A Securities Market View of the Third Plenary Session of the 18th CPC Central Committee

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I. First third plenary session of the CPC Central Committee under the new Chinese government

1. Third Plenary Session of the CPC Central Committee

The Third Plenary Session of the 18th Central Committee of the Communist Party of China ("Third Plenary Session of the 18th CPC Central Committee") was held over four days on 9–12 November 2013. On the final day of the meeting the Committee approved the *Decision of the Central Committee of the Communist Party of China on a Number of Important Issues Regarding the Comprehensive Deepening of Reform*, a summary of which[1] was published by the Xinhua news agency on the evening of the final day (at 19.49 Beijing time). The full text of the *Decision* was then published on the evening of 15 November, less than a week after the final day of the meeting (at 18.53 Beijing time)[2].

The *Decision* attracted considerable attention both in China and overseas because it represents the largely economic reform program of the new government (led by Xi Jinping, General Secretary of the CPC, President of the PRC, and Chairman of the Central Military Commission, and Li Keqiang, Premier of the PRC), which was elected by the 18th National Congress of the CPC in November 2012, marking the country's first change of government in 10 years.

2. Status of plenary sessions of the CPC Central Committee

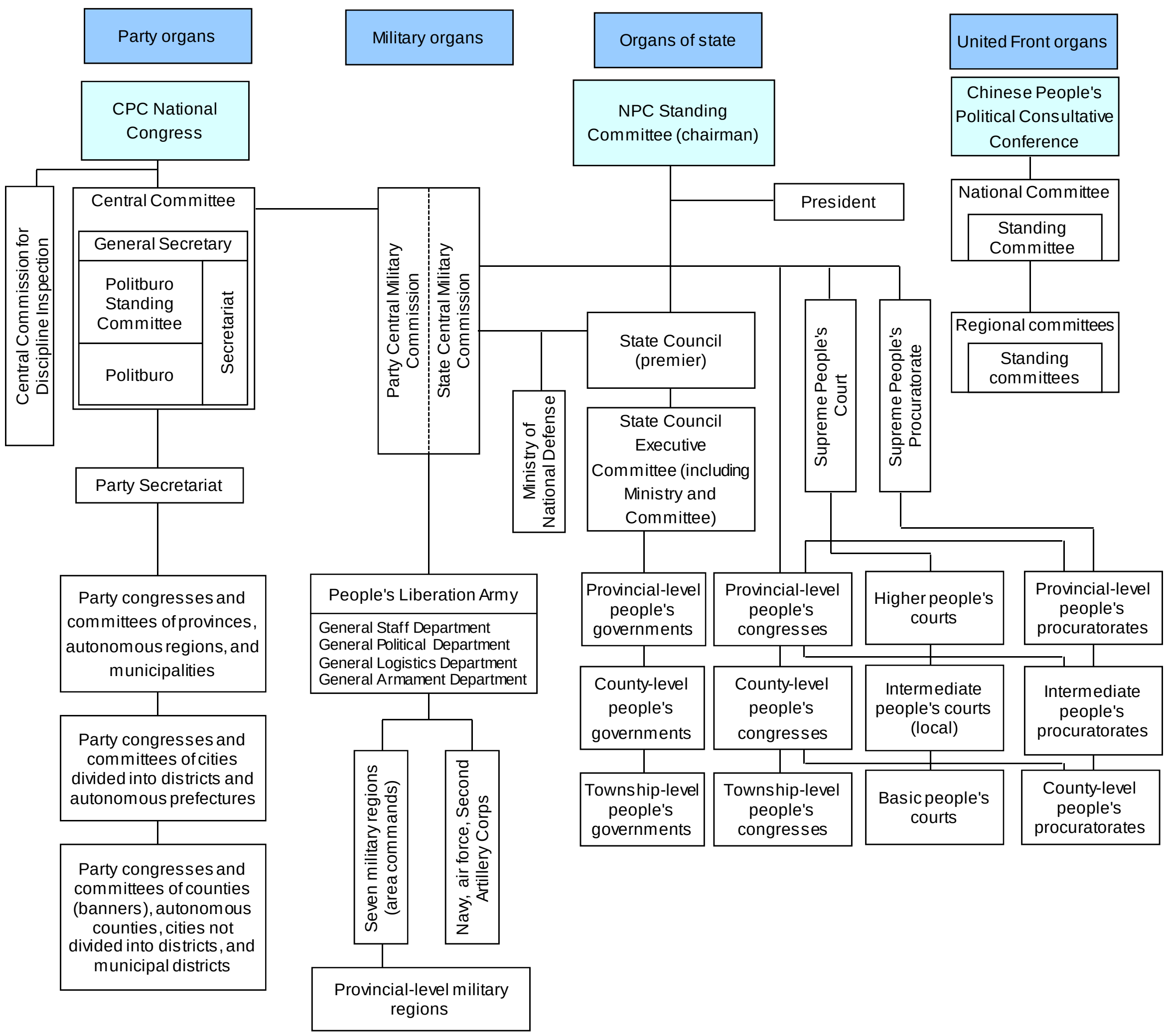
1) Two supreme decision-making organs: National People's Congress and CPC National Congress

China has two supreme decision-making organs: the National People's Congress (the state organ corresponding to parliament) and the CPC National Congress (the Communist Party organ) (Figure 1). However, since the constitution, which is established by the National People's Congress, guarantees the leadership position of the Communist Party, one-party rule by the Communist Party of China is established

1 http://news.xinhuanet.com/politics/2013-11/12/c_118113455.htm
2 http://news.xinhuanet.com/politics/2013-11/15/c_118164235.htm

in law. Decisions by the Communist Party of China are therefore, to all intents and purposes, decisions of the state.

Figure 1: Organizational chart of the Chinese state



Source: Nomura Institute of Capital Markets Research, based on Japan-China Economic Association, *China Economic Data Handbook 2012*.

2) Central Committee decision-making organ when CPC National Congress not in session

Of these two decision-making organs, the CPC National Congress meets once every five years around the time of the anniversary of the founding of the People's Republic of China on 1 October 1949 and elects the Central Committee as well as making important party decisions. When the CPC National Congress is not in session, the Central Committee implements its resolutions, takes charge of all party matters, and represents the Communist Party of China overseas.

The Central Committee's plenum meets once a year in the autumn. The recent plenum was the third plenum of the Central Committee elected by the 18th CPC National Congress (held in 2012).

II. Previous third plenary sessions and financial reform

1. Previous third plenary sessions and China's opening up

It is clear from previous third plenary sessions that they are the place where new governments' key economic policies are approved following the CPC National Congress the previous year.

First of all, the Third Plenary Session of the 11th CPC Central Committee, held 35 years ago under the guiding hand of the then supreme leader, Deng Xiaoping, approved China's open door policy and the establishment of special economic zones on the export-processing zone model—a grand experiment with no precedent anywhere (Figure 2). To begin with, the special economic zones, which were established in Shenzhen (adjacent to Hong Kong) and three other cities, served as the interface between the Chinese economy and the global economy.

Figure 2: Overview of past third plenary sessions

Name	Dates	Main theme	Overview
Third Plenary Session of 11th CPC Central Committee	18-22 December 1978	Restoring order	The plenum accepted the leadership's policy of emancipating one's mind, using one's head, seeking truth from facts, and uniting as one in looking to the future as well as the policy of shifting the focus to carrying out a program of socialist modernization and market-oriented reforms.
Third Plenary Session of 12th CPC Central Committee	20 October 1984	Spreading reform from the countryside to the cities	The plenum passed the Decision of the CPC Central Committee on Economic Structural Reform. This document established the direction, nature, issues and policies of reform, and set economic reform in motion.
Third Plenary Session of 13th CPC Central Committee	26-30 September 1988	Paving the way for further reform	The plenum approved the document the Initial Plan on Price and Wage System Reform as well as policies to improve the working of the economy and carry out further wide-ranging economic reforms, paving the way for further economic reform.
Third Plenary Session of 14th CPC Central Committee	11-14 November 1993	Outlining the framework of a socialist market economy	The plenum accepted policies to establish the basic framework of a socialist market economy and a modern enterprise system as well as further reform the rural economy and open up the national economy.
Third Plenary Session of 15th CPC Central Committee	12-14 October 1998	Building a socialist new countryside	The plenum approved the Decision of the CPC Central Committee on Important Issues of Agriculture and Countryside Work as well as the policy of maintaining a dual-track system based on the household responsibility system.
Third Plenary Session of 16th CPC Central Committee	11-14 October 2003	Completing the market economy system	The plenum approved the Decisions of the CPC Central Committee on Issues of Completing the Socialist Market Economy System as well as policies on developing the non-publicly owned economy, reforming state-owned enterprises, transferring government functions, and establishing a system of modern property rights.
Third Plenary Session of 17th CPC Central Committee	9-12 October 2008	Pushing forward rural reform	The plenum approved the Decisions of the CPC Central Committee on Several Significant Issues of Rural Reform and Development as well as policies on improving the creation of a rural system, actively developing modern agriculture, increasing agricultural production, and speeding up the development of public works in the countryside.

Source: Nomura Institute of Capital Markets Research, from People's Daily Online, 17 October 2013 (http://j.people.com.cn/94474/8428120.html)

Second, the Third Plenary Session of the 14th CPC Central Committee, held 20 years ago under the guiding hand of former president Jiang Zemin, approved the basic framework of the country's socialist market economy. China subsequently became increasingly committed to an open door policy, while a growing number of foreign companies established operations in China. These developments marked the beginning of China's rapid economic growth.

Third, the Third Plenary Session of the 16th CPC Central Committee, held 10 years ago in 2003 under the guiding hand of former president Hu Jintao, approved measures to enhance China's socialist market economy. This approval led to further opening of China's economy following China's accession to the World Trade Organization (WTO) in 2001 and eventually, in 2010, to China becoming the world's second-largest economy.

2. The Third Plenary Session of the 14th CPC Central Committee in 1993 and financial reform

As we have seen, previous third plenary sessions have seen the launch of major policies at turning points in China's economic development. The financial sector has been no exception, with third plenary sessions seeing the launch of major policies to enable financial service companies to improve how resources are allocated during the transition from a planned economy to a market economy.

First of all, the Third Plenary Session of the 14th CPC Central Committee, which was held in 1993 and approved a policy of creating a modern financial system, achieved the following results.

First, the *Law Governing the People's Bank of China* and the *Commercial Bank Law* were passed, providing the basic regulatory framework for the operation of commercial banks and laying the groundwork for the listing of Chinese commercial banks at home and abroad in the 2000s.

Second, the way in which movements in commercial banks' deposit and lending rates were regulated was modified, and interbank markets and interbank bond markets were established, laying the foundations for the later deregulation (literally, "marketization") of interest rates.

Third, a foreign exchange system and market were established. Also, from 1994 a single foreign exchange rate was established. These measures laid the foundations for the later mechanism for determining the renminbi's exchange rate. In 1996, China became an IMF Article VIII country, with the renminbi trading freely on the current account.

3. The Third Plenary Session of the 16th CPC Central Committee in 2003 and financial reform

The Third Plenary Session of the 16th CPC Central Committee, held in 2003, approved further measures to reform and open up China's financial sector. In particular, the following measures were approved to enable foreign financial institutions to enter the Chinese market.

First, foreign financial institutions were allowed to become shareholders in Chinese financial institutions, enabling them to operate in mainland China. Licenses were granted to a total of 13 joint-venture securities companies, including the time before and after China's accession to the WTO.

Second, cross-border securities investment on China's capital markets was enabled, especially by the creation of a system of qualified foreign institutional investors (QFIIs) and qualified domestic institutional investors (QDIIs). The QFII system, adopted in 2002, initially had an investment limit of $10 billion, but this was increased to $150 billion in July 2013. The QDII system, adopted in 2006, currently (as of end-October 2013) has an investment limit of $81.3 billion. In addition, China's State Administration of Foreign Exchange (SAFE), which manages the country's foreign exchange reserves, China Investment Corporation (CIC), and China's National Social Security Fund (NSSF), which manages the country's public pension funds, have become a growing presence on international financial markets.

Third, the renminbi has become a much more international currency and has begun to be used for cross-border transactions. The use of the renminbi for cross-border transactions began in 2009 with its use to settle trade transactions and has been extended to its use for inward and outward direct investment, and offshore renminbi can now be repatriated to the mainland. As of August 2013, the renminbi was the world's eighth most traded currency, having become more important as an international source of funding and means of investment.

4. Hopes pinned on Third Plenary Session of 18th CPC Central Committee

Now, following the Third Plenary Session of the 18th CPC Central Committee, China faces a new economic challenge. This is to develop a new economic growth model.

Once a country's economy has completed its catch-up phase, developing a new growth model is no easy matter. China is no exception. China's 18th CPC National Congress, held in November 2012, approved policies to (1) double China's per capita GDP from its 2010 level by 2020 (creating "xiaokang shehui" or a moderately well-off society) and (2) move to a growth model based on domestic demand and services rather than, as hitherto, one based on exports and investment. We now take a closer look at the reforms proposed by China's new government at the Third Plenary Session of the 18th CPC Central Committee.

III. Overview of Third Plenary Session of 18th CPC Central Committee

1. Basic aims

We think the summary and full text of the Third Plenary Session of the 18th CPC Central Committee reflect the views of China's new government as follows.

1) Desire for comprehensive reform

The first point is that the new government has considered the results of China's open door policy in the 35 years since the Third Plenary Session of 11th CPC Central Committee and the implications of further comprehensive reform in a number of key respects. In addition, the reforms take into account the importance of systematicness, globality, and harmony as well as aiming to achieve and develop socialism with Chinese characteristics.

Since it came to office, the new government has advocated a top-down approach to reform. Similarly, the CPC Central Committee and State Council emphasized the need for a clear overall scheme, roadmap, and timetable at the Central Economic Work Conference held in December 2012[3]. We think the policies approved by the Third Plenary Session confirm that the new government is seeking comprehensive reforms that take account of policy interaction as part of a grand design rather than as isolated measures.

2) Focus on economic reform

Second, the focus of the government's plans for comprehensive reform is on the economy. In particular, the plans aim to improve the relationship between the government and the market, to give the market precedence in allocating resources, and to enable the government to function more effectively.

The reference to the role of the market in allocating resources occurs three times in the summary and is an indication of an important aspect of the new government's attitude to managing the economy. With regard to the reference to enabling the government to function more effectively, the new government has already taken action to reform central government's powers of approval. In addition, on 1 November, just before the Third Plenary Session of the 18th CPC Central Committee, the State Council held a meeting to discuss local government reform[4], and we expect developments on this front in the coming months.

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[3] Sekine, Eiichi, "Seichou Seisaku to Bunpai Seisaku kara Mita Chuugoku no Kin'yuu/Shihon Shijou Kaikaku" (The Reform of China's Debt and Equity Markets in Terms of Development and Distribution Policy), Capital Market Quarterly, Spring 2013 (in Japanese).

[4] http://www.gov.cn/ldhd/2013-11/08/content_2523935.htm

3) Reform timetable

Third, the Third Plenary Session of the 18th CPC Central Committee has set a timetable for reform. In particular, it hopes to make solid progress in a number of key areas by 2020.

As we have mentioned, 2020 is the year by which the new government expects per capita GDP to double from its 2010 level, but it is also the year before the hundredth anniversary of the founding of the Chinese Communist Party in 1921. Although we think the goals for 2020 were set politically, it will be interesting to see how this translates into a timetable for individual reforms.

4) Creation of a "central leading team"

Fourth, the government intends to establish a "central leading team for comprehensively deepening reform." The team will be responsible for (1) the grand design of the reform program, (2) consistency and cooperation, (3) overall progress, and (4) overseeing and encouraging reform.

Although there used to be a State Commission for Restructuring the Economic Systems and a State Council Office for Restructuring the Economic Systems, the CPC will now be responsible for ensuring that the reforms are actually carried out. We think this will also be linked to an assessment and promotion scheme for senior CPC officials.

2. Areas of reform

1) Comprehensive scope of reforms

The reforms of the Third Plenary Session of the 18th CPC Central Committee cover a wide range of areas. The full text, released on 15 November 2013, is 20,000 characters long. The 60 reforms cover 15 areas. Leaving aside the question of how difficult they will be to implement, the reforms are interesting in that no areas are sacrosanct. We will therefore have to monitor how it is proposed they will be implemented.

① Continuation and improvement of basic economic system (public and private corporate ownership)

② Speeding up the adoption of a modern market system (giving precedence to the market in the allocation of resources)

③ Speeding up reform of the role of government (administrative reform)

④ Implementing fiscal and tax reform (fiscal and tax reform)

⑤ Devising a means for town and country to develop in tandem (urbanization, rural issues)

⑥ Creating an open economic structure (implementation of open door policy)

⑦ Improving creation of a socialist democratic system (improvement of political decision-making process)

⑧ Ensuring rule of law (legal reform)

⑨ Limiting exercise of political power and Improving system of control (controls and other anticorruption measures)

⑩ Promoting innovation in cultural institutions and mechanisms (increasing “soft power”)

⑪ Innovation and the reform of social sectors (issues of employment, income distribution, and social security)

⑫ Reforming social management system (improving law and order and national security)

⑬ Speeding up creation of an ecological civilization (energy and environment)

⑭ Defense and military reform ((omitted))

⑮ Improving leadership of comprehensive reform of the CPC (creation of reform leadership group)

2) Creation of “national security council”

The Third Plenary Session of the 18th CPC Central Committee approved a policy to create another new body in addition to a new reform leadership group. In particular, ⑫ (reforming social management system) provides for the creation of a “state security committee” to devise and implement a system and strategy for national security. Some observers see this as a move to create China’s equivalent of the National Security Council in the US.

3. Incorporation of two different views on reform of state-owned enterprises

1) Is progress likely to be made in reforming state-owned enterprises

The reform of state-owned enterprises and the encouragement of private capital relate directly to investment banking issues such as initial public offerings, capital increases, M&A, and bond issues. These matters are dealt with under the first of the above 15 areas (continuation and improvement of basic economic system). As this is important, we quote the full text of the basic policies on these issues.

(Continuation and improvement of basic economic system)

The basic policy of pursuing a hybrid system of ownership based on public ownership is the cornerstone of China’s system of socialism with Chinese characteristics as well as a pillar of the socialist market economy.

The public-sector and private-sector economies are both key elements of China's socialist market economy and essential for its social and economic development.

China needs to continue to develop its public-sector economy without wavering, maintain state ownership as its main form of ownership, make the most of the leading role of the public-sector economy, and increase its effectiveness, dominance, and influence.

It also needs to continue to encourage the development of, support, and guide its private-sector economy, and foster its effectiveness and creativity.

It needs to create a system whereby rights of ownership are safeguarded, encourage mixed ownership, foster the development of state-owned enterprises as modern companies, and assist the healthy development of private ownership.

We can see from the above that the policies appear to encourage the development of both the public and private sectors, and that there is nothing in print to suggest that the government favors any particular type of ownership for key national industries, the areas of activity of public- and private-sector companies, or sectors such as manufacturing and services. However, the use of the term "mixed ownership" does suggest that the government sees scope to transfer some of the equity in state-owned enterprises to private investors.

2) Sounding out opinion on the reform of state-owned enterprises

In fact, articles that have appeared in mainland Chinese media suggest that the reform of state-owned enterprises was a bone of contention at the Third Plenary Session of the 18th CPC Central Committee.

(1) Preceding the Third Plenary Session of the 18th CPC Central Committee

First, according to a report that appeared in the *Shanghai Securities Daily* on 1 November 2013 (i.e., just before the Third Plenary Session of the 18th CPC Central Committee)[5], guidelines on the continuing reform of state-owned enterprises and guidelines on the realization of public ownership are due to be published following the Third Plenary Session of the 18th CPC Central Committee.

Moreover, we have heard from some of those involved that (1) the way state-owned enterprises are classified, regulated, and supervised (especially, the distinction between their public responsibilities and their commercial aims), (2) the adoption of a scheme of stock remuneration for (up to 40% of the remuneration of) senior managers of mainland-based state-controlled listed companies, (3) the use of a market for preferred shares for areas from which state-owned enterprises have withdrawn on a large scale, and (4) the creation of more opportunities for private capital to be

5 http://www.cs.com.cn/xwzx/hg/201311/t20131101_4190473.html

involved in the restructuring and listing of state-owned enterprises will determine the direction of the reform of state-owned enterprises.

(2) During the Third Plenary Session of the 18th CPC Central Committee

Second, according to a report that appeared in *China Daily* on 11 November 2013[6], 10–15% of the equity of the 112 central state-owned enterprises whose assets are administered by the State-owned Assets Supervision and Administration Commission (of the State Council) (SASAC) may be made available to private investors in the form of private equity.

Both reports suggest that there is disagreement over the extent to which the equity of state-owned enterprises should be made available to private investors, and we think this may have led to the reference to both public and private ownership in the summary of the Third Plenary Session of the 18th CPC Central Committee as well as the use of the term "mixed ownership". The publication on 12 November 2013 in *China Daily* of an article by a foreign contributor entitled "Privatization should occur 'carefully'" also suggests some disagreement about the reform of state-owned enterprises[7]. As it is, we will just have to wait and see whether the approval of this policy by the Third Plenary Session of the 18th CPC Central Committee leads to any new policies on reforming state-owned enterprises and greater use of private capital.

4. Stepping up the pace of financial reform

1) Outlook for financial reform

The direction of financial reform is indicated by "Upgrading the financial market system" in the second of the above 15 areas ("Speeding up the adoption of a modern market system").

Judging by the new government's approach to financial reform since it came to office, the Third Plenary Session of the 18th CPC Central Committee adopted the same approach to interest rates, exchange rates, and the movement of capital as that advocated for financial reform in the *Key Areas of Reform* approved by the State Council on 18 May 2013: (1) the gradual deregulation of interest rates and the creation of a deposit protection scheme; (2) the gradual deregulation of exchange rates; and (3) the gradual move to deregulated rates of exchange for renminbi items on the capital account.

Furthermore, the summary of the Third Plenary Session of the 18th CPC Central Committee advocates relaxing investment restrictions and establishing more free trade zones as part of the sixth item ("Creating an open economic structure"). As it happens, over the next three years the recently (in October 2013) created Shanghai Pilot Free Trade Zone will serve as a testing ground for the deregulation of inward direct

6 http://usa.chinadaily.com.cn/business/2013-11/11/content_17094189.htm
7 http://usa.chinadaily.com.cn/business/2013-11/12/content_17096674.htm

investment by means of a negative list as well as for financial services, including the deregulation of interest rates, exchange rates, and the movement of capital[8]. The Shanghai Pilot Free Trade Zone should perhaps be seen as a leading indicator of the outlook for financial reform in China.

2) Financial reform and securities markets

At the very beginning of the section on improving financial market systems in the full text of the Third Plenary Session of the 18th CPC Central Committee it clearly states the objective of increasing inward and outward access to financial services. At the moment, there are still restrictions on cross-border capital movements as well as on foreign shareholdings in financial institutions applying for a mainland Chinese operating license. However, given the policy of opening up China's financial markets as part of the move to change the country's economic growth model, the possible trends in Chinese investment banking, market trading, and asset management (including asset management for retail investors) will become apparent by 2020.

IV. The direction of securities market reform

Judging by the full text of the Third Plenary Session of the 18th CPC Central Committee, we expect the following developments in securities market-related activities (Figure 3).

1. Investment banking

In investment banking, the main trend is likely to be raising capital to enable the switch to a new economic growth model, restructuring of the industry, and a new approach to managing financial institutions.

1) Corporate services

First, it states that, as a rule, companies need to establish themselves as investors and make greater use of direct finance. We expect the government to encourage companies to raise capital on either the stock or the bond market. In particular, it refers to the need to reform the system of approval for issuing equities, confirming the government's desire to move from the current system of government approval to one of shelf registration.

Second, it calls for the service sector to be opened up, albeit gradually, and for foreign-invested companies also to be given pre-establishment national treatment and to be subject to a negative list. Being subject to a negative list means that, as a rule,

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[8] Sekine, Eiichi, "*Financial Impact from the Shanghai FTZ*," Nomura Journal of Capital Markets, Winter 2014, Vol.5, No.3.

companies are free to invest in any area not on the list, which consists of restricted or prohibited activities. This should enable foreign-invested companies to engage in greenfield investment and M&A in service industries.

Figure 3: Third Plenary Session of the 18th CPC Central Committee and Securities Markets

Main items of full text		Sub-items of full text		Main points	Securities business affected	Direction
2.	Continuation and improvement of basic economic system	(6)	Active development of mixed-ownership economy	Public and private capital to be allowed to co-invest	Investment banking	M&A
				Employee stock ownership plans to be permitted	Asset management	Adoption of employee stock ownership plans
				State asset operating company to be established	Investment banking	M&A
		(7)	Development of modern enterprise system for state-owned enterprises	Ownership and operation (of electric power, railway, telecom, etc. companies) to be separated	Investment banking	Restructuring of infrastructure industry and listing of companies
				Effective, long-term incentives to be created	Asset management	Introduction of stock-based incentive schemes
3.	Speeding up development of modern market system	(9)	Devising fair, open and transparent market rules	Foreign-invested companies to be given pre-establishment national treatment and be subject to a negative list	Investment banking	Greenfield investment, M&A
				Market-oriented corporate bankruptcy system to be established	Investment banking	Advisory services, M&A
		(12)	Upgrading of financial market system	Financial sector to be opened up to private capital, both Chinese and foreign	Investment banking	Greenfield investment, M&A
				More diversified capital markets to be created; equity shelf registration system to be reformed; equity finance to be diversified; bond market to be developed and standardized; share of direct finance to be increased	Investment banking	Equity and bond issuance and underwriting, private equity investment
				Exchange and interest rates to be deregulated; yield formation on the government bond market to be determined by demand and supply	Market-related business	Product development
				Capital markets to be opened up in both directions; implementation of convertibility of the renminbi on the capital account to be speeded up	Market-related business Asset management	Cross-border securities investment
				Deposit protection scheme to be adopted; mechanism to enable financial institutions to exit the market to be devised	Investment banking	Advisory services and M&A resulting from restructuring of financial services industry
		(13)	Further reform of science and technology system	Better terms of finance for science and technology SMEs to be provided; venture capital system to be improved; commercialization of fruits of science and technology to be improved	Investment banking	Private equity investment, venture capital investment, and IPOs and M&A as exit strategies
4.	Speeding up transfer of government functions	(14)	Further reform of investment system	Need for companies to establish themselves as investors	Investment banking	Retaining a requirement for government approval of investments affecting national and ecological security, the location of production facilities in the country as a whole, the strategic development of natural resources, and important matters of public interest, while allowing companies to make their own investment decisions
				Production overcapacity to be avoided; long-term solution to be found	Investment banking	M&A

Main items of full text		Sub-items of full text		Main points	Securities business affected	Direction
5.	Pushing forward fiscal and tax reform	(17)	Improvements to budget management system	Standardized and efficient risk management system to be developed for central and local government debt	Investment banking Market-related business	Restructuring government debt, underwriting of government and local government bonds
6.	Devising a mechanism for the joint development of towns and villages	(23)	Development of system and mechanism for healthy urbanization	Local governments to be allowed to diversify sources of funding for urban development	Investment banking Market-related business	Issuance and underwriting of local government bonds
				Investment in and operation of urban infrastructure to be permitted via franchises	Investment banking	Alternative investments
				Specialist financial institution for urban infrastructure and housing policy to be considered	Investment banking	Issuance and underwriting of corporate bonds
7.	Building a new system for a market-oriented economy	(24)	Lowering entry barriers to investment	Financial services to be opened up in an orderly manner	Investment banking Market-related business Asset management	Establishment by financial institutions of branches on the mainland
				Shanghai Pilot Free Trade Zone to be established	Investment banking Market-related business Asset management	Establishment by financial institutions of branches in the Shanghai Pilot Free Trade Zone
				Outward investment by companies and individuals to be increased; greenfield investment, M&A, securities investment, and joint investment to be promoted	Investment banking Market-related business Asset management	M&A, cross-border securities investment
		(25)	Increasing market opening and cooperation with Greater China	Ties with Hong Kong, Macao and Taiwan to be strengthened	Investment banking Market-related business Asset management	Issuance, management, and development of bonds on offshore renminbi markets
		(26)	Opening up border areas	Development organization to be established, and joint use of infrastructure with neighboring countries to be speeded up	Investment banking	Issuance and underwriting of corporate bonds to meet related financial needs
12.	Pursuing reform and innovation in social enterprises	(44)	Creating sensible and orderly distribution of income	More routes such as investment and rental services to be created; better ways to be found for listed companies to reward investors; investors' interests to be safeguarded; individuals to have a variety of options for increasing the income from their assets	Asset management	Development of means of building financial assets for individuals
		(45)	Creating a fairer and sustainable social security system	Basic state pension combining a (pay-as-you-go) social pooling element and (funded) individual accounts to be maintained, while individual accounts are set up and pension fund assets pooled at a national level	Asset management	Consulting and investment advisory services
				Public and standardized scheme for housing savings plans to be set up, and arrangements for withdrawing, using, and managing them to be improved	Asset management	Investment advisory services
				Management and supervision of investments by social insurance funds to be improved and their portfolios diversified and given greater market exposure	Asset management	Consulting and investment advisory services
				Tax incentives such as tax exemption or deferment to be offered; development of corporate/occupational pension schemes and commercial insurance to be speeded up; and a diversified social security system to be created	Asset management	Consulting and investment advisory services

Source: Nomura Institute of Capital Markets Research, from CPC sources

Third, with regard to M&A, the concept of "mixed ownership" is proposed and justification provided for allowing public and private capital to share ownership. Also, the importance of avoiding and reducing excessive production capacity is confirmed. The need for companies to engage in more outward investment is also stated. We expect these measures will make it easier to restructure domestic companies and for Chinese companies to engage in cross-border M&A. The full text also allows for the creation of a state asset operating company along the lines of Singapore's Temasek Holdings, a concept that has attracted considerable interest.

It is also clear from the full text that, although, as a rule, it is companies that are expected to be the investors when domestic industries are restructured, the government will retain its right of approval in exceptional cases affecting national or ecological security, the need for a nationwide production network, strategic asset development, and where it is in the public interest. We will have to monitor how China's *Anti-monopoly Law* and regulations governing foreign-invested enterprises are now applied.

2) Services for financial institutions

First, we expect private capital to increasingly invest in the financial sector. According to the full text, eligible private capital will be allowed to establish financial institutions such as small banks, provided regulation and oversight are improved. We therefore expect a growing number of non-financial companies to establish and invest in financial institutions, and for consumers to benefit from greater convenience while private SMEs find it easier to raise capital.

Second, another key point is that a deposit protection scheme has been proposed along with a mechanism to enable financial institutions to exit the market, hinting at the possibility of bank restructuring. The full text calls for interest rate deregulation to be speeded up. In particular, the creation of a deposit protection scheme and a mechanism to allow financial institutions to fail are essential preconditions for the deregulation of deposit interest rates. We envisage the possibility that failed financial institutions could be sold off to outside shareholders.

Third, the full text also covers the creation of the Shanghai Pilot Free Trade Zone. This is to be a testing ground for the participation of private capital in the financial sector as well as for the deregulation of interest rates, exchange rates, and the movement of capital. Foreign financial institutions may also be able to establish branches and sub-branches there as well as financial joint ventures.

3) Services for the public sector

First, in the section on interest rate deregulation the full text specifically refers to yield formation on the government bond market determined by demand and supply, suggesting that the market mechanism could play a greater role than hitherto in government bond underwriting. It is likely to become increasingly important for financial institutions to be authorized as government bond underwriters in the domestic market.

Second, we think there may be further deregulation of the local government bond market and reform of the system. For a start, we think a restructuring of government debt, which increased as a result of the RMB4 trillion economic stimulus package in 2008, and of local government debt, which increased particularly sharply, is inevitable. After that, we expect improvements in the procedures and the market for the issuance of the new bonds needed to finance regional economic development, including urbanization.

Third, we expect new developments in regional financing, be it the establishment of financial institutions specializing in regional infrastructure development or the adoption of approaches used by the private sector.

2. Markets

When it comes to markets, we expect the deregulation of interest rates, exchange rates, and the movement of capital to facilitate the efficient allocation of resources to the national economy to be accompanied by an expansion of existing operations and the creation of new ones.

1) Development of hedging instruments

We expect the deregulation of interest rates and exchange rates to be accompanied by a growing demand from companies and financial institutions for the development of new instruments for hedging interest rate and exchange rate risk. However, the development of such instruments will depend on the extent to which exchange rates are allowed to fluctuate and indicators such as Shibor (the Shanghai interbank rate) are accepted by financial markets.

2) Cross-border securities investment

First, we expect existing licenses and quotas for cross-border securities investment such as QFII and QDII status to be gradually deregulated along with the movement of capital. In particular, we think the use of negative lists for inward direct investment will require a balance to be struck with existing purchases of listed stocks by means of the QFII scheme and a single method of investing in listed stocks to evolve. We attribute People’s Bank of China (PBOC) governor Zhou Xiaochuan’s reference during the Third Plenary Session of the 18th CPC Central Committee to a gradual abolition of the QFII scheme to such a development[9]. The evolution of a single method of investing in listed stocks is also presumably a precondition for a US-Chinese bilateral investment treaty as sought by the Chinese government.

Second, we expect a speeding up of the implementation of convertibility of the renminbi on the capital account to contribute to its internationalization. In particular,

9 http://www.pbc.gov.cn/publish/goutongjiaoliu/524/2013/20131128174634334873326/20131128174634334873326_.html

we expect the investment quotas and geographical areas of the scheme for facilitating the repatriation of offshore renminbi resulting from trade settlement (RQFII) to be increased.

Third, we expect offshore renminbi markets as well as the issuance of and investment in renminbi bonds in overseas Chinese territories such as Hong Kong, Macao, and Taiwan to expand as a result of further market opening and cooperation.

Chinese companies are, in our view, increasingly likely to press foreign exporters to accept the renminbi in the settlement of import payments as the economy becomes more oriented towards domestic demand. We therefore think that the provision of attractive and convenient domestic financial markets that will enable foreign financial institutions and non-financial companies to invest their renminbi holdings remains an urgent issue and that China's financial authorities also have ample incentive to deregulate China's domestic financial markets to stimulate cross-border securities investment.

3) Private equity and venture capital investment

First, we expect increasing support for investment in unquoted domestic Chinese stocks as part of the moves to create more diversified capital markets in view of the full text's inclusion of the need to diversify equity finance. Private equity investment by foreigners in unquoted stocks is covered by the qualified foreign limited partnership (QFLP) scheme, whose investment quotas and pilot areas we expect to be increased.

Second, the full text mentions the need to provide better terms of finance for science and technology SMEs, and advocates venture capital as a means of achieving this. We expect more support for venture capital for this purpose.

Third, we see scope for greater use of and larger investment quotas for the qualified domestic limited partnership (QDLP) scheme to enable individual Chinese to invest in growth industries overseas.

3. Asset management (including retail business)

A larger investor base will be needed if investment banking and markets are to develop as outlined above. The full text of the Third Plenary Session of the 18th CPC Central Committee also includes asset-building measures for financial institutions and individuals.

1) Pension fund consulting and investment advisory services

First, we look at the trend towards greater market investment by public pension funds. The full text reports that the management and supervision of investments by social insurance funds will be improved and their portfolios diversified and given greater market exposure. China has five different types of social insurance, including basic endowment insurance, which is the equivalent of a basic old age pension[10]. Hitherto, these funds have been largely invested in bank deposits and government bonds for the sake of liquidity and low risk. In addition, China has a National Social Security Fund (NSSF), which was established in 2000 to supplement these social insurance funds and manages one of the world's largest investment portfolios. As institutional investors these funds are expected to provide the liquidity for China to switch to a new economic growth model and, ultimately, an investment return for the individuals who are its beneficiaries. Hence, as mentioned in the full text, there is an on-going need to find a solution to the issue of how to provide individual accounts and pool assets for basic endowment insurance at a national level.

Second, we look at the trend towards greater market investment by corporate pension funds. The full text identifies a need for tax incentives such as tax exemption or deferment, a need to speed up the development of corporate/occupational pension schemes and commercial insurance, and a need to create a diversified social security system. Defined contribution pension schemes with individual accounts were introduced in China in 2004. Once tax incentives are introduced, we would expect more individual accounts to be invested in the market.

2) Introduction of stock-based incentive schemes

First, according to the full text, employee stock ownership plans will be permitted as the government embraces the concept of hybrid ownership. In August 2012 public comment was invited on regulations governing employee stock ownership plans for listed domestic companies. It would appear from the Third Plenary Session of the 18th CPC Central Committee that the go-ahead has now been given for such plans. It will therefore be interesting to see what happens.

Second, companies will be expected to create effective, long-term incentive mechanisms as state-owned enterprises are gradually transformed into modern companies. Some Chinese state-owned enterprises and state-owned financial institutions have adopted stock option plans, and more companies may adopt such stock-based incentive schemes.

3) Assistance for individual asset-building

First, according to the full text, more routes such as investment and rental services will be created; better ways will be found for listed companies to reward investors, investors' interests will be safeguarded, and individuals will have a variety of options for increasing the income from their assets. It will be interesting to see how mechanisms to enable individuals to manage their financial assets either directly or via financial institutions are devised as approval is granted for employee stock

[10] For more on public and company pension schemes in China, see Sekine, Eiichi, "Jijo Doryoku o Unagasu Chuugoku no Nenkin Seido Kaikaku" (China's Pension System Reforms Encourage Self-reliance), Capital Market Quarterly, Autumn 2013 (in Japanese).

ownership plans (see above) and tax incentives provided for defined contribution pension plans. We also expect more safeguards for investors. At the moment, each type of financial service tends to have its own safeguards.

Second, according to the full text, there will be a public scheme for standard housing savings plans, and arrangements for withdrawing, using, and managing them will be improved. We also expect such plans to increasingly invest in the market. The full text also says that a financial institution specializing in housing will be established, which may draw on the experience of other countries in this field.

V. Financial sector likely to lead the way following the Third Plenary Session of the 18th CPC Central Committee

1. Third Plenary Session of the 18th CPC Central Committee and financial reform

As we have said, the Third Plenary Session of the 18th CPC Central Committee came up with policies for general reform. However, we expect financial sector reforms to lead the way as they are relatively easy to implement. This is because, first of all, the aims of deregulating interest rates, exchange rates, and the movement of capital are clear; everyone has a clear idea of what the outcomes should be; and they will be easier to implement than reforms of state-owned enterprises and the *hukou* (family registration) system. Second, financial sector reforms will make the non-financial economy more efficient, starting with the supply side, and the government realizes how important they are in ensuring that economic resources are allocated efficiently. Third, the internationalization of the renminbi that financial reforms and financial deregulation should lead to will also boost China's national prestige, realizing the new government's "Chinese dream," and is also an easy policy to sell to the Chinese public.

As it happens, on 12 November 2013, the final day of the Third Plenary Session of the 18th CPC Central Committee, *China Daily* published the following comments by an expert: (1) there has apparently been less opposition to financial reforms such as interest rate deregulation and the start of the Shanghai Pilot Free Trade Zone than there was to the reforms of the system of land/property registration and of state-owned enterprises; and (2) China's financial system is already more exposed to the market than other sectors of the economy, and the benefits of this are apparent[11].

We think that financial reform will continue to be the starting point and driving force of all economic reform in China and that the new government will continue to make financial reform a priority.

[11] http://usa.chinadaily.com.cn/business/2013-11/12/content_17096962.htm

2. Financial reforms already under way

Financial reforms such as these have been under way since before the Third Plenary Session of the 18th CPC Central Committee, and the pace of their implementation has been stepped up in the following way since it ended.

1) Deregulation of deposit and lending rates

With regard to interest rate deregulation, Chinese banks made their first moves towards deregulating their deposit and lending rates around the time of the Third Plenary Session of the 18th CPC Central Committee.

First, they have begun to deregulate their lending rates. In October 2004 China abolished the ceiling on lending rates, and some nine years later, in July 2013, it abolished the floor on these rates. As part of this process and in order to provide a benchmark for lending rates, the PBOC has published a loan prime rate (LPR) since 25 October 2013. The LPR is a commercial bank's most favorable lending rate to its highest-rated customers. The PBOC's LPR is a weighted average of the LPRs of Industrial and Commercial Bank of China and eight other banks, excluding the highest and lowest rates, and is published every business day at 11.30.

Second, they have begun to deregulate their deposit rates. Following the publication by the PBOC on 8 December 2013 (with effect from 9 December 2013) of its *Provisional Administrative Measures on the Issue of Certificates of Deposit*,[12] financial institutions resumed issuing certificates of deposit, starting with large-denomination certificates[13]. The first batch (totaling some RMB19 billion) was issued by five major banks on 12 December.

2) Relaxing foreign exchange controls and deregulating the movement of capital

The relaxation of foreign exchange controls as part of the internationalization of the renminbi and the deregulation of the movement of capital began before the Third Plenary Session of the 18th CPC Central Committee.

First, in October 2013 the Chinese government signed an agreement with the Singaporean and UK governments for the renminbi to be traded directly against sterling and the Singaporean dollar. In accordance with the agreement on financial cooperation between Japan and China of December 2011, direct trading of the renminbi against the yen began in both Tokyo and Shanghai in June 2012, while direct trading of the renminbi against the Australian dollar began in April 2013. This direct trading had increased in volume before the Third Plenary Session of the 18th CPC Central Committee.

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12 http://www.pbc.gov.cn/publish/goutongjiaoliu/524/2013/20131208161020551335275/20131208161020551335275_.html

13 China suspended issuance of certificates of deposit after the Asian Currency Crisis of 1997–1998.

Second, in October 2013 the Chinese government increased the RQFII investment quota for direct trades of the renminbi against the Singaporean dollar to RMB50 billion and for those of the renminbi against sterling to RMB80 billion. The RQFII scheme was introduced in December 2011 as a means of repatriating offshore renminbi via securities investment. However, we expect trading volume to continue to increase as part of the move to deregulate the movement of capital.

3) Shanghai Pilot Free Trade Zone

Moves to create a free trade zone in Shanghai as a pilot for financial deregulation have gathered momentum since the Third Plenary Session of the 18th CPC Central Committee.

First, on 2 December 2013, the PBOC published *Opinions of the People's Bank of China on Providing Financial Support for the Development of China (Shanghai) Pilot Free Trade Zone*,[14] a 30-section document (also known as the *PBOC Opinions*) of deregulatory measures based on proposals thitherto published by the State Council (cabinet), the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC), and the China Insurance Regulatory Commission (CIRC). The Shanghai municipal government had already set up a group to promote cooperation in financial services in the Shanghai Pilot Free Trade Zone. Similarly, the Shanghai Head Office of the PBOC plans to implement most of the *PBOC Opinions* by March 2014 and to create financial management models that can be replicated and implemented nationwide in the course of 2014[15].

Second, foreign banks have begun to set up branches and sub-branches on the basis that financial deregulation in the Shanghai Pilot Free Trade Zone will go ahead. According to a 5 December 2013 report on www.stcn.com, nearly 10 foreign banks have already been granted permission to open branches and sub-branches in the Shanghai Pilot Free Trade Zone, and three Japanese megabanks also have plans to do so[16].

4) Reforming system of issuing stocks

Reform of the system of issuing stocks had begun before the Third Plenary Session of the 18th CPC Central Committee started.

First, domestic initial public offerings, which had been on hold since the autumn of 2012, resumed. On 30 November 2013, the CSRC published *Opinions on Further Promoting IPO System Reforms*[17] as a proposal to move closer to a market-led system of issuing new stocks based on information disclosure while retaining the existing

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[14] http://www.pbc.gov.cn/publish/goutongjiaoliu/524/2013/20131202094934794886233/20131202094934794886233_.html

[15] http://shanghai.pbc.gov.cn/publish/fzh_shanghai/2974/2013/20131203203424945282322/20131203203424945282322_.html

[16] According to *Nihon Keizai Shimbun* of 7 November 2013 and NHK on 1 December.

[17] http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201311/t20131130_239079.htm

system of due diligence and approval. Later the CSRC published related regulations in the form of *Interim Measures on the Public Offering of Shares Held by Company Shareholders at Initial Public Offering* (on 2 December 2013)[18] and a revised version of *Measures for the Administration of Securities Issuance and Underwriting* (on 13 December 2013)[19]. Apparently some 50 companies planning to list will undergo due diligence in January 2014. In addition, backdoor listings have become subject to the same stringent regulation as IPOs, with, for example, the Shenzhen Stock Exchange's Second Board (for start-ups) banning backdoor listings altogether[20]. The aim is presumably to maintain the standards of listed companies.

Second, preferred shares were introduced. One of the objectives of the latest third plenary session was to enable companies to raise different types of equity capital. As part of that endeavor, on 30 November 2013 the State Council promulgated its *Guiding Opinions on Launching the Pilot Program for Preferred Shares*,[21] while, on 13 December 2013, the CSRC invited public comment on its *Measures for the Administration of Preferred Shares*.[22] The issuance of preferred shares is seen as essential to the reform of state-owned enterprises and the recapitalization of state-owned commercial banks, so it will be interesting to see what rules are adopted. In this context, it is perhaps worth mentioning that on 5 December 2013, the Ministry of Finance, with an eye to the recapitalization of state-owned financial institutions, published regulations governing convertible bonds (that had been enacted on 16 November 2013)[23].

Third, SMEs were encouraged to seek a quotation on the over-the-counter (OTC) market. On 14 December 2013 the State Council published *Decisions on Relevant Matters Concerning National SME Share Transfer System*,[24] which simplify the due diligence procedure for SMEs seeking such a quotation (and abolishes the requirement for due diligence by the CSRC in the case of SMEs with fewer than 200 employees). Later, on 16 December 2013, the CSRC invited public comment on a draft revision of the *Measures for the Supervision and Administration of Unlisted Public Companies*,[25] paving the way for detailed implementation rules.

5) Encouraging individual investors to invest in the market

There have also been moves to encourage individual investors to invest in the market.

First, domestic listed companies have been encouraged to pay cash dividends. On 30 November 2013 the CSRC published its *No.3 Guideline for the Supervision of Listed Companies—Cash Dividend Distribution of Listed Companies*, which contains

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18 http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201311/t20131130_239079.htm
19 http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201312/t20131213_239894.htm
20 http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201311/t20131130_239075.htm
21 http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201311/t20131130_239077.htm
22 http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201312/t20131213_239889.htm
23 http://jrs.mof.gov.cn/zhengwuxinxi/zhengcefabu/201312/t20131205_1020949.html
24 http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201312/t20131214_239918.htm
25 http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201312/t20131216_239945.htm

guidelines for companies to pay either 20%, 40%, or 80% of their dividends in cash, according to the stage of their development[26]. According to the CSRC, in the three years from 2010 to 2012, 50%, 58%, and 68%, respectively, of domestic listed companies paid a cash dividend, with the share of the cash dividend being 18%, 20%, and 24%, respectively. It will be interesting to see whether encouraging companies to pay a cash dividend as the guideline recommends contributes to a decline in the number of individual investors in the stock market.

Second, taxes on investment gains from company and occupational pension schemes can now be deferred. On 6 December 2013 the Ministry of Finance, the Ministry of Human Resources and Social Security, and the State Administration of Taxation published a *Notice on Issues Pertaining to the Collection and Administration of Individual Income Tax on Enterprise Annuities and Occupational Pensions* and announced that from 1 January 2014 the point of taxation for voluntary employer contributions could be deferred to retirement age and that a tax deduction for voluntary employee contributions would be allowed[27]. We think this pilot project has the potential to accelerate the growth in defined contribution pension plans, which were introduced in China in 2004, and to encourage members of such schemes to invest in the market.

Third, securities companies now have to comply with more stringent information disclosure requirements when dealing with individual investors. On 29 November 2013 the CSRC released a revised version of the *Guidelines on the Content and Format of Annual Reports of Securities Firms*, which came into effect on 1 January 2014[28]. The revised guidelines require even unlisted securities companies to submit copies of their annual reports to the CSRC and to publicly disclose them via the Securities Association of China's website. We think these more stringent information disclosure requirements will also induce unlisted securities companies to exercise more discipline.

VI. Conclusion

As we have described, the reforms decided by the Third Plenary Session of the 18th CPC Central Committee will be backed up by personnel policies as well as by the timetable to 2020 and the creation of a leadership group for achieving reform in order to ensure they are effective.

On 9 December 2013 the Organization Department of the CPC Central Committee promulgated a *Circular on Improving the Work Evaluation of Local Party and Government Leaderships and Officials* and announced that in assessing regional cadre (1) it will base its assessments not simply on regional GDP and GDP growth, and (2) will (as a corollary of this) include the state of management of local government debt.

26 http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201311/t20131130_239076.htm
27 http://szs.mof.gov.cn/zhengwuxinxi/zhengcefabu/201312/t20131206_1021661.html
28 http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201311/t20131129_239009.htm

The question of local government debt is also a matter of financial risk[29]. As the new government's attitude to reform takes account of financial risk management, a timetable, and organizational and personnel matters as well as financial reform, we think it should be taken seriously.

Also, the financial reforms include the prospect of amendments to the rules governing securities markets. On 10 December 2013 Mr Xiao Gang, chairman of the CSRC, announced in *Century Weekly* that China's *Securities Law*, which was amended in 2005, would undergo further amendments and that a *Futures Law* would be enacted[30]. At the same time, he announced that *Regulations for Regulatory Oversight of Listed Companies, Regulations for Securities and Futures Investors' Protection Fund*, *Regulations for the Issuance of Classified Shares*, and *Regulations for the Regulatory Oversight of Private Equity Funds* would also be enacted in due course. We think these legislative provisions for the securities market will be well worth watching as they are essential to the effective implementation of the securities market reforms decided by the Third Plenary Session of the 18th CPC Central Committee.

[29] For further details of local government debt in China, see Sekine, Eiichi, "Chuugoku no Chihou Saimu o Dono You ni Toraerubeki na no ka" (What Should We Make of China's Local Government Debt?), Capital Market Quarterly, Autumn 2013 (in Japanese).

[30] http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201312/t20131210_239701.htm