The Restructuring of China's Securities Industry

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I. Introduction

The recent period of radical change in the environment for China's securities firms has exposed a number of problems those firms are facing. The long period of stock market stagnation that began in 2001 has weighed particularly heavy on the securities firms' management. Since the industry recorded its first overall loss in 2002 those losses have continued to mount, reaching 9.4 billion yuan in 2003, 10.36 billion yuan in 2004, and approximately 11 billion yuan in 2005.[1]

Meanwhile, China joined the World Trade Organization (WTO) on 11 December 2001. One of the conditions for joining the WTO was that China had to completely open its banking sector to foreign firms within five years, and the securities industry also had to allow in foreign capital, albeit with conditions attached. This prompted foreign-capitalized banks to accelerate their equity participation in Chinese banks, and securities house joint ventures were also established between foreign-capitalized and Chinese securities firms. This influx of foreign funding power and management expertise is expected to strengthen China's domestic financial institutions, but it has also created concern that the markets will be dominated by foreign-capitalized firms.

In response, the Chinese government proposed guidelines for a broad reorganization and restructuring of domestic securities firms, providing support to the strongest ones while reorganizing and restructuring those with problems. With share prices also recovering, earnings for the industry overall finally recovered in H1 2006, but there is now a need to make serious improvements in the firms' viability.

In this paper, we analyze the problems in China's securities industry thus far and what may be behind those problems, and then project future industry issues and the direction of development once restructuring over the next few years is complete.

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[1] Figures for 2004 are as announced by the Securities Association of China (SAC). Figures for 2003 and 2005 are from the *21st Century Business Herald*, dated 18 July 2006. The data was aggregated from 122 securities firms in 2003, 114 firms in 2004, and approximately 110 firms in 2005.

II. China's securities industry: Overview and problem areas

1. Problems with China's securities sector and what may be behind those problems

China's securities industry has grown rapidly since its first securities firm was established in the Shenzhen special economic zone (SEZ). As of end-December 2004, there were 133 securities companies in China with 3,075 business locations and over 120,000 employees. Based on the latest published statistics, at end-2004 the total assets of 130 securities firms (excluding three that were either newly formed or ceased operations) were 401.5 billion yuan, and net assets were 96.3 billion yuan.

Although the securities industry has grown rapidly, it also has many problems. Many of these problems have become particularly evident since June 2001, when share prices entered a sustained period of weakness. Illegal activities were rampant, including the misappropriation of client funds, the guaranteeing of yields in discretionary accounts, proprietary trading in violation of rules, and market manipulation. When share prices were climbing, these illegal activities brought massive profits to securities firms, but during the period of sustained share price weakness, large losses resulting from illegal behavior have weighed heavily on the firms and put pressure on management. This also hurt the interests of investors and drove them away from the market, causing share prices to fall even further in a vicious cycle.

The problem of misappropriation of client funds and government bonds held on deposit was one of the most serious of the securities firms' illegal actions. Since 2002, approximately 30 securities firms have been shut down by the China Securities Regulatory Commission (CSRC), nearly all of them for the primary reason of losses generated by such illegal activity as misappropriation of client funds and government bond deposits as well as illegal discretionary accounts. A typical case involves securities firms trading on their own account by diverting client funds, and because of the sustained weakness of share prices, not only did the firms incur huge losses on these proprietary trades, some became unable to return the funds to client accounts. Under the old rules, securities firms could only trade on their own account with their own funds, but since the diversion of client funds made it possible for them to do such trading on a much larger scale, it also paved the way for them to manipulate the price of certain shares, manipulate the market, and engage in other illegal activities.

Although the guarantee of yields in discretionary accounts is prohibited, some securities firms agreed to guarantee yields to attract customers. But with share prices declining, securities firms became unable to earn the yields guaranteed to clients by investing in stocks, and were forced to make up the difference with their own funds.

This problem can be attributed to insufficient internal controls at the securities firms as well as to limitations in the old securities laws and institutions (trading systems and oversight/management mechanisms).

We look first at the internal controls at securities firms. Many of China' securities firms have been spun off from state-owned financial institutions (including banks and

investment trusts), and thus securities firms in the initial stages were basically 100% state-owned enterprises. Although they have since been converted into joint-stock corporations, the management mechanisms and practices formed during their many years as state-owned enterprises remain. Consequently, many securities firms are joint stock corporations in name only, but have yet to institute the management structure to go with it. For example, although the representative directors are nominally chosen by the Board of Directors, they are effectively government appointees.

We look next at the limitations of the laws and institutions. These limitations have two aspects: delays in putting the laws and institutions in place, and limitations on the content of the laws and institutions that are in place. First, although the first securities firm was established in 1988, a securities law was not promulgated until 1998, 10 years later (the old *Securities Law of the People's Republic of China*, implemented in 1999, and the new *Securities Law*, which took effect in January 2006), while the *Measures on the Administration of Securities Companies*, the administrative regulations on the supervising and administration of securities firms, was not implemented until March 2002. Prior to implementation of the *Securities Law*, the State Council and regulatory authorities wrote and promulgated a large number of administrative regulations and notices, but they were not very legally binding, and because so many different government agencies were involved in writing and issuing the regulations, there was tendency for the regulations and notices to either be inconsistent with one another or leave loopholes.

Second, limitations stemming from the content of the laws and institutions have shown up starkly in (1) limitations on funding methods for securities firms and (2) the simplicity of business and earnings structures.

China's securities firms operate almost entirely on internal funding, and their options for procuring outside funding are extremely limited. In the 1990s, China's securities firms had almost no other way to procure funding besides government bond repos and privately placed capital increases. The reason for this severe limitation on outside funding was that because many banks owned stakes in securities firms, it was easy for the securities firms to procure loans from the banks, and this led to an outbreak of irresponsible loans and other problems. It also created a very cautious attitude toward bank lending to securities firms within the Chinese government, which since the Asian financial crisis in 1997 has been concerned over the negative impact that the bankruptcy of securities firms could have on the banking system, and has tried to keep stock market risk from propagating to the banking system.

The situation stayed like this until around 1999. Since then, a variety of measures have been proposed to relax rules on funding by security firms, including approval for securities firms to enter the inter-bank market, to list their shares, to make loans collateralized by stocks, and to issue bonds. In fact, however, standards for issuing bonds and listing stock are so strict that very few securities firms can meet them, and there has yet to be a fundamental solution to the funding problem of securities firms.

Regarding the simplicity of business and earnings structures, Chinese securities firms are highly dependent for their earnings on the traditional security businesses as

brokering trades, proprietary trading, and underwriting. On an overall basis, it appears that about 70% of revenues come from brokerage commissions, 20% from underwriting, and about 5% each from proprietary trading and fund management. Other businesses, such as M&A, financial advisory, and securitization, have been virtually nonexistent.

Because brokerage is the primary source of earnings for the securities firms, those earnings swing widely in reaction to share price trends. Furthermore, under the old *Securities Law*, securities trading in China was limited to cash trades only, and futures trades and margin trades were not allowed. Consequently, investors only generated profits when share prices were rising, making it likely that trading volume would shrink when share prices were heading downward, and this had an immediate impact on securities firm earnings.

III. Restructuring of securities sector at a fever pitch

1. Basic policy toward restructuring: "supervision by category" and "feed-the-strong, starve-the-weak"

During the stock market weakness since mid-2001, a variety of problems facing securities firms came to light, and the CSRC responded with a proposal to consolidate the securities sector. After a number of bankrupt securities firms were closed in 2002-03, policy congealed around a "supervision/administration by category" and "feed-the-strong, starve-the-weak" approach, and serious consolidation got underway.

Under "supervision/administration by category," each of the securities firms are categorized by their level of risk, extent of illegal activity, and development potential, while the strongest securities firms are helped (feed the strong) and the companies with high-risk, serious problems with illegal activity, and little hope for improvement are weeded out (starve the weak). The CSRC evidently classifies securities firms into four categories (A, B, C, and D) by their level of risk, with A being the lowest risk category, although specific criteria for these ratings have not been disclosed. In general, A firms are the strongest with almost no risk or illegal activity, B firms are slightly weaker than A firms, C firms have roughly an average risk level, and D firms are at high risk of seeing a deterioration in their business. A and B firms receive assistance, D firms are targeted for liquidation and closure, and the treatment of C firms seems to depend on conditions.

On 29 July 2005, the State Council (central government) announced a plan to reorganize and restructure securities firms including specific targets, naming the plan the *Comprehensive Plan for Consolidation of Securities Firms*, aimed at eliminating the existing risk at securities firms and implementing new supervisory and administrative mechanisms during the two-year period that began with the full-scale launch of consolidation in 2004.

The organizations actually in charge of implementing the consolidation plan include Central Huijin Investment[2], the China Construction Bank Investment Company (CCB Investment), the China Securities Investor Protection Fund (CSIPF), the asset management companies that have been taking care of the non-performing loans of big four state-owned banks, and securities firms.

In addition to government-led restructuring, the strongest securities firms are actively engaged in their own efforts to make acquisitions and restructure operations. Recently, there has also been an increase in the number of securities firms seriously considering listing their own shares, apparently as a way to become more competitive and increase their market share after restructuring.

2. Progress toward restructuring

1) Measures to "feed the strong" include enhancing liquidity and offering the "pilot securities firm" qualification," etc."

Measures to feed the strong thus far can be classified as one of two types, (1) business-related measures and (2) liquidity enhancing measures.

The focus of business-related measures has been on awarding securities firms with qualifications as either a "pilot" or a "standard" firm. The CSRC and the SAC published documents concerning certification in August 2004 for pilot securities firms and in April 2005 for standard securities firms.[3] Based on these documents, securities firms meeting certain requirements can apply for qualification as either a firm doing "innovative pilot activity" or as a standard securities firm. The requirements for the pilot qualification are that the securities firm must design and implement a system for the separate management of client funds, prepare reports on the administrative status of client assets, government bond repos, and proprietary trading, and have net capital for the past year of at least 1.2 billion yuan. Securities firms with the pilot qualification are able to enter new securities businesses first.

The requirements for submitting an application as a standard securities firm are fundamentally the same as for the pilot qualification, including the need to design and implement a system for the separate management of client funds and prepare reports on administrative status of client assets, government bond repos, and proprietary trading, but are somewhat easier to meet, including a need to only have net capital of at least 200 million yuan and to have not been fined for a serious violation over the past year (versus three years for the pilot qualification). As soon as a standard

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2 In 2003, the Chinese government injected funds into state-owned commercial banks and then established this entity as a wholly owned subsidiary to manage the injected funds. The official name of the organization is the Central Huijin Investment Company Ltd.

3 In August 2004, the CSRC issued its Circular on *Issues Concerning the Boosting of Securities Industry Innovation* and SAC issued its *Provisional Measures on Evaluating and Approving Pilot Securities Companies*, then in 2005, the CSRC announced its Circular on *Issues Related to Assessing, Inspecting, Supervising, and Administering Standard Securities Companies*, while SAC announced its *Provisional Measures Concerning the Assessment and Inspection of Standard Securities Companies*.

securities firm meets the qualifications for pilot, they can submit an application to upgrade their status.

As of August 2006, 18 companies were qualified as pilot securities firms and 25 were qualified as standard firms.

Measures to enhance liquidity include, in their order of implementation, approval to issue short-term bonds, get low-interest loans, receive capital infusions, and issue subordinated debt.

In October 2004, the People's Bank of China promulgated its *Measures for Administering Short-term Lending by Securities Companies*, and the law went into effect on 1 November. Under this law, securities firms that meet the conditions are allowed to issue short-term bonds up to 91 days in maturity. Both pilot and standard securities firms are exempt from credit ratings. So far, short-term bonds have been issued by Guotai Junan Securities, China International Trust Investment Company (CITIC), China Merchants Securities, and Haitong Securities.[4]

On the low-interest financing side, in July-August 2005, the People's Bank of China provided a one-year central bank loan totaling 10 billion yuan, at an interest rate of 3.87%, to five of the pilot securities firms, (GF Securities, Orient Securities, Huatai Securities, Citic Securities, and Haitong Securities). These loans had to be used to improve management capabilities and to develop pilot businesses and services related to the reform of nontradable shares.[5] The securities firms have already entirely paid back the loans.

In September 2005, Central Huijin Investment injected capital of 2.5 billion yuan into Shenyin Wanguo Securities and 1 billion yuan into Guotai Junan Securities.[6]

Regarding the issuance of subordinated securities, on 16 December 2005 the CSRC issued its Circular on Relevant Issues concerning Securities Companies' Borrowing Subordinated Debt. The notice allows securities firms to issue subordinated debt and count it as part of its net capital up to a certain percentage. At end-2005, Great Wall Securities issued the first subordinated securities, amounting to 642 million yuan. On 22 June 2006, Industrial Securities' proposed subordinated debt issue (a total of 800 million yuan in two tranches) was approved at its general shareholders meeting. After issuance of the first tranche, Industrial Securities, currently a standard securities firm, will meet the net capital requirements for applying to be a pilot securities firm.

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4 Because there are few securities firms that meet the conditions stipulated in the regulations, the market for short-term bonds from securities firms is not very active.

5 During this time, however, share prices were also weak, and the view within China is that low-interest financing was provided by government as a way to prop up share prices by enabling securities firms to buy stocks on their own account.

6 This gave Central Huijin a 37.3% stake in Shenyin Wanguo Securities, making it the leading shareholder, and a 21.0% stake in Guotai Junan, making it the second leading shareholder.

2) Starve the weak means either receivership and closure or capital injection and revival

Looking at examples thus far of the "starve the weak" policy, i.e., the handling of problem securities firms, we see that those firms deemed hopeless and incapable of survival are first put under receivership ("*tuoguan*" in Chinese) and then shut down, while those deemed viable are injected with capital and revived.

Receivership is a method whereby the authorities entrust the management of a problem securities firm to another financial institution, which cleans up the problem firms assets and liabilities and restructures the organization and its staff. The receiving institution is without exception a relatively sound company with considerable financial resources, and in many cases it winds up acquiring all or a portion of the problem firm's securities business, office locations, staff, and customer accounts, after which the problem firm is shut down. There were several of these receivership cases in 2002-03, but the number has been increasing since 2004, and from 2004 until mid-2006, approximately 20 companies went through the process.

In 2004, nearly all of the receiving companies were asset management companies, but since 2005 they have primarily been pilot securities firms. There are several reasons for this, including (1) around 2004, when the consolidation of securities firms started to pick up, there were virtually no other securities firms strong enough to act as receiver; (2) in 1999, four asset management companies were established to purchase and dispose of the nonperforming loans owned by state-owned banks, with their charters set to expire in 10 years, such that each of the companies will have to propose a new business model if they are to survive past 2009; and (3) owing to assistance given to the strongest securities firms, some have become strong enough to act as receiver, and they now are trying to expand their business by acting as receiver to other companies.

Among the financial institutions acting as receiver, the China Securities Investor Protection Fund has recently been attracting attention. In September 2006, that fund established Anxin Securities (capital of 1.51 billion yuan, of which it owns 1.5 billion yuan). Anxin Securities took over the securities assets of three securities firms that went into receivership under the CSIPF: Zhongguancun Securities and China Sci-Tech Securities (in February 2006) and Guangdong Securities (in November 2005). Anxin is widely expected to be the receptacle for other securities firms when they become subject to closure.

The firms that are allowed to survive are revived with an injection of capital. Often this reconstruction is led by the central government for larger firms, and by the regional government for smaller firms that are more regionally oriented. One classic example of the former is the reorganization of China Galaxy Securities, a state-owned enterprise at the central government level. China Galaxy Securities, established in August 2000 with the merger of the securities divisions of four state-owned banks and a trust company subsidiary of a state-owned life insurer, was at one time one of

China's largest[7] securities firms, with about 200 offices nationwide and 3 million client accounts. After running up huge losses from illegal activity over the past two years, however, it became a candidate for reorganization. In June 2005, Central Huijin and the Ministry of Finance jointly invested in China Galaxy Financial Holding, and established three companies under the holding company: China Galaxy Securities, Galaxy Investments, and Galaxy Asset Management. The new China Galaxy Securities plans to acquire the securities assets of the existing China Galaxy Securities.

Examples of reorganizations led by regional governments include Southwest Securities and Kinghing Securities. Located in Chongqing, Southwest Securities' business suffered because of its diversion of client guarantee funds and illegal trades. Its reorganization plan, which is being managed by the Chongqing State-Owned Assets Supervision and Administration Commission (SASAC), calls for China Construction Bank Investment to provide an infusion of capital as well as a working capital loan. Located in Hangzhou, Zhejiang province, Kinghing Securities posted huge losses related to the diversion of government bonds owned by its major shareholder, Kinghing Trust & Investment, and to its provision of large amounts of collateral to Kinghing Trust. At end-2005, Kinghing Trust suspended operations, and as it became more difficult to demand repayment from the company, the Zhejiang government made the decision to rescue Kinghing Securities. In April 2004, a state-owned enterprise owned by Zhejiang province injected capital into Kinghing Securities through a subsidiary, and on 1 July changed the company's name to Zheshang Securities.

As a result of these dispositions, the number of securities firms in China declined from about 130 in 2004 to 109 by end-June 2006.

The handling of bankruptcies will probably be important moving forward. So far, there have been almost no examples of securities firms going bankrupt, even after being shut down by administrative order. In January 2006, a mid-level people's court in Shenzhen ordered the bankruptcy of Dapeng Securities, which had been shut down in January 2005. A bankruptcy law was not adopted until 27 August 2006, however, and became effective from 1 June 2007. It is likely that the number of bankruptcy cases involving securities firms where the reorganization is not going well will increase once the bankruptcy law is implemented. This shift from closure by administrative order to bankruptcy processing should make the entire process of reorganizing a securities firm more transparent.

3) Securities firms start to list their shares

The leading securities firms are also becoming more interested in listing their shares. A large number of securities firms have reported plans to list, including Everbright, Changjiang, Donghai, Haitong, Orient , China Merchants, Huatai, Guoyuan, and Goldstate.[8]

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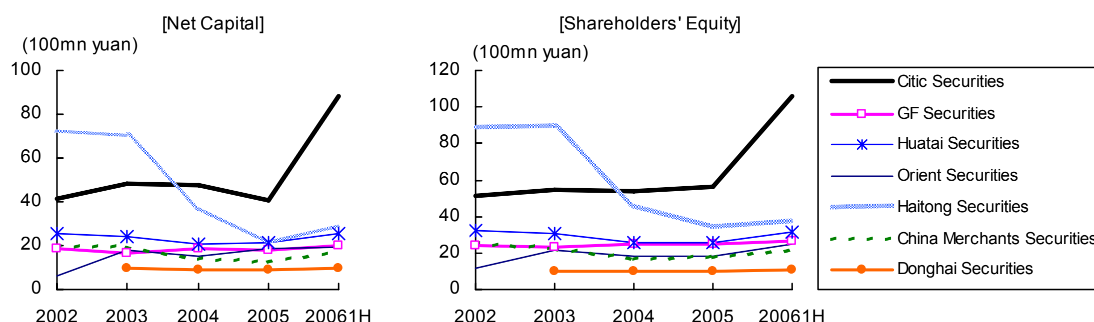
7 The company was ranked No. 1 in registered capital, with 4.5 billion yuan in 2003, in trading volume with A shares in 2004, and in government bond trading volume.

8 *Securities Times*, dated 28 July 2006.

One reason that the securities firms have taken to the idea of listing their shares is that developing the new services and products that are being deregulated requires large amounts of funds.

Currently, there are only two listed securities firms, Citic Securities and Hongyuan Securities.[9] The success in making acquisitions and expanding market share that Citic Securities had as a result of its listing and resulting increase in capital has become the envy of the other securities firms (Figure 1).

Figure 1 Amount of capital at Citic Securities (compared with other pilot securities firms)



Source: Nomura Institute of Capital Markets Research, based on data from Wind Information

Those securities firms that want to list their share are considering do so through a backdoor ("hermit crab") listing ("*jieke*" in Chinese) rather than through a direct IPO. Under a backdoor listing, an unlisted company injects assets into a listed company and changes the name of the listed company to that of the unlisted company, thereby achieving its listing through the back door. This borrowing of the listed company's listing qualifications, or shell, has been likened to the way a hermit crab borrows a shell.

The steps required for an IPO are time consuming, and the listing review done by the CSRC looks closely at whether the applicant has posted a profit for the past three years consecutively.[10] Because many securities firms posted losses in 2002-05, even if they turn profitable in 2006, the earliest they could achieve three straight years of profits would be 2008. A backdoor listing offers a way around this issue.

There are also restrictions on backdoor listings, however. Because government regulations prohibit a financial institution from also operating a non-financial business,

9 Company name and code are Citic Securities (600030.SH) and Hong Yuan Securities (000562.SZ).

10 The Securities Law includes a provision (in Article 13) stating that one of the requirements for an IPO is that the firm have no false record in its financial statements over the latest 3 years and have no other major irregularity, but one of the key factors to be considered according to the rules of the CSRC's Public Offering and Listing Review Committee is whether the company has posted a profit for the past three years consecutively.

there is a need for a clean shell ("*jingke*" in Chinese) that does not own any non-financial assets. Since the listed company's non-financial business assets must be sold to create a clean shell, those assets have to be fairly easy to sell. The asset sale must be agreed to by the listed company's shareholders and, in the case of a company that is critical to a regional economy, agreement by the regional government is also essential. In choosing a shell, there are some securities firms that have established criteria that the shell must meet: (1) asset disposition must not be difficult, (2) the listed company's major shareholders have an intention of selling their shares, and (3) the shell's capital must be of suitable size.[11]

There were rumors of a number of backdoor listings planned for 2006, but almost none came to fruition, owing to opposition from either the listed company itself or a regional government that did not want to let the companies go. GF Securities has received approval from the authorities for its planned backdoor listing through Yanbian Highway Construction, however. In September 2006, Yanbian Highway announced that it had exchanged shares with GF Securities at a ratio of 1:0.83, and then changed its names to GF Securities. If GF Securities succeeds with its backdoor listing it will be the first to do so, and its success will likely lead to an increase in the number of backdoor listings in the future.

3. Implementation of new supervisory system and looming deadline for completing consolidation

1) Implementation of new supervisory system

In step with the reorganization and restructuring of securities firms, the system for supervising and administering securities firms is also in the process of changing.

The authorities view the current period of consolidation as a "special period for disposing of risks" and the period after that as a "period of normal supervision and administration." CSRC Chairman Shang Fulin, speaking at a roundtable discussion on consolidation of securities firms in September 2006, noted changes in the supervisory and administrative system between the two periods included (1) a shift in the supervisory approach from eliminating existing risks and ex-post surveys and penalties to preventing risk and instilling discipline; (2) a shift in supervisory methods from empirical-based judgment and qualitative analysis to indicator-based administration and quantitative supervision and administration; (3) a shift in the supervisory structure from governmental supervision and administration to an integrated, triangular system relying on governmental supervision, industry self-regulation, and each company's internal controls.

The authorities have already begun to gradually implement new methods prior to the normal supervisory period to make their supervision and administration of

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[11] *Securities Markets Weekly*, dated 6 August 2006, from a conversation with the Vice President of Changjiang Securities, who is also the vice chairman of a working group on listing activities.

securities firms more effective. During this process, the focus has been on implementing risk control indicators for each type of business.

In July 2006, the CSRC formally announced Administrative Measures for Securities Companies Risk Control Indicators (*Risk Control Law*) and new rules for calculating net capital for securities firms (*Net Capital Rules*). Both were implemented effective 1 November 2006.[12]

Although rules on risk control indicators for securities firms were already in place, they were scattered across various regulations and circulars, only a few indicators were covered, and certain aspects of the method for calculating the indicators were not rigorous. The law sets down more detailed and scientific rules for the risk indicators.

The new law quantifies indicators of risk control at securities firms and establishes net capital requirements for each business. For example, for the securities company overall, the ratio of net capital to net assets cannot fall below 40%, the ratio of net capital to debt cannot fall below 8%, the ratio of net assets to debt cannot fall below 20%, and the ratio of current assets to current liabilities cannot fall below 100%. For the proprietary trading business, total proprietary trading in stocks cannot exceed 1x net capital and the proprietary trading business overall cannot exceed 2x net capital. A further requirement is that a securities firms' securities borrowing and lending (SBL) to a single client cannot exceed 5% of net capital.

2) Looming deadline for completing consolidation

The end of this round of securities firm reorganization and restructuring that entered high gear in 2004 is finally approaching.

CSRC Chairman Shang reemphasized at the roundtable that all of the reorganization and restructuring of securities firms currently taking place had to be completed by August 2007. He also emphasized that there were earlier deadlines for phased-in targets: (1) by end-October 2006, all problems, including diversion of client trade settlement funds and client bonds, illegal discretionary accounts, and the diversion of funds by shareholders in securities, must be eliminated, and the ratio standards prescribed in the Risk Control Law had to be met; and (2) by end-December 2006, the government bond repo problem must be resolved and securities companies must disclose basic information.

The October 2006 deadline in the *Risk Control Law* requires that securities firms have net capital of at least 200 million yuan in order to engage in securities underwriting and recommendation, proprietary trading in securities, or the business administration of securities assets. This is also the minimum capital requirement for being qualified as a standard securities firm. There are currently about 60 securities firms that have neither the pilot nor standard qualification. Because those firms that

[12] The comment-seeking drafts underlying the two were announced in January 2006, and after making revisions based on a request for comments from the industry, they were formally announced in July.

do not meet the net capital requirement by end-October would theoretically be subject to closure, we expect the companies to restructure and enhance their capital on an accelerated basis. We expect this to result in a further consolidation in the number of securities firms, currently at 109, from 2007.

4. New pecking order in the securities industry

1) Affiliates of the asset management companies, of Central Huijin, CCB Investment, or the CSIPF, and of the pilot securities firms are emerging as major domestic players

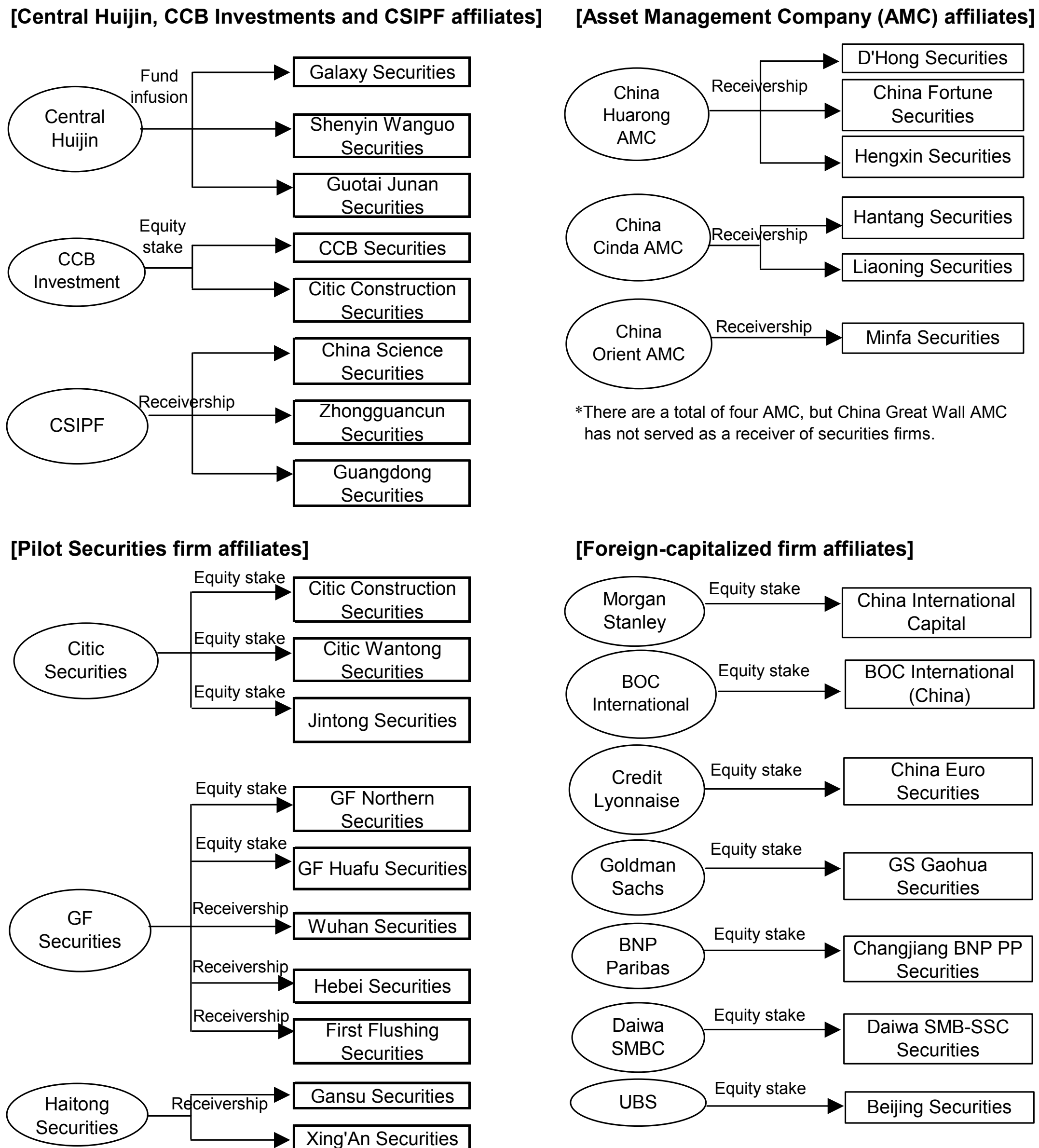
The power relationships within the securities industry are being redrawn through this process of securities firm consolidation and reorganization (Figure 2).

In the early stages of this program of receivership for problem securities firms, a receiving asset management company would take over the securities business of the problem company, which has to some extent provided a basis for the asset management company itself being transformed into a securities firm.

Since then, Central Huijin and CCB Investment have become shareholders of a large number of securities firms through capital infusions. Central Huijin is now a shareholder in a number of leading securities firms, including China Galaxy Securities, Guotai Junan Securities, and Shenyin Wanguo Securities, while CCB Investment owns stock in Southwest Securities, Citic Construction Securities, CCB Securities, and Qilu Securities. Additionally, CSIPF established Anxin Securities, as noted above. There is a strong possibility that Anxin Securities will become a receiver for shuttered securities firms, and if it does it would give birth to a powerful CSIPF-Anxin Securities group.

The pilot securities firms that both take problem securities firms under receivership and also acquire other companies are also increasing their influence in the sector. Among the 18 pilot securities firms, there has been a notable increase in the trading share of Citic Securities, GF Securities, Everbright Securities, and Huatai Securities. Data on shares of trading in securities (stocks, mutual funds, bonds, and warrants) shows that although Citic Securities has only a 2.9% share on its own, that share rises to 7.7% when including the three companies that it has acquired ownership of: Citic Construction Investment Securities, Jintong Securities, and Citic Wantong Securities. Likewise, GF Securities by itself has a 3.5% share, but counting the five companies that it acquired it has a 5.4% share (Figure 3).

Figure 2 Three major domestic categories and foreign firms in the securities industry



Source: Nomura Institute of Capital Markets Research

Figure 3 Share of securities trading volume for pilot securities firms and their affiliates

		Securities trading volume (100mn yuan)	Share	
1	**GF Securities**	3,740	3.5%	5.4%
	GF Northern Securities	211	0.2%	
	GF Huafu Securities	627	0.6%	
	First Flushing Securities	308	0.3%	
	Wuhan Securities	213	0.2%	
	Hebei Securities	644	0.6%	
2	**Citic Securities**	3,050	2.9%	7.7%
	Citic Construction Securities	3,403	3.2%	
	Jintong Securities	1,099	1.0%	
	Citic Wantong Securities	594	0.6%	
3	**Haitong Securities**	4,500	4.2%	4.6%
	Xing'An Securities	281	0.3%	
	Gansu Securities	87	0.1%	
4	**Everbright Securities**	2,862	2.7%	4.1%
	Tianyi Securities	1,270	1.2%	
	Kunlun Securities	188	0.2%	
5	**Huatai Securities**	1,860	1.8%	4.0%
	Asia Securities	902	0.8%	
	United Securities	1,505	1.4%	
7	**China Merchants Securities**	3,333	3.1%	4.0%
	Beijing Securities	914	0.9%	
6	**Guosen Securities**	3,883	3.7%	3.9%
	Min'An Securities	217	0.2%	
8	**Orient Securities**	1,909	1.8%	2.1%
	Northern Securities	309	0.3%	
9	**Changjiang Securities**	1,186	1.1%	1.3%
	Dapeng Securities	197	0.2%	
10	**Donghai Securities**	429	0.4%	0.5%
	Wuzhou Securities	114	0.1%	
12	**Guotai Junan Securities**	7,379	6.9%	
11	**Shenyin Wanguo Securities**	5,390	5.1%	
13	**BOC International (China)**	1,455	1.4%	
14	**China International Capital**	1,504	1.4%	
15	**Ping An Securities**	1,141	1.1%	
16	**Guoyuan Securities**	911	0.9%	
17	**Shanghai Securities**	699	0.7%	
18	**Guodu Securities**	431	0.4%	

Note: 1. Names in bold are pilot securities firms and indented names are securities firms that the pilot firms have a stake in.
2. Securities trading volume is for stocks, bonds, mutual funds, and warrants, etc., from January to June, 2006. Shares are percentages of total, including trades by non-pilot securities firms.

Source: Nomura Institute of Capital Markets Research, based on data from Wind Information

2) Trends among foreign-capitalized firms

Prior to China's accession to the WTO, two foreign-capitalized securities firms had already been established in China. One of those, established in 1995, is China International Capital, with the foreign partners including US-based Morgan Stanley and a non-financial company based in Hong Kong. The other company, established in 2001, is BOC International (China), with the foreign partner Hong Kong-based BOC

International Holdings. After China jointed the WTO, and then implemented its *Rules on the Establishment of Foreign-shared Securities Companies* on 1 July 2002[13], the first foreign-capitalized securities firm to be established was China Euro Securities, on 19 December 2002.

China currently has six foreign-capitalized securities firms. In September 2005, UBS Securities announced that it was taking a stake in Beijing Securities, an acquisition that was apparently approved in June 2006. Although UBS has only a 20% stake, it has effective management control, and has also de facto obtained a full license (the company is scheduled to change its name to Ruiyin Securities).

Meanwhile, on 15 December 2005, the CSRC announced a freeze on all applications for equity participation in foreign-capitalized securities firms.[14] The likely reasons for the freeze were (1) growing criticism within China that its securities firms were selling out too cheaply to foreign capital and (2) criticism, pointing to the approval of a full license for UBS, that the rules were not being consistently applied.[15]

Because there are still advantages from obtaining the business and governance expertise that comes with foreign capital, once the targets for the reorganization and restructuring of securities firms are met, the freeze on foreign capital participation is likely to be lifted.

5. Problems left by this restructuring and more restructuring to come

This round of consolidation has expelled problem securities firms from the market and improved the situation of the leading securities firms, thereby producing numerous benefits, including a reduction in security market risk and a restoration of investor confidence in securities markets.

There are still problems and issues remaining, however. First is that although many of the securities firm shareholders have been replaced following the current round of consolidation, there has yet to be any fundamental change in China's shareholder structure, which remains dominated by state ownership. The new shareholders added from the recent capital increase are also state-owned enterprises, and in some cases management at these securities firms is either appointed by the government or comprises former government officials. This explains why there is still doubt over whether corporate governance is functioning effectively at securities firms following the consolidation.

Second, the securities firms are trying to enhance their capital through such means as capital increases and listing of shares in order to develop new services and expand market share. In this regard, not only a larger capital base but also qualitative improvements aimed at making better use of this capital have become increasingly important. Enhancement of risk management capabilities is probably critical to improving quality when capital is growing.

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[13] Article 10 stipulates that foreign ownership cannot exceed one third.
[14] *China Securities Journal*, dated 15 December 2005.
[15] WTO rules state that securities house joint ventures cannot offer brokerage of A shares.

With these problems and issues still around, we expect to see a further redrawing of the power relationships within the securities industry that is being formed from this consolidation, consisting of affiliates of pilot securities firms, of asset management companies, of Central Huijin, CCB, and CSIPF, and of the foreign-capitalized securities firms.

To start with, the intervention of Central Huijin, CCB, and CSIPF in the restructuring of the industry and their ownership of shares in securities firms is aimed at eliminating financial risk and improving the health of the securities market. This suggests that once these objectives are met, there is a high probability that the three companies will sell their holdings, either through a transfer or listing.

Second, acquisition and restructuring is generally an effective way for a company to get access to external funding, personnel, and markets. In the case of China's securities firms, however, services and earnings structures have so far been similar and thus offer little in the way of complementarity on the business side. Consequently, the advantages of acquisition have been minimal outside of obtaining storefronts, clients, and personnel related to the brokerage business. Nevertheless, as explained below, new products and services are now being implemented. The companies are each changing their business models in step with the development of these new products and services, and this should lead to new restructuring opportunities.

V. Diversification of products and services

1. Establishing the legal framework for diversification

The diversification of products and services plays a major role in restructuring and strengthening the securities industry. Looking at recent developments concerning financial innovation, the master plan for capital markets reform announced in January 2004, entitled *Several Opinions on Promoting the Reform, Opening Up, and Stable Development of Capital Markets* (so called "nine opinions"), proposed the diversification of products for securities investment (futures markets and derivatives).

In response, the Circular on *Issues Concerning the Boosting of Securities Industry Innovation* was issued in August 2004, which proposed that (1) security firms innovate businesses, business methods, and organizations, raise the level of service, and improve profit models to become stronger and (2) after improving the relevant regulations following an initial trial phase, gradually develop financial innovations.

Also in August 2004, the CSRC, which had been inspecting securities firms, solidified its policies of "supervision/administration by category" and "feed-the-strong, starve-the-weak" and announced its model for pilot securities firms and standard securities firms. Specifically, new products and services would initially be introduced on a trial basis by pilot securities firms, which in fact are trying to implement all of the new products and services outlined below based on these principles.

The new *Securities Law* went into force on 1 January 2006. The new law moves away from the old approach of regulations and is a revolutionary law that has changed course toward deregulation. First, in regards to new products and services, the turmoil in financial markets in the 1990s prompted the People's Bank of China (the central bank) to prohibit financial institutions from participating in futures markets, and in 1998 the old *Securities Law* also limited securities transactions to cash trades only. The new *Securities Law* opened the door to futures, options, and margin trades (Articles 42 and 142 of the new *Securities Law*) in order to advance the functioning of capital markets and enable their future development.

Second, there were also substantial revisions made to security firm businesses, and the system of administration by category in which securities firms were categorized as either general securities firms or brokerage securities firms, was abolished. This administration by category was effective in the initial development of securities firms, but as time passed it became a barrier to business innovation in the industry, and also resulted in some serious problems in which the inability of securities firms to differentiate their businesses produced some excessive competition. Under the new law, the administration of securities firms was revised to separate administration by type of business, such as securities brokerage, investment advisory, underwriting, recommendation, and asset management, and capital requirements were also revised to fit each business.

2. New products and services attracting interest

In response to these changes, pilot securities firms have been allowed to move into new businesses since 2005. Collective trust accounts, warrants, and ABS (asset-backed securities) have already been introduced, and preparations are under way for margin trading and stock index futures, which are expected to be introduced before the end of 2006.

1) Collective trust accounts (collective asset management schemes)

Under collective trust accounts, a securities firm collects funds from wealthy investors privately and then manages those funds under a client agreement in a product also called a collective asset management scheme. The basic laws governing this are the *Provisional Rules on the Business of Clients' Asset Management Business by Securities Companies* and the Circular on *Issues Regarding Conducting Business of Collective Asset Management by Securities Companies*,[16] and a comment seeking

[16] The discretionary accounts noted earlier that did so much damage to the businesses of securities firms are primarily in the form of two-party contracts between the securities firm and the client, and the problem was the guaranteed yield. The collective trust accounts of recent interest are based on one-to-many contracts. The *Provisional Rules on the Business of Clients' Asset Management by Securities Companies* (implemented in 2004) classifies discretionary accounts as the "predirected" asset management business and collective trust accounts as the "collective" asset management business; the guarantee of either principal or yield is prohibited for both.

draft entitled *Implementing Rules for Collective Asset Management Business of Securities Companies* was announced in July 2006. This comment-seeking draft includes a bankruptcy remoteness provision to separate out collective trust accounts from a securities firm's property when that firm goes bankrupt. Collective trust accounts are currently handled by pilot securities firms, but the plan calls for standard securities firms to eventually be able to handle them as well.

Since the first of these products was sold in March 2005,[17] 12 pilot securities firms[18] have sold 19 such products, with a total of 28.252 billion yuan in assets under management (an average of about 1.5 billion yuan per product).

Collective trust accounts, unlike funds collected through public subscription (mutual funds), are funded through private offering, and thus cannot be advertised in mass media (it is possible, however, for the company to sell them itself or contract the sale to other securities firms or commercial banks). The assumption is that the customer is already a customer of that firm or of the bank, etc. that is selling the product, and thus has investment experience and the ability to tolerate risk. Minimum investment amounts are fairly high, 50,000 yuan for restricted products and 100,000 yuan for unrestricted products, and thus the product is aimed at high-income earners.

The restricted products are primarily invested in government bonds, bond mutual funds and other products with strong credit ratings and high liquidity, and stocks of companies with strong earnings and equity mutual funds are restricted to no more than 20% of the portfolio. The unrestricted products are invested based on an agreement without these restrictions.[19] These products have the features of money market funds, bond funds, or stock funds, depending on the investment guidelines.

Securities firms can earn management fees and can also put their own funds in the product. In other words, they can earn income based on results. Management fees seem to be in the area of around 0.5% of total assets, and the firms' own funds usually account for about 3-5% of the product's net assets. The rate of growth in net assets of collective trust accounts was reported to be over 7% for April-June 2006.[20]

2) Warrants

Although warrants were traded in China during the 1990s, trading was suspended following the financial turmoil in the mid-1990s and the authorities' shift to a more cautious stance, just as was the case for futures trades as explained below. The exchanges later began to reconsider their reintroduction, and the reform of nontradable shares became the direct catalyst to resume the listing and trading of warrants in August 2005, nine years after the suspension began. Legislatively, the *Provisional Measures on Administration of Warrant Related Business by Shanghai*

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17 Everbright Securities' Sunshine Plan.
18 *Securities Times*, dated 24 July 2006.
19 Use of bond holdings for repo transactions is prohibited.
20 *Shanghai Securities News*, dated 27 July 2006.

Stock Exchange came out in July 2005 (as did a similar law for the Shenzhen Exchange), followed by a number of circulars.

According to the provisional measures, both the issuer of the stocks subject to the warrant and third parties are able to issue warrants. The warrants currently being traded in China, however, were issued in the context of the reform of nontradable shares, and effectively, the issuers of existing shares (or their parent companies) are issuing call and put options.

One key feature of the nontradable share reforms is that the holder of nontradable shares must pay consideration to the holder of tradable shares in order to acquire the right to trade the nontradable shares. Warrants were included as one of the methods of paying this consideration. As of mid-September 2006, there were 26 warrant issues, and the issuers are primarily the collective entities comprising the parent companies of the listed companies. The combined total amount of trades in the Shanghai and Shenzhen markets was 1.87704 trillion yuan in H1 2006[21], and the pilot securities firms have noted that their income from warrant trading commissions has been growing since 2005.

The introduction of warrants has led to speculation, which has had a negative impact by distorting market prices, and consideration is being given in some areas to implementing a market-maker system. Also, as the reform of nontradable shares gradually moves toward closure, there will not be any more warrants issued in connection with nontradable shares, and minus any other changes we expect the size of the warrant market to shrink moving forward. Partly as a way to build a serious derivatives market, we expect to see efforts made to introduce warrants issued by securities firms and other third parties.

3) ABS

ABS are securitized products based on cash flow-generating assets owned by corporations. The first ABS were introduced in August 2005 (securities backed by the revenue streams generated by United Telecommunications' CDMA mobile network leases and handled by China International Capital), based on the *Provisional Rules on the Business of Clients' Asset Management Business by Securities Companies*, but since those measures did not contain any provisions expressly related to ABS, in March 2006 the Circular on *Measures for Specialized Asset Management by Securities Firms* was announced. After that, in June 2006 an initial draft of the Circular on *Problems Related to the Trial Development of the Asset Securitization Business by Securities Firms* was published, along with a request for comments from the securities industry and others.

As with other new products, the CSRC is following the principle of experiment first and expand later, and at the present stage it is the pilot securities firms that are handling ABS. Nine securitized products have already been issued, at a total issuance

21 *China Securities Journal*, dated 12 July 2006.

amount of 26.35 billion yuan.[22] The cash flows of the underlying assets of most of these issues are relatively stable, including highway tolls and utility fees for water and electricity. In addition to these securitized products based on corporate assets, there are also securitized bank loans, including MBS issued by the CCB in December 2005 and ABS issued by the China Development Bank.

Investors include mutual funds, the social security fund, financial firms, trustee investments and other institutional investors, and insurance companies are likely to start investing in the future. The minimum purchase amount for beneficial securities is 100,000 yuan, and it appears that the draft circular published in June raise that to 1 million yuan. It appears that the authorities, taking account of risk tolerance, want to effectively limit purchasers to institutional investors.

Income for the securities firms include underwriting and financial advisory fees, and they are also able to invest their own funds, provided their investment does not exceed 10% of the number of beneficiary certificates issued.

The June draft circular is reportedly clear on the bankruptcy remoteness of the assets.[23]

4) Margin trading

The CSRC announced in June 2006 its *Measures for the Administration of Margin Financing and Securities Lending Business of Securities Companies on a Trial Basis* and the *Guidelines for the Internal Control of Margin Financing and Securities Lending Business of Securities Companies on a Trial Basis*. These laws lifted the prohibition on margin trading.

Specifically, the small number of pilot securities firms will be approved to conduct the margin trading business initially, and the approved securities firms are able to lend stocks and funds in their portfolio to customers. The securities that clients are able to trade are limited to listed securities announced on a securities exchange. After the relevant regulations are improved following an initial trial phase, other securities firms will also be allowed to conduct the margin trading business, and this will lead to growth in the number of sources of funds and securities for the SBL business. To engage in the margin trading business, a securities firm must meet the seven conditions outlined below. (1) Over three years experience in the securities brokerage business, and approval as a pilot securities firm; (2) Sound corporate governance; (3) No legal violations over the past two years; (4) Favorable financial condition; (5) Separate management of client assets; (6) Centralized management of trades, settlement, client accounts, and risk control; (7) The people, systems, and funds required to develop the trial margin trading business.

This business is expected to be limited to only the leading pilot securities firms.

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22 *China Securities Journal*, dated 15 September 2006.

23 When the company that owns the underlying asset of an ABS, the securities firms or the trust institution goes bankrupt, said assets have never been attached.

On 1 August 2006, the CSRC began receiving applications for the SBL businesses. Eight pilot securities firms have turned in applications: GF, Everbright, Guotai Junan, Citic Investment, Orient, Guosen, China Merchants, and China International Capital.[24] Four of them have net assets of less than 1.2 billion yuan and therefore are probably planning a future capital increase.

Also in August 2006, both exchanges announced their *Rules for Implementation of Pilot Margin Trading and Securities Lending*. The underlying securities for margin trading must meet several conditions, including (1) being listed on the Shanghai Stock Exchange for at least three months, (2) in the case of margin buying, a float of at least 100 million shares and a secondary market cap of at least 500 million yuan, and (3) in the case of margin selling, a float of at least 200 million shares, a secondary market cap of at least 800 million yuan, and at least 4000 shareholders. Other rules include a loan period of six months, guarantee funds of at least 50%, a collateralization of at least 130%, and a collateral value for the underlying security of 70%.

In regards the earnings generated by the securities firms from margin trades, we expect interest rates, which are higher than those on bank loans and vary by company, to be around 8% for most of the companies. Citic Securities had 1.2 billion yuan in funds that it could lend to clients when it launched this business, and using an annual interest rate of 8%, we estimate revenues in the first fiscal year of 96 million yuan.[25]

During the trial period of margin trading, securities firms will do the business with their own funds. As the trial scope widens and the level of margin trades increases, however, the sector will not be able to keep up with the margin trading business using only its own funds. For this reason, securities firms will probably have to introduce new financing ways in the future, either directly from the money market or indirectly through securities financing corporations.

5) Financial futures trading

Stock index futures are expected to be introduced before end-2006. For a long time now, both securities companies and institutional investors have had strong interest in hedging tools, and recent moves to introduce China stock index futures in overseas markets (Singapore) should also provide further impetus for their introduction in China. Futures on the Shanghai & Shenzhen 300 Index are to be introduced first, with an increasing variety of products after that.

Recently, the China Financial Futures Exchange (CFFE) was established on 8 September 2006. Additionally, the *Regulations on Administering Futures Trades* are currently limited to commodity futures, but there are plans to amend the Regulations to include financial futures.

On 18 September, the CFFE announced a provisional Shanghai & Shenzhen 300 Index futures contract. The contract terms include (1) the contract month of the index

24 *Securities Times*, dated 2 August 2006.
25 *The Economic Observer*, dated 6 August 2006.

future would be the current month, the following month, and the final month of the next two quarters (for a contract in July 2007, the contract months would be July, August, September, and December), (2) guarantee funds of 8%, and (3) a one-day stop high (low) of +-10% of the previous days settlement price. The contract details will be adjusted, if necessary, following simulated trades, after which the futures will be listed.

According to new reports, futures companies will handle the dealing of futures, and securities companies will not be allowed to directly engage in the financial futures dealing business. On the other hand, pilot securities firms will engage in the business of introducing futures transactions, which means introducing their investors to the futures companies. This business is expected to eventually be extended to standard securities firms.

The authorities will prohibit the establishment of new futures companies moving forward, while encouraging securities firms to acquire existing futures companies. Seven of the pilot securities firms already own a futures company, and the others have already begun making moves to acquire their own. Some of the securities firms aim to either have 100% control or at least 70-80% control, and about half of the approximately 180 futures companies that currently exist are said to be considering selling their shares.

VI. Conclusion -- Issues and outlook for China's securities industry

There have always been doubts over the business viability of the securities firms that were established by regional governments as a way to compete with other regions. Particularly during the four-year period of declining share prices that began in 2001, huge losses were generated in discretionary accounts, and this became a problem for the securities industry overall. Among some securities firms, the problem became so serious that delaying a solution was not an option, and this motivated the authorities to launch a reorganization and restructuring of the securities industry from 2004. Failed securities firms were weeded out through a variety of means, while the securities firms with strong financial positions were turned into organizations capable of pursuing new business opportunities. This arrangement was basically meant to make the strong companies even stronger, and in the future, we expect the direction taken will be to distinguish the major securities firms from the second-tier niche firms as a way to stabilize the industry.

At the same time that the securities industry is classified in this way, it is also important that China's financial industry gradually moves toward a universal banking model. First, the increase in savings from economic development and the emergence of a high-income class will create demand for diversification of financial products and services. The impact from other financial reforms, such as when interest rates and exchange rates become more volatile owing to the increasing liberalization of interest

rates and capital account, should create demand for hedging tools and other new services. This will create more room for each of the different subsectors within the financial industry to encroach on the others in the new products and services arena.

Second, China's transition period following WTO entry reaches a major milestone at end-2006, five years after entry, when its financial institutions will be subject to international competition. Some observers believe that with financial institutions from the industrialized world increasingly moving toward universal banking, if China does not do the same it will become uncompetitive.

In fact, the proposed 11th five-year plan, passed by the Central Committee of the CPC on 11 October 2005, recommended the steadfast promotion of trial integrated financial businesses (Section 25), and the integrated financial model appears to be a forgone conclusion. The same is suggested on the legislative and supervisory fronts, including the *Provisional Regulations on Intermediary Business of Commercial Banks* (2001, adoption of registration system and inspection and ratification based on type of intermediary business), the *Commercial Banking Law* (December 2003, potential to enter non-banking businesses through stock investments and other methods), and the State Council's *Several Opinions Concerning the Reform and Development of the Insurance Industry* (June 2006, known as the "Ten Articles;" it covers trial integrated management in the insurance industry and equity participation in commercial banking using insurance funds), and the new *Securities Law* (revision of Article 6: exceptions for industry divisions separately prescribed by the state).

There are already examples of mutual encroachment among the subsectors, including (1) banks establishing mutual fund companies, (2) insurance companies investing directly in the stock market and establishing mutual fund companies, and (3) insurance companies taking equity stakes in banks and securities firms. Additionally, as noted above between the securities firms' collective trust accounts and the asset management products of banks, the products of different sectors are becoming similar enough to compete with each other.

For the time being, we look for a gradual move toward integrated management, with each financial institution preparing its internal controls and the authorities setting up their supervisory mechanisms, and we expect this will later lead to the formation of financial holding companies.

When that happens, it will become important for the supervisory and administrative function to respond to risks from the overall financial system. Financial authorities already acknowledge that the current vertical division of sectors for supervision and administration is becoming anachronous to actual conditions in the financial industry.

In fact, the People's Bank of China, the China Banking Regulatory Commission (CBRC), the CSRC, and the China Insurance Regulatory Commission (CIRC) are now looking at establishing a cooperative regulatory body for the overall financial system to prepare for the emergence of financial conglomerates. It appears that this would be a permanent institution within the State Council with a slightly higher status than these other regulatory bodies, and that it would be tasked with formulating a state

financial strategy, formulating a development strategy for each financial sector, and supervising and administering financial conglomerates. We expect the specifics of this body to emerge at the Central Financial Work Conference[26], slated to convene at the beginning of 2007.

[26] Held jointly by the China Communist Party and the State Council, this important commission, decides China's financial policies, and is not the same as the Financial Work Conference that is held annually. It has only been held twice in the past, in both cases when the financial situation had become critical. The first time it was held was immediately after the Asia financial crisis began, on 17-19 November 1997, and the second time it was held on 5-7 February 2002, right after China joined the WTO.