Chapter III

Securities Sector and the Capital Market

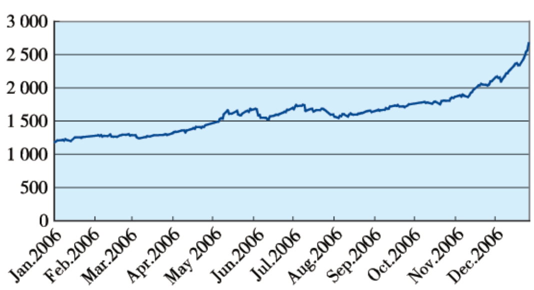
In 2006, the capital market reform continued. The non-tradable state share reform of listed companies was close to completion; the comprehensive restructuring of securities companies showed initial results; institutional investors kept on growing; the market functions were further improved with stronger institutional development; therefore, the capital market was facing a benign development opportunity.

Recent Developments

The market further expanded, with greater financing function. As of the end of 2006, there were 1 434 listed companies on the Shanghai and Shenzhen Stock Exchanges, 53 more than the previous year. The total capitalization was about RMB 8.94 trillion yuan, an increase of 176.78% y-o-y. The ratio of stock capitalization to GDP went up from 17.7% at the end of 2005 to 42.69%. In May 2006, Shanghai Stock Exchange re-opened A-share IPO. After that, BOC, Daqin Railway, Air China, ICBC and many other large companies successfully executed IPOs in the A-share market. The A-share market improved its function of financing substantially, and raised total fund worth RMB 243.2 billion yuan in 2006, up by 619.31% y-o-y. As of the end of 2006, the outstanding RMB bonds reached RMB 9.25 trillion yuan, an increase of about RMB 2 trillion yuan y-o-y, or 27%. The outstanding USD bonds stood at USD 4.23 billion, up by 67% y-o-y. New issues of RMB bonds in 2006 totaled RMB 5.56 trillion yuan, up by 35.34% y-o-y, including T-bonds of RMB 888.33 billion yuan, increasing by 26.15%, policy-related financial bonds of RMB 898 billion yuan, up by 53.46%, and corporate bonds (including enterprise bonds and commercial notes) of RMB 393.83 billion yuan, an increase of 92.4%.

The market maintained an upward trend in general, with the scale of securities and futures trading growing rapidly. In 2006, Shanghai Stock Exchange Composite Index soared to 2698.90 points at the peak and closed at 2675.47 points at the year-end, up by 130.43% over the year beginning (Figure 3.1). The scale of stock trading continued to increase, with an aggregate trading volume on Shanghai and Shenzhen Stock Exchanges worth RMB 9.05 trillion yuan, covering 1.61 trillion shares, up by 185.71% and 143.75% respectively y-o-y. The inter-bank bond market index climbed from 113.42 points at the beginning of the year to 116.74 points at the end of the year, up by 2.93%. The exchange T-bond index grew from 109.19 points at the year beginning to 111.39 points at the year-end, up by 2.01%. Spot deal in the inter-bank bond market was worth RMB 10.26 trillion yuan in 2006, up by 4.24 trillion yuan over 2005, or 70.6%. Spot trading of T-bond in exchange market totaled RMB 154.1 billion yuan in 2006. Trading volume in the futures market totaled 450 million units in 2006, an increase of 39.2% y-o-y; the aggregate trading volume reached RMB 21. 01 trillion yuan, up by 56. 23%, the highest in history.

Figure 3. 1 Trend of Shanghai Stock Exchange Composite Index in 2006 (Based on the closing prices)



Source: CSRC.

Assets of securities and futures institutions grew rapidly, and the operations were in better shape. As of the end of 2006, there were 104 securities companies, whose total assets amounted to RMB 620. 3 billion yuan, an increase of RMB 313. 3 billion yuan, or 102. 05%. The net profit stood at RMB 25. 5 billion yuan. There were 183 futures brokerage companies, whose total assets worth RMB 27. 784 billion yuan, an increase of 7. 784 billion yuan, or 38. 92%. Their net profit stood at RMB 199 million yuan.

Institutional investors continued to develop, and investors' structure became more rationalized. In 2006, securities investment funds, QFII, social security funds, insurance companies and other institutional investors developed rapidly. As of the end of 2006, 58 fund management companies managed 307 funds. There were 622. 1 billion shares of fund under management, up by 32% y-o-y. The total fund value stood at RMB 856. 5 billion yuan, increasing by 83% y-o-y. Total quota of 52 QFIIs was worth USD 9. 045 billion, and total capitalization of stock they held reached USD 97. 1 billion, up by 222% y-o-y. Direct investment of insurance funds and social security funds in stock market increased further, worth RMB 80. 3 billion yuan and RMB 56. 3 billion yuan respectively, up by 405. 41% and 174% y-o-y respectively. In 2006, 9 fund management companies signed corporate annuity contracts worth RMB 3 billion yuan. There were more participating entities in the inter-bank bond market. As of the end of 2006, there were 6 439 market participants including commercial banks, securities companies, insurance companies, etc., an increase of 931 over 2005.

Innovation of securities products and business pressed ahead steadily, with more diversified investment products available. Taking ICBC's IPO as a juncture, the institutional arrangement of concurrent A-share and H-share listing simultaneously was introduced. With the issuance of splittable convertible bonds and the startup of A-share private placement, there were more re-financing channels available for listed companies to enhance re-financing efficiency. Encouraged to conduct innovative businesses, innovation-type securities companies developed the ABS products rapidly through asset management, hence creating a new channel for fund-raising and investment. Support was rendered to encourage commercial banks to issue mixed capital bonds, so as to explore more channels for capital replenishment and diversify the types of bonds in the market. White sugar futures and bean oil futures were launched to make commodity futures market further play the role of serving national economy. Research was done to improve the margin financing and securities lending business and its related system. CFFE was established, and preparatory ground was laid for the launch of stock index futures and other financial derivatives.

The legal framework of securities regulation was further improved, and the regulation was reinforced. According to the amendments to *Company Law* and *Securities Law*, relevant authorities researched or promulgated a series of regulations in alignment with these two laws. The integrated supervisory system over listed companies that involved various relevant authorities and local governments at various levels was actively pursued to improve the information sharing mechanism and emergency response mechanism, and the handling of misappropriation of listed companies' fund by big shareholders achieved initial results. In addition, risk monitor of securities companies based on net capital was reinforced. High-risk securities companies that failed to rectify were disposed of effectively in a timely manner. As of the end of 2006, risk monitoring indicators of 92% securities companies met the required level, and standardized operations were further improved.

Reform and Achievement

In 2006, the capital market was further institutionalized, and long-standing deep-rooted conflicts and structural problems were basically solved.

The reform of non-tradable state shares was close to completion

As of the end of 2006, 1 301 listed companies had either completed or started the reform, accounting for 97% of the total, and their capitalization accounted for 98% of the total market capitalization. Only 40 listed companies did not start the reform. The progress in the reform strengthened the common interests of various types of shareholders of the listed companies, and created fundamental conditions to improve the market's pricing function and resources allocation function, as well as to improve corporate governance and stimulate innovation.

The comprehensive restructuring of securities companies showed initial results

In 2006, most of the legacy problems in securities companies were solved, and the fundamental institutions of the securities market were gradually established and improved, so as to lay a solid foundation for the standardized, sustainable and steady development of securities companies.

Risk disposal of securities companies progressed steadily. After identifying the risk profiles of securities companies, the securities regulatory authority specified policies and time limit for rectification of the problematic companies. For companies that didn't make the utmost to rectify themselves, corresponding regulatory measures were adopted to expedite rectification, and companies that could not be rectified or restructured or that with new serious violations were disposed of timely. In 2006, relevant authorities closed down 12 securities companies with high-risk profile in a smooth manner. Most problems such as misappropriation of clients' transaction and settlement fund, misappropriation of clients' bonds, illegal asset management practice, capital impropriation by shareholders and related parties, higher-than-ceiling ownership of tradable shares in investment business, illegal off-balance sheet operations and other violations were basically solved.

The role of the Securities Investor Protection Fund was put into full play. In 2006, the Fund was actively engaged in disposing of high-risk securities companies, acquiring the individual creditors' rights of the 12 closed securities companies and covering the gap in the clients' transaction and settlement fund. In addition, the Fund raised capital through multiple channels in accordance with the principle of "taking capital from the market and using capital for the market". As a result, the long-term mechanism of risk disposal began to show initial results.

Great progress was made in the restructuring of securities companies. In 2006, plans to restructure Tiantong Securities, Southwest Securities and Xinjiang Securities were finalized and successfully implemented through capital injection, liquidity support and other methods on the platform of China Jianyin Investment Co., Ltd. Meanwhile, market-based restructuring of certain securities companies was completed within the time limit required by the regulatory authority.

Reform of the fundamental institutions pressed ahead on all fronts. Referring to the *Securities Law*, the securities regulatory authority specifically required the entire sector to implement the third-party custodian of clients' securities transaction and settlement fund. As of the end of 2006, 13 companies had implemented the third-party custodian system, and 58 companies reached agreements of cooperation with a number of custodian banks. In May 2006, the exchange bond market put in place a new T-bond repurchase system, which reinforced risk control. Securities companies were urged to report all their proprietary trading accounts and asset management accounts, so as to raise the effectiveness of securities exchanges overseeing the front-line transaction activities of securities companies in real time. In accordance with the *Administrative Measures on Securities Company Risk Control Indicators*, the risk monitoring and pre-warning system centering on net capital was set up to monitor securities companies by quantitative indexes in a dynamic way. The financial reports disclosure system was pushed ahead; as of the end of 2006, 50% securities companies disclosed their audited financial reports.

The classified regulation of securities companies was pursued steadily. In

2006, 5 securities companies and other 16 ones were classified as innovation-type company and compliance-type company respectively. As of the end of 2006, there were 51 innovation-type and compliance-type companies in total, including 20 innovation-type ones that accounted for 52% and 61% of the total net assets and total net profit of the sector respectively (and 19% of the total number of securities companies). 14 innovation-type companies launched 22 collective asset management products and 9 specialized asset management products, and these two types of products managed about RMB 60 billion yuan. 7 innovation-type companies were approved to set up branches in Hong Kong, thus creating favorable conditions for domestic securities companies to conduct cross-border businesses.

Quality of listed companies was steadily improved

Relevant authorities undertook a series of work in 2006 to improve the quality of listed companies, and positive results were achieved.

Deepen the securities issuance system reform and encourage more high-quality companies to get listed. With the deepening of the securities issuance reform, the verification issuance regulatory system took shape relatively. Meanwhile, new initial public offering mechanism of all tradable shares was implemented so as to reinforce market discipline, improve financing efficiency and promote the financing methods and instruments innovation. A large number of well performing companies were successfully listed in the A-share market, having significantly enhanced the structure of listed companies in general.

Improve the M&A and restructuring system of listed companies and optimize the structure of previously listed companies. In 2006, the *Regulations on the Takeover of Listed Companies* and the information disclosure principles were revised to improve the verification system of M&A and restructuring, simplify the verification procedure and promote the innovation with regard to M&A and restructuring. Certain listed companies were merged, acquired, restructured or listed on the entirety through such innovative approaches as acquisition by shares swap, merger and etc. Their asset quality was improved and the structure of the listed companies further optimized.

Reinforce the consolidated regulation of listed companies to urge the big shareholders to pay off the misappropriation capital. The consolidated regulatory system involving multiple parties had taken shape, which strengthened the regulation, achieved a lot in the work of big shareholders of listed companies paying back the misappropriated capital, and was effective to safeguard the interests of listed companies. As of the end of 2006, there were 399 companies that had completed or in the course of capital pay-back, and the capital involved was about RMB 39 billion yuan, the number of listed companies and the sum of misappropriation declined by 93% and 84% respectively compared to these of the end of 2005.

The pricing capacity of institutional investors began to show positive results

With the diversification of institutional investors and the increase of investment volume, the investors' structure in the capital market became more reasonable gradually, and the valuation and pricing capability of the A-share market also improved. In 2006, when ICBC launched IPOs in A-share and H-share markets simultaneously, the price range quoted by domestic institutional investors was very close to the quote of foreign institutional investors, laying a basis for upcoming simultaneous issuance and listing in A-share and H-share markets at the same price.

The legal framework of the securities market was improved continuously

The *Amendment to the Criminal law (VI)* adopted in June 2006 linked to the revisions of the *Company Law* and the *Securities Law*. New clauses were added, especially the clarification of legal liabilities owing to Board members, supervisors, senior management, controlling shareholders and actual controlling parties violating due diligence or the entrustment obligations to "empty" the listed companies, and securities companies and their employees violating the entrustment obligations to misappropriate clients' properties. Criminal punishment against the above activities was intensified. The improvement of the legal framework could better regulate the market and promote the sound development of the capital market.

Soundness Assessment

The soundness assessment of the securities market is done by analyzing a series of indicators reflecting the quality of the market and the development of the market participants. The IMF-recommended soundness indicators focus on microanalysis, using quantitative indicators to measure the market depth, capital adequacy and risk-resistance capability. With reference to the IMF-recommended indicators, indicators were constructed through taking into account the actual situation of China to assess the soundness of the securities sector. The indicators cover the direct financing to indirect financing ratio, the structure of the direct financing market, and the quality of the market operation itself, including types of trading products, investors' structure, market liquidity and volatility, and the healthiness of securities intermediaries.

Direct financing ratio was too low, and there was still room for financing structure improvement

For a long time, indirect financing played a dominant role in financing, leading to a concentration of risks in the banking system. In 2006, this situation remained unchanged remarkably. As of the end of 2006, direct financing scale (including stock, T-bond, policy-related financial bond, common financial bond and corporate bond) only accounted for

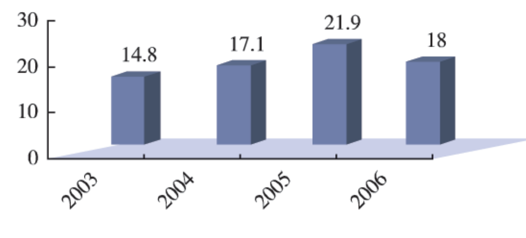
18.0% of the total social financing volume, decreasing by 3.9 percentage points compared to 2005 (Figure 3.2). Such problems as excessively low percentage of direct financing and single financing channel should be addressed, and the financial structure should be improved.

The bond market lagged behind, and should be coordinated with the development of stock market

The coordinated development of the stock market and bond market is conducive to the diversification of financing channels, and easing the adverse impact of economic cyclical fluctuations. The imbalance development between the bond market and the stock market has existed for a long time; in particular the corporate bond based on credit rating of companies develops very slowly. In 2006, proceeds of corporate bond issuance increased steadily to RMB 393.83 billion yuan, up by 92.4% over 2005, accounting for 18.06% of the entire volume, an increase of 4.51 percentage points (Figure 3.3). However, compared to the rapid development of the stock market, the development of the bond market lagged behind by a large margin (Figure 3.4). Therefore, while developing the stock market, the growth of the bond market should be expedited to promote the coordinated development of these two markets.

Figure 3.2 Percentage Changes of Direct Financing

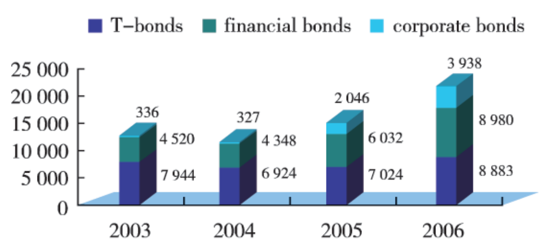
(*percent*)



Source: CSRC.

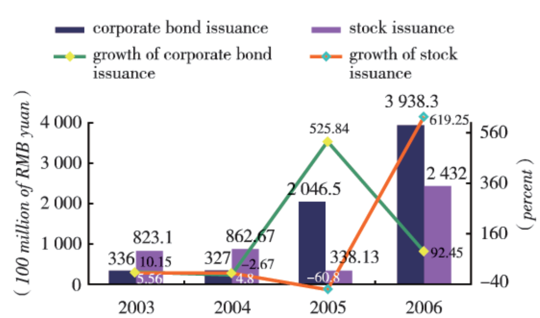
Figure 3.3 Structure of Bond Financing

(*100 million of RMB yuan*)



Source: PBC.

Figure 3.4 Changes of Growth of Stock and Corporate Bond



Source: PBC.

The structure of the stock market took a better shape but needs to be improved

In 2006, the stock market structure was further improved in the following areas: First, big-cap blue chips played a bigger role. The total capitalization of the top 10 companies accounted for 57.17% in 2006, compared to 26.5% in 2005. The increasing share of blue-chip stocks reduced market speculation, strengthened the market stability and improved the overall quality of listed companies. The performance of listed companies in 2006 reached several new highs. The average weighted EPS of 1 254 companies that had publicized their financial reports stood at RMB 0.26 yuan, an increase of 18.18% over 2005. Second, the investors' structure became more optimal. Securities investment funds grew rapidly in scale, and raised RMB 402.8 billion yuan in 2006, close to the total proceeds in the past 8 years. The net assets under management reached RMB 856.5 billion yuan, a growth of 83%. QFII investment increased substantially. There were more insurance funds and social security funds. Besides, enterprise annuity started.

The undesirable structure of the securities sector was still a big problem, so it was an arduous task to improve the market structure. First, monotonous product structure led to homogenous investment behaviors and created unilateral operation of the market. Diversified products would help to create more trading demand so as to improve the pricing efficiency of the market and reduce the trading cost on the part of investors. Second, the investors' structure was still not desirable. The stock market was dominated by individual investors, while institutional investors had only about 30% of the total capitalization. Institutional investors usually hold long and seldom engage in short-term speculative trading, hence conducive to the market stability. Therefore, institutional investors should be further developed, such as securities investment funds, insurance funds, social security funds and enterprise annuity.

Market liquidity improved somewhat and market efficiency had room for improvement

Generally, market liquidity refers to the capability of fast execution of transactions while prices don't fluctuate excessively. It is a measurement of the readiness of transactions and the reasonableness of prices. Poor liquidity not only fuels speculation and manipulation, but also increases price volatility and the trading cost, exerting an adverse impact on the sound development of the securities markets and the international competitiveness. The IMF-recommended FSIs regarding securities market pay special attention to market liquidity, so we choose the indicators of price shock impact, bid-ask spread and market volatility to show the liquidity and soundness of the securities market in China.[1]

The indicator of price shock impact (the measurement of liquidity cost) is defined as the degree of shock impact on the market

1 See the *Report on the Market Quality of Shanghai Stock Exchange 2006*.

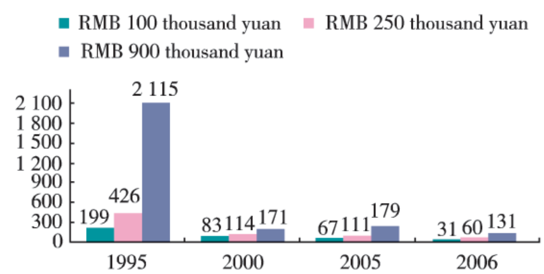
price upon completion of a transaction of certain value or certain amount of shares. The bigger the price shock impact, the higher the trading cost, and the poorer the liquidity. In Figure 3.5, the market price shock indicators of Shanghai Stock Exchange among different groups by value (RMB 100 000 yuan, RMB 250 000 yuan, and RMB 900 000 yuan) in selected years show that in the past 10 years, the liquidity cost reduced dramatically and the liquidity increased continuously. However, compared with liquidity lost of other securities markets in the world, the liquidity cost of Shanghai Stock Exchange far exceeds that of mature markets and certain emerging markets, so the stability had room for improvement.

The bid-ask spread refers to the difference between the best buying price and the best selling price in current market, and is used to measure the exercise cost of potential orders. The smaller the spread, the lower the exercise cost and the better the market liquidity. Figure 3.6 shows that recently the bid-ask spread narrowed substantially and the market stability and efficiency improved step by step.

The market volatility measures the short-term transaction price fluctuation and the capability of the market to restore equilibrium. The less volatility indicates more stability. Figure 3.7 shows recently the market volatility gradually dropped in general.

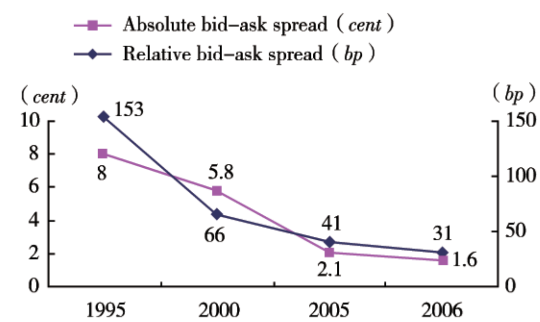
Figure 3.5 Price Shock Impact Indicators of All Shares in Selected Years

(*bp*)



Source: Shanghai Stock Exchange.

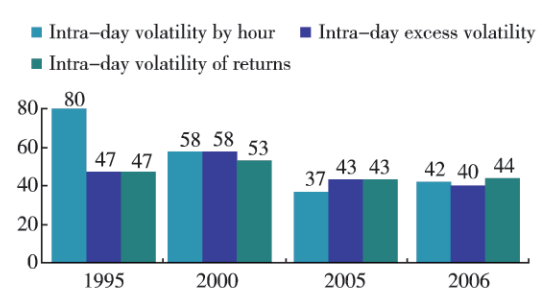
Figure 3.6 Absolute Bid-ask Spread



Source: Shanghai Stock Exchange.

Figure 3.7 Volatility of Selected Years

(*bp*)



Source: Shanghai Stock Exchange.

The legacy problems of securities companies were mostly solved and their soundness was enhanced.

Generally speaking, the brokerage, underwriting and asset management business of securities companies belong to financial intermediate services. In the process of forming savings to investment, securities companies do not undertake risks directly, which is much different from banks and insurance companies. As a result, the financial soundness assessment in most parts of the world does not focus on securities companies. However, due to the short development time for the securities companies and the shortcoming in the system, there existed poor internal control, irregular operations and other problems, such as misappropriation of clients' transaction and settlement fund and clients' securities assets. In the past few years, the risks exploded and spilt over onto other industries and sectors through the misappropriation of clients' transaction and settlement fund and clients' securities assets, influencing the financial and social stability. Due to such problems, in July 2005, the consolidated restructuring of securities companies was started.

In 2006, the consolidated restructuring of securities companies showed initial results. First, misappropriation of clients' securities transaction and settlement fund and clients' securities assets were sorted out and rectified. As of the end of 2006, 92% of securities companies' risk monitoring indicators met the standards, and the legacy problems were basically solved. Second, the fundamental institutions construction made important progress. According to the *Securities Law*, clients' securities transaction and settlement funds across the sector will be kept in the third parties custodian before August 2007, making it possible to terminate the misappropriation risk. Third, the Securities Investor Protection Fund began to take effects. In 2006, the Fund covered the gap in the clients' securities transaction and settlement funds, purchased the individual creditors' rights, and raised capital through multiple channels, so the long-term risk disposal mechanism showed initial effects. As the market-based operational system continues to improve, the adverse impact of securities companies' risks on the market stability will diminish gradually.

Aspects Worth Attention and Reform Measures

The non-tradable state share reform of listed companies, the consolidated restructuring of securities companies and other reform measures have provided good opportunities for the capital market development. However, since the capital market is still at its initial development stage, and the foundation for stable market operation is not yet solid, some measures focusing on solving the systematical and institutional problems should be taken to strengthen the fundamental institutions construction.

Enhance the ratio of direct financing and optimize the social financing structure

In 2006, although the scale of direct financing increased considerably, the ratio of direct financing to total financing was still too low. At present, we should fully capitalize on the benign internal and external environment to take practical measures to increase the direct financing ratio.

First, accelerate the development of the bond market. Improve the mechanism of bond market management, the market-based bond issuance and the bond issuers' self-disciplining. Meanwhile, diversify the bond products and increase the bond financing scale. Second, continue to improve the stock market structure. Expedite the market-based stock issuance management system, improve the quality of listed companies and establish a multi-layer stock market system in line with Chinese characteristics. Third, cultivate institutional investors. Further develop the private and collective asset management of commercial banks, securities companies, fund management companies, insurance companies and other financial institutions, increase the fiscal support to the social security system to make basic pension insurance, enterprise annuity and social security fund as important institutional investors in the capital market. Fourth, increase investors' risk awareness, and improve their ability to identify risks so as to make informed and rational decisions.

Box 5 International Experiences of Bond Market Development Modes

The healthy development of the bond market has important significance for expanding the direct financing channels for enterprises, improving the resources allocation efficiency and maintaining the financial stability. In recent years, especially after the 1997 Asian financial crisis, governments have attached increasing attention to the development of bond market, and have taken measures to expedite the bond market development. Internationally, the bond market varies from country to country, but generally the market has the following features:

First, institutional investors are dominant investors in the bond market. Individual investors only account for no more than 5% in the US, UK and Japan, while the percentage in emerging markets such as Korea is only 10%.

Second, most transactions are in the OTC market. In the US, even though government bonds, municipal bonds and corporate bonds with high credit rating are listed on the exchange, the exchange transactions only account for less than 1% of the total. Besides the US, bond transactions in other main developed bond markets, such as Japan and the UK are almost in the OTC market as well. OTC market is above 95% of the total bond transactions in emerging economies such as Korea.

Third, self-disciplined management has become the major force. US National Association of Securities Dealers (NASD), Bond Market Association (BMA), Japan Securities Dealers Association (JSDA) and Korea Securities Dealers Association (KSDA) are playing a key role in self-disciplined management.

The dominance of institutional investors and OTC market of the bond market suits the nature of bond products. As a fixed-income instrument, bond has relatively more foreseeable future cash flow and fewer risks, but the yield rate is low. As the yield is not obvious for small-amount investment, it is not very attractive to individual investors. On the other hand, broad professional knowledge and investment skills are needed in the bond trading because of the various types of bond products, complicated transaction methods, and sophisticated mathematics and investment techniques required for investment portfolio which limit the investment of individual investors. Therefore, bond investment is more suitable for institutional investors with strong market analytical and risk-resistance capabilities. Because bond products are mainly invested by institutional investors, while most of them make large-scale transactions, the transaction orders are more easily completed in the OTC market at lower transaction cost. So in developed countries, most bond transactions are done in the OTC market, and the exchange is only announcing prices and improving the issuers' credit.

Strengthen the risk management of the stock market and promote its long-term healthy and stable development

Since 2006, the stock market reform has yielded good results, but the market foundation is still weak. Attention should be paid to large stock price fluctuations. The risk management mechanism should be established and improved to further strengthen the fundamental mechanism of the market and promote its long-term healthy and stable development.

First, steadily push forward the building of multi-layer capital market. Make endeavors to develop and launch the SME board while developing the blue-chip market, and improve the market structure and functions. Second, promote products innovation. Prudently introduce stock index futures and other financial derivatives, and fully utilize their market risk management function. Third, strengthen supervision and regulation. Properly coordinated the relationship between supervision and development. More forceful supervision and law enforcement are needed against insider trading, market manipulation and other outstanding violations in order to protect the legitimate rights and interests of small investors. Fourth, prevent large stock price fluctuations. Make more efforts in investor education, develop institutional investors, and improve the market pricing capability and self-adjustment mechanism.

Box 6 Stock Index Futures

Stock index futures are standardized futures contracts with stock index as the underlying assets. Each contract is to buy or sell a fixed value of the index in certain period of time. Upon maturity, the contracts are settled on cash basis. Research deems that there is a lead-lag relationship between the stock index futures price and the spot price, so the launch of stock index futures is good for the realization of the price-finding function, and will influence the spot market through the arbitrage mechanism between the futures market and the spot market.

Since the first stock index futures was introduced in US in 1982, the influence of the stock index futures on the spot market has gained a lot of attention. Comparison of the stock indices fluctuation before and after the launch of the stock index futures shows that in most cases the fluctuation remains unchanged or reduced (C. Sutcliffe, 1997). As for increased fluctuation, some scholars hold that the rapid information flow is the reason. The introduction of stock index futures increases the diffusion and quality of information flow into the stock spot market.

International experiences show that the launch of stock index futures requires certain conditions, including a relatively mature capital market, sound market mechanism, adequate information disclosure and improved regulatory system. So the relevant supporting measures should be improved to prudently launch the stock index futures: First, expedite cultivation of institutional investors. Only when there are sufficient players equipped with basic professional knowledge and techniques, will the market be high liquidity and low trading cost. Second, extend the investors' education on financial futures. Urge intermediaries to fully disclose the risks concerning financial futures to help investors to get to know the features of these products. Third, strengthen the coordination among financial regulators according to the feature of financial futures. Establish and improve the risk monitoring, information sharing and supervisory coordination mechanism to prevent cross-sector and cross-market risks. Fourth, strengthen the regulation over futures companies and futures exchanges. Improve the fundamental institutions such as deposit of margins to prevent malicious overdraft, misappropriation of clients' transaction and settlement fund and other major risks from impacting the stable operation of the stock index futures.

Improve the fundamental institutional arrangements in securities companies to improve their sustainability

The overall risks of securities companies were primarily solved through the consolidated restructuring, and their operations improved. But the operation sustainability needs further strengthening, and the third-party custodian of clients' transaction and settlement fund and other fundamental institutional arrangements should be further exercised. As the new *Accounting Standards for Business Enterprises* comes into effect, more attention should be paid to its important influence on financial accounting and risk management modes in securities companies.

First, develop a sustainable business mode for securities companies. At present, securities companies rely heavily on traditional businesses for their profits, while innovative businesses take a small share. The next step will be to encourage eligible securities companies to participate the innovative business, such as stock index futures, margin financing and securities lending, on the precondition of risk control, to establish a sustainable and viable profit-making mode centering on the seller-side business. Second, encourage securities companies to participate in the capital market through various channels. As important intermediary in the capital market, securities companies shall develop themselves by leveraging on the capital market. Qualified securities companies shall be encouraged to enter the capital market through IPOs, restructuring and M&A to improve their competitiveness. Third, further implement the third-party custodian of clients' securities transaction and settlement fund. Fourth, improve the market exit mechanism. Improve the risk monitoring and pre-warning system based on net capital, and conduct risk disposal of securities companies that don't conform to regulatory requirements and cannot be rectified within specified time limit.

Reinforce the complementarities, coordination and interaction between the Mainland and Hong Kong markets to improve the overall international competitiveness

The end of the transitional period after the WTO accession signifies that the opening-up has entered a new era. The new circumstances make it necessary to further develop the complementarities, coordination and interaction between the mainland and Hong Kong markets, in order to enhance the overall international competitiveness of our securities markets, consolidate and enhance Hong Kong's status as the international financial center.

In 2006, ICBC successfully executed A-share and H-share IPOs simultaneously. This opportunity should be taken to establish and improve the coordination mechanism between the A-share and H-share markets and support mainland enterprises and individuals to fully leverage on the two markets for resources allocation optimization. Research on how to facilitate qualified institutional investors to make cross-border investment should be carried out in next step; to steadily pursue the QDII pilot programs for fund management companies and securities companies; and to strengthen the product innovation to support the H-share and red-chip shares companies listed in the A-share market.

Box 7 ICBC's A + H Share Offering

On 27 October, 2007, ICBC got listed simultaneously on the A-share and H-share markets. The concurrent same-price A + H share offering solved the institutional and technical problems of dual listings in a creative way, and had deep influence on the coordination of the two markets, market innovation and the overall international competitiveness of the capital market of China.

First, it promoted the coordination of the mainland market with the Hong Kong market. Through the cooperation of relevant authorities in mainland and Hong Kong, the A + H share offering of ICBC realized simultaneous road-show, simultaneous price inquiry, simultaneous pricing, simultaneous issuance and listing.

Second, it promoted market innovation. In the IPO course, ICBC introduced ("Green shoe") analysts meetings and other internationally accepted arrangements for the first time in mainland market, which are beneficial for narrowing the price gap between the primary market and the secondary market, and reducing the short-term market risks for investors. In addition, the pre-disclosure mechanism was used for the first time in the Hong Kong market to guarantee equitable information disclosure in the two markets.

Third, it provided mainland investors with a good investment opportunity, and greatly supported the healthy development of the mainland capital market. The concurrent A + H dual listing set a good example of listing for Chinese enterprises in particular big-cap blue-chip enterprises; provided mainland investors with a good investment opportunity; and better balanced the market stability and development. The IPO scheme could attract more big-cap blue-chip shares to get listed in the mainland capital market, so as to improve the overall quality of listed companies, make the mainland market more attractive, enlarge the A-share market capitalization, enhance the market liquidity and improve the market quality.

Fourth, it enhanced the A-share market's pricing capability and its international influence. The A + H dual listing can not only display the information advantage enjoyed by the mainland investors, but also capitalize on the pricing experiences of international institutional investors, which is helpful to improve investors' investment concepts and stimulate the A-share market to grow to its maturity.

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