
Complete Regulatory Overhaul of China's Capital Market Underway

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I. China Securities Regulatory Commission announces plan for regulatory framework

China's capital markets are expected to undergo a complete regulatory overhaul in 2011. At a forum on corporate governance held by the Shanghai Stock Exchange on 4 December 2010, Shang Fulin, Chairman of the China Securities Regulatory Commission (CSRC), announced a five-point plan for regulating China's capital markets, as outlined below.

1. Promote a legal framework for capital markets at multiple levels

In order to build nationwide OTC markets with unified management and supervision, and based on the expansion of trial OTC transactions in the Zhongguangcun Development Zone, an area within Beijing with a concentration of universities and startup firms, enact as soon as possible the Measures on the Listing of Unlisted Limited Liability Companies¹, while at the same time consider and enact the Measures on the Oversight of Unlisted Public Companies (Figure 1).

Figure 1: Currently planned regulatory changes for China's capital markets

| New regulations | Revisions | Date enacted | Effective date |
|---|---|---|--|
| | | Measures on the Listing of Unlisted Limited Liability Companies | Provisional Measures for the Issuance of Corporate Bonds |
| Measures on the Oversight of Unlisted Public Companies | Law on Funds for Investment in Securities | 28 October 2003 | 1 June 2004 |
| Futures Law | Regulation on Administration of Futures Trading | 6 March 2007 | 15 April 2007 |
| Administrative Ordinance on the Oversight of Listed Companies | | | |

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

¹ "Measures" is the term used for administrative rules and regulations.

In addition, revise the Provisional Measures for the Issuance of Corporate Bonds, which address those corporate bonds issued on a securities exchange by listed companies, in order to establish methods for issuance, optimize investor structures, standardize rules, and promote mutual interaction with the interbank bond market that is run by the People's Bank of China.

2. Revise and establish new laws regarding mutual funds

China's Law on Funds for Investment in Securities, which was promulgated on 28 October 2003 and made effective from 1 June 2004 (Figure 2), will be completely revised. The plan is to reference the experience gained in other countries to build an appropriate supervisory framework for privately placed funds that makes sense in light of the demand for and current level of development of privately placed funds within China.

3. Establish laws on trading futures

China's Regulation on Administration of Futures Trading was promulgated on 6 March 2007 and went into effect on 15 April that year. Based on the overall experience since this regulation went into effect, and from the perspective of promoting the long-term, stable development of the futures market, establish a new Futures Law aimed at clarifying the legal stature of the futures market while providing a mechanism for managing risk through trading futures.

4. Establishing a legal framework for the oversight of listed companies

Newly enact the Administrative Ordinance on the Oversight of Listed Companies, to strengthen the oversight of the controlling shareholders, and those effectively in control, of listed companies.

Figure 2: Overview of Law on Funds for Investment in Securities

| | |
|------------|---|
| Chapter 1 | General Provisions (Articles 1-11) |
| Chapter 2 | Fund Managers (Articles 12-24) |
| Chapter 3 | Fund Custodians (Articles 25-35) |
| Chapter 4 | Raising of Capital (Articles 36-46) |
| Chapter 5 | Trading of Fund Units (Articles 47-50) |
| Chapter 6 | Subscription and Redemption of Fund Units (Articles 51-56) |
| Chapter 7 | Operation of Funds and Disclosure of Information (Articles 57-64) |
| Chapter 8 | Modification and Termination of a Fund Contract and Liquidation of Fund Assets (Articles 65-69) |
| Chapter 9 | Rights of the Holders of Fund Units and Exercise of the Rights (Articles 70-75) |
| Chapter 10 | Supervision and Regulation (Articles 76-82) |
| Chapter 11 | Legal Responsibility (Articles 83-100) |
| Chapter 12 | Supplementary Provisions (Articles 101-103) |

Source: Nomura Institute of Capital Markets Research, based on the Law on Funds for Investment in Securities

In addition, establish rules governing mergers and acquisitions that incorporate market mechanisms. Likewise, promote research on rules governing the delisting of listed companies.

5. Build a regime for providing oversight of, and enforcing the law in, specialized capital markets

Referencing the experience of other countries and build a specialized judiciary optimized to the demand for supervision, aimed at enabling effective supervision of capital markets at both the administrative and judiciary levels. In addition, establish a judicial policy document² governing the application of criminal and civil law, as well as administrative actions, related to securities futures.

II. Focus on revision of the Law on Funds for Investment in Securities

While heading up the Ninth International Forum on Mutual Funds in China held on 2 December, CSRC Vice Chairman Yao Gang laid out four areas of the securities industry that the CSRC would be pursuing reform of³.

1. Reform of the Law on Funds for Investment in Securities

Reiterating what Shang Fulin had said earlier, the CSRC plans to completely revise the Law on Funds for Investment in Securities and related regulations. The basic approach to reform is to strengthen supervision and monitoring through stricter standards of conduct, while loosening restrictions on investment services and promoting innovation in those services. In addition, it will create uniform standards for monitoring and supervising wealth management products, expand the scope of that supervision and monitoring to an appropriate level, and work to prevent and reduce avenues of profit not subject to supervision and monitoring.

2. Establish governance of fund management (asset management) firms

It plans to build an incentive mechanism suitable to the investment industry while strengthening the supervision and monitoring of the shareholders and effective controlling parties of fund management (asset management) companies. In order to strengthen the control function within the Board of Directors, it will incrementally increase the proportion of the directors who are not shareholders, thereby giving a greater role to independent directors.

² Judicial interpretations by China's Supreme Court are used as legal precedent, binding on lower courts, and thus viewed as having a legislative function.

³ It also proposed strengthening controls on insider trading.

In addition, it plans to consider allowing participation in the investment industry by joint stock corporations and partnerships, and to research employee stock ownership plans aimed at providing long-term and effective incentive mechanisms, thereby empowering the stable and long-term development of the investment industry.

3. Reform sales channels

It has proposed further expanding mutual fund sales channels, by adjusting rules governing participation by companies specialized in sales and by promoting the establishment of mutual fund sales companies by individuals with such sales expertise.

In addition, provide a suitable level of centralization of services for registering open-end mutual funds by completing the backup project aimed at creating a central repository of data on the registration of all fund management companies.

4. Product innovation

Provide an overall system for examination and approval of each mutual fund product, standardize the rules and contracts for mature products, simplify the examination and approval procedures, and consider introducing a system for registering products without need for examination. In addition, establish a mechanism for evaluating and examining new products.

Consider supervisory approaches that are appropriate for each type of fund management firm. Next, allow fund management firms that meet certain criteria to establish specialized subsidiaries to handle services different from those performed by the parent company, and run a trial of management at the group level.

On the administrative side, lower the barriers to developing wrap accounts⁴ and products for qualified domestic institutional investors (QDII), setting criteria by which each company can operate based on their own style. Encourage those fund management firms that meet the criteria to develop business internationally, and at the same time encourage mutual funds based overseas to market within China on a trial basis.

III. Implications for overseas investment firms

The CSRC's proposed capital market regulations and investment industry reforms are quite significant for overseas investment firms interested in developing an asset management business in China.

This begins with their bringing with them the experience they gained overseas. The establishment of a comprehensive legal framework for China's capital markets will

⁴ Wrap accounts are also referred to as separately managed accounts. *Zhuanhulicai* in Chinese.

probably increase the number of opportunities for overseas investment firms to relay to China their experiences with regulations related to their home markets, as well as with how those regulations were implemented. China is in the process of reforming its Law on Funds for Investment in Securities in a way that encompasses a broader swath of funds, including privately placed funds, and there will probably be portions of Japan's Financial Instruments and Exchange Act, both in approach and in system design, that will be of reference for China. The CSRC has made it a priority to develop China's privately placed fund industry, which is closely tied to fostering growth of startup firms and new industries.

Second is to invigorate cross-border securities trading. Building a nationwide OTC market is significant for foreign-capitalized private equity firms in that it will provide them with more opportunities to sell their equity stakes on the market, in addition to the Shenzhen Stock Exchange's ChiNext market. An easing of the standards for qualified QDII products and the trial marketing within China of overseas-based mutual funds should also increase overseas investment firms' sales of financial products from their home country.

Third, overseas investment firms should be able to enter new asset management segments in China. There is a possibility that with fund management firms establishing specialized subsidiaries, product marketing channels being expanding, and rules governing the opening of wrap accounts being eased, new segments that overseas investment firms can get involved in will be created. In addition, with employee stock ownership plans being given legal status under capital markets-related legislation, overseas firms doing business in China can probably secure a more stable legal basis by implementing such plans⁵.

Figure 3: Top 10 countries/regions based on mutual fund assets

| End-March 2010 | | | End-June 2010 | | |
|----------------|----------------|----------------------------|---------------|----------------|----------------------------|
| Rank | Country/region | Total assets (\$ billions) | Rank | Country/region | Total assets (\$ billions) |
| 1 | USA | 11,205 | 1 | USA | 10,500 |
| 2 | Luxembourg | 2,321 | 2 | Luxembourg | 2,115 |
| 3 | France | 1,727 | 3 | France | 1,486 |
| 4 | Australia | 1,254 | 4 | Australia | 1,136 |
| 5 | Ireland | 885 | 5 | Ireland | 837 |
| 6 | Brazil | 803 | 6 | Brazil | 807 |
| 7 | UK | 732 | 7 | UK | 687 |
| 8 | Japan | 681 | 8 | Japan | 671 |
| 9 | Canada | 608 | 9 | Canada | 556 |
| 10 | China | 345 | 10 | China | 298 |

Note: The International Investment Funds Association compiles data on open-end publicly offered mutual funds.

Source: Nomura Institute of Capital Markets Research, based on materials from the Investment Trusts Association Japan

⁵ For more on the current rules for China's employee stock ownership plans, see Eiichi Sekine, *Chuugoku de no Juugyoin Mochikabukai no Setsuritsu wo Meguru Doukou* (Trends in establishing employee stock ownership plans in China), Spring 2009

China already ranks among the top 10 countries of the world based on the amount of assets held in open-end mutual funds (Figure 3). The CSRC also plans to promote the "differentiation, specialization, and globalization" of fund management firms. The key to further growth in China's asset management industry probably lies in the comprehensive legal framework planned from 2011. Progress in establishing a legal framework for China's capital markets remains an important news story.