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Zhou, Weimin, Zhongguo Zheng, and Jian Hui. 1998. "A Critique of the Shortcomings of the CSRC's Temporary Rules on Prohibiting Entry to the Securities Market." *FaXue* [Legal Science] 4:60–61.

Comment Qiao Liu

The current chapter by William T. Allen and Han Shen (henceforth AS) assesses the Chinese securities markets from aspects that are of central concern in developing these markets: the positioning of securities markets in the national system of finance, their size and scope, their evolution pattern, the regulatory environment, and the corporate governance of the Chinese listed firms. Allen and Shen carefully document and discuss at length several key characteristics of the Chinese securities markets, including the share segmentation system, the state sector centric market design, concentrated ownership structures, low level of liquidity and poor pricing efficiency, limited market access for the private sector, the contradictory mandates of the CSRC (China Securities Regulatory Commission, the watchdog of the Chinese capital markets), and the control-based corporate governance mechanisms used by the listed firms. Allen and Shen characterize the Chinese securities markets as top-down markets designed by the government to ensure the state purposes. As such, these markets deem to be politically driven and cannot exert significant economic effects on the Chinese economy. The authors also conclude that the further development of China's securities markets hinges on whether the Chinese government is willing to give up the control over these markets and allow them to serve basic economic roles rather than the state purposes.

This chapter offers many structured details to illustrate the top-down nature of the Chinese securities markets. Such illustrations contribute to the understanding of the approaches used by the Chinese government to develop capital markets and assist interested readers, especially those with little knowledge about China, to understand the working of the Chinese securities markets.

I have two principal concerns about the thesis of this chapter. First, as I will show later, I believe that top-down is an oversimplified characterization of the Chinese securities markets. Second, AS overemphasize the state sector in their analysis and fail to consider the quick surge of the private sector.

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This missing link, as I will show, is arguably a more important shaper of the future of the Chinese securities markets.

Top-Down Meets Bottom-Up

Although I agree with AS on all the facts provided in their chapter, I believe that top-down is an oversimplified characterization. Several more fundamental institutional factors shape the Chinese securities markets. Some of them are top-down, and some are bottom-up.

Allen and Shen correctly point out that the purposes of developing the securities markets in China are twofold: one is to find alternative financing sources for the state sector, and the other is to improve the state sector's governance and efficiency. However, together with this top-down consideration, several other factors are also in a full play to shape the Chinese securities markets. These factors include a weak legal system and law enforcement, strong ties between politics and business, poorly developed financial intermediation that leaves the general public with fewer investment vehicles and hence fosters their enthusiasm about the securities markets, and the retail investors' dominated investor base. In such an institutional context, the Chinese government naturally chose an "administrative governance" approach to actively control the securities markets. The regulatory authorities, especially the CSRC, also have to take balancing acts between control and growth, instead of acts solely for the purpose of control.

The top-down nature of the Chinese securities markets is therefore a reflection of these driving forces. More fundamental institutional factors lie underneath the control approach used in the Chinese markets. This understanding yields a very different policy implication—the further development of the Chinese securities markets, to a great extent, depends on the overall intuitional improvement rather than the government's willingness to give up their control.

Take the following as one example: many conclusions in AS result from their analysis of the share segmentation system, which has its root traced back to the specific Chinese institutional background. Without improving overall institutions, even a complete reform of the share segmentation system, which as a matter of fact is under way, cannot solve problems in China's capital markets.

The State Sector versus the Private Sector

Allen and Shen's characterization of the Chinese securities markets as top-down is largely due to the focus of their analysis on the state-controlled listed firms in China, which used to account for more than 90 percent of China's listed firms. However, the structure of the Chinese stock markets is changing significantly over time—more and more listed firms are now controlled by families or groups of individuals with concerted actions. Table

3C.1, which is modified from a table in Liu, Zheng, and Zhu (2010), shows that from 2001 to 2008, the faction of the privately-controlled listed firm increased from 12.2 to 35.8 percent. If this trend continues, the private firms very likely will account for more than 50 percent of China's listed firms by 2015. Notably, the quick surge of the private sector in the Chinese stock markets was not planned by the government. It is largely driven by the market mechanisms and the changes in the institutional environment.

Since the private firms are now playing an increasingly important role in the Chinese markets, an assessment of the Chinese securities markets should factor them into the analysis. Firms controlled by individuals or families differ from the state-controlled listed firms in many ways. As shown in table

Table 3C.1 Corporate ownership structures of the Chinese listed firms by ownership types of the ultimate controllers

	2001	2002	2003	2004	2005	2006	2007	2008	Total
				Central state-controlled listed firms					
No. of firms	199	210	230	232	239	244	264	280	1,898
Layer	3.734	3.757	3.774	3.819	3.887	3.898	3.939	4.000	3.860
Control rights	0.484	0.489	0.476	0.472	0.461	0.431	0.434	0.435	0.458
Ownership	0.432	0.435	0.416	0.410	0.400	0.374	0.377	0.377	0.400
OC	0.883	0.871	0.852	0.846	0.850	0.859	0.861	0.855	0.859
Control rights–Ownership wedge	0.052	0.054	0.060	0.062	0.060	0.058	0.057	0.059	0.058
				Local state-controlled listed firms					
No. of firms	660	662	640	644	619	571	568	569	4,933
Layer	3.136	3.160	3.211	3.244	3.278	3.317	3.347	3.404	3.257
Control rights	0.483	0.483	0.479	0.473	0.458	0.416	0.416	0.422	0.455
Ownership	0.463	0.459	0.451	0.441	0.424	0.380	0.378	0.381	0.424
OC	0.955	0.945	0.934	0.926	0.918	0.908	0.900	0.898	0.924
Control rights–Ownership wedge	0.020	0.024	0.028	0.032	0.034	0.036	0.038	0.040	0.031
				Privately-controlled listed firms					
No. of firms	129	178	237	317	332	377	435	474	2,479
Layer	3.698	3.753	3.654	3.546	3.593	3.531	3.421	3.344	3.522
Control rights	0.355	0.341	0.347	0.353	0.346	0.343	0.360	0.370	0.354
Ownership	0.212	0.196	0.216	0.225	0.219	0.225	0.256	0.267	0.234
OC	0.579	0.567	0.603	0.623	0.621	0.642	0.699	0.709	0.647
Control rights–Ownership wedge	0.142	0.144	0.132	0.128	0.127	0.118	0.104	0.103	0.120

Notes: The table is modified from table 3 in Liu, Zheng, and Zhu (2010). It reports the means of variables measuring the extent of corporate pyramids by the ownership types of the ultimate controllers over 2001 to 2008. The sample includes all listed firms, with the ultimate owners controlling at least 20 percent of voting rights. The sample accounts for more than 93 percent of the universe of the Chinese listed firms. "Layer" is the number of intermediate layers between the ultimate controller and the listed firm. "OC" is the ratio of ownership rights to control rights. "Wedge" is defined as control rights minus ownership rights.

3.1, a comparison of the ownership structures of the privately-controlled and the state-controlled listed firms shows that (a) both the private owners and the state owners build extensive pyramidal structures, and the ones built by the private owners tend to be more extensive; (b) the evolution trajectories for the privately-controlled and the state-controlled pyramids are divergent in China from 2001 to 2008—while the privately-controlled pyramids become streamlined over time (measured by an increasing OC and a decreasing Wedge), the local state-controlled pyramids get more extensive over time.

This dichotomy shows that the private and state owners in China respond to the changing economic and institutional conditions in different ways. Fan, Wong, and Zhang (2010) find that quality of institutions affects the extent of the local state-controlled pyramids. Specifically, the local states tend to build more extensive pyramidal structures in the listed firms when they are subject to a greater degree of market and legal discipline. They also find that the extent of local state-controlled pyramids is positively correlated with firm performance because corporate pyramids allow the ultimate government owners to transfer decision rights to professional managers, and effectively separate firm management from political interferences. Liu, Zheng, and Zhu (2010) further point out that the quality of institutions affects the privately-controlled pyramids in an exactly opposite way. The private owners build more extensive corporate pyramids when they are subject to a lesser degree of market and legal discipline and more political discretion; the extent of pyramidal structures is negatively correlated with the performance of the private firms.

The dichotomy just discussed thus highlights the importance of distinguishing the private ownership and the state ownership in understanding the Chinese listed firms and the Chinese capital markets. A more complete assessment of the Chinese capital markets should consider these differences.

Concluding Remarks

Allen and Shen depict the Chinese securities markets as some sort of caged creature designed by the Chinese government to serve the state purposes. This depiction is largely true for these markets in their early development stages. However, this creature has already grown bigger than the cage. The changes in the institutional environment and the surge of the private sector have greatly changed the nature of the Chinese securities markets. The top-down forces driven by the government are meeting with the bottom-up forces driven by the market system. Mapping out such interactions and understanding their dynamics are the key to assess the Chinese securities markets and understand their future developments.

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