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目　录

China's Informal Stock Market: How It Developed, How It Works and How It Might Grow*

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Summary

China has a highly active informal market in shares. The shares of over 1 000 companies are traded and some 3 m investors take part in a market in corporate equities organised in various locales outside the two stock exchanges in Shanghai and Shenzhen. China's informal share market has appeared in a number of different guises since the establishment of the stock market in the late 1980s, partly as a result of the government's restrictions as to which type and what number of firms can publicly issue shares. While the central government has at various times attempted to close down these informal markets, they continue to flourish as shareholding firms seek to raise capital and owners of firms seek to transfer their ownership rights outside the bounds of the formal financial sector. This suggests that the government should move to formalise these markets, a move that would recognise the incipient demand for shares and allow the government to introduce a basic regulatory

* This paper was first published as the Asia Programme Working Paper No. 8 by the Asia Programme, Royal Institute of International Affairs in London in October 2003 (http://www.riia.org/pdf/research/asia/OTC LiuGreenPDF.pdf).

framework for a market which evidently can not be easily suppressed.

This paper is divided into three parts. The first section provides a brief historical overview of the development of informal share markets in reform China, from the kerb markets of the mid-1980s to the Internet-based brokers of 2003. The second section looks in detail at the organisation of the market today; how shares are issued, traded and settled. Third, and last, the paper identifies the problems inherent in the market at present and outlines the possibilities for its future.

目　录

1 Informal share markets in reform China

In China since the mid-1980s, thousands of companies' shares have been traded on the street and in market institutions not recognised by law or by the central government. This is China's off-exchange stock market, otherwise known as the over-the-counter (OTC) market. It offers investors the opportunity to trade the shares of shareholding companies that are not listed on either of the two officially-authorised stock exchanges and it is an important but often overlooked part of China's capital market infrastructure. The development of the informal share market can be divided into three stages.

1.1 Before 1991 — the OTC market and trading on the black market

In 1981, three firms in Shenzhen issued reform China's first shares①. Hundreds of firms subsequently organized initial public offerings (IPOs) in Shenzhen and elsewhere. However, there was no market to facilitate the trading of these shares until August 5th 1986 when the Liaoning Trust and Investment Company, with the permission of the local People's Bank of China, opened a desk to facilitate the transfer of corporate bonds. The Jing'an Securities Office of the Industrial and Commercial Bank of China (ICBC) Investment and Trust Company, a subsidiary of the Shanghai Branch of the ICBC, began trading in two stocks (Yanzhong Industrial and Feile Acoustics) on an OTC basis also in September 1986. The prices of the shares were controlled and few people were willing to sell the shares they held. The total trading volume in the last three months of 1986 was only some 1 000 shares. This was reform China's first OTC stock market.

As demand for shares rose, people began to buy and sell them in black markets in a number of cities. The black market was especially popular during 1990—1991. According to one trader's estimate, the daily turnover was

① China's stock market dates back to the 1860s when brokerage firms opened in Shanghai to trade shares of foreign companies. In the 1930s, the Shanghai Stock Exchange was the largest in Asia. However, it and two other exchanges were closed during 1949—1952 after the founding of the socialist People's Republic of China. Along with China's reform and opening policy in late 1970s and 1980s, firms began to issue shares again and two stock exchanges — the Shanghai Stock Exchange and the Shenzhen Stock Exchange — were established in December 1990. For a review of the history of China's stock markets, see Liu Ti, *Cong Huaerjie Dao Waitan: Zhong Wai Gushi Shihua* [*From Wall Street to the Bund: A Brief History of Stock Markets*], Shanghai: *Shanghai Yuandong Chubanshe*, 1999; Green, S. *China's Stockmarket: A Guide*, Profile Books, 2003; Green, S. *China's Stock Market, 1984—2002: Equity Politics and Market Institutions*, Routledge Curzon, London, forthcoming 2004.

several thousand shares in Shanghai during July and August 1990, larger than the OTC market's trading volume. The Shanghai Branch of the PBoC, the Shanghai Public Security Bureau and Industrial and Commercial Bureau took a number of measures to attempt to eliminate the black market in 1990, though these measures were not effective. The real blow came in December 1990 when the OTC and black markets were replaced by the two stock exchanges, which meant that all shares were now to be registered at the exchanges.

1.2 1992 and the Subscription Rights Certificate market

In the early years of market development, there was a huge demand for IPO shares. The authorities invented the Subscription Rights Certificate (*Rengu Quanzheng*, hereafter SRC) in order to attempt to balance supply and demand. People who wanted to buy IPO shares had to first buy the certificate which qualified them to take part in a lottery for IPO shares. However, since the cost of the certificate and the IPO share price was usually substantially lower than the first-day trading price, SRCs became extremely popular and very profitable to trade in, and a black market for these certificates sprung up in 1992. After Deng Xiaoping's reformist southern sojourn and the explosion in interest in shares, a SRC issued at Rmb30 could be sold on the black market for Rmbl 500. However, this market disappeared in 1993 as increasing numbers of companies issued shares, demand for shares weakened and SRCs were later abolished with the introduction of a system for IPO subscriptions based on bank accounts.

1.3 1993 to the present — the market for shares of non-listed companies

The third phase of the informal share market's development quickly followed. In 1993, employees' shares in shareholding companies began to be traded illegally *en masse*. According to government regulations on the issue, the employees of such companies were obliged to hold the shares they were allocated by their employer for at least three years. Moreover, these shares could only be transferred among the employees of the same company after the three-year limit expired. Instead, a black market in employees' shares rapidly developed, stimulated by the illegal mass issuance of "employee" shares to managers (who then sold them into the market).

During 1993—1999, hundreds of companies, frustrated by their inability to gain a place on the national share issuance quota, issued shares to the public and their shares were traded informally. Dozens of local securities trading centres (*zhengquan jiaoyi zhongxin*, hereafter STCs) were subsequently set up in provincial capitals to facilitate the trading of many of these shares[①]. In March 1998, the State Council, concerned about the instability these markets (particularly via the repo market) produced issued a ban on the off-exchange market and the China Securities Regulatory Commission (*Zhongguo Zhengquan Jiandu Guanli Weiyuanhui*, hereafter CSRC) moved to close the STCs, a task that occupied the regulator most of 1998—1999. However, informal trading of non-listed companies' shares quietly continued in informal settings.

In 2001, the off-exchange market revived in the form of the "the one-and-a-half market" (*yijiban shichang*)[②]. There were two main reasons for the revival both based on the relationship between the informal and formal markets. First, the efforts of the CSRC to establish a second board stock market (initially designed for technology stocks and then modified to accept small and medium-sized companies operating across sectors) in Shenzhen created incentives for speculators to purchase shares in the companies which could potentially meet the new board's proposed listing requirements. The ambition of these investors was to profit from the likely premium to be gained when the shares were allowed to trade publicly. However, with the cooling of investment sentiment towards high-tech companies during 2001—2002 and the diminishing likelihood of the second board market being established, such speculative demand declined.

Second, as part of the 1998 restructuring of the STCs, the State Council had encouraged formally listed companies to acquire the shares of those companies which were traded on the STCs and at other informal trading sites, either via purchasing their shares or a share swap[③]. In general, investors in off-exchange traded companies could earn a high return if these companies were formerly listed and this created an additional incentive to trade

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① On the STCs see Green, S. *China's Stock Market, 1984—2002: Equity Politics and Market Institutions*, Routledge Curzon, London, forthcoming 2004, pp. 118—134.

② In Chinese this new off-exchange market is known as the "one-and-half-tier" (*yijiban shichang*) market. The Chinese call the IPO/primary market the first-tier (*yiji shichang*) market, and the trading market the secondary market (*erji shichang*). Various web-sites offer information as to prices and information regarding the firms traded in various locales on this "oneand-half-tier" market: http://www.lizilian.com, http://www.axtz.com, http://www.hifortune.com.

③ The listed company might, for instance, offer one share in itself for five shares of the informally-traded firm. About ten off-exchange traded companies in Zibo City, for instance, were acquired and merged into listed companies. Qinghua Tongfang bought Luying Electronics (Luying Dianzi), Wanjie High-Tech (Wanjie Gaoke) bought Wanjie Medicial Instruments (Wanjie Yiliao), Huaguang Ceramics (Huaguang Taoci) bought Shandong Huibao, Qingdao Shuangxing bought Huaqing Gufeng and Luxi Chemicals (Luxi Huagong) bought Luping Chemicals (Luping Huagong).

informally.

At around the same time, during 2000—2001 there was a huge increase in the number of auctions being held for legal person (*faren gu*, hereafter LP) shares①. LP share auctions had their origins in a speculative play on the part of *zhuangjia*, the well-capitalised investors who play (and manipulate) the share market. In early 2000, many of them came to the conclusion that the State Council would soon allow LP shares to be converted into normal individual shares and be listed so many travelled around the country and buying up tens of thousands of LP shares, usually for less than 10% of the price of the listed shares. They then started organising auctions for these LP shares, mostly in Shanghai, but also in Beijing and Shenzhen. The buyers and sellers at these auctions were large investors who set up small private companies to facilitate their ownership of LP shares (individuals still being banned from owning them). Shares were initially traded at close to their net asset value (NAV) but then rose in price, although to levels still well below market prices. According to the *China Economic News*, Shanghai hosted auction trade worth Rmb500m ($60m) in the first five months of 2001. Another report claimed that in the first four months of the year auction firms nation-wide received close to Rmb30 m ($3.6m) in commission fees. However, prices soon dropped as it became obvious that the CSRC was not going to make LP shares tradable anytime soon. Moreover, at the end of 2001, concerned that the market was growing out its control, the CSRC clamped down, banning transfers of LP shares that amounted for less than 5% of total share capital. This effectively killed the LP share auction market②.

After the decline of the informal market in LP shares, in many locales trading in non-listed firm shares resumed. An investigation by Shanghai Stock Exchange (SHGSE) in December 2002 estimated that there were more than 100 off-exchange share markets before 1998, about 30 of which were highly active. 17 of them (such as the markets in Zibo (Shandong), Chengdu (Sichuan), Shenzhen, Xi-an (Shaanxi), Fuzhou (Fujian), Haikou (Hainan), and Tianjin) were national in scope, attracting investors from all over the country③.

① See Green, S. *China's Stock Market: A Guide*, London: Profile Books, pp. 194—195.

② Interview, Shenzhen, September 2003.

③ Liu Ti and Lu Xiaonan, "Xi'an Tijiban Shichang Diaocha Baogao [The Off-Exchange Stock Market in Xi'an City]", Shanghai Stock Exchange Working Paper, February, 2003.

The Red Temple (*Hong Miao*) market in Chengdu City is one of the most famous off-exchange markets, having survived in various forms from the early 1990s to the present day①. At the time of writing the daily turnover of the market had fallen to some 300 000 shares a day, while the market hosts trading in the shares of some 100 companies traded and 20 member firms②. The Zibo market in Shandong Province is another active informal market. Since Shandong Bohai Company issued shares in 1984, 40 Shandong-based companies have listed shares on the Shanghai and Shenzhen exchanges and 147 have had their shares traded in other share markets in the province. Among them, the shares of 126 companies were traded in Zibo City. The Zibo Automated Quoting System (*Zibo Zizong Baojia Xitong*, hereafter ZAQS) began operations in 1993 and after the closure of the system by the CSRC in 1998, a black market sprung up again in various places. One of the reasons for this is that several dozen companies previously traded informally have been accepted for a formal listing in recent years. This creates incentives for black market activity since investors speculate that than one day all informally traded shares will be accepted for formal trading③. The Xi'an off-exchange market has also been popular. By the end of June 2001, there were 232 shareholding companies based in Shaanxi Province, with 17. 8bn shares in total. However, only 22 of them were formally listed. According to a survey by the CSRC's Xi'an office in 2002, the shares of more than 60 of the others were being traded. This involved some one billion shares, worth some Rmb1. 5bn ($181m) in capitalisation and about 100 000 active investors in Xi-an④. Many

① Named after the site where the first informal trading took place in the early 1990s, the open-air *Hong Miao* market has since moved site, indoors, though it informally retains the same name and is known formally as the Chengdu Technology and Property Rights Exchanges (*Chendu Jishu Chanquan Jiaoyisuo*). The market is now situated on the first and second floors of the Huoju Building, 16 Chuangye Road, High-and-new Tech Zone, Chendu City, Sichuan Province, http://www. ccdtse. com.

② Figures provided by Wei Feng, general manager of Anhui Xinfeng Investment Consulting Company, a member firm of the Chengdu market.

③ About ten off-exchange traded companies in Zibo City were acquired and merged into listed companies, e. g. , Qinghua Tongfang bought Luying Electronics (Luying Dianzi), Wanjie High-tech (Wanjie Gaoke) bought Wanjie Medicial Instruments (Wanjie Yiliao), Huaguang Ceramics (Huaguang Taoci) bought Shandong Huibao, Qingdao Shuangxing bought Huaqing Gufeng, and Luxi Chemicals (Luxi Huagong) bought Luping Chemicals (Luping Huagong).

④ CSRC, Xi'an Office, "Xi'an Dixia Gupiao Shichang Baogao [A Report about the Off-Exchange Stock Market in Xi'an City]", mimeo, 2002. The CSRC in Xi-an, together with the Public Security Bureau and Industrial and Commercial Bureau, were anxious to close the market down. At the end of 2002 the market was reported to have "disappeared", though this is no guarantee that trading has stopped entirely.

of the companies whose shares were traded were high-tech concerns hoping to eventually list on the proposed second board.

Shares traded in the off-exchange market are characterised by small capitalisation and low prices. Prices of stocks usually vary between Rmb1 and Rmb2, compared to the average price of shares of formally listed companies of about Rmb10 at the end of 2002. Investors do speculate on this potential mark-up. For instance, a former off-exchange traded company, "Small Commodity City" (*Xiao Shangpin Cheng*), was listed on the SHGSE in May 2002 with a first-day opening price of Rmb27 (US$3.3). The share had been previously traded informally in Zhejiang province at around Rmb4—5. There are numerous stories of investors in off-exchange shares becoming very rich. According to a report in the *Securities Times*, Huang Wusheng earned more than Rmb10m (US$1.2m) with an initial investment of Rmb15 000 (US$1 814) both through investing himself and acting as a broker (see below)①. However, there are of course considerable risks also attached: shares may not ever be formally listed and returns are uncertain. Though the prices of many off-exchange shares have doubled or tripled in price in the last three years, the prices of others have fallen dramatically. Indeed, the prices of a few stocks have fallen from Rmb8—10 to about Rmb1, and sometimes lower than the per share net asset value.

2 How today's informal share market works

2.1 How to issue shares in the off-exchange market

There are three methods by which a firm can issue shares to the public in the off-exchange market. First, the firm can issue shares directly to the public. However, the usual method is to sell the shares through professional marketing firms or though share "touts" (known in Chinese as *huangniu*)②. Touts' main business is brokering, but some also sometimes underwrite firms' offerings. A well-capitalised tout may even buy all the shares and then sell them to the public at a mark-up over a long period of time.

Second, the founders of a firm may sell a limited number of their shares to the public. In practice this can happen in three ways. First, the firms' founders sell their shares to the public. Persons who have just committed to

① *The Securities Times* (*Zhengquan Shibao*), August 6th 2001.

② Literally "yellow bull". The authors are unsure of the derivation of the name. Yellow is obviously the colour of gold, so the term may have developed as a moniker for what were bullish and probably rich people.

contributing capital to the company but have not yet actually invested the money, can sell their "virtual" shares after they have been recognised as shareholders by the company. For example, Baolai Biologic, a bio-medicines manufacturer based in Shaanxi Province, applied to become a shareholding company with one person holding 19% of the company's shares and committing Rmb7.3m ($885 000) in capital to the new company. However, the money was not paid into the company's account. Just after the government approved the establishment of the shareholding company, the investor sold the virtual shares①. In the third case, some founders of an already going-public company sell their shares to the public before the period of restricted trading outlined in the Company Law has lapsed.

Third, intermediaries sell the shares they hold to the public. Some intermediaries, including commercial banks, finance companies and securities firms first buy all the shares at a firm's IPO and then sell them in the off-exchange market. Sometimes the firm offers some shares as a reward for the intermediaries' efforts in marketing the company's shares, and the intermediaries sell these shares to the public too.

For a share to be listed at an off-exchange market, either a market maker (see below) will recommend the firm's shares to be listed, or the firm's owners will approach the market maker or the market's organiser. The firm involved then signs a share depository and registration contract with the market organiser, with the issuance price determined by the market maker and the market organiser, with reference to the firm's financial performance②. After that, the sponsoring market maker will offer to trade the shares for a set period.

2.2 How to trade shares in the off-exchange market

In the off-exchange market most shares are issued and traded physically, whereas all shares traded in the formal exchange markets are traded electronically with all share certificate held by the two clearing and settlement companies. Figures 1 and 2 show a sample share, that of Integrity Software (*Zhengwei Ruanjian*). The front side carries the company's name and the number of shares the certificate represents (5 000 shares in this example). The obverse is used for transfer endorsements. Investors in the off-exchange

① Liu Ti and Lu Xiaonan, "The Off-Exchange Stock Market in Xi'an City", Shanghai Stock Exchange Working Paper, February 2003.

② The Shenzhen High and New Tech Exchange charges a depository fee for a company of Rmb6 000 ($725).

market can trade shares in the following four ways.

Figure 1 Sample share traded in the off-exchange market (front)[①]

股 东 登 记 栏

股　东	背书栏	经办人	股　东	背书栏	经办人
姓名 身份证	年 月 日	年 月 日	姓名 身份证	年 月 日	年 月 日
股　东	背书栏	经办人	股　东	背书栏	经办人
姓名 身份证	年 月 日	年 月 日	姓名 身份证	年 月 日	年 月 日

备注：股东以此凭证在有关机构办理确认、托管等有关手续。

Figure 2 Sample share traded in the off-exchange stock market (back)

2.2.1 Market makers

In the better-organised informal markets, investors can trade with market makers. Since the STCs were closed, the most famous of the more formal markets are the Chengdu Technology and Property Rights Exchange (*Chengdu Jishu Chanquan Jiaoyisuo*) and the Shenzhen High and New Technology Exchange (*Shenzhen Gaoxin Jishu Jiaoyisuo*). At the start of 2003, the Chengdu market had some 20 member firms each of whom had two persons situated on the trading floor of the market acting as market makers on behalf of their firm. They quote prices for the stocks their firm has chosen to provide a market in, providing the bid and ask price with a narrow spread. To

① The authors hasten to add that Liu Ti did not purchase this share, but instead made a copy of a photo of it from CSRC Xi'an office.

become a member firm of the market, the broker-dealer (usually an investment or consulting firm) must meet certain criteria laid down by the market organisers. For example, the Shenzhen High Technology Exchange requires its members to deposit Rmb500 000 (US $60 000) as a guarantee. Some markets require that member firms who make a market in a particular stock must hold at least 3% of the total shares of that company in order to ensure that the market maker can ensure adequate liquidity.

2.2.2 Stock touts

Investors can trade with stock touts, people who play an important role, especially in the less well-organised markets. Touts usually congregate around a trading site and set up stalls, placing an advert in front of their desk on which the names and prices of ten to 40 stocks are displayed. Figure 3 shows an example of such a list, and Figure 4 shows the name-card of Mr. Dai Zhengli, a tout who trades in a number of companies including Jinye Xinhua, Weitong, and Xifei in Xi-an. According to the CSRC's Xi'an office, there are sometimes hundreds of touts offering to trade in the city's market[①]. There are, in general, two kinds of tout. Some operate like securities brokers, buying and selling shares on behalf of their customers but not holding shares themselves. They charge commission (on both the buyer and the seller) with the commission usually priced at less than Rmb0.1 per share. Other touts not only act as brokers, but also engage in proprietary trading.

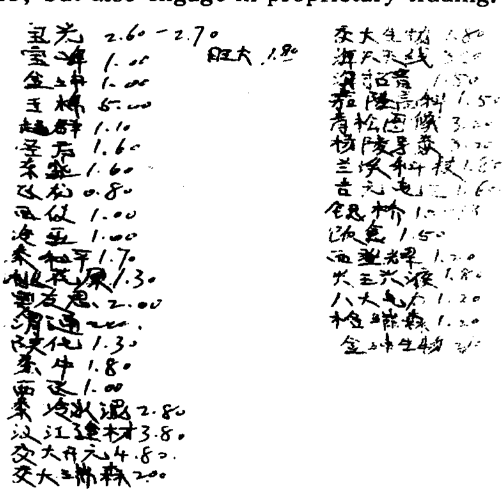

Figure 3 A share tout's company quotes

① CSRC, Xi'an Office, "A Report about the Off-Exchange Stock Market in Xi'an City", mimeo, 2002.