UNDERSTANDING THE CHINESE STOCK MARKET CRASH, 2015: A PRIMER TO CHINESE CAPITAL MARKETS LAW

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1. INTRODUCTION

In an interconnected world described by cooperative monetary exercises, capital markets frame the foundation of exchanges. While capital markets are an umbrella term for a combination of monetary markets like value and security markets they work as an inseparable unit to empower money related exchanges. China today is a huge player in the realm of capital markets because of not just its potential outcomes that are getting to be accessible to other global players but also because of the exceptional size of the Chinese economy.

It is crucial to note that the Chinese capital markets are not as open while contrasted with other capital markets in the world, for example in the United States of America. The blockades of government regulation and approbation restrict the extent of entry into Chinese capital markets.[1] However, on the other

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[1] Dong Anshen & Han Liyu, *How Law Reform Enhances Trading on the Chinese Capital Market*, 10 Uniform Law Review, 226-227 (2005).

hand China's entrance into the World Trade Organization has made its internal securities market more appealing to investors globally.[2]

While perceiving the restrictions of Chinese capital markets, it is crucial to enlist China's financial force both in Asia and universally. In 1970 China endeavored an economic reform to replace the state owned and controlled economy to a market players' economy elucidated by multiple players. This prompted the conception of China's driving national security exchanges, the Shanghai and the Shenzhen stock Exchange.[3] These trades today assume a dynamic part and have the capability of getting to be bigger to empower more noteworthy worldwide collaboration.

China as a country is known for its saving patterns and the capital markets endeavor to channel such reserve funds to pump the financial markets, while regulating the same with the arrangement of national stock exchanges. The populace and savings are therefore motivators for development of Capital

[2] Yuwa Wei, *Volatility of China's Securities Markets and Corporate Governance*, Suffolk Transnational Law Review, 207, (2005-2006)

[3] Serena Y. Shi, *Comment Dragons' House of Cards: Perils of Investing in Variable Interest Entities domiciled in the People's Republic of China and Listed in the United States*, 37 Fordham International Law Journal, 1265-1266, (2013-2014).

markets in China.[4] However, 2015 has seen the collapse of the very same stock exchanges in China. 24th August 2015 has been coined "Black Monday" following this catastrophic collapse in China.[5] The crisis unfortunately is not limited to China alone and its aftershocks have been felt across the world, as seen in the Dow Jones in America to the National Stock Exchange in India.[6]

This paper attempts to scrutinize the background of the crash in order to establish the key factors of Chinese capital markets that failed. Further the Author has adopted a comprehensive research model that analyses the overall Capital market activities in China, to explain the formation of this financial bubble. The Author also elucidates the deep and pervasive control of the Government in the capital markets, criticizing it for its inability to enable smooth functioning of markets in China. Lastly, the author briefly discusses the future of China and the impacts of the crash on the rest of the World.

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[4] *China: Financial Sector Assessment Program*, Financial Sector Assessment, (Nov 2011), http://www.worldbank.org/content/dam/Worldbank/doc/WB-Chinas-Financial-Sector-Assessment-Report.pdf.

[5] Frances Coppola *China's Black Monday Signals The End of Its Growth Cycle*, FORBES MAGAZINE, http://www.forbes.com/sites/francescoppola/2015/08/24/chinas-black-monday-signals-the-end-of-its-growth-cycle (last updated Aug 24, 2015).

[6] *Chinas Black Monday sends markets reeling across the globe*, THE GUARDIAN,http://www.theguardian.com/business/live/2015/aug/24/global-stocks-sell-off-deepens-as-panic-grips-markets-live (Aug 24, 2015).

2. UNDERSTANDING CHINESE CAPITAL MARKETS

In this chapter the Author introduces factors that have played an important role in the causation of the triggers of the Stock Market crash. While some factors have contributed directly and others have an ancillary contribution, the Author has attempted to elucidate all of them in congruence to form the basis of the latter sections of this paper. The factors have been analyzed below-

2.1. The trend of High Savings

Before the economic reforms in China in the 1970's the savings of the general population in was simply stored in State banks.[7] Be that as it may, with the rise of stock markets such investment funds have now become a capital source adding up to very nearly 40 percent of China's Gross Domestic Product.[8] Furthermore, the development of national securities exchanges has brought in procedures and regulations that have to be complied with to be a player in the Chinese capital markets.

In the past this was missing leaving State run companies and organizations without a checks and balance framework. Together these elements have prompted a more effective

[7] Solomon M. Karmel, *Emerging Securities Markets in China: Capitalism with Chinese Characteristics*, China Quarterly, 11-5, (1994).

[8] John H Makin, *Does China save and Invest Too Much*, No. 2, 26 CATO Journal, 316-317 (2006).

capital markets spine when contrasted with the past. Dissimilar to the regular myth encompassing Chinese companies, it is crucial to understand that organizations in China are actually encouraged to list in local capital markets as this permits greater economic participation and empowers the Chinese Government to check the threat of insider trading that has tormented Chinese companies.[9] In the absence of a clearly demarcated Corporate Governance code, this urges privately owned companies to be listed too, supporting competition in the market and thereby increasing transparency.[10]

2.2. Deciphering the Securities Market-

Until, 1992 the Peoples' Bank of China controlled the Chinese securities market. In 1992, this changed with the development of a regulatory structure. The monetary policy, economic atmosphere and the danger of distress lead to a squeezing need to frame a regulatory body that could unify the practices in the securities markets. The first Securities law was consequently formulated in 1998 to give standard practices and achieve norms of investor protection.[11]

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[9] DONG, *supra* note 1, at 225.

[10] Donald C. Clarke, *Law without Order in Chinese Corporate Governance Institutions*, 30 Nw. J. Int'l L. & Bus. 131 (2010)

[11] Daniel M Anderson, *Taking Stock in China: Company Disclosure and Information in China's Stock Markets*, 88 Georgetown Law Journal, 1919, (1999-2000).

The 214 Articles of this Statute direct the issuance and exchange of shares while indicating liabilities for disregarding any procurements of the Statute. It further perceives that admin or company law would oversee any lacunae in securities law.[12] Further, the types of shares in China are divided into tradable and non-tradable. Non-tradable shares are used only in private transactions, provided the governmental approval is met.[13] Tradable shares on the other hand are those shares that can be traded in both International and national stock exchanges.[14] This distinction is important to understand the Crash of 2015 as it forms the premise of a further classification of shares in China, which were the primary culprits of the crash.

2.3. Further Classification of Shares – Type A and Type B

This classification of shares is most important in understanding the Crash. The impacts of the classification have been addressed in the latter sections of the paper. Type A shares are those that are valuated and traded in Local currency and can only be help by domestic investors in China. On the other hand Type B shares are valued by the local currency, Yuan but can

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[12] *Id.*

[13] Yeung, Horace W. H., "*Non-Tradable Share Reform in China: Marching Towards the Berle and Means Corporation?*" (2009). COMPARATIVE RESEARCH IN LAW & POLITICAL ECONOMY. Research Paper No. 48/2009.

[14] ANNETTE KLEINBROD, THE CHINESE CAPITAL MARKET PERFORMANCE, PARAMETERS AND FURTHER EVOLUTION AND IMPLICATIONS FOR DEVELOPMENT, 84-85, (2008 ED.).

be traded in other foreign currencies. These are shares held by foreigners.[15] While the recent past has seen a slow but steady blurring in this distinction as the Chinese government has started allowing foreign investors to invest in Type A shares, it remains a pivotal factor in the crash.[16] To limit the scope of research the Author has not explored this model and focuses upon features of Type A shares instead.

Type A shares can be further classified based upon who owns the shares. There are three possible holders, the State, legal persons or individual investors. While the altter is freely tradable on national exchanges, the prior two are not and require State permission. Hence they are considered non-tradable shares.[17] It is important to keep this classification in mind while analyzing the latter sections of the causes of the crisis.

2.4. The Chinese Security Regulatory Commission (CSRC)

China saw the adoption of its corporate laws in 1994. Post this the regulatory body CSRC was formed. However, an ailing issue in China lies in the extent of governmental control on this

[15] Hui Huang, *The New Takeover Regulation in China: Evolution and Enhancement*, 42 The International Lawyer, 153-154, (2008).

[16] Woody Wu & Hua Zhang, *Shareholding Structure and Corporate Performance of Partially Privatized Firms: Evidence from Listed Chinese Companies*, 8 Pacific Basin Finance Journal, 587-593 (2000).

[17] ANNETTE, *supra* note 12, at 85-87.

body[18] Further, the absence of clearly codified rules and procedures in corporate law and the Securities Statute leads to misapplications of legal principles amounting in gross violations, especially in the light of company law and securities law overlapping.[19]

Hence despite having two separate codes, a rampant overlap persists. In 1994, an attempt to separate this overlap was made, giving the judiciary the power to fill any lacunae in securities law.[20] However, the over interference of the CSRC has ensured the opposite in multiple aspects, such as imposing Corporate Governance norms for duties not linked to the securities market. Further, this has ensured a lingering Government presence in Chinese securities markets dampening the movement towards privatization.[21]

[18] Chenxia Shi, *Competition in China's Securities Market: Reform of Current Regulatory System*, 3 Loy. U. Chi. Int'l L. Rev. 213 (2006).

[19] Nicholas Calcina Howson, *"Quack Corporate Governance" As Traditional Chinese Medicine-The Securities Regulation Cannibalization of China's Corporate Law and a State Regulator's Battle Against Party State Political Economic Power*, 37 Seattle University Law Review 667-668, (2013-2014)

[20] Nicholas C. Howson, *Corporate Law in the Shanghai People's Courts: Judicial Autonomy in a Contemporary Authoritarian State*-1992-2008, 5 East Asia Law Review, 304-305 (2010).

[21] Chen Daisong, *Legal Developments in China's Securities Market During three decades of Reform And Opening-Up*, Asli Working Paper No. 005, Asian Law Institute and National University of Singapore.

2.5. Foreign Players in the Chinese Markets-

China directs the entry of foreign players and its capital administration policy prevents Chinese investors from putting their savings into certain investment classifications that are more alluring. This is combined with the low number of offerings in the Chinese securities sector prompting an inflated valuation of shares.[22] Together, these variables leave China helpless against a bubble crisis on account of any change in the securities law. The "Nationality Principle" which recognizes and differentiates between Chinese nationals and foreign investors entering the Chinese securities markets.[23]

Article 138 of the Securities Law mandates that only a Chinese company or individual can open an exchange account in China. Another shortcoming of this rule lies in the grouping of shares, which depends on corporate possession and the ensuing issuances of shares.[24] This is in contradiction with Western economies where stocks are arranged on the premise of

[22] Phillip Barber, *Bull in the China Market: The gap between investor expectations and auditor liability for Chinese Financial Statement* Frauds, 24 Duke Journal of Comparative and International Law, 349-350 (2014).

[23] Lee Ming Hau, *Encouraging Foreign Participation and Investment in Chinese Securities Markets*, 23 Singapore Law Review, 125-126 (2003).

[24] OECD (2011), Corporate Governance of Listed Companies in China: Self-Assessment by the China Securities Regulatory Commission, OECD Publishing, http://dx.doi.org/10.1787/9789264119208-en.

expected profits or dividends, ensuring the markets valuation are self-governed.[25]

2.6. Heavy Reliance on Direct Financing

While most developing economies rely upon direct financing via an array of products such as issuance of shares and bonds, China continues to rely primarily upon Bank loans. [26]In the Chinese context these banks are state owned enterprises and reliance on other lending corporations is limited. This limited option of financing is ensured by the government to sustain the development of governmental agencies in the financial market.[27] Hence there is limited diversity in funding and this leads to a stagnating growth. When the sole financing route is impacted, it becomes a cause for a financial crisis like we have seen in 2015.

2.7. Limited products traded in China

The restricted compass of items exchanged on Chinese securities exchanges postures yet another test for the capital markets. Innovative items like financial derivatives have

[25] *China's Capital Markets: The Changing Landscape*, KPMG, (2011), https://www.kpmg.com/cn/en/IssuesAndInsights/Publications/Doc/China-Capital-Markets-FTSE-201106.pdf

[26] Qi, Bin, *China Capital Markets Development Report : China Securities Regulation Commission*, (2008), https://openknowledge.worldbank.org/handle/10986/12643,

[27] Yuwa Wei, *Volatility of China's Securities Markets and Corporate Governance,* Suffolk Transnational Law Review, 207, (2005-2006).

restricted exploration in China, with securities exchanges concentrating essentially on shares and bond trading.[28] This happens because of shortcomings in the trading mechanism in China. Besides, Short selling techniques were not present in China for quite a while contrasted with other developing capital markets, for example, in India and were initiated by the Hong Kong-Shanghai Connect and became applicable only in March, 2015.[29]

3. DIRECT CAUSATION OF THE CRASH DUE TO THE FACTORS ANALYZED ABOVE

Keeping in mind the factors of Chinese capital markets, which are often distinct from other open economies both in the West and Asia, China has embarked on a path of its own. While this path has been obstructed by the crisis of 2015, it is essential to study the combination of the factors in the previous section and read them in congruence with other economic and policy considerations in China before the Crash.

Owing to the limited opportunities of investing money and the limitations on investing money abroad, Chinese individual

[28] Fabella, Raul; Madhur, Srinivasa. 2003. *Bond Market Development in East Asia: Issues and Challenges*, ASIAN DEVELOPMENT BANK.

[29] Lissa Jucca, *Shanghai-Hongkong Stock connect to allow short-term selling from March*, Reuters, http://www.reuters.com/article/2015/02/23/china-hongkong-connect-idUSL4N0VX0ET2015022 (last updated Feb 23, 2015).

investors find themselves with two options. The first is putting in savings in state owned banks and financial corporations, yielding much lower returns and no scope for diversification of assets.[30] Secondly, they have the option of exploring the vulnerable stock exchanges in China. The reasons for the same have been analyzed in the previous section. In the year preceding the Crash China introduced the Hong Kong – Shanghai Stock Connect.

This collaborative securities arrangement enabled smoother relationships with Hong Kong and was seen as a boost to Joint Ventures and companies located in Mainland china with a Hong Kong presence and vice versa.[31] As a result the stock markets saw a boost. Further, in the same year the Chinese media capped onto this trend and encouraged Chinese individual investors to invest in the two major exchanges (share markets). This was in alliance with the objective of the state and as is known the Government in China controls the media, leading to congruence in thinking.[32]

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[30] Chen Xindong, *Chinas Capital Markets; Untapped Potential*, Eurobiz, http://www.eurobiz.com.cn/chinas-capital-markets-untapped-potential/ , (last updated June 10, 2013),

[31] *The through train: stock connect's impact and future,* THOMSON REUTERS, *(*Dec, 2014). http://share.thomsonreuters.com/assets/forms/shanghai-hk-stock-connect-1008885.pdf

[32] Jim Zarroli, *Beijing Government spurred investors to make risky margin bets,* NATIONAL PUBLIC RADIO

Investors therefore flocked to the stock market, with the objective of higher returns in the Chinese capital markets vis-à-vis state owned banks. This led to a gradual inflation in the stock markets, with prices of shares soaring due to the demand from Chinese investors. While this scenario has been seen in the past with other stock market crashes, what sets the Chinese crash apart is the rampant use of margin lending to investors in order to be able to buy shares. Often the amounts lent were much higher than the expected profitability or returns that were stipulated by the companies' investors put money into.[33] Margin lending is a mechanism of financing in which a loan is provided to the investor for investing shares. In return the lender uses the same shares as security. China right before the crash gave out margin loans to the quantum of 339 billion dollars, leading to a flooding in the shares and their prices soared.[34]

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http://www.npr.org/2015/08/27/435113627/china-s-government-encouraged-ordinary-investors-to-make-risky-margin-bets, (last updated Aug 27, 2015).

[33] *China takes heavy hand to settle markets,* T D ECONOMIC OBSERVATION (July 9, 2015). https://www.td.com/document/PDF/economics/special/China_StockMarketRout.pdf

[34] Tracy Alloway, *China's Gray Market in Margin Lending Is Probably Massive*, BLOOMBERG BUSINESS, http://www.bloomberg.com/news/articles/2015-07-09/china-s-gray-market-in-margin-lending-is-probably-massive (last updated July 9, 2015).

While margin loan funding in itself is not a problematic concept in capital markets, it is Chinas non-regulation of the same that has facilitated this catastrophe. Fund Matching companies in China indulge in such margin lending without any regulation to enable peer-to-peer lending. However, this scheme of financing is not included in margin loans regulation and therefore remains unregulated. Investors, who buy and sell their shares often, leading to a fluctuation in share prices, use peer to peer financing in China.[35]

Unfortunately, China saw the rise of margin calls fueling the crisis. A margin call flows from margin lending and occurs when the lender realizes fluctuations in the stock market and fears devaluation of the securities held as collateral. Therefore the lender demands a greater collateral in the form of more shares, payment or disposal of currently held shares before values fall. This creates a domino effect as is best illustrated in the Chinese context.[36]

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[35] Gabriel Wildau, *China wary of killing stocks rally with margin lending curbs,*THE FINANCIAL TIMES, http://www.ft.com/intl/cms/s/19263298293b11e58613e7aedbb7bdb7,Authorised=false.html?siteedition=intl&_i_location=http%3A%2F%2Fwww.ft.com%2Fcms%2Fs%2F0%2F19263298293b11e5Dintl&_i_referer=&classification=conditional_standard&iab=barrier-app#axzz3odjDqWgP (last updated July 13, 2015).

[36] Ben Chu, China stock collapse: Why the country's market crash is not what it seems, The Independent. http://www.independent.co.uk/news/world/asia/china-stock-collapse-why-

Further, another aspect that sets this crash apart from the West is in the nature of investors. In China, the current crisis saw eighty percent of investors who had invested were individual investors trading independently on the Stock Exchange. This is unlike more modern, usually Western stock markets where institutional investors are the biggest contributors.[37] Pension funds, Mutual funds and insurance companies often invest their pooled funds on behalf of individual investors in the West, making the impact of this crisis closer to the Chinese populous who can seek no accountability of their losses post the crisis.

The savings trend in China contributed to this impact, as in the absence of the Western model of security systems; individuals are forced to save for the rainy day. The government itself has been accused of intentionally keeping interest rates of state banks low, to boost corporations in China, leading to the flocking of stock markets by individual investors.[38] Critics of the crash believe that beyond the falling prices and the crash,

the-countrys-market-crash-is-not-what-it-seems-10477305.html ,(last updated Aug 28, 2015).

[37] *Chinas Black Monday sends markets reeling across the globe*, THE GUARDIAN, http://www.theguardian.com/business/live/2015/global-stocks-sell-off-deepens-as-panic-grips-markets-live (last updated Aug 24, 2015).

[38] Gywwn Guildfors, *Everything you've heard about Chinas stock market crash is wrong*, QUARTZ MAGAZINE, http://qz.com/8everything-youve-heard-about-chinas-stock-market-crash-is-wrong/ (last updated Aug 27, 2015).

there is a greater plague in China that is posed by the Governmental regulation at each step of the securities market. In attempting to adopt the Western securities market China has successfully put up a similar structure for capital markets but has failed to comply with the substantive legal requirements due to excessive governmental control.[39]

Answering the second most pertinent question regarding foreign investors, it is essential to recapitulate the classification of shares- Type A and B. In the given crisis the value of Type A shares was lost. Chinese individual investors or corporations can only own these shares. As a result the losses in Type B shares are limited to a mere 2 percent for foreign investors in China.[40] However, when viewed numerically the losses in Type A share also seem insulated due to China’s 1.36 billion population. Research shows that only one in every 30 Chinese has lost money in the stock market crash. However the quantum and effects of this crash has extended to an already

[39] CHU B. (2013), CHINESE WHISPERS: WHY EVERYTHING YOU’VE HEARD ABOUT CHINA IS WRONG, (Weidenfeld and Nicolson, London) (2013).

[40] Alfred Joyner, *China stock market crash explained in 90 seconds, International Business Times,* http://www.ibtimes.co.uk/china-stock-market-crash-explained-90-seconds-151695 (last updated Aug 25, 2015).

declining price of commodities such as Iron ore and crude oil, thereby impact the global economy.[41]

The trigger to this crisis as portrayed by the Chinese government was a news report by Journalist Wang Xiaolu who published a report on the speculation of the Chinese regulatory body, CSRC withdrawing funds.[42] This led to further confusion in the market and the chaos saw investors panicking and withdrawing their money as is common for most stock market crashes. However, the government has been grossly criticized for advancing this theory, as a crash of this magnitude is not due to a false report but only exposes the greater challenges that the Chinese securities market and regulations have been unable to address.[43] The attempt of the Government of China, to increase its production and efficiency by devaluing its currency in July, 2015 could be pointed to as the first domino to fall in this crash.

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[41] Keith Fitz-Gerald, *The Real Threat from China's Stock Market Crash,* The Blaze,http://www.theblaze.com/contributions/the-real-threat-from-stock-market-crash/ (last updated Sept. 4, 2015).

[42] *Chinese journalist jailed after stock markets crash coverage,* AL JAZEERA STAFF, http://america.aljazeera.com/articles/2015/8/27/chinese-journalist-jailed-over-stock-market-crash-coverage.html (last updated Aug 27, 2015).

[43] *China Is Trying to Blame Its Stock Market Crash on Journalists and Businessmen*, Vice News,https://news.vice.com/article/china-is-trying-to-blame-its-stock-market-crash-on-journalists-and-businessmen(last updated Aug 31, 2015)

The Chinese government has been accused of notoriously devaluing their currency for import- export trade profits and this supplemented by the recent fall in property prices could be individual triggers of the crash.[44] However, we must keep in mind while these triggered the crisis the causes of the same are more deeply rooted in Chinese securities law itself, as analyzed in Chapter I.

4. CONCLUSION

The Chinese stock market crash shows a very deeply rooted problem in the working and structure of Chinese capital markets. For a country that is a production hub and has a huge population, China has failed to provide adequate high yielding investment opportunities. China also has a savings trend that is higher than most other countries.

Yet the government in consonance with the Regulator, CSRC ensure limited options and vehicles for investment. This in turn hit individual investors in China who are plagued by the unfortunate investment opportunity in low interest rates providing state owned banks and corporations. Analyzing the slowing trend that followed in China after the introduction of

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[44] Peter Spence, *china's stock market crash: five numbers you need to know*,the telegraph, http://www.telegraph.co.uk/finance/china-business/11772729/chinas-stock-market-crash-five-numbers-you-need-to-know.html (last updated july 31, 2015).

its economic reforms, the government urged investors to invest in state owned corporation listed on stock exchanges in India.

The minute classifications in types of shares governed by who holds what share further cements this control of the government in the securities market. The problems of shadow margin lending and short selling have been identified as triggers of the said crash. However it is essential to note that they are not triggers but only the first domino to fall due to the basic fallacies in the structure of Chinese capital markets. In adopting the Western structures of capital markets, China failed to provide an accompanying code of clear regulations that would govern securities.

Further, the scope of government intrusion limits markets from functioning independently. As a result of these factors, we saw a plummeting of the value of Type A shares, impacting not only China but also other stock markets in countries like the USA and India. Further this crisis has been linked to an already declining commodities price impacting jurisdictions across the world. Hence there is a pressing need for the Chinese government to step aside, let the regulators remain in a system of checks and balance and ensure that the free market runs the pricing and cycles of the stock market.