



# **Chapter III**

## ***Securities Sector and the Capital Market***

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In 2007, the capital market reform continued, the quality of listed companies was steadily improved, and the strength of securities and futures companies was notably improved. The institutional building of market infrastructure was further enhanced, the market scale was rapidly expanded, the market function was further strengthened, and the capital market was playing a more important role in national economy.

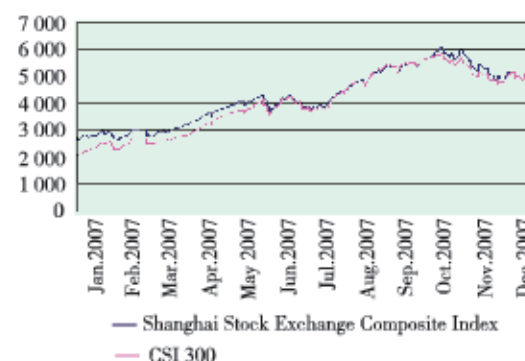
## Recent Developments

**The market further expanded, with its role further strengthened.** As of the end of 2007, there were 1550 listed companies on Shanghai and Shenzhen Stock Exchanges, 116 more than the previous year. The total capitalization was about RMB 32.71 trillion yuan, an increase of 265.91% y-o-y; the flotation of tradable shares stood at RMB 9.31 trillion yuan, an increase of 272.2% y-o-y. The A-share market further improved its function of financing, and raised a total of RMB 772.8 billion yuan in 2007, up by 217.8% y-o-y, among which IPOs raised a total of RMB 459.5 billion yuan, a large increase over the previous year. New issue of corporate bonds totaled RMB 518.1 billion yuan (including enterprise bonds, bonds issued by listed companies and short-term financing bills), an increase of 31.6% y-o-y.

**The stock market maintained a large upward trend in general, with securities and futures trading actively.** In 2007,

Shanghai Stock Exchange Composite Index was 6124.04 points at its peak and closed at 5261.56 points at the end of year, up by 2586.09 points, or 96.66% over the year beginning. CSI 300 Index was 5891.72 points at its peak, and closed at 5338.28 points at the end of the year, up by 2297.23 points, or 161.55% over the year beginning (Figure 3.1). The total trading volume on Shanghai and Shenzhen Stock Exchanges registered RMB 46.01 trillion yuan in 2007, with a daily turnover averaging RMB 190.312 billion yuan, up by 409.08% y-o-y and 406.97% y-o-y respectively. The futures market traded briskly, with total transaction of 728 million lots in 2007, up by 62.06% y-o-y, and trading volume of RMB 40.97 trillion yuan, up by 95.06% y-o-y. The inter-bank bond market continued the momentum of rapid development, with a turnover totaling RMB 15.6 trillion yuan, an increase of 52.05% y-o-y.

**Figure 3.1 Trends of Shanghai Stock Exchange Composite Index and CSI 300 Index in 2007 (Based on the Closing Prices)**



Source: CSRC.

**The strength of securities and futures companies was notably enhanced, and their sustainability was upgraded.** As of the end of 2007, net assets of 106 securities companies registered about RMB 340 billion yuan, and the total assets amounted to RMB 1.7 trillion yuan, up by RMB 1.1 trillion yuan, or 177.3% y-o-y. Net profits of the industry totaled RMB 132 billion yuan, hitting a historic high. 59 fund management companies managed a total of 346 funds, with a net value of RMB 3.28 trillion yuan, up by RMB 2.46 trillion yuan, or 300% y-o-y. The financial condition and risk-proof capacity of 91 futures companies was greatly improved after capital replenishment.

**The number of market participants increased rapidly, and the dominant role of institutional investors was further strengthened.** In 2007, investors actively entered the market, and the new accounts witnessed a rapid growth. As of the end of 2007, there was a total of 138 million accounts on Shanghai and Shenzhen Stock Exchanges, among which there were 110 million accounts on the A-share market, 38.05 million more than that at the beginning of the year, up by 50.85%. The number of institutional investors was further expanded, with their share holding percentage being 46%, up by 27 percentage points from that in 2004, initially changing the dominant role of retail investors that had lasted for a long time, and further enhancing the dominant role of institutional investors in the market.

**The supervision on the securities indus-**

**try was enhanced, and the market operation was further standardized.** In order to adapt to the new development in the capital market, the law enforcement system on securities was reformed. The chief enforcement office and investigation team of the CSRC were established to set up a centralized investigation system to improve investigation. In response to the new trend in securities irregularities, and in order to strengthen cracking down on illegal activities, the CSRC earnestly dealt with a series of big cases such as Zhejiang Hangxiao Steel Structure Co., Ltd, and safeguarded the normal order of the securities market; comprehensively carried out a net capital-based risk supervision system on securities companies, and urged securities companies to sort out historic problems. As of the end of 2007, all risk control indicators of securities companies reached the required standards. The third-party custodian system of clients' securities transaction and settlement fund was put in practice across the industry, and the standardized operation of the securities industry was further improved.

## Reform and Achievements

In 2007, the institutional building of the capital market made new progress, and the profitability of the securities industry improved noticeably. The quality of listed companies was steadily improved, the opening-up of the industry was deepened, and the capital market faced new opportunities.

### *The Comprehensive Restructuring of Securities Companies Was Basically Completed*

In 2007, the comprehensive restructuring of securities companies achieved its goal. The securities companies' risks left over from the past were basically resolved and the infrastructure of the securities market was improved.

First, risk handling of securities companies was initially completed. During the risk handling of securities companies, 31 high-risk securities companies were handled in cumulative terms, among which 28 securities companies were resolved by administrative measures, 2 securities companies by market-based method, and 1 securities company by means of bankruptcy and restructuring. As of the end of 2007, among 28 securities companies that were resolved by administrative methods, the proportion of recovery of the clients' transaction and settlement fund and purchase of the individual creditors' rights reached more than 90%. And among 23 securities companies that had entered into the process of bankruptcy and liquidation, 3 securities companies have applied for bankruptcy to local courts.

Second, noticeable progress was made in the restructuring of securities companies. The restructuring of securities companies was an important part of comprehensive reform of securities companies. Since June 2005, PBC, jointly with other concerning authorities, had used Huijin Company and China Jianyin Investment Co., Ltd as the restructuring platform, and in response to the actual situation of different securities companies and restructuring

models, taken a series of measures, such as capital replenishment, liquidity injection, and introducing strategic investors, to restructure 9 securities companies including Yinhe Securities Company. By the end of 2007, the restructuring of 9 securities companies that PBC took the main charge of had been completed with a noticeable achievement. The aforementioned measures resolved the risks of securities companies effectively, uplifted the confidence of investors, maintained the stability of securities market, and strengthened the comprehensive strength of the restructured securities companies through consolidation. In the meantime, the value of state-owned assets had been maintained and increased. Additionally, some securities companies that were restructured by market-based means also achieved good results within the pre-determined schedule prescribed by regulatory authorities.

Third, building of fundamental institution of the securities industry was pushed ahead on a comprehensive basis. According to the requirement of the *Securities Law*, the third-party custodian system for clients' transaction and settlement fund was implemented across the securities industry in August 2007. As of the end of 2007, 97% of qualified fund accounts were verified. The standardized work of securities accounts had achieved initial achievements, and more than 20 million dormant securities transaction and settlement accounts were put in different vaults. The disclosure of information and financial reports was carried out on a comprehensive basis, and all securities companies should compulsively disclose their audited financial reports.



### *The Operations of Listed Companies Were Further Strengthened*

In 2007, in order to adapt to the market development after the reform of non-tradable shares, authorities further strengthened the fundamental institutional building of listed companies and achieved positive results.

First, enterprises of quality were encouraged to be listed on the A-share market. Efforts were made to encourage enterprises of quality to be listed on the A-share market, and attract companies listed on the H-share market to be re-listed on the A-share market, so as to boost the rapid development of the A-share market.

Second, support was given to listed companies to realize optimized structure through acquisition and merging. With the further improvement of acquisition and merging and restructuring of listed companies, 266 listed companies completed group listing and sector consolidation through acquisition and merging. Nearly RMB 80 billion yuan of assets was injected into listed companies, the total capitalization of listed companies was increased by about RMB 800 billion yuan, and the stock structure of listed companies was optimized noticeably.

Third, the rule on information disclosure of listed companies was promulgated. In response to the new development of irregularities against the background of listing of non-tradable shares, in February 2007 the *Administrative Rule on Information Disclosure of Listed Companies* was promulgated, which further

strengthened the responsibility of listed companies and relevant parties in terms of information disclosure, initially established a prompt reaction mechanism between the information disclosure of listed companies and market supervision, and further improved the quality of information disclosure of listed companies and effectiveness of supervision.

Fourth, efforts were made to improve corporate governance of listed companies. Efforts were made to carry out the specific work of strengthening corporate governance of listed companies, strive to resolve issues including lack of independence of listed companies and operation irregularities of shareholder meeting, board of directors, and board of supervisors, which helped listed companies standardize their operation and improve internal governance. Since state-owned holding companies and financial listed companies had their own characteristics, the securities regulatory authority and relevant departments set up an institutionalized coordinated supervision mechanism, so as to improve the consolidated supervision system of listed companies.

### *The Construction of Multi-layered Capital Market Achieved Positive Progress*

In 2007, the construction of multi-layered capital market achieved progress in the following aspects:

First, the small and medium-sized enterprise board started to play an important role. With the rapid development of main board on Shanghai and Shenzhen Stock Exchanges, the small and medium-sized enterprise board on

Shenzhen Stock Exchange also took initial form and operated soundly. As of the end of 2007, 100 listed companies were added to the small and medium-sized enterprise board, totaling 202 listed companies, and the small and medium-sized enterprise board became the main financing channel for small and medium-sized enterprises.

Second, the construction of corporate bond market made breakthrough. In August 2007, the *Pilot Rules on the Issuance of Corporate Bonds* was promulgated and implemented. Issuance of bonds by listed companies was activated. By the end of 2007, 3 listed companies including China Yangtze Power Co., Ltd had successfully issued a total of RMB 11.2 billion yuan of corporate bonds.

Third, the overall plan of growth enterprise market was approved. Accelerating the building of growth enterprise market and rendering full support to innovation of enterprises are an important part of the implementation of innovative strategy on an initiative basis in the capital market stipulated by the state. In August 2007, the overall plan of growth enterprise market building was approved. For the time being, IPO on the growth enterprise market, transaction and settlement, and market supervision were basically put in place, which laid a solid foundation for the launch of the growth enterprise market in a steady and timely manner.

#### *The Legal Framework of the Securities Market Was Further Improved*

In 2007, the building of accessory legal sys-

tem of the *Securities Law* and the *Company Law* was further strengthened. The *Administrative Rules on Supervision of Listed Companies* publicly solicited the opinions of the society and the amended *Regulations for the Administration of Futures Trading* was promulgated. With the promulgation and amendment of relevant regulations, the regulatory authority released a series of rules and regulations in succession, such as the *Administrative Rules on Information Disclosure of Listed Companies*, further improving the regulatory legal system of the securities market, strengthening the foundation of standardized operation of the securities market, and pushing ahead the healthy development of the capital market.

#### *The Securities Market Was Further Opening Up to the Outside World*

In terms of “going out”, efforts were made to steadily promote the pilot QDII scheme. By the end of 2007, 5 securities companies, 15 funds management companies had been qualified for QDII, and 5 QDII products had raised a total of RMB 107.5 billion yuan cumulatively. 8 securities companies, 6 futures companies had been approved to set up branches in Hong Kong, which created conditions for securities companies to conduct cross-border business. In terms of “introducing foreign investment”, the rule for establishment of securities companies with foreign equity participation was amended and released, and it was announced that the examination and approval of joint venture securities companies was resumed and the business scope of joint venture securi-

ties companies was expanded gradually, and the investment quotas of QFII were increased. The rules on administration of representative office of foreign stock exchanges in China was promulgated and released, and 4 foreign stock exchanges were approved to set up representative offices in China.

## Soundness Assessment

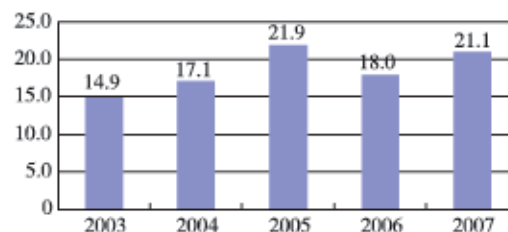
In 2007, the capital market played a better role in fundraising, with an improved financing structure of the society and increased liquidity on the stock market. However, since the structural problem was yet to be resolved, the stability and pricing efficiency of the market needed improvement, and the education work of investment risk warranted urgent attention.

### *The Proportion of Direct Financing Was Increased Somewhat, and There Was Still Room for Improvement in terms of Financing Structure*

In 2007, direct financing increased rapidly, reaching a historic high. By the end of 2007, outstanding direct financing (including stock, T-bond, corporate bond) had amounted to RMB 1.24 trillion yuan, accounting for 21.1% of social financing scale, up by 5.9 percentage points over the previous year (Figure 3.2). The financing role of the capital market was strengthened, and the financing structure was optimized somewhat.

**Figure 3.2 Percentage of Direct Financing**

(percent)



Source: PBC.

Although the development of the capital market contributed to the increase of the proportion of direct financing, the dominant role of indirect financing in total financing had not been changed. The proportion of direct financing was still too low, and the situation that enterprises highly relied on bank loans had not been resolved, which was not conducive to broadening the channels of transforming savings into investments, and to some extent, contributed to the concentration of risks in the banking system. Therefore, great efforts should be made to develop direct financing, increase the proportion of direct financing, and optimize the financing structure.

### *The Bond Market Took Its Initial Shape, and the Development of Corporation Bond Market Needs to Be Accelerated*

In 2007 the bond market continued its momentum of rapid development. Excluding the issuance of RMB 1.55 trillion yuan of special



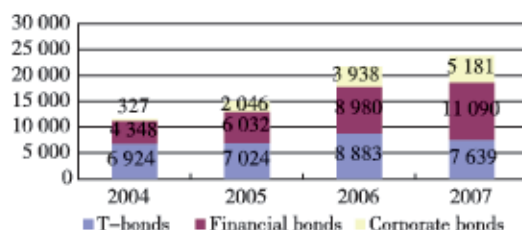
government bonds, the financing scale of the bond market amounted to nearly RMB 2.38 trillion yuan, an increase of 9.11% over the previous year (Figure 3.3). Among the bond market, the issuance of corporate bonds increased rapidly. In particular, the activation of pilot program of issuance of bonds by listed companies enriched the varieties of corporate bonds. In 2007, the outstanding amount of corporate bonds reached RMB 518.1 billion yuan, an increase of RMB 124.3 billion yuan over the previous year, or 31.6%, among which the issuance of enterprise bonds amounted to RMB 172 billion yuan, an increase of 73% over the previous year; the issuance of short-term financing bills amounted to RMB 334.9 billion yuan, an increase of 14.7% over the previous year; and the bond issuance by listed companies amounted to RMB 11.2 billion yuan.

However, compared with the rapid growth of the stock market, the corporate bond market existed great potential for further development. The development of the bond market, the corporate bond market in particular, would not only be good to expand the scale of China's capital market and broaden the investment channels of investors, but also be of great significance to the structural optimization of direct financing market and the diversification and resolving of financial risks. Therefore, great efforts should be made to develop the bond market and expedite the coordinated development of the stock market and the bond market.

#### *The Structure of the Stock Market Needed to Be Improved, and Attention Should Be Paid to Potential Risks*

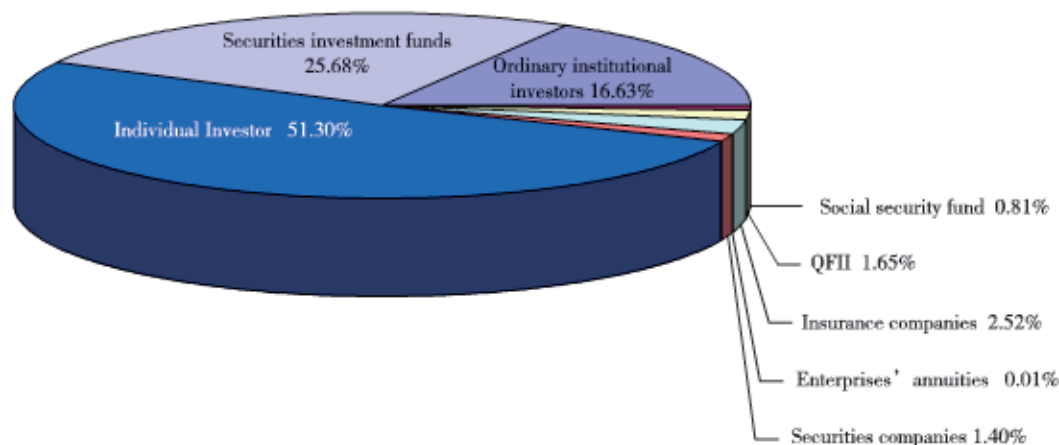
In 2007, the structure of the stock market was further improved in the following areas: First, the structure of listed companies was improved noticeably. As of the end of 2007, the market capitalization of 100 largest large-cap stocks including China Petro Co. and ICBC accounted for 71% of total market capitalization on two stock exchanges. The dominant role of blue chips took initial form, and some listed companies that had large scale and high profitability became the main force of the capital market. Second, the structure of investors was further optimized. By the end of 2007, the proportion of institutional investors of the stock market had accounted for 46% of the total market capitalization, initially changing the dominant role of retail investors in the stock market.

**Figure 3.3 Structure of Bond Financing**  
(100 million of RMB yuan)



Source: PBC, CSRC.

Figure 3.4 Market Shares of Investors on the Stock Market



Source: CSRC.

The structure of institutional investors needed to be optimized further. By the end of 2007, the market capitalization held by securities investment funds had accounted for 25.7% of the total capitalization, or 55% of the capitalization held by institutional investors, whereas insurance companies and social security funds only had accounted for a total of 6.4%. Among the securities investment funds, open-ended funds had accounted for 80% of the stock market capitalization held by securities investment funds. Once the open-ended funds are redeemed in large scale, the liquidity risks of funds will transform into market risks, which will elevate market fluctuation.

#### *The Turnover Ratio Increased Rapidly, While Pricing Efficiency Had Room for Improvement*

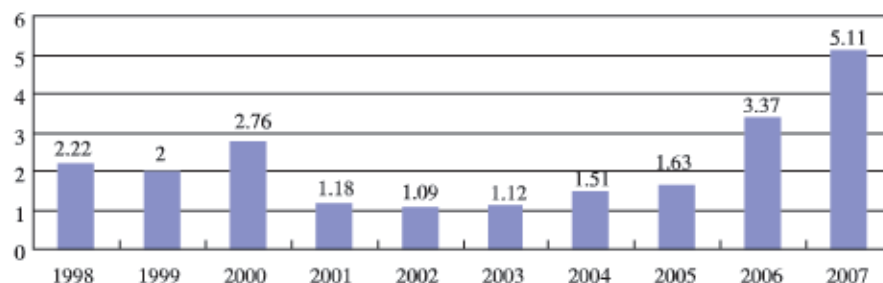
Liquidity is an important indicator of stability in the stock market. The average daily turnover ratio is employed to measure the liquidity level of China's stock market. From 1998 to

2007, the average daily turnover ratio increased rapidly (Figure 3.5), from 3.37% in 2006 to 5.11% in 2007.

The trend of annual daily turnover ratio reflected the increase of the A-share market liquidity in 2007, however, the higher turnover ratio also reflected too frequent transaction of the stock market to some extent, and would have the probability of ensuing market speculation. Combined with the evaluation of A-share market, on the last trading day of 2007, the overall price-to-earning ratio was 38.58 times, much higher than the average 20 times of other mature markets at the same time. Furthermore, there was apparent price difference between the prices of the same listed company on the A-share market and the H-share market. At the end of 2007, the arithmetic average price ratio of the A-share market to the H-share market was 2.52 times. The high price of A-share market had some bearings on the

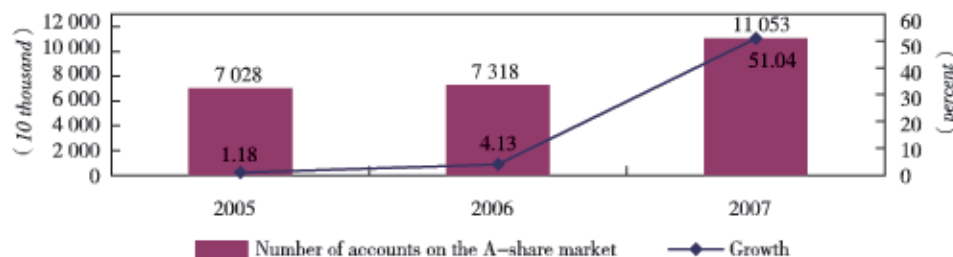
Figure 3.5 Average Daily Turnover Ratio During 1998 – 2007

(percent)



Source: Wind Database.

Figure 3.6 The Number of Accounts on the A-share Market and Its Change During 2005 – 2007



Source: CSCC.

high daily average turnover ratio. The relatively high daily average turnover ratio, to some extent, contributed to the irrational price of the A-share market, and the pricing efficiency of the A-share market needed to be further improved.

*The Proportion of Small and Medium-sized Investors Was Relatively High, and the Risk to People's Livelihood Warranted Attention*

In 2007, the number of investors, small and

medium-sized investors in particular, increased rapidly. According to statistics, among the 110.53 million accounts of the A-share market, there were 37.35 million new accounts opened in 2007, representing a growth of 51.04% over 2006. The proportion of newcomers reached a proportion as high as 34%.

According to a typical survey done by relevant departments, recently, individual investors mainly concentrated on the investor with low and medium income. For example, the pro-

portion of investors whose monthly income was less than RMB 5,000 yuan reached 68.6%. In terms of the amount of funds put into the stock market, individual investors with less than RMB 100,000 yuan accounted for 25.1% of the total, and investors with fund between RMB 100,000 yuan and RMB 300,000 yuan accounted for 25.7%. About 70% of individual investors put more than 33% of their total household financial assets (including banking deposits, bonds, stocks and mutual funds) into the stock market, and among which 13.4% of investors put all household financial assets into the stock market. Some individual investors had weak sense of risk and low capability of assuming risks. Some individual investors even put most of savings (including pension) into the stock market, or got financing through the mortgage loans. Once the stock market fluctuated rapidly, these investors would not bear the investment risks. The investment behavior and proceeds of small and medium-sized investors concerned people's livelihood, and had a direct impact on social stability, which warranted attention.

## Issues Worth Attention and Reform Measures

China's capital market has played an increasingly important role in the national economy. However, some internal and external factors hindering capital market development still ex-

ist. The self-regulating mechanism of risk prevention and resolution has not been fully established, and the foundation for sustainable and stable market operation is not yet solid.

### *Strengthen Market Infrastructure and Improve Market Supervision*

After the reform of non-tradable state share of listed companies, the reform and development of China's capital market entered into a new stage. The scale and amount of the capital market increased many folds, and the behavior mode of market participants was witnessing new changes. With the further development of the market, some illegal and irregular activities became more complicated and disguised. Illegal and irregular activities were the source of investment risks, which not only damage the interests of small and medium-sized investors, but also hinder the sustainable development of listed companies and the healthy operation of the securities market.

Therefore, with the improvement of the quality of listed companies and promotion of multi-layered system building of the capital market, efforts should be made to strengthen market supervision and punish illegal and irregular activities. Measures should be taken to prevent frequent reoccurrence of frauds on the securities market, strengthen continuous supervision on inside trading and stock price manipulation, and severely punish irregular and illegal activities, so as to ensure the healthy and stable development of the securities market.



### Box 3 International Comparison of Stock Issuance Systems

Stock issuance system is one of fundamental systems of the capital market, covering a series of standard procedures and requirements in issuing stocks, mainly consisting of stock issuance examination system, stock issuance pricing system, and information disclosure system.

In terms of stock issuance examination system, there are big differences across countries. In general, the stock issuance examination system can be classified into registration system represented by the US and approval system represented by France. In countries that carry out the registration system, the regulatory authority will not only determine whether the issuers are qualified for mandatory conditions of issuance, but also check the authenticity and inclusiveness of materials and files submitted by the issuers. However, the regulatory authority will not make judgment on the behavior of issuing securities and the value of securities. On the other hand, in countries that carry out the approval system, the regulatory authority will not only check the properness of submitted materials, but also make value judgment on securities to be issued according to some conditions.

Generally, compared with the approval system, the registration system is more efficient, and can put the role of market in allocating resources into full play. If the information disclosure complies with the requirements, stock issuance can be arranged

by the issuer, and investors can take factors such as cost, risk and expected return into full consideration so as to make an investment decision. Since the registration system cut the room for discretion and improper intervention by the regulatory authority, it can better reflect fairness. For stock issued under the registration system, it is up to investors to judge its investment value, which entails greater demand on the quality of investors, relevant legal system, and market standardization. On the other hand, the approval system can prevent some highly risky companies with poor performance from entering into the stock issuance market to some extent. However, evaluating different companies according to the same standard will not only influence the fairness of stock issuance, but also decrease the efficiency of resource allocation, due to some rigid standard and condition. Furthermore, the issuance approval system may help investors form a dependent psychology, which may not be conducive to the improvement of their risk sense.

In terms of stock issuance pricing mechanism and information disclosure system, the situation is basically the same across countries. The issuance pricing mechanism is mainly market-based, while taking consideration of the role of institutional investors. And the information disclosure abides by the principle of completeness, accuracy, and timely disclosure.

Generally speaking, whether there is any difference among specific operations, a particular issuing system depends on the specific market environment and other supporting system, aimed at clarifying the right, re-

sponsibility, interest of market subjects, through institutional constraints and incentives, so as to improve the efficiency of resource allocation and protect the legitimate rights of investors.

### *Promote the Institutional Building of Multi-layered Capital Market and Optimize the Market Structure*

According to international experiences, a mature capital market system composes exchange market and over-the-counter (OTC) market. The exchange market includes not only the main board market and the growth enterprise market, but also the platform for large-sum transaction and transfer of non-tradable shares. All sorts of capital markets depend on and get connected with each other, so as to promote the continuous transfer of savings into investment and spur sustainable economic growth. Compared with mature markets, China's bond market is relatively small, and the stock exchange market only composes Shanghai and Shenzhen main boards, and the SME board is still in its initial stage with small scale and narrow coverage of industries. The growth enterprise market has not yet been established, and there are few OTC markets. The system of transferring shares on an agent basis needs to be further improved.

For the time being, great efforts should be made to develop the capital market, especially to build a multi-layered capital market in line with economic development to promote the

deepening and widening of market economy. Measures should be taken to cultivate the blue chip market of Shanghai and Shenzhen Stock Exchanges, vigorously develop the SME market, timely launch growth enterprise market, and steadily promote the building of OTC market, so as to perfect market structure and functions.

### *Strengthen Financial Product Innovation and Provide Multiple Investment Channels*

Currently, China's capital market still has some problems, such as few investment channels, limited variety of investment products, lack of financial innovation, and etc. Against the backdrop of single financial product, homogenous investment behavior, and especially the relative excess liquidity, the asset price is prone to large fluctuation.

Therefore, efforts should be made to strengthen financial product innovation, which include paying attention to the development of equity and fixed-income products, steadily developing risk-transfer products such as standby warrants and stock index futures, and facilitating the building of the bond market (corporate bond market in particular), so as to perfect financial product structure, and strengthen the stability of the capital market.

### *Optimize the Profit Structure of Listed Companies and Maintain Their Sustainable Development*

In 2007, the overall profitability of listed companies showed a rapid upward trend. However, from the point of profit structure, investment proceeds and the profit from the fair value change which was a new item after the new *Accounting Standard for Business Enterprises* implemented were important factors behind the rapid increase of profits of listed companies. According to statistics, as of the end of 2007, the net proceeds from fair value change and investment accounted for 28% of profits of listed companies.<sup>1</sup> In the second market, some listed companies that profited from equity investment but had no sustainability of profits were amplified by the market.

The profitability that can promote the strength of listed company is the foundation for healthy development of the market. First, put the role of market into full play in allocating resources so as to improve the quality of listed companies. Efforts should be made to encourage and attract the listings of large quality firms and high-growth enterprises so as to optimize the overall structure of listed companies. Second, perfect internal check and balance mechanism of listed companies and improve the standardized operation of listed companies. Efforts should be made to encourage listed companies to improve their core competitiveness through technology innovation, cost reduction and management improvement. Third, rationally

analyze components of listed companies' performance and promote the concept of value-oriented investment. Efforts should be made to signal investment risks and protect the legitimate rights of the investors. Fourth, further improve supervision on listed companies and improve the transparency of listed companies. Efforts should be made to promote the building of self-disciplinary organizations and gradually form an all-round complementary supervisory system including administrative supervision, legal supervision, self-supervision and social supervision.

### *Pay Attention to Price Fluctuation on the Stock Market and Ensure the Soundness of the Financial System*

In 2007, the amount of IPOs reached historic high. In the second market, the stock index continued to rise with huge fluctuations. Under this situation, efforts should be made to prevent the risk accumulation of the stock market. As international experience indicates, large stock price fluctuation will have negative impact on economic operation and properties of residents.

Close attention should be paid to market development, and comprehensive measures should be taken to avoid large fluctuations of the stock market. First, improve the system of stock market operation, steadily expand market scale, and develop financial derivative products including stock index futures. Second, perfect corporate governance and information disclosure system, so as to help listed

<sup>1</sup> According to consolidated annual data of listed companies by Wind Database.

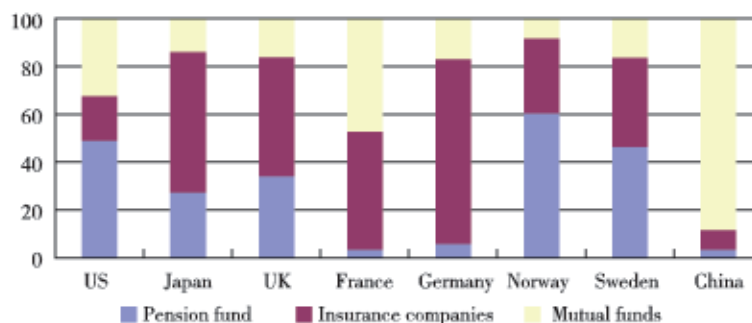
companies to continuously improve their quality. Third, develop multi-layered capital market and launch the growth enterprise market at an appropriate time. Fourth, further develop institutional investors and broaden the channel of long-term funds entering into the market. Fifth, strike irregular and illegal activities such as inside trading and market manipulation, prevent irregular funds from entering into the stock market, and establish an open, fair and equitable market order. Sixth, take fiscal, taxation, and financial policy measures on a timely basis to effectively regulate market demand and supply.

*Optimize the Structure of Institutional Investors and Cultivate the Concept of Value Investment*

With the increase of institutional investors, currently the behavior of institutional investors

has an increasing influence on the securities market, however, as securities investment funds held by institutional investors account for a large proportion, the structure of institutional investors needs to be optimized. By the end of 2007, the market capitalization of stocks held by securities investment funds had accounted for 25.7% of the total market capitalization, or 55% of market capitalization of stocks held by institutional investors, while the market capitalization of stocks held by insurance companies and social security funds had accounted for merely 6.4% of the total, in striking contrast to other mature markets (figure 3.7). The relatively high proportion of securities investment funds will exacerbate the “herd effect” of institutional investors, which is not conducive to market stability.

**Figure 3.7 Comparison of Institutional Investor Structures Across Major Economies**  
(percent)



Source: US SIA, Wind Database.



The following measures should be taken to optimize the structure of institutional investors; first, efforts should be made to further develop securities investment funds, and meanwhile develop institutional investors with source of long-term funds, such as social security funds, insurance companies and enterprise annuities, so as to form different investment style and expertise and promote the coordina-

ted development of different types of institutional investors. Second, efforts should be made to improve risk management capability of open-ended investment funds, perfect internal governance structure of fund management companies, build and perfect compliance and risk management mechanism, and improve risk identification and risk-handling capability through properly allocating asset.

#### **Box 4 The Relationship between Securities Investment Fund and Stock Market Fluctuation**

Since 1980s mutual fund has been playing an increasingly important role on the stock market, and the relationship between the flow of mutual fund and the stability of the stock market received wide attention. Research shows that the flow of mutual fund can influence stock market price, while the performance of the stock market can also influence the flow of mutual fund. The feedback trading theory proposed by Warther (1995) indicates that, the flow of mutual fund and price fluctuation of the stock market can form a relationship of a positive feedback mechanism, i. e. , the net redemption of mutual funds can result in price reduction of stocks, while the decrease of stock price can result in further increase of redemption of mutual funds. Such repetition makes the market plunge into vicious cycle, creating shock to the stability of the stock market.

In recent years, with the rapid growth of institutional investors, securities investment fund, open-ended fund in particular, became the largest institutional investor on China's stock market, and its behavior had an increasing impact on the stock market. By the end of 2007, the market capitalization of stocks held by securities funds had accounted for 25.7% of total market capitalization, or more than half of capitalization of stocks held by institutional investors, while other parts such as insurance fund and social security fund had accounted for only 6.4% of the total. Among the securities investment fund, open-ended investment fund had accounted for 80% of the total capitalization. The structure of institutional investors contrasted sharply with the pattern of coordinated development of pension fund, insurance fund and mutual fund in mature markets.

The operation and investment of open-ended fund is affected by investment preference and behavior of mutual fund holders to a large degree. In China, most of mutual fund holders are individual newcomers on the stock market, and their short-term behavior influences the investment mode of open-ended fund, which may affect the investment behavior of mutual fund managers, and influence the stability of the stock market.

In order to promote the long-term, healthy and stable development of the mutual funds industry and avoid the boom-and-bustle of the stock market, some experts have put forward the following suggestions: first, promote the diverse development of institutional investors. Aside from further developing securities investment funds, great efforts should be made to develop institutional

investors with long-term fund sources such as social security funds, insurance funds and enterprise annuities, so as to form different investment style and expertise and promote the coordinated development of different institutional investors. Second, strengthen the education of investors. Efforts should be made to let investors fully understand the necessity and importance of long-term investment of mutual funds, and promote the concept of holding mutual funds for a long term. Third, improve the risk-management capability of funds management companies. Efforts should be made to improve the internal governance structure of mutual funds, establish and perfect business compliance and risk management mechanism, and improve the risk management capability of fund management companies.

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