The Chinese Stock Market: A Review and Future Reforms

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Goals of Establishing a Stock Market

- Efficient markets allow efficient allocation of resources;
- Providing **equity** capital to support firms’ innovations and growth, esp. tech firms and new industry (services) firms in the non-state sectors;
- A developed market provides long-term savings vehicle for households, firms and the government;
- Improving firms’ corporate governance
Main Topics to be Covered

- Brief History of the Chinese Stock Market
- Institutional Background
- Performance of the Stock Market
- Crises and Future Reforms
- Conclusion

A partial literature review:

- Papers on the Chinese stock market
- Working paper by Allen, Qian, Shan, and Zhu (AQSZ, 2018)
Section 1. History of the Stock Market

- Establishment of the stock exchanges
- Stock market regulations
- Evolution of domestic (A-share) listed firms
Section 1. History of the Stock Market

- Establishment of Stock Exchanges
  - **Time of Establishment and Market Size**
    - Shanghai Stock Exchange (SSE) was established on November 26, 1990
    - Shenzhen Stock Exchange (SZSE) was established on December 1, 1990
  - **Available products traded on the exchanges**
    - **Stocks**
    - **Fixed-income securities/bonds**
      - Treasury, local government bond, corporate bond, convertible bond
    - **Funds**
      - ETF, money market fund, open-ended fund, closed-end fund
    - **Derivatives**
      - Warrants, index futures, stock options (ETF50 option)
## Large Stock Exchanges in the World (End of 2017)

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Exchange</th>
<th>MktCap ($Mil)</th>
<th>Turnover</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>NYSE</td>
<td>22,081,367.01</td>
<td>60.00%</td>
</tr>
<tr>
<td>2</td>
<td>Nasdaq - US</td>
<td>10,039,335.64</td>
<td>116.79%</td>
</tr>
<tr>
<td>3</td>
<td>Japan Exchange Group</td>
<td>6,222,834.71</td>
<td>103.94%</td>
</tr>
<tr>
<td>4</td>
<td>LSE Group</td>
<td>5,611,031.74</td>
<td>67.19%</td>
</tr>
<tr>
<td>5</td>
<td>Shanghai Stock Exchange</td>
<td>5,084,357.76</td>
<td>161.60%</td>
</tr>
<tr>
<td>6</td>
<td>Euronext</td>
<td>4,393,016.14</td>
<td>47.96%</td>
</tr>
<tr>
<td>7</td>
<td>Hong Kong Exchanges and Clearing</td>
<td>4,350,500.69</td>
<td>49.18%</td>
</tr>
<tr>
<td>8</td>
<td>Shenzhen Stock Exchange</td>
<td>3,617,883.45</td>
<td>264.54%</td>
</tr>
<tr>
<td>9</td>
<td>TMX Group</td>
<td>2,367,131.58</td>
<td>56.64%</td>
</tr>
<tr>
<td>10</td>
<td>National Stock Exchange of India</td>
<td>2,351,463.85</td>
<td>51.01%</td>
</tr>
<tr>
<td>11</td>
<td>BSE Limited</td>
<td>2,331,568.12</td>
<td>7.46%</td>
</tr>
<tr>
<td>12</td>
<td>Deutsche Börse AG</td>
<td>2,262,233.41</td>
<td>67.25%</td>
</tr>
</tbody>
</table>
Market Cap/GDP of Large Countries (in %)
Section 1. History of the Stock Market

- Stock Market Regulations
  - Security Laws
    - Passed by the National Peoples’ Congress of China on December 29, 1998 and recently revised in 2014
  - Regulatory reforms and changes:
    - Restrictions of price limit (1996)
    - Reduction of stock brokerage fees 佣金 (2002) and the stamp duty 印花税 (2009)
    - Introduction of the split-share reform (2005-2007)
    - Introduction of margin trading 融资融券 (2010), stock index futures and government bond futures (2010), and the ETF50 options (2010)
    - Launch of the small-and-medium sized enterprises board 中小板 (SME broad), the growth enterprises board 创业板 (GME board) and the New Third Market 新三板;
    - Introduction of QFII (2002), QDII (2006), and RQFII (2011);
    - Launch of the Shanghai-Hong Kong Connect (2014), and Shenzhen-Hong Kong Connect (2016)
    - A share added to MSCI index in 2018
    - Shanghai-London Connect to be launched this year (?)
### Sec 1. Composition of firms (AQSZ Table 1)

#### Panel A. # of Chinese Stocks Listed in A-Share and in External Markets

<table>
<thead>
<tr>
<th>Year</th>
<th># Listed Firms</th>
<th># of Listed SOEs</th>
<th>Average Assets ($ Billion)</th>
<th># Listed Firms</th>
<th># of Listed SOEs</th>
<th>Average Assets ($ Billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>1379</td>
<td>779</td>
<td>0.34</td>
<td>73</td>
<td>46</td>
<td>3.22</td>
</tr>
<tr>
<td>2001</td>
<td>1406</td>
<td>844</td>
<td>0.43</td>
<td>86</td>
<td>47</td>
<td>2.93</td>
</tr>
<tr>
<td>2002</td>
<td>1585</td>
<td>900</td>
<td>0.53</td>
<td>102</td>
<td>47</td>
<td>2.92</td>
</tr>
<tr>
<td>2003</td>
<td>1705</td>
<td>796</td>
<td>0.60</td>
<td>125</td>
<td>53</td>
<td>3.33</td>
</tr>
<tr>
<td>2004</td>
<td>1755</td>
<td>820</td>
<td>0.72</td>
<td>155</td>
<td>62</td>
<td>3.60</td>
</tr>
<tr>
<td>2005</td>
<td>1757</td>
<td>813</td>
<td>0.83</td>
<td>211</td>
<td>70</td>
<td>6.45</td>
</tr>
<tr>
<td>2006</td>
<td>1802</td>
<td>823</td>
<td>0.94</td>
<td>264</td>
<td>80</td>
<td>11.50</td>
</tr>
<tr>
<td>2007</td>
<td>2032</td>
<td>841</td>
<td>1.11</td>
<td>352</td>
<td>102</td>
<td>11.46</td>
</tr>
<tr>
<td>2008</td>
<td>2312</td>
<td>858</td>
<td>1.18</td>
<td>410</td>
<td>111</td>
<td>12.97</td>
</tr>
<tr>
<td>2009</td>
<td>2593</td>
<td>873</td>
<td>1.26</td>
<td>461</td>
<td>123</td>
<td>14.86</td>
</tr>
<tr>
<td>2010</td>
<td>2712</td>
<td>910</td>
<td>1.47</td>
<td>561</td>
<td>131</td>
<td>17.79</td>
</tr>
<tr>
<td>2011</td>
<td>2760</td>
<td>902</td>
<td>1.68</td>
<td>603</td>
<td>133</td>
<td>21.14</td>
</tr>
<tr>
<td>2012</td>
<td>2747</td>
<td>943</td>
<td>1.83</td>
<td>582</td>
<td>141</td>
<td>25.12</td>
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<tr>
<td>2013</td>
<td>2570</td>
<td>1157</td>
<td>1.89</td>
<td>614</td>
<td>140</td>
<td>28.33</td>
</tr>
<tr>
<td>2014</td>
<td>2425</td>
<td>919</td>
<td>2.28</td>
<td>610</td>
<td>172</td>
<td>33.24</td>
</tr>
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</table>

### # of Unique Firms and Average Total Assets

<table>
<thead>
<tr>
<th># of Unique Firms</th>
<th>Average Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>2872</td>
<td>1219</td>
</tr>
</tbody>
</table>
Section 2. Institutional Features of the Market

- The Initial Public Offering (IPO)
- The Delisting Process
- Trading Mechanisms and Regulations
Section 2. Institutional Features of the Market

- The Initial Public Offering (IPO)

- The CSRC set a series requirements on the listing firm’s information disclosure, operation, accounting quality and usage of proceeds raised from stock issuance.

- It sets especially strict requirements on earnings and cash flows for the issuing firm:
  - Positive earnings in the past three consecutive years;
  - Accumulated earnings exceed 30 million RMB yuan;
  - Accumulated cash flows no less than 50 million RMB yuan in the past three consecutive years, or
  - The cumulative operating income has exceeded 300 million yuan;
  - Besides, the minimum capital stock has to be no less than 30 million yuan prior to IPO.
Section 2. Institutional Features of the Market

- The Delisting Process

- **Special treatment firms**
  - Firms that experience losses for two consecutive years would receive ST, and firms that experience losses for three consecutive years would receive warnings for delisting.

- **Restructuring and Delisting**
  - A voluntary delisting results from a firm being privatized.
  - An involuntary delisting usually happens when the firm violates regulations or cannot meet the minimum financial requirements set by the exchange.
    - On March 21, 2016, ST Boyuan was delisted from the A share. This is regarded as the first case of forced delisting due to serious illegal operations.
  - Firms listed in China stock market are rarely delisted.
ST Firms in China and Delisted Firms in the US (AQSZ Fig 7)
Section 2. Institutional Features of the Market

- Trading Mechanisms and Regulations:
  - The daily price change limit (+/- 10% 涨跌停板)
  - T+1 trading rule (T+0 for futures and options)
  - Trading suspension (停牌)
  - Circuit breaker (熔断机制)
  - The B-share market
  - Key regulations: insider trading, market manipulation, disclosure requirements, etc.
Section 2. A Case Study

- **China Everbright Securities (光大证券’乌龙指’事件)**
  - 11:05 on August 16, 2013, Shanghai Composite Index rose by 100 points within 1 minute, more than 5%
  - Prices of more than 70 stocks went up by 10%
  - **Defective trading system**: mistakenly triggered buy-order of RMB 23 billion (original order is 80 million)
    - Lost 194 million in a single day
    - Market value lost RMB 4 billion
    - Fined 500 million by CSRC due to suspicious market manipulation and insider trading

- **Findings and lessons:**
  - Firm level: defective trading system, *the firm did not have a warning system*
  - Exchange level: *No automatic reaction mechanism to abnormal price movement; No circuit breaker for individual stocks*
Section 2. Institutional Features of the Market

- Stocks Listed and Traded on Different Boards
  - **Main stock exchanges**
    - Strict listing requirement:
      - Positive earnings in the past three consecutive fiscal years, and the cumulated earnings should be no less than 30 million RMB yuan
  - **Second-tier market:**
    - Growth Enterprise Market (GEM; 创业板, October 2009)
    - Nasdaq in the US and Alternative Investment Market (AIM) in the UK
    - Looser requirement on earnings and cash
    - Small-and-Medium Enterprise Board (SME; 中小板 May 2004)
      - Transitory form of the GEM Board
  - **Third-tier market**
    - Old Third-board Market was an over-the-counter market dominated by low-quality stocks with little liquidity
    - New Third-board Market” (新三板; Sep 2012) or “New over-the-counter (OTC) Market”, aimed to provide a pilot trading platform for transfer of shares of unlisted private firms
Section 2. Institutional Features of the Market

- **Stock Market Products**
  - Exchange-traded funds (ETF)
  - Warrant
  - Index future
  - Stock/index option
  - The Shanghai- and Shenzhen-HK Connect

- **Unintended consequences**
  - It is found to be exploited by speculative investors for regulatory arbitrage.
  - Some risk-taking investors in mainland China have been seeking ways to **lever up** their positions by circumventing the regulation.
  - Anecdotal evidence shows that some stock brokerages and private equity funds in the mainland raise cheap debt financing in Hong Kong and then invest in A-share stocks under the Shanghai-HK Connect.
  - The real leverage of the position has exceeded the asset-management regulatory minimum but is out of the reach of window operation in mainland.
Section 2. Institutional Features of the Market

- **The HK stock market**
  - As of May 2018, there are 2,201 firms listed in the Hong Kong Exchange, with the total market capitalization amounting to 35 trillion HK dollars
    - 1,076 firms from mainland listed in the HKSE
  - A variety of financial products are actively traded in the Hong Kong Exchange
    - Stocks and bonds
    - Securities include exchange traded products (ETF), Real Estate Investment Trust (REIT)
    - Structured products such as derivative warrants, callable bull/bear contracts, and debt securities
    - Shorting allowed
  - Different listing standards as compared to A share
- **Recent reforms in HK market:**
  - Biotech firms: can IPO without making a profit
  - Dual-class shares allowed
Section 2. Institutional Features of the Market

- Chinese Firms Listed in HK and Overseas Market
  - Direct listing: IPO
    - CSRC sets a series of requirements that the firm has to meet
  - Indirect listing: Reverse mergers ("借壳上市")
    - "Reverse takeover" or "backdoor listing"
    - RMs are generally cheaper and quicker than traditional IPOs, while the amount of capital raised via an RM is much less than what would be available from an IPO (Lee, Li, and Zhang, 2014)
  - Lee, Li, and Zhang (2014) document 146 Chinese firms getting listed in the US stock exchange through a reverse merger
    - They find “no evidence that CRMs are systematically more problematic than similar firms already trading on the same exchange”
    - More interestingly, they find CRMs outperformance US RMs in the long run (subsequent one to three years) in terms to stock returns and operating performance
Section 3. Performance

- Metrics and characteristics: Returns, valuation, liquidity, turnover ratio, volatility, etc.

- Performance of stocks and markets:
  - Performance of stock index
  - Performance of individual stocks
  - Factor models in A-share market
  - Reaction to news and policy changes
  - Synchronicity, investor behavior, market efficiency

- Performance of listed firms (AQSZ, 2018):
  - Earnings, investment, net cash flows
  - Contrasting with firms listed in other large countries
  - Contrasting with Chinese firms listed in HK and overseas markets
  - Contrasting with unlisted firms in China
  - Corporate governance and related-party transactions
Bekaert, Chen and Zhang (2017): The P/E ratio in China has been significantly than in the US.
Volatility: Hu, Pan and Wang (2018, Figure 3.1)

- Monthly returns of large stocks listed in A share market
Volatility: Hu, Pan and Wang (2018, Figure 3.2)

- 5-year Rolling standard deviation of large and small stocks listed in A share market

Figure 3.2: Rolling 60-Month Standard Deviation (%) for Large and Small Company Stocks
Comparison of Risk (annual return vol based on monthly returns; AQSZ 2018)
Performance

- Performance of A-share listed stocks
  - Performance of stock index
    - The performance of A share market has been poor in the long run (Allen, Qian, Shan and Zhu, 2018)
    - A share market offers low correlation with other equity markets (Allen et al, 2018; Carpenter, Lu and Whitelaw, 2018)
    - Stock prices are informative about future profits as they are in US (Carpenter et al, 2018)
  - Performance of individual stocks
  - Factor models in A-share market
    - Size and value factor, with P/E rather than M/B as the valuation measure (Liu, Stambaugh and Yuan, 2018)
    - Significant size effect (Chen, Hu, Shao and Wang, 2018)
    - Reaction to news and policy changes (synchronicity, investor behavior etc)
AQSZ Fig. 2: Buy-and-hold Returns of Major Stock Indices
(Jan 1992 – Dec 31, 2017; inflation adjusted; cash dividends included)
AQSZ Fig. 4: Buy-and-Hold Returns of Listed Stocks in Large Countries (2000-2014; inflation adjusted; dividend included)
AQSZ Fig. 5: Buy-and-hold Returns of Stocks vs. Bank Deposits in China (2000-2014; inflation adjusted)
Market Efficiency and Synchronicity

- The Chinese warrant bubble in 2005-2008
  - Xiong and Yu (2011)
  - Each warrant was traded more than three times within one day at inflated prices
  - Highlight joint effects of short-sale constraints and heterogeneous beliefs in driving bubbles
- Stock prices are informative about future profits as they are in US: Carpenter et al, 2018
- Stock prices move together more in poor economies than in rich economies. This is explained poor investor property rights in emerging markets (Morck, Yeung, and Yu, 2000)
- The A-share market has higher synchronicity than other markets in the world (Jin and Myers, 2006)
  - The stock market synchronicity is higher in countries with low per-capita GDP and less developed financial systems
  - Information opaqueness reduces firm-specific risk and increases synchronicity
Dividend Payout

- **Low (cash) dividend payout** in A share market than other large markets

<table>
<thead>
<tr>
<th>Dividend Yield (Dividend/Stock Price)</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>0.20%</td>
<td>0.65%</td>
<td>0.47%</td>
</tr>
<tr>
<td>US</td>
<td>1.40%</td>
<td>2.06%</td>
<td>2.62%</td>
</tr>
<tr>
<td>Brazil</td>
<td>1.00%</td>
<td>3.84%</td>
<td>4.83%</td>
</tr>
</tbody>
</table>

- Reasons for the low and unstable dividend payout in the A share market:
  - Lack of competition
  - Problematic IPO mechanism
  - Concentrated ownership structure: Minority shareholders and retail investors cannot voice their dis-satisfaction
Panel A1. Investment: Firms Listed in China vs. Firms Listed in Other Large Countries
Panel A2. Investment: Firms Listed in China and Chinese Firms Listed Overseas
Panel B1. Net Cash Flow/Total Assets: Firms Listed in China vs. Firms Listed in Other Large Countries

- China
- United States
- India
- Brazil
- Japan
AQSZ Fig. 6: Listed and Matching Unlisted Firms in China (ROA)
Summary of AQSZ (2018)

- Disconnection between economic growth and stock market in China

- We compare listed firms in China with:
  - Listed firms from developed and developing countries
  - Unlisted firms in China

- Explaining the poor performance
  - Problems with the listing and delisting process; low investment returns

- Implications:
  - Listing process: Lowering standards, encourage the listing of more privately owned and growth firms, administrative process => market process (‘registration’ system)
  - Delisting process: Tougher regulations on delisting
  - Corporate governance (e.g., restrain RPTs)
Section 4. Crises and Further Reforms

- **The 2007-2008 Market Rise (bubble) and Crash**
  - Before May 2007: The stock prices tripled in 2005-2007, peaked at 6100; partly due to investors’ high sentiment after the split-share reform
  - **2007.5.29 midnight:** The Ministry of Finance of China announced that the *stamp duty* will be raised from 0.1% to 0.3%
  - **2007.5.30:** the Shanghai Stock Exchange Composite Index (SSE Index) dropped by 281.83 points, or 6.5%; the Shenzhen Stock Exchange Index dropped by 829.45, or 6.2%
  - **2007.5.31:** The A share stock index slightly increased. However, the number of stocks that see price increase far exceeded the number of stocks that see price decrease: 237 stocks’ prices went up; 612 stocks’ price went down, out of which 170 stocks saw their price drop hit the daily price change limit
  - **2007.6.1:** The majority of A-share stocks have price drop. The A share index dropped significantly before closing. The SSE Composite Index declined by 2.65%. The Shenzhen Component Index declined by 3.95%. More than 600 stocks’ price drop hit the limit
  - **2007.6.4:** The “Black Monday”. The SSE Composite Index declined by 8.26%. More than 700 stocks’ price drop hit the limit
  - **After June 2007:** Stock prices continued to drop, Shanghai Composite index bottomed at 1600 in 2008
Section 4. Crises and Further Reforms

- The 2015 Market Crash
- Timeline (June 15-August 26, 2015)

- First Round of Crash
  - First week (June 15-June 19):
    - The SSE Composite Index, Shenzhen Component Index, and the GEM Board Index dropped by 13.32%, 13.11%, and 14.99%, respectively
  - Second week (June 22-June 26):
    - June 26 is a “Black Friday”, on which more than 2,000 stocks’ price drop hit the daily price change limit
    - June 27, the Peoples’ Bank of China (PBOC) announced a 0.25% decrease in the base interest rate
  - Third week (June 29-July 3):
    - June 29, around 1,500 stocks’ price drop hit the limit
    - June 30, the SSE Index recovered by 5% to 4,200 points
    - July 2, the CSRC announced its plan to inspect market manipulation
    - From June 15 to July 3, the SSE Index, Shenzhen Component Index and the GEM Board Index dropped by 28.64%, 32.34% and 33.19%, respectively
Section 4. Crises and Further Reforms

- **The 2015 Market Crash**

- **Timeline (June 15-August 26, 2015) – Cont’d**
  - July 4, the State Council called together the PBOC, CSRC, China Banking Regulatory Commission (CBRC), China Insurance Regulatory Commission (CIRC), Ministry of Finance and officials of large state-owned enterprises to discuss possible ways to save the market.
  - July 5, CSRC announced that PBOC will take a variety of measures to provide liquidity to China Securities and Financial Limited, which is the key platform in the rescue.

- **Fourth week (July 6-10):**
  - July 6, the SSE Composite Index rose by 2.4%, while the CIC 500 Index dropped by 9%. More than 1,000 stocks experienced a price run-up at opening but a quick reverse afterwards, and the price drop finally hit the limit at closing.
  - July 7, The majority of the stocks listed on the GEM Board dropped by 10%. Over 50% of the stocks suspended trading.
  - July 8, the SSE Index dropped by 5.9%. 1,300 stocks’ drop hit the limit. More than 1,400 stocks are in trading suspension.
  - July 10, the SSE Index rose by 4.54%. More than 1,300 stocks’ price increase hit the limit. Market indices become stable.
Section 4. Crises and Further Reforms

- **Second Round of Crash**
  - **August 11:** Exchange rate reform
  - **August 18-26:** The SSE Composite Index dropped by 25% to below 3,000 points. Thus far, the SSE Composite Index shed 38% of its value from June 12 to August 24
  - **August 24:** Another “Black Monday”, the SSE Composite Index dropped by 8%. On the same day, world stock market went down substantially. Commodity prices and most Asian currency hit historical new low with the stock market plunge.
  - **August 25:** Another day of sharp losses on the SSE Composite Index which dropped by 7.6%
  - **August 26-September 25:** Second round of rescue started. The SSE Index became stabled at 3,000 points
Section 4. Crises and Further Reforms

- The 2015 Market Bubble and Crash

- A series of government interventions:
  - Government purchase program:
    - Government purchase increased value of the rescued firm with a net benefit about 5% of the Chinese GDP. Government purchase reduced default probability and increased liquidity (Huang, Miao and Wang, 2016)
  - Prohibiting large shareholders from selling, suspension of trading
  - Short-lived circuit breaker
  - Jan 4-7, 2016
Section 4. Crises and Further Reforms

- The 2015 Market Bubble and Crash

- 场外配资 (shadow margin lending), margin trading

  - Margin investors heavily sell their holdings when their account-level leverage edges toward their maximum leverage limits. Unregulated and highly-leveraged shadow financed margin accounts contributed more to the market crash (Bian, He, Shue and Zhou, 2017)

  - Individual margin traders have a strong tendency to scale down their holdings after experiencing negative portfolio shocks. Returns of stocks help forecast future returns of stocks that share common margin-investor ownership (Bian, Da, Lou and Zhou, 2017)
Section 4. Crises and Further Reforms

- Problems in the current “bear market”:
  - 股权质押 (bank loans using stocks as collateral): Qian (2018)
  - Almost all listed firms have this type of loans
  - When prices fall below “平仓线” => forced sale of stocks => greater drop in stock prices (also drop in related stocks) => more forced sales
  - Key is how to price collateral asset (stock)?
    - Mark-to-market vs. pricing model based on disclosed firm info.
    - Similar episodes during crisis in the US (2008-09) and Japan (1990s)
  - What to do with bad loans on the banks’ balance sheet?
Sec 4. Ongoing and Further Reforms

- Restrictions on margin trading and leverage (including brokerage and WMPs)
- Development in derivatives market: lift restrictions on index future trading; options on individual stocks; reduce cost of shorting
- Trading mechanisms: 停牌 too frequent suspension
- Encouraging (long-term) institutional investors to enter the market
- Reforms on IPO mechanism
- Tougher punishments (and consistent enforcement) for breaking laws and regulations
Section 4. Further Reforms

- Goals of market regulation:
  - Government intervention hurts information efficiency of asset prices. Government intervention is an additional factor driving asset prices, and can divert investor attention toward acquiring information about this noise factor rather than fundamentals (Brunnermeier, Sockin and Xiong, 2017).
  - Dual roles of regulator and SOE shareholder.
  - When to intervene and have credibility in the (global) markets and investors?
  - Protection of retail investors (paternalistic attitude) vs. developing an efficient market.
Conclusion

- The Chinese stock market has been developing rapidly since its inception in 1990
- Reforms on the IPO mechanisms, strengthening information disclosure and corporate governance, are much needed
- Call for more financial products
- Role of government and regulators in the market
- Further development of the stock market is one of the key tasks of the Chinese financial system in the next decade