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China's securities industry one year after landmark deregulatory conference

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Executive Summary

China has announced many deregulatory measures since unveiling an ambitious deregulatory agenda for its securities industry at the Conference on Innovation and Development of Securities Companies nearly a year ago. How securities firms respond to deregulation will be a key focal point going forward.

Nearly a year has passed since China's May 2012 Conference on Innovation and Development of Securities Companies. A draft plan to promote liberalization and growth of the securities industry was unveiled at the conference in the aim of improving the business models of securities firms overly dependent on the brokerage business. Intended to promote expansion and diversification of securities firms' operations, the plan comprises 11 measures broken down into 36 specific measures[1). Much of the plan has already been codified into new regulations[2)(see table). Following is an assessment of the measures implemented relatively early and update on recently announced measures.

Asset management business's growth has defied authorities' intentions

First, in terms of deregulation of the asset management business, a high priority of both the China Securities Regulatory Commission (CSRC) and the securities industry, the CSRC issued regulations in October 2012 to enlarge the range of assets in which asset management plans (pooled investment funds) are permitted to invest. Asset management plans' assets under management grew dramatically in 2012[3), but this growth was largely attributable to banks' off-balance-sheet wealth management products, which are merely a vehicle for circumventive bank lending[4). Such growth runs counter to the intent of the new eased regulations, which was to offer a diverse range of products to investors with varying risk tolerances.

In February 2013, the CSRC issued provisional regulations (effective from June 2013) for publicly offered securities investment funds run by asset management institutions. These regulations will allow securities firms to operate publicly operate securities investment funds like fund management companies[5).

NOTE

1) See "Deregulation of China's securities industry is accelerating" (October 2012) (http://www.nri.co.jp/english/opinion/lakyara/2012/pdf/lkr2012151.pdf).

2) According to the CSRC (March 13 press conference), 25 of the 36 specific measures have been implemented as of December 31, 2012. Several additional measures have been announced since then.

3) Securities firms' assets under management grew from RMB280 billion to RMB1.9 trillion during 2012.

4) See "Risks posed by Chinese banks' off-balance-sheet lending" (March 2013) (http://www.nri.co.jp/english/opinion/lakyara/2013/pdf/lkr2013161.pdf).

5) Such funds may be operated by insurers and private equity funds also.

New regulations governing asset securitizations by securities firms took effect in March 2013. They expanded the scope of securitizations to basically include most assets that generate cash flows. Securities firms will be able to structure asset securitizations using specialized asset management plans, one type of asset management plan offered by securities firms. Asset securitizations are expected to become a key pillar of the asset management business.

Meanwhile, Xiao Gang replaced Guo Shuqing as chairman of the CSRC in March 2013. In December 2012, Mr. Gang, former chairman of Bank of China, warned that banks' off-balance-sheet wealth management products pose risk if incoming funds from new clients are used to pay interest on or redeem existing products. The China Banking Regulatory Commission (CBRC) is stepping up regulation of off-balance-sheet wealth management products. Stricter regulation will also affect securities firms' asset management operations related to banks' off-balance-sheet transactions. It remains to be seen whether securities firms' asset management operations progress in the direction intended by the aforementioned deregulation of publicly offered funds and securitizations.

Security firms' response as deregulation enters implementation stage

In terms of other businesses, sales of financial products on behalf of other financial institutions was deregulated in November 2012, but some securities firms do not seem optimistic about such product sales as a profit source, partly because securities firms generally have smaller branch networks than banks.

In March 2013, the CSRC issued regulations for management of securities firms' branches and sales offices and the Securities Association of China (SAC) issued rules on opening new customer accounts. The CSRC's new regulations eliminated numerical and geographic restrictions on opening new branches and sales offices. Securities firms with sound operations and no material risks[6] are now basically able to open branches and sales offices anywhere in China. They may also open new accounts online.

6) To qualify, securities firms must meet specified risk management benchmarks and have a clean regulatory record for the preceding two years.

Private-placement bond offerings by small and mid-sized enterprises were legalized in May 2012 to expand the OTC market in the aim of providing new business opportunities to securities firms. Issuance of such bonds was initially brisk but it subsided after a few months. The market's small size and lack of liquidity have been cited as impediments.

Among OTC markets, growth in markets that trade unlisted equity securities cannot be overlooked. First, the State Council authorized expansion of the so-called new third-board market[7)] in August 2012. Companies eligible to be traded on the new third-board market were previously limited to high-tech companies located in Beijing's Zhongguancun Software Park (Z-Park), but eligibility has been expanded to now include high-tech parks in Shanghai, Wuhan, and Shenzhen.

7) The new third-board market is an OTC market (established in 2006) on which unlisted development-stage companies located in Beijing's Z-Park are traded.

Exhibit: Recent Major Deregulatory Measures

Subject matter		Effective date	Related regulations
Customer service	(Asset management products, new businesses)	Sept 2012	Guidelines for Securities Companies' Cash Management Products (Shenzhen Stock Exchange and China Securities Depository and Clearing Corporation)
Customer service	(Asset management products, new businesses)	Oct 2012	Pilot Measures for Administration of Securities Companies' Customer Asset Management Businesses and related detailed rules
Customer service	(Asset management products, new businesses)	March 2013	Measures for Administration of Securities Companies' Securitization Businesses
Customer service	(Financial product sales)	Nov 2012	Provisions on the Administration of Securities Companies' Sales of Third-Party Financial Products
Customer service	(Opening of branches, sales offices, accounts)	March 2013	Measures for Supervision and Administration of Securities Companies' Branches and Sales Offices
Customer service	(Opening of branches, sales offices, accounts)	March 2013	Customer Account Opening Rules for Securities Companies (SAC)
Proprietary trading		Nov 2012	Securities Company Direct Investment Rules (SAC)
Proprietary trading		Nov 2012	Amendment of Provisions on Scope of Securities Companies' Proprietary Trading and Related Matters
Infrastructure	(OTC market)	May 2012	Pilot Regulations for Securities Companies' Underwriting of SME Private-Placement Offerings (SAC)
Infrastructure	(OTC market)	June 2012	Notice of Problems Related to Securities Investment Funds' Investments in SMEs' Private-Placement Bonds
Infrastructure	(OTC market)	Aug 2012	Guidance on Regulation of Securities Companies' Involvement in Regional Equity Trading Markets
Infrastructure	(OTC market)	Dec 2012	Rules for Securities Companies' OTC Trading Businesses (SAC)
Infrastructure	(OTC market)	Jan 2013	Interim Measures for Administration of National SME Share Transfer System Co., Ltd.
Infrastructure	(OTC market)	Feb 2013	Operational Rules for Securities Companies' Entry into Regional Equity Trading Markets (SAC)
Outward liberalization, etc.		Oct 2012	Amendment of Rules for Establishment of Partially Foreign-Owned Securities Companies and Pilot Regulations on Establishment of Subsidiaries by Securities Companies
Outward liberalization, etc.		Jan 2013	Supervisory Guidelines for Companies' Overseas Listing Applications and Review Thereof
Outward liberalization, etc.		March 2013	Measures for Pilot Program of Securities Investment in China by RMB Qualified Foreign Institutional Investors
Oversight, risk management, etc.		Nov 2012	Amendment of Provisions on Standards for Calculating Securities Companies' Risk Capital Reserves
Oversight, risk management, etc.		Dec 2012	Securities Company Investor Suitability Handbook (SAC)
Oversight, risk management, etc.		Jan 2013	Securities Company Governance Rules

Note: For further details, see "Deregulation of China's securities industry is accelerating" (http://www.nri.co.jp/english/opinion/lakyara/2012/pdf/lkr2012151.pdf). The above regulations were issued by the CSRC unless noted otherwise.
Source: NRI, based on information from CSRC, SAC and media sources

The CSRC similarly issued guidance on regional equity trading markets[8)] in August 2012. The guidance says that securities firms are permitted to acquire ownership stakes in regional markets, recommend companies that trade on regional markets, execute trades in such companies' equity securities and private-placement bonds, conduct private-placement bond and allotment equity offerings for such companies, and offer investment advisory, registrar, and settlement services. Expansion of the new third-board market and formalization of regional equity markets have broadened the foundations of trading unlisted companies' equity securities[9)].

Additionally, rules for securities firms' OTC trading businesses issued in December 2012 legalized OTC trading of financial products (including derivatives). Fifteen securities firms have obtained licenses to trade OTC financial products as of February 28, 2013. While interest rate and currency derivatives account for the bulk of OTC trading in developed countries, Chinese securities firms initially will chiefly market and trade asset management plans and sell financial products on behalf of others. They will do so in bilateral negotiated transactions mainly with institutional investors, but they plan to eventually establish themselves as market makers to enhance OTC market liquidity[10)].

In sum, China has unveiled many regulatory measures over the past year. Securities firms are currently preparing to implement various business reforms. Whether their reforms proceed in accord with the intent of deregulation will be a key focal point going forward.

8) Regional equity trading markets are private-placement markets set up by provinces to provide a venue for issuance and trading of local companies' equity securities and bonds. They have become subject to regulation in recent years in response to their rapid development. Securities traded on these regional markets are limited to those of companies with no more than 200 shareholders (private-placement offerees). Regional markets may not engage in continuous, intensive trading of standardized products like the major stock exchanges.

9) On September 28, 2012, the CSRC issued Measures for the Regulation of Unlisted Public Companies (which took effect on January 1, 2013). The measures clarified previously ambiguous regulations pertaining to unlisted public companies, defined as companies that are not listed on a securities exchange but (1) have more than 200 shareholders due to equity issuance or (2) conduct public offerings of equity securities. As a result of the regulatory clarification, companies listed on the new third-board market are no longer prohibited from having more than 200 shareholders as a result of allotment offerings.

10) On March 15, the SAC released a standard financial derivatives trading contract and related rules, which took effect on the same date.

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