A MINI REVIEW OF THE CHINESE STOCK MARKET: FROM 1978 TO 2010

Yi An*, Umesh Sharma**, Harun Harun*

Abstract

The Chinese economic reform, starting from 1978, facilitated the emergence and development of the capital markets. This paper provides a brief review of the Chinese stock market from various perspectives, such as the regulation, issuance of shares, shareholding structure and financial reporting of listed firms, and future development. It is expected that our paper could offer readers and researchers who are interested in the Chinese capital market, particularly in the area of accounting and finance, a general understanding of the market.

Keywords: Stock Market, Regulation, Issuance, Ownership Structure, Financial Reporting, China

*Corresponding Author. Department of Accounting, University of Waikato Management School, Private Bag 3105, Hamilton, New Zealand
Tel: 64-7-856 2390
Email: ya13@waikato.ac.nz
**Department of Accounting, University of Waikato Management School, New Zealand
***Faculty of Business, Government and Law, University of Canberra, Australia

Introduction

Since the implementation of the "reform" and "openness" policy in 1978, China had achieved rapid economic growth over the past several decades. The Chinese stock market was established and developed during the period. There has been considerable empirical research concerned with the listed companies in the capital market (e.g. Ding and Graham, 2007; Liu and Liu, 2007; Liu and Shrestha, 2008; Huyghebaert and Quan, 2009; Cai et al., 2011). However, limited research provides an overall landscape as to the market. To fill the gap, we briefly reviewed the development and the characteristics of the market from various perspectives. The purpose of this paper is to inform the future empirical research relating to the Chinese stock market in the field of accounting and finance. It is expected that this paper could make readers and researchers, who are interested in the Chinese capital market, obtain a general understanding with regard to the market.

The paper is structured as follows. Section 2 describes the reasons and the process regarding the emergence of the Chinese stock market. In addition, two stock exchanges (Shanghai and Shenzhen) are introduced in this section. Section 3 presents how the Chinese government regulates the market through administrative and legal instruments. Section 4 demonstrates the evolution of the stock issuance system. The shareholding structure and the reporting framework of listed companies are detailed in section 5. Finally, section 6 draws some conclusions.

Emergence of the stock market

The economic reform paved the way for the emergence of the Chinese stock market (CSRC, 2008; Zhang et al., 2008). During the early 1980s, the Chinese government began to reform the state financial sector in order to fit in with the new economic situation. Some commercial banks[6] were established to replace the state planning budgetary system[7] as the main channels for Chinese enterprises to raise capital. It is apparent that borrowing from those commercial banks would generate high transaction costs for enterprises. Chinese enterprises, particularly those state-owned enterprises (SOEs), realized that they needed to diversity their funding channels rather than solely borrowing from the commercial banks or relying on the governmental grants or interest-free loans (CSRC, 2008; Seddighi and Nian, 2004). Meanwhile, the income of domestic residents grew rapidly commensurate with the country's rapid economic growth. However, they had to deposit their money in banks for minor interest rates owing to the shortage of investment channels (Liu and Shrestha, 2008; Yi and Davey, 2010). Some of them had attempted to seek new investment opportunities for higher rate of returns. Furthermore, the Chinese government attempted to attract capital

[6] Including Bank of China, China Construction Bank, Industrial and Commercial Bank of China, and Agricultural Bank of China.

[7] In that funds and capital were centrally administered and allocated to enterprises.

infusion in the state-owned enterprises so as to restructure the firms as well as improve the performance of them (Seddighi and Nian, 2004; Zhang and Zhao, 2004). In these circumstances, the Chinese stock market started to develop.

In the beginning, some informal stock markets, mainly initiated by small state-owned and collectively-owned enterprises in urban areas, were founded around the country. In January 1985, the first public offering of standardised corporate equity was launched by Shanghai Yanzhong Industrial. Subsequently, two over-the-counter markets appeared in Shanghai and Shenyang in 1986. Until November 1990, the first stock exchange was established in Shanghai with the approval of the Chinese government. Several days later, the second stock exchange, namely the Shenzhen stock exchange, started to operate in December 1990. Since then, a formal stock market has been formed in (mainland) China. In recent years, the Chinese stock market has grown rapidly to be the largest emerging market in the world (Ding and Graham, 2007; Zhang et al., 2008).

Chinese stock exchanges

At present, there are actually three stock exchanges in China. Two of them – the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE) – are in the Chinese mainland. Another one is Hong Kong Stock Exchanges and Clearing Limited (the full name of the Hong Kong Stock Exchange) located in Hong Kong. According to An et al. (2011, p. 109):

> *"Chinese (domestic) stock exchanges refer to the Shanghai and the Shenzhen stock exchange other than the Hong Kong stock exchange because Hong Kong is independent in economy although it has been a special administrative region of China since 1997. As a matter of fact, the Hong Kong stock market is defined as a developed market, whereas the Chinese stock market is regarded as an emerging market."*

In recent years, the two stock exchanges developed rapidly from both size and quality. The SHSE mainly focuses on large corporations. Until December 2010, there were a total of 894 companies listed on the SHSE with a total market capitalization of 17.9 trillion yuan[8]. The SZSE is concerned with not only large firms but also small and medium sized firms (SMEs). It set up a small and medium enterprise board in 2004 and a growth enterprise board in 2009 that allowed the SMEs with huge potential to raise funds in the capital market. The launch of the two boards facilitates the construction of a multi-tiered capital market in China. At the end of 2010, a total of 1169 firms, including 485 firms on the main board, 531 firms on the small and medium enterprise board, and 153 firms on the growth enterprise board, were listed on the SZSE, with a total capitalization of 8.64 trillion yuan.

Regulation

Regulation is defined by Mitnick (1980, p.5) as "the intentional restriction of a subject's choice of activity, by an entity not directly party to or involved in the activity". It is usually conducted by governmental agencies using legal weapons (e.g. laws, rules and regulations). The purpose of regulation is to protect both the public and the private interests. For the regulation of the Chinese stock market, it is carried out by a government-driven regulatory and supervisory framework and a legal framework, both of which are described as follows.

Regulatory and supervisory framework

As a formal stock market with two stock exchanges was launched in the early 1990s, the Chinese government attempted to establish a centralized regulatory and supervisory framework for the oversight of the market. The first initiative was setting up the Securities Supervision Office in the People's Bank of China (PBC, namely the central bank of China) in May 1992. Subsequently, the Securities Committee (SC) and the China Securities Regulatory Committee (CSRC) were established by the State Council in October 1992 so as to better oversee the market as well as work in accordance with international practices (CSRC, 2008).

In April 1998, the Chinese government consolidated the supervisory functions of PBC and SC into the CSRC, and made the CSRC become the solo regulator for the capital markets. Before long, the CSRC developed a regional supervision system by absorbing the provincial securities regulatory offices. With a total of 36 regional offices across the country (including 11 directly subordinated to the CSRC and 25 with independent planning status), a centralized regulatory and supervisory framework was constructed.

In 2004, the CSRC reformed the framework in that the regional supervision offices were reorganized into (36) provincial supervisory bureaus (refer to table 1), and supervisory responsibilities were decentralized to the local agencies. Meanwhile, CSRC also strengthened its coordination with local governments for the supervision of capital markets. It was acknowledged by CSRC (2008) that the introduction of the new system improved the regulatory and supervisory efficiency, and in turn facilitated the healthy and orderly development of the market.

[8] The unit of Chinese currency (RMB), one US dollar is approximately equal to six yuan.

Table 1. Provincial supervisory bureaus

Provincial supervisory bureaus (36)			
Beijing	Guangxi	Hainan	Chongqing
Guizhou	Gansu	Qinghai	Ningxia
Shenzhen	Xiamen	Tibet Autonomous Region	Fujian
Sichuan	Shanxi	Xinjiang	Yunnan
Tianjin	Hebei	Shanxi	Inner Mongolia Autonomous Region
Liaoning	Jilin	Heilongjiang	Dalian
Shanghai	Jiangsu	Zhejiang	Ningbo
Anhui	Shandong	Henan	Qingdao
Hubei	Hunan	Jiangxi	Guangdong

Moreover, the CSRC strengthened cooperation on market supervision with other international organizations (e.g. IOSCO, namely International Organizations of Securities Commissions) and its overseas counterparts. At present, it has been an ordinary member for all the committees (the President Committee, the Executive Committee, the Technical Committee, and the Emerging Markets Committee) in IOSCO. And since June 2006, Mr. Shang Fulin, Chairman of the CSRC has been the vice-chairman of IOSCO's Executive Committee. In addition, the CSRC had signed 43 bilateral Memorandums of Understanding (MOUs) with capital markets regulatory authorities in 39 countries and regions by the end of 2009. The cooperation contributes to the sharing of supervisory information, provides assistance on cross border investigations, and facilitates staff exchanges and cooperation on research (CSRC, 2008).

Legal framework

There are usually two elements for the construction of a legal system: first of all, the enactment of laws, regulations and rules; secondly, the enforcement of the laws, regulations and rules. In the following, the two elements for the construction of a legal framework for the Chinese capital market are described.

Laws, regulations and rules

Since the inception of the capital market, a number of laws, regulations and rules were issued by the Chinese government as instruments to regulate the market, including (under a chronologic order):

Laws

- *The company law* (implemented since July 1994): setting out specific provisions for the conditions of establishing a company, the organization of a company, share issuance and transfer, corporate bonds, liquidation procedures and legal liabilities; also setting standards of corporate governance for limited liability companies and joint stock companies, laying the legal foundation for the development of joint stock companies and in turn, the capital market.
- The purpose of the law: to protect the legitimate rights and interests of firms, shareholders and creditors; accelerate the restructuring of SOEs; and facilitate the economic growth.
- *The security law* (effective since July 1999): the first national law to regulate the issuance and trading of securities in (mainland) China; confirming the importance of the capital market and formalizing the legal status of the market.
- The purpose of the law: to protect the rights and interests of investors; maintain the healthy development of China's capital markets; safeguard the economy and public interests; and accelerate the development of the socialist market economy.
- Both laws were amended by the Standing Committee of the National People's Congress of the People's Republic of China in 2005 for the new development of the markets. [9]

Regulations and rules

- The *Provision Regulation on the Issuing and Trading of Shares* (effective in April 1993): to regulate share issuance and trading as well as the acquisition of listed firms.
- The *Implementation Rules on Information Disclosure of Companies Issuing Public Shares* (promulgated in June 1993): setting up standards for mandatory information disclosure of listed firms.
- The *Provisional Measures on Prohibiting Fraudulent Conducts Relating to Securities* and the *Circular on Prohibiting Securities Market Manipulation* (issued in August 1993 and October 1996, respectively): establishing the criteria for defining illegal trading activities and relevant supervisory sanctions.

The aforementioned laws, regulations and rules formed a fundamental legal framework for the

[9] However, the fundamental principles for both laws were not changed.

Chinese capital market, which significantly facilitated the take-off of the market, and laid a foundation for further improvement of relevant regulations and rules.

Enforcement

For the enforcement of laws, regulations and rules relating to the capital market, it was initially conducted by enforcement offices in the regional supervisory bureaus. In 2002, the CSRC set up a special securities crime bureau working together with the Securities Crime Investigation Bureau of the Ministry of Public Security (also established in 2002) to investigate crimes in the capital market (e.g. market manipulation and insider trading).

Until 2007, the CSRC established the Sanction Committee, Chief Enforcement Office and the Law Enforcement Task Force in Beijing, and reinforced its enforcement offices with a larger workforce in the regional bureaus. A centralized enforcement system was then established. In the system, the function of inspection and sanctions within the CSRC are separated, which avoids conflicts of interests as well as ensures professionalism, efficiency and justice in the law enforcement. The establishment of the law enforcement framework is very helpful to protect the interests of investors and ensure market integrity.

Issuance of shares

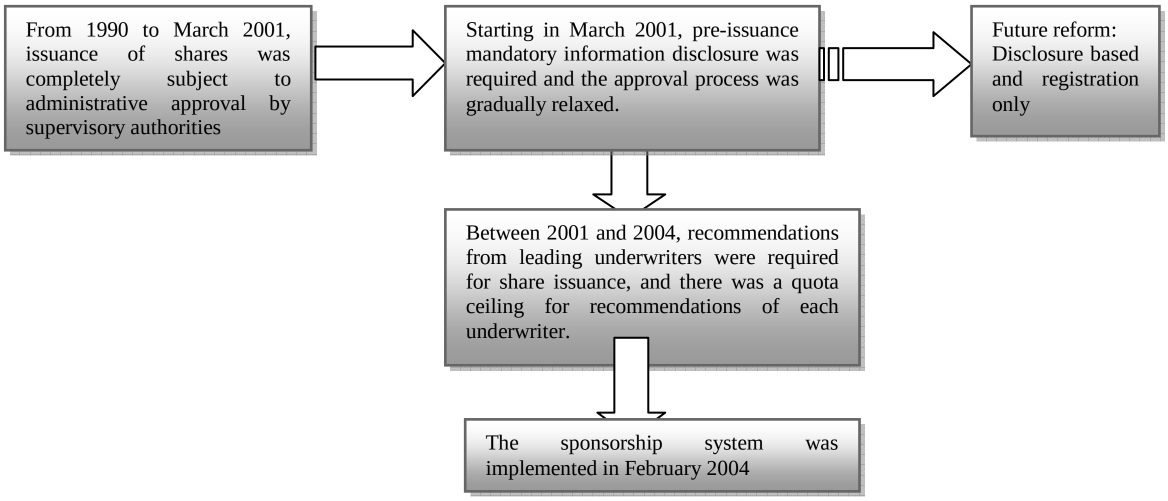
After the establishment of stock exchanges in the 1990s, stocks could be issued through public offerings to all investors around the country. However, the public offering of shares was subject to administrative approval from some governmental authorities. In the beginning, the CSRC along with the SPC (State Planning Commission) and the PBC (People' Bank of China) jointly undertook the administrative function. They imposed a quota for the new share issuance on an annual basis in order to curb the potential excessive (investment) demand in a pre-mature market where market participants had not obtained a profound understanding with regard to the market rules, their rights and obligations (CSRC, 2008; Huyghebaert and Quan, 2009).

The quota was then assigned to 29 industry supervising bodies and 32 provincial governments (including provinces, municipalities and autonomous regions) according to the distribution of the industry and production, and the regional economic development (Tian and Megginson, 2005). The industry supervising bodies and local governments would recommend enterprises for public offerings within the given quota on the basis of the firm-level performance, the attainment of the industry, and the local economic development objectives (Huyghebaert and Quan, 2009). The CSRC would make final decisions for the approval of public offerings through an internal committee (namely the Public Offering Review Committee). Once approved, initial public offerings (IPOs) of shares of enterprises were usually underwritten by leading firms in the security industry. The pricing of IPOs was determined by the profit after tax and a fixed price earning ratio set by the government.[10]

In March 2001, The CSRC introduced a new ex-ante review and approval system for public offerings of shares in that the pre-IPO mandatory information disclosure was required, and the approval process was relaxed gradually. In the meantime, leading underwriters, replacing the industry supervisory bodies and provincial governments, became referees for enterprises for the issuance of shares. However, they were limited in the number of recommendations. More recently, the CSRC reformed the issuance system again. A sponsorship system was introduced to replace the leading underwriter recommendation system. Under the system, sponsors (or representatives of the sponsoring institutions) should be qualified practitioners who come from securities firms or asset management corporations, with a license for underwriting IPOs. Moreover, one sponsor is required to work on one case (or enterprise) only at a time. Simultaneously, the pricing of IPOs was reformed in that a book-building process, principally supervised by the market, replaced the governmental approval for the share (issuance) price. Figure 1 demonstrates the evolution of the issuance system in the Chinese stock market.

[10] Issue price of a new share = profit after tax per share × price earning-ratio of the issue.

Figure 1. the evolution of the issuance system



Source: adapted from CSRC (2008, p. 219)

The recent reforms have accelerated the transformation of share issuance from being government-driven to being market-driven. However, compared with the developed markets in that public offerings are usually disclosure-based, and the registration is required by the supervisory authorities only, and the procedures for share issuance tend to be simple and standardized (with the share price determined by the market directly), there still leave spaces for China to further improve the share issuance system.

Listed companies

After initial public offerings, companies would be listed on the stock exchanges for public trading by investors. There are some unique features for Chinese listed companies. The most representative are the shareholding structure and the corresponding financial reporting framework. Both features are presented as follow.

Shareholding structure

The shareholding structure of Chinese listed firms is split. It is characterized by two general classifications of shares. The first classification includes circulation (or tradable) shares and non-circulation (or non-tradable) shares. Only circulation shares can be traded at stock exchanges under the regulation of the CSRC. [11] The second classification consists of domestic shares and foreign shares (refer to figure 2).

The domestic shares (namely A-shares) can be further classified into three classes, comprising state-owned shares, institutional (or legal person) shares and public shares, each of which accounts for one-third of the total approximately. The state-owned and the institutional shares are non-circulation shares that cannot be traded on the stock exchanges. But the institutional shares can be traded amongst institutions through Securities Trading Quotation System (an over-the-counter market). The public shares, so-called circulation A-shares, can be traded at both the Shanghai and Shenzhen stock exchanges. A-shares, denominated by RMB (Renminbi, namely the Chinese currency), are subscribed and traded in RMB, and only available to domestic investors until December 2002 when the Chinese government launched the Qualified Foreign Institutional investor (QFII) programme that allows licensed foreign institutional investors to trade A-shares in the secondary market.

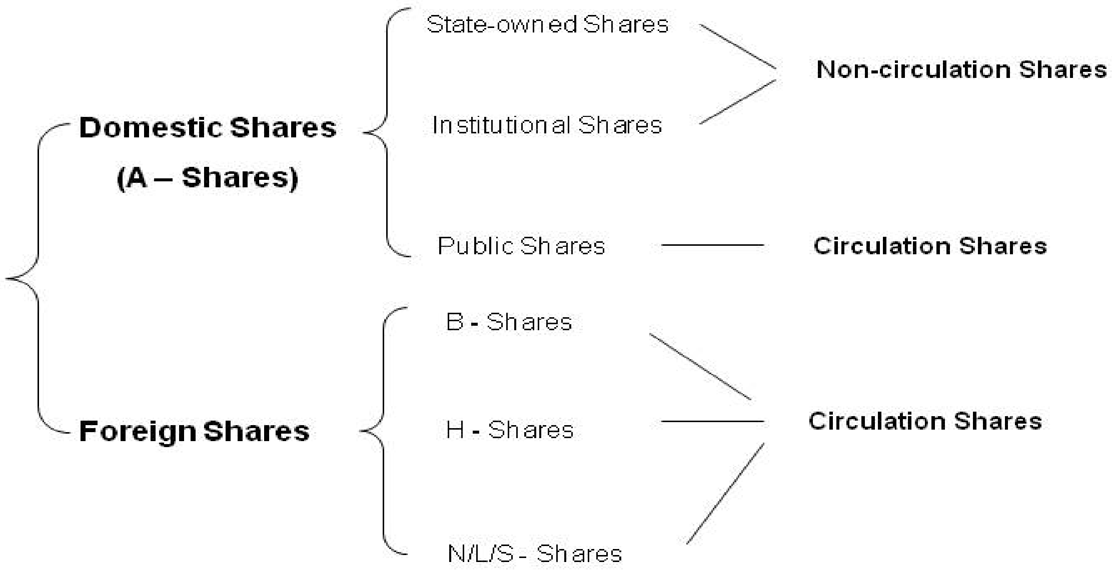
Foreign shares are composed of B-shares, H-shares, N-shares, L-shares and S-shares, all of which are circulation shares and primarily available for foreign investors.[12] B-shares are ordinary shares denominated in RMB but subscribed for and traded in either US dollars on the Shanghai stock exchange or Hong Kong dollars on the Shenzhen stock exchange. In February 2001, the Chinese government through the CSRC released the B-shares market in which individual domestic investors with legal foreign currency accounts were allowed to own and trade B-shares (Liu and Liu, 2007). According to Lu et al. (2007) and Hung (2009), the opening of the B-share market to domestic investors and the limited opening

[11] In 2005, the CSRC launched the non-tradable share reform in which non-circulation shares would be converted into circulation shares gradually. However, after the reform, only a limited number of converted shares are available to investors (Cheng et al., 2009).

[12] Since May 2006, the Chinese government, through the Qualified Domestic Institutional investors (QDII) programme, has allowed licensed domestic institutional investors to invest in foreign shares.

of the A-share market to foreign investors greatly enhance market efficiency.

Figure 2. Classifications of Chinese shares



Source: Yi and Davey (2010, p. 328)

H-shares represent shares issued by Chinese mainland companies but listed and traded on the Hong Kong stock exchange. Since the Chinese government authorized Chinese firms to be listed on the Hong Kong stock exchange in July, 1993, there have been 165 mainland firms issuing H-shares at present.[13] The other three types of foreign listings, comprising N-shares, L-shares and S-shares, represent shares issued by Chinese mainland firms, but listed and traded on the New York, London and Singapore stock exchange, respectively. There are very limited Chinese firms issuing N/L/S shares currently. The majority of (Chinese) overseas listed firms issue H-shares, which highlights the significance of H-shares for Chinese firms in attracting foreign investment (Cai et al., 2011).

Varied classes of shares are entitled by law to the equal rights (e.g. voting, dividend and cash flow claims) and bear the same obligations (Balsara et al., 2007; Bao and Chow, 1999; Cheng et al., 2009). Nevertheless, the pricing of them may be distinct. In accordance with Chen et al., (2001) and Tian (2007), there is a significant premium of A-share prices over B-share prices for the same company although it has been reduced after the release of the B-share market. Seddighi and Nian (2004) also state that A-shares issued by a listed company on the Shanghai stock exchange are usually traded at three times the price-earning ratio of the corresponding B-shares, and four times the ratio on the Shenzhen stock exchange.

Chinese enterprises are not permitted to be listed on both the Shanghai and Shenzhen stock exchanges at the same time. However, they can be dual-listed on either of domestic exchanges and foreign stock exchanges.[14] That is, a Chinese listed firm can issue both A- and H/N/L/S-shares (e.g. A+H/A+N/A+L/A+S). In reality, the majority of the dual-listed firms issue A-shares and H-shares (A+H) because of very limited Chinese firms listed on other foreign stock exchanges. By the end of 2010, there were 69 dual-list A and H share firms in China. Most of them are large corporations according to market capitalization as well as top performers in their sectors, and even in the national economy (Yi and Davey, 2010).

The segmented shareholding structure of listed companies is a unique feature of the Chinese stock market. According to CSRC (2008) and Li (2007), the segregation, on the one hand, strengthens control of the Chinese government over the market; on the other hand, it undermines market efficiency due to the restrictions to different investors. Therefore, the Chinese government needs to further reform the shareholding structure of listed firms so as to reduce market restrictions, and consequently enhance the market efficiency.

Financial reporting framework

Since 1993, the CSRC had issued many regulations regarding financial reporting issues of listed firms, such as the content and the format of prospectus, interim reports and annual reports. According to the

[13] By the end of 2010.

[14] In addition, Chinese companies can issue both A- and B-shares simultaneously on the same domestic exchange (Shanghai or Shenzhen), also called dual-listing. But in this research, dual-listed companies only refer to those listed on two stock exchanges (usually a domestic stock exchange and a foreign stock exchange).

regulations, annual reports of listed firms should be prepared within 120 days after the end of a financial year (31, December of each calendar year). Moreover, the annual report should be prepared in accordance with relevant accounting standards in terms of the shareholding structure.

As for firms issuing A-shares, annul reports should be prepared under the Chinese generally accepted accounting principles (GAAP) and mostly audited by local accounting firms.[15] Furthermore, they should be released in the designated journals by the CSRC. If a firm issues B-shares as well, the annual report should be also prepared according to the International Accounting Standards (IAS) and audited primarily by the big 4 international accounting firms[16] for the purpose of international comparison and credibility recognition (Liu and Liu, 2007). The firm should publish the English version of its annual report under the IAS for oversea investors. It is required by the CSRC that firms issuing both A- and B-shares should reconcile accounting information under the two accounting standards (Chinese GAAP and IAS). But the reconciliation information is only released to A-share investors rather than B-share investors. Annual reports of firms issuing H-shares or other foreign shares should be prepared in accordance with the IAS[17] and audited by the big 4 accounting firms. The firms usually release their annual reports through journals or newspapers in the region where they are listed.

There are some significant differences with respect to financial reporting between the Chinese GAAP and the IAS although the Chinese authorities have attempted to converge the differences as much as possible in recent years (Grant Thornton Hong Kong, 2004; Liu and Liu, 2007; Qu et al., 2012). For instance, there is a more restrictive policy for measuring inventory, investment, estimating bad debt expense, depreciation expense, and the recognition of related parties, under the Chinese GAAP (Bao and Chow, 1999; Liu and Liu, 2007). According to Bao and Chow (1999), three factors are primarily accountable for the differences: different accounting regulations; policy intervention by the Chinese government; and differences in professional judgments between domestic and international auditors, which reflect distinct institutional arrangements between the two standards.

[15] Since 2007, there has been great convergence of Chinese GAAP with the *International Financial Reporting Standards* (IFRS), through the issuance of *Accounting Standards for Business Enterprises* (ABSE 2007) by Ministry of Finance (Qu et al., 2012). However, there are still some differences between the two standards due to distinct institutional arrangements.

[16] Including Deloitte & Touch, Ernst & Yong, KPMG and PriceWaterhouseCoopers.

[17] The Hong Kong GAAP has fully harmonized with the IAS since 2005.

Conclusion

In less than two decades, the Chinese stock market has undergone fundamental changes that have taken some developed markets many decades to achieve (CSRC, 2008). Now it has been the largest in Asia after Japan, as well as the largest emerging capital market in the world. By the end of 2010, there were totally 2063 companies listed on the Shanghai and Shenzhen stock exchange, including 1955 A-share companies, 108 B-share companies, 86 companies issuing both A-share and B-share, and 69 companies issuing both A-share and H-share. The total shares issued by listed companies were 3.32 trillion, and the total raised capital was RMB 54.56 trillion in 2010. Among the total shares, there were a total of 2.56 trillion tradable shares.

Meanwhile, the total market capitalization of Chinese listed firms was RMB 26.54 trillion that is equivalent to 67% of GDP[18]. However, the capitalization of tradable shares was RMB 19.31 trillion, around 49% of GDP. Despite the tremendous growth in recent years, the Chinese stock market still lacks the depth and maturity, as compared with the major developed markets in the world (Balsara et al., 2007). For example, the market capitalization of US listed firms over GDP was around 300-400 percent. Moreover, weak rule of law, inadequate institutions, lack of training for fund managers, weak corporate governance and internal control of listed companies, and inappropriate governmental interventions are also limiting future development of the market (CSRC, 2008; Zhang et al., 2008).

To address the barriers, the CSRC (2008, pp. 286-293) following *Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets*[19] promulgated the following development strategies:

- Maintain a fine balance between the government and the markets, strengthen legal and regulatory framework, and build fair, transparent and efficient markets
- Create a fully multi-layered stock market to meet diverse needs
- Improve the quality of listed firms
- Encourage competition to foster a more globally competitive financial service industry in China
- Open up gradually and build up globally competitive capital markets
- Improve capital markets' culture and foster an environment suited to the sustainable development of capital markets.

These strategies appear to be practical and feasible, and it is expected to solve the legacy (structural)

[18] The total GDP of China was RMB 39.798 trillion in 2010.

[19] Released by the State Council in January 2004 as high-level guidelines for further reform and development of the capital markets.

problems and facilitate further development of the market.

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