里，
我们都经历了很多：思念，孤独，迷茫，泪水，欢笑……
只有我们自己才知道这份成功和荣耀背后保藏了多少不为人知的付出与辛酸。
今天的女儿在你们的百般呵护，精心栽培下学有所成，长大成人了，
在此刻我想要竭尽全力的向全世界呐喊：
"感谢我亲爱的父母为我无怨无悔，用不疲倦的无私付出，我爱你们！"
与此同时，我生命的一个崭新篇章已经开始，我会继续让你们为我感到骄傲！
我还要感谢我的爱人，隋三龙，谢谢你的爱，你的支持，以及你所给予我的一切！
作为我生命中最最重要的男人，我会永远在心中为你置留一份特殊的位置！
谢谢我所有的亲属在我不在父母身边的日子里照顾他们!
还感谢在我生命中出现的所有给过我爱和帮助的人们！

I dedicate this project to my parents, my lover-Sanlong, and all my aunts, uncles, and cousins! You will never know how much your lover, support, encouragement, and help meant to me!

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1 INTRODUCTION

As a developing country with an extremely high economic growth rate, China has been experiencing numerous evolutions in its economy structure. As an economy, it has gained priceless experience and knowledge regarding a mature economic system from successful examples of developed countries, and also from its own business practices. In the last 20 years, "Chinese economic growth has been impressive and its high growth rate has been sustained with relatively minor fluctuations" (Tisdell & Chai, 1997). Moreover, researches describe the great progress of China's economy by proclaiming that "China's rapid economic growth since commencing its economic reforms in 1978... is unprecedented in the three thousand years of China's written history and also rare in the world history too" (Tisdell & Chai, 1997). In this environment, China's capital market is a most critical aspect which has great influence on the country's development. Since its formal setup in late twentieth century, the Chinese stock market has suffered criticisms, pressures, discouragements, failures, scandals, and even dangers of collapse. In spite of these hardships, China still holds strong belief to build up a stable and mature capital market as those of Western countries.

However, existing inefficiencies in the Chinese stock market cannot be ignored. A researcher's description vividly reflects the current status of the Chinese stock market, "like a baby who cries and must be fed continuously, or it will not stop crying. It is also like a patient with a chronic blood disease, whose life depends on transfusions" ("Crisis Lurking in Chinese Stock Market", 2004). His saying demonstrates feed and transfusions are all keys to resolve or at least to solve the ongoing problems, and these keys are special designed based on the natural of symptoms. Therefore, China also can employ pertinent strategies and techniques to improve its vulnerable stock market through clear understanding its shortcomings. Obviously, the key is to seek out fundamental problems and the root of such problems. As a result, any reformation and enhancement towards the Chinese stock market will be rational, constructive, valuable, and practicable. In other words, "suit(ing) the remedy to the case" is the pivot.

Based on relevant research, this paper partially analyzes current status of the Chinese stock market. Section one provides a brief overview of the Chinese stock market, including its history, major exchanges, share types, indices, types of stocks, and regulations. Section two reveals Chinese stock market's major problems associated with corresponding causes. Section three presents a series of actions taken by regulators to solve problems discussed in the previous section. Finally, section four gives a conclusion including the author's personal suggestions on the Chinese stock market.

2 OVERVIEW OF THE CHINESE STOCK MARKET

2.1 History and Background

When talking about a stock market, most people may not realize that the Chinese stock market even has a longer history than many developed countries, such as U.S., Germany, or England. The earliest record of stock trading in China can be tracked to mid Nineteenth Century, and probably earlier. The first trade of securities trading in Shanghai begins in late 1860s. In 1891, due to the boom in mining shares, the Shanghai Share Broker's Association, China's first stock exchange, was established. That exchange became the largest and wealthiest stock market in Asia at that period. Unfortunately, it was shut down in 1941, a time of war, turbulence and confusion (Fan, 2003).

However, the later stock markets in China were set-up corresponding with the revolution of the economy. In late twentieth century, firms in Shanghai began issuing shares, and Chinese investors were once again trading shares in enterprises. Based on this situation, a trading counter was established by the Industrial and Commercial Bank of China in 1986 (Sinomania, 2006). Meanwhile, China's major stock exchanges opened in that period. Unlike developed countries' capital markets, the Chinese stock market was established primarily for the reason of "allowing state-owned enterprises to raise capital from Chinese investors and from foreign entities by initial public offerings (IPOs) of unseasoned (never traded before) shares as a substitute for continued central government funding of such capital investment" (Los Angeles Chinese Learning Center, 2006). As such, it is not surprising that companies listed in Chinese stock exchange were only those in high need of capital funding, and those were likely in danger of bankruptcy. The consequent result was that there were few "high-quality" companies in the Chinese stock market at that early period of stock trading, and investment opportunities were also limited.

On the other hand, China's economy has never stopped developing since major stock exchanges opened. As economy progresses and its structure is modified to be more formal and integrated, Chinese stock markets are growing towards to a more standardized direction. The most obvious changes are changed nature and trading intention of companies getting listed. Companies in the relatively new stock market are mainly aiming at raising funds from investors for the purpose of making incremental investments, expanding business, and consequently maximizing shareholders' wealth. In the business world, it is widely acceptable that the primary objective of running business is the maximization of shareholders' wealth. So, the new trend in the Chinese stock market mentioned here seems to be consistent.

2.2 Major Chinese Stock Exchanges

Shanghai and Shenzhen Stock exchanges were both opened in 1990, and they are the largest stock exchanges on Mainland China. Additionally, Hong Kong Stock Exchange remains to be one of the world's largest and most important markets (Wu, 2004). Table 2.1, 2.2, and 2.3 show key statistics on the Shanghai and Shenzhen Exchanges.

Table 2.1 Key Statistics of the Two Major Stock Exchanges (up to 20 July 2006)

	Shanghai Stock Exchange	Shenzhen Stock Exchange
Number of Listed Companies	833	530
Number of Listed Securities	1,105	706
Total Listed Capital (100 millions)	7,030	2,210.15
Total Aggregate Float Market Capitalization (100 millions)	1,899	1,084.37
Total Market Capitalization (100 millions)	36,212	12,804.75
Total Float Market Capitalization (100 millions)	10,477	6,078.18

Data Source: Shenzhen Stock Exchange, Shanghai Stock Exchange

Table 2.2 Key Statistics of Shenzhen Stock Exchange

Statistics of Shenzhen Stock Exchange				
Year	**Total Float Listed Capital (100 Mil. shares)**	**Total Market Capitalization (RMB 100 Mil.)**	**Total Float Market Capitalization (RMB100 Mil.)**	**Total Stock Turnover (RMB100 Mil.)**
1995	105.13	948.62	351.22	8,944.27
1996	158.76	4,364.57	1,458.29	13,949.34
1997	275.06	8,311.17	2,690.95	18,627.96
1998	361.21	8,879.73	2,798.15	11,964.97
1999	457.93	11,890.70	3,964.28	16,310.85
2000	584.33	21,160.08	7,606.19	33,143.78
2001	643.35	15,931.64	6,081.06	17,432.48
2002	687.41	12,965.40	5,017.26	14,039.68
2003	704.22	12,652.79	4,977.38	11,291.13
2004	822.81	11,041.23	4,337.76	15,863.35
2005	934.29	9,334.15	3,875.91	12,424.56

Data Source: Shenzhen Stock Exchange

Table 2.3 Key Statistics of Shanghai Stock Exchange

Statistics of Shanghai Stock Exchange			
Year	Total Stock Turnover (100 Mil. shares)	Total Stock Turnover (RMB100 Mil.)	Market Capitalization (RMB100 Mil.)
1991	1.24	8.07	0.00
1992	17.78	248.96	0.00
1993	147.42	2,340.54	0.00
1994	656.76	5,735.07	0.00
1995	513.83	3,103.46	0.00
1996	1,101.88	9,114.82	5,335.61
1997	1,215.68	13,763.17	0.00
1998	1,123.96	12,352.69	0.00
1999	1,560.38	16,965.79	14,580.47
2000	2,437.65	31,373.86	26,930.86
2001	1,819.95	22,709.38	27,590.56
2002	1,781.10	16,959.09	25,363.72
2003	2,692.73	20,824.14	29,804.92
2004	3,607.74	26,470.60	26,014.34
2005	3,986.59	19,240.21	23,096.13

Data Source: Shanghai Stock Exchange

2.3 Types of Chinese Stocks

Stocks in Chinese stock markets are often classified into three categories: A-shares, B-shares, and H-shares. A-share companies are incorporated in Mainland China and shares are quoted in Renminbi (Chinese currency). Currently only mainlanders and selected foreign institutional investors are allowed to trade A-shares. B-share companies are incorporated in Mainland China and traded in the mainland B-share markets (Shanghai and Shenzhen Stock Exchanges). B-shares are quoted in foreign currencies. In the past, only foreigners were allowed to trade B-shares. Starting from March 2001, Mainlanders can trade B-shares as well, but they must trade with legal foreign currency accounts (Chen & Shih, 2002). Although B-share market plays a significant role for protecting A-share market from crash in a period of financial crisis and withdraws foreign investment, it is not common that there are two different markets (A-share market and B-share market) and different currency trading in a single country. Besides, it is more extraordinary that in the Chinese stock market a listed company could have stocks listing in both

A-share market and B-share market with different share prices. According to these irregular circumstances, regulators and policy makers have already considered altering the market structure. Their objective is to naturally merge A-share market and B-share market. So, it is predictable that in the near future the Chinese stock market will not have the existing complex situation that Shanghai Stock Exchange (SSE) has two different share markets: A-share (SSEA) and B-share (SSEB) markets, and Shenzhen Stock Exchange has two share markets: A-share (SZSA) and B-share (SZSB) markers ("Difference between A-Shares and B-Shares", 2006). Table 2.4 summaries the main characteristics of A-share and B-share markets.

Table 2.4 Main Characteristics of A-share and B-share Markets

	A-share Market	B-share Market
Investors	Mainlanders (organizations, individuals), except investors from Taiwan, Hong Kong, and Macao	Investors from foreign countries, Taiwan, Hong Kong, and Macao
Currency Quoted	RMB (Chinese currency)	Shanghai Stock Exchange: U.S. Dollar; Shenzhen Stock Exchange: Hong Kong Dollar
Minimum Trading volume	100 Shares	Shanghai Stock Exchange: 1,000 shares; Shenzhen Stock Exchange: 100 shares
Trading Time	Mon. to Fri. AM 9:30 – 11:30; PM 1:00 – 3:00	Mon. to Fri. AM 9:30 – 11:30; PM 1:00 – 3:00
Maximum fluctuation	10%	10%
Characteristics of Stocks	Traditional industries, High-tech, Internet, biochemical, etc.	Mainly traditional industries
Characteristics of market	Higher liquidity, more choices of stocks	Lower liquidity and daily trading volume, listed companies have relatively lower capital.
Number of Investors	Up to the end of 2005, Shanghai Stock Exchange: 37.413 Mil; Shenzhen Stock Exchange: 34.75 Mil.	Up to the end of 2005, Shanghai Stock Exchange: 998,600; Shenzhen Stock Exchange: 619,200.

Data Source: Shenzhen Stock Exchange, Shanghai Stock Exchange, http://fn.yam.com

H-shares are floated and listed on Hong Kong Stock Exchange. The best-rated H-shares are called "Red Chips". On the top of that, there are also C-shares, N-shares, and L-shares: C-hares are denominated and traded in Rinminbi and held by state-owned "legal persons" (i.e., state-owned companies and banks); N-shares are floated and listed on the New York Stock Exchange; L-shares are Chinese companies listed on the London Stock Exchange (Sinomania, 2006).

2.4 Stock Indices

Among various indices in the Chinese stock market, Hang Seng index and Jing An index are the largest and most significant. Hang Seng Index (HSI) comprises representative stocks on Hong Kong stock market. Figure 2.1 and figure2.2 illustrate behaviours of Hang Seng Index. Hang Seng China Enterprises Index that tracks Chinese incorporated companies listed on the Hong Kong exchange or H-shares. The Jing An index is used for Shanghai and composite indexes for both Shanghai and Shenzhen Stock Exchange (Sinomania, 2006). Other stock indices include SSE (Shanghai Stock Exchange) Index (Table2.5 lists all SSE Indices and Figure 2.3 shows the movement of SSE Index during the period between 1990 and 2006), Hang Seng Composite Index, Shanghai & Shenzhen 300 Index, Shenzhen Composite Index (Figure 2.4 illustrates the behaviour of Shenzhen Composite Index in the period of 1997 - 2006), Shanghai 180 Index, Shenzhen 180 R Index, etc. Figure2.5 demonstrates the constituents of the Hang Seng Composite Index. Appendix A provides specific information about all indices currently available in Shanghai Stock Exchange and Appendix B shows constituents of the Hang Seng Index.

Table 2.5 List of SSE Indices

Index Name	Shortened Form	Code	Launch Date	Base Day	Base Value
Constituent Index					
SSE 180 Index	SSE 180	000010	2002-7-1	2002-6-28	3299.06
SSE 50 Index	SSE 50	000016	2004-1-2	2003-12-31	1000
SSE Dividend Index	SSE Dividend	000015	2005-1-4	2004-12-31	1000
Composite Index					
SSE Composite Index	SSE Index	000001	1991-7-15	1990-12-19	100
SSE New Composite Index	New SSE Index	000017	2006-1-4	2005-12-30	1000
SSE A Share Index	A Share Index	000002	1992-2-21	1990-12-19	100
SSE B Share Index	B Share Index	000003	1992-8-17	1992-2-21	100
Sector Index					
SSE Industrial Index	Industrial Index	000004	1993-5-3	1993-4-30	1358.78
SSE Commercial Index	Commercial Index	000005	1993-5-3	1993-4-30	1358.78
SSE Real Estate Index	Real Estate Index	000006	1993-5-3	1993-4-30	1358.78
SSE Utilities Index	Utilities Index	000007	1993-5-3	1993-4-30	1358.78
SSE Conglomerates Index	Conglomerates Index	000008	1993-5-3	1993-4-30	1358.78
Other					
SSE Fund Index	Fund Index	000011	2000-6-9	2000-5-8	1000
SSE Government Bond Index	Government Bond Index	000012	2003-1-2	2002-12-31	100
SSE Corporate Bond Index	Corporate Bond Index	000013	2003-6-9	2002-12-31	100

Figure 2.1 Hang Seng Index Historical Prices 1964 – 2004

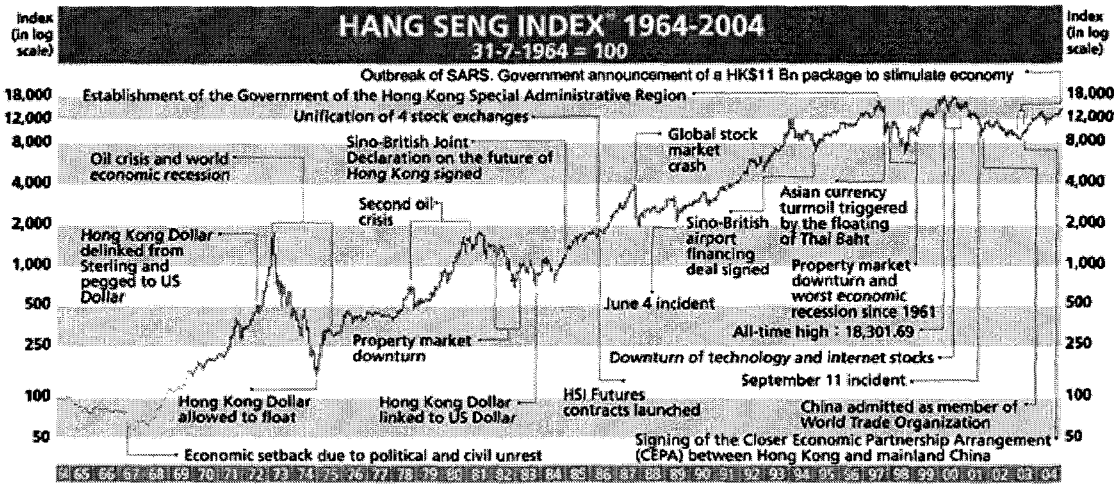

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Figure 2.2 Hang Seng Index and Stock Market Turnover 2004

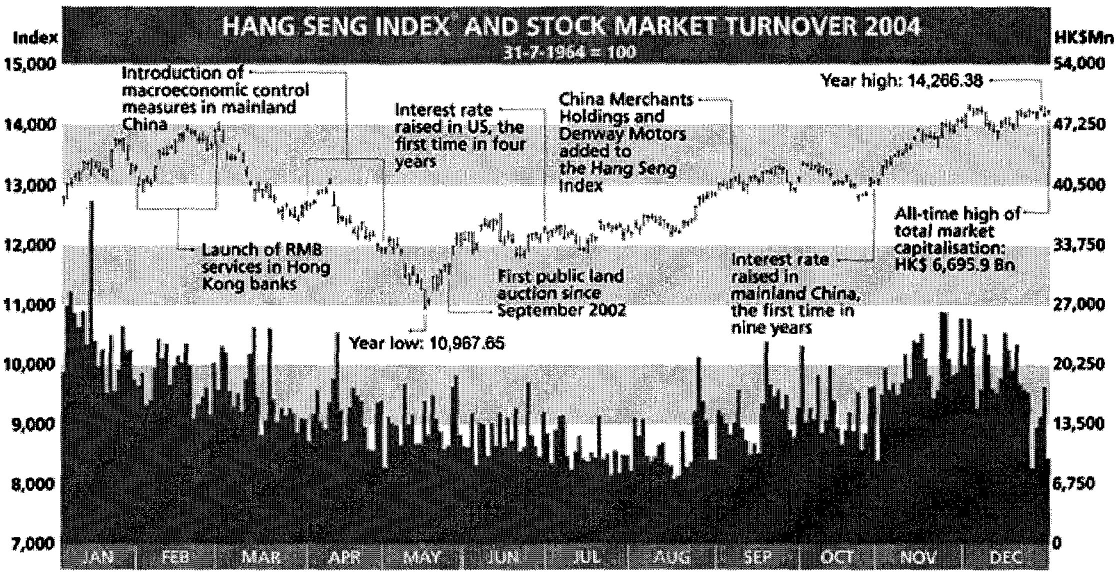

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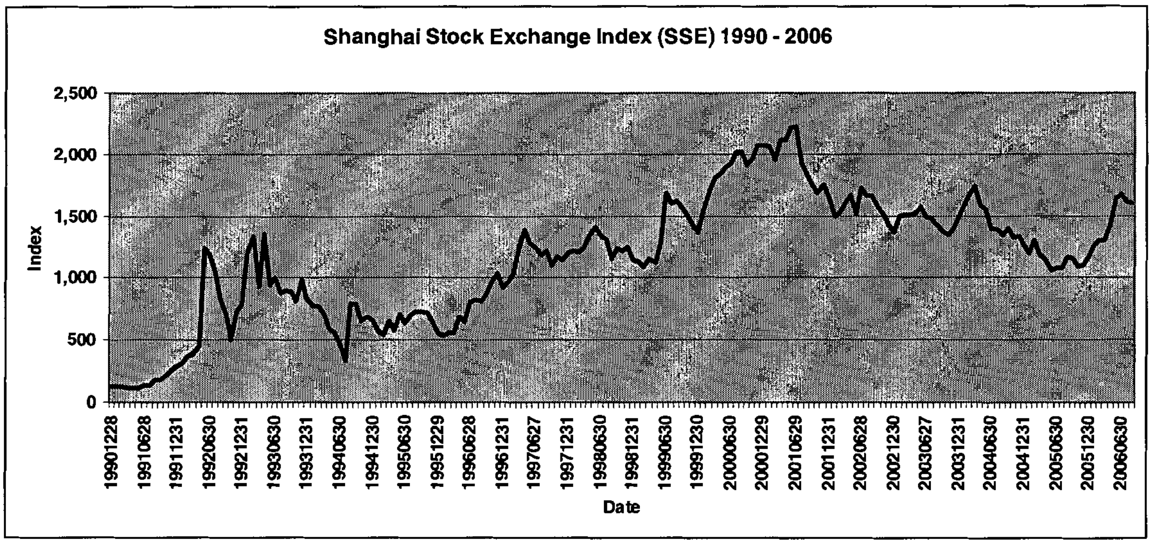
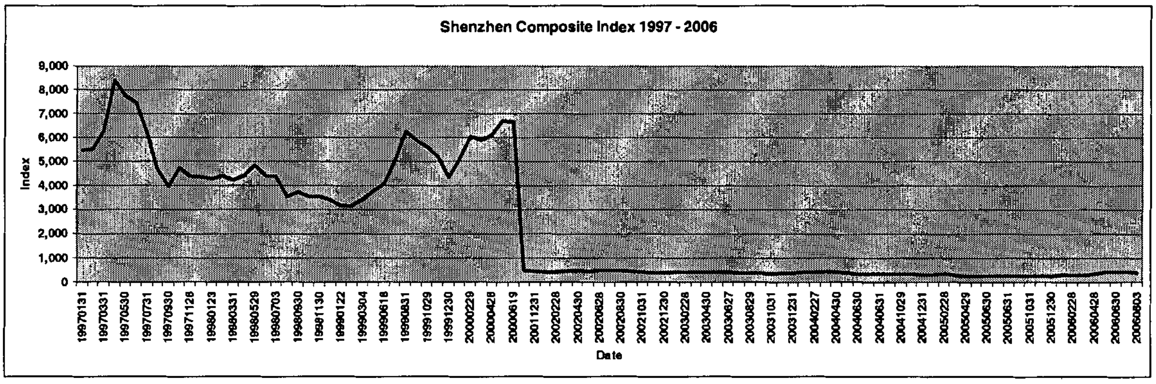
Figure 2.3 Shanghai Stock Index Historical Prices 1990 – 2006



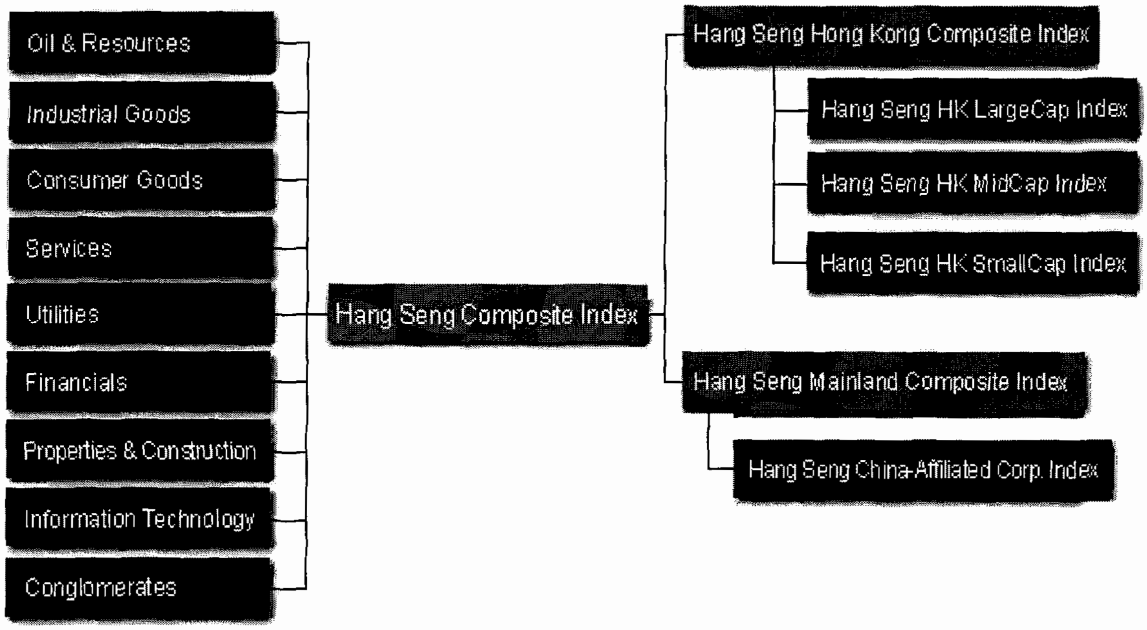
Data Source: stock.sohu.com

Figure 2.4 Shenzhen Composite Index Historical Prices 1997 – 2006



Data Source: stock.sohu.com

Figure 2.5 Constituents of Hang Seng Composite Index



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2.5 Types of Shares Issued

According to the nature of investments, shares issued in the Chinese capital market are categorized into state shares, corporation shares, and individual shares. State shares are held by state owned asset administration bodies. Since most Chinese listed companies are originally state-owned organizations, state shares are count for a large proportion of the total capital market. By restructuring those organizations, various and even contradictory economic factors are allowed in one single corporation. However, the government is still attempting to control more resources using less capital. The vehicle it uses to achieve this goal is to owning state shares in those organizations (Xu, 1998).

Corporation shares are held by legal economic entities, partly state owned enterprises. Presently, about 20% of all shares issued in the Chinese stock market are corporation shares. Corporation shares can also be divided into local corporation shares, cross-country corporation shares, and raising corporation shares (Xu, 1998).

Individual shares are held by private citizens of China, and they are the only shares that could be traded on the exchange (Xu, 1998). China Company Act stipulates that any individual investor cannot own more than five-thousandths of shares in a single company (Sinomania, 2006).

Currently, most individual shares are tradable in the market, but state and corporation shares are not tradable in the market. In spite of their lack of tradability, government's ownership in listed companies can be transferred by signing a contract with prospective investors. This contract must be approved and sanctioned by the national department in charge of securities (Sinomania, 2006). In the book *Diagnosis and Remediation: Disclose Chinese Stock Market.*, the author claims that non-tradable shares lead to an oversized capital market, instability of the stock market, market manipulators' over control, and conflict of interests between owners of individual shares and owners of state shares and corporation shares (Cheng, 2003). These problems will be analysed in detail in Section 3.2.

2.6 Regulations

In the Chinese stock market, the national regulatory body in the securities industry currently is the China Securities Regulatory Commission (CSRC) under the State Council. The main regulatory reference is from China's Securities Act that took effect in mid 1999 (Sinomania, 2006). So, China's Securities Act is the primary guidelines that direct behaviours of people in the stock market. China's Securities Act is China's first economic governance law established by the nation's highest legislature following international best practices. The inducement to establish China's Securities Act was the infamous Asian financial crisis in 1998. The Asian financial crisis warned China about significant impact of financial risks and reminded China the importance of relevant regulations that could help prevent or mitigate financial risks. Because of this original intention, China's Securities Act is set up mainly for the purpose of mitigating against financial risks. With respects to this relatively simple purpose, there are lots of criticisms towards this Act. Most complaints are about the large umber of restrictions and prohibitions corresponding with the great emphasis on financial risks. Besides, people also criticize that the Securities Act does not have enough clauses set for the purpose of protecting investors' legal rights and interests. Therefore, this Act is to be revised with greater considerations for common investors (Southcn, 2006).

3 MAJOR PROBLEMS IN THE CHINESE STOCK MARKET

Today, no one can neglect the fast economic development in China. Many experts even predict that China will be an economic superpower in the new millennium. This prediction is not exaggerated and unreasonable, as demonstrated by key economic statistics in 2004 and 2005, China's GDPs were increased by 10.1%, and 9.9% respectively. These remarkable numbers are high enough to bring China to be the fifth country with the highest GDP growth rate all over the world. A British economist describes China as a speedy steamboat to rapidly develop its economy (Li, 2006).

Because of China's booming economy, one may infer that the Chinese stock market must be strong enough to match the optimistic economic framework. This belief is valid in a well-established and mature stock market. However, relevant research reveals an inverse relationship between China's GDP growth rate and the performance of its stock market. In fact, the fraction of stocks and bonds, which are significant components of GDP, is significantly lower in China than it in developed country (Chen et al., 2000). In other words, China's continuously growing economy does not provide a corresponding and consistent environment for its stock market. For example, in 2005 when GDP increased by 9.9%, the Chinese stock market was highly inconsistent and volatile. Significant indices even could not have continuously increased figures for three successive days: it was wander around 1,100 points in the whole year, and in March, 2005 the index dropped to the lowest point in six years (Zhang, 2006).

3.1 Investors' Lost Confidence on the Chinese Stock Market

According to a survey conducted by Shenyin & Wanguo Securities Co., from January 2001 to February 2002, almost ninety percent of retail investors suffered losses in their stock market investments, among which 81.64% reported that their losses were over 30%. In the same time period, composite indices in Shanghai and Shenzhen Stock Exchange dropped 28%, referring to statistics compiled by Hong Kong China News Agency (Rong, 2006). It is obvious that investors' great loss and high economic growth rate do not match each other at all. It is a critical task for China's stock market to find out the source of this anomaly in order to ensure a strong stock market, which contains healthy and attractive investment opportunities. Based on a great number of investigations and studies, China's current inefficient stock market can be considered as a product of investors' lack of confidence on it. In other words, from investors' points of view, China's stock market is long on promise but short on reliability. This point is also confirmed by a statement of a famous Chinese economist, Xiaomin Liang. Mr. Liang claims that "the biggest problem in current Chinese stock market is investors completely lost confidence on the market and on listed companies" (Xie, 2005). This poor situation is rooted in a fact that many listed companies' main purpose is not to maximize shareholders' wealth and make reasonable investment, instead, is to raise a substantial amount of money for temporary use, for example, for paying back overdue debts, or for questionable expansion plans. In order to fulfil these short-term goals, many listed companies violate accounting principles and publish false financial statements or illegally employ uncertified auditors. What they are doing is for the purpose of building up good public image and making investors to believe their companies are good investment opportunities. In the beginning, investors were innocent and unaware that they were making investments based on misleading information. Without question, investors lost significantly. By contrast, listed companies guiltily gain their desired funds at the expense of investors' loss. According to an article in China News, "the 2005 Corporate Credibility Index of listed companies, released by Economic Observer Research Institute, is just 37.7 points. In other words, Chinese listed companies are all unqualified in terms of credibility index" (Chinanews, 2005).

Moreover, some companies are even deceptive with their names in order to build up good public image. For example, there used to be one listed company named "China International Travel". However, this company was not a nation wide company that operates domestically and internationally. Like this typical company, many Chinese companies try to build up "good image" by having misleading names (Xie, 2003). Time and time again, painful losses have raised investor's ire. They start doubting listed companies' true identities and eventually lose confidence in the entire market.

3.2 Shares' Illiquidity

As discussed earlier, the Chinese stock market was setup with an original intention of allowing state-owed firms to raise capital. Government and certain entities own these state-owed firms by possessing their state shares. Statistics show that "currently only 30% of state shares can be transferred on the market and the remaining 70% is non-circulating and non-transferable" (Fang, 2005). Obviously, the illiquidity problem of shares in the Chinese stock market is serious. Yet, one of the most appealing theories in stock market is the liquidity preference theory, which is built upon the basic assumption that investors prefer to preserve their liquidity and invest funds for short periods of time (John C., 2005). Apparently, shares in the Chinese capital market significantly lack for liquidity. Therefore, investors eventually lose interest in investing in the domestic market.

Moreover, due to the problem of illiquidity, when share price needs to adjust for new valuable information, only a limited number of shares which can be freely traded can properly respond to that information. So, the overall share price level cannot appropriately response to changes on the market by moving to a new level. Generally speaking, the stock market cannot effectively and timely react to market changes in a normalized fashion, so cannot be regarded as a dynamic reflection of the true market.

3.3 Potential Danger of Non-Transferable Shares

Because of the ownership structures of most listed companies, the certain percentage of state and corporation shares not tradable is held by the corporation itself or by some government entities. Scholars Wang and Jiang point that a typical Chinese listed firms usually have a substantial portion of non-transferable shares in the form of state (government-owned) shares, legal person shares, and employee shares. By the end of 2000, publicly tradable shares accounted for only for 35.7% of total shares, and non-transferable government and legal person shares accounted for 38.9% and 18.2% respectively" (Wang & Jiang, 2003). Besides, there are still a number of regulations seemed to discriminate against shareholders holding tradable shares. For example, typically shareholders of state shares can buy shares at RMB 1 per share, but the average price for shareholders holding tradable shares is RMB 9 per share. After deducting all fees, e.g. transaction fee, sales fee, shareholders holding tradable shares have to pay four times market value for one share. With this price discrepancy, it is equivalent to say that shareholders holding state shares intangibly stole investment capital from shareholders owning non-tradable shares (Yang, 2002).

The potential danger of non-tradable shares to the Chinese stock market is visibly demonstrated by Mr. Cheng, who is a commissioner in Standing Committee of the 9th National People's Congress. He states that the resulting impacts of non-tradable shares are factitiously exaggerative size of capital market, fallen down stability of the capital market, and market manipulators' easy control on the market. More seriously, the conflict of interests between owners of individual shares and owners of state and corporation shares is getting severer (Cheng, 2003). On the top of that, Mr. Cheng reinforces his position by saying that since non-tradable shares are countable for a considerable portion of total shares in the Chinese capital market, these shares radically skirt regulations to listed companies. He makes further clarification for this point: since government and other relevant organizations possess a substantial number of shares in listed companies, the management is mostly not under investors' supervision. Consequently, holding shareholders' periodic meetings is meaningless because of shareholders' lack of control over the company. In other words, shareholders' meeting cannot perform its ordinary functions, such as evaluate periodic financial performance, analyze management's work, etc. Due to the dysfunction of shareholders' meeting, disclosure of illusive information, inside trading, fraudulent trading, factitious manipulation over the market, and other depressing phenomenon occur frequently in the Chinese stock market (Cheng, 2003).

The harm of non-tradable shares can also be analysed from an individual investor's point of view. Because of the ownership of these special shares, investors understand that at some future point, those shares might be poured into the stock market. If this is the case, share prices will be driven down due to extensively increased number of shares. An increased number of shares implies individual shareholders' shrinking ownership in the firm. Without doubt, the potential influx of shares with special ownership is the basis of Chinese stock market's great volatility and investors' lost confidence in the market.

Professor Sheng Hua, an economist and the president of Yangjing University, warns Western senior managers, who are interested in the Chinese stock market, that since 2/3 of shares in the Chinese stock market are non-tradable, stocks essentially do not have market price. For this reason, there are always misinterpretations and false messages generated by direct application of Western capital markets' statistic methodologies. Therefore, Western capital markets' efficient and practical statistical and market analytical tools must be applied prudently in the Chinese stock market (Hua, 2003).

3.4 Conflict of Interests within Listed Companies Owned by Government

As mentioned earlier, the ownership of most listed companies in the Chinese stock market is held by the government; this special ownership is another important factor which contributes to the market's inefficiency. Therefore, it is not surprising that CEOs of these companies are appointed by the government, and they are presenting the interest of the government. This special group of CEOs leads to significant conflicts of interests within the corporation. As everyone knows, investors and shareholders desire high return on their investments in the corporation, so they care more about dividends, EPS, etc. On the other hand, CEOs in government –owned corporations do not care about returns, but care more about how much money they can raise from their shareholders. This crucial conflict of interest completely disorders the fundamental purpose of running a business, which is to maximize shareholders' wealth. The corporation's opposite interest can also be viewed as another explanation of investors' vanishing confidence in the stock market. Because of this ownership structure, when a firm performs poorly, shareholders actually can do nothing to change the firm's status because of their lack of control to the ownership. This fact worsens the relationship between shareholders and the corporation as a whole.

3.5 Lack of Hostile Takeover in the Chinese Stock Market

According to academic research, the lack of "hostile takeovers" is a fatal problem for the Chinese stock market (Fang, 2005). In an efficient stock market, a firm's shares can be unrestrictedly traded among investors. This reasonable system ensures fair valuation for share prices. For example, if a firm does not perform well, investors will sell its shares. Consequently, share prices will drop. In this case, share price accurately reflects the firm's poor performance. When prices continuously drops to a near bankruptcy level, an opportunity for a takeover will occur. The firm's only solution to stop its share price from dropping and avoid takeover is to exert to improve its performance by intelligent business strategies, such as operational cost reduction, new business campaigns, and products redesigns, etc. The pressure of possible takeover drives and motives firms to continuously increase or at least maintain a certain level of efficiency. The ensured efficiency does not only protect shareholders, but also contributes to the improvement and stability of the general economy's condition.

However, the case of the Chinese stock market is completely different. A scholar claims, "even though there are shareholders in state-owed firms, 70% of the shares cannot be traded. Consequently hostile takeovers cannot take place, and the managers of state-owed enterprises cannot be "fired" by the market" (Fang, 2005). As analysed in Section 3.2, share price's inability to reflect changes on both the market and the firm makes the public confuse about the firm's real financial situation. Moreover, shareholders' lack of management and control in a corporation results in their helpless plights: they cannot do anything about the falling down share prices, and they can only witness their investments keep losing value. On the other hand, listed companies do not have any stress about hostile takeover because of government's ownership in the form of holding a great amount of non-tradable mainly state shares. In other words, there is no point for listed companies to be annoyed about the fearful outcome of poor performance and other organizational problems: listed companies understand that they possess the most powerful support from the government, which can bear and absorb considerable loss by its authority and overwhelming power. As a result, most listed companies do not have enthusiasm and motivation for the firm's continuous development. Consequently, the overall economic development is discounted.

3.6 Prohibition of Short Selling

China's Securities Act plainly states that short selling is strictly prohibited in the Chinese stock market. This prohibition of short selling is one of the great differences between the Chinese stock market and mature capital markets. "Short selling is the act of borrowing a stock and selling it in anticipation of being able to repurchase it at a lower price, at or before the time it must be returned to the lender" (Gabelli, 2001). In terms of the traditional investment strategy, investors "bought securities, held on them until the price of the securities went up, and then sold them for a profit". This strategy is often referred to as "buy and hold" strategy" or "going long" (Gabelli, 2001). The fundamental problem with this traditional investment strategy is its vulnerability to the unpredictable declines of the stock market. In order to make profit even in a down market, Alfred Winslow Jones, a truly remarkable individual, developed a financial strategy - short selling defined above (Gabelli, 2001). By combining two separate techniques, short selling and leverage (investing with borrowed money in order to generate a higher rate of return with small amount of own capital invested), and maintaining long positions as well, Jones was able to "hedge" his bets against market downturns, while still making profits from raising ones. In short, he could be profitable no matter what the markets were doing (Gabelli, 2001). Based on the nature of short selling, it is reasonable to conclude that short selling does not only enrich investment strategies, it also enhances investment returns and builds up investors' confidence.

However, the Chinese stock market is called "Single Side Market" by some professionals because spot transaction is the only trading technique allowed within this market. Financial scholars assert that this "Single Side Market" can result in investors' overwhelming speculations on the market as well as investors' short-term investing horizon. In a capital market that prohibits short selling, a downward market implies no investment opportunity. So investors are pouring into the market with a small signal of upward trends. The subsequent outcome of investors' "group action" will be a large fluctuation in the market. On the other hand, once a recession and a bear market comes, most investors will be hitched to their investments and lose significantly. Generally speaking, lack of short selling makes investors stand pat in a bear market or in a market downturn: they can only be audience and wait the market to recover. As a result, investors will gradually lose passion for the stock market. On the top of that, the vice president of National People's Congress points that because of the single trading mechanism in the Chinese stock market, both individual stocks and indices seem to maintain upward trends in the long run (Cheng, 2003).

3.7 Inside Trading and Asymmetric Information in the Chinese Stock Market

Asymmetric information and inside trading are also problems in the Chinese stock market. In an efficient stock market, stock price level is a valuable source of information for investors and managers of the firm (Grinblatt & Titman, 2001). However, in the Chinese stock market, government's ownership in listed companies leads to a fact that "the well-being of these state owned corporations depends on government policies" (Shih, 2005). In other words, the Chinese stock market "has not yet been used as an instrument to value companies efficiently" (Carl E. & Fraser J. T., 2001), it however does mainly appropriately reflect changes on government policies or reflect intentions of insiders who have control over government policies. With respect to this problem, Scholar Chen states that government policies and authoritative information play significant roles in the Chinese stock market, and these two factors are the ground for abnormal price movement in this capital market. He also gives examples to support his point: during the period between 1991 and 2001, the twenty-five trading days with highest and lowest prices in Shanghai Stock Exchange Index (SSE Index) all followed releases of relevant policies and information. Consistently, another professor emphasizes that every peak and trough in the Chinese stock market is evidently traceable to government policies and relevant information (Jia, 2003). Due to the noteworthy function of intangible official control over the Chinese stock market, the Chinese stock market is visualized as a "policy market" in the academic field (Cheng, 2003).

The impact of "policy market" is that the majority of investors, especially investors with medium and small investment, heavily rely on trends of official policies and information. They also firmly believe that in case of a down market and economy recession, government will exert to support and rescue the market. This point is completely consistent with the statement of Mr. Carl E. Walter who regards the Chinese stock market only as a reflection of government's position and inclination, instead of the real economic condition and list companies' financial statuses (Carl E. & Fraser J. T., 2001). In terms of "policy market", Professor Robert Chiller from Yale University deems that peaks and troughs in the Chinese stock market cannot be regarded as real market movements in mature capital markets, because these movements caused by relevant policies are extremely trivial comparing with those in Western capital markets. These relatively light movements are results of government control and protection. Therefore, Professor Chiller defines movement in the Chinese stock market only as a random walk with small fluctuations (Jia, 2003).

Furthermore, due to the significant political impact, people who have advanced knowledge of government policies and who have great control over such policies have great opportunities to take advantage of their domination over information

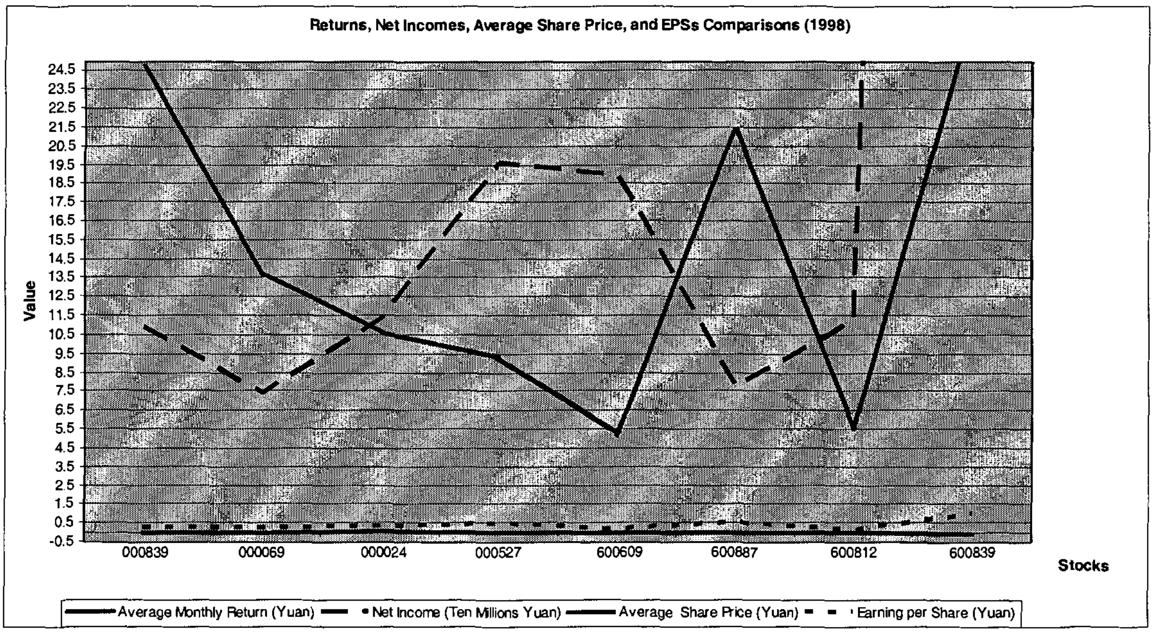
Moreover, the problem of asymmetric information can also cause excessive speculations in the stock market. The criteria to judge whether the speculation is excessive is to evaluate whether the capital market deviates from the trade-off between risk-return (John C., 2005). In order to test this trade-off in the Chinese stock market, eight stocks from different industries listed in both Shanghai and Shenzhen Stock Exchanges (four from each Exchange) are picked up. Their average monthly returns and average share prices are calculated here. Then, their returns, net incomes, average share prices, and earnings per share are compared. Table 3.1 – 3.9 disclose the results.

Table 3.1 Returns, Net Incomes, Average Share Price, and EPSs Comparisons of the Eight Stocks for the Year of 1998

Stock Code	Average Monthly Return (Yuan)	Net Income (Ten Millions Yuan)	Average Share Price (Yuan)	Earning per Share (Yuan)
000839	-0.040	10.92	24.64	0.27
000069	-0.026	7.38	13.72	0.213
000024	0.013	11.38	10.54	0.316
000527	-0.021	19.57	9.25	0.455
600609	-0.001	18.90	5.18	0.1944
600887	-0.017	7.72	21.27	0.53
600812	-0.051	11.23	5.56	0.11
600839	-0.076	200.40	27.31	1.01

Data Source: stock.sohu.com

Figure 3.1 Returns, Net Incomes, Average Share Price, and EPSs Comparisons (1998)



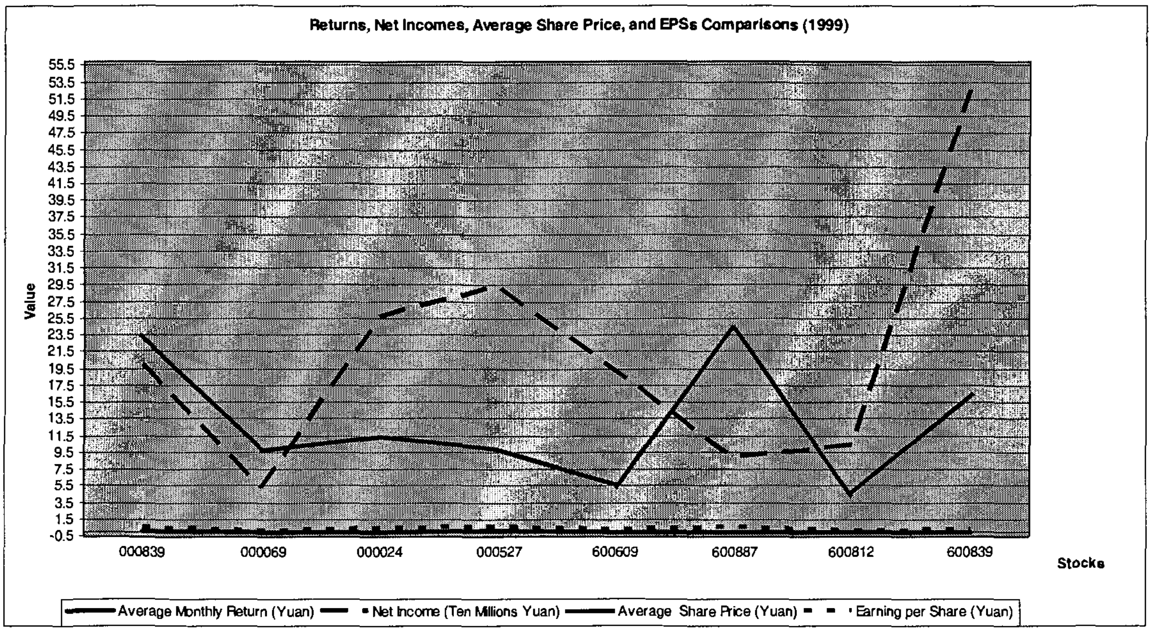
Data Source: stock.sohu.com

Table 3.2 Returns, Net Incomes, Average Share Price, and EPSs Comparisons of the Eight Stocks for the Year of 1999

Stock Code	Average Monthly Return (Yuan)	Net Income (Ten Millions Yuan)	Average Share Price (Yuan)	Earning per Share (Yuan)
000839	0.071	20.02	23.57	0.5004
000069	0.010	5.33	9.69	0.154
000024	0.010	25.60	11.25	0.403
000527	0.039	29.40	9.84	0.61
600609	0.004	19.26	5.51	0.1982
600887	0.015	8.93	24.27	0.61
600812	0.007	10.37	4.486	0.09
600839	-0.014	52.53	16.61	0.243

Data Source: stock.sohu.com

Figure 3.2 Returns, Net Incomes, Average Share Price, and EPSs Comparisons (1999)



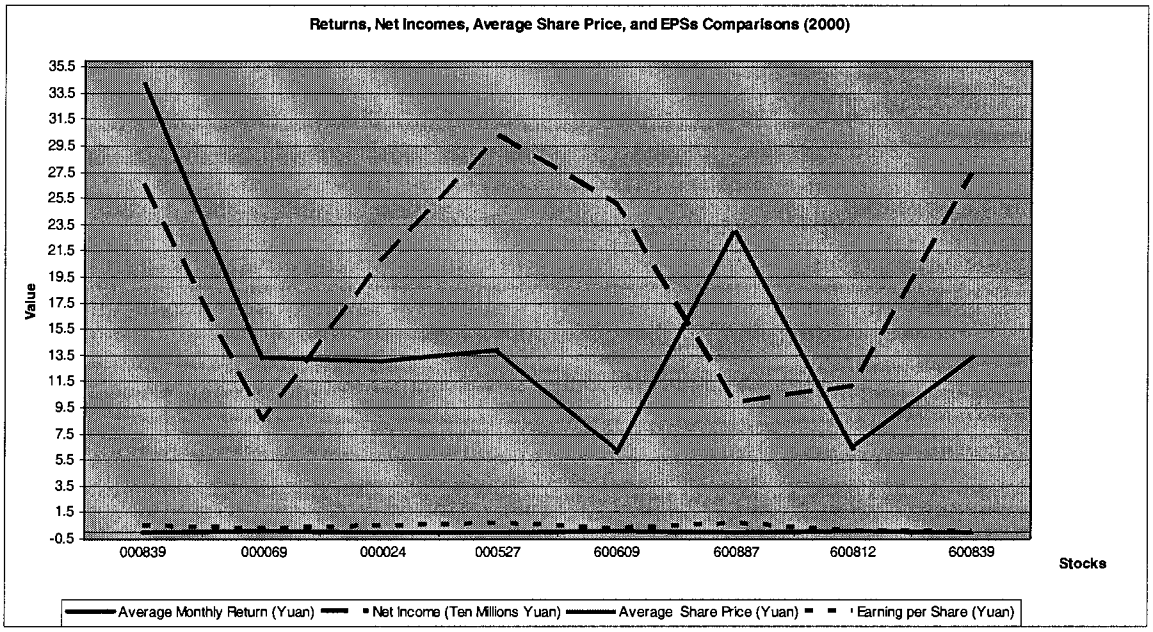
Data Source: stock.sohu.com

Table 3.3 Returns, Net Incomes, Average Share Price, and EPSs Comparisons of the Eight Stocks for the Year of 2000

Stock Code	Average Monthly Return (Yuan)	Net Income (Ten Millions Yuan)	Average Share Price (Yuan)	Earning per Share (Yuan)
000839	-0.035	26.58	34.10	0.4505
000069	0.038	8.57	13.26	0.23
000024	0.027	20.89	13.03	0.439
000527	0.005	30.32	13.86	0.63
600609	0.035	24.99	6.14	0.2287
600887	0.012	9.85	22.75	0.67
600812	0.041	11.12	6.43	0.1
600839	-0.016	27.42	13.49	0.127

Data Source: stock.sohu.com

Figure 3.3 Returns, Net Incomes, Average Share Price, and EPSs Comparisons (2000)



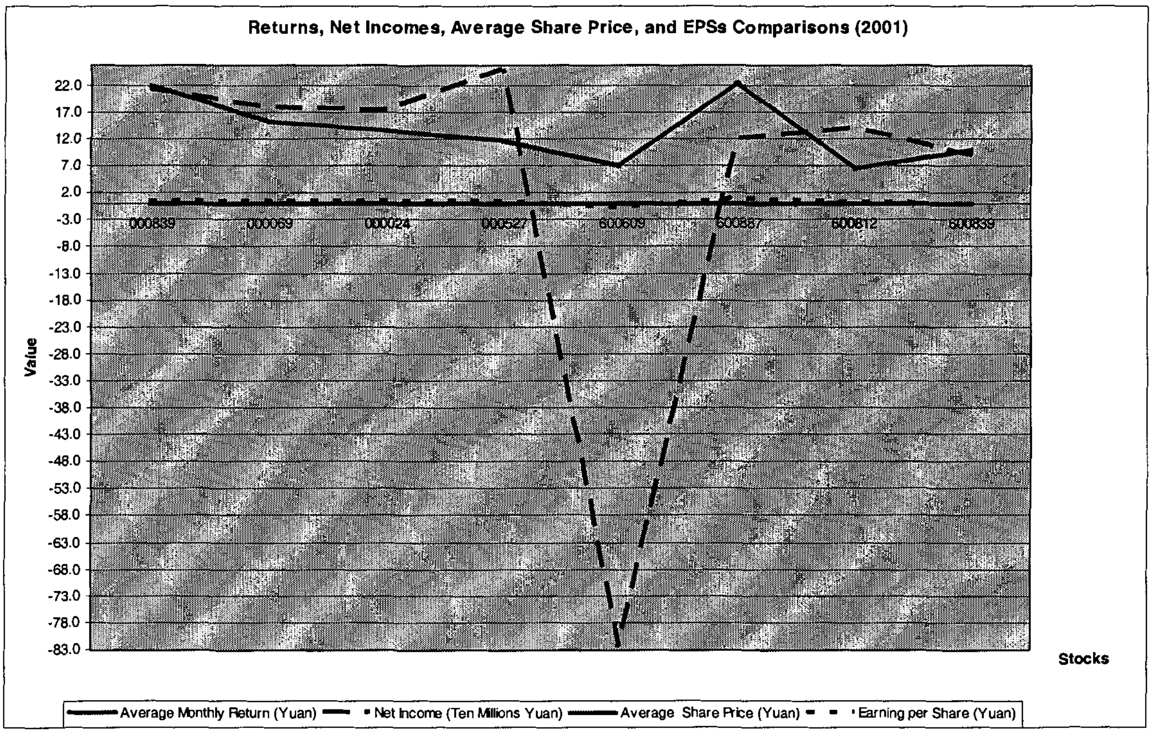
Data Source: stock.sohu.com

Table 3.4 Returns, Net Incomes, Average Share Price, and EPSs Comparisons of the Eight Stocks for the Year of 2001

Stock Code	Average Monthly Return (Yuan)	Net Income (Ten Millions Yuan)	Average Share Price (Yuan)	Earning per Share (Yuan)
000839	-0.040	21.28	21.92	0.36
000069	-0.020	18.00	15.00	0.403
000024	-0.020	17.50	13.44	0.367
000527	-0.025	25.11	11.50	0.52
600609	-0.023	-82.50	6.78	-0.7551
600887	-0.023	11.97	22.67	0.82
600812	-0.026	13.98	6.24	0.12
600839	-0.039	8.85	9.95	0.041

Data Source: stock.sohu.com, jrj.com

Figure 3.4 Returns, Net Incomes, Average Share Price, and EPSs Comparisons (2001)



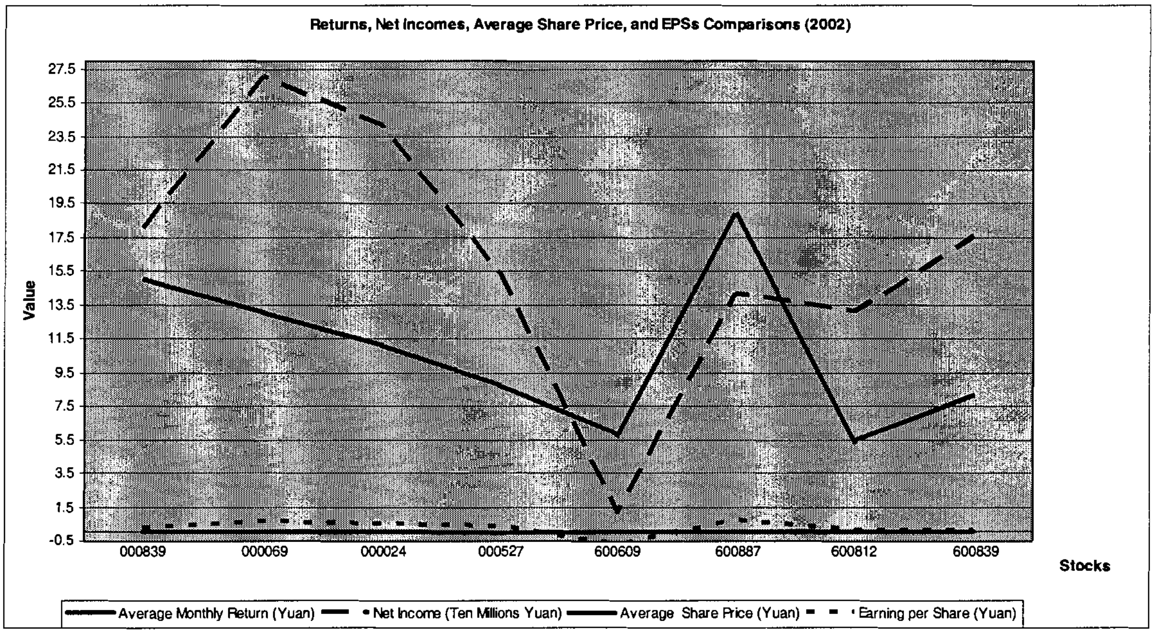
Data Source: stock.sohu.com, jrj.com

Table 3.5 Returns, Net Incomes, Average Share Price, and EPSs Comparisons of the Eight Stocks for the Year of 2002

Stock Code	Average Monthly Return (Yuan)	Net Income (Ten Millions Yuan)	Average Share Price (Yuan)	Earning per Share (Yuan)
000839	-0.002	18.07	14.97	0.27
000069	0.010	27.02	13.05	0.604
000024	-0.001	24.18	11.04	0.508
000527	-0.023	15.46	8.72	0.32
600609	0.007	1.09	5.76	-0.7551
600887	-0.004	14.19	18.81	0.73
600812	0.008	13.09	5.36	0.11
600839	0.005	17.60	8.14	0.08

Data Source: stock.sohu.com, jrj.com

Figure 3.5 Returns, Net Incomes, Average Share Price, and EPSs Comparisons (2002)



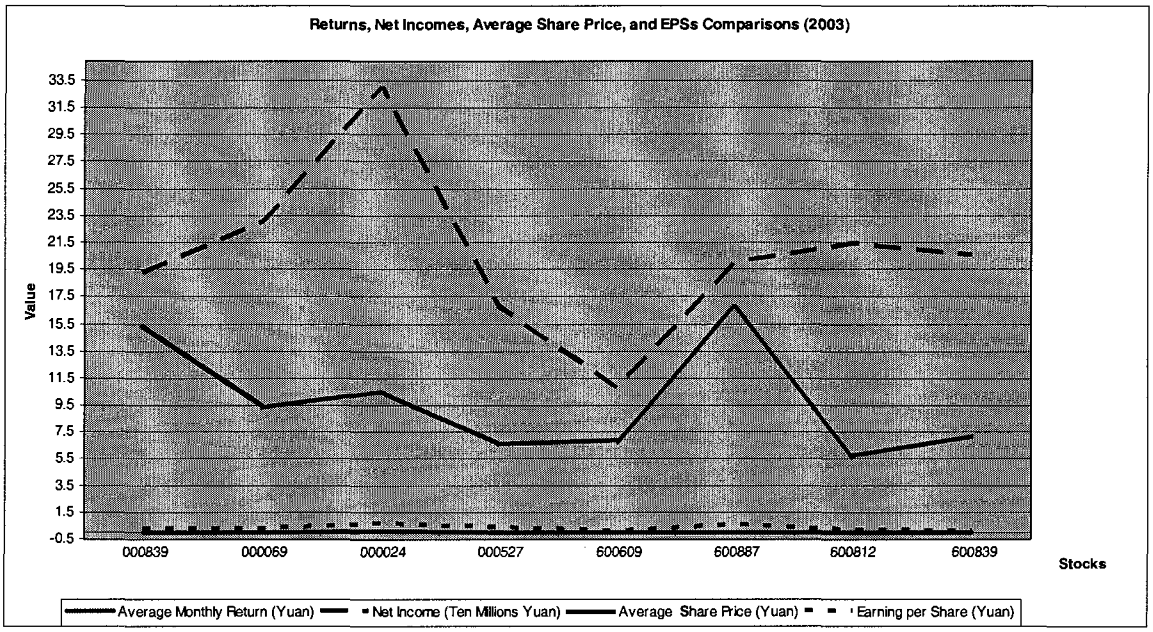
Data Source: stock.sohu.com, jrj.com

Table 3.6 Returns, Net Incomes, Average Share Price, and EPSs Comparisons of the Eight Stocks for the Year of 2003

Stock Code	Average Monthly Return (Yuan)	Net Income (Ten Millions Yuan)	Average Share Price (Yuan)	Earning per Share (Yuan)
000839	-0.003	19.23	15.33	0.29
000069	-0.060	22.97	9.35	0.22
000024	0.022	33.05	10.43	0.641
000527	-0.011	16.79	6.57	0.35
600609	0.008	10.81	6.85	0.0989
600887	-0.038	19.96	16.73	0.51
600812	0.0001	21.37	5.70	0.18
600839	-0.004	20.57	7.15	0.095

Data Source: stock.sohu.com, jrj.com

Figure 3.6 Returns, Net Incomes, Average Share Price, and EPSs Comparisons (2003)



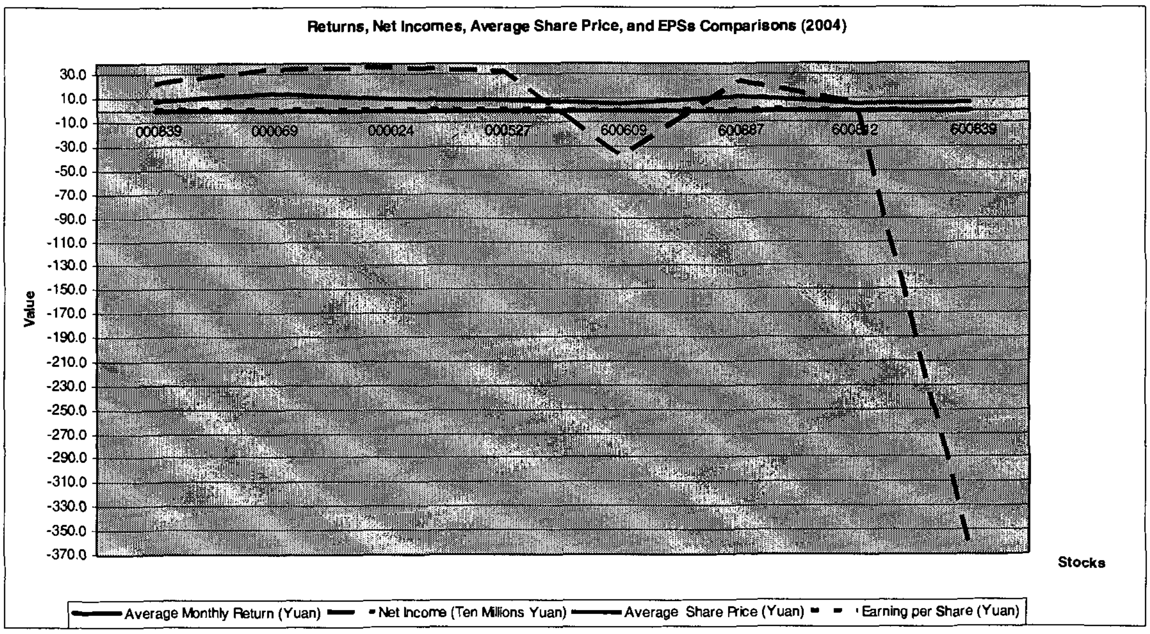
Data Source: stock.sohu.com, jrj.com

Table 3.7 Returns, Net Incomes, Average Share Price, and EPSs Comparisons of the Eight Stocks for the Year of 2004

Stock Code	Average Monthly Return (Yuan)	Net Income (Ten Millions Yuan)	Average Share Price (Yuan)	Earning per Share (Yuan)
000839	-0.020	21.60	6.75	0.33
000069	0.010	33.61	13.26	0.312
000024	-0.036	35.98	9.70	0.581
000527	0.011	32.66	7.86	0.67
600609	-0.074	-38.54	4.57	-0.353
600887	-0.014	23.91	11.46	0.61
600812	-0.039	5.91	5.18	0.08
600839	-0.058	-368.11	6.56	-1.701

Data Source: stock.sohu.com, jrj.com

Figure 3.7 Returns, Net Incomes, Average Share Price, and EPSs Comparisons (2004)



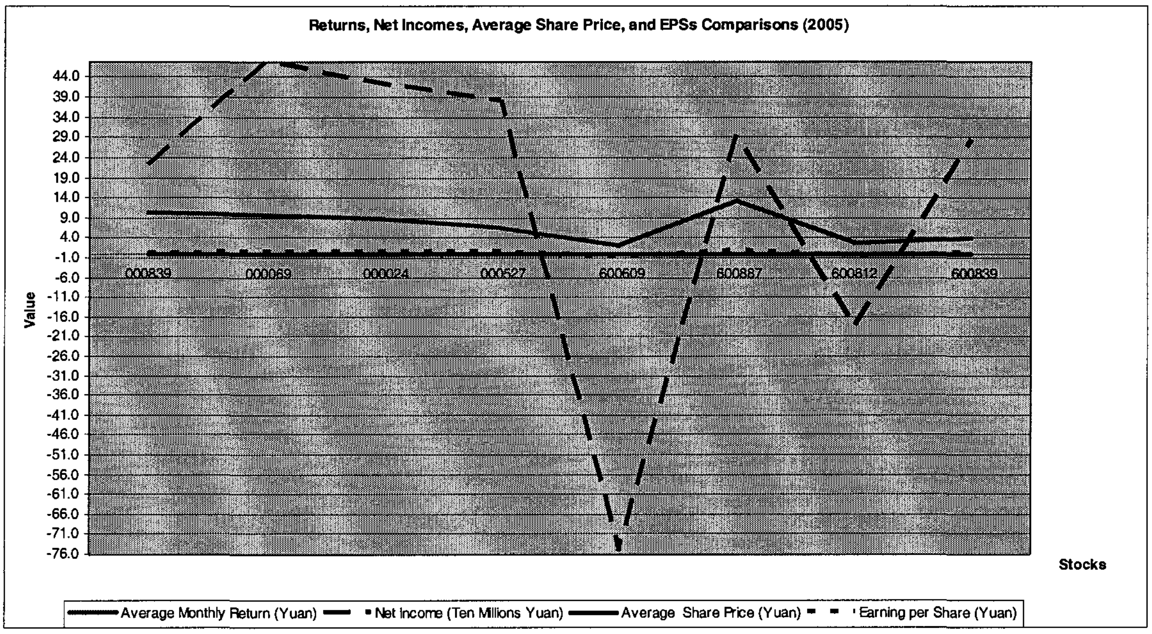
Data Source: stock.sohu.com, jrj.com

Table 3.8 Returns, Net Incomes, Average Share Price, and EPSs Comparisons of the Eight Stocks for the Year of 2005

Stock Code	Average Monthly Return (Yuan)	Net Income (Ten Millions Yuan)	Average Share Price (Yuan)	Earning per Share (Yuan)
000839	0.010	22.46	10.06	0.34
000069	0.020	48.00	9.54	0.432
000024	0.033	42.16	8.53	0.681
000527	-0.018	38.18	6.38	0.61
600609	-0.044	-75.25	1.89	-0.69
600887	0.041	29.34	13.22	0.75
600812	-0.038	-18.77	2.65	-0.25
600839	0.011	28.50	3.80	0.13

Data Source: stock.sohu.com, finance.sina.com.cn, jrj.com

Figure 3.8 Returns, Net Incomes, Average Share Price, and EPSs Comparisons (2005)



Data Source: stock.sohu.com, finance.sina.com.cn, jrj.com

Table 3.9 Returns, Net Incomes, Average Share Price, and EPSs Comparisons of the Eight Stocks for the Year of 2006

Stock Code	Average Monthly Return (up to Aug 3, 2006) (Yuan)	Net Income	Average Share Price (up to Aug 3, 2006) (Yuan)	Earning per Share
000839	0.040	N/A	13.8425	N/A
000069	0.010	N/A	12.06	N/A
000024	-0.018	N/A	11.73	N/A
000527	0.048	N/A	7.66	N/A
600609	0.072	N/A	1.843	N/A
600887	0.027	N/A	19.30	N/A
600812	0.061	N/A	2.68	N/A
600839	-0.038	N/A	3.69	N/A

Data Source: stock.sohu.com

The above tables clearly show that stocks of listed companies that generate the highest net income do not have the highest return or highest average share prices, but they actually have relatively lower returns than others. This phenomenon is more obvious in the period 1998 – 2003. In 1998, stock (600839) had the lowest average monthly return, but its company had the highest net income and highest average share price among the eight stocks. In 2001, stock (000839) had the smallest average monthly return, but the company had the second highest net income and average share price among the eight stocks. In general, stocks with the lowest returns are those of listed companies having outstanding earnings and operations. Obviously, the Chinese stock market, high net income (implies less risk) does not necessarily come with high stock return (implies high return). So, the trade-off between risk and return is significantly violated in the Chinese stock market, even though this abnormality has been improved since 2004. Due to this violation, it is not surprising to conclude that speculation is excessive in the Chinese stock market. On the top of that, financial professors also confirm that arbitrage opportunities resulting from asymmetric information greatly contribute to the violation of risk-return trade-off (Cheng, 2003).

In addition to the extreme speculation, rapid expansion of stock market bubbles is also a product of the problem of asymmetric information. General speaking, stock market bubbles lead to dramatically high share prices, which will in turn make listed stocks significantly overvalued.

This is why most people agree to the statement that stock market bubbles can cause an exaggerated bull market. "Although they may exist for an undetermined length of time, financial bubbles (stock bubbles here) by their very definition are predestined to burst" (Lee & Jr., 2003). The time that bubbles burst is also the start point for a stock market crash. It is easy to understand that with the intention of creating a robust market, Chinese government's extensive support and blind manipulation are primary sources of stock market bubbles and causes for bear markets. A scholar verifies this point by saying that "the bubble bursts because the stock market had been driven to unsustainable levels by forces unrelated to economic fundamentals and the pace of equity retirements could not be maintained" (Lee & Jr., 2003).

According to key statistics, the Chinese stock market currently has excessive bubbles comparing with mature markets. In 1991 and 2000, Shanghai and Shenzhen composite indexes have annual cumulative bubbles 63.4% and 58%, respectively. However, Dow Jones Industrial only had 19.5% annual cumulative bubbles for the same time period (Cheng, 2003). This set of statistics facilitates further demonstration of great distance between the Chinese stock market and mature capital markets.

3.8 Drawbacks of Internal Audit System

According to its definition, "auditing refers to the tracking of activity by users" (Mitton & Beadles, 2000), it is also "the act of verifying the correctness of a procedure" (Bernard, Jari and David, 2000). The function of a auditing system in a listed company includes, but not limited to, to ensure the organization operates following standard rules; to focus on accounting standards and reporting rules of financial transactions and make sure GAAP is not violated; to review the firm's adherence to laws, regulations, and relevant policies; to seek to establish evidence of impropriety; and to add value and improve an organization's governance, risk management, and control processes, etc. ("Statement of Purpose, Types of Audits, and Standards", 2005). Simply put, auditing plays a significant role as a monitor to oversee and watch out the company's overall performance and ensures that it does not violate regulations.

In China, CSRC does require listed companies to establish efficient auditing systems, but most listed companies do not enable the auditing system actually perform its expected functions and accomplish its ordinary objectives. However, auditing system's incompetence is an inevitable outcome of regulators' negligence. This problem can be illustrated by a comparison of regulations on auditing system between New York Stock Exchange (NYSE, a typical mature stock exchange in the world) and the Chinese stock market (A more completed comparison between this two stock markets is summarized in Appendix A). In NYSE, a listed company must establish an auditing committee, and qualifications of members in the auditing committee must comply with the Security Act (1934). In addition to Security Act (1934), capital market regulations set up for listed companies in NYSE are also fundamental guidelines for an efficient auditing system. The independence of auditing committee members is the most crucial point emphasized in standing rules: all members in the auditing committee must be independent with the company. When determining the independence, companies have to examine whether the person has substantial relationship with the company, such relationship includes direct or indirect business connection with the company, being shareholder or officer of the company, etc. On the top of that, if the person was the company's employee in past three years or obtained more than $100,000 annual reward from the company in past three years, he is not be considered as an independent person of the company (China Petroleum & Chemical Corporation, 2005). These independence criteria are reasonable, because they are helpful in avoiding the conflict of interests between auditors and employees or management and in ensuring the auditing committee's neutral position. Moreover, rules in NYSE specify that the auditing committee has to coordinate the Board of Directors to ensure integrity of the company's financial statements and annual reports, efficiency of the internal audit department, compliance of the company with relevant laws and regulations, and high-quality performance of independent auditors, etc. Besides, in order to evaluate and further improve the auditing committee's efficiency, an annual evaluation is implemented on its performance. Moreover, U.S. Securities Regulatory Commission also command that an annual report about auditing committee's actual achievements must be included in the company's annual report (China Petroleum & Chemical Corporation, 2005).

On the other hand, standing rules regarding to the Chinese stock market do not specify any requirement for auditing committees. For example, policy makers do not mention necessity of auditing committee members' independence. Most importantly, regulators in the Chinese stock market do not call for an evaluation and annual report concerning auditing committee's performance (China Petroleum & Chemical Corporation, 2005). Lack of specific guidelines for auditing systems is another reflection of Chinese capital market's immaturity, because it seems that the Chinese stock market just blindly follows the trend of establishing an auditing committee within an organization, but it does not actually realize the important function of the committee. More severely, some listed companies even make use of the auditing system to hide valuable information or juggle data in order to evade regulations and public attentions. Accordingly, people may question that how an immature capital market which lacks efficient auditing systems can ensure that accounting rules are not disobeyed, inside trading does not occur, and businesses are running functionally and properly.

3.9 Lack of Ethics Code in Listed Companies

Ethics codes need to be established for the purpose of educating and remaindering people basic moral standards. In an undeveloped capital market, such guidelines are especially crucial because players in the market may not fully understand the "rules of the game", which includes operation process as well as moral norms. In spite of its importance, ethics code in listed companies is a disregarded area in Chinese business. Again, a comparison between a mature capital market like U.S. stock market and the Chinese stock market greatly reflects this problem. In NYSE, listed companies must disclose principles of right conducts and moral values for boards of directors, management and employees. And, the ethical code is updated frequently according to any change in the current market situation. On the top of that, CEOs in listed companies must annually report to the NYSE that their companies have no violation to the relevant ethics code (China Petroleum & Chemical Corporation, 2005).

By contrast, local listed companies in the Chinese stock market have no similar ethical code even though broad of directors and management understand that their moral responsibility for the company. Moreover, CEOs are not asked to report to upper-level administrators about any immoral or unethical event (China Petroleum & Chemical Corporation, 2005).

Without such ethics codes and regulatory requirements, it is extremely hard to prevent the overall market from being interfered by people's intentional or unintentional immoral behaviours. A realistic example helps illustrate the importance of ethics code. If an auditor believes that a failure to disclose the company's significant investment loss is acceptable and forgivable because the loss is a completely contingent incident and it will not take place again for sure. Therefore, in stead of feeling guilty and immorally, people in charge of the disclosure process may strongly deem that their doings actually reinforce the company's financial imagine and help strengthen investors' confidence in the company. In spite of their explanation, their conducts completely breach professional ethics and harmfully mess up the environment of the capital market. If there is no any discipline to direct people's professional behaviour and no specific punishment for such dishonest behaviours, those anti-profession performances will be gradually acquiesced. In this case, not only the pertinent industry is harmed, but the country's entire economic system including its capital market is also hurt. Therefore, in addition to set up professional codes, establishing ethics codes for players in the capital market is a key to avoid the capital market from being damaged by immoral behaviours. Like a steering wheel for a driver, ethics code is playing the same role for the capital market to ensure that everyone is actually pursuing the standards and contributing to the continuous development of the market.

4 RECENT REFORMATIONS AND NEW REGULATIONS IN THE CHINESE STOCK MARKET

The Chinese stock market's relatively poor performance and unhealthy operations model are gradually becoming obstacles to China's continuous economic growth. In a disordered capital market, a strong regulation system is decisive to drive the market back to the right track. For example, when 1929 stock market collapse occurred in United States, the regulatory response implemented in the 1930s, culminating in the Securities Act (1934), was to prohibit all activities aimed at manipulating market prices and trading on insider information (Poitras, 2002). This timely response from regulation system efficiently prevented the stock market from suffering more and helped the market recover sooner.

Today, all negative phenomenon in the Chinese stock market reminder regulatory body the necessity of schematize and standardize the stock market. Policy makers have taken a number of actions to formally regulate the market. As researcher Rong states, "(I)n 2001, China Securities Regulatory Commission introduced 51 new regulations and rules, disciplined more than 81 listed companies and 10 intermediaries, including law firms and accounting firms" (Rong, 2006).

In the article "Stock Market Needs Regulation Overhaul", the author stresses that "in a market economy, corporate profits are linked to the interests of shareholders, and stock prices are positively related to companies' economic performance and the national economic condition. However, in the Chinese stock market, stock prices are virtually divorced from the performance of listed companies (Bei, 2004). This point is completely consistent with problems analysed in previous sections. To deal with these problems, restructuring the market seems to be the first constructive solution.

4.1 New IPO Process

The new IPO process is the most remarkable one among all actions currently taken by regulators. For this modified and improved process, stricter criteria for issuing IPO are established (Liu, 2005). In previous IPO process, IPO prices were determined by listed companies and security companies approved by China Securities Regulatory Commission under the State Council (Luo, 2005). In most cases, in order to gather a great amount of funds by issuing IPO, listed companies and underwriters used to set IPO prices much higher than shares' intrinsic values. The subsequent result was either that investors were misled to invest in a valueless stock, or that new shares were rejected by investors because of their unreasonable prices. The former case would cause investors to lose significantly, and latter one might drive the share price below the IPO price or even drive the listed company out of the stock market, resulting in bankruptcy.

The new approach of issuing IPO is all about negotiated offerings, where IPO prices must be based on an overall price evaluation from certain security and investment companies, mutual fund companies, trust companies, financial services companies, and insurance companies, as well as qualified foreign investment companies. On the top of that, specific qualifications of those price evaluation organizations are also specified in details (Wang, 2006). For instance, these organizations must get formal operation permissions from relevant regulatory bodies; these organizations also must be approved to have no violation records of any significant securities rule; they also have to have outstanding credits and complete systems of internal assessment and internal control, etc. (Wang, 2006). By saying this, the final price of IPO will be reasonable enough to reflect assessment from different angles.

Obviously, the new IPO price process greatly decreases listed companies decision power on IPO prices, reduces the possibility of list companies' deceiving behaviours, and mitigates investors' risk of loss on purchasing IPOs.

Likewise, a report about 2005 Chinese capital market, created by Finance and Security Department of Renmin University of China, reveals that "the new negotiated offering could enlarge the supply of funds in the stock market, in the mean time, insurance, financing, trust companies would more actively participate in IPO pricing (Luo, 2005). The author of the report also argues that this new negotiated offerings policy is coming into effect in a special period that the internal environment of the Chinese stock market has not been completely cleaned up, the conflict of interests caused by ownerships of state-owned firms has not been resolved, and the efficiency of rules and regulations of the stock market has not been improved. Therefore, the question of whether the market can successfully absorb and adapt this completely fresh system of IPO is still suspicious (Luo, 2005).

Also, Mr. Li, a senior professor in Finance and Security Department of Renmin University of China, admits, "the new negotiated offering is the first step and the most significant part of reforming the Chinese capital market" (Luo, 2005). However, he also warns "when considering the complexity of a capital market, the relevant regulatory body should pay more attention to negative impacts of the new system, and frequently correct and modify the current model of the stock market" (Luo, 2005). His points are rational and persuasive. As stated in previous sections, the Chinese stock market lags far behind mature capital markets. Even though the major difference does appear in the capital market, the reason for these differences and does not only root in the stock market itself, but also comes from other aspects of the nation, like the overall economic structure, the political system, etc. For this reason, regulators and policy makers cannot be over-ambitious to reform the market. But, they have to think about other economic factors, culture traits, and even political issues before making any change to the current market.

4.2 Large-Scale Reformation of State Shares

Reformation of state shares is the hottest topic in today's Chinese stock market. For convenience, people abbreviate "Reformation of State Shares" to "Stock Reformation". The purpose of "Stock Reformation" is to assign tradability to non-tradable shares by requiring their shareholders to pay certain prices (Qing, 2006). The starting point of "Stock Reformation" is the recognized harmful impact of non-tradable shares on the overall capital market. Previous examination of the Chinese stock market proves that non-tradable shares is a product of China's special economic system, listed companies' unique ownerships, Chinese capital market structure, and China's political schemes. The phrase that "same stock, but distinct tradable rights" is often used to describe the difference between tradable and non-tradable shares of one single listed company (Southcn, 2006). A scholar sums up the impact of non-tradable shares by stating that the existence of non-tradable shares does not only contradict internationally acceptable routine, but also interferes with Chinese stock market's development. On the top of that, it cannot well reflect the fairness in the capital market (Southcn, 2006).

After recognizing potential dangers of non-tradable shares, the Chinese government established and has already started exercising the plan of "Stock Reformation". The core of this plan is the "exchange price", which is paid by shareholders of non-tradable shares to shareholders holding tradable shares in order to receive the trading right (Xu, 2005). In terms of payment, it can be in forms of shares with certain value set by negotiation between the two parties (shareholders of non-tradable shares and shareholders of tradable shares), cash, or others acceptable by both parties.

An appealing point in this reformation plan is the balancing power and right between the two parties involved: shareholders of non-tradable shares and shareholders of tradable shares, because the exchange price is finally set by bargaining between both sides. In this situation, the communication between the two is particularly important. Therefore, to facilitate in efficient interaction between the two parties, most companies organize forums for investors' relations, meetings with medium and investors, and interviews with investors. Other companies also set up hot-lines, faxes, and emails which are convenient for investors to communicate with them (Xu, 2005). So, there are various methods for investors to participate in the actual work of "Stock Reformation". Journalist Xu gives a real story about an investor's participation in this reformation. Mr. Li, who originally had 1,000 tradable shares of SANY HEAVY INDUSTRY CO., LTD. (code 600031), has started research about the current market situation since the announcement of reformation. He also made calls to the company to express his personal opinions about the "Stock Reformation" taken in the company and his ideal exchange price for non-tradable shares. Mr. Li expresses that the company treats his viewpoints seriously and carefully. And, his suggestion about the exchange price results that the company decides to rise up the exchange price from paying 3 shares for every 10 shares to paying 3.5 shares. This 0.5 shares more benefit is coming from company's respect to investors, and from shareholders' actual involvements (Xu, 2005). Obviously, list companies and the government have recognized the necessity and value of respecting investors, especially shareholders of tradable shares, and they have started considering shareholders' positions and points of views. The fact that shareholders of tradable shares obtain more consideration is an excellent starting point to fundamentally alter Chinese stock market's structure and diminish and eventually eliminate the discrimination against shareholders holding tradable shares (as analyzed in Section 3.2).

Generally speaking, "Stock Reformation" primarily aims at creating identical benefits among investors regardless of types of shares they are holding. By fulfilling this goal, the right of investors especially individual investors is greatly protected and strengthened. When summarizing the up-to-date accomplishment achieved by implementing the "Stock Reformation" plan, a representative of CSRC says that "the 'Stock Reformation' plan is an outstanding strategy that has dramatically changed the Chinese stock market in five major areas: 1. It clarifies characteristics of non-tradable and tradable shares which characteristics were originally problematic and confusing; 2. Improves quality of listed companies; 3. Strengthens comprehensive regulations towards securities companies; 4. Expands the number of organization investors; 5. Standardizes capital market regulation" (Xinhuanet, 2006).

Regulators in the Chinese stock market also take actions to ensure that shareholders of non-tradable shares actually fulfil their agreement and make agreeable payment (regardless the form of payment) to shareholders of tradable shares. The actual fulfilment is the deterministic factor for the success of the "Stock Reformation", because it is the core of this reformation plan. CSRC sets up specific clauses regarding to the contract fulfilment by shareholders of non-tradable shares. For instance, CSRC requires these shareholders to prepare written statement about their willingness to honestly implement their promises. Also, these shareholders cannot transfer their shares before completely fulfilling their promises unless transferees agree and are capable of fulfilling the original promises (Wang, 2005).

Additionally, in order to reinforce the success of "Stock Reformation" plan, CSRC establishes more rigorous criteria for companies willing to reform non-tradable shares. It prohibits listed companies from reforming non-tradable shares under certain circumstances, including the case that listed companies are suspected of breaching relevant stock market regulations and rules, engaging in illegal market manipulation, and the case that relevant personnel in the company make use of information about "Stock Reformation" to do inside trading, etc. These potentially problematic companies have to demonstrate that the suspicion on them is waived and that they do not have any foreseeable risk associated with the "Stock Reformation" plan (Wang, 2005). Table 4.1 shows major provinces' numeric accomplishments on "Stock Reformation".

Table 4.1 Major Provinces' Current Accomplishments on "Stock Reformation"

Province	Accomplished Reformation Value (in 100 millions)	Target Reformation Value (in 100 millions)	Accomplishment Ratio (%)
Heilongjiang	153.11	469.84	32.59
Gansu	91.95	236.2	38.93
Beijing	3354.27	7958.61	42.15
Jililn	212.75	430.32	49.44
Xizang	33.79	65.17	51.85
Hunan	324.42	615.26	52.73
Fujian	402.92	692.46	58.19
Jiangsu	1043.14	1644.91	63.42
Chongqing	222.72	346.99	64.19
Shandong	1245.26	1886.78	66
Liaoning	737.29	1116.65	66.03
Hubei	642.35	962.12	66.76
Sichuan	855.01	1268.47	67.4
Hainan	188.7	269.22	70.09
Shanxi	215.84	296.84	72.71
Guangxi	251.96	336.47	74.88
Tianjin	507.19	671.91	75.49
Zhejiang	858.93	1134.06	75.74
Xinjiang	306.23	398.6	76.83
Jiangxi	395.53	497.59	79.49
Qinghai	166.41	203.11	81.93
Hebei	584.3	707.81	82.55
Shanghai	5173.29	5968.73	86.67
Yunnan	410.14	471.89	86.91
Guizhou	556.49	637.56	87.28
Ningxia	80.12	91.18	87.87
Guangdong	4361.72	4946.05	88.19
Henan	586.62	658.56	89.08
Anhui	718.5	772.07	93.06
Neimenggu	429.22	456.33	94.06
Shanxi	532.79	558.71	95.36

Data Source: http://news.xinhuanet.com/stock

4.3 Reduction Plan on State Shares

As discussed previously, among the three types of shares issued in the Chinese stock market, state shares are the basis for major management and operational problems in corporations due to its non-tradability characteristic. According to key statistics, on December 31, 2000, tradable shares accounted for 35.8% of total shares issued in Shanghai and Shenzhen Stock

Exchanges, but the percentage of non-tradable shares was up to 64.2%. And the major composition of non-tradable shares is state shares, so shareholders of state shares have absolute control in listed companies (Yi, 2001). Based on the significant impact of state shares, the Chinese government launches a scheme concerning with reducing the number of state shares in stated-owned organizations. Its intention is clear: to legally reduce the dominant position of shareholders holding of state shares by reducing the number of state shares, meanwhile to bring in other types of shares. The government's direction is rational: the resulting higher weight of other types of shares implies that more active control over listed companies will come from shareholders of non-state shares. In other words, individual shareholders' relatively poor power and control in listed companies (the issue discussed in Section 3.4) will be improved gradually by executing such a plan.

This plan does not only assist improving specific shareholders' control over listed companies, it also has significantly beneficial impact on the work of reorganizing state-owned corporations. When restructuring these organizations, the Chinese government recognizes the profound significance of such restructure: its success directly affects the whole plan of China's economy construction and it is also the key for reformation of the capital market and economic system. Therefore, pushing the restructure plan into a healthy and international direction is another purpose of the shares reduction plan (Yi, 2001). This benefit of this plan on restructuring state-owned corporations is not limited to facilitate in balancing shareholders' control within companies, it also provides substantial amount of funds necessary for the restructure because funds generated from reducing state shares will be used in restructuring and developing stated-owned organizations (Chinese Communist Party Central Committee, 1999).

Additionally, this shares reduction plan also has benefits for the construction of the Chinese capital market. Analyst Yi states that by absorbing and reducing state shares, functions of capital in the market will be adjusted, structure of resources will be normalized, uses of funds will be directed, and stock indexes and prices will be stabilized (Yi, 2001). Previous analysis shows that the existence of three different types of shares with different characteristics is fundamental cause for the stock market's abnormal phenomenon and listed companies' operation inefficiencies. Besides, it also has enormous influence on listed companies and investors' unethical behaviours. Shortly, it seriously discourages the capital market to mature towards an ongoing, normative, and healthy direction. However, evidence shows that deliberatively reducing the number of state shares helps eliminate the difference among the three types of stocks and actualise the goal of equal tradability of all shares. A representative of State Council of the People's Republic of China specifies five methods of reducing state shares:

1. Match sale of state shares: state shares are periodically sold to specific investors. The government practices this method with the hope that state shares will be gradually tradable in the market and that state-owned asset will increase in value.

2. Repurchase of state shares: listed companies repurchase their stated shares and subsequently revoke these shares. Repurchase will benefit investors through the increased share price.

3. Merge shares: listed companies merge state shares based on their initial prices, then pour new shares into the market for trade.

4. Auction: public investors can bid for state shares. Shares auction can bring ready cash to organizations. Although the deal price is finally determined by investors and the market, sellers could set up a minimum acceptable price. Therefore, listed companies will not incur substantial losses.

5. Transfer state shares into debt: the derivative debt can be repaid in instalments and also can be converted to bonds traded in the market (Xinhuanet, 2006).

This shares' reduction plan is currently exercising by the government, and it has performed well so far. In terms of the government influence, analyst Li provides an example to illustrate its importance. In 1998, Hong Kong Government decisively intervened Hong Kong stock market by investing a great amount of capital to absorb shares. The government's action effectively resisted the attack of foreign idle fund and stabilized the overall stock market and economy trend (Yi, 2001). The Chinese government uses this example for reference and exerts to alter its capital market's poor status by establishing such effective strategies as this shares reduction plan.

4.4 Amendment of Relevant Acts

In last October, revised editions of China's Securities Act and Company Law were approved by National People's Congress. President Hu Jintao signed an order to proclaim the two revisions (Zhuang, 2005). The amendment focus on the concern that how to reasonably construct a legal system for the security market, how to establish an innovative mechanism for financial products which take considerations of investors and the market, and how to figure out legal relationships among each party in the capital market (Zhou, 2005).

4.5 Other and Further Improvement Plans

Furthermore, a variety of proposals towards reforming the Chinese stock market are expected to come out in this year. Among various suggestions, plans regarding more transparent disclosure of listed companies' financial and trading performance are investors' most interests (Wu, 2004). Because of the problem of asymmetric information discussed above, investors are somehow like gamblers in the market. More seriously, a substantial number of policy makers and regulators absurdly support the point that stock market is actually a casino and investors are unearned speculators. Due to this belief, these groups of people think investors should bear all investment risks, even bear the systematic risk caused by government policies (Yang, 2002).

However, as discussed above, speculation and gamble should not exist in a properly running capital market and in an efficient market. Instead, investors should make their reasonable investment decisions based on all available information. Therefore, a researcher says that in its maturation process, China's stock market confronts the issue of enforcing the regulation of information disclosure (Ma, 2004). As stated by Xu, "financial reporting in China was poor and its accounting standards lagged behind international reporting standards. Even when the financial information was available, the lack of a standard statement system made it difficult to understand and compare. Besides, the Chinese managers lacked understanding of the desirability and importance of information disclose. As a result, reliable financial figures for listed companies were not always available to the general public" (Xu, 1998). According to this poor circumstance, regulators have to consider establishing completed disclosure rules for listed companies (Appendix J presents the Current Information Disclosure Requirement in Code of Corporate Governance for Listed Companies in China Issued by China Securities Regulatory Commission and State Economic and Trade Commission).

The reason beyond this urgent reformation is that a stock market should be a place where investors have vote of confidence according to publicly disclosed information of listed companies. So "a high standard of information reporting and disclosure allows investors to make informed judgments about the true value of securities they purchase" (Xu, 1998). Therefore, by having completed and sound accounting standards especially disclosure requirement, protections on shareholders as well as their confidence in the market will be dramatically increased.

5 CONCLUSION

A country's capital market is the most important enabler of its economic system: a mature and healthy stock market can effectively support its private economy, even offset certain weaknesses of the economic system; but an inadequate stock market could slow down economic development and restrict economy activities, or even deteriorate the economy. Therefore, constructing a supportive and well-developed stock market can be considered as an initial step for building up a country's economy. Moreover, a well-established capital market can also help prevent great economic fluctuations and ensure a positive correlation between stock market and the whole economy. However, in China, the development of stock market and economy is asymmetric. This point is verified by a scholar's statement, he says, "in China, stock indexes never were an economic barometer, because the stock market has never been a crucial component of national economy" (Hu, 2005). This disordered relationship leads to a high volatility in China's relatively unstable economy in spite of its high growth rate. In his book, *The Emerging Fixed-Income Markets in Asia*, Mr. Eric Banks affirms that a well-functioning stock market will create more openness and efficiency in various sectors of industry, like manufacturing, trade and agriculture (Banks, 1994).

According to stock market's significant impact on the overall economy, solving fundamental problems within the Chinese stock market seems to be one of the most important tasks for its economic development. Even though successful operations of mature stock markets are ideal examples for China, China cannot directly apply their models into its own market. The same point is further illustrated by the study *The Development of Stock Market in the People's Republic of China and Implications for International Investors*, it reveals that "the two (major) fledgling stock markets (Shanghai & Shenzhen) in China are different from those in the West since they are still very small in size and are still in an immature stage of development, they are not always driven by the market, and there are still many regulatory factors influencing artificially the operation of the two markets" (Kong, 1994). Furthermore, many other factors, such as economy structure, economic development pace, major compositions of economy activities, regulations of economy activities, the political system, are also significantly different across countries. Therefore, a well-running capital market model may work well in one country, but not in another. The author of the book *China: Finance and Investment* shows that "it is necessary to emphasize the interrelatedness of the various elements of the reform" (Bank, 1988). Therefore, instead of directly copying others' models, China should modify them and design a specialized capital market model that best suits its own situation.

With the purpose of restructuring and standardizing its capital market, the Chinese government has taken a great number of actions towards the current problematic stock market. For example, its focus on improving efficiency of management in listed companies, regulating information disclosure, and strengthening supervisions and regulations towards securities and mutual fund companies. It is reasonable to conclude that this series of remediation could greatly help alter the problematic Chinese capital market in some ways. However, due to a variety of issues within it and its complicated situation, the above actions are not sufficient and cannot fundamentally solve basic problems. Therefore, relevant regulatory body should capture the primary dilemmas and constitute systematic and most satisfactory solutions. Then, the confidence in the capital market can be improved.

With great global interest in the Chinese stock market, this paper starts with a short introduction of the Chinese stock market, and reveals its core problems. Based on problems analysed, this paper also includes a list of remedial actions taken by regulators. Finally, the paper ends with limited constructive suggestions on development of the Chinese stock market.

APPENDICES

Appendix A All Indices Currently Available in Shanghai Stock Exchange

Index Universe

1. SSE 180 Index: All A shares listed at Shanghai Stock Exchange excluding stocks that are:
   1) IPOs within the last 3 months (unless the daily average negotiable market capitalization of a stock is ranked top 18 in Shanghai Market).
   2) Suspended from listing.
   3) Experiencing materially abpara events in operation or management, or severe losses in the latest financial statements.
   4) Experiencing large price volatility that shows strong evidence of being manipulated.
   5) Considered by the Advisory Committee as inappropriate.
2. SSE 50 Index: Constituents of SSE 180 Index.
3. SSE Dividend Index: A shares listed at Shanghai Stock Exchange that meet the following requirements:
   1) Continuously paid dividend in the past two years and the cash dividend yield (after tax) each year is higher than 0
   2) Daily average negotiable market cap in the past one year is ranked top 50% of Shanghai A shares.
   3) Daily average trading value in the past one year is ranked top 50% of Shanghai A shares.
4. SSE New Composite Index: Constituents for SSE New Composite Index are listed stocks at Shanghai Stock Exchange that have completed Split-share Reform.
5. SSE Composite Index: Constituents for SSE Composite Index are all listed stocks (A shares and B shares) at Shanghai Stock Exchange.
6. SSE A Share Index: Constituents for SSE A Share Index are all listed A shares at Shanghai Stock Exchange.
7. SSE B Share Index: Constituents for SSE B Share Index are all listed B shares at Shanghai Stock Exchange.
8. Sector Indices: Listed companies are divided into 5 sectors: Industrial, Commercial, Real Estate, Utilities, and Conglomerate. Constituents for a sector index are all listed stocks (both A and B shares) of that sector.
9. SSE Fund Index: Constituents for SSE Fund Index are all security investment funds listed at Shanghai Stock Exchange.
10. SSE Government Bond Index: All government bonds listed at Shanghai Stock Exchange.
11. SSE Corporate Bond Index: All none equity-linked corporate bonds listed at Shanghai Stock Exchange.

Source: Shanghai Stock Exchange, http://www.sse.com.cn

Appendix B Constituents of Hang Seng Index

FINANCE SECTOR (4 stocks)	UTILITIES SECTOR (3 stocks)	PROPERTIES SECTOR (5 stocks)	COMMERCE & INDUSTRY SECTOR (21 stocks)
HSBC Holdings plc	CLP Holdings Ltd.	Cheung Kong (Holdings) Ltd.	Wharf (Holdings) Ltd., The
Hang Seng Bank Ltd.	Hong Kong and China Gas Co. Ltd., The	Henderson Land Development Co. Ltd.	PCCW Ltd.
Bank of East Asia, Ltd., The	Hongkong Electric Holdings Ltd.	Sun Hung Kai Properties Ltd.	Hutchison Whampoa Ltd.
BOC Hong Kong (Holdings) Ltd.		Sino Land Co. Ltd.	New World Development Co. Ltd.
		Hang Lung Properties Ltd.	Swire Pacific Ltd. 'A'
			MTR Corporation Ltd.
			China Merchants Holdings (International) Co. Ltd.
			Johnson Electric Holdings Ltd.
			CITIC Pacific Ltd.
			China Resources Enterprise, Ltd.
			Cathay Pacific Airways Ltd.
			Esprit Holdings Ltd.
			Li & Fung Ltd.
			Yue Yuen Industrial (Holdings) Ltd.
			China Unicom Ltd.
			CNOOC Ltd.
			China Netcom Group Corporation (Hong Kong) Ltd.
			China Mobile Ltd.
			Lenovo Group Ltd.
			Cheung Kong Infrastructure Holdings Ltd.
			COSCO Pacific Ltd.

Appendix C List of H-shares Companies Meeting the Conditions for Inclusion in the Stock Universe for Hang Seng Index Review (17 July 2006)

The following H-share companies have met with one of the following conditions and will become part of the stock universe for the Hang Seng Index Review:

1. The H-share company has 100% of its ordinary share capital in the form of H-shares which are listed on the Stock Exchange of Hong Kong;

2. The H-share company has completed the process of Share Reform, with the result that there is no unlisted share capital in the company; or

3. For new H-share IPOs, the company has no unlisted share capital.

H Shares Companies Meeting the Conditions for Inclusion in the Stock Universe for Hang Seng Index Review

	Stock Code	Company Name
1	42	Northeast Electric Development Co. Ltd.
2	177 •	Jiangsu Expressway Co. Ltd.
3	187	Beiren Printing Machinery Holdings Ltd.
4	317	Guangzhou Shipyard International Co. Ltd.
5	323 •	Maanshan Iron & Steel Co. Ltd.
6	347 *	Angang New Steel Co. Ltd.
7	358 *	Jiangxi Copper Co. Ltd.
8	548	Shenzhen Expressway Co. Ltd.
9	719	Shandong Xinhua Pharmaceutical Co. Ltd.
10	763 •	ZTE Corporation
11	874	Guangzhou Pharmaceutical Co. Ltd.
12	902 •	Huaneng Power International, Inc.
13	914 •	Anhui Conch Cement Co. Ltd.
14	939 *	China Construction Bank Corporation
15	995	Anhui Expressway Co. Ltd.
16	1065	Tianjin Capital Environmental Protection Co. Ltd.
17	1072	Dongfang Electrical Machinery Co. Ltd.
18	1108	Luoyang Glass Co. Ltd.
19	1138 •	China Shipping Development Co. Ltd.
20	1171 •	Yanzhou Coal Mining Co. Ltd.
21	3988	Bank of China Ltd.

*It is also the Hang Seng China Enterprises Index constituent.

Appendix D Weighted Average Dividend Yield of Hang Seng Index (Month-End Figures in Percentage)

Weighted Average Dividend Yield of Hang Seng Index (1973 – 2006)

Weighted Average Dividend Yield of Hang Seng Index (Month-End Figures in Percentage)

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC
1973	--	--	--	--	2.51	3	1.87	2.23	2.58	2.21	2.73	3.26
1974	3.11	3.78	4.48	5.09	3.77	3.81	4.48	5.88	7.24	6.8	8.77	8.94
1975	6.84	6.31	5.21	4.27	4.51	4.26	4.53	4.83	4.53	4.64	4.5	3.89
1976	3.36	3.31	3.18	3.72	3.78	3.72	3.95	3.79	3.87	4.33	4.05	3.8
1977	3.93	4.04	4.25	3.99	4.03	4.03	4.28	4.44	4.43	4.53	4.56	4.94
1978	4.95	4.88	4.64	4.62	4.54	3.86	3.68	3.29	3.62	3.43	4.67	4.82
1979	4.39	4.55	4.64	4.7	4.6	4.82	4.37	4.88	4.27	4.34	3.92	3.52
1980	3.29	3.3	3.99	3.94	3.82	3.22	2.99	3.04	3.14	2.56	2.71	2.62
1981	2.44	2.59	3.07	3.22	2.78	2.69	2.64	2.75	3.72	3.75	3.01	3.11
1982	3.09	3.48	4.03	4.09	3.89	4.23	4.57	5.18	5.85	7.14	7.88	7.08
1983	6.27	5.46	5.76	5.64	6.23	5.86	5.29	5.87	7.48	6.55	6.65	6.48
1984	5.05	5.22	5.23	4.93	5.65	5.76	6.69	5.73	5.29	5.16	4.68	4.4
1985	3.87	3.85	3.86	3.5	3.3	3.39	3.21	3.27	3.58	3.26	3.23	3.22
1986	3.33	3.34	3.9	3.53	3.63	3.67	3.44	3.44	3.18	2.99	2.99	2.73
1987	2.75	2.47	2.94	2.96	2.7	2.39	2.12	2.07	1.93	3.48	3.78	3.51
1988	3.64	3.44	4.03	4	4.13	3.65	3.65	4.15	4.21	3.94	4.1	3.9
1989	3.43	3.49	3.95	3.82	4.34	5.41	4.78	4.94	4.57	4.66	4.69	4.54
1990	4.7	4.39	4.8	4.88	4.59	4.51	4.3	4.82	5.4	5.05	5.15	5.04
1991	4.71	4.31	4.12	4.59	4.54	4.6	4.2	4.23	4.31	4.29	4.19	4.04
1992	3.78	3.58	3.82	3.53	3.18	3.17	3.3	3.43	3.53	3.19	3.45	3.64
1993	3.5	3.17	3.41	3.21	3.02	3.14	3.19	2.96	2.99	2.52	2.6	1.97
1994	2.05	2.28	2.89	2.9	2.77	3.03	2.79	2.67	2.8	2.86	3.27	3.38
1995	3.79	3.53	3.62	3.72	3.36	3.44	3.35	3.44	3.25	3.23	3.27	3.19
1996	2.89	2.98	3.15	3.15	3.11	3.18	3.29	3.13	2.96	2.81	2.61	2.6
1997	2.63	2.63	3.13	3.04	2.69	2.62	2.36	2.73	2.58	3.75	3.8	3.73
1998	4.27	3.6	3.65	3.72	4.38	4.58	4.91	5.35	4.75	3.5	3.41	3.53
1999	3.73	3.68	3.09	2.53	2.78	2.5	2.55	2.49	2.62	2.52	2.17	1.9
2000	2.07	1.88	2.05	2.3	2.4	2.18	2.1	1.71	1.88	1.98	2.1	1.84
2001	1.72	2.13	2.58	2.47	2.51	2.4	2.49	2.77	3.05	3	2.67	2.65
2002	2.81	2.89	2.93	2.83	2.88	3.08	3.17	3.22	3.62	3.46	3.24	3.38
2003	3.4	3.43	4.42	4.41	4.05	3.99	3.78	3.5	3.38	3.11	3.08	3.02
2004	2.88	2.76	3.25	3.44	3.37	3.34	3.35	3.19	3.15	3.17	2.94	2.91
2005	3	2.91	3.54	3.45	3.46	3.37	3.21	3.21	3.16	3.41	3.29	3.3
2006	3.12	3.09	3.48	3.31	3.48	3.39						

Calculation Formula:

$$\text{Index Dividend Yield} = \frac{\text{Total Dividends of Index Constituent Stocks}}{\text{Total Market Capitalisation of Index Constituent Stocks}} \times 100$$

Appendix E Weighted Average P/E Ratio of Hang Seng Index (Month-End Figures, in Percentage)

Weighted Average P/E Ratio of Hang Seng Index (1973 – 2006)

Weighted Average P/E Ratio of Hang Seng Index (Month-End Figures, in Percentage)

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC
1973	--	--	--	--	43.56	33.14	38.1	31.69	25.65	29.47	24.01	20.21
1974	21.13	16.84	14.17	12.28	16.31	16.13	13.71	11.11	8.73	9.23	7.32	7.09
1975	9.28	10.57	11.56	12.4	13.39	14.22	13.51	13.28	13.72	13.7	13.82	15.75
1976	17.92	19.1	19.65	17.3	16.91	17.19	16.18	16.03	15.5	14.33	14.77	16.33
1977	15.81	15.05	14.41	14.85	14.74	14.7	13.91	13.82	13.37	13.2	13	12.36
1978	12.1	12.14	12.31	12.44	12.87	15.18	15.68	17.95	16.46	17.29	12.75	12.34
1979	13.53	12.86	12.04	11.72	12.22	11.57	12.89	11.57	13.49	13.26	14.93	16.68
1980	17.86	17.05	14.32	14.83	15.08	17.96	19.26	19.26	17.49	20.97	19.54	20.17
1981	21.65	19.83	17.23	16.97	20.04	20.72	20.33	19.96	13.8	12.92	16.53	16
1982	16.14	14.36	11.94	10.6	11.14	10.29	9.51	8.4	7.43	6.18	5.57	6.2
1983	7.01	8.06	8.48	8.66	8.07	8.47	9.42	8.46	6.75	7.69	7.49	7.68
1984	10.11	9.73	9.9	10.58	9.24	9.03	7.58	8.83	9.59	10.16	11.22	11.93
1985	13.57	13.61	13.87	16.13	17.01	16.53	17.59	17.35	15.84	17.29	16.84	16.53
1986	15.97	15.9	13.82	14.96	14.55	14.54	15.42	15.64	16.94	17.42	17.46	19.04
1987	19.2	21.15	16.8	16.11	17.62	19.41	20.92	21.22	22.35	12.31	11.28	12.15
1988	11.81	12.56	11.6	11.91	11.35	13.05	13.08	11.79	11.66	12.39	11.83	12.51
1989	14.22	13.91	12.37	12.82	11.23	9.15	10.34	10.06	10.96	10.74	10.83	11.19
1990	10.63	11.38	10.3	10.13	10.76	11.08	11.63	10.4	9.29	9.88	9.76	9.96
1991	10.85	11.88	11.98	11.68	11.89	11.73	12.82	12.69	12.49	12.43	12.66	13.11
1992	14.03	14.81	13.54	14.8	16.57	16.62	15.99	15.31	14.96	16.41	15	14.23
1993	14.77	16.3	13.22	13.94	14.94	14.4	14.09	15.22	15.17	17.85	17.24	22.64
1994	21.82	19.68	15.08	15.02	15.84	14.49	15.69	16.43	15.64	15.21	13.6	13.16
1995	11.71	12.69	12.62	12.28	13.68	13.38	13.73	13.34	13.94	13.84	13.83	14.19
1996	15.65	14.94	14.12	14.13	14.38	14.07	13.62	14.19	14.98	16.01	17.22	17.3
1997	17.11	17.11	14.48	14.91	16.95	17.43	19.2	16.59	17.48	12.26	12.07	12.29
1998	10.62	12.76	12.54	11.84	9.88	9.45	8.83	8.09	9.18	12.55	12.8	12.36
1999	11.7	13.15	17.89	21.76	20.75	23.11	22.62	23.12	21.72	22.41	25.5	27.88
2000	25.52	26.18	12.33	11.1	11	12.06	12.55	13.63	12.48	11.9	11.19	12.74
2001	13.59	12.08	18.28	17.68	17.4	17.65	15.93	14.35	13.08	13.34	14.9	15.06
2002	14.18	13.79	17.83	18.63	18.29	17.18	16.64	16.29	14.72	15.44	16.47	15.45
2003	15.35	15.15	13.18	13.32	14.61	14.83	15.69	17.03	17.69	19.2	19.41	19.82
2004	20.9	21.73	18.25	17.18	17.55	17.51	17.44	18.32	18.4	18.31	19.72	19.96
2005	19.25	19.87	15.11	15.29	15.24	15.85	16.61	16.63	16.03	14.74	15.3	15.24
2006	16.14	16.29	12.72	13.38	12.77	13.1						

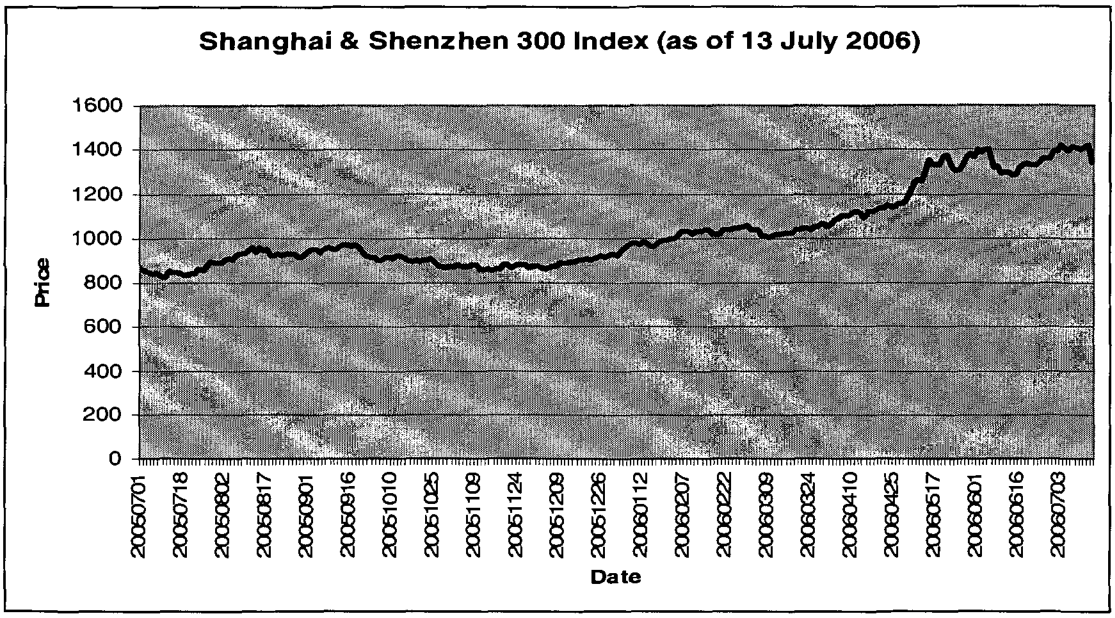
Calculation formula:

$$\text{Index Price/Earnings Ratio} = \frac{\text{Total Market Capitalisation of Index Constituent Stocks}}{\text{Total Earnings of Index Constituent Stocks}}$$

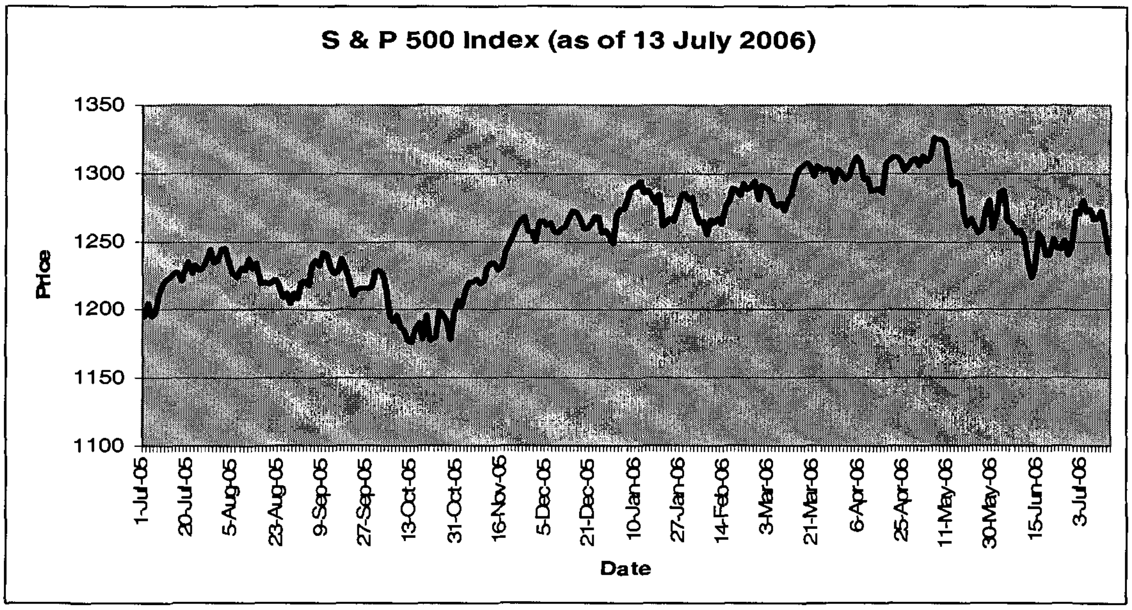
Appendix F Price Comparison between Shanghai & Shenzhen 300 Index and S & P 500

Price Comparison between Shanghai & Shenzhen 300 Index and S&P 500

(As of 13 July 2006)



Data Source: stock.sohu.com



Data Source: finance.yahoo.com

Appendix G Stocks in Shenzhen Stock Exchange with the Highest Fluctuation Rate at July 10, 2006

Stocks in Shenzhen Stock Exchange with the Highest Fluctuation Rate at July 10, 2006

Ranking	Stock Code	Shortened Company Name	Open (RMB Yuan)	Close (RMB Yuan)	Fluctuation Rate (%)
1	000686	锦州六陆	10.31	9.6	-6.89
2	00059	G 辽 通	4.89	5.16	-5.23
3	002017	东信和平	8.91	8.48	-4.83
4	002023	海特高新	13.03	12.43	-4.6
5	000759	G 中 百	7.44	7.1	-4.57
6	000869	G 张 裕	37.5	35.85	-4.4
7	000061	G 农产品	9.33	8.92	-4.39
8	000725	G 京东方	3.49	3.34	-4.3
9	002015	霞客环保	8.48	8.13	-4.13
10	000578	*ST 数码	3.68	3.53	-4.08
11	000617	石油济柴	21.52	20.65	-4.04
12	000591	桐 君 阁	10.5	10.08	-4
13	000011	深物业 A	5.53	5.31	-3.98
14	000761	G 本 钢	5.09	4.89	-3.93
15	000558	G 莱 茵	3.85	3.7	-3.9
16	002024	苏宁电器	50.98	49.02	-3.84
17	000722	G 金 果	3.74	3.6	-3.74
18	000557	G ST 广夏	1.91	1.84	-3.66
19	000410	G 沈 机	14.01	13.5	-3.64
20	000970	G 三 环	11.21	10.81	-3.57

Data source: www.cnlist.com

Appendix H Statistics of Stock Trading for the Period of Oct. 2001 – Oct. 2002 (Published by CSRC)

Statistics of Stock Trading (Oct. 2001 – Oct. 2002)

	Trading	Trading Value		Daily Trading Value		Trading Volume		Daily Trading Volume	
Date	Days	Trading Value (100 million Yuan)	Change	Daily Trading Value (100 million Yuan)	Change	Volume (100 million shares)	Change	(100 million shares)	Change
200110	18	1951.5	-25.51%	108.41	-29.66%	181.03	-7.33%	10.05	-12.60%
200111	22	2092.26	-58.25%	95.1	-58.25%	200.31	-45.12%	9.11	-45.08%
200112	21	2079.25	-44.36%	99.02	-44.39%	200.15	-26.23%	9.53	-26.40%
200201	20	1954.65	-35.13%	97.74	-54.59%	233.22	5.97%	11.66	-25.82%
200202	10	1262.74	-35.24%	126.27	16.41%	143.83	-5.32%	14.39	69.69%
200203	21	4673.75	-8.27%	222.55	-3.90%	487.03	-0.26%	23.19	4.45%
200204	22	3006.68	-44.27%	136.66	-46.81%	306.79	-27.37%	13.94	-30.71%
200205	18	1876.13	-57.86%	104.23	-57.85%	190.49	-41.98%	10.58	-41.99%
200206	20	4070.62	-17.21%	203.53	-13.07%	430.53	21.10%	21.52	27.11%
200207	23	3136.18	1.14%	136.35	-3.26%	323.86	41.88%	14.09	35.87%
200208	22	1886.04	-24.28%	85.73	-20.83%	182.46	-17.55%	8.29	-13.91%
200209	20	1403.09	-20.57%	70.16	-20.57%	137	-11.42%	6.86	-11.25%
200210	18	1139.24	-41.62%	63.3	-41.61%	142.48	-21.29%	7.92	-21.19%
Total	194	24409.12	-28.48%	125.82	-27.38%	2577.69	-6.32%	13.29	-4.88%

Appendix I Major Difference on Regulations for Listed Companies between New York Stock Exchange (NYSE) and the Chinese Stock market

	NYSE	Chinese Stock Market
Independence of Directors	The majority of directors in a listed company must be independent. The criterion for independence is to evaluate whether the individual director has substantial relationship with the company (direct or indirect relationship with company's partners, shareholders, and officers, etc.). Additionally, if the director meets specific condition, the director is not considered as independent. Such conditions include being an employee in past three years, receiving more than $100,000 annual reward from the company.	A listed company must have a system of independent directors and have detailed requirement for independence of directors. Such requirements include an independent director cannot hold any position besides director; he (she) is not the main director of the listed company, etc.
	Directors, who are not in charge of managing company's daily operation, are empowered to supervise and control management. They must hold periodic administration meeting without management participation.	No similar requirements.
Nomination and Company Management Committee	A listed company must have a Nomination and Company Management Committee which is completely composed of independent directors.	A nomination Committee, which is under boarder of directors, is elected by boarder of directors. In the nomination Committee, independent directors must be in the majority.
	Nomination and Company Management Committee must present public a written document specifying the purpose and duties of such committee. Its major responsibilities include looking for qualified directors; selecting and suggesting candidates for next annual directors meeting; researching and suggesting regulations for the company; supervising the evaluation for boarder of directors and management personnel; and evaluating the committee itself performance, etc..	Most responsibilities of Nomination Committee are similar to NYSE. However, its major duties do not include researching and suggesting regulations for the company; supervising the evaluation for boarder of directors and management personnel. And, the committee's performance is not evaluated.
Payroll Committee	A listed company must have a Payroll Committee which is completely composed of independent directors.	A Payroll and Assessment Committee, which is under boarder of directors, is elected by boarder of directors. In this Committee, independent directors must be in the majority.
	The committee's written document must specify its major purposes and duties at	The relevant duties are similar to NYSE. However, the committee is not responsible for creating the

	least include the following: (1) Assess and approve the reward standard relating to the CE0; and determine the reward level for the CEO based on his performance; (2) Suggest reward levels for officers not CEO; (3) Create report regarding to management's reward and payment. As required by U.S. Securities Regulatory Commission, such report must be included in the company's annual report. This committee's performance must be evaluated annually.	reward and payment report. Besides, the committee's performance is not required to evaluate.
Administration rules	The company's Administration rules must disclose qualification standards for directors, directors reward and pay, directors' continued education, performance evaluation of boarder of directors, etc.	China Securities Regulatory Commission issues Administration Rules for listed companies. All listed companies must comply with the rule.
Ethic code for directors, management, and employees	A listed company must disclose conduct and moral rules for directors, management and employees. CEOs in listed companies must annually report to the NYSE that their companies have none violation to the ethic regulation.	Does not have similar rules. No similar requirements.

Source: http://www.sinopec.com.cn/ir/jianguan/3466.shtml

Appendix J Current Information Disclosure Requirement in Code of Corporate Governance for Listed Companies in China Issued by China Securities Regulatory Commission and State Economic and Trade Commission

Chapter 7 Information Disclosure and Transparency

(1) Listed Companies' Ongoing Information Disclosure

87. Information disclosure is an ongoing responsibility of listed companies. A listed company shall truthfully, accurately, completely and timely disclose information as required by laws, regulations and the company's articles of association.

88. In addition to disclosing mandatory information, a company shall also voluntarily and timely disclose all other information that may have a material effect on the decisions of shareholders and stakeholders, and shall ensure equal access to information for all shareholders.

89. Disclosed information by a listed company shall be easily comprehensible. Companies shall ensure economical, convenient and speedy access to information through various means (such as the Internet).

90. The secretary of the board of directors shall be in charge of information disclosure, including formulating rules for information disclosure, receiving visits, providing consultation, contacting shareholders and providing publicly disclosed information about the company to investors. The board of directors and the management shall actively support the secretary's work. No institutions or individuals shall interfere with the secretary's work.

(2) Disclosure of Information Regarding Corporate Governance

91. A listed company shall disclose information regarding its corporate governance in accordance with laws, regulations and other relevant rules, including but not limited to: (1) the

members and structure of the board of directors and the supervisory board; (2) the performance and evaluation of the board of directors and the supervisory board; (3) the performance and evaluation of the independent directors, including their attendance at board of directors' meetings, their issuance of independent opinions and their opinions regarding related party transactions and appointment and removal of directors and senior management personnel; (4) the composition and work of the specialized committees of the board of directors; (5) the actual state of corporate governance of the company, the gap between the company's corporate governance and the Code, and the reasons for the gap; and (6) specific plans and measures to improve corporate governance.

(3) Disclosure of Controlling Shareholder's Interests

92. A company shall timely disclose detailed information about each shareholder who owns a comparatively large percentage of shares of the company, the shareholders who actually control the company when acting in concert and the company's actual controllers in accordance with relevant regulations.

93. A listed company shall learn about and disclose in a timely manner, changes in the shareholding of the company and other important matters that may cause changes in the shareholding of the company.

94. When controlling shareholders increase or decrease their shareholding or pledge the company's shares, or when the actual control of the company transfers, the company and its controlling shareholders shall timely and accurately disclose relevant information to all shareholders.

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