Chapter 1

Brief Review of the Development of China’s Capital Markets

The reforms and liberalization starting in the late 1970s have allowed China to undergo a remarkable transformation from a centrally-planned economy to a more market-oriented economy. The increasing sophistication of the Chinese economy and the reform of state-owned enterprises (SOEs) have called for more accommodating financial systems. China’s capital markets began to emerge against this backdrop. As China’s market economy has evolved, there has been an increasing demand for a more market-oriented approach towards resource allocation, leading to the gradual establishment and development of China’s capital markets.

In retrospect, China’s capital markets have gone through three phases of development since the introduction of the reform and opening-up policy:


Phase II: From 1993 to 1998, with the establishment of China Securities Regulatory Commission (CSRC) as a key milestone; China consolidated the supervision of capital markets. The regional pilot programs were expanded nationwide, and national capital markets began to emerge and evolve.

Phase III: From 1999 to 2007, with the promulgation of the *Securities Law* as a key milestone; the legal status of China’s capital markets in the economy was formalized and strengthened, and a series of major reforms were implemented to facilitate further development of the capital markets.

This historical review shows that the emergence and evolution of China’s capital markets can be seen both as a cause and a result of the economic development and reforms of the past two decades. The capital markets
have become one of the driving forces behind a series of important economic and social reforms, and their contribution to and influence on China’s economic and social development have grown steadily. Over time, they are becoming a dynamic component of China’s financial system and increasingly embracing more market-oriented principles, establishing more market disciplines and adopting international best practices.
Section 1
The Emergence of China’s Capital Markets, 1978-1992

China’s economic reform paved the way for the emergence of China’s capital markets. At the 3rd plenary session of the 11th Party Congress in 1978, the central government launched a long-term economic development program to revitalize national economy. At the heart of that were twin strategies of reform and opening-up the economy.

The introduction of economic reforms meant that enterprises needed to diversify their funding channels for the first time, calling for the emergence of capital markets. Prior to the reform, funds and capital were typically centrally administered and allocated to enterprises under China’s planning economic system.

Securities in China’s History

- As early as in “the Spring and Autumn” and “Warring States” periods, from 770 B.C to 256 B.C, kings and nobles were already borrowing and lending, giving rise to the earliest form of bonds in China.
- During late Ming Dynasty and early Qing Dynasty (mid 17th century), some “high risk, high return” sectors began to “invite investors to be shareholders by putting funds into a pool to run a business”. The participants entered into a contract for their investment, which was regarded as a primitive form of shares.
- In 1872, following the western model, China’s first joint stock company, China Ships & Merchants Co., was established and offered shares to the public.
- In June 1918, the Beijing Stock Exchange opened and became the first stock exchange established by the Chinese.
- During the 1920s and 1930s, Shanghai became a leading financial center in the Far East with active trading on its securities market.

1. Shareholding reform and the emergence of stocks

Starting from 1978, a household contract responsibility system was introduced. The joint stock rural township enterprises, established by farmers in the late 1970s, were the early form of shareholding companies.
During the early 1980s, some small state-owned and collectively-owned enterprises in urban areas also initiated share-holding reforms, giving rise to various forms of shareholding structures. In 1984, state control over small state-owned and collective urban enterprises was relaxed. From 1984 to 1986, Beijing, Guangzhou, and Shanghai selected a few large and medium-sized enterprises to experiment with shareholding systems. In 1986, it became a national strategy.

**Early attempts of shareholding reform in early 1980s**

- In January 1980, the Fushun Branch of the People’s Bank of China acted as the agent for Fushun Red Brick Factory to issue 2.8 million shares to enterprises.
- In July 1980, Chengdu Industrial Exhibition and Trust Co., Ltd. raised funds by selling 2000 shares at RMB 10,000 (US $6,667) each to collectively-owned enterprises and SOEs. By 1983, the company had raised US $7.1 million. This was the first joint stock company established through share placement after 1949.
- In July 1983, United Investment Corporation of Bao’an County in Guangdong Province placed a public offering advertisement in the Shenzhen Special Economic Zone Daily, announcing the issuance of shares guaranteed by the county government to raise US $6.6 million. This was the first company to place a public offering advertisement in newspaper after 1949.
- In July 1984, Beijing Tianqiao Department Store issued shares with a fixed-term of three years to the public. This was the first SOE to carry out shareholding reform.

---

1. In October 1984, China identified the direction of reform for urban area and the overall economic system.
2. For example, in 1984, Beijing Tianqiao Department Store became the first pilot for shareholding reform. In 1985, Shanghai Yanzhong Industrial went through shareholding reform. Guangzhou Municipal Government approved three medium and small-sized SOEs (Guangzhou Silk and Linen Factory, Mingxing Pharmaceutical Factory and Qiaoguang Leather Processing Factory) for their ownership structure.
to expand the SOE restructuring program and an increasing number of enterprises, including some of the largest SOEs, began to experiment with shareholding reform and issue shares publicly or semi-publicly.

Shares were normally issued at par, and most were similar to bonds in that dividends were fixed and guaranteed and shares were redeemed on maturity. These shares were usually issued by the enterprises themselves without underwriter, and privately offered to employees and local residents.

2. The emergence of bonds

**Treasury bonds.** China relaunched treasury bonds in July 1981. At that time, treasury bonds typically had a long term (10 years), were non-transferable, and offered a higher interest rate to individual buyers than that paid to corporate buyers. Although the treasury bonds were sold through administrative allocations, their issuance nonetheless increased the public awareness of investing.

**Enterprise bonds.** From 1982 onwards, a few enterprises began to take the initiative to raise interest-bearing funds, either internally or from the public. These became the early form of enterprise bonds. By the end of 1986, these unregulated bonds reached more than US $2.9 billion in outstanding value. In 1987, the State Council stipulated that further bond issuances would be subject to approval by the People’s Bank of China (PBC), and that the PBC, the State Planning Commission (SPC), and the Ministry of Finance (MOF) would set a limit on the total amount of annual enterprise bonds issues. A quota of US $806 million was set that year. In 1992, the total issuance

---

(1) In December 1986, the State Council issued *Provisions for Furthering Reform and Revitalizing Enterprises.* According to the provision, “a few qualified large and medium-sized enterprises owned by the state can be selected to experiment with the shareholding system”.

(2) From 1954 to 1958, the Chinese government issued a total of RMB 36 billion in State Economic Construction Bonds.

(3) China’s enterprise bonds were mainly issued in accordance with the *Regulation on the Supervision of Enterprise Bonds* promulgated in 1993, when the *Company Law* had yet to be introduced and “corporations” were not mainstream enterprises. In 1994, the *Company Law* was enacted, but the provisions on “corporate bonds” were not implemented and the *Regulation on Enterprise Bonds* still applied. The enterprise bonds embodied the legacy of the planned economy: issuers of these bonds were mainly SOEs, there was an annual issuance quota, government approvals and bank guarantees were also required. This process was not comparable to the issuance of corporate bonds in the international capital markets.

(4) The exchange rates for each year are available in the appendix II.

(5) Currently known as the National Development and Reform Commission (NDRC).
reached a record high of US $12.7 billion. However, in the fever of issuing enterprise bonds, many enterprises did not prepare to pay back the bonds on maturity, and many defaulted. Starting in 1993, the issuance of enterprise bonds saw a long period of decline.

**Financial bonds.** In 1984, China implemented a stringent monetary policy to curb inflation. Against this macroeconomic environment, some construction projects financed by bank loans ran short of funds. Banks started to issue financial bonds with interest rates higher than the deposit rates to support the completion of these projects. As a result, financial bonds became a regular financing tool for banks.

![Figure 1.1 Funds raised by various securities, 1981-1992](image)

Note: Funds raised by bonds represent the total amount of bonds issued less the amount of bonds redeemed each year. Financial bonds include policy banks’ financial bonds and financial bonds by financial institutions.


3. The emergence of the securities market and stock exchanges

As the volume of securities issued increased and the number of investors grew, there was a pressing demand for securities brokerages and trading. Over-the-counter transactions then appeared for stocks and bonds. In August 1986, Shenyang Trust & Investment Corporation became the first company to provide brokerage service for stock and bond trading, and loans with enterprise bonds as collateral. A month later, the Jing’an District Branch of the Shanghai Trust & Investment Company, a subsidiary of the ICBC, started over-the-counter trading of shares it underwrote for the Feile Audio Equipment Co. and Yanzhong Industrial Co., Ltd., marking the first occurrence of secondary trading.
Starting from April 1988, the trading of treasury bonds by retail investors was permitted in seven cities\(^3\). Two months later, the business expanded to 28 provinces and municipalities, and 54 large and medium-sized cities. By the end of that year, the trading of treasury bonds had spread across the country, marking the earliest form of the secondary bond market.

In 1990, the Chinese government began to allow some large cities to establish stock exchanges. Consequently, the Shanghai and Shenzhen Stock Exchanges were established in December 1990. At the end of 1991, the Shanghai Stock Exchange (SSE) had 8 listed stocks and 25 members,\(^4\) while the Shenzhen Stock Exchange (SZSE) had 6 listed stocks and 15 members. On April 4, 1991, SZSE launched the Shenzhen Composite Index, taking the previous day as the base of 100 points. On July 15, 1991, SSE launched the Shanghai Composite Index, taking December 19, 1990 as its base of 100 points.

The once prosperous “Hong Miao Zi Market”

In December 1992, an informal market for trading the non-listed company shares held by employees emerged and became very active on the small street called “Hong Miao Zi” in Chengdu, the capital city of Sichuan Province. Investors from Shenzhen and other parts of the country rushed into the market to purchase the non-listed share certificates before the public listing of the local companies in Sichuan Province from the employees of these companies, driving the price up quickly. It became a talk of the town at the time that “the share price doubled minutes after you buy it on Hong Miao Zi Market”. At its peak, the market saw several thousand investors on a daily basis. Almost all companies in Sichuan Province (except for Chongqing), traded their shares and share certificates in this market. Up to 80 different kinds of products were traded at one point, including bonds and warrants. In May 1993, the government ordered the closure of Hong Miao Zi market.

4. The emergence of securities intermediaries and self-regulatory organizations

The development of the primary and secondary markets led to the creation and expansion of the securities industry. In 1984, the Jing’an District Branch of the Shanghai Trust & Investment Company, a subsidiary of ICBC, under-

---
\(^3\) The seven cities were Shenyang, Shanghai, Shenzhen, Guangzhou, Wuhan, Chongqing and Harbin.
\(^4\) Initial members of the stock exchanges were mainly trust and investment companies or their securities divisions, and nascent securities firms.
wrote two stocks — “Feile Audio” and “Yanzhong Industry”. In September 1987, Shenzhen Special Zone Securities Firm, the first professional securities firm in China, was established. In 1988, in response to the nationwide expansion in treasury bond trading, the PBC allotted funds to establish 33 securities firms across the country. Meanwhile, the MOF and its local bureaus also established several securities firms, which were the first securities firms in China. These were mainly engaged in treasury bond trading.

In August 1991, the Securities Association of China, a not-for-profit organization, was founded in Beijing as the self-regulatory organization(SRO) of the securities industry.

5. Experiments with futures exchanges

In October 1990, Zhengzhou Grain Wholesale Market was opened and forward contracts were introduced, marking the beginning of forward trading in China. In October 1992, Shenzhen Nonferrous Metals Futures Exchange introduced the “Standard Contract for Special Grade Aluminum Futures”, the first standard futures contract in China, achieving the transition from forward contracts to futures transaction.

6. The need for proper regulation and supervision

During the early stages of shareholding (or corporate ownership) reform, various stock issuance measures were developed by enterprises in the absence of regulation and supervision. Some enterprises offered special awards for their issues, including

---

1. China Securities Association is a self-regulatory organization which securities institutions are required to join. Its main responsibilities are: submitting the suggestions and requirements of members to the securities regulatory administer; establishing self-regulatory principles for its members and arranging training and competency exams; mediating dispute among members and between members and clients, and so forth.

2. In July 1984, the Shanghai branch of the PBC issued Provisional Measures for Administration of the Issuance of Shares, which was revised to Provisional Measures of Shanghai Municipality for Administration of Shares in 1987; in October 1986, Shenzhen Municipal Government issued the Provisional Regulations of Shenzhen Economic Special Zone on State-owned Enterprises’ Pilot Shareholding Reform; the Provisional Regulations on Over-the-counter Transactions of Securities was issued in January 1987.
enrolling subscribers into lottery, or offering guaranteed interest payment and principals. These practices added an element of chaos to the primary market.

In March 1990, Shanghai and Shenzhen were permitted to pilot the public offering of stocks, and issued rules for IPOs and stock trading. ① Since the dividends paid by certain stocks were more generous than bank deposits, and there were few joint stock enterprises offering IPOs at the time, demand far outstripped supply, ② with investors swarming to Shenzhen and Shanghai to purchase shares. Although municipal governments took measures to cool the market, the serious shortages caused by the limited number of subscription forms, ③ together with market irregularities and malpractice, finally led to the “August 10 Incident”, an investor-led protest against irregularities.

The speech made by Deng Xiaoping during his southern tour of China in early 1992 ushered in a new era of reform and opening-up. While visiting Shenzhen, the city bordering HongKong, Deng Xiaoping made the following remarks on securities market: “Securities, stock markets, are they good or evil? Are they dangerous or safe? Are they unique to capitalism or also applicable to socialism? Let’s try and see. Let’s try for one or two years; if it goes well, we can relax controls; if it goes badly, we can correct or close it. Even if we have to close it, we may do it quickly, or slowly, or partly. What are we afraid of? If we maintain this attitude, then we will not make big mistakes.” ④ In that same year, China defined its key economic reform objective as the “construction of a socialist market economy”. ⑤ The key strategy was to transform the

---


② Shenzhen Municipal Government took a series of administrative measures in May 1990: banning illegal off-floor trading; imposing a 0.5% stamp duty on both sellers and buyers; setting a daily price change ceiling and floor limits of 10%; increasing the number of branches; and enhancing the disclosure of market information and the provision of proper guidance to the public.

③ Subscription forms were distributed by companies that issued a fixed amount of shares at a specific location within a certain period of time. People who bought the forms were eligible for share allocation and participation in the IPO.

④ Selected Works by Deng Xiaoping, Volume III, Page 373.

⑤ Pursuant to the resolution passed at the Fourteenth National Congress convened in October 1992.
China Capital Markets Development Report

SOEs into joint stock companies and allow them to raise funds through the stock market. In the following year, the stock issuance piloted in Shanghai and Shenzhen was further extended nationwide, turning a new page for the history of China’s capital markets.

Summary

In this early stage of development, China’s capital markets began to emerge as an answer to the massive economic transition that was taking place in China. The capital markets evolved from a number of regional schemes, which lacked a unified regulatory and supervisory framework. The “August 10 Incident” in Shenzhen further exposed the pitfalls of such disorderly development, and signaled that the capital markets urgently needed unified regulation and supervision.
Section 2

In October 1992, China’s State Council established the Securities Committee (SCSC) and the China Securities Regulatory Commission. This marked an important milestone as China’s capital markets started to align for the first time under a single centralized regulatory framework. This propelled the capital markets into an important new stage of development.

In the following years, the authorities established a series of rules and regulations. To mitigate financial risks in the aftermath of the 1997 Asian Financial Crisis, China consolidated unauthorized securities trading markets and rectified irregularities in the operations of securities firms, investment funds, futures brokerage firms and exchanges. In addition, the shareholding reform and listing of SOEs fostered steady growth in the size of the market and in the number of intermediaries and investors.

The State Council’s Circular on Stock Market Development in 1992

In late 1992, the State Council issued the Circular on Further Strengthening of Macro-management Over the Securities Market when, within a short period, volatility and a steep correction occurred in the stock market. The 1992 circular is regarded as the first ever official document by the government to spell out a relatively complete and systemic framework for regulating the stock market. Drafted in the backdrop of the lessons learned from earlier experiment and pilot programs, the circular spells out key strategic directions for future development. Since then, the development of capital markets has been on the governments’ agenda. The circular deals with seven issues, including the streamlining and strengthening of the regulation and supervision of capital markets, standardizing the issuance and listing procedures, planning for stock issuing in 1993, further opening up of the securities market, reinforcing the legal framework for the securities market, drafting the securities market’s strategy and development plan, stepping up the infrastructure development of the securities market, enhancing its management and supervision, and safeguarding its healthy development. Many attributed the early development of capital markets in China to this circular.
1. Establishing a centralized regulatory and supervisory framework

The first institution exercising centralized supervision over China’s securities market was the Securities Supervision Office of PBC, which was established in May 1992. In July of the same year, the State Council instituted the Joint Staff Meeting for Securities Supervision to oversee the securities market on its behalf. However, the “August 10 Incident” demonstrated that the establishment of a dedicated regulator, working in accordance with international practices, was needed. Therefore, the State Council set up the SCSC and the CSRC in October 1992. In December, the State Council issued the Circular on Further Strengthening of the Macro-management Over the Securities Market, defining the government oversight of the securities market under centralized supervision.

The SCSC and the CSRC

In October 1992, the SCSC was established to oversee the securities market on behalf of the State Council. SCSC was composed of the heads of ministries and commissions such as the State Commission for Restructuring and Economic Reform, the SPC, the MOF, and the PBC. SCSC was responsible to draft relevant laws, rules and regulations for securities market, develop long-term strategies, deliver guidance and coordinate among central and local governments, conduct supervision and inspection of market activities. The CSRC reported to SCSC and was responsible for developing market rules and regulations, supervising the securities firms, especially their proprietary trading activities, and listed companies as well as their issuance and selling of securities to the public, and overseeing the overseas listing of domestic companies. During the National Financial Sector Work Conference in November 1997, the supervision of securities firms which had been carried out by the PBC was transferred to CSRC. In April 1998, the SCSC also merged with the CSRC.

In November 1997, China’s financial system adopted an approach to separate the operations and supervision of the banking, securities and insurance industries. In April 1998, the CSRC became the regulator of the national securities and futures markets by consolidating the supervisory functions of SCSC and PBC into the CSRC. It also developed a regional supervision system by absorbing the provincial securities regulatory offices. With a total of 36 regional offices across the nation, a centralized supervisory framework was established.

---

1 Including securities regulatory offices for nine regions (Tianjin, Shenyang, Shanghai, Jinan, Wuhan, Guangzhou, Shenzhen, Chengdu and Xian), two offices (Beijing and Chongqing) were directly subordinate to the CSRC, and securities regulatory offices for specially-appointed agents were set up in 25 provinces, autonomous regions, and municipalities with independent planning status.
2. The legal framework shapes up

The CSRC has driven the formulation of a number of laws, rules and regulations for the securities markets since its inception, including

- The Provisional Regulation on the Issuing and Trading of Shares was promulgated in April 1993 to regulate share issuance and trading as well as the acquisition of listed companies.

- The Implementation Rules on Information Disclosures of Companies Issuing Public Shares, issued in June 1993, set up standards for required information disclosures of listed companies.

- The Provisional Measures on Prohibiting Fraudulent Conducts Relating to Securities and the Circular on Prohibiting Securities Market Manipulation, promulgated in August 1993 and October 1996, respectively, specified the criteria for defining illegal trading activities and related supervisory sanctions.

The Company Law, implemented in July 1994, sets out specific provisions for the conditions of setting up a company, the organization of a company, share issuance and transfer, corporate bonds, liquidation procedures and legal liabilities. It also sets standards of corporate governance for limited liability companies and joint stock limited liability companies (joint stock companies), laying the legal foundation for the development of joint stock companies and in turn, the capital markets.

The CSRC has issued a series of regulations over the operations of securities firms, including Administrative Procedures for Securities Brokerage Institutions’ Equity Underwriting Businesses and the Proprietary Trading Businesses. In November 1997, the Provisional Administrative Procedures on Securities Investment Funds was issued, which promoted the development of the securities investment fund industry.

The above-mentioned laws, rules and regulations facilitated the take-off of China’s capital markets significantly. They also laid a foundation for further improvements in related rules and regulations.

3. Establishment of an approval system for share issuance

Following the establishment of SCSC and CSRC, stocks could be now issued through public offering to all investors in the country. However, the CSRC imposed a quota on the maximum number of shares that could be issued
each year with the intention of curbing the potential excessive investment demand in a pre-mature market where market participants had not developed an understanding of the market rules, their rights and obligations. Accordingly, provincial governments and industry supervising bodies were assigned issue quota and they would recommend enterprises for listing within the given quota. The CSRC would then give final approval on public offerings.

With respect to issuance, the CSRC introduced measures such as offering an unlimited number of application forms, a subscription deposit system, and online bidding from 1993, in an effort to promote the principle of “openness, fairness and equality”, a lesson drawn from the “August 10 Incident”.

With respect to pricing of IPOs, different approaches have been adopted. Before the creation of the exchanges, shares were mainly issued at par value when there was no system in place to determine the price. After the establishment of the exchanges, the issuance price was usually determined by the profit after tax and a fixed price earning ratio due to the immaturity of both issuers and underwriters, and the lack of institutional investors.


1. The SCSC initially determined the total issue ceiling based on demand generated from China’s economic development and the actual situation of the capital markets, and then further allocated the quota according to the nature of each province, industry sector, and demand. The quota were US $0.8 billion, US $0.6 billion, US $1.8 billion, and US $3.6 billion in 1993, 1994, 1996 and 1997 respectively.

2. This refers to the condition that under the exchange’s trading system, with the leading underwriter as the sole “seller” of the shares, investors subscribe to shares with a buy order within a specified period. After the end of subscription, the stock exchanges’ host computer then confirms it as an effective subscription according to the capital actually received.

3. Issue price of a new share = Profit after tax per share × price earning ratio of the issue
Chapter 1

Brief Review of the Development of China’s Capital Markets

Table 1.1 Details of the securities market, 1993 – 1998

<table>
<thead>
<tr>
<th>Year</th>
<th>Total funds raised from A-shares (Billion US$)</th>
<th>Total funds raised from B-shares (Billion US$)</th>
<th>Number of investors’ accounts opened (million)</th>
<th>Total market capitalization of shares (Billion US$)</th>
<th>Total market capitalization of tradable shares (Billion US$)</th>
<th>Trading volume of Shanghai and Shenzhen Stock Exchanges (Billion US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>4.8</td>
<td>0.7</td>
<td>8.4</td>
<td>61.5</td>
<td>15.0</td>
<td>62.9</td>
</tr>
<tr>
<td>1994</td>
<td>1.2</td>
<td>0.4</td>
<td>11.1</td>
<td>42.8</td>
<td>11.2</td>
<td>94.3</td>
</tr>
<tr>
<td>1995</td>
<td>1.0</td>
<td>0.4</td>
<td>12.9</td>
<td>41.6</td>
<td>11.2</td>
<td>48.3</td>
</tr>
<tr>
<td>1996</td>
<td>3.5</td>
<td>0.6</td>
<td>24.2</td>
<td>118.4</td>
<td>34.5</td>
<td>256.6</td>
</tr>
<tr>
<td>1997</td>
<td>10.0</td>
<td>1.3</td>
<td>34.8</td>
<td>211.5</td>
<td>62.8</td>
<td>370.6</td>
</tr>
<tr>
<td>1998</td>
<td>9.4</td>
<td>0.3</td>
<td>42.6</td>
<td>235.8</td>
<td>69.4</td>
<td>284.2</td>
</tr>
</tbody>
</table>

Notes: 1. Since state shares and legal person shares were not tradable on China’s stock markets before 2005, there is a difference between the total market capitalization and the market capitalization of tradable shares.
2. Total funds raised from A-shares includes stocks and convertible bonds.

Figure 1.3 Funds raised by various securities, 1993-1998

Note: The amount raised in the bond market is the difference between the issuance volume and those redeemed during the year. Financial bonds include policy bank’s financial bonds and common financial bonds issued by financial institutions.
4. The inauguration and development of stock exchanges

The Shanghai and Shenzhen Stock Exchanges, founded in 1990, have gradually moved to a paperless securities system, eliminating the need to transfer paper certificates of securities in trading. The two exchanges introduced an automatic trading system by matching numerous buy and sell orders in a centralized process, with centralized order matching, prioritized according to price and time. Consequently, market transparency and information disclosure became much better than at the previous off-the-street markets and the regional over-the-counter retail markets, substantially reducing transaction costs and risks. At the same time, the exchanges depository and clearing companies established highly-automated electronic depository systems respectively. \(^1\) In an effort to reduce price volatility, the daily price change floor and ceiling limits were introduced and adjusted a number of times, and have been set at a range of 10% in either direction since December 1996.

---

### Consolidation and closure of unauthorized securities trading centers

Before and after the establishment and operation of the Shanghai and Shenzhen Stock Exchanges, a considerable number of local assets and property rights trading centers, securities trading centers or securities automatic quoting systems were established by the local governments without authorization from the State Council. They engaged in trading of equities of unlisted companies and some were later connected to the Shanghai and Shenzhen Stock Exchanges to function as their local trading floors. These unregulated trading centers assumed substantial financial risks. In March 1998, the State Council and the CSRC issued “The Plan to Consolidate and Restructure the Unregulated Stock Trading Platforms”, prohibiting the local asset and property rights trading centers from engaging in any public offering and subsequent trading of shares. In September 1998, the State Council and CSRC again issued “the Plan to Consolidate and Liquidate the Securities Trading Centers”, closing down all securities trading centers and their subsidiary securities depository companies that had organized public offering and trading of shares and warrants of unlisted firms as well as funds by connecting to the Shanghai and Shenzhen Stock Exchanges. The CSRC then consolidated and closed 41 illegal off-the-street and over-the-counter retail trading centers through a process of “cutting the expansion of such centers, consolidating their business into formal exchanges and finally closing them down”.

---

\(^1\) In March 2001, the China Securities Depository and Clearing Corporation Limited was incorporated by restructuring and merging the original depository and clearing systems of Shanghai and Shenzhen Stock Exchanges, with a registered capital of US $72.5 million.
As the market developed, new products were added to the Shanghai and Shenzhen Stock Exchanges, including government bonds, warrants, enterprise bonds, convertible bonds, and closed-end funds. With the establishment of the national trading platforms of the Shanghai and Shenzhen Stock Exchanges and a centralized regulatory framework, there has been steady growth in the number of listed companies, total market capitalization, total tradable shares market capitalization, funds raised from share issuance, number of investment accounts and total trading volume.

5. The growth of intermediaries

The number of intermediaries has grown in the wake of the creation and expansion of the national securities markets. October 1992 saw the incorporation of three national securities firms, namely Huaxia, China Southern and Guotai, affiliated with ICBC, Agricultural Bank of China (ABC), and China Construction Bank (CCB). In subsequent years, a number of securities firms were established with capital mainly from banks, local governments and central government agencies. Their business covered securities underwriting, brokering, proprietary trading and industrial investment. Furthermore, trust and investment companies (TICs) also undertook securities business, whilst commercial banks participated in government bond underwriting and dealing. At the end of 1998, there were 90 securities firms and 2412 branches. The number of professional service firms involved in the securities industry had also risen, with 107 accounting firms, 286 law firms and 116 asset appraisal companies active in this field.

6. The emergence of securities investment funds and their regulation

From 1991, a number of funds invested in securities, futures and real estate “Old Funds” were formed. With the support of local governments or bank branches, these funds raised capital from the public. By the end of 1996, there were 78 closed-end funds, with a total fund size of approximately US $794 million. A large portion of their portfolios were illiquid real estate investments. Some of the listed funds were targeted by speculators, causing significant market disturbance. In November 1997, the Provisional Measures on Administration of Securities Investment Funds was promulgated to regulate the development of securities investment funds, whilst the winding up of

---

1) In October 1992, Shenzhen Baoan Enterprises (Group) Joint Stock Company issued warrants for the first time.
old funds began. By the end of 1998, six new fund management companies were approved to set up closed-end securities investment funds. The combined size of these funds reached about US $1.5 billion.

7. Opening-up to the outside world

**B-share market.** The early 1990s were characterized by a shortage of foreign currency and tight foreign exchange control. Against this backdrop, China undertook a pilot scheme to issue Renminbi-denominated shares to foreign investors aimed at attracting foreign capital to the securities market. These shares, known as B-shares, are domestically-listed shares, denominated in Renminbi but subscribed to and traded in US or Hong Kong dollars by overseas investors.

**B-, H-, N-, and S-shares**

- In November 1991, Shanghai Vacuum Electron Devices Company Limited issued 1 million special Renminbi-denominated shares at par of RMB100 (US $18.8) each to overseas investors. The company went to list on the SSE in February 1992, becoming the first B-share in China’s securities market.
- In June 1993, Tsingtao Brewery Company Limited was listed in Hong Kong, becoming the first Chinese company to issue H-shares.
- In August 1994, Shandong Huaneng Power Development Company Limited was listed on the NYSE and was the first company to issue N-shares.
- In March 1997, Beijing Datang Power Generation Company Limited became the first Chinese company to go public on the London Stock Exchange, known as L-shares.
- In May 1997, Tianjin Zhongxin Pharmaceutical Group became the first S-share company to go public on the Singapore Stock Exchange, known as S-shares.

By the end of 1998, a total of US $7.4 billion had been raised from issuing B-shares. This, to some extent, eased the shortage of capital, improved corporate governance and management, and improved legal and accounting practices for China’s securities markets.

Following the listing of domestic companies in Hong Kong (H-shares) and

---

1 After October 2000, the B-share market suspended share issuance. In February 2001, China permitted domestic residents to open B-share accounts with legally-obtained foreign currency and trade in B-shares. In 2003, the issuance of B-shares resumed when Shanggong Shenbei (Group) Company Limited (900924. SH) issued 100 million of B-shares to 14 strategic investors in November.
New York (N shares), and the listing of PRC companies incorporated overseas in Hong Kong (red chips), the importance of B-shares declined, and trading volume and market capitalization shrank.

**Listing abroad.** In June 1993, the first domestic enterprises began listing in Hong Kong and were well received by international investors. This success attracted more and more Chinese enterprises to the Hong Kong market (see Table 1.2) and also gradually led to listings in the U.S., Singapore and London. Overseas listings provided more financing options for Chinese enterprises, and led to the initial exposure of international investment banks to China. The listings also accelerated the restructuring of large SOEs and enhanced their reputation and competitiveness. At the same time China’s securities industry gained exposure to international practices and international investors began to learn about Chinese economy and build up confidence in investing in China.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Funds raised (Billion US$)</td>
<td>1.1</td>
<td>2.2</td>
<td>0.4</td>
<td>1.2</td>
<td>4.7</td>
<td>0.5</td>
</tr>
</tbody>
</table>

Source: CSRC.

**Other.** In August 1995, Isuzu Motors Ltd. and Itochu Corporation of Japan were the first foreign companies to become the largest shareholders of a PRC-listed company, “Beijing Beilu”, through a contractual agreement to acquire the non-tradable shares of the Chinese firm. This was the first case of foreigners becoming the largest shareholder in a Chinese listed company through the purchase of “legal person” shares. Also, a gradual stream of Sino-foreign equity joint ventures went public in China.

In July 1995, the CSRC became an official member of the International Organization of Securities Commission (IOSCO) at its 21st annual meeting.

8. Initial attempts in developing the futures markets

Treasury bond (T-bond) futures were introduced by the SSE in December 1992, initially to securities firms only. Availability was expanded to the gen-

---

1 In August 1994, the Special Regulation For PRC Joint stock Companies Issuing Shares and Listing Outside of the PRC was implemented.

Similarly, China’s commodity futures market also saw chaotic development. By 1993, there were more than 40 commodity futures exchanges and more than 300 futures brokerage companies. Some futures brokerage firms were poorly managed, while others engaged in speculative futures trading with state-owned capital. Many were recklessly involved in overseas futures trading, whilst underground deals and fraud occasionally occurred.

At the end of 1993, China began to clean up the futures markets. The State Council made it clear that the SCSC and CSRC were responsible for supervising the futures markets. The State Council ceased to approve the incorporation of any new futures exchanges, and gradually consolidated the existing exchanges into just three. It imposed rigorous controls over futures trading by state-owned entities, punished a number of illegal futures brokerages and suspended the futures trading of a number of commodities. Following the

---

**Disturbance of Series 327 T-Bond Futures**

Series 327 refers to a futures contract on the 3-year T-Bond to be delivered in June 1995. Due to different expectations on inflation and the discount rates of government bonds, major investors held divided views on the price of this futures contract. On February 23, 1995, the price of Series 327 went up drastically, and Wanguo Securities, a major player that shorted the Series 327, if failed to keep the price below US $17.78, it could have faced a total loss of US $718.5 million. During the last eight minutes before the market closed, Wanguo Securities placed a massive sell order of 7 million contracts worth of US $16.8 billion, which cut the closing price to US $17.66, from the highest of US $18.12 that day. The SSE issued an emergency notice, declaring that all transactions conducted in the last eight minutes of the day were invalid due to gross irregularities in the trading. In May 1995, The T-bond futures trading was suspended after two years’ experiment.

---

1. In November 1993, the State Council issued the *Circular on Preventing Reckless Development of the Futures Market*. In May 1994, the State Council’s General Office endorsed the *Instructions Requested for Certain Opinions on Resolutely Preventing Reckless Development of the Futures Market* drafted by the SCSC.

2. By April 1995, the number of futures exchanges had been reduced to 14. In August 1998, the State Council issued the *Notice on Further Reorganizing and Regulating the Futures Market*, and further reduced their number to three in Dalian, Shanghai, and Zhengzhou.
“Disturbance of Series 327” in 1995, the CSRC made further improvements to the structure of the futures markets by regulating trading activities, and reinforcing risks monitoring and management.

Summary

With the establishment of a central regulatory framework for capital markets, China’s regional stock markets rapidly developed into a centralized national market, which quickly grew under the framework of newly-issued laws and regulations. In the meantime, problems arose as imperfections in market mechanisms accumulated. This emphasized the need for continued improvement of the legal and regulatory frameworks.

---

1 The CSRC issued *Opinions on Membership Reform of the Futures Exchanges* and *Circular on Further Controlling the Risks of Futures Market and Stringently Cracking Down on Market Manipulation* in September and October 1995, respectively. In February 1996, it issued *Circular on Requesting Instructions for Further Reinforcing Supervision on the Futures Market.*
Section 3

The *Securities Law*, issued in December 1998 and enacted in July 1999, confirmed the importance of the capital markets and formalized its legal status in China for the first time. It was subsequently amended in November 2005. These milestones had a profound impact on the development of the capital markets’ legal system.

During this period, China continued its reforms to improve its socialist market economic system to develop a more prosperous society. As economic reforms progressed, joint stock companies, both state-owned and private, increasingly raised funds on the capital markets. In December 2001, China was admitted to the World Trade Organization (WTO), and further opened its door to the outside world. The financial sector reforms moved forward again while the capital markets grew broader and deeper.

1. Refinement of the capital markets’ legal and regulatory system

The *Securities Law* enacted in 1999 was the first national law to regulate the issuance and trading of securities in China. In response to extensive reforms in the financial sector, as well as the development of the capital markets, the National People’s Congress (NPC) began to amend the *Securities Law* and the *Company Law* in 2003, with revisions being announced in 2005 and enacted consequently in 2006.

The introduction of a centralized supervisory framework in 1998 led to a gradual improvement in the regulatory and supervision systems of the securities and futures markets. In 2004, the CSRC reorganized its regional supervision offices into provincial supervisory bureaus, and decentralized supervisory responsibilities to the local agencies. Meanwhile, CSRC also developed the mechanism to coordinate its supervision with local governments.

The enforcement of laws and regulations related to capital markets gradually improved as the CSRC set up enforcement offices in the local supervisory offices.

---

1. The CSRC had no enforcement department when it was established in 1992. It set up an enforcement department in 1995 to investigate illegal activities in the securities and futures markets.
bureaus, and in 2002 a special securities crime investigation bureau was established to investigate market manipulation and insider trading. The Securities Crime Investigation Bureau of the Ministry of Public Security was also established to work together with the CSRC to investigate crimes in the securities market.

A centralized enforcement system was developed in 2007 when the CSRC set up the Sanction Committee, Chief Enforcement Office and the Law Enforcement Task Force in its headquarters and reinforced its Enforcement Offices with a larger workforce at local supervisory offices. Inspection and sanctions are now managed as separate functions within the CSRC, to avoid conflicts of interest and to ensure professionalism, efficiency and justice in law enforcement.

In strengthening law enforcement and fulfilling its supervisory mandates, the CSRC conducted investigation and imposed sanctions on illegal securities trading activities to protect the interests of investors and ensure market integrity. Examples of this include the cases of “Qiong Min Yuan”, “Yin Guangxia”, “Zhongke Venture”, “Delong Group”, “Ke Long”, “Southern Securities firm” and “Minfa Securities firm”. From 2003 to 2007, the CSRC investigated 736 cases, forwarded 104 cases for criminal charges and imposed sanctions on 212 cases involving 180 entities and 987 individuals. Some 165 executives and professionals were deprived of the right to practice in the securities market for extended periods.

The Qiong Min Yuan Incident

Qiong Min Yuan, or the Hainan Min Yuan Modern Agriculture Development Company Limited, was once the dark horse of China’s stock market in 1996, when its share price rocketed 1,059% that year. The company was investigated on charges of false accounting and its shares were suspended from trading on March 1, 1997. The investigation found that US $79 million of its capital surplus, as well as US $68.1 million out of the US $68.7 million in profits as stated in its 1996 annual report, were fictitious. The Chairman of Qiong Min Yuan was sentenced to three years of imprisonment in November 1998. The company was acquired by another firm in July 1999.

Footnote ① Enforcement Bureau II. The original Enforcement Bureau, which dealt with general violations of regulations, was renamed Enforcement Bureau I.
2. Development of market discipline in capital markets

China’s capital markets grew rapidly with the promulgation of the 1998 Securities Law. The transaction, registration, and settlement systems of the exchanges were made more efficient. The relevant legal and accounting regulations had become better formulated, and the secondary market grew more active. Nonetheless, some problems remained embedded as the capital markets evolved. These problems, together with systematic and structural...
limitations, remained unresolved and became more serious. Starting from 2001, the market entered a 4-year period of adjustment. Stock indices slumped. Companies struggled to secure initial public offerings (IPOs), and listed companies also encountered difficulties in obtaining refinancing. Securities firms battled to survive, and by 2005, the securities industry had recorded losses for four consecutive years.

The origin of non-tradable shares in China

Share-split refers to a phenomenon in China where the shares of listed companies in China’s domestic market (known as A-share market), are divided into tradable and non-tradable shares based on whether they can be listed and traded on stock exchanges. The tradable shares are those purchased by public investors in IPOs and listed on the exchanges. The non-tradable shares are those held by the shareholders before the companies went public and can only be transferred through negotiation among designated parties. It is a legacy from an early experiment of the shareholding reform, in which the transfer of state-owned shares was deemed unnecessary and was therefore put on hold for an indefinite period even though no specific rules were drafted for the overhang.

In May 1992, an Opinion on Regulating Joint Stock Companies issued by the former State Planning Commission provided that “the transfer of state-owned shares and shares held by foreign investors will be subject to relevant rules of the government”. The State Council’s Provisional Regulation on the Issuance and Trading of Shares issued in April 2003 also provided that “Transfer of shares owned by the State must be approved by the relevant authorities and the relevant rules shall be issued separately”.

In practice, the transfer of state-owned shares was shelved and no “regulation” or “specific measures” relating to such trading was issued. Consequently, non-state shares such as legal person shares and natural person shares before public offerings followed an arrangement similar to that for state-owned shares and became non-tradable. Specifically, a listed company would commit in the prospectus or public listing announcement that all shares (including state shares, public corporate shares, foreign investors’ shares and natural person shares) held by the company’s shareholders before the public offering would not be listed and traded publicly in accordance with the laws, regulations and the Notice on Examining and Approving Share Issuance issued by the CSRC. Accordingly, all shares publicly offered by a listed company were tradable on a stock exchange, whereas all shares before public offering were still unlisted and non-tradable. In fact, such a practice resulted in there being a large number of shares overhung and non-tradable. All shares derived from a rights issue and a bonus issue were classified into tradable and non-tradable shares based on whether their original stocks were tradable or not. This is the origin of non-tradable shares in China.

---

† On June 14, 2001, the Shanghai Composite Index reached a record-high of 2,245.44 points. On June 6, 2005, the index had plunged below 1,000 points, to 998.23 points.
In retrospect, many of the problems stemmed from the transition of China's economy from a planned economy to a market economy. Some problems, although originally not recognized as significant, grew into obstacles to market development. These problems included the incomplete corporate ownership restructuring for listed companies, unsound corporate governance, poorly managed brokerage firms, lack of institutional investors, limited supply of blue chip companies, fixed income products and financial derivatives, and the lack of a market-maker system or hedging tools for institutional investors.

In recognition of these problems, the State Council issued *Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets* in January 2004, which triggered another round of reforms in the capital markets, including: implementing non-tradable share reform, enhancing the quality of listed companies, restructuring securities firms, promoting the development of institutional investors and reforming the IPO process. These reforms resulted in substantial improvement in investor confidence, and a turn-around in market sentiment.

3. Efforts to develop a multi-layered market system and diversified product structure

China's capital markets have long been dominated by the exchanges in Shanghai and Shenzhen without much diversification. The stringent listing requirements on size, profitability and industry focus exclude many companies. This limits their financing options and reduces the range of risk-return profiles available to investors. To expand the market, the SZSE began to explore the possibility of building a growth enterprise market in 2001 and set up the Small and Medium-sized Enterprises (SME) Board in May 2005. By the end of 2007, 202 SMEs were listed.

The Securities Association of China (SAC) set up a Share Transfer System in 2001 to help the transfer of tradable shares for companies originally listed on the STAQ and NET systems, which had been closed by the government in 1999. The system later also enabled transfers of shares of the de-listed companies from Shanghai and Shenzhen Stock Exchanges. In January 2006, ...

---

1. STAQ refers to the Securities Trading Automatic Quoting System developed in July 1992 by the Joint Office for Designing Securities Exchanges (known as the Joint Office originally, and renamed as China Securities Market Research and Design Center). The system mainly carried out trading of legal person shares.
2. NET refers to the National Electronic Trading System developed in April 1993 by China Securities Trading System Co. Ltd for the trading of legal person shares.
the System was further expanded to include share transfer of unlisted joint stock companies in Beijing’s Zhongguanchun Science Park. By the end of 2007, the System hosted trading for 8 firms originally on the STAQ and NET systems, 41 stocks de-listed from the two exchanges, and 23 companies of Zhongguanchun Science Park. A total of 570,000 accounts had been opened with the total trading volume amounting to 4.4 billion shares, and US $1.4 billion.

**De-listing Mechanism**

- The promulgation of the *Company Law* in 1994 stipulated in principle the conditions for the suspension of trading and de-listing of companies, but these rules were not implemented in practice.
- In April 1998, the Shanghai and Shenzhen Stock Exchanges created a “Special Treatment” (ST) category to distinguish shares of those companies with financial problems and their daily price change floor and ceiling limits were restricted to 5%. In April 1999, “Xia Haifa” became the first ST company after recording two consecutive years of losses.
- Subsequent to the enactment of the *Securities Law* in July 1999, the two exchanges issued new rules on suspension of the trading of shares of those companies which had recorded losses for three consecutive years, and categorized them as “Particular Transfer” (PT) stocks. Any PT company recording losses for a further three consecutive years would be de-listed. A PT company recording profits in any one year within three years of PT treatment could then apply for the resumption of its trading.
- In February 2001, the CSRC abolished the PT practice, and a company recording losses for three consecutive years was suspended from trading, and the exchanges no longer provided any share transfer services. A company would be de-listed if it failed to reverse losses in the year following its suspension. In April 2001, PT Shuixian became the first de-listed company from the A-share market.

With the launch of the SME Board and the Share Transfer System, China moved a step closer to developing a multi-layered market. New products were launched to meet the diversified demands of investors. These products included convertible bonds; asset-backed, mortgage-backed and non-performing loan-backed securities; collective investment schemes and warrants issued by enterprises or securities firms.
China Capital Markets Development Report

Table 1.3  Summary of the securities markets, 1999 – 2007

<table>
<thead>
<tr>
<th>Year</th>
<th>A-share funds raised (Billion US$)</th>
<th>B-share funds raised (Billion US$)</th>
<th>Number of securities accounts (million)</th>
<th>Total market value of shares (Billion US$)</th>
<th>Market value of floatable shares (Billion US$)</th>
<th>Total Turnover (Billion US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>10.8</td>
<td>0.05</td>
<td>48.1</td>
<td>319.8</td>
<td>99.2</td>
<td>378.3</td>
</tr>
<tr>
<td>2000</td>
<td>18.4</td>
<td>0.2</td>
<td>61.5</td>
<td>580.9</td>
<td>194.3</td>
<td>734.8</td>
</tr>
<tr>
<td>2001</td>
<td>14.3</td>
<td>0</td>
<td>69.7</td>
<td>525.8</td>
<td>174.7</td>
<td>462.8</td>
</tr>
<tr>
<td>2002</td>
<td>9.4</td>
<td>0</td>
<td>72.0</td>
<td>463.1</td>
<td>150.8</td>
<td>338.2</td>
</tr>
<tr>
<td>2003</td>
<td>9.9</td>
<td>0.04</td>
<td>73.4</td>
<td>513</td>
<td>159.2</td>
<td>388.0</td>
</tr>
<tr>
<td>2004</td>
<td>10.1</td>
<td>0.3</td>
<td>75.9</td>
<td>447.7</td>
<td>141.2</td>
<td>511.5</td>
</tr>
<tr>
<td>2005</td>
<td>4.1</td>
<td>0</td>
<td>77.1</td>
<td>395.9</td>
<td>129.8</td>
<td>386.5</td>
</tr>
<tr>
<td>2006</td>
<td>30.9</td>
<td>0</td>
<td>82.5</td>
<td>1,121.5</td>
<td>313.7</td>
<td>1,134.9</td>
</tr>
<tr>
<td>2007</td>
<td>105.8</td>
<td>0</td>
<td>138.9</td>
<td>4,478.6</td>
<td>1,274.1</td>
<td>6,305.0</td>
</tr>
</tbody>
</table>

Note: The “number of securities accounts” includes those accounts opened for A-shares, B-shares and securities investment funds.

Figure 1.4  Number of listed companies, 1999–2007

4. The initial development of the bond market

Relative to the scale of China’s economy, the national bond market was small, fragmented in its regulation and limited in the types of bonds traded. However, major developments in the legal and regulatory frameworks, the clearing and settlement systems, as well in the trading platforms, did occur. Information disclosure of issuers.

**Bond trading on exchanges.** The range and volume of bonds traded on the stock exchange continued to grow, with continued improvements to the trading systems. The net price bond trading introduced in 2002 facilitated more active trading on the market and improved liquidity. In 2004, government bond outright repo transactions were introduced, and in September 2005, the first domestic asset-backed security by a non-financial institution, China Unicom, was listed. In 2006, convertible bonds with strippable warrants were launched, while rules on registration, custody, and settlement of securities, especially the government bond repos, were further improved. In addition, some enterprise bond offerings were made publicly available on-line via the exchanges’ networks, enhancing the transparency and infor-

---

1. Currently, bonds traded on the exchanges are mainly government bonds, enterprise/corporate bonds, and asset-backed securities.
2. Net price refers to bond price quoted without accrued interest.
3. A strippable convertible bond is a combination of a bond and stock, and differs from a convertible bond in that the stock warrant is detachable from the bond, and there are no reset and redemption provisions.
Inter-bank bond market. The PBC set up the inter-bank bond market in 1997, where mainly institutional investors trade through the China Government Securities Depository Trust & Clearing Co., Ltd. (CDC) platform. The market expanded after 2000 by introducing new products and simplifying the rules. Financial institutions could now participate in the market simply by registration rather than formal approval by PBC as previously required, and their financial bonds could be issued with simplified pre-issuance review. Commercial papers could be issued by filing with the PBC. The range of market participants was broadened to include foreign institutional investors and domestic non-financial institutions. International institutions were also given permission to issue bonds denominated in Renminbi, also known as Panda bonds. The types of bonds issued by financial institutions included short-term, ordinary, foreign currency, subordinated, hybrid and asset-backed bonds. Bond forwards were introduced and enterprise bonds were also traded on inter-bank bond market. The introduction of DVP settlement and STP trading systems simplified the settlement and clearing process.

Retail services at bank counters. The counter service offered by commercial banks, an extension of the inter-bank market, was set up in 2002 for individual investors and SMEs to trade in treasury bonds. Since then, the locations for trading government bonds have increased rapidly. There was also a marked increase in the number of individual investors and settlement amounts.

China’s corporate bond market lagged behind due to the absence of a credit-rating system and fragmented supervision. Furthermore, the bond market’s development was hindered by the overlapping trading platforms regulated by different government agencies. These add extra costs to investors and deter new product development across the markets.

---

1. In October 2005, the International Finance Corporation and the Asian Development Bank issued RMB-denominated bonds of US $138 million and US $122 million, respectively, on the national inter-bank bond market. They were the first foreign institutions to issue such bonds, and this important move was beneficial in opening China’s bond market.

2. The PBC and CBRC issued the Measures for the Pilot Supervision and Administration of the Securitization of Credit Assets in 2005. The China Development Bank and CCB, as the first batch of issuers, respectively issued US $510 million of “Kaiyuan” and US $368 million of “Jianyuan” credit-backed securities.

3. Delivery versus payment. A delivery versus payment (DVP) settlement system for the inter-bank market began operation on November 8, 2004, when the book-entry and payment systems were connected.
The initial legal and regulatory framework for the futures market was completed with the promulgation of the *Provisional Regulations on the Administration of Futures Trading* in 1999 and the four regulations on the futures exchanges, brokerages firms, and the qualification of senior management and professionals in the futures markets.

At the same time, the futures market was cleaned up with the closure or suspension of brokerages that were either unqualified or acting illegally. In December 2000, the China Futures Association, the national self-regulatory body for the futures industry, was established in Beijing.

From 2003 onwards, the CSRC increased its efforts to strengthen risk management and supervision in the futures market by introducing a series of new regulations and measures. From 2004 onwards, new commodity futures con-

---

5. The futures market recovers

The initial legal and regulatory framework for the futures market was completed with the promulgation of the *Provisional Regulations on the Administration of Futures Trading* in 1999 and the four regulations on the futures exchanges, brokerages firms, and the qualification of senior management and professionals in the futures markets.

At the same time, the futures market was cleaned up with the closure or suspension of brokerages that were either unqualified or acting illegally. In December 2000, the China Futures Association, the national self-regulatory body for the futures industry, was established in Beijing.

From 2003 onwards, the CSRC increased its efforts to strengthen risk management and supervision in the futures market by introducing a series of new regulations and measures. From 2004 onwards, new commodity futures con-

---


![Table 1.4 Bonds issued, 1999 – 2007](image)

### Table 1.4 Bonds issued, 1999 – 2007

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>48.5</td>
<td>21.8</td>
<td>1.9</td>
<td>--</td>
<td>0.2</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>2000</td>
<td>56.3</td>
<td>19.9</td>
<td>1.0</td>
<td>--</td>
<td>0.3</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>2001</td>
<td>59.0</td>
<td>31.3</td>
<td>1.8</td>
<td>--</td>
<td>0</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>2002</td>
<td>71.7</td>
<td>37.2</td>
<td>3.9</td>
<td>--</td>
<td>0.5</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>2003</td>
<td>75.9</td>
<td>55.1</td>
<td>4.3</td>
<td>--</td>
<td>2.2</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>2004</td>
<td>83.7</td>
<td>61.5</td>
<td>4.0</td>
<td>--</td>
<td>2.5</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>2005</td>
<td>86.0</td>
<td>86.9</td>
<td>25.0</td>
<td>--</td>
<td>0</td>
<td>17.4</td>
<td>1.7</td>
<td>--</td>
</tr>
<tr>
<td>2006</td>
<td>111.4</td>
<td>119.4</td>
<td>49.4</td>
<td>--</td>
<td>0.5</td>
<td>2.6</td>
<td>36.6</td>
<td>3.5</td>
</tr>
<tr>
<td>2007</td>
<td>299.6</td>
<td>163.0</td>
<td>23.5</td>
<td>15.3</td>
<td>1.2</td>
<td>1.4</td>
<td>45.8</td>
<td>2.4</td>
</tr>
</tbody>
</table>


---

1. China Futures Association is a self-regulatory organization for securities industry. The members are either securities firms, special members of future exchanges, and professionals. Its key responsibilities are to communicate with the securities regulatory authority on behalf of its members, develop code of conducts for its members and play an arbitrage role between its members and between members and their clients.
tracts were introduced, including cotton, fuel oil, corns, No.2 soybean, sugar, soybean oil, PTA, zinc, rapeseed oil, LLDPE and olive oil. The preparation for the futures contract on gold was mostly finished. At the same time, the Guidelines on Corporate Governance of Futures Companies and the Administrative Measures for the Segregation of Futures Trading Margins were promulgated. Subsequently, client margin accounts were separated from those of the futures brokerage firms. The futures brokerage firms were required to report their net capital and other financial ratios, commercial banks were designated as custodians of margin funds and an investor protection fund was set up.

In May 2006, the China Futures Margin Monitoring Center was established to reconcile margin data from the brokerages, exchanges and custodian banks, and to allow investors to monitor their margin accounts and for supervisors to ensure the safety of these funds. As a result, futures trading now better reflected the economy and the underlying commodities spot market, which provided better hedging and pricing for market participants. In September 2006, the China Financial Futures Exchange was set up in Shanghai and the first financial futures products are due to be introduced soon.

As of the end of 2007, 16 commodity futures are traded in China. The three commodity futures exchanges in Shanghai, Dalian and Zhengzhou have been gradually unifying their trading rules and expanding the use of a common trading portal to lower transaction costs.

In March 2007, the revised Regulations on the Administration of Futures Trading was promulgated to introduce financial futures and options in addition to commodity futures, and to strengthen risk management and supervision.

6. WTO accession and the opening-up of the market

The opening-up of China’s capital markets gathered pace after China was admitted to the WTO in December 2001. By the end of 2006, China had fulfilled the commitments made to open-up the securities market at the time.

1 The commitments concerning the securities industry made by China when it entered the WTO included: (1) foreign securities firms could directly trade B-shares; (2) representative offices of foreign securities firms in China could apply for special membership at all domestic exchanges; (3) foreign service providers could set up joint ventures for securities trading and fund management, with initial shareholding capped at 33%, and 49% within three years of the WTO accession; and (4) within three years of the WTO accession, foreign securities firms could set up joint ventures with shareholding not exceeding 1/3, and the joint ventures could, without the need to enlist the service of an Chinese intermediary, underwrite A-shares, underwrite and trade B-/H-shares and government/corporate bonds, as well as launch funds.
of its accession to the WTO. The opening-up of China’s securities market accelerated the internationalization of the capital markets and related market reforms.

**Joint venture brokerages.** China issued the *Rules for the Establishment of Securities Firms with Foreign Investment and the Rules on the Establishment of Sino-foreign Joint Venture Fund Management Companies* in 2002. By the end of 2007, China had 7 Sino-foreign securities firms and 28 Sino-foreign fund management companies, of which 19 firms had foreign ownership holdings above 40%. The China offices of 4 foreign securities firms became special members of Shanghai and Shenzhen Stock Exchanges. Foreign securities firms trading B-shares reached 39 and 19 on Shanghai and Shenzhen Stock Exchanges respectively.

In addition, China Galaxy Futures and ABN Amro set up the first Sinoforeign futures joint venture in 2006, marking the start of foreign participation in China’s futures market.

**Launch of the QFII and QDII Programs.** Although there were restrictions in the convertibility of the capital accounts, China launched the Qualified Foreign Institutional Investor (QFII) program in December 2002 to allow licensed foreign institutional investors to trade A-shares on the secondary market. By the end of 2007, 52 foreign institutional investors had been granted QFII status, of which 49 had been allocated quota totaling US $9.995 billion. In addition, 5 of the 13 banks permitted to provide QFIIs custodian services were foreign. The QFII program has raised the international profile of China’s securities market and changed the landscape of competition in the fund management industry.

The Qualified Domestic Institutional Investor (QDII) program, launched in May 2006, allows licensed domestic institutional investors to invest in overseas markets. By the end of 2007, 15 fund management firms and 5 securities firms had been granted QDII status and an aggregate investment quota of US $24.5 billion. The introduction of the QDII program helped to balance the supply and demand in the foreign exchange market, and provided Chinese investors with opportunities to invest in international capital markets with a broader range of products.

**Large SOEs listed on overseas markets.** Large SOEs have continued to raise funds through overseas listing since 1999. In 2006, a total of US $39.3 billion had been raised. Red-chip and H-share companies have become
an important component of HongKong’s capital markets. (see Table 1.5)

![Graph showing QFII investment quota and market value of A-shares held by QFIIs, 2003-2007](image)

**Figure 1.6** QFII investment quota and market value of A-shares held by QFIIs, 2003-2007

Source: CSRC.

<table>
<thead>
<tr>
<th>Year</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funds raised (Billion US$)</td>
<td>0.6</td>
<td>6.8</td>
<td>0.9</td>
<td>2.3</td>
<td>6.5</td>
<td>7.8</td>
<td>20.6</td>
<td>39.3</td>
<td>12.6</td>
</tr>
</tbody>
</table>

Source: CSRC.

**Foreign investment in listed companies.** In November 2001, China permitted eligible foreign investment enterprises to apply for listing on the domestic exchanges.

In November 2002, foreign companies were allowed to purchase state-owned shares and legal person shares of listed companies. In February 2006, foreign investors were allowed to make strategic investments

---

[1] *Certain Opinions Relevant to Foreign Investment in Listed Companies* was issued in November 2001. Before that, the listing of some joint ventures had been approved, e.g. the listing of Shanghai Yaohua Pilkington Glass Company Limited in August 1993.

[2] *The Notice on the Transfer of State-Owned Shares and Corporate Shares of Listed Companies to Foreign Investors* was issued in November 2002.
in the A-shares of listed companies which had completed their non-tradable share reform.

**International cooperation on securities market supervision.** The CSRC has continued to enhance communication and cooperation with its overseas counterparts and other international organizations such as IOSCO. By the end of 2007, the CSRC had signed 37 bilateral Memorandums of Understanding (MOUs) with securities and futures regulatory authorities in 33 countries and regions. These MOUs contribute to the sharing of supervisory information, provide assistance on cross border investigations, and facilitate staff exchanges and cooperation on research. In June 2006, Mr. Shang Fulin, Chairman of the CSRC, was elected as the vice-chairman of IOSCO’s Executive Committee.

**Summary**

During this period, significant progress was made in strengthening the legal and regulatory frameworks of China’s capital markets with the promulgation of the *Securities Law* in 1999, and the amendments to the *Securities Law* and *Company Law* in 2006. Enforcement was enhanced with investigation and sanctioning of several severe cases of market irregularities, which also helped mitigate market risks and strengthen market integrity. *The Opinions* issued by the State Council spelled out government priorities on capital markets development and underpinned a series of structural changes and reforms that were aimed at promoting more market-oriented principles. The non-tradable share reform was one of the most prominent developments among all the reform efforts during this period and this contributed significantly to improving market efficiency. The introduction of foreign participation in the securities industry and the launch of the QFII program provided evidence of the further opening-up and internationalization of China’s capital markets. By 2006, China’s capital markets began to show more dynamism in response to these reforms and restructuring efforts.

---

1. *The Measures for the Administration of Strategic Investment in Listed Companies by Foreign Investors* was issued in February 2006.
Section 4
The Capital Markets’ Role in the National Economy and Social Development

The development of China’s capital markets has been made possible by China’s economic and financial reforms, and in turn it facilitated China’s economic and financial reforms. Consequently, the capital markets’ impact on the evolution of the corporate sector and on the economy and society as a whole continues to grow.

1. The impact of the capital markets on economic and corporate sector development

In the planned economy, resources were allocated by administrative means with low efficiency. With the gradual transition to a market economy, China’s capital markets have become an important platform for the allocation of economic resources.

_Listed companies have become an important component of China’s economic system._ By the end of 2007, the market capitalization of listed companies reached US $4.5 trillion, equivalent to about 132.6% of China’s GDP. Large-scale, profitable enterprises such as Bao Steel, SINOPEC, ICBC, China Life, China Ping An Group and Daqin Railway have become the backbone of the capital markets. Meanwhile, listed companies have begun to represent a broader range of industries in the economy, transitioning from the traditional industrial and commercial sectors to manufacturing, telecommunications, electronics, electricity and power, petroleum, chemicals and financial sectors. This development mirrors the growing importance of China’s capital markets to the national economy.

_The capital markets began to play an important role in financing and improving the allocation of resources, facilitating the growth of the corporate sector._ The capital markets have enabled business entities to access more external financial sources while reducing their reliance on bank loans and fiscal appropriations. This has contributed to a reduction in the leverage ratio of corporate sector. By the end of 2007, listed companies had raised a total of the US $245.9 billion from stock issues, and US $160.0 billion from bond issues. Furthermore, the capital markets
Figure 1.7  Comparison of industry distribution of listed companies between 2007 and 1992

2. Distribution by industry is based on market capitalization.
Source: CSRC.
have facilitated resource allocation into high performance sectors to build the core competitiveness of some key market players, and boosted the development of several key industries, including machinery manufacture, finance, electronics, energy, iron and steel, petroleum and chemicals. In addition, the capital markets have proactively fostered corporate restructuring and industrial structural adjustments. As a result, the value of state-owned assets has been safeguarded and even enhanced, while privately-owned enterprises have been given more development opportunities with the support of the capital markets.

**The capital markets make it possible for Chinese companies to discover and reassess their value.** Prior to the existence of capital markets in China, there was no valuation mechanism available for Chinese firms. In most cases, Chinese firms were sold at a price much lower than their market value when corporate valuation was based on net assets only and the transfer of equity and assets of SOEs were orchestrated within an opaque system, sometimes involving only one or two bidders. In the capital markets, the value of a corporate is based on its future cash flow rather than net assets. The higher the future profitability, the larger the expected cash flow and the higher the value
of the company. It is possible that the value of the firm is several times higher than its net assets. With the participation of various investors, institutional investors in particular, the companies can reach a relatively fair market value on the capital markets.

Many public firms, especially SOEs, have been able to realize a much higher valuation than the original SOE asset valuation through the capital markets development during the past two decades.

*The capital markets have also induced fundamental changes in corporate governance and the management of SOEs and state-owned assets.* In the course of their creation and development, China’s capital markets have promoted shareholding reforms for SOEs. A majority of state-owned listed enterprises have pioneered shareholding reform, and set a good example for other enterprises, while supporting the establishment of corporate governance in China.

Corporate governance, which was once ignored and almost non-existent, is now being given high priority and continually enhanced. Shareholders’ general meetings, boards of directors, and boards of supervisors are now in place in listed companies. Shareholders’ general meetings have assumed a more important role, with the increased participation of small shareholders who have a stronger sense of their rights. Boards of directors have become more independent (from controlling shareholders) and effective, with better procedural mechanisms. Supervisory committees have also achieved higher levels of vigilance. At the same time, the introduction of incentive structure has realigned the interests of both the management and shareholders. Listed companies are now subject to more external supervision following the introduction of independent directors and improved information disclosure.

SOEs have started to establish corporate governance through shareholding reforms and public listings. The capital markets have provided channels for the capitalization of state-owned assets. The management of state-owned assets began to shift its focus from supervision of the operations of SOEs to their financial performance, while risk management and comprehensive corporate performance indicators were developed and implemented in SOEs. For example, stock price and earnings per share have become the key performance indicators for SOEs since the completion of non-tradable share reform.

*Capital markets provide new channels to attract foreign capital, facilitating integration of China into the global economic system.* In the past, China was...
able to attract foreign capital only through foreign direct investment or joint investment when the public trading platform was not available. The competitive advantages in technology of foreign firms at the time left China with few choices but to open a market in order to acquire the necessary technology.

The emergence of capital markets provided Chinese firms with a more effective and transparent platform to raise international capital. Both international strategic investors and financial investors are attracted to invest in Chinese firms via the capital markets. Pricing of Chinese companies has in turn become more transparent and fair. With the completion of non-tradable share reform, China’s capital markets have no fundamental differences from foreign markets in terms of pricing and valuation. Foreign investors are now able to assess and price Chinese companies in accordance with international standards. Chinese companies are beginning to make their names known to international investors through capital markets, attracting more international capital and further integrating China to the world economy.

Enterprises growing along with the capital markets

*Zhenhua Port Machinery (Zhenhua).* Zhenhua was first listed in the B-share market in 1997, and has since raised a total amount of US$229 million from both the A-and B-share markets. Enjoying an eighteen-fold increase in net profit since its IPO, Zhenhua is now the world’s largest manufacturer of port machinery and large steel structures. Commanding a 60% share of the world market, it has consistently outperformed its competitors in terms of sales of large container machinery in recent years.

*China Merchants Bank (CMB).* Listed in 2002, CMB raised US $1.3 billion from its IPO in A-share market, US $2.6 billion from the issue of H-shares, US $785.3 million from the issuance of US $422.9 million from the issuance of subordinated bonds. With a four-fold growth in net profit between 2001 and 2006, CMB has recorded an increase of its core capital adequacy ratio from 4.23% to 9.58%.

*Su Ning Electronics Corporation (Su Ning).* Su Ning received gross proceeds of US $195 million from its IPO in 2004 and a secondary offering in 2006. With a six-fold increase in net profit since its IPO, Su Ning has rapidly expanded its chain operations and market share, while building up its market competitiveness.

The risk management and hedging functions of the futures market are being developed. The futures market provides risk management tools to economic entities to effectively set production targets and manage operational
brief review of the development of china’s capital markets

chapter 1

risks through their participation in futures contract trading or from the futures price information. Agricultural futures prices have become the indicative prices of agricultural products such as corn, soybeans, wheat, and cotton for the farmers in Northeast and Northern China, who have been able to adjust their crop mix accordingly and consequently enjoy more stable income. Thirdly, certain large commodity futures in China such as copper and fuel oil have an increasing bearing on international prices, indicating that futures prices are more reflective of the supply and demand situation in China. This has greatly enabled Chinese companies to better understand world market trends and to influence respective pricing, thus enhancing their international competitiveness.

2. The capital markets have given an impetus to financial system reforms

*Reshaping the financial structure.* Prior to the 1990s, China’s financial system was dominated by indirect financing. This led to an acute structural imbalance in financial structure. The subsequent emergence and development of capital markets has been key to driving the structural changes in China’s financial sector. At the end of Sep.2007, the total assets of the capital markets represented 37% of total financial assets in China.

![Figure 1.9 Direct financing as percentage of incremental loans, 1993-2007](image)

Notes: Direct financing amounts include those of stocks, convertible bonds, and corporate bonds.

Source: CSRC, PBC and *China Securities and Futures Statistical Yearbook, 2007.*
**Improving corporate governance in commercial banks.** In recent years, China’s leading commercial banks, including the state-owned banks, have been able to improve their capital adequacy ratios, diversify ownership structure and enhance corporate governance by undertaking shareholding reforms, introducing strategic investors and pursuing public listings.

**Enhancing profitability of financial institutions.** For many years, the interest spread between loans and deposits has been the principal source of profit for China’s commercial banks. However, the international trend shows that commercial banks around the world are gradually refocusing their business from the traditional deposit taking and lending to fee-based intermediary services. The development of the capital markets has widened the scope of intermediary businesses for China’s commercial banks by introducing, among other things, fund distribution, fund custody, and third-party deposit custody services. The revenues generated by these businesses have grown steadily over the past few years.

![Figure 1.10](image-url)

**Figure 1.10 Revenue from the fund custody service of commercial banks, between 2003-2007**

Source: CSRC.

---

① These include ICBC, BOC, ABC, CCB, CMB, Pudong Development Bank, Minsheng Bank, Industrial Bank, Huaxia Bank, China Everbright Bank, Bank of Communications, and CITIC Bank.
In addition, the capital markets also provide financial institutions, such as banks and insurance companies with access to a diversified range of investment instruments. Banks have increased their capital efficiency by investing in fixed-income instruments such as government and enterprise bonds. Likewise, insurance companies’ asset management has also undergone tremendous changes with reduced reliance on bank deposits and a higher percentage of capital invested in securities investment funds and equity, resulting in a significant shift in their business models.

Figure 1.11  
Investment in equity and securities investment funds as percentage of total investment by insurance companies, 1999-2007

Source: China Insurance Regulatory Commission.

3. The capital markets are demonstrating growing influence over social development

*The capital markets offer diversified investment channels to Chinese residents.* With the emergence of the capital markets, the range of investment products has expanded from solely bank deposits to stocks, government bonds, enterprise bonds, convertible bonds, securities investment funds, warrants and futures. Meanwhile, many new financial concepts have also been introduced into society. In particular, wealth management is becoming increasingly popular among retail customers, with the number of investment accounts increasing from 8.4 million in 1992 to nearly 138 million by the end of 2007. As a result, Chinese individuals are becoming increasingly interested in the performance of listed companies and macroeconomic development when investing in the capital markets and sharing in the growth of the Chinese economy.
**Investors earn return from the stock market.** Although China’s stock market has experienced several cyclical changes with bear and bull periods, investors have enjoyed relatively high stock market returns over the long run. Investors can now share in the growth of the Chinese economy by investing in the domestic stock market where large blue-chip companies have been listed and dividends have been paid by listed companies. Between 1992 and mid-2007, a total of US $74.0 billion was paid in dividends by Chinese listed companies. The wealth effect of the stock market has become evident through increased domestic consumption and the growth of related service industries.

**The capital markets are facilitating the improvement of the social security system.** The capital markets have provided diversified investment instruments for insurance companies and the NSSF and indirectly supported the improvement of the social security system. Over the years, insurance companies and social security funds have been increasing their investment in the capital markets. By the end of 2007, insurance companies and the NSSF held a total of US $31.4 billion and US $10.1 billion worth of floating A-shares respectively, and enterprise annuity funds invested a total of US $7.4 million in the capital markets through securities investment funds management companies.
A fully-fledged pension and medical insurance system will require the capital markets to provide effective investment channels. In turn, further development of the capital markets will be beneficial to developing a more inclusive social security system in China.

**The capital markets are nurturing new industries and a large number of professionals.** The development of China’s capital markets has prompted the emergence of securities, fund management and futures companies that not only have assisted Chinese firms to expand their business and create more job opportunities, but also have trained a large number of financial professionals in new business fields such as investment banking, securities brokerage, assets management, securities analysis and investment advisory services.

**Overview of financial professionals in capital markets**

According to the Statistics of SAC. As of June 15, 2006, there were 58,022 registered actioners in the securities industry in China. They were employed by securities firms (91.7%), fund management companies (4.5%), securities investment advisors (2.5%), fund custodians (0.8%) and other entities (0.5%). Among them, 59.2% are college graduates. Those working with fund management companies possessed higher academic qualifications, with 53.8% holding a master’s degree or higher.

**Promoting further improvement of legal and accounting systems.** The legal and regulatory systems of capital markets have developed in parallel with the progress of the capital markets, promoted the development of accounting rules and other relevant laws. For instance, China’s Property Rights Law recognizes the legal rights of securities with the emergence of a variety of new securities. A large number of administrative measures and regulations for the management of state-owned assets have also been enacted and amended with

**Capital markets and the enacting of the Company Law**

In 1980s, China started the shareholding reform of SOEs, and the capital markets established in early 1990s accelerated this process. To become a listed company, an enterprise had to be restructured into a shareholding company, with separate ownership and management, and modern corporate governance. Therefore, the commencement of capital markets promoted the restructuring of Chinese enterprises and the establishment of modern corporate governance, and also called for improvement in legal infrastructure. This promoted and accelerated the legislation of company law. The Company Law was promulgated in 1993, which provided foundation for the SOE restructuring and capital markets’ development.
more and more SOEs going public. Further, criminal laws are continually being improved and amended to counter illegal practices in financial markets.

The development of China’s capital markets has also promoted the improvement and enactment of new business accounting rules. The new China Accounting Standards, particularly with respect to the implementation of new financial reporting and auditing standards, have moved China closer to international accounting standards. This effort will help improve the quality of financial information disclosure so as to provide more objective and accurate information on the financial status of Chinese firms to investors and other market participants.

**Summary**

The development of China’s capital markets has exerted a profound influence on the national economy and society. Benefiting from the capital markets’ development, China’s corporate sector has restructured, expanded and integrated, state-owned enterprises and their assets are now better managed, private enterprises have developed, and listed companies have become key components of the national economy. China’s financial structures have also been transformed, with improved direct financing ratios and an enhanced capacity to counter financial risks. Financial institutions have improved their profitability and operational efficiency. More importantly, the growth and development of the capital markets has prompted many economic and social changes in China. Joint stock companies have become the mainstream of the Chinese corporate sector, resulting in an improvement in corporate governance, as well as spurring a refinement of relevant legal and accounting systems, and fiduciary trust. Wider public participation in the domestic capital markets has led to a wealth effect and the inception of wealth management for households. From the outset, development of the capital markets has been at the forefront of China’s economic reforms and a growth driver for China’s economy. The experiences and lessons learned from the reforms in capital markets have constituted a major part of the valuable experience of China’s economic reform.
Chapter 2

Important Capital Markets Policies and Reforms in Recent Years

China’s capital markets have developed rapidly. However, there are some deep-rooted problems and structural issues that are limiting the effective functioning of the markets and restricting future market expansion. China’s capital markets can be best described as “emerging markets in a transitional economy”.

These problems and issues arose in the process of development, and have to be solved by further reforms. In early 2004, the State Council released *Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets* which highlighted the strategic importance of the capital markets in the development of the national economy, and set out certain guidelines for future market development.

At the same time, the CSRC implemented a series of reforms to improve market infrastructure and functionality. These measures included the launch of non-tradable share reform, improving the quality of listed companies, the restructuring of securities firms, reform of the share issuance procedure, liberalization of the investment fund management industry and development of institutional investors. Supplementary rules and regulations have also been developed and adjusted since the enacting of the amended *Company Law* and *Securities Law* in 2006. The combination of these measures resulted in profound changes in China’s capital markets.

A review of the lessons learned in the recent reforms shows that capital market development can only be ensured if it is taken as an integral part of the national strategy for economic development, and supported by well-coordinated policies and regulatory development. In addition, the capital markets should serve China’s national economic reform and development goals. One should also recognize that China’s capital markets development has been driven by a mix of government direction and organic market development, which is in contrast to that of more advanced markets. Com-
patible with the gradual approach for market liberalization, China’s capital markets are gradually adopting international practices in rules and regulations. Three key themes characterize the recent reforms and changes in China’s capital markets, namely market liberalization, standardization of rules and regulations, and globalization.
Section 1
Release of Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets

1. Background

In less than two decades, China’s capital markets have undergone fundamental changes which have taken other more mature markets many decades to complete. However, China’s capital markets are still at an early stage of development and retain certain structural problems arising from overall social and economic development constraints. In 2001, the stock market entered a period of stagnation which highlighted these structural problems.

On January 31, 2004, the State Council released Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets (the Opinions). This effectively served as high-level guidance for the further reform and development of the capital markets, and elevated the development of China’s capital markets to a national, strategic level.

2. Key policy directions

The Opinions declares that developing the capital markets is of strategic importance, as it will support the development of a socialist market economy; optimize resource allocation; funnel surplus capital into long-term investment; facilitate the restructuring of state-owned enterprises; accelerate private sector growth; improve the structure and efficiency of the financial markets; and help maintain financial security.

The Opinions states that developing the capital markets should follow the principles of openness, fairness and equality, and the policy of “rule of law, supervision, self-regulation, and standardization”. The rule of law must be upheld and the legitimate rights and interests of investors, particularly individual investors, must be protected. Further liberalization has to be carried out, which will give full play to market forces. In addition, problems arising from market development should be solved in a pro-active way, and the level of openness of the market to the outside world should be increased.

The Opinions sets out the policy objectives for market reform and stable
development, which includes increasing the ratio of direct financing, and fully recognizing the fundamental role of capital markets in resources allocation.

To achieve these objectives, efficient and transparent capital markets need to be nurtured with the features of optimized structure, healthy infrastructure, versatile functions and high efficiency; moreover, it is also necessary to gradually establish a multi-layered capital markets system to satisfy the diverse needs of enterprises.

*The Opinions* also determined that non-tradable share reform will be carried out according to market principles.

![Figure 2.1 Main contents of the Opinions](image)
Summary

*The Opinions* is the first pronouncement by the Chinese government that comprehensively described the government’s take on the importance of developing the capital markets, the policy guidelines and key tasks to be accomplished and the specific measures to be taken for implementation.

*The Opinions* represented a significant elevation of the status of the capital markets to a level of national strategic importance. The State Council’s move has profound historical significance, and provides guidelines for the future development of China’s capital markets in the coming years.
Section 2
Non-tradable Share Reform

1. Background

The problematic legacy of the non-tradable shares stemmed mainly from a lack of consensus on shareholding systems in the early years; a lack of clarity over the role and functions of the securities markets; and a lack of awareness of how to manage state assets through capital markets. This inherent flaw in the system hampered the development of China’s equity markets and management of state-owned assets. With the increasing issuance of new shares, the hangover of the non-tradable share on the growth of the capital markets has become increasingly obvious in recent years.

Attempts to reduce the state-owned shares

In September 1999, Lujiazui Development Company (Ticker: 600663) bought back 200 million state-owned shares at US $0.24 each through a share buyback agreement. In December 1999, the owners of non-tradable shares in China Jialing (Ticker: 600877) and Guizhou Tyre (Ticker: 000589) pioneered the reduction of state-owned shares by selling them to existing shareholders. Other methods later explored included equity transfer agreements, direct placements, and the issuance of the remaining state-owned shares to the public.

The Provisional Measures on Raising Social Security Funds through Sales of State-owned Shares was issued by the State Council to expand the funding sources for the National Social Security Fund (NSSF) on June 12, 2001. According to the proposal, when joint stock limited companies with state-owned shares (including companies listed abroad) conducted IPOs and secondary offerings, it is mandated that additional shares, equivalent in value to 10% of the IPO proceeds, should be sold on the market as well, and the proceeds should be submitted to the NSSF. For all negotiated equity transfer, the representative unit authorized by the state-owned shareholders should submit to the NSSF a certain percentage of the transferred gains.

In June 2002, the MOF and the CSRC suspended the reduction of state-owned shares in the A-share market.

Prior to the Opinions, there had been attempts to reduce the amount of state-owned shares through sales of these shares on the open market, which were later suspended for various reasons. By the end of 2004, the total shares of listed Chinese companies were 714.9 billion, of which 454.3 billion shares, or 64% of the total, were non-tradable. Of the non-tradable shares, 74% were state-owned.
2. Main elements of the reform and implementation process

Effective resolution of the non-tradable shares problem could only be achieved through a transition to an entirely new shareholding structure. Such a system needed to eliminate differences between the various types of A-shares, balancing the interests of non-tradable and tradable shareholders with issues being resolved through negotiation. On April 29, 2005, under the leadership of the CPC and the State Council, the CSRC launched the reform. The reform was carefully designed and well-organized in its implementation, following the principle of “centralized organizing and decentralized decision-making”. An implementation strategy based on pilot programs to test the market reaction was followed by a gradual and coordinated market roll-out.

The problem of the overhang of non-tradable shares can be dated back to the early experiment of corporate ownership restructuring, when the listed companies promised in the IPO prospectus or the public announcement for listing that the shares owned by the shareholders prior to the public offering would remain unlisted and non-tradable. The non-tradable share reform was intended to lift such restrictions and make these shares publicly tradable. The non-tradable share reform was implemented following the guiding principles and implementation strategies outlined in Figure 2.2.

Figure 2.2 Guiding principles and implementation strategies of the non-tradable share reform

The problem of the overhang of non-tradable shares can be dated back to the early experiment of corporate ownership restructuring, when the listed companies promised in the IPO prospectus or the public announcement for listing that the shares owned by the shareholders prior to the public offering would remain unlisted and non-tradable. The non-tradable share reform was intended to lift such restrictions and make these shares publicly tradable. The program design and implementation process allowed market participants to be in the driver’s seat. The Contract Law requires the holders of non-tradable shares to reach agreement with the holders of tradable shares in order to
change the status of shares and settle on appropriate compensation. In practice, the holders of non-tradable shares generally compensated the holders of tradable shares by giving out a portion of their shares at mutually agreed prices. The final considerations\(^\text{1}\) were decided by all the shareholders based on the principles of “fair negotiation, mutual trust, and independent decision making and reflected the specific situation of each listed companies. No government intervention or standard pricing was imposed. The process typically started with a proposal for floating the non-tradable shares put forward by the holders of non-tradable shares, which would then be revised by all shareholders. This would be followed by a vote on the proposal by all shareholders and by holders of tradable shares respectively. Listed companies were required to provide the necessary IT systems to allow shareholders to vote online. The proposal could only be passed if at least two-thirds of the shareholders voted and at least two-thirds of holders of tradable shares endorsed the proposal, a measure to protect the interest of small investors in the negotiation process. Listed companies planning to float the non-tradable shares could take measures to stabilize share prices when necessary.\(^\text{2}\) The design and implementation of the reform were based on market-oriented principles.

Non-tradable share reform helped to eliminate the legacy problems in China’s stock market, where unequal rights were given to the shareholders of state-owned shares, legal person shares and tradable shares, resulting in different pricing of these shares. After the reform, unified equity rights and pricing were established and the secondary market started to reflect the value of the listed companies more accurately. The reform helped to a large extent to improve resource allocation efficiency in China’s capital markets, while narrowing the gap with international markets in terms of fundamental market mechanisms.

\(^\text{1}\) In practice, listed companies gave either shares or warrants to shareholders of tradable shares in return for getting their vote for floating the non-tradable shares. On average, three additional shares were given out for every ten shares held by shareholders of tradable shares.

\(^\text{2}\) Including sales of shares to controlling shareholders, share buy-back by listed companies, preset conditions for sales of previously non-transferable shares, preset repurchase prices, and issuance of warrants.
**Milestones of the non-tradable share reform**

**2005**

- **April 29**
  - CSRC issued the *Circular on Relevant Issues Regarding Pilot Programs of Non-tradable Share Reform of Listed Companies* and initiated the non-tradable share reform.

- **May 8**
  - The Shanghai and Shenzhen Stock Exchanges and the China Securities Depository and Clearing Corporation (CSDC) jointly issued the *Guideline on the Operational Practices Regarding Pilot Programs of Non-tradable Share Reform of Listed Companies*. Sany Heavy Industry, Zijiang Enterprise, Jinniu Energy, and Tsinghua Tongfang Computer became the first batch of pilot companies under the reforms.

- **June 10**
  - The reform plan of Sany Heavy Industrial was passed by a high margin, making Sany Heavy Industry the first listed company to successfully undertake the reforms.

- **June 16**
  - CSRC issued the *Provisional Measures on stock Buyback of Public-held Shares by Listed Companies (Trial)* to help build a market environment conducive to the reforms.

- **June 17**
  - SASAC issued the *Guideline on the Non-tradable Share Reform of State-controlled Listed Companies*.

- **June 19**
  - The second batch comprising 42 companies started reform procedures.

- **August 23**
  - The reforms became mainstream when the CSRC, SASAC, MOF, PBC and MOFCOM jointly issued the *Guideline on the Non-tradable Share Reform of Listed Companies*, and CSRC issued the *Measures on the Non-tradable Share Reform of Listed Companies*.

- **September 6**
  - The Shanghai and Shenzhen Stock Exchanges and the CSDC jointly issued the *Guideline on Operational Practices of Non-tradable Share Reform of Listed Companies*.

- **September 12**
  - 40 listed companies announced the initiation of the non-tradable share reform marked the second wave of pilot companies.

- **November 5**
  - CSRC and MOFCOM jointly issued the *Circular on Relevant Issues Regarding Management Foreign Capital in the Non-tradable Share Reform of Listed Companies*, to standardize the reform of foreign-invested listed companies.

- **November 22**
  - All 50 companies, listed on the small and medium-sized enterprise board of the SZSE, finished the reforms.

**2006**

- **May 8**
  - The *Measures of Securities Offering of Listed Company* took effect, and the listed companies that had finished the non-tradable share reform were allowed to raise funds on the stock market again.

- **May 24**
  - China CAMC Engineering Co., Ltd. became the first company to have an IPO after the reform.

**2007**

- **By the end of 2007**
  - Listed companies that represented 98% of the market capitalization had completed the reform or at least started the process.
By the end of 2007, 1,298 companies listed on the Shanghai and Shenzhen Stock Exchanges had either initiated or completed the process of non-tradable share reform, accounting for 98% of the total listed companies that were subject to the reform. Only 33 listed companies had not completed the reform. Therefore, non-tradable share reform was mostly completed within two years.

**Summary**

The reform of non-tradable shares was a landmark in improving the infrastructure and the efficiency of China’s capital markets. It was remarkable not only for solving legacy structural problems in the market, but also for paving the way for further innovation and other capital market reforms.

The successful implementation of non-tradable shares reform demonstrated that capital markets reform must be designed to follow the basic market principles, promote market stability and develop and protect the legitimate rights of investors, particularly individual investors. In resolving legacy structural issues and dealing with a complex web of market interests, the reform programs should be designed to seek a desirable balance between the dynamics of reforms and the need for market stability. For the successful implementation of reform strategy, the interaction of the government and the market should be clearly defined to strike a balance between the government-driven reform program and a market-driven decision making process by market participants.
Section 3
Improvement in the Quality of Listed Companies

1. Background

Listed companies are the foundation of capital markets. For more than 10 years, China’s listed companies have been developing and expanding. They have become a driving force behind corporate reform and industrial growth. Nevertheless, due to various systematic and institutional factors, a number of listed companies have poor corporate governance and low quality, which have significantly affected investors’ confidence and hampered the healthy development of the capital markets.

In recent years, after the release of the State Council’s *Opinions*, the CSRC initiated a series of reforms to boost the quality of listed companies, protect investors’ rights and interests, and promote the sustained and robust development of capital markets. This included formulating *Opinions on Upgrading the Quality of Listed Companies*, which the State Council approved in November 2005. Since March 2006, the CSRC has initiated a number of specific programs aimed at enhancing the compliance of listed companies, strengthening corporate governance and improving the quality of listed companies.

2. Specific measures

*Improvement in the supervision and regulation of listed companies.* In 2004, the CSRC decentralized frontline supervision to its regional offices, a milestone in the reform of the supervision of listed companies. The new supervisory structure required the CSRC’s regional offices to take an active role in supervising listed companies in their respective jurisdictions, delegating the supervisory authorities and responsibilities to these regional offices and encouraging collaboration among them. This new approach allowed the CSRC to improve the efficiency and effectiveness of supervision, maximize supervisory resources and focus on systemic risks while giving more authority and responsibility to the regional offices. Regulatory resources have been consolidated and streamlined, and the coverage and vigor of supervision has been enhanced. Consequently, the CSRC has stepped up the development of a comprehensive supervisory system for listed companies jointly with many other central government departments, as well as local governments.
The Opinions on Enhancing the Quality of Listed Companies

In November 2005, the State Council circulated the Opinions on Enhancing Quality of Listed Companies, drafted by the CSRC to improve the healthy development of the capital markets. The document addresses the following six areas:

1) Enhancing the quality of listed companies is of great importance to capital markets development.

2) Improving the corporate governance of listed companies so as to build up their competitiveness and profitability. Internal control measures should be established, operations should be more transparent, incentives for and supervision of senior management and employees should be developed.

3) Developing policies that target the causes and effects of the prominent problems that constrain the performance of the listed companies. These include ensuring the independence of listed companies, requiring proper disclosure of usage of funds raised, prohibiting misappropriation of funds, preventing listed companies to provide guarantees to other firms against rules and regulations, regulating related party transactions, and sanctioning on false financial and accounting reports.

4) Developing measures to facilitate the growth and expansion of listed companies. These could include encouraging high quality companies on the market to expand and innovate, enhancing the efficiency of refinancing for listed companies and developing multi-layered capital markets.

5) Improving supervision of listed companies, and coordinating and strengthening supervision among government agencies. This could be achieved by improving fiduciary trust for listed companies, regulating the market conducts of the controlling shareholders or de facto controllers of listed companies, supervising the senior management of the listed companies, and giving full play of the self-regulation in the industry.

6) Creating a favorable policy environment at all government levels for listed companies, by attaching importance to the quality of listed companies, developing measures to prevent and mitigate risks, and building an environment that encourages growth of listed companies.

Strengthening information disclosure. After 1999, the supervision of listed companies gradually shifted from administrative approval to information disclosure. In light of the development of the capital markets, the CSRC initiated a concerted, ongoing effort to standardise information disclosures of listed companies. The CSRC formulated the Administrative Measures for the Information Disclosure of Listed Companies,\(^1\) to accomplish several necessary changes. These changes included supporting the stricter requirements on information disclosure of listed companies stipulated in the new Company Law and Securities Law; improving the transparency of operations of listed companies; adapting to increased requirements regarding listed company

\(^1\) Administrative Measures for Information Disclosure of Listed Companies was announced in February 2007.
supervision following the non-tradable share reform; and enhancing the quality of information disclosed by listed companies as well as the effectiveness of supervision.

**Improving corporate governance.** In recent years, the CSRC has released a number of regulations and rules to improve the corporate governance of public companies, including the *Guidelines for the Articles of Association of Listed Companies*, *Opinions on Standardization of General Shareholders’ Meeting*, *Code of Corporate Governance for Listed Companies*. It has also introduced an independent directorship. After the commencement of non-tradable share reform, the CSRC amended the *Rules for the General Meetings of Shareholders of Listed Companies*, *Guidelines for the Articles of Association of Listed Companies* and other relevant rules, which facilitated the establishment of the basic framework and principles for corporate governance of listed companies, and enabled the standardization of the corporate governance practices.

**Forced repayment of misappropriated funds of listed companies.** The problem of misappropriation of funds by major shareholders or related parties in many listed companies has severely hindered the healthy growth of these listed companies. To tackle these problems, the CSRC enacted regulations to strictly prohibit controlling shareholders and other related parties from misappropriating the funds of listed companies. Pilot projects of “debt-equity swaps” were carried out and a comprehensive drive for repayment of misappropriated funds was undertaken with the cooperation of local governments and relevant departments. To establish a mechanism with long-term effects and prevent the recurrence of this problem, an article on the crime of the misappropriation of listed companies’ assets was added to the *Criminal Law of the People’s Republic of China*. The crackdown on the misappropriation of funds of listed companies by majority shareholders or controlling shareholders intensified significantly.

By the end of 2006, 399 companies had entered into or completed a repayment of misappropriated funds. The funds involved amounted to US $4.9 billion. The number of listed companies affected by fund misappropriation and the

---

1. To further improve the structure of corporate governance of listed companies and their operation, the CSRC released the *Guidance Opinions on the Establishment of an Independent Director System in Listed Companies* in August 2001. An independent director is a director who has not assumed any other positions in the company and who has no material relationship with the listed company employing him and its major shareholders which may affect his ability to make independent and objective judgement. An independent director has fiduciary and due care responsibility to the listed company and all its shareholders.
amount of funds misappropriated declined by 93% and 84% respectively, compared to those of the same period of the previous year. The problems of fund misappropriation by controlling shareholders or de facto controlling shareholders had been mostly resolved.

**Figure 2.3** Misappropriation of funds of listed companies by major shareholders, 2001-2006


**Establishment of incentive structure.** With the amendments to Company Law and Securities Law and the implementation of non-tradable share reform occurring at full speed, the legal foundations and market environment for providing incentive structure steadily improved. The CSRC announced the *Administrative Measures on Stock Incentives by Listed Companies (Provisional)* (Administrative Measures) in January 2006. Aimed at promoting the establishment and improvement of a sound incentive and supervision mechanism for listed companies, the *Administrative Measures* prescribed that stock incentives should be mainly in the form of restrictive shares and stock options. It also set rules for implementation procedures and information disclosure of these stock incentive programs. The *Administrative Measures* have had far-reaching effects on the compliance and sustainable growth of listed companies.

Prior to this, the CSRC released the *Opinions on Regulation of Stock Incentives by Listed Companies* in November 2005, prescribing that listed companies that had completed non-tradable share reform may implement a stock incentive mechanism.
Pushing forward market-driven M&A and restructuring. There has been a significant increase in merger and acquisition activities, restructuring of listed companies and listing of industrial groups in the market, following the revision of the *Administrative Measures on the Merger and Acquisition Transactions Involving Listed Companies* in 2006 and the issuance of information disclosure standards. A new pilot program encouraged controlling shareholders of listed companies to put their quality assets into the listed companies. This also triggered new M&A activities. Furthermore, the CSRC set up a review committee for mergers and acquisitions of listed companies to review and approve transactions under a unified set of evaluation standards. This aimed to enhance the transparency and efficiency of supervisory approval procedures. At this point, the capital markets became the main vehicle for corporate restructuring and industrial consolidation for Chinese firms.

Summary

Listed companies are the foundation of China’s capital markets as the group of companies with high growth potential in the national economy. It is in the interest of Chinese companies as well as capital market investors to see the listed companies increase their ability to build up their competitive edge in the market and maintain growth. The quality of listed companies is a critical determinant of the vitality of the capital markets, which play an important resource allocation function within the economy. For listed companies, further efforts have to be made to maximize shareholders’ interests, improve corporate governance and management, improve transparency and market integrity of listed companies, and maintain growth momentum and performance. In the meantime, all relevant parties should make efforts to create an environment which encourages listed companies to continuously improve standards of corporate governance and commercial performance.

---

1 The original Administrative Measures was formulated in 2002 and amended in 2006.
Section 4
Comprehensive Restructuring of Securities Firms

1. Background

The role of securities firms as intermediaries is critical to the healthy development of the capital markets. Many securities firms quickly expanded their business without building up sound business models, proper corporate governance and internal control measures. These deficiencies became apparent as they engaged in wild speculation in the market. Many were found engaging in illegal activities such as misappropriation of clients’ capital and insider trading. By early 2004, the whole industry was on the brink of bankruptcy with years of risky and sometimes illegal investments and a lack of proper supervision and enforcement. In response to this, and with the State Council’s endorsement, the CSRC launched a comprehensive restructuring program to turn around ailing securities firms. In order to address both the symptoms of the problems and the root causes, the CSRC implemented three key strategies, namely liquidation and restructuring of failed companies, stricter supervision and industry capacity building, and initiated the comprehensive restructuring of securities firms.

2. Restructuring measures

Starting in 2004, the CSRC categorized securities firms according to their risk exposure level and developed different policies and supervisory measures toward each. The CSRC established a set of standards for assessing

---

1 During the period from 2002 to the end of 2003, the CSRC imposed sanction on eight securities firms, such as Anshan Securities Firm, Dalian Securities Firm, and Xinhua Securities Firm. In August 2004, the CSRC held a special symposium, which specified the overall direction, basic principles and main objectives of the monitoring and supervision of the securities firms. Also in this symposium, an extensive action plan was created and a comprehensive governance programme was formally initiated. In July 2005, the State Council Office forwarded the Scheme for the Comprehensive Restructuring of Securities Firms, formulated by the CSRC, requiring the active cooperation and collaboration of local governments and relevant authorities. By the end of October 2006, 31 securities firms were ruled against, including the Southern Securities Firm, Minfa Securities Firm, Deheng Securities Firm and Guangdong Securities Firm.

2 Since August 2004, the CSRC has divided over 130 securities firms into four categories, A, B, C, D. Companies in the “A” category are “innovative companies” qualified for “innovative” business activities; companies in the “B” category are standard companies qualified for IPO pricing, asset management and financing on the inter-bank market; companies in the “C” category are companies with high business risks; and companies in the “D” category are those with the highest risks of failure. Companies in the “C” and “D” categories are the targets of the comprehensive restructuring program.
the operations of securities firms. Companies which were assessed as being “innovative” or “standard” were supported when expanding their business on the condition that the potential operating risks would be measurable, controllable, and acceptable. The CSRC then conducted a survey of securities firms’ risk exposure. It investigated and punished illegal or high-risk activities, such as the misappropriation of clients’ deposits, bonds or discretionary funds, the misappropriation of companies’ assets by shareholders or other related parties, and illegal off-balance-sheet operations.

While maintaining market and social stability as a top priority, the CSRC imposed sanctions against 31 companies, whose high-risk operations were not rectifiable by the companies themselves, or who had seriously violated laws or regulations based on thorough investigation. The CSRC explored diversified models for the restructuring and merging of these companies and punished the responsible persons according to law; mandated third-party custody of clients’ assets and revised the operating systems for government bond repurchasing, assets management, and proprietary trading.

A public disclosure policy on securities firms’ basic and financial information was instituted. Risk monitoring and early-warning systems were developed based on net capital rules. Supervision of the senior management and shareholders of securities firms and their business activities was strengthened.

Having learned from international experience, the Chinese Securities Investor Protection Fund Co., Ltd. was established to enhance investor protection and facilitate market exit and liquidation of securities firms. At the same time, where the potential operating risk was measurable, controllable and acceptable, the CSRC also began to allow innovation for qualified securities firms in terms of product, and business model, on a “trial and error” basis. The successful pilots established examples for others to follow. In July 2007, the CSRC categorized securities firms according to their risk management

---

1. The recent restructure and merger models used for securities firms include: entrusting a third party to manage the company; restructuring companies on the edge of bankruptcy or a financial crisis; restructuring companies currently within a financial crisis via additional investment; merging well-performing securities firms to integrate industry resources; and introducing foreign investment for merging.

2. Founded in August 2005 with a registered capital of US $771 million, its operation scope includes making payments to creditors according to relevant national legislation when a securities firm is terminated, stops operating or becomes bankrupt, or, subject to compulsory measures, a securities firm is taken over by the CSRC or by a designated trustee.
capacity and performance\(^1\), encouraging more competitive companies to excel.

By the end of August 2007, the CSRC announced that it had completed the comprehensive restructuring program of securities firms and achieved its desired goals. This comprehensive restructuring program was key to resolving the accumulated historic market risks and problems, such as false financial information, illegal off-balance-sheet operations, and misappropriation of assets, which previously had compromised the effective operation and development of securities firms.

![Figure 2.4 Total assets and operating income of securities firms, 2001-2007](image)

Source: CSRC.

The restructuring of securities firms resulted in establishing a long-term risk prevention mechanism, with many fundamental infrastructure systems being improved or modified. Upon completion of the restructuring, securities brokerage companies raised their awareness of operational compliance. Innova-

\(^1\) Securities firms are now categorized into 5 classes and 11 sub-classes, ie, A(\text{AAA,AA,A}), B(\text{BBB,BB,B}), C(\text{CCC,CC,C}), D and E, with A-class firms being those with the best performance in risk management, E-class firms being those with the highest risk and having commenced the crisis-control process.
tive programs were introduced to improve industry efficiency. By the end of 2007, the total assets and net assets of the 106 securities firms reached US $237.0 billion and US $47.2 billion respectively, 354% and 283% greater than those at the end of 2003 prior to the restructuring reforms. In 2007, the annual operating income of the industry was US $39.0 billion, with net profits of US $18.1 billion. All but two of China’s 106 securities firms generated profits in 2006, ending four consecutive years of loss across the industry between 2002 and 2005. All major financial indicators for the industry reached or surpassed previous record levels.

![Figure 2.5 Net profits of the securities firms, 2001-2007](image)

Source: CSRC.

**Summary**

The success of the comprehensive campaign to restructure the securities firms indicates that market risk mitigation and mechanism-building should be carried out in parallel to reinforce each other. The enforcement of regulation and the need for innovation should be integrated. Securities market reforms should not only address the symptoms, but also the root causes of fundamental problems while the latter are more crucial. The restructuring of securities firms with high risks should proceed with minimum disturbance to the market.
and social stability. The long-term health of the securities industry can only be guaranteed with continued improvement in the fundamental mechanism governing its operation and supervision.
Section 5
Issuance System Reform

1. Background

Between 1990 and 2000, when China’s capital markets began to develop, public offerings of shares were subject to administrative approval from the authorities. In March 2001, a new ex-ante review and approval system for public offering of stocks was introduced by the CSRC, which required pre-issuance mandatory information disclosures and post-issuance investigations. At the same time, a regulatory system for supervising public offerings was developed with simplified and standardized procedures. Subsequently, more market-driven pricing gradually replaced government-driven pricing mechanisms during the offering process. Comparatively, public offerings in developed markets usually require registration with supervisory authorities and the procedures for stock issuance tend to be simple and standardized, with the price decided by the market directly. There is still room for improvement in the issuance system in China for the sake of enhancing market efficiency.

Figure 2.6 The evolution of the issuance system
2. Main measures and the reform process

*Improving the transparency of the share issuance approval system.* In February 2004, the *Provisional Measures on the Sponsorship System for Issuing and Listing of Securities* was put into effect by the CSRC, replacing the leading underwriter recommendation system (with a quota ceiling for each underwriter) for issuing and listing of securities, with a sponsorship system.

The establishment and reform of the Public Offering Review Committee (the Committee)

Established in September 1999, the Committee was given responsibility to provide professional opinions on the performance of companies applying for public offering. The committee was composed of 80 members from the CSRC, other government agencies, stock exchanges and academia. For each meeting, nine members of the Committee would be selected on an anonymous basis. Voting results by the members would dictate the final decisions of the CSRC for either approving or rejecting the applications. Voting was also anonymous and at least 2/3 of the votes were needed to pass an application. The establishment of the Committee marked the beginning of issuance system reform. However, its operations had been secret and the identities of the committee members confidential, a practice questioned by market participants as it generated cases of corruption.

In December 2003, major restructuring of the Committee was carried out with the *CSRC’s Provisional Measures on Public Offering Review Committee*. The size of the Committee was reduced from 80 people to 25, including 13 full-time members from the CSRC, accounting firms, asset appraisal companies and law firms, 12 part-time members from the CSRC, other government agencies, academia, stock exchanges and financial intermediaries. Seven members of the Committee would attend each committee meeting; at least five votes would be needed for acceptance of an application. Voting results would be recorded in real names and the responsibilities of members of the Committee were clearly defined and made known to the public. Prior to each committee meeting, the CSRC would inform the public the identities of the participating members, the applicants information, and the final decision of the meeting afterwards. This marked a significant improvement in the transparency of the operations of the Committee.

In May 2007, the number of full-time committee members was increased from 13 to 17, without changing the total number of committee members catering to increasing IPO applications.

The establishment and reforms of the Public Offering Review Committee have upgraded the professionalism and transparency of the issuance examination process; and have also augmented public supervision and issuance efficiency.

---

1. Channel restrictions: the system under which the number of the stock issuance channels held by securities firms was assigned by the CSRC and the SAC. The CSRC only accepted a new IPO application from a securities firm after that firm’s previous application was approved. This system aimed at controlling the number of IPO companies being simultaneously recommended by securities firms. After the implementation of the sponsor system in February 2004, the CSRC used both systems during a transitional period till January 2005, when the channel restriction system was formally abolished.
system. At the same time, an accountability mechanism for controlling sponsor institutions and sponsor representatives was established. At the end of 2004, the *Provisional Measures for Public Offering Review Committee* was implemented. These measures abolished the secrecy rule to keep the identity of committee members confidential, replaced the anonymous voting with real-name voting by the Committee members and defined the accountability and supervision mechanisms for committee members. The provisions also ensured that all stakeholders under the verification and approval system for issuance shared the responsibilities and risks, marking the first step towards a market-oriented issuance system.

**The sponsorship system for stock issuance**

The sponsorship system for stock issuance was first introduced in December 2003 for initial public offering of securities by shareholding companies and for listed companies to issue new shares, convertible bonds under the *Provisional Measures for Sponsorship of Securities Issuance and Listing*. Representatives of the sponsoring institutions should be securities industry practitioners who meet the requirements set by the supervisor. Securities firms (as well as Cinda, Orient, Huarong and Great Wall asset management corporations) with a license to underwrite IPOs and with at least two qualified representatives for sponsorship can qualify as sponsoring institutions.

The CSRC finalized the sponsoring system procedures in January 2005, clarifying that one sponsoring representative could work on only one case at a time, and defining the licensing and registration criteria for new sponsoring representatives and the renewal of the license.

In May 2006, the CSRC issued “*Guidance on Due Diligence Performed by Sponsoring Representatives*” which defined in greater detail the methodology and coverage of due diligence. It emphasized the independent opinions of the sponsors and the need to investigate related-party transactions. The Guidance set out key criteria for assessing the integrity and performance of the sponsors by the CSRC.

**Strengthening market discipline on securities issuance.** In 2006, the CSRC issued *The Administrative Measures on the Securities Issuance for listed Companies, the Administrative Measures on IPO*, and *Administrative Measures on Securities Issuance and Underwriting* and other related regulations. Together, these new rules and regulations promoted the introduction of the new IPO system after non-tradable share reform. Under the new IPO system, listed companies could issue additional shares at market prices or
retrieve from public offering if the share placement failed.\(^1\) The new policies increased the sponsor’s responsibilities and removed the mandatory one-year mentoring period originally required for any IPO. The provisions improved financing methods and tools, such as allowing the listed companies to issue convertible corporate bonds. Several new features of the IPO system were implemented, including regulations concerning road shows and the book-building process, share allotment among designated strategic investors, simultaneous issuance and listing in domestic and overseas markets, a pilot mechanism relating to over-allotment options (or “green shoe” options),\(^2\) and non-public issuance and equity warrants.\(^3\) These new systems improved market discipline and the efficiency of the IPO system.

**Figure 2.7 IPOs in A-share market, 1990-2007**

![IPOs in A-share market, 1990-2007](image)


1. If the controlling shareholders fail to fulfill the commitment of share allotment, or if by the end of the underwriting period the quantity of the share subscribed by original shareholders does not reach 70% of the planned allotment quantity, the issuer then returns the funds raised plus bank interests accrued during the period to shareholders that already had subscribed to the shares at the issuing price.

2. The over-allotment option, the so-called “green shoe” option, is an option granted to the leading underwriter by the issuer. Under the option, the leading underwriter can over-allot up to 15% of the total underwriting amount at issuing price i.e., the leading underwriter sells shares to investors with a share quantity not exceeding 115% of the underwriting amount. Within 30 days of the listing, the leading underwriter has the right to purchase stocks of the issuer, or demand the issuer issue more shares to investors up to the over-allotment amount.

3. Equity warrants are often issued by listed companies themselves, or by intermediary securities institutions. The subject assets are usually the shares of the listed company or its subsidiaries. The equity warrant entitles the warrant holder a right to buy shares of a listed company at an agreed time and price. Currently, most of the equity warrants are European call warrants. When reaching the agreed time, if the market value of the share exceeds the exercise price of the warrant, the warrant holder would then demand to buy shares from the issuer if the market price is higher than the agreed price. The issuer then satisfies the warrant holder via issuing more shares.
**Market-driven pricing mechanism.** With the increasing capacity of institutional investors in pricing, at the end of 2004 the CSRC enacted the *Circular on Several Issues concerning the Book-building Procedure for IPOs*, removing the government approval of the share issuance price and replacing it with a book-building process, which augmented the market supervision over stock issuance. The *Administration Measures for Securities Issuance and Underwriting*, issued in September 2006, accomplished several goals. These included introducing key regulations on the book-building process, pricing and share allotment during IPO, improving the book-building process, and stepping up supervision of the issuers, securities firms, other intermediaries and investors at the share issuance.

---

**The simultaneous IPOs of Industrial and Commercial Bank of China (ICBC) on the domestic and overseas markets**

In October, 2006, ICBC listed its shares on the Shanghai and Hong Kong stock markets at the same time, achieving several new historical records:

- The first to provide consistent information disclosure in both markets, coordinated issuance time schedules on both markets, overcoming technical and regulatory difficulties through coordination and communication between the supervisors of the two markets. The first IPO of A-shares and H-shares at the same time and at the same price.
- The first IPO that introduced the “Green Shoe” option in domestic A-shares issuance.
- The first H-share IPO to allow Chinese institutional investors (insurance companies and large enterprises) to participate, thus opening the door for domestic institutional investors to invest in the international capital markets.
- The first A-share IPO to hold analyst meetings commonly used in international markets.
- The world’s largest IPO till then, the total funds raised reached (A+H shares combined) US $ 19.1 billion prior to exercising the over-allotment option.

---

**Summary**

The reform of the stock issuance system showed that the capital markets should be gradually transformed from being government-driven to being market-driven. Market discipline and transparency should be enhanced and IPO pricing should be decided by the market. The market-driven issuance

---

1 Price quotes can be provided by qualified securities investment and fund management companies, securities firms, trust investment companies, finance companies, insurance institutional investors, QFIs, and other institutional investors recognized by the CSRC.
process will not only make the pricing more accurate and contribute to the healthy growth of the market, it will also allow market participants to bear risks appropriately while enjoying a return on investment. Securities firms should also be motivated to improve their risk management capacities and enhance their core competitiveness.
Section 6
Liberalization of the Fund Management Industry and Development of Institutional Investors

1. Background
China’s capital markets were dominated by individual investors in the early stages of development, creating unfavorable conditions for the long-term development of the market. Drawing upon international experience, the CSRC began to launch reforms to promote the development of China’s fund management industry in 1998 after cleaning up the “old funds”. During the initial stage of development, the fund industry suffered from low efficiency in operations due to lack of experience, coupled with high speculation and irregular trading. A number of “fund scandals” dealt a heavy blow to the industry. In response to this, the CSRC investigated the fund management industry and punished relevant parties. Starting from 2000, the CSRC put forward the strategy to aggressively develop institutional investors, taking it as a key measure for improving the investor structure of the capital markets.

2. Reforms and development progress

The liberalization of the fund industry. In 2002, gradual liberalization of the funds approval system was initiated by the CSRC. Approval procedures were simplified and a system of expert review was introduced, making the fund product approval process more systematic, transparent, professional and standardized. After 2003, approval procedures were further simplified to converge with internationally-accepted registration systems.

---

1 The article “Fund Scandal”, appearing in the October 2000 issue of Caijing Magazine, revealed the problems in the domestic fund industry. These included buying and selling funds’ own holdings to artificially boost trading volumes to attract other investors and making transactions between two funds of the same management company at a pre-arranged price, quantity and time. These pre-arranged trading activities had the effect of elevating stock prices and increasing the net asset value of funds in order to impress investors.
From the beginning of 2002 to the end of 2005, the reforms unlocked the potential of the fund industry despite an overall downturn in the market. Total net value of funds increased to over US $57 billion from US $10 billion. The market value of the tradable shares held by securities investment funds also increased from 5 percent to nearly 20 percent of the total market capitalization of the tradable shares. In 2006, a total of US $50.5 billion

---

According to the Investment Company Institute (ICI), from 1955 to 1979, the net assets of mutual funds in the U.S. increased from US $8 billion to US $80 billion, and the ratio of the market value of shares held by mutual funds to total market capitalization increased from 4% to 24%.
of new funds was raised by the fund industry with the gradual recovery of
the market. This amount almost equals the total amount of funds raised over
the previous eight years combined. By 2007, funds under management by
fund companies reached US $ 448.5 billion. Today, the fund industry is rec-
ognized by the market as being more transparent and better operated than
before and has gradually gained a strong reputation among the public.

![Figure 2.9](image)

Market competition introduced through this reform process sparked a sharp
increase in the innovation capabilities and service quality of fund management
companies. Since 2002, open-end funds have become the market’s mainstream
products, replacing closed-end funds. In six years, the China fund industry has
developed almost all the varieties of fund products found in mature markets,
providing investors with more investment choices, and bringing the local
market in line with international markets.

<table>
<thead>
<tr>
<th>Year</th>
<th>Innovation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>first open-end fund launched</td>
</tr>
<tr>
<td>2002</td>
<td>first bond fund and index fund launched</td>
</tr>
<tr>
<td>2003</td>
<td>first umbrella fund, principal-guaranteed fund, and money market fund launched</td>
</tr>
<tr>
<td>2004</td>
<td>first convertible bond fund, listed open-end fund, and exchange traded fund launched</td>
</tr>
<tr>
<td>2005</td>
<td>first mid/short-term bond fund launched</td>
</tr>
<tr>
<td>2006</td>
<td>first QDII fund launched</td>
</tr>
</tbody>
</table>
Promoting market opening and competition. In July 2002, Rules on the Establishment of Joint venture Fund Management Companies began to take effect and by the end of 2007, there were 28 joint venture fund management companies out of 59 fund management companies. The effective competition between domestic companies, joint ventures, and QFIIs has not only increased product variety in the fund industry, but also helped improve the compliance and management efficiency of the industry, facilitating learning among the industry and improving the international competitiveness of domestic fund management firms. At the same time, the fund industry has trained many talented local financial professionals, who are now equipped with a better understanding of both international practices and the characteristics of China’s capital markets.

The development of other institutional investors. With the development of the capital markets, institutional investors, such as insurance companies, enterprise annuity funds, and the NSSF have gradually entered into the capital markets (see Figure 2.10 and Figure 2.11). This has started to improve the overall investor structure of the capital markets and helped to correct the unbalanced profile of institutional investors.

![Figure 2.10 Total outstanding investment in the stock market by the NSSF, 2002-2007](image_url)

Note: The outstanding amount of 2007 was preliminary data. Source: National Council of Social Security Fund.
Liberalization, standardization and globalization have been the focus of the recent reforms in China’s fund industry, leading to its healthy growth. The liberalization of the fund industry has changed the profile of investors dramatically in recent years, with institutional investors now playing an important role in a market that was previously dominated by individual investors. The standardization of market practices and industry set-up have gradually won the trust of investors, and more and more Chinese individuals and families have begun to invest in mutual funds. The opening-up of the fund industry has also proved that a gradual opening-up process will foster a more competitive environment, which should help the industry gain international competitiveness. In the past few years, institutional investors, particularly mutual funds, have grown rapidly, and consequently, the prevailing investment philosophy in the capital markets has also changed fundamentally, with long-term investments based on fundamental research taking the center stage in contrast to the speculation that prevailed in the past.
Section 7
Gradual Refinement of the Legal System
Governing the Capital Markets

1. Amendments to the *Company Law* and the *Securities Law*

The *Company Law* and *Securities Law* are two important laws aimed at regulating the capital markets. The *Company Law*, effective since 1994, standardized the organization and operation of companies. The purpose of the law was implemented to protect the legitimate rights and interests of companies, shareholders and creditors, promote the restructuring of SOEs, and facilitate economic development.

The *Securities Law*, which came into effect in 1999, was the first law to regulate the issuance and trading of securities. The law was implemented to protect the rights and interests of investors, support the healthy development of China’s capital markets, safeguard the economy and public interests, and promote the growth of the socialist market economy.

**Major amendments to the *Company Law* in 2005**

- Modified the process for company establishment to allow for a more diversified capital base and promote economic development.
- Enhanced corporate governance, and improved internal control and operation efficiency.
- Improved protection of shareholders’ rights and public interests.
- Standardized the corporate governance of listed companies, strictly defining the legal obligations and responsibilities of listed companies and relevant personnel (stock listing and trading rules were taken out and covered by the *Securities Law*).
- Multiplied financing options for companies, elevating the role of the capital markets in the development of the national economy.
- Adjusted the enterprise accounting system to meet the actual operating and supervisory needs of companies.
- Enhanced the rules for mergers, splits and company liquidation to facilitate capital restructuring and improve liquidity while protecting the legitimate rights and interests of creditors.
- Highlighted the social responsibility of a company, establishing the principles of fiduciary trust, promoting the building of a credit system, maintaining market discipline and protecting public interest.
- Established communication channels between company employees and management to protect the interests of company employees.
- Allowed establishment of single-person limited liability companies
Important Capital Markets Policies and Reforms in Recent Years

Chapter 2

The deepening of economic and financial reforms, coupled with rapid economic development has led to many fundamental changes in the nature of the capital markets. Such changes have resulted in the emergence of new issues and challenges necessitating continued revision of the two laws.

In October 2005, the Standing Committee of the National People’s Congress of the People’s Republic of China amended the *Company Law* and *Securities Law*. The amended laws took effect on January 1, 2006.

### Major amendments to the *Securities Law 2005*

- Expanded the scope of the *Securities Law* to incorporate the issuance and transaction of securities derivatives.
- Relaxed restrictions on the range of financial services provided by the securities, banking, trust, and insurance industries while abiding by the principle of segregated management and supervision.
- Improved rules on securities issuance, transaction, registration and settlement systems. Clearly defined the legal basis for public share issuance, providing a legal foundation for cracking illegal public share issuance, and leaving room for building a multi-layered market system.
- Refined the supervision system for listed companies to improve their quality. Enhanced the transparency of the IPO approval process, established a sponsorship system for IPOs, enhanced the regulations regarding the integrity and legal obligations of controlling shareholders or actual controllers, as well as directors, supervisors and senior managers of listed companies.
- Enhanced the supervision of securities firms to mitigate securities market risks. Improved the internal control requirements of securities firms to ensure the safety of clients’ assets, enhanced the senior management qualification system for security firms, raised the qualification standards for main shareholders of security firms, and improved the supervision measures of securities firms.
- Enhanced the protection of the rights and interests of investors, particularly minority investors. Established a protection fund for securities investors and enhanced the civil liability compensation system for the losses to investors caused by illegal investment or bankruptcy of the securities firms.
- Improved the system for the supervision and regulation of securities by increasing law enforcement measures, enhancing supervisory powers and clarifying related responsibilities.
- Imposed heavier punishment for breaching the securities laws. Clearly defined the compensation obligations related to securities issuance and trading. Held controlling shareholders or de facto controllers accountable for civil liabilities and administrative responsibilities. Increased obligations of senior management and other directly responsible personnel of listed companies and securities firms. Granted the regulatory authority the right to ban individuals who seriously violate the rules and regulations from re-entry into the market.
2. Refinement of related laws, regulations and rules

In line with the revision of the two laws, the National People’s Congress and the ministries and commissions of the State Council took the effort to amend related laws, regulations and departmental rules. The National People’s Congress passed Amendments to the Criminal Law (VI)¹ to clarify the responsibilities of listed companies, securities and futures operating entities related to breaches of the law, and impose heavier punishments for market manipulation. The Enterprise Bankruptcy Law² was revised at the same time to regulate bankruptcy procedures and protect the interests of all parties involved. The CSRC formulated administrative regulations to supplement the amendments to the two laws through the following actions: Implementing Measures on Freezing and Sealing-up of Corporate Assets, Code of Corporate Governance for Listed Companies, Rules for the General Meetings of Shareholders of Listed Companies, Guidelines on Articles of Association of Listed Companies (2006 Amendments), Rules of Private Placement of Listed Companies, Administrative Measures for the Qualifications of Directors, Supervisors and Senior Managers of Securities Firms, and Measures on the Administration of Securities Settlement Risk Funds.

Summary

The development and steady growth of capital markets are best supported with a sound legal and regulatory framework. As China’s capital markets are emerging markets in a transitional economy, it will be even more critical for China to develop and improve its legal and regulatory system to support the market development. The revision of the two laws and related rules and regulations of the capital markets has been key steps in the improvement of market operations and the economy as a whole. They provided legal safeguards to facilitate strategic decision-making in the capital markets, elevate

¹ The Amendments to Criminal law (VI) defines the disciplinary criterion for a company’s violations of its obligations regarding information disclosure which causes harm to the interests of shareholders or others. It specifies that a director, supervisor or senior manager of a listed company violates his fiduciary duty to the company by taking advantage of his office to manipulate the company so causing heavy losses to the company, and by manipulating the market. It also sets stricter requirements for the prevention of crimes committed by a director, supervisor or senior manager of a listed company.

² According to the new Enterprise Bankruptcy law, where a director, supervisor or senior manager violates his duties of fiduciary and due care and thus leads an enterprise into bankruptcy, they will be held liable under civil law. A person who has violated his duties is not permitted to assume the post of director, supervisor or senior manager of any enterprise within three years as of the day when the procedures for bankruptcy are concluded.
the overall prominence of the rule of law in the capital markets and support capital markets reforms.

**Latest snapshot of China’s stock market**

Since 2006, many legacy issues in the Chinese capital markets have been resolved, and the legal system has been gradually refined, leading to a series of profound changes. As the figure below shows, the markets expanded rapidly in 2006 and 2007. By the end of 2007, the Shanghai and Shenzhen Stock Exchanges hosted 1,550 listed companies, with a total market capitalization of US $4.5 trillion, ranking the highest among emerging markets, equivalent to 132.6% of the GDP of China. The total funds raised through IPOs in 2007 reached US $62.9 billion, ranking the first in the world. Daily trading volume averaged US $26.1 billion, and China’s capital markets were among the most active markets in the world. The clearing and settlement systems as well as the supervisory system were tested at the time of exponential increase of trading volume and market expansion, and proved to be stable.

![Figure 2.12 Recent development of China’s stock market](image)

Source: China Securities Index Co., Ltd.

The sustained growth of the Chinese capital markets can be attributed to the stable development of the Chinese economy, and the successful implementation of well-paced liberalization reforms, a pragmatic approach to market development, learning from international best practices and adapting them to China’s unique economic and social situations.

Several key lessons can be drawn from the reforms and development of capi-
tal markets in recent years. First, capital markets development should be an integral part of the national economic development strategy and should be implemented under concerted programming by the central government. Second, capital market development should provide a full spectrum of financing to serve the needs of China’s national economy, while coordinating market development with economic and social goals. Third, liberalization should be stepped up to provide incentives to market participants to realize the goals of development and innovation. Fourth, legal, regulatory and supervisory framework development should be further improved to enhance market disciplines and enforcement. Finally, China should further open up its capital markets and learn from international best practices so as to gradually and continuously build up the competitiveness of China’s capital markets in the global financial system in the future.
Chapter 3

The Challenges Facing China’s Capital Markets

A comprehensive analysis of the major issues in China’s capital markets and the challenges they are facing is a prerequisite for mapping out future development strategies. This chapter bases its analysis on the Chinese economy’s current development status, and provides comparisons with more mature markets and other emerging markets.

China’s capital markets are emerging markets in a transitional economy. As such, they face many issues, such as limited overall scale, a low percentage of direct financing, an unbalanced structure between stock and bond markets, suboptimal market mechanisms, low operational efficiency, weak corporate governance, a low level of competitiveness among securities firms, suboptimal structure of the investor base, limited and uneven development among institutional investors, an insufficient legal system and an unsatisfactory environment. Regulation, supervision and enforcement efficiency all need further improvement.

China’s buoyant economic outlook, together with its need to further modernize, provides China’s capital markets with a historic opportunity to develop further. Yet, compared with the future demands from China’s economic growth and to the developmental status of other emerging and mature markets, China’s capital markets still have many areas for further improvement.
Section 1  
The Capital Markets’ Overall Scale to be Further Enlarged and Structure to Be Further Optimized

Over the past ten years, China’s stock market has surpassed its initial scale, the bond market has developed to a certain extent, the number of products traded on commodity futures markets has increased, and a financial derivatives market has started to emerge. Yet, despite all these developments, the overall scale and structure of China’s capital markets still have much room for improvement, if they are to meet future economic development demands and compete with overseas mature markets as well as other emerging markets.

1. Limited overall scale, low percentage of direct financing, and unbalanced development of the equity and bond markets

**Limited overall scale.** At the end of 2006, the total value of securities assets constituted only 22% of China’s total financial assets, whereas in the U.S., U.K., Japan, and Korea, the proportion was 82%, 71%, 62%, and 75% respectively. Although it had increased to 37% (see Figure 3.1) by the end of September 2007, the ratio remained relatively low and the overall scale of China’s capital markets is still small.

---

1 Securities assets include equity and bond assets. For China, bond assets include treasury bonds, policy financial bonds, other financial bonds, enterprise bonds, corporate bonds, convertible bonds, strippable convertible bonds, short-term commercial papers, asset-backed securities, and panda bonds.
Low percentage of direct financing. In most mature and some emerging markets, corporations obtain external financing primarily through direct financing, either equity or bond issuances, instead of bank loans. However, in China, the proportion of direct financing among corporations’ external financing is still very small. Between 2001 and 2007, the ratio of funds raised from domestic capital markets to the annual incremental amount of bank loans was 9.5%, 4.1%, 3.0%, 4.5%, 2.1%, 8.4%, and 22.0% respectively. Even though the ratio has increased over the years, but it has remained relatively low (see Figure 3.2). In 2006, funds raised through direct financing only accounted for 15.1% of all non-financial institutions’ external financing, with bank loans accounting for the remaining (see Figure 3.3).

Unbalanced development of the stock and bond markets. By the end of 2007, the total amount outstanding of the bond market in China accounted for only 26.7% of the total market capitalization of the stock market. This contrasts sharply with more mature markets such as the U.S. and some other emerging markets such as Korea and India (see Figure 3.4).
Figure 3.2  Direct financing vs. incremental bank loans in China

Note: In this figure, direct financing does not include funds raised from enterprise bonds, short-term commercial papers or funds raised from overseas capital markets by Chinese companies.

Figure 3.3  Composition of external financing for China’s non-financial institutions in 2006

2. Limited amount of floating shares in equity market, multi-layered market structure still emerging, and investment and financing to be satisfied

**Limited amount of floating shares** in equity market. By the end of 2007, the buoyant domestic stock market recorded a total market capitalization of US $4.4 trillion, which represented 132.6% of the country’s 2007 GDP. However, floating shares only account for 28.4% of the total shares outstanding. This percentage is even lower for some listed companies with large capitalizations (see Figure 3.5).

**The Main Boards of the Shanghai and Shenzhen Stock Exchanges are still relatively small.** By the end of 2007, the total market capitalization of all companies listed on the Shanghai and Shenzhen Stock Exchanges ranked behind other major overseas stock exchanges (see Figure 3.6).

---

1 These refer to the shares of listed companies which can be freely traded on the secondary market and not subject to lock-up restrictions.
Figure 3.5 Percentage of floating shares for the top ten listed companies in China by market capitalization at the end of 2007

Source: CSRC.

Figure 3.6 Comparison of the gross market capitalization of the world’s leading stock exchanges

Note: Data is as of the end of 2007.
Source: CSRC and World Bank.
The SME Board in SZSE is still at an early development stage with limited scale and industry coverage. By the end of 2007, only 202 companies were listed on the Small & Medium-sized Enterprise Board (SME Board), with a total market capitalization of US $141 billion. This is far from sufficient to satisfy the growing demand from the increasing number of high growth small and medium-sized enterprises.

Figure 3.7 Various segments of China’s stock markets at the end of 2007

Source: CSRC.
**Lack of growth enterprise market.** International experiences have shown that a healthy growth enterprise market is conducive to meet the direct financing needs from small and medium-sized enterprises, especially high-tech companies, as well as providing exit channels for venture capital firms. Such a market has not yet been set up.

**The Share Transfer System needs further enhancement.** This system was originally designed to facilitate share transfers for de-listed companies and to solve some legacy problems. It has suffered from an unclear market positioning, limited functions, as well as a narrow scope of services. The system is now handicapped by low trading volume and thin liquidity, and the clearing and settlement system also needs to be upgraded.

**Lack of over-the-counter (OTC) market.** Although there are a large number of non-listed corporations in China, there are very limited means for their shares to be transferred efficiently.

3. Core competency of stock exchanges to be further improved

**Limited number of products.** On most mature and some emerging markets, stock exchanges not only provide shares and bonds spot-trading, but also many financial derivatives as well as other innovative products. Currently, a very limited range of products are traded on stock exchanges in China (see Table 3.1).

**Trading systems need further optimization.** Currently, the domestic exchanges do not have a market-maker system, and do not allow intra-day trading (T+0) or securities’ lending/borrowing business. Partially due to this weakness, domestic equity market cannot fully facilitate the unique characteristics of a wide range of products, and cannot satisfy the needs of different types of investors (see Table 3.2).

**Undiversified revenue structure.** Both the Shanghai and Shenzhen Stock Exchanges rely heavily on fees generated by equity transactions. High value-added services to customers are under-developed, resulting in an unstable revenue base (see Table 3.3).
Table 3.1 International comparison of products traded on stock exchanges

<table>
<thead>
<tr>
<th>Product type</th>
<th>China, mainland</th>
<th>Germany</th>
<th>U. S.</th>
<th>U. K.</th>
<th>Japan</th>
<th>India</th>
<th>Korea</th>
<th>HK, China</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic shares</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Foreign shares</td>
<td></td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Treasury bonds</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Convertible bonds</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Asset-backed securities</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mutual funds</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>REITs</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>ETFs</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Warrants</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Commercial papers</td>
<td></td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Futures</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Stock futures</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Options</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Stock options</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>ETF options</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Structured derivatives</td>
<td></td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
</tr>
</tbody>
</table>

Notes: 1. “✓” indicates product availability.
2. * refers to the NYSE and NASDAQ only.


Table 3.2 Comparison of trading mechanisms of stock exchanges worldwide

<table>
<thead>
<tr>
<th>Trading mechanism</th>
<th>China</th>
<th>U. S.</th>
<th>India</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities lending and borrowing and short selling</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>Intra-day trading</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>Market maker system</td>
<td>no</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>Price limit system</td>
<td>5% or 10%</td>
<td>no</td>
<td>20% or circuit breakers for individual shares</td>
</tr>
<tr>
<td>Circuit breaker</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>Types of order</td>
<td>limited</td>
<td>more</td>
<td>more</td>
</tr>
<tr>
<td>Basket trading convenience</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>OTC market</td>
<td>undeveloped</td>
<td>developed</td>
<td>relatively developed</td>
</tr>
<tr>
<td>Settlement cycle</td>
<td>T + 1</td>
<td>T + 3</td>
<td>T + 2</td>
</tr>
<tr>
<td>Trading costs</td>
<td>high</td>
<td>low</td>
<td>high</td>
</tr>
</tbody>
</table>

Source: CSRC.
4. Bond market, especially corporate bond market lagging behind

**Small bond market.** By the end of 2007, the total outstanding value of the bond market was US $1.2 trillion, accounting for only 35.3% of the year’s GDP. This amount is far below that of overseas mature markets (see Figure 3.8).

![Figure 3.8 Comparison of selected countries bond market sizes in relation to their GDP](image)
Suboptimal structure of bond market. By the end of 2007, treasury bonds and financial bonds together accounted for 90.3% of China’s total bond market, while enterprise bonds amounted to only US $50.3 billion, or 5.2% of the market. At the same time, short-term commercial papers, asset-backed securities, convertible bonds and corporate bonds by listed companies continued to play a minor role and accounted for only 4.6% of the total bonds outstanding (see Figure 3.9).

Corporate bonds market lagging far behind. In China’s domestic market, only short-term commercial papers (US $42.6 billion), convertible bonds and strippable convertible bonds (US $4.3 billion collectively), and corporate bonds from listed companies (US $1.5 billion) are considered true corporate bonds, and by the end of 2007, amounted to only 4.2% of the bond market. The ratio of corporate bonds outstanding to GDP was only 1.5% in 2007, far lower than that of other more mature markets (see Figure 3.10).

Fragmented markets with unbalanced investor base. Currently, China’s domestic bond market is segregated into stock exchanges, the inter-bank bond market, and bank OTC retail markets (see Figure 3.11 and Table 3.6). Investor types are few and commercial banks are the dominant players holding 79% of all bonds outstanding.
Figure 3.10  Ratio of outstanding corporate bonds to GDP

Note: China’s data is as of the end of 2007, and the data for other countries is as of the end of 2006.

Figure 3.11  Bond markets in China (2006)

5. Under-developed commodity futures and financial derivatives markets

A small-scale market. In 2006, the total turnover of futures and options in the global market hit 11.9 billion contracts, of which 4.6 billion contracts were traded in the U.S. In contrast, 220 million contracts were traded on China’s three domestic commodity futures exchanges, accounting for only 1.9% of the global turnover, while China’s GDP constituted 5.5% of the world’s aggregate GDP.

![Figure 3.12 2006 global futures and options market (percentages of total number of contracts traded)](source: CSRC)

Limited product range. The small scale of China’s futures market is closely linked to its limited product range. Currently, China offers some commodity futures but no financial futures or future options. In terms of commodities, the globally most actively-traded futures are energy contracts, but these remain unavailable in China.

Insufficient product innovation. By the end of 2007, only 16 products were traded on China’s futures market while thousands of futures products were traded in global markets. Even though new commodity future products have been added to the market in recent years, more new products are needed and financial innovations need to be further enhanced. In the late 1990s, Korea

---

1. In 2006, financial futures and option’s global turnover reached 10.8 billion contracts, accounting for 90.7% of the global turnover in futures and options.
proactively developed its futures and options market, and in recent years, has enjoyed the largest market turnover in the world. Likewise, India introduced new financial futures products such as index futures and several commodity futures. Today, it has a portfolio of approximately 100 trading products. These developments illustrate the slow pace of financial innovation on China’s domestic futures and options markets.

*A limited investor base.* By the end of 2006, China’s three commodity futures exchanges had a total of more than 715,000 trading codes. Among these, only about 36,000 or 5% were held by institutional investors. In mature markets, the proportion of institutional investors is typically much higher and it demonstrates the need to further optimize the structure of domestic investors.

*Weak intermediaries.* By the end of 2007, China’s futures brokerage companies collectively reported gross assets of US $6.9 billion and net assets of US $1.6 billion, while realizing net fee income of US $421 million and a gross profit of US $116 million. Some of these companies are weak and vulnerable.

*Lack of a financial derivatives market.* Today, only a few financial derivative products such as warrants (put and call) and strippable convertible bonds are traded on exchanges. Products such as index futures, interest rate futures, currency futures and options which are popular in many other markets are still unavailable. A meaningful domestic derivatives OTC market has yet to be developed.
Section 2
Suboptimal Market Mechanisms and Market Efficiency to Be Improved

In recent years, the CSRC has initiated a number of market reforms, resulting in greatly enhanced market mechanisms and improvements in the functionality of asset allocation. However, capital markets cannot outgrow the overall Chinese economy; nor can they outpace other ongoing systematic reforms. With a less-than-fully-functioning market economy and a less than satisfactory integrity environment, the capital markets have not fully established disciplinary mechanisms. The linkage between market price discovery mechanisms and resource allocation or corporate behavior is still very weak.

1. More reforms of issuance process to be implemented

*Further reform of share issuance & listing process is greatly needed.* As a result of market reforms in recent years, the processes of stock issuance and listing have been liberalized to a large extent. However, the current system is still prone to too much administrative control and complex approval procedures. On one hand, the current system is still a merit-based approval system with considerable administrative influence during the process. Issues such as listing companies’ credit worthiness, the issuance size and time for listing are still largely controlled by the regulator (see Table 3.4 and Table 3.5). Yet most overseas mature markets use registration-based systems for stock issuance. These are more convenient and efficient for issuers, since the price discovering process is totally market-driven. On the other hand, the current system does not leave enough room for intermediaries and professional institutional investors to play a meaningful role during the pricing process.

Table 3.4 Comparison of equity issuance procedures

<table>
<thead>
<tr>
<th>Market</th>
<th>Shanghai Stock Exchange</th>
<th>Shenzhen Stock Exchange</th>
<th>New York Stock Exchange</th>
<th>NASDAQ</th>
<th>London Stock Exchange</th>
<th>Hong Kong Exchange &amp; Clearing, Main Board</th>
<th>Hong Kong Exchange &amp; Clearing, GEM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Approval/Registration</td>
<td>Approval</td>
<td>Approval</td>
<td>Registration</td>
<td>Registration</td>
<td>Registration</td>
<td>Registration</td>
<td>Registration</td>
</tr>
</tbody>
</table>

Source: CSRC.
### Table 3.5 Listing standards of major stock exchanges worldwide

<table>
<thead>
<tr>
<th>Exchange</th>
<th>Operating Record</th>
<th>Profit Record</th>
<th>Business Scale</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Main boards of Shanghai and Shenzhen Stock Exchanges</strong></td>
<td>three years</td>
<td>Over the latest three fiscal years, the company should not have operating losses, and accumulative net income must be over RMB 30 million; the accumulative operating cash flow must be over RMB 50 million, or accumulative revenue must be over RMB 300 million for the same period</td>
<td>The shareholders’ equity before issuance must be over RMB 30 million</td>
</tr>
<tr>
<td><strong>SME board of Shenzhen Stock Exchange</strong></td>
<td>three years</td>
<td>Over the latest three fiscal years, the company should not have operating losses, and accumulative net income must be over RMB 30 million; the accumulative operating cash flow must be over RMB 50 million, or accumulative revenue must be over RMB 300 million for the same period</td>
<td>The shareholders’ equity before issuance must be over RMB 30 million</td>
</tr>
<tr>
<td><strong>New York Stock Exchange</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic companies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Standard 1</td>
<td>three years</td>
<td>For the latest three fiscal years, aggregate pre-tax earnings must be over US$ 10 million; minimum in each of the two most recent years must be over US$ 2 million and must be positive amount in the 3rd year</td>
<td>Market value of public shares must be over US$ 60 million</td>
</tr>
<tr>
<td>Standard 2</td>
<td>three years</td>
<td>For companies with no less than US$ 100 million in revenues during the most recent 12 months, aggregate operating cash flow over the last three years must be over US$ 25 million (must be positive amount in every year)</td>
<td>Total market capitalization must be over US$ 500 million</td>
</tr>
<tr>
<td>Standard 3</td>
<td>one year</td>
<td>Revenue in the most recent year must be over US$ 75 million</td>
<td>Total market capitalization must be over US$ 750 million</td>
</tr>
<tr>
<td>Exchange</td>
<td>Operating Record</td>
<td>Profit Record</td>
<td>Business Scale</td>
</tr>
<tr>
<td>--------------------------</td>
<td>------------------</td>
<td>-------------------------------------------------------------------------------</td>
<td>-----------------------------------------------------</td>
</tr>
<tr>
<td>New York Stock Exchange</td>
<td></td>
<td>For the latest three fiscal years, aggregate pre-tax earnings must be over US$ 10 million, minimum in each of the two most recent years must be over US$ 25 million</td>
<td>none</td>
</tr>
<tr>
<td>Foreign companies</td>
<td></td>
<td>For companies with no less than US$ 100 million in revenues during the most recent 12 months, aggregate operating cash flow over the last three years must be over US$ 25 million</td>
<td>Total market capitalization must be over US$ 500 million</td>
</tr>
<tr>
<td>Standard 2</td>
<td>three years</td>
<td>Revenue in the most recent year must be over US$ 75 million</td>
<td>Total market capitalization must be over US$ 750 million</td>
</tr>
<tr>
<td>Standard 3</td>
<td>one year</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nasdaq Global Select Market</td>
<td></td>
<td>Aggregate pre-tax earnings in prior three fiscal years over US$ 11 million and each of the two most recent fiscal years over US$ 2.2 million (must be positive amount in each of the prior three fiscal years)</td>
<td>none</td>
</tr>
<tr>
<td>Standard 1</td>
<td>three years</td>
<td>Aggregate cash flow in prior three fiscal years over US$ 27.5 million (must be positive amount in every year) and revenue in the previous fiscal year over US$ 110 million</td>
<td>Average market capitalization in prior 12 months over US$ 550 million</td>
</tr>
<tr>
<td>Standard 2</td>
<td>three years</td>
<td>Revenue in prior fiscal year over US$ 90 million</td>
<td>Average market capitalization in prior 12 months over US$ 850 million</td>
</tr>
<tr>
<td>Standard 3</td>
<td>one year</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### The Challenges Facing China’s Capital Markets

#### Chapter 3

<table>
<thead>
<tr>
<th>Exchange</th>
<th>Operating Record</th>
<th>Profit Record</th>
<th>Business Scale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Market</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Standard 1</td>
<td>one year</td>
<td>Income from continuing operations before income taxes (in the latest or in two of the last three fiscal years) over US$ 1 million</td>
<td>Stockholders’ equity over US$ 15 million, publicly held shares over 1.1 million, market value of publicly held shares over US$ 8 million</td>
</tr>
<tr>
<td>Standard 2</td>
<td>two years</td>
<td>none</td>
<td>Stockholders’ equity over US$ 30 million, publicly held shares over 1.1 million, market value of publicly held shares over US$ 18 million</td>
</tr>
<tr>
<td>Standard 3</td>
<td>none</td>
<td>none</td>
<td>Market value of listed securities or total assets over US$ 75 million, and total revenue over US$ 75 million, market value of publicly held shares over US$ 20 million</td>
</tr>
<tr>
<td>Nasdaq</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Standard 1</td>
<td>two years</td>
<td>none</td>
<td>Stockholders’ equity over US$ 5 million, market value of publicly held shares over US$ 15 million</td>
</tr>
<tr>
<td>Standard 2</td>
<td>none</td>
<td>none</td>
<td>Stockholders’ equity over US$ 4 million, market value of publicly held shares over 15 million, market value of listed securities over US$ 50 million</td>
</tr>
<tr>
<td>Standard 3</td>
<td>one year</td>
<td>Net income from continuing operations in the latest or in two of the last three fiscal years over US$ 750,000</td>
<td>Stockholders’ equity over US$ 4 million, market value of publicly held shares over US$ 5 million</td>
</tr>
</tbody>
</table>

253
<table>
<thead>
<tr>
<th>Exchange</th>
<th>Operating Record</th>
<th>Profit Record</th>
<th>Business Scale</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Main board of London Stock Exchange</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Standard 1</td>
<td>three years</td>
<td>none</td>
<td>Market capitalization over £ 20 million</td>
</tr>
<tr>
<td>Main board of Hong Kong Stock Exchange and Clearing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Standard 1</td>
<td>three years</td>
<td>Net income in the latest fiscal year over HK$ 20 million, aggregate net income in last two years over HK$ 30 million</td>
<td>none</td>
</tr>
<tr>
<td>Standard 2</td>
<td>three years</td>
<td>Revenue in the latest fiscal year over HK$ 500 million, aggregate cash flow in prior three years over HK$ 100 million</td>
<td>Market capitalization over HK$ 2 billion</td>
</tr>
<tr>
<td>Standard 3</td>
<td>three years</td>
<td>Revenue in the latest fiscal year over HK$ 500 million</td>
<td>Market capitalization over HK$ 4 billion</td>
</tr>
<tr>
<td><strong>GEM of Hong Kong Stock Exchange and Clearing</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Standard 1</td>
<td>two years</td>
<td>none</td>
<td>Total assets over HK$ 500 million in the latest audited report or expected market capitalization over HK$ 500 million</td>
</tr>
<tr>
<td>Standard 2</td>
<td>one year</td>
<td>Revenue in the latest 12 months over HK$ 500 million</td>
<td></td>
</tr>
</tbody>
</table>

Source: CSRC and websites of respective exchanges.
**Fragmented bond issuance system.** Specific approval rules and regulations by different regulatory authorities vary extensively, and this creates different issuance standards for different type of bonds. Also, the enterprise bond issuance process is still based on quota, which is prone to great administrative influence. All these problems have impeded the bond market’s healthy development.

<table>
<thead>
<tr>
<th>Product Type</th>
<th>Short-term Commercial Papers</th>
<th>Enterprise bonds</th>
<th>Corporate bonds by listed companies</th>
<th>Convertible bonds and strippable convertible bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulator</td>
<td>PBC</td>
<td>NDRC</td>
<td>CSRC</td>
<td>CSRC</td>
</tr>
<tr>
<td>Issuance process</td>
<td>Registration and filing</td>
<td>Quota</td>
<td>Approval</td>
<td>Approval</td>
</tr>
<tr>
<td>Related regulators</td>
<td>No</td>
<td>PBC, CSRC</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Requirement of bank guarantee</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Quota</td>
<td>No</td>
<td>Determined by the State Council, NDRC, PBC, MOF jointly</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Historical record</td>
<td>No breach of law or major irregularities by the issuer in the most recent three years; no default in prior issuances</td>
<td>No</td>
<td>No false information in financial/accounting documents, or breach of law by the issuer; the latest un-audited net assets meet the requirements set by laws, regulations, and other rules by CSRC</td>
<td>No false information in financial/accounting documents or breach of law by the issuer in the three years prior to issuance</td>
</tr>
<tr>
<td>Credit ranking requirement</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Profit requirement</td>
<td>one year</td>
<td>three consecutive years</td>
<td>The average annual distributable profits of previous three years shall not be less than the annual interest payable</td>
<td>three consecutive years</td>
</tr>
<tr>
<td>Industrial policy requirement</td>
<td>No</td>
<td>In line with the government’s industrial policy</td>
<td>In line with the government’s industrial policy</td>
<td>In line with the government’s industrial policy</td>
</tr>
<tr>
<td>Trading platform</td>
<td>Inter-bank market</td>
<td>Inter-bank market, exchanges, bank OTC market</td>
<td>Exchanges, inter-bank market</td>
<td>Exchanges</td>
</tr>
</tbody>
</table>

Source: CSRC, NDRC, and PBC.
Finally, due to the lack of liquidity of treasury bonds, the yield curve is far from complete (see Figure 3.13). This results in a lack of benchmark interest rates during bond issuance and secondary trading, in turn reducing the market’s price discovering efficiency.

Note: Due to the limited liquidity of the treasury bond market in China, the yield curve is not available, and the Shanghai Interbank offered rate (SHIBOR, December 29, 2007) is used instead. The date of yield curve of other countries is October 15, 2007. Source: www.shibor.org and World Bank.

2. Trading mechanisms to be further improved

*Suboptimal trading mechanisms and high transaction cost.* The absence of short-selling has long prevented the development of an effective arbitrage mechanism in the equity market. This has impeded the pricing process from functioning fully, reducing overall operational efficiency. Meanwhile, market maker and intra-day trading systems have not been established, and trading mechanisms need to be further improved.

Currently, China’s stock transaction cost (50 basis points on average) is higher than that of more mature markets (see Figure 3.14 and Figure 3.15).

China’s stock market still trails its major international competitors in terms of market depth and liquidity cost. A comparison of the market impact cost
(market impact index\(^\text{\textsuperscript{1}}\)) for China with those of major international markets illustrates that the Shanghai and Shenzhen exchanges’ liquidity cost is higher than that of mature bourses in the U.S., U.K., Germany, and Japan as well as that of other emerging markets such as India and Korea (see Figure 3.16).

\(^{1}\) The “market impact index” indicates investors’ covert transaction cost calculated at the degree of price shock in basis points for every RMB 100,000.

Note: Commission is charged at a minimum of RMB 5, and capped at 3‰ (30 basis points). In reality, as commission is usually below 30 basis points, an average of 20 basis points is used for this report.

Source: Analysis and Recommendations on 2006 Market Efficiency, the SZSE.
Inadequate bond trading mechanism. The inter-bank, exchange and bank OTC bond markets currently operate separately, which has led to high transaction costs and low efficiency (see Figure 3.17).

Note: For China, the data is as of 2004, for other countries, the data is as of Oct.2007.
3. Insufficient legal and risk management systems for securities clearing and settlement

The revised 2005 *Securities Law* and its supporting regulations, along with *Measures for the Administration of Securities Registration and Clearing*, collectively define the principles and legal status of securities registration, clearing and settlement. However, the current rules and regulations do not fully encompass the complex relationships among assets, contracts and trading during the registration and clearing of securities transactions. This issue becomes particularly urgent in protecting the clearing and settlement company during the liquidation of a failed financial institution. Furthermore, the risk management system centering on “delivery versus payment” has not been fully implemented. Under these circumstances, the safety and efficiency of the clearing and settlement system as well as the investors’ protection remains undermined to some extent.

Although China has a centralized registration, clearing and settlement system, due to historical reasons, the technical systems of the Shanghai and Shenzhen Stock Exchanges currently operate separately. Consequently, investors must open separate accounts to register their holdings with each bourse. This has not only reduced the efficiency of stock exchange operations, but also has made it difficult to introduce inter-market products, such as the Shanghai & Shenzhen 300 ETF.

As regards the bond market, custody and registration of bonds are carried out by the China Securities Depository and Clearing Corporation and the China Government Securities Depository Trust and Clearing Co. Ltd. separately. Although bonds can be transferred between the two, the segmented depository and clearing systems still impede transaction efficiency.

4. Segregated markets hampering market efficiency

China’s stock market currently comprises of the inland A-share and B-share markets, along with red-chip and H-share markets in Hong Kong. The bond market comprises the inter-bank market, exchanges, and bank OTC markets. The segregation of the markets, coupled with the absence of an arbitrage mechanism, undermines the market efficiency of China’s capital markets.
Section 3
The Overall Competitiveness of Listed Companies to Be Further Improved and Corporate Governance and External Disciplinary Mechanisms to Be Further Enhanced

1. Under-representation of the dynamics of the national economy by listed companies

Currently, many group companies have only listed some of their businesses or assets on the market, while others are either not listed at all or listed only on overseas markets. The limited number of blue-chip companies trading on the stock market does not adequately reflect the growth of China’s economy. Since the second half of 2006, some large companies in banking, insurance, and railway sectors have gone public. This has helped improve industry coverage of the stock market, but there are still not enough blue chip companies overall.

On the other hand, with China’s substantial reforms and rapid economic growth, a large number of private companies and enterprises have emerged, many of which show strong innovation capability and high productivity. However, these companies are also under-represented in the domestic market. Although the SME Board in the SZSE has given these types of enterprises better access to capital markets, they remain significantly under-served. Overall, the present composition of China’s capital markets still does not fully represent the dynamics of the national economy.

2. Corporate governance to be enhanced

Although notable progress has been made in enhancing the corporate governance of listed companies in China, there remain some prominent problems in terms of corporate governance, due to some historical and systemic constraints.

Controlling shareholders of some listed companies directly intervene in companies’ daily business. Although some listed companies nominally keep

\[1\] For instance, among the “big four” in the telecommunications industry, only China Unicom is currently listed on the domestic market, whereas China Mobile, China Telecom and China Netcom have all gone public overseas.
their property, staffing and daily operations separate from those of controlling shareholders, in reality it is quite easy for them to be affected or even controlled. Some controlling shareholders bypass general meetings, the board of directors, and management, and directly intervene in staff appointments, daily operations, business decision-making, or the implementation of new business initiatives. In some cases, they have used trades with related parties to harm the legitimate interests of the company.

*Governance in some listed companies only exists on paper, but not in reality; general meetings, board meetings and supervisory board meetings all become a mere formality.* In some listed companies, general meetings, the board of directors, and the supervisory board do not provide checks and balances over the relationships between controlling and minority shareholders, internal and external directors, as well as the board of supervisors and board of directors. General meetings have become “major shareholders’ meetings”, while the rights given to the board of directors have become the rights of the chairman and independent directors are unable to perform their duties adequately. In some listed companies, there is too much overlap between management and directors, which makes it very hard for the board of directors to make decisions independently, appoint or dismiss key personnel, and oversee performance.

*In some state-controlled listed companies, ownership structures are unclear and management takes control.* Due to the unclear ownership structure of the state’s interests in some state-controlled listed companies, it can be easy for senior management to seize control and become the *de facto* controlling shareholder. There is usually no check and balance in decision-making or business operations in such cases. Controlled by “insiders” (the senior management) can prevent companies from operating legally or growing healthily in the long run, aggravates short-termism in business decision making, resulting in loss of profit, and in some cases, loss of state assets.

*Unsatisfactory integrity of senior management in some listed companies.* The integrity and professionalism of the senior managers in some listed companies is unsatisfactory. Some directors do not carry out their responsibilities adequately, neglecting due representation at board meetings either by frequent absence or improper delegation of their duties to others, violating their fiduciary duty. Some directors even go as far as assisting the controlling shareholders to harm the interests of the listed companies.
3. Market-driven screening mechanisms to be improved

**De-listing process needs further improvement.** On one hand, the existing de-listing process does not have enough flexibility. China’s capital markets are emerging markets in a transitional economy. The surrounding environment is changing constantly and rapidly, but due to the lengthy process of revising the *Corporate Law*, the de-listing criteria are largely fixed in reality. On the other hand, the existing de-listing criteria hinge too much upon loss in three consecutive years. This is helpful in improving the profitability of near-de-listing companies and alerting investors to potential de-listing risks in those companies, but in general, it makes the de-listing criteria too rigid. In addition, current de-listing criteria are too simplistic, lacking in different criteria for different boards. This is not helpful in promoting a multi-layered market system in China. Overall, the “fit and proper test” function is not fully carried out based on market mechanisms.

**Market-driven merger and acquisition mechanisms need to be improved.** Prior to non-tradable share reform, the shareholder structure in listed companies was highly concentrated, with non-tradable shareholders in a dominant position. This meant that the only way to take control of a listed company was to acquire non-tradable shares through one-on-one negotiations, which lacked a competitive open auction mechanism. In light of the recent non-tradable share reform, all shares of listed companies have theoretically become freely floating, yet the market-based merger and acquisition mechanism still needs to be improved. Some merger and acquisition transactions involving state-controlled listed companies are still affected by administrative factors, and transaction prices are heavily influenced by administrative means in some cases. The level of compliance and integrity remains relatively low among market participants and illegals and irregularities still sometimes occur. The lack of a well-functioning market-based merger and acquisition mechanism has weakened corporate governance in listed companies, and hampered the capital markets’ resource allocation capability. Meanwhile, foreign participation in the merger and acquisition market has been increasing rapidly with the gradual opening-up of the capital markets. Under these conditions, it is becoming a major challenge for the market regulator to promote an “open, fair and equal” environment for the merger and acquisition market, to crack down on insider trading and market manipulation
effectively, to optimize market-based merger and acquisition mechanism continuously, and to deal with the legal and policy issues in cross-border transactions.
Section 4
Weak Competitiveness of Securities Firms

After the recent comprehensive restructuring campaign, China’s securities firms have now entered a new period of rapid growth. Since 2006, major lingering problems in the securities industry have been solved effectively, the industry has turned around after a four-year losing period, and the industry continued its rapid growth in 2007. However, international comparisons show that China’s securities firms are still relatively small, and their core competitiveness need to be further enhanced.

1. Overall small scale

By the end of 2007, there were 106 securities firms in China, with a total market capitalization of US $211.0 billion, and total assets of US $235.4 billion. In 2007, the industry’s total revenue reached US $39.0 billion, with US $26.2 billion in earnings before tax, and total assets under management were US $11.0 billion. Nonetheless, compared with major international players, except for the shareholders’ equity, China’s securities firms are still relatively small in total assets and assets under management (see Figure 3.18).

2. Little differentiation in business model

At present, China’s securities firms generate most of their profits from the brokerage business. High value-added services such as direct investments and merger and acquisition advisory services only represent a small proportion of net income (see Table 3.7). Most firms’ business models are simple and very similar, lacking tailor-made products and differentiated services for clients.

3. Industry highly fragmented

China’s securities industry is still very fragmented, with a large number of small firms. At the end of 2007, the Herfindahl-Hirschman Index (HHI) of China’s securities industry was 252, far lower than that of mature markets. In more mature markets, investment banks have usually evolved from small and fragmented firms into multinational full service companies. Statistics

---

1. The amount only included the total clients’ assets of the asset management business of securities firms.
2. This figure is calculated based on total revenue in 2007, if based on net income for the same period, the index number would be 275.
Notes: For China’s securities firms, the data is for 2007.
For international investment banks, the data is for 2006.
Source: CSRC, respective companies’ websites.

Table 3.7 China’s and international securities firms’ profit model comparison

<table>
<thead>
<tr>
<th>Business type</th>
<th>China’s securities firms</th>
<th>Goldman Sachs</th>
<th>Morgan Stanley</th>
<th>Merrill Lynch</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment bank business</td>
<td>5%</td>
<td>15%</td>
<td>14%</td>
<td>14%</td>
</tr>
<tr>
<td>Asset management business</td>
<td>1%</td>
<td>11%</td>
<td>15%</td>
<td>19%</td>
</tr>
<tr>
<td>Brokerage business</td>
<td>56%</td>
<td>15%</td>
<td>11%</td>
<td>17%</td>
</tr>
<tr>
<td>Proprietary trading and other investment businesses</td>
<td>30%</td>
<td>59%</td>
<td>48%</td>
<td>35%</td>
</tr>
<tr>
<td>Other businesses</td>
<td>8%</td>
<td>0</td>
<td>12%</td>
<td>15%</td>
</tr>
</tbody>
</table>

Notes: For China’s securities firms, the data is for 2007.
For international investment banks, the data is for 2006.
Source: CSRC and World Bank.
show that consolidation has driven down the number of investment banks in U.S., with the result that total capital of the top ten investment banks in U.S. rose from 1/3 of the industry in the early 1970s to 3/4 in the early 2000s. In Japan, the number of securities firms has fallen from 1,127 in 1949 to 232 in 1997. Today, there are only 10 plus large securities firms left in the industry, and more than 80% of securities trading in Japan is conducted by these top companies.

### Table 3.8 International securities industry concentration comparison

<table>
<thead>
<tr>
<th>Nation (Region)</th>
<th>China mainland</th>
<th>U. S.</th>
<th>U. K.</th>
<th>Japan</th>
<th>Korea</th>
<th>China, Hong Kong</th>
</tr>
</thead>
<tbody>
<tr>
<td>HHI</td>
<td>252</td>
<td>1,761</td>
<td>2,537</td>
<td>2,069</td>
<td>1,232</td>
<td>1,106</td>
</tr>
</tbody>
</table>

Notes: HHI index for every country and region is based on the total income of its securities firms. For China mainland, data is for 2007; for international companies, it is for 2006.

Source: CSRC and World Bank.

4. Weak corporate governance and internal control

Current ownership structures in the securities industry are suboptimal, hampering efforts to further improve corporate governance. There are two extreme situations. In some securities firms, shareholders’ structures are highly concentrated with one dominating shareholder. In such cases, the management team is usually controlled by the dominant shareholder. In some other firms, the shareholders’ structures are very scattered with a large number of small shareholders, weakening the supervisory function of the shareholders’ meetings and the board of directors over management, making the company vulnerable to insider control and managerial entrenchment.

Current corporate governance in securities firms still needs improving. In some cases, institutions such as shareholders’ meetings, board of directors, and board of supervisors do not fulfill their mandates as required by laws and regulations, which makes it easier for the senior management to take control.

Internal control in some securities firms is only a formality and implementation is very weak. Consequently, in some securities firms, there is little internal check and balance among business units and between headquarters and branches.

Furthermore, most securities firms have not set up effective incentive and disciplinary mechanisms. Because of this, management of some securities firms tends to focus on short-term results. This makes it very hard to enhance
overall competitiveness of the securities industry, which is centred around human capital.

5. Innovation capability needs further enhancement

Currently, there are many constraints for securities firms to develop new products, new business, or new forms of organization, and the overall industry innovation capability is limited. On one hand, due to some legal and regulatory constraints, innovation lead times tend to be very long and in some cases very unpredictable. This could discourage firms from making real efforts to innovate. On the other hand, due to the lack of efficient risk management systems, some firms may incur unduly high business risks when introducing new innovative products or businesses, increasing the cost of innovations to some extent.
China’s capital markets used to be dominated by small and medium-sized individual investors. In recent years, China has seen rapid development of institutional investors, especially securities investment funds. However, the overall investor base is still unbalanced, with relatively small and unevenly developed institutional investors.

1. High proportion of retail investors with frequent trading behavior

The proportion of retail investors, especially small and medium-sized individual investors is still too high. By the end of 2007, investors in China’s stock market have opened a total of 139 million accounts. However, only about one-
third of these accounts actually hold shares, according to recent research by
the SZSE\(^1\). The research shows that during the period of 2005, 2006 and
January to August of 2007, total numbers of accounts which actually hold
shares averaged 11.2 million, 10.6 million, and 11.8 million respectively, rep-
resenting 33%, 28% and 26% of the total accounts opened with SZSE during
same periods.

In SSE, between January and March 2007, small investors with less than
RMB 1 million in cash or shares equivalent, accounted for 98.8% of total
number of accounts, 40.9% of total market capitalization (see Figure 3.19).

**Figure 3.20** Shenzhen stock market’s investor structure
from January to August 2007

Source: *Report on the Analysis of Investor Structure and Behavior* (October 2007), SZSE.

\(^1\) Source: *Report on the Analysis of Investor Structure and Behavior released by the SZSE.*
In SZSE, between January and August 2007, small investors with less than RMB 1 million in cash or shares equivalent, accounted for 99.3% of total number of investors’ accounts, 99.3% of total number of active trading accounts, and 73.6% of the trading volume, these investors also held shares with a market capitalization of 45.9% of the total (see Figure 3.20), showing a very similar pattern observed in SSE.

*Short shareholding duration* and *frequent-trading pattern.* According to the statistics from SSE, all investors in the SSE tended to have relatively short investing periods in the first three months of 2007. Accounts holding shares for less than three months represented 85.6% of the total (see Figure 3.21). On the SZSE, in 2006 and January to August 2007, the majority share holding periods were less than three months on average.

In 2006, accounts holding shares for less than three months represented
68.7% of the total, while during the first 8 months of 2007, this percentage rose to 77.0% (see Figure 3.22). All statistics show that China’s stock market is still largely characterized by short-term investment and a shortage of long-term investors.

Compared with investors in more mature markets, the average turnover ratio in China’s stock market is high (see Figure 3.23). Furthermore, the turnover ratios for individual investors are more than two times those of institutional investors, while the turnover ratios for small individual investors are even higher. This phenomenon became even more pronounced between 2005 and 2007.

From an investment behavior perspective, individual investors, especially small and medium-sized individual investors, tend to hold and trade in small-cap, low-priced, poorly-managed, and high-PE stocks. Also, in contrast to institutional investors, they hold shares only for a short time and trade relatively frequently. According to empirical studies, individual investors are more sensitive to price and trading volume volatility. In general, investors need to be further educated with concepts such as value-driven investment.
2. Small scale of institutional investors

The role of institutional investors within China’s stock market has evolved considerably in recent years. Securities investment funds are becoming major institutional investors, and their market influence has been strengthening as well. However, insurance companies and pension funds remain relatively small in the market and are yet to play an important role (see Figure 3.24).

China’s institutional investors tend to hold shares for shorter periods of time, trade more frequently, and exhibit a stronger desire for short-term investment gain, when compared to their international counterparts (see Figure 3.21 and Figure 3.22). In addition, existing institutional investors are too homogeneous in their investment strategies and investment pools, which could be detrimental for the long-term development of China’s stock markets.

3. Securities investment funds: limited products and weak innovation capability

The fund management industry has witnessed rapid growth in recent years,
yet it is still relatively small in size compared with more mature markets (see Figure 3.25).

**Fund management companies’ business models are simple and undifferentiated, while the range of fund products is limited.** Despite their rapid development, China’s fund management companies tend to have an uneven structure of assets and products. The industry mainly caters to retail investors, offering limited services appropriate to institutional clients. Currently, most fund management companies are only permitted to offer mutual funds publicly, with only a small number of firms allowed to manage assets for institutional clients such as the National Social Security Fund and corporate pension funds in separate accounts. Consequently, the asset management market for institutional clients in China is relatively underdeveloped compared to other more mature markets. At present, product offerings are highly concentrated on high-risk products, such as equity funds and hybrid funds, with a small amount of low-risk products such as bond funds and money market funds. As such, the structure of products offered is suboptimal and
lacks full diversification.

The absence of a well-balanced shareholder structure and a long-term incentive mechanism for fund management companies has become a significant stumbling block in the fund management industry’s future development. In addition, the substantial expansion of China’s fund management industry has generated an urgent need for qualified fund managers. The absence of these talents has slowed the industry’s growth.

4. Limited participation of insurance companies, the NSSF and other social security funds

Compared to securities investment funds, the participation of other institutional investors in capital markets is still low and their market influence is limited. First, China’s social security system lags behind the overall economic development. Second, insurance companies’ investment in capital markets remains small both in absolute amounts and in the ratio to total assets of the insurance industry. The relative underdevelopment of these institutions as well as their low participation in the capital markets has contributed to the shortage of long-term investors in China’s capital markets.

5. Un-unified regulation of collective investment schemes

Collective investment scheme products in China are regulated under a series of complex rules by multiple government agencies. Even though these products are similar and can substitute each other to a large extent, regulations
and supervisory conditions differ due to different regulating bodies (see Table 3.9). The lack of a harmonized system of concerned rules and regulations has resulted in higher compliance costs, as well as lower market efficiency. These limitations can be harmful for the long-term development of China’s capital markets.

<table>
<thead>
<tr>
<th>Products</th>
<th>Issues</th>
<th>Regulators</th>
<th>Laws and regulations</th>
<th>Regulating system</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mutual funds</td>
<td>Fund management companies</td>
<td>CSRC</td>
<td>Securities Investment Fund Law</td>
<td>Approval</td>
</tr>
<tr>
<td>Collective investment plans</td>
<td>Securities firms</td>
<td>CSRC</td>
<td>Securities Law</td>
<td>Approval</td>
</tr>
<tr>
<td>Collective wealth management</td>
<td>Commercial banks</td>
<td>CBRC</td>
<td>Interim Measures for the Administration of Commercial Banks' Personal Financial Management Services</td>
<td>Registration and filing</td>
</tr>
<tr>
<td>Trust plans</td>
<td>Trust investment companies</td>
<td>CBRC</td>
<td>Notice on Relevant Issues Concerning Further Regulating the Trust Plans of Assembled Funds</td>
<td>Registration and filing</td>
</tr>
<tr>
<td>Unit-linked insurance products</td>
<td>Insurance companies</td>
<td>CIRC</td>
<td>Provisional Measures for the Administration of the Investment-linked Insurance</td>
<td>Approval</td>
</tr>
</tbody>
</table>

Source: CSRC, CBRC, and CIRC.
6. Under-developed privately-placed fund management business

In overseas markets, privately-placed funds are well developed with a large number of participants. In contrast, domestic private equity funds are comparatively insignificant and their development is slow due to poor management and a lack of exit strategies, and their market influence is limited. Consequently, overseas venture capital and private equity funds have been playing a dominant role in China.

Privately-placed funds which invest mainly in the secondary market have remained unregulated for a long time. As China’s stock markets grew rapidly in recent years, these privately-placed investment funds also gained increasing market influence. However, they still face a number of problems in terms of their business models, internal control, risk management and fund custody.
Chapter 3
The Challenges Facing China’s Capital Markets

Section 6
Legal Environment, Market Integrity, and Regulatory and Enforcement Effectiveness to Be Improved

1. Improvement of the legal system and regulatory frameworks still an ongoing effort

As emerging markets in a transitional economy, the development of China’s capital markets is still constrained by some structural and institutional problems, which can only be solved along with the gradual improvement of the legal system. Also, with the fast development of the capital markets in recent years, adjustments, revisions and improvement of the existing laws, rules and regulations will be an ongoing effort.

2. The evolution of a regulatory and supervisory framework lagging behind market development, and supervisory capacity to be further enhanced

*Market regulation and supervision relies on administrative measures to a large extent.* In China’s capital markets, issuers, investors, and intermediaries have been relying on the regulator and its policies for a long time. Although the situation has been improving since the implementation of a series of market reforms, capital markets still could not maintain their own integrity through market mechanisms. As a result, market supervision has relied on administrative measures to a certain extent. Moreover, the external sanction system such as supporting civil and criminal court systems has not been fully developed. Such a situation can no longer meet the growing needs of the capital markets.

*The regulatory and supervisory framework and its capacity have lagged market developments.* The prominent features of the capital markets are market-oriented mechanisms and a wide range of participants. As markets have grown rapidly and the degree of opening-up has increased, the lead time for new products and services has shortened, while the complexity has increased, leading to higher uncertainty. As such, the difficulties involved in regulatory and supervisory work have increased dramatically, and demands for qualified professionals in regulatory agencies are increasing as well. Yet due to constraints from bureaucratic systems and related factors, the overall...
qualification of the regulatory professionals is less than satisfactory and the overall efficiency of regulation and supervision is still suboptimal.

**More efficient cross-agency regulatory and supervisory coordination is needed.** With capital markets growing rapidly and the introductions of new and complex financial products that fall under the scrutiny of several supervisory bodies, it is imperative to increase cross-agency regulatory and supervisory coordination. It is becoming increasingly difficult for any single regulator to function on its own. At present, there is still some unnecessary regulatory overlap or regulatory vacuum in some sectors where rules and regulations made by different regulatory agencies are not harmonized (see Table 3.10 and Table 3.11). Overall, China still needs to develop a well-functioning financial supervisory coordination system and a crisis management system.

### Table 3.10 Supervision of the fixed-income securities in China

<table>
<thead>
<tr>
<th>Products</th>
<th>Authorities for issuance approval</th>
<th>Issuance approval system</th>
<th>Supervisor(s) of trading</th>
</tr>
</thead>
<tbody>
<tr>
<td>Convertible bonds</td>
<td>CSRC</td>
<td>Approval</td>
<td>CSRC</td>
</tr>
<tr>
<td>Strippable convertible bonds</td>
<td>CSRC</td>
<td>Approval</td>
<td>CSRC</td>
</tr>
<tr>
<td>Enterprise bonds</td>
<td>NDRC, PBC</td>
<td>Quota</td>
<td>PBC, CSRC</td>
</tr>
<tr>
<td>Corporate bonds by listed companies</td>
<td>CSRC</td>
<td>Approval</td>
<td>CSRC</td>
</tr>
<tr>
<td>Short-term commercial papers</td>
<td>PBC</td>
<td>Registration and filing</td>
<td>PBC</td>
</tr>
<tr>
<td>Asset-backed securities</td>
<td>PBC, CBRC (for bank credit asset-backed securities)</td>
<td>Approval</td>
<td>PBC</td>
</tr>
<tr>
<td></td>
<td>CSRC (for corporate asset-backed securities)</td>
<td>Approval</td>
<td>CSRC</td>
</tr>
</tbody>
</table>

Source: CSRC, NDRC, PBC, and CBRC.

### Table 3.11 Supervision of financial derivatives in China

<table>
<thead>
<tr>
<th>Type of derivatives</th>
<th>Interest rate derivatives</th>
<th>Currency derivatives</th>
<th>Stock derivatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulator</td>
<td>PBC</td>
<td>PBC</td>
<td>CSRC</td>
</tr>
</tbody>
</table>

Source: CSRC.
**Enforcement efficiency needs further improvement.** In the area of enforcement, difficulties in conducting investigations, collecting evidence and punishing illegal and irregular activities are still hampering the effectiveness of enforcement. One reason is that enforcement teams are scattered around the country with insufficient manpower. In addition, because of the importance of listed companies and securities firms to the regional economy, the regulator sometimes can not carry out independent investigations due to interventions or pressure from various interest groups. At the same time, the necessary legal framework has not been developed fully, making it difficult to resort to affirmative actions according to the law.

3. Limited role of the self-regulatory organizations

Self-regulatory organizations such as the SAC and exchanges have not been fully functioning, and lack the ability to work independently from regulatory agencies. Although SROs provide continuous training, promote knowledge sharing and organize professional examinations for professionals in the securities industry, their effectiveness in self-regulation needs further enhancement. In addition, they are expected to play a more active role in safeguarding the interests of the industry and its members, improving the business environment for the industry, while promoting and encouraging greater innovation and development of the industry.

4. The building-up of a much-needed equity and credit culture is a long way off

**Building up a strong equity culture is still an ongoing process.** A healthy investment environment and a strong equity culture will contribute to the sustainable development of capital markets. A strong equity culture will require the management of listed companies and practitioners in the securities services industry uphold high standards of professionalism in their roles, with the management fulfilling fiduciary duties to investors, safeguarding the long-term interests of shareholders, complying to laws and regulations and acting in the best interests of their clients. Due to the relatively short history of capital markets in China and with the transition from a central-planned economy to market economy not yet complete, there are still many cases of management entrenchment or “insider control” in capital markets. Fraud, price manipulation and insider trading by securities professionals occur from time to time, damaging the reputation and credibility of the profession.

**Professional integrity needs to be further enhanced.** A high degree of
integrity among market participants plays a key role in building up healthy and efficient capital markets. Currently, China’s capital markets are still emerging markets in a transitional economy, and the legal system and regulatory framework have not been able to keep up. More revisions and reforms in these areas are needed, as are enforcement and sanction processes. In addition, the effectiveness of punishment against frauds or even illegal activities needs to be greatly enhanced. Compared to mature markets, the lack of real seriousness of punishment indirectly encourages fraudulent information disclosures and other fraudulent activities, and has undermined market integrity by damaging the rights and interests of investors. This has led to a negative impact on the long-term development of the capital markets. Furthermore, rating agencies still need to be better regulated, as they have not been able to play an active role in promoting a healthy credit culture in capital markets.

Summary

China’s capital markets, when assessed against overall economic development goals, and in comparison with more mature markets and other emerging markets, still have to catch up on several fronts. China still needs to improve its capital markets in terms of overall scale, internal structure and market efficiency, improve the corporate governance of listed companies, enhance the international competitiveness of securities and futures firms, improve the efficiency and competitiveness of the exchanges, optimize market infrastructure, as well as laws, rules and regulations, and provide more effective enforcement.

Nevertheless, China’s strong economic prospects and its need for capital markets to play a key role in supporting the economic transition also creates an unprecedented opportunity. An objective analysis of the strength and weaknesses, opportunities and challenges of China’s capital markets in the context of China’s specific development issues, together with learning from the experiences of more mature markets, will provide a good foundation for drafting future development strategies for China’s capital markets development.
Despite all that has been achieved since the beginning of the reform era, China still faces the fundamental challenge of a suboptimal economic structure. Unbalanced growth has become an impediment to the nation’s goal of achieving long-term and sustainable development. China needs to adjust its industry structure to encourage value-added production and technological innovation. As witnessed both in China and abroad, strong capital markets can play a critical role in this process. Therefore, the reform and development of China’s capital markets should be pursued with a strategic vision to support sustainable economic growth and promote innovation.

The market reforms of the past two decades have given China considerable experience which could be applied to future strategic measures in capital markets development, including:

- promoting capital markets as part of a national development strategy and increasing public awareness of their importance
- incorporating capital markets into the national economy, while coordinating development with economic and social goals
- engaging in further liberalization by providing incentives to market participants
- enforcing the rule of law and strengthening market regulation
- gradually opening up the market to improve China’s global competitiveness.

With more sophisticated legal and regulatory systems, bigger and more efficient markets, and improved international competitiveness, China’s capital markets can play an important role in building a harmonious society. Over time, China will become a significant and influential member of the world financial system.
Section 1
Strategic Objectives and Fundamental Principles

Introduction

The strategic objective of China’s capital markets is to become fair, transparent, and efficient, thereby achieving higher efficiency of resource allocation. In addition, China hopes to become more open and influential in the world financial system. To reach these objectives, China is following *Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets*, and applying the following five fundamental principles.

Figure 4.1 Strategic objectives and fundamental principles
1. Promote capital markets as part of national strategies, and increase public awareness of their importance

Finance is at the core of modern economies and capital markets are a critical element of the financial system. A nation’s economic advancement can be closely tied to the maturity of its capital markets. Sophisticated capital markets facilitate allocation of resources, and enhance the security of the financial system. This could lead to growth and prosperity, and help in building a more harmonious society. Therefore, the importance of the capital markets should be fully recognized and treated as a strategic priority for policy makers.

Actively foster financial markets, including bond and equity markets. —— 14th CPC Party Congress, 1992

More channels, including those for direct financing, must be added as ways of enlarging corporate capital base. The development of capital, labor and technology markets is a top priority. —— 15th CPC Party Congress, 1997

Promote the reform and steady development of the capital markets, while balancing the interests of the real economies. —— 16th CPC Party Congress, 2002

Developing capital markets is one of the strategic tasks which will help us realize our goal of doubling our GDP within the first two decades of this century. —— The Opinions, 2004

Optimize capital markets structure and increase the scale and share of direct financing. —— 17th CPC Party Congress, 2007

2. Incorporate capital markets into the national economy, while coordinating market development with economic and social goals

The purpose of developing capital markets is to promote sustainable economic growth in China. Despite its great successes, China still faces challenges in creating a more balanced economy. Capital markets help to ensure sustainable economic development by facilitating restructuring and transformation. China’s capital markets should address the current issues they face with a view of sustainable growth, to encourage innovation and reflect the true values of the real economy. At the same time, policy makers should aim to
enhance the state welfare system and facilitate balanced development of both the capital markets and domestic economy.

3. Engage in further market liberalization to provide incentives for market participants

In transforming from a planned economy to a market economy, China’s capital markets still lack some of the mechanisms of more mature markets. It is essential that China stays on the pro-market path that advocates a healthy dialogue between the government and market participants, clarifies the scope of government authorities, and leads to a gradual reduction of governmental control and administrative red tape. The ultimate goal should be to create an environment that rewards innovation and offers incentives to all market participants.

4. Strengthen the legal and regulatory framework

As emerging markets, China’s capital markets are still developing the necessary legal and regulatory frameworks, credit systems, and common standards. The current frameworks need further strengthening to address these issues, and regulators should step up enforcement efforts to maintain market order and protect investors’ interests.

5. Gradual opening-up of the market to make it more competitive in the world financial system

As China becomes part of the global economy, its capital markets compete more directly with developed markets. International competitiveness has become a vital issue. With the integration of the world financial markets under way, a global perspective should be applied to China’s market reform strategy. Capital markets reform should be conducted at a balanced pace, emphasizing global competitiveness.
1. Maintain a fine balance between the government and the markets, strengthen legal and regulatory framework, and build fair, transparent and efficient markets

The government typically plays a dual-role both as a market regulator as well as an advocate during the process of emerging markets development. To a large extent, the sustainable development of the market will be determined by the role the government plays and its ability to maintain a fine balance with market forces.
Simplify administrative procedures and foster market-driven IPO process and products innovation. As markets develop, the government should strive to minimize administrative approval and control. This will further enable the market to realize its potential and motivate market participants. The stock issuance process will gradually change from an approval-based to a registration-based process. By creating an environment that fosters market-driven innovations, China’s capital markets will be better positioned to welcome new products that will serve the Chinese economy.

Strengthen the legal and regulatory framework. China needs to improve the laws and regulations of the market and build a sound legal system. It needs to improve its ability to quickly detect, prevent and resolve any issues that may arise. It needs to strengthen enforcement to raise the cost of non-compliance; improve coordination and collaboration with the police, administrators of industry and commerce, other financial regulators, prosecutors and courts; establish arbitration mechanisms to settle disputes arising within the capital markets.

Reinforce regulatory team-building and improve regulatory efficiency. Following international best practices, China should continuously deepen the reform of regulatory bodies, increase the independence of market regulation, optimize the internal structure of the regulator, attract high quality professionals, and meet the demand of market development. At the same time, the regulator should improve its regulatory philosophy and methodology, focusing more on information disclosure instead of administrative approval. Institutional regulation should gradually move to functional regulation. Other measures could include reinforcing research on strategic issues of market development, setting up risk alarms and contingency measures, and building a multi-layered regulatory system which includes the regulator, SROs, and exchanges to improve regulatory efficiency.

Improve regulatory coordination to prevent financial crisis. China should improve coordination among different regulatory bodies, build fast-response mechanisms to deal with various financial risks and external shocks, and maintain market stability and financial security.

2. Create a fully multi-layered stock market to meet diverse needs

As the Chinese economy continues to grow, both the funding requirements of enterprises and the needs of investors grow more diverse, and the need for
a multi-layered stock market is becoming increasingly apparent. Building a fully multi-layered stock market will be a long-term task.

**Expand the main board market.** In an effort to develop such a multi-layered market, continuous support will be given to the growth of companies listed on its main board, encouraging high-quality domestic companies to go public, and attracting overseas-listed companies and red-chips to issue shares on domestic exchanges. Overseas companies will be encouraged to list on domestic markets to increase market capacity. Other measures will include encouraging mergers and acquisitions among listed companies and improving incentive structures, internal control and corporate governance for listed companies. In addition, stricter penalties on false information disclosure and non-compliance will be imposed, while supervision of controlling shareholders, de facto controllers, management and directors will be enhanced.

**Encourage the development of the SME board.** The SME board will be enlarged with a more flexible listing and refinancing mechanism for small and medium-sized enterprises. Industrial coverage of the board should be further expanded, and the trading mechanism should be improved to increase market liquidity, depth and breadth.

**Growth Enterprise Market (GEM).** The GEM will function as an exit channel for venture capital, and innovative high-growth enterprises can tap this market for their funding needs. To design more market-driven issuance and listing mechanisms that can meet the needs of innovative companies, international practices will be benchmarked. The trading and information disclosure rules will be geared for innovative enterprises to weather risk and protect investors.

**A national over-the-counter (OTC) market under unified supervision.** By setting up a national OTC market which expands the current share transfer system, China can provide a necessary platform for the transfer and distribution of shares of unlisted public companies\(^1\) under unified supervision.

**Build different trading and transfer mechanisms among and between different boards.** Establish differentiated trading and risk management mechanisms to meet the diversified needs of enterprises and investors and improve market efficiency. Mechanisms for transfers among different boards will be installed to build an integrated market system.

---

\(^1\) Unlisted public companies refer to companies with more than 200 shareholders but remain unlisted.
**Improve registration, custodian, and settlement systems.** Improve relevant rules and regulations to specify the rights and duties of parties involved, and protect investor interests. Risk control measures shall be put in place to ensure the safety and efficiency of the markets according to international standards.

3. Carry out liberalization reform of the bond markets and speed up the bond market development

Bond markets are a major component of the capital markets. They provide an alternative source of funding to enterprises and offer investors less risky products with stable returns. The development of bond markets can increase the proportion of direct financing, which would improve the overall structure of China’s financial system.

**Improving the regulatory framework and issuance mechanism.** To help develop China’s corporate bond markets, a unified and centralized regulatory system, which prescribes clear responsibilities, should be established with a set of rules addressing the issuance, trading and disclosure of bonds. A set of market-oriented corporate bond approval procedures will help to improve efficiency, and issuers will gradually be allowed to decide on the rate, maturity, and type of bonds they issue.

**Enhance the accountability of bond issuers.** Set up disclosure rules to ensure timely and accurate information disclosure to bond holders, regulate a financial intermediaries to improve its management and quality of service, improve the credit rating system to improve market discipline, create a credibility archive that is open to the public, implement effective administrative, civil and criminal penalties for violators, enhance bondholders education and protect their legitimate rights.

**Build an interconnected trading and settlement system for bond markets.** Improve the connections between the inter-bank market and exchange market to build a more secure and efficient bond market. Expedite technical system upgrades to improve the efficiency of custody transfer process between the two. These will lead to a multi-layered bond market, comprising both inter-bank and exchange markets, and provide optimal trading platforms for different investor groups.

**Increase the number of products offered and optimize investors’ structure.** Establish a market-driven innovation mechanism to further develop bond
markets, introduce more products such as asset-backed securities and other fixed-income products while improving existing markets for treasury bonds, corporate bonds, and convertible bonds. Enlarge the institutional investors’ base to include more investors who are capable of understanding and managing risks and build an external environment which is supportive for the development of the bond markets.

4. Steady development of the futures and financial derivatives markets

The futures and derivatives markets are crucial to the development of the economy as a whole. Hence it is important to push for the steady development of the futures market, strengthen the regulatory framework, while encouraging new products and bigger volumes to allow a bigger role for the market forces in the national economy.

New products. In order to support the development of the Chinese economy, there is a great need to expand commodity futures markets, including energy, mineral metals and agricultural products, to help companies manage their risk exposure. Along the way, there will also be commodity options and financial derivatives.

Enhance the trading mechanisms of futures products. To ensure market discipline and stability, futures margins and the net capital of futures companies will be monitored. In order to maintain market stability, more effort shall be applied to improving futures exchanges and settlement processes.

Investor composition. Investors should mainly consist of institutional investors with prudent risk management capability. Financial institutions, subject to compliance rules, will be allowed to use futures markets as a risk management tool. Hedging transactions in the futures markets will be encouraged. All types of financial institutions will participate in financial derivatives markets in line with their business strategies.

5. Improve the quality of listed companies

The quality of listed companies is essential to the foundation of capital markets. The regulation and supervision of listed companies, together with market discipline, will help govern issuers, while also improving their performance.

Disclosure and compliance. Improvements on the required content and
format of information disclosure will be made to improve the quality of disclosure. New monitoring methods will also be introduced to improve effectiveness and increase non-compliance costs. International best practices for electronic filing will be benchmarked to improve the timeliness of disclosures.

**Corporate governance.** To continuously improve corporate governance, more initiatives will be introduced, such as:

- Improving the effectiveness of independent directors
- Encouraging listed companies to strengthen internal controls, and reinforce self assessments and external audits
- Establishing and improving incentive structure
- Encouraging institutional investors to exercise external supervision

**Encourage M&A activities.** Fostering active, market-driven, and disciplined M&A activities with relevant laws and regulations to supervise during and after transactions. M&A activities provide external discipline for listed companies to compete and grow.

**De-listing process.** A more flexible de-listing mechanism will be introduced. Senior managers of de-listed companies who have violated laws and regulations will be held legally accountable. The rights of investors and creditors will be protected in accordance with the new *Bankruptcy Law*.

6. Encourage competition to foster a more globally competitive financial service industry in China

The efficiency and health of capital markets rely on the performance of securities firms, fund management companies, futures companies, and other market players. To achieve the full development of the capital markets, it is vital to establish an environment supporting innovation and fair competition in the securities and futures industry.

**Further liberalization to allow more financial innovation and fair competition of participants.** To create such an environment, reduced regulatory and approval requirements and further empowerment of market participants will be necessary. This will enable securities and futures companies to innovate while the regulator will monitor and manage the risk for the entire market and innovation process. A level-playing field will encourage more financial institutions to compete.
**Governance and incentive mechanism.** The evolution towards good corporate governance and management of securities, fund management, and futures companies will be actively pursued, with reference to domestic circumstances and international experience. In addition, share-based incentive schemes will be set up to attract and retain talents.

**Controls and diversification.** Securities firms should enhance their internal controls and develop comprehensive and effective risk management mechanisms. The diversification of operations and expansion of business scope, coupled with M&A and exit mechanisms, will help market players to better compete in the dynamic global environment.

**Institutional investors.** Efforts to develop innovative products and services among fund management companies will better position the capital markets for future growth. Insurance funds, social security funds, corporate pension funds and other institutional investors will play a bigger role in capital markets. Privately raised funds will also be allowed to operate in the market, establishing a multi-layered institutional investor base.

**Financial professionals.** Through continued education, certification examinations and market competitions, a more qualified base of professionals will emerge, equipped with skill sets that combine local knowledge with international best practices.

7. Open up gradually and build up globally competitive capital markets

It is envisaged that capital markets will open up in a gradual, balanced, and mutually beneficial manner. This will help to improve the international competitiveness of China’s capital markets.

**The pace of opening.** The route and pace of the opening should be in accordance with the domestic circumstances. While taking precautions to protect the safety and integrity of the domestic financial system, restrictions on foreign shareholding in securities joint ventures and their business scope will be gradually lifted to enhance the overall competitiveness of the securities and future industry. The share of overseas capital in the domestic market will increase. Overseas companies will also be accepted for listing on domestic exchanges, which will open domestic markets to the outside world and raise global competitiveness.

Further cooperation with Hong Kong, Macau and Taiwan will be encouraged.

292
Encourage financial institutions to invest in overseas markets with a prudent risk control mechanism. Encourage qualified securities firms, futures companies, and fund management companies to set up branches or joint ventures in overseas markets, and provide selected services in global markets. Encourage institutional investors with sound internal control to invest in international markets, where they can learn from international best practices, to further improve their competitiveness.

Collaboration with international market regulators. Collaboration with overseas securities regulators, international securities regulatory organizations and other relevant bodies will be enhanced with the objective of managing cross-border financial risks that come with a globalized marketplace.

8. Improve capital markets’ culture and foster an environment suited to the sustainable development of capital markets

A supportive overall environment is crucial to the development of capital markets, and it is important to build a healthy capital markets culture and foster an environment that is favourable to market development.

Investor education. Education programs for all investors, especially small and medium-sized investors, will be conducted, focusing on risk awareness and value investment. This should enhance investors’ understanding regarding the protection of their own interests, the fact that they are responsible for their own risk, and that they can protect their legitimate interests through various means. Education will also nurture rational individual investors, and foster discipline on institutional investors. Enhanced investor knowledge of capital markets will also create an impetus for product innovation.

Build healthy capital markets environment and fiduciary trust. The development of a healthy capital markets culture and fiduciary trust is a systematic project that involves many parties. While public educational programs would help society recognize the value of shareholder rights, a more comprehensive regulatory scheme also needs to be built and law enforcement needs to be strengthened in order to deter abusive practices.
Section 3
Prospects for China’s Capital Markets (2020)

The past two decades have provided China’s capital markets with a myriad of experience and achievements. Building on such experiences, while borrowing international best practices, China will be able to map out development strategies to fully realize its market potential. In this way, China’s capital markets will grow and prosper while making significant contributions to the economy.

Prospects for China’s capital markets (2020)

- A fair, transparent, and efficient marketplace supported by a sound legal and regulatory framework.
- Extended market depth and width, marked by efficiency, multiple layers and openness.
- World-class investment banks and asset management institutions emerge to provide better services.
- A larger role in economic and social progress, and a driving force in building a harmonious society.

1. A fair, transparent, and efficient marketplace supported by a sound legal and regulatory framework

By 2020, China’s legal and regulatory framework will be more sophisticated and complete, supporting a market system that is more fair, transparent and efficient.

_A sound legal and enforcement framework will be mostly completed._

Against the backdrop of a sound legal and regulatory system, China will focus on enforcement action to ensure that markets operate well. Litigation and non-litigation settlement methods will be introduced, and relevant legal responsibilities will be clearly spelled out. Criminal and non-compliant behaviors associated with securities markets will be severely penalized to protect investors’ interests and market stability.

_Efficient and effective regulation and supervision._ A comprehensive regulatory and supervisory framework will be established, consisting of regulators, industry disciplines, self compliance, and independent reviews. The emphasis of supervision will shift from administrative approval to disclosure require-
ments, and the form of supervision will change from institutional regulation to functional regulation. The role of government will have transformed from a manager to a supervisor. Industry associations will act as a self-regulatory body for market participants.

2. Extended market depth and width

By 2020, China will have significantly extended the depth and width of its bond, stock, commodities and financial derivatives markets, bringing a rich collection of product offerings and a variety of trading platforms to help Chinese enterprises gain financial strength.

_A highly efficient, liquid and deep market._ Transaction costs will be greatly reduced as the market becomes more efficient. Market mechanisms will guide capital markets on origination, pricing, trading and other aspects. Barriers to entry will be significantly lowered. Market liquidity will be improved and impact costs will be reduced. Risk monitoring mechanisms will be set up to control systematic risks. The market will become deeper and more stable as a result.

_Product range widely extended._ As the equity market grows in size, most household names in China will be listed, especially blue-chip companies and innovative companies that benefit from the leverage on capital markets. Listed companies will greatly improve their corporate governance.

In the coming years, the bond market, as an important component of capital markets, will offer a broader range of products to diverse investors. Market activities and liquidity will improve with the emergence of new fixed-income, structured and securitized products in response to the needs of the growing economy. China will diversify its commodity futures and financial derivatives products, enabling price discovery and risk management by participants, who will be more mature, knowledgeable, and risk savvy. The market trading activities and liquidity will be greatly improved.

_Multi-layered markets, trading system and exchanges._ China will establish a multi-layered market system in which exchanges and OTCs complement each other. Trading and settlement will improve with mature short selling and market making mechanisms. After the liberalization reform of exchanges, they will enjoy better business patterns, governance and global competitiveness.

_An open and internationally competitive market._ In conjunction with China’s
globalization process, China’s capital markets will be an open, global venue in which domestic and international players can compete in a healthy manner, to provide first-class services. International capital will be more involved and international companies will be able to float on China’s markets. The infrastructure will continue to improve and China will have significant impact on international markets.

3. The emergence of world-class players

By the time China’s capital markets reach maturity in 2020, securities, fund management, and futures companies will have achieved higher standards of management, sounder governance, more effective incentive schemes and more sophisticated risk management structures. A large number of financial professionals with both global and local knowledge will join the workforce to serve in China.

The emergence of world-class securities firms. Securities firms will become more globally competitive thanks to their success in the domestic market. More diversified sources of revenue will help to enhance securities firms’ risk management. A number of world-class players will emerge through market selection.

World-class institutional investors led by asset management firms. In the coming years, China’s funds sector will enjoy steady growth with more assets under management. Fund managers will offer a greater range of products while insurance companies, social security funds, and corporate annuity funds will invest more in capital markets. China will have its own world-class asset management houses and the market will be driven by institutional investors.

Other professional services. Against the backdrop of strengthening capital markets, other professional service firms such as accounting firms, law firms, appraisal firms and credit rating agencies will grow and develop. There will be more, bigger and more professional financial intermediaries with a higher standard of services.

4. China’s capital markets will play a larger role in economic and social progress, and become a driving force in building a harmonious society

By 2020, China’s capital markets will have developed from the emerging markets in a transitional economy to a more mature market. These fully oper-
China’s financial system will be primarily based on direct financing, optimizing the financial structure, and improving the stability and elasticity of the financial system. Capital markets will become the most important place to raise capital and allocate resources. Equity and debt financing will become major funding avenues for Chinese enterprises. The securitization ratio will reach that of a developed country, and China will have a well structured financial system with more elasticity, vigor and stability.

Figure 4.3  Prospects for China’s capital markets (2020)
**Foster Chinese enterprises to grow.** As market efficiency and M&A activities increase, resources will flow to listed companies, particularly those with strong records of management and compliance in their pursuit of world class excellence. Meanwhile, China’s multi-layered market system can serve as a cradle for hi-tech and innovative enterprises that are pursuing high value-added growth.

**Playing a significant role in building a harmonious society.** By 2020, not only will China’s capital markets be supporting enterprise growth and upgrading the industrial base, they will also be redirecting investment to less developed regions. Futures contracts on agricultural products will help transform rural production and operation, contributing to the prosperity of the new socialist countryside. Capital markets will provide an investment avenue for pension funds and social security funds, thus supporting China’s aging population. Above all, China’s capital markets will evolve into a platform for fair competition and economic opportunities, thereby playing a significant role in building a harmonious society.

**Summary**

The reform and development of China’s capital markets should be pursued with a strategic vision to support sustainable economic growth and promote innovation via improving the efficiency of resource allocation. The future strategic measures should follow the principles that have been developed in the past two decades. These principles include: promoting capital markets as part of a national development strategy and increasing public awareness of their importance; incorporating capital markets into national economy, while coordinating development with economic and social goals; engaging in further liberalization by providing incentives to market regulation; and gradually opening up the market to improve China’s global competitiveness.

It can be foreseen that China’s capital markets will grow and prosper while making significant contributions to the economy. Looking forward, with sound legal and enforcement frameworks, extended market depth and width, and well-improved market efficiency, China’s capital market will become a driving force in building a harmonious society, and an open and internationally competitive market which will have significant impact on the global financial market.
Appendix I: Abbreviations

ABC  Agriculture Bank of China
AIM  Alternative Investment Market
BOC  Bank of China
CAMCE China CAMC Engineering, a listed company
CBRC China Banking Regulatory Commission
CCB China Construction Bank, a listed company
CDC China Government Securities Depository Trust and Clearing Co. Ltd
CITIC China International Trust and Investment Corporation
CMB China Merchants Bank, a listed company
COSCO China Ocean Shipping (Group) Company, a listed company
CPC Communist Party of China
CPIC China Pacific Insurance Company, a listed company
CSDC China Securities Depository and Clearing Corporation
CSRC China Securities Regulatory Commission
DVP Delivery Versus Payment
ETF Exchange Traded Fund
GDP Gross Domestic Production
GEM Growth Enterprise Market
HHI Herfindahl-Hirschman Index
ICBC Industrial and Commercial Bank of China, a listed company
IOSCO International Organization of Securities Commission
IPO Initial Public Offering
LLDPE Linear Low Density Polyethylene, a commodity product
M&A Merger and Acquisition
MOF Ministry of Finance
MOFCOM Ministry of Commerce of People’s Republic of China
MOU Memorandum of Understanding
NASDAQ National Association of Securities Dealers Automated Quotations
NDRC National Development and Reform Commission
NSSF National Social Security Fund
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>NET</td>
<td>National Electronic Trading System</td>
</tr>
<tr>
<td>NPC</td>
<td>National People’s Congress</td>
</tr>
<tr>
<td>NYSE</td>
<td>New York Stock Exchange</td>
</tr>
<tr>
<td>OTC</td>
<td>Over-the-counter</td>
</tr>
<tr>
<td>PBC</td>
<td>People’s Bank of China</td>
</tr>
<tr>
<td>PRC</td>
<td>People’s Republic of China</td>
</tr>
<tr>
<td>PT</td>
<td>Particular Transfer</td>
</tr>
<tr>
<td>PTA</td>
<td>Purified Terephthalic Acid, a commodity product</td>
</tr>
<tr>
<td>QDII</td>
<td>Qualified Domestic Institutional Investor</td>
</tr>
<tr>
<td>QFII</td>
<td>Qualified Foreign Institutional Investor</td>
</tr>
<tr>
<td>REITs</td>
<td>Real Estate Investment Trusts</td>
</tr>
<tr>
<td>RMB</td>
<td>Renminbi</td>
</tr>
<tr>
<td>SAC</td>
<td>Securities Association of China</td>
</tr>
<tr>
<td>SASAC</td>
<td>State-owned Assets Supervision and Administration Commission</td>
</tr>
<tr>
<td>SCSC</td>
<td>State Council Securities Committee</td>
</tr>
<tr>
<td>SME</td>
<td>Small and Medium-sized Enterprise</td>
</tr>
<tr>
<td>SOE</td>
<td>State-owned Enterprise</td>
</tr>
<tr>
<td>SPC</td>
<td>State Planning Commission</td>
</tr>
<tr>
<td>SRO</td>
<td>Self-Regulatory Organization</td>
</tr>
<tr>
<td>SSE</td>
<td>Shanghai Stock Exchange</td>
</tr>
<tr>
<td>ST</td>
<td>Special Treatment</td>
</tr>
<tr>
<td>STAQ</td>
<td>Securities Trading Automatic Quoting System</td>
</tr>
<tr>
<td>SZSE</td>
<td>Shenzhen Stock Exchange</td>
</tr>
<tr>
<td>T-Bond</td>
<td>Treasury Bond</td>
</tr>
<tr>
<td>TIC</td>
<td>Trust and Investment Company</td>
</tr>
<tr>
<td>WTO</td>
<td>World Trade Organization</td>
</tr>
</tbody>
</table>
## Appendix II:

### Exchange Rates of RMB to U.S. Dollar from 1981 to 2007

<table>
<thead>
<tr>
<th>Year</th>
<th>Exchange Rate</th>
<th>Year</th>
<th>Exchange Rate</th>
<th>Year</th>
<th>Exchange Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>2.3270</td>
<td>1993</td>
<td>5.7620</td>
<td>2002</td>
<td>8.2770</td>
</tr>
</tbody>
</table>

Source: National Bureau of Statistics of China (NBS), the State Administration of Foreign Exchange (SAFE).
Acknowledgements

The drafting of the China Capital Markets Development Report was initiated in May 2006 as a key project of the CSRC. The drafting team would like to thank the senior leaders of the CSRC for their commitment, support and advice in this effort.

During the drafting, we have been fortunate to receive comments and advice from former leaders of the CSRC. We are grateful to the executives, professionals and researchers who shared with us their frank views and comments during workshops, interviews and discussions. This report could not have been completed without the support we received from the various departments of the CSRC, the exchanges, listed companies, securities firms, fund management companies, futures brokerage companies, the Securities Association of China and the China Futures Association.

This report also benefited from the technical assistant of the World Bank. The World Bank project team shared with the drafting team international experiences and lessons learned in capital markets development, introduced capital markets assessment methodology, and contributed to the analysis of capital markets development strategies. The drafting team would like to express our appreciation for the constructive advice and technical assistance provided by the World Bank.

We would also like to thank KPMG, Goldman Sachs Group, Inc. and UBS for assisting in translation of the report.

The Drafting Team

“China Capital Markets Development Report”

January 2008