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Emphasis shifts to risk control at China securities industry's 2013 Innovation and Development Conference

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Executive Summary

Risk control was at the forefront of this year's Innovation and Development Conference, in contrast to last year's conference, where a sweeping deregulatory agenda was unveiled. The Chinese securities industry has entered a phase of steady implementation of deregulatory measures already announced.

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Further deregulation put on hold

China's securities industry held a Conference on Innovation and Development of Securities Companies again this May. At last year's conference, the China Securities Regulatory Commission (CSRC) unveiled a deregulatory agenda. Chinese authorities subsequently announced a series of deregulatory measures[1]. A key focal point of this year's conference was whether Xiao Gang, who replaced Guo Shuqing as chairman of the CSRC in March 2013, would follow in his predecessor's footsteps with further deregulation.

Chairman Xiao ended up not attending the conference, making it a lower-profile event than last year's. Moreover, speakers at the conference emphasized risk control with comments such as the following[2]. "Innovation and development must be dynamically balanced with risk control and compliance" (CSRC Vice Chairman Zhuang Xinyi). "If severe risk problems arise in the course of innovation and development, the securities industry would lose the trust of markets and customers. In such an event, securities firms' growth potential would be substantially diminished. Securities firms must build internal risk control systems and strengthen self-regulation" (Shenzhen Stock Exchange President Song Liping).

As of March 2013, the CSRC had reportedly prepared 32 specific deregulatory measures as a follow-up to last year's deregulation (11 measures broken down into 36 specific measures), but it decided against unveiling them at this year's conference. It plans to delay their implementation until conditions are right.

One reason for this delay was concerns about the feasibility of accelerating deregulation beyond its rapid pace under former chairman Guo.

NOTE

1) See http://www.nri.co.jp/english/opinion/lakyara/2013/pdf/lkr2013165.pdf.

2) As quoted in media reports.

A second reason is that the securities industry has failed to meet the CSRC's expectations in terms of developing innovative new products in the asset management business, one of the key targets of deregulation. Last year's rapid growth in asset management plans (pooled investment funds) was largely attributable to the plans being used to facilitate circumventive financing by banks. Securities firms, some of which are still grappling with challenges such as human resource shortages, have undeniably had difficulty adapting to recent deregulation.

A third reason is that the CSRC ordered some securities firms to improve their organizations and business processes after inspecting their asset management products in March and April 2013. The CSRC's inspections identified problems such as failure to comply with review processes for products being sold to customers.

Crackdown by regulators

Although not directly related to securities industry deregulation since last year, another recent development is that the CSRC is working to normalize China's securities markets through such means as cracking down on insider enrichment schemes in the bond market and penalizing securities firms for IPO-related fraud in the aim of containing risks before they become widespread.

First, in the bond market, illegal trading by financial institution employees in their own or a related party's account has become a problem. Specific examples include trades that enrich related parties and trades conducted to conceal financial institutions' losses or temporarily evade regulations.

Although such illegalities are not new, they have recently been growing in magnitude. In response, the regulators launched intensive investigations of major securities firms, securities investment fund companies, and banks in April 2013. Additionally, in the interbank bond market, regulators temporarily banned opening of new accounts for parties other than financial institutions and bond purchases in such accounts[3].

Regulators are also cracking down harder on IPO-related illegalities. One problem that has been identified is rapid deterioration in newly listed companies' earnings after their IPOs in venture equity markets. On May 14, the CSRC penalized Ping An Securities for fraudulent misrepresentations in offering documents related to the 2011 IPO of Wanfu Biotechnology (Hunan) Agricultural Development Co. In addition to being admonished, Ping An Securities was fined triple the fee it earned from sponsoring the

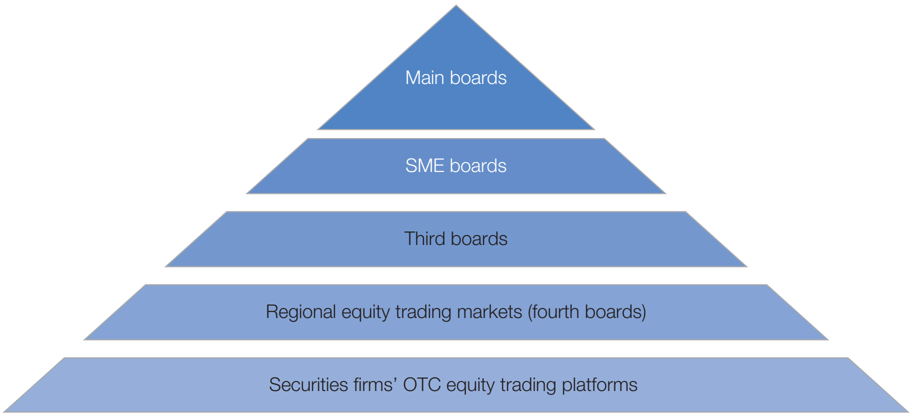
3) These accounts are called Type C accounts. There are three types of accounts in the interbank bond market. Type A accounts are for commercial banks. Type B accounts are used by non-bank financial institutions, securities investment funds, and pension funds in addition to commercial banks. Type C accounts are for nonfinancial corporations. Trades in Type C accounts must be executed and settled through Type A accounts.

IPO and had its IPO sponsorship privileges suspended for three months. Additionally, the Ping An executive in charge of the IPO was fined RMB300,000, stripped of his IPO sponsor qualifications, and permanently barred from working in the securities markets. The penalties were said to be the most severe imposed since the IPO sponsorship system's inception in late 2003. Several other securities firms are apparently also under investigation.

Future outlook

With this May's Innovation and Development Conference disappointing those who were hoping for further deregulation and the CSRC placing more emphasis on risk

Exhibit 1. China's multi-tiered equity market



N o t e: Strictly speaking, the SME boards are part of the main boards.
Source: NRI (Beijing)

Exhibit 2. Securities firms authorized to engage in OTC trading

First group (announced December 21, 2012)		Second group (announced February 5, 2013)	
1	Haitong Securities	8	China Merchants Securities
2	China Galaxy Securities	9	CITIC Securities
3	Guotai Junan Securities	10	CICC Securities
4	Shenyin & Wanguo Securities	11	CIC Securities
5	China Securities (CSC)	12	Shanxi Securities
6	Guangfa Securities	13	BOCI Securities
7	Industrial Securities	14	Changjiang Securities
		15	Qilu Securities

N o t e: Securities companies authorized by the Securities Association of China to engage in OTC trading on a pilot basis.
Source: NRI, based on SAC data

and stepping up oversight of certain activities, securities firms currently appear to be reassessing their future prospects.

However, regulators' recent actions have not halted or reversed deregulation. For the time being, the securities industry has entered a phase of steady implementation of deregulatory measures already announced.

A case in point is securities firms' OTC trading operations. OTC trading venues in China include trading platforms operated by securities firms in addition to so-called third-board markets and regional equity markets[4)] (see exhibits). Securities firms could use these trading platforms to sell new asset management products. As deregulation progresses, securities firms should reap synergistic benefits from the various deregulatory measures through such an approach.

4) See footnotes 7, 8 and 9 in http://www.nri.co.jp/english/opinion/lakyara/2013/pdf/lkr2013165.pdf.

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