



Chapter III

Securities and Futures Sector

China's securities sector withstood the challenge from the international financial crisis in the year of 2009. The number of listed companies and their market capitalization witnessed a remarkable increase. The strength and capacity of securities and futures companies in servicing real economy were further enhanced and the market functions were improved. Notable progresses had been achieved in market development within the year.

Recent Developments

Both the number of listed companies and total market capitalization grew largely. As of the end of 2009, there were 1 718 listed companies on Shanghai and Shenzhen Stock Exchanges (including 108 B-share listed companies), 93 more than the previous year (99 new listed companies and 6 delisted companies). The total market capitalization was about RMB 24.39 trillion yuan, an increase of 100.99 percent y-o-y; the market capitalization of tradable shares stood at RMB 15.13 trillion yuan, an increase of 234.54 percent y-o-y. The total capitalization of China's stock market had ranked the 3rd around the world, just below US and Japan. There were 327 SME Board companies on the A-share market, with the total market capitalization of RMB 1.69 trillion yuan and the market capitalization of tradable shares of RMB 0.75 trillion yuan, an increase of 169.11 percent and 180.75 percent y-o-y. The GEB was

launched on October 30, 2009, and 36 companies had been listed on the GEB by the end of 2009, with a total market capitalization of RMB 161.008 billion yuan and market capitalization of tradable shares of RMB 29.897 billion yuan respectively.

The strength of securities and futures companies was enhanced significantly.

As of the end of 2009, total assets of 106 securities companies registered about RMB 2.03 trillion yuan, net assets amounted to RMB 483.877 billion yuan and net capital registered RMB 383.182 billion yuan, with an increase of 70.19, 34.98 and 32.73 percent y-o-y respectively. Operating income totaled RMB 205.041 billion yuan, including RMB 141.945 billion yuan from broker services, RMB 15.162 billion yuan from securities underwriting and financial consulting services, RMB 1.596 billion yuan from asset management, and RMB 23.173 billion yuan from securities investments. The net profits of the securities sector totaled RMB 93.271 billion yuan in 2009. 104 securities companies were profitable, accounting for 98.11 percent of the whole sector. 60 fund management companies managed assets with a total value of RMB 3.1 trillion yuan, an increase of 40 percent y-o-y. 118 new funds were issued, raising RMB 378.2 billion yuan. The total assets and profits of futures companies were RMB 120.728 billion yuan and RMB 2.337 billion yuan respectively, with an increase of 103.19 percent and 147.62 percent y-o-y respectively.

The dominant role of institutional investors in the market was further expanded.

As of the end of 2009, there were a total of 140.28 million accounts on Shanghai and Shenzhen Stock Exchanges, up 38.71 percent than that at the beginning of the year. The number of institutional investors and individual investors were 0.57 million and 139.71 million, up 16.66 percent and 38.80 percent respectively. After deducting the dormant accounts, the effective investor accounts amounted to 120.38 million. As of the end of 2009, there were 51.48 million A-share accounts with equity investments, 8.61 percent more compared with the previous year. Tradable shares held by individual investors were worth RMB 4.7 trillion yuan, accounting for 30.95 percent of market capitalization of tradable shares. Tradable shares held by institutional investors were worth RMB 10 trillion yuan, accounting for 69.05 percent of market capitalization of tradable shares, up 14.41 percentage points from the previous year.

Reform and Achievements

As part of central government's efforts and plans to boost steady and rapid national economic growth in response to the international financial crisis, a number of measures were taken to minimize the negative impacts on China's securities sector and capital market caused by the crisis. Regarding China's recent economic and financial scenarios, the authority effected many initiatives to enhance the institutional infrastructure of capital market as well as strengthen the capacity of the securities

sector and capital market in meeting the needs from real economy.

Reinforced the Institutional Infrastructure to Foster and Enhance Market Operating Mechanism

Approved the pilot programs of margin trading and short selling and the launch of stock index futures. In January 2010, the pilot programs for margin trading and short selling of securities companies and the launch of stock index futures were approved in principle by the State Council, which marked an important progress in strengthening the institutional infrastructure of China's capital market, improving the securities trading methods and market functions, as well as consolidating the institutional base for stable operation of the market.

Promoted steadily institutional building for M&A in capital market. Efforts were delivered to revise the mechanisms for acquisition and substantial assets restructuring of listed companies, and to draw up the mechanisms of merger by absorption and stock repurchase. The authorities launched pilot programs to promote split listing of listed companies, encouraged the M&A with the purpose of overall listing and industrial integration, improved the institutional arrangements for the suspension and resumption of trading in M&A, and encouraged the enterprises to carry out industrial restructuring and upgrading through capital market.

Refined the trading and clearing system. The authority revised the *Administrative*

Measures on the Securities Registration and Clearing and specified rules for partnership enterprises to open securities account. The data exchange system between China Financial Futures Exchange and China Securities Depository & Clearing Corporation had been established, which laid a solid foundation for intensifying the market supervision.

Strengthened investor education. Effective investor education programs were conducted, emphasizing the responsibility of investor education on the regulators, self-regulatory organizations, and securities and futures companies, promoting knowledge dissemination of capital market and risk warning, and enhancing investors awareness of risk and self-protection.

Improved the operating mechanism of the Securities Investor Protection Fund. CSIPF actively sought new approaches and new mechanisms to protect legitimate rights and interests of investors after the securities companies with high-risk profile had been disposed properly. First, CSIPF strictly implemented the compensation policy of China and had finished over 99 percent of the compensation of individual creditors' rights and customer securities trading and clearing funds of the

disposed securities companies. Second, CSIPF also contributed great efforts to improve its marker-oriented funding mechanism by aligning member companies' contribution to the Fund with their risk profile, encouraging securities companies to further strengthen risk management and assisting the securities sector to resolve market risks through its own accumulation. Third, CSIPF launched its monitoring system on transaction settlement fund at the securities market, endeavored to make a better investor education and service system, and explored to build a long-term effective investors protection mechanism in combination of "monitoring, appraisal and service".

The Launch of the GEB Marked a Breakthrough in Developing China's Multi-tiered Capital Market

The GEB launched in a steady manner. The GEB was launched on October 23, 2009, marking an important breakthrough in developing China's multi-tiered capital market. As of the end of 2009, 223 companies had submitted their IPO application to the Board and 36 of them had been listed. All in all, the launch of the GEB provided an important financing platform for China's high-tech and high-growth enterprises.

Box 8 The Launch of the GEB

The first 28 stocks were listed and traded on the GEB in Shenzhen Stock Exchanges on October 30, 2009, marking the launch of

the GEB. There were a total of 36 companies listed on the GEB in Shenzhen Stock Exchanges within the year, most of which

were engaged in the emerging industries such as electronic information, biomedicine and modern service.

The launch of the GEB has introduced a series of high-growth and high-tech innovative companies to the capital market, offering investors more choices. The opportune introduction of the GEB under the background of continuing global financial crisis has great significance. First, the launch of the GEB will contribute to the transition of China's economic growth mode. The introduction of the GEB will promote better utilization of resource allocation function of the capital market, encourage the effective integration of innovative resources and capital market, foster new economic growth engine, promote the optimization and upgrading of industrial structure and achieve sustainable economic development. Second, the launch of the GEB will be contributive to implementing the innovation-oriented national strategy. The GEB will increase the direct financing channels for SMEs and innovative companies, promote the rapid development of high-growth and high-tech companies, as well as provide the institutional guarantee for improving the ability of independent innovation in China and implementing the innovation-oriented national strategy. Third, the launch of the GEB will improve the multi-tiered capital market system. Tailored to SMEs' diversified financing needs, the GEB will enrich

the risk management instruments and strategies for market participants, and better reinforce the price discovery and capital discipline mechanism of capital market.

In spite of a good start of the GEB, some issues were worth further attention. First, the number of companies listed on the GEB was small. Only 36 companies were listed within the year, which was not sufficient to meet investors' demands and may lead to over speculation in the market. Second, the IPO prices of the GEB listed companies were excessively high. The average P/E ratio of the 36 listed companies on the GEB was 61.9, among which Jinlong Machinery & Electronic ranked the highest in the IPO history of China with the ratio hitting 126.67. Third, the speculative behaviors in the market were prominent and worth attention. The average increase of 36 listed companies' stock prices on the first day was 92.67 percent, while some of them increased by almost 100 percent during a short period. Based on the closing price of December 31, 2009, the average P/E ratio of the 36 listed companies on the GEB amounted to 105.38. The excessively high P/E ratio caused by the speculative behaviors overdrew future growth of enterprises and was harmful to the companies' healthy growth. Therefore, efforts should be made to improve the operating mechanism of the GEB, and to promote normal and healthy development of the GEB.

The Main Board continued to grow and expanded fast. With IPO resumed, authorities continued to promote the listing of large competitive enterprises as well as SMEs with good growth prospects or the high-tech background (including listing on the SME Board). This greatly led to the expansion of the Main Board.

The infrastructure for OTC market was further strengthened. The authority continued to improve the stock transfer agent system and the pilot program for the Zhongguancun Hi-tech Park non-public companies to transfer their shares. Adjustments were also initiated to the rules in a number of related areas, including the investor access, quotation criteria, information disclosure, share lock-up and trading and clearing, etc. As of the end of 2009, 59 companies were quoted in the system under the Zhongguancun pilot program. 11 companies had completed targeted financing and 2 companies that were quoted in the system went public on the SME Board and the GEB.

Strengthened Routine Supervision and Promoted the Normal Development of Market Participants

Improved corporate governance and information disclosure of listed companies. After being urged to carry out effective measures to correct deficiencies in corporate governance, the governance of listed companies were obviously enhanced. Efforts were also delivered by the authorities to establish the interactive mechanism between routine su-

pervision and M&A supervision, with great focus attached to making regulatory requirements for information disclosure related to abnormal fluctuation of stock prices. The regulator put more efforts on inspection and conducted on-site inspections of listed companies. The regulator enforced the regulatory responsibility on market intermediaries and extended the inspection to audit firms. Regulations on information disclosure of listed companies in banking, insurance, real estate and other special industries were also strengthened.

Enhanced compliance management of securities companies. The classified supervisory system for securities companies based on the risk management capacity had been established in an all-around manner, with the aim of urging securities companies to further strengthen risk management and improve net capital-based dynamic risk monitoring system. Efforts were also made in the introduction of stress-testing mechanism. The broker system was launched and implemented in an orderly manner. The standardization of securities companies' operational branches was basically completed. The historical relationship between the regulator and some specific securities companies were redefined and the relationship between the regulator and securities companies directly under its management was ended. For example, the Galaxy Securities Company, as the last company directly managed by the regulator, had been transferred to China Investment Corporation in September 2009.

Promoted innovation of securities companies. The pilot program of direct invest-

ment business by securities companies had been expanded. Qualified securities companies were encouraged to explore cross-border business opportunities. Securities companies were supported to expand their assets management

business moderately. The regulator also improved the rules and regulations on the pilot program of margin trading and short selling, making preparations for the launch of the pilot program.

Box 9 Risk Monitoring System and Classified Regulation Mechanism of Securities Companies

Since the 30s of last century, some western countries represented by US, had attempted to strengthen the risk supervision system for financial institutions including securities companies, and initially established the net capital-based risk monitoring system. In the middle of 1990s, such system was built up and improved worldwide. At present, the economies that have adopted the system include the US, UK, EU, Australia, Hong Kong SAR, Singapore, Malaysia, etc.

Net capital is a comprehensive risk control indicator based on the net asset positions, which considers the risk-based adjustments to the positions of balance-sheet items and business in line with securities companies' business scope and liquidity profile. The net capital indicator attaches highlights to the items of net assets that are highly liquid, to better evaluate the cashability of securities companies in meeting payment demands and addressing risks, which is also the core of risk monitoring on securities companies.

It's important for the healthy development of securities sector to establish the net capital-based risk monitoring system of securi-

ties companies. In the first place, it will help regulatory authority to strengthen risk control on securities companies on the ex-ante basis, prevent risks from being accumulated and spreading as well as lift the pertinence and efficiency of routine supervision. In the second place, the system will urge securities companies to establish and improve risk identification, measurement and monitoring system, to improve their internal control system. In the third place, this system will urge securities companies to keep adequate and cashable liquid assets to resist potential risks, ensuring the safety of investors' assets and better protecting investors' interests.

Drawing on international experiences, in line with the features of China's securities sector and current regulatory regime, the regulatory authority had established a mature net capital-based risk supervision system. In July 2006, CSRC issued the *Administrative Measures on Risk Control Indicators of Securities Companies* (hereinafter referred to as the Measures), preliminarily setting up the framework of the system. In

June 2008, the regulator made some revisions to the Measures to consolidate the system. Major changes included the adjustments to the computation methodology of net capital and required minimum ratio of venture capital reserves as well as refinement of risk control indicators reflecting proprietary trading scale of securities companies. CSRC issued the revised *Provisions for Classified Regulation on Securities Companies* in May 2009, completing the comprehensive supervisory assessment on securities companies and classifying all the securities companies into 5 categories and 11 sub-categories based on assessment results.

The implementation of classified regulation mechanism achieved positive results, enhancing the pertinence, appropriateness and efficiency of regulation. Also, it created both pressure and incentives for securities companies to operate compliant to rules and regulations, urged securities companies to take effective risk management and internal control measures to meet the regulatory requirements. The innovation of businesses and products will be promoted in steady manner on the fair and public basis under the reasonable and evident expectations.

Promoted the innovation and operation integrity in the fund management sector.

The regulatory authority established the market-oriented fund product classification review system, improved the efficiency of administrative approval and promoted structural transformation of fund products. The smooth launch of “one-to-many” asset management business and ETF-linked Fund demonstrated the support from regulator for business development and product innovation of fund management companies. The regulator also en-

deavored to set up the fund evaluation system and sales charge management system to guide long-term investment in the sector. Besides, the registration system for fund managers was built up, as well as fund investment monitoring mechanism was strengthened. The regulator conducted joint on-site inspections on fund management companies and fund sales agencies, engaged in cracking down on any illegal behavior like “rat trading”, unfair trading and interest transfer deals, to increase credibility in the sector.

Box 10 Promoted the Fund Management Companies to Carry out Innovations in Business and Products

Breakthroughs have been achieved in the innovation of the fund management companies in terms of both business and products in 2009. This not only pushed forward the

rapid development of the sector, but also boosted the sector’s competitiveness as a whole.

In respect of the business innovations, “one-to-many” asset management services were launched in a steady manner, making the business of targeted client asset management develop harmoniously with the public fund management business. Since the implementation of pilot program in 2008, the “one-to-one” wealth management business was promoted smoothly, and the pilot work made progress steadily. Based on that, CSRC issued *Provisions of Asset Management Business for a Specific Number of Clients by Fund Management Companies* and *Guidelines for the Contents and Format of Contracts Utilized in Asset Management Business for a Specific Number of Clients by Fund Management Companies*, marking the introduction of “one-to-many” asset management business of fund management companies which experienced a smooth and orderly development. As of the end of 2009, the total scale of “one-to-one” business and “one-to-many” business amounted to RMB 38.6 billion yuan and RMB 21.2 billion yuan respectively. With the steady progress of related work, the wealth management products of the fund management sector were enriched, the investment strategies were

increasingly diversified, and a multi-tiered wealth management service market will be expected.

In respect of the product innovations, Feeder Fund was marketed, which meant that the sales network in the banking sector for ETF was established in support of the rapid development of ETF. As a common product in the international market, ETF expanded slowly in China. An important factor was that banks were not allowed to participate in subscribing and redeeming ETF under the current regulatory regime, which impeded investors to invest ETF through banks. Therefore, fund management companies issued Feeder Fund, through which banks’ clients could invest ETF indirectly, effectively enlarging the investor scope for ETF. As of the end of 2009, 5 ETF Feeder Funds had been issued, raising funds totaled RMB 32.6 billion yuan.

Besides, the authorities had started to research on the issues related to the cross-market and cross-border ETF as well as the exchange-traded REITs, so as to create conditions for further product innovation.

Intensified routine supervision and reinforced the institutional infrastructure for futures companies. Regulatory efforts had been delivered to implement the net capital-based risk supervision system, margin supervision system and Chief Risk Officer System of futures companies. Besides, the regu-

latory authority issued guidelines for futures companies’ shareholders, ensuring the stable and rapid development of futures companies. The futures companies classified supervision system was established and the preliminary risk categorization under the system had been completed. The futures company information

publicity system was implemented to promote transparency of the sector.

Standardized the practice of securities service providers. The regulatory authority further strengthened the supervision on accounting firms and asset appraisal firms and established the reporting system of accountants who would provide signatures to the securities business. The regulator also conducted on-site inspections on some rating agencies, accounting firms and asset appraisal firms to standardize the practice of securities service providers.

Enhanced Work for IT Security of the Securities and Futures Sector

Attached great importance to IT security. The ad-hoc inspections of IT security were organized and conducted to ensure safe operation of the core market system. The authority required that tests be fully carried out before any new trading system came into play, so as to provide strong support for financial innovations in the market.

Enhanced the institutional infrastructure of the IT security system. 9 documents were issued by the regulators in the area of IT security, including *Contingency Plan on Network and IT Security Incidents in the Securities and Futures Sector* and 8 rules were issued by the stock exchanges and industry associations to strengthen self-regulation on IT security. The regulator also planned to issue *IT Security Report of China Securities and Futures Market*.

Improved the sector's emergency response regime in IT security. The regula-

tor had carried out the industry-wide emergency drilling for IT security, covering 70 thousand staff from 435 financial institutions, to enhance capacity of the whole sector to deal with any emergency IT security failure.

Promoted the standardization of institutional infrastructure of the sector. CSRC has actively improved the management and institutional infrastructure of the Subcommittee on Securities Sector Standardization of China Financial Standardization Technical Committee. Latest progress included the research and formulation of the *Framework of Standardization in Securities and Futures Sector*.

Consolidated the Legal Framework of Securities and Futures Sector and Cracked down on Illegality

Consolidated the legal framework of securities and futures sector. The *Amendment 7 of Criminal Law* added more provisions on financial practitioners' "rat trading" and other frauds in transactions. The judicial interpretations on trial and execution of cases relating to disposed securities companies were issued, and some rules and regulations were formulated or revised.

Established the coordination mechanism in the judicial framework for securities and futures sector. The public security, procurator and court agencies as well as the relevant regulators formed the Working Group for Combating Illegal and Criminal Activities in Securities and Futures Sector, which had made investigations and punishments on violations in time. The regulators had also es-

tablished the cooperation mechanism with relevant judicial authorities to better deal with significant and highly sensitive cases.

Standardized the administrative behaviors comprehensively. Efforts were delivered to promote openness and transparency of regulatory information, formulate the rules of open for comments on securities and futures regulations, and draw up the implementation procedures of administrative licensing and regulatory measures. All such efforts strengthened the discipline on the regulator's entire administrative behaviors.

Strengthened the investigations and punishments on violations of rules and laws. Rapid and efficient investigations and punishments had been made in a number of major cases that got market attention and had great social impact, like the cases of "rat trading" of Rongtong Fund and insider trading of Gaochun Ceramics, enhancing the deterrent effect on any violations.

Cracked down on illegal activities in the securities sector. The regulator continued to crack down on illegal offering and illegal trading of shares of unlisted companies and other illegal activities, supervised over the handling of important cases, such as the case of Jiaotong University Bio-sep, Yi'er Hi-tech. The regulator also corrected illegal use of internet and other media to carry out securities investment advisory activities, worked with the public security authority to crack nearly a hundred cases of illegal securities activities. The above moves purified the environment of capital market and protected legitimate rights

and interests of investors.

Actively Participated in International Exchange and Cooperation, and Steadily Pushed Forward the Opening-up of Securities Sector

Actively pushed forward bilateral and multilateral cooperation on regulation.

CSRC had joined in IOSCO Technical Committee in February 2009, which demonstrated that the development and regulation of China's capital market had gained general recognition of the world. Meanwhile, the bilateral cooperation had been pushed forward steadily and the cross-border cooperation on regulation had achieved considerable progresses. As of the end of 2009, 45 MOUs had been signed between CSRC and regulators from 41 jurisdictions. A number of cross-border regulatory investigation assistance, information exchange and staff training initiatives had been launched based on MOU arrangements.

Steadily pushed ahead the opening-up of capital market and securities sector.

In 2009, CSRC had approved business licenses of 1 joint venture securities company and 1 joint venture fund management company, granted QFII status to 19 overseas financial institutions, and increased the investment quota cap for QFIIs. Meanwhile, domestic institutions were encouraged to explore the cross-border business. For example, 2 domestic securities companies and 3 fund management companies had been approved to set up or acquire branches in Hong Kong SAR; QDIIIs had been approved to invest overseas, and 5 fund management companies had obtained

QDII licenses in 2009. CSRC also committed to increase the investment quota cap for QDIIs.

Further strengthened the exchange and cooperation with Hong Kong SAR and Chinese Taipei markets. The opening-up to Hong Kong market was further expanded. In the supplement 6 to the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA), qualified Hong Kong securities companies were allowed to set up joint-venture securities investment consulting firms in Guangdong Province. The regulator would also consider the possibility of cross-border ETF investing in Hong Kong stocks. With respect to the cooperation with Chinese Taipei, CSRC actively participated in the discussion of *Cross-Strait Financial Cooperation Agreement*, and signed *Memorandum of Understanding Regarding Cross-Strait Regulatory Cooperation on Securities and Futures* with regulators of Chinese Taipei. The cross-strait cooperation mechanism on regulation of securities and futures sector had been initially established.

Soundness Assessment

In 2009, the securities and futures sector's performance continued to be sound and stable, with major indicators favorable. However, along with the expansion of securities market and the introduction of new businesses and new financial products, the operation environment of securities and futures companies are

increasingly complicated, some potential risks are worthy of concern.

The Net Capital of Securities Companies Was Continuously Increasing, Which Helped the Sector to Strengthen Its Risk-resistance Capacity

Net capital is the most important resource to withstand risks for securities companies. In order to enhance the quality of net capital and its role in risk management, securities companies adopted new guidelines since December 2008, involved with the calculation rule for net capital and stricter requirement for discounting factor. According to the new calculation rule, net capital of 106 securities companies amounted to RMB 383.182 billion yuan, achieving a y-o-y increase of 32.73 percent and marking the enhancement of the whole sector's resilience.

The increase of the sector's net assets was a major contributing factor to the rise of net capital. On the one hand, the profits of securities sector witnessed a large increase in 2009, achieving RMB 120.6 billion yuan in total and a y-o-y increase of 102 percent. On the other hand, some securities companies increased capital strength by additional offerings and IPOs. Everbright Securities Company and Merchants Securities Company finished their IPOs in August and November of 2009, raising RMB 11 billion yuan and 11.1 billion yuan respectively.

The Securities Sector Remained High Profit but the Revenue Structure Needed to Be Balanced

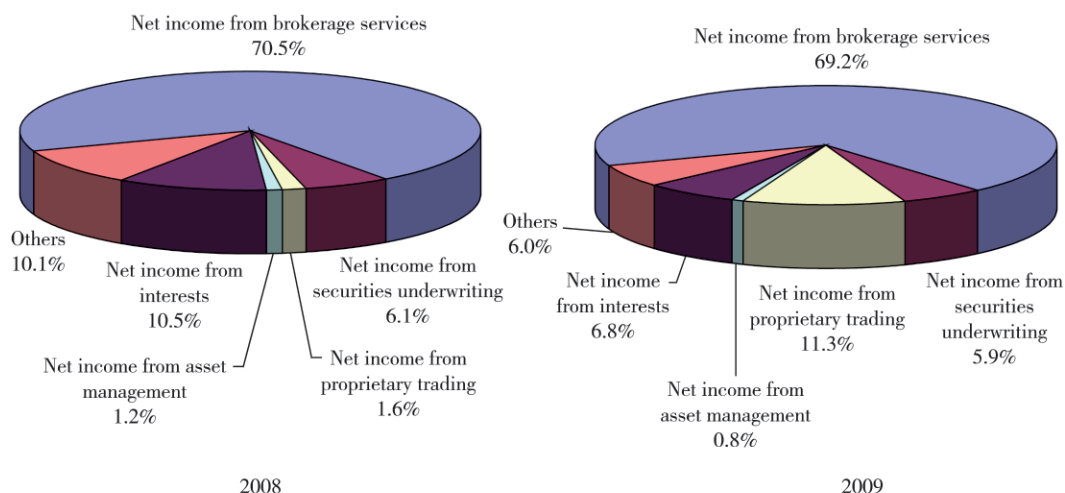
In 2009, the net profits of the securities sector

totaled RMB 93.271 billion yuan, with an increase of 93.49 percent y-o-y. The profitability indicators of the sector performed well, with the ROA and ROE reporting 4.59 percent and 19.28 percent respectively, increasing by 0.45 percentage point and 5.5 percentage points compared with last year.

In terms of the income structures (Figure 3.1), the brokerage services remained the main source of income, accounting for 69.2 percent of total operating income despite a small decrease compared with the previous year. Ben-

efiting from the hike of stock market, the income from proprietary trading had witnessed a large increase compared with last year, up from 1.6 percent to 11.3 percent in total operating income. The income from asset management, securities underwriting and other businesses kept relatively stable, seeing no significant change in share from last year. The trend is that the sector's income structure will be more diversified with the introduction of some new businesses and new products, like margin trading and short selling and stock index futures.

Figure 3.1 Comparison of Income Structure of Securities Companies between 2008 and 2009



Source: the Securities Association of China.

Debt Financing Was Limited for Securities Companies, Marking Less Exposure to Liquidity Risk

In terms of the sector's balance-sheet in 2009

(Table 3.1), the asset/liability ratio for the sector was 76.13 percent, with most liabilities from funds of agency customer transactions in the brokerage services. The liabilities of securities companies accounted for only 8.43 per-

cent of their total assets after the deduction. After deducting the customer margin deposits, the sector's currency funds accounted for 11.7

percent in total assets, which were sufficient to repay obligations. The liquidity risk exposure the sector faced was low.

Table 3.1 Balance Sheet of the Securities Companies of 2009

(percent)

Assets	Ratio	Liabilities and Equity	Ratio
Currency funds	71.75	Short-term loan	0.01
Of which: customer margin deposits	60.05	Interbank borrowing	0.01
Reserves for settlement	7.95	Trading financial liabilities	0.01
Of which: settlement reserves of customers	7.18	Selling for repurchase of financial assets	4.1
Trading financial assets	8.80	Funds of agency customer transactions	67.7
Buying for resale of financial assets	0.61	Long-term borrowings	0.36
Available-for-sale financial assets	5.0	Other liabilities	3.94
Held-to-maturity investments	0.18	Total liabilities	76.13
Other assets and investments	5.72	Total equity	23.87
Total assets	100	Total liabilities and equity	100

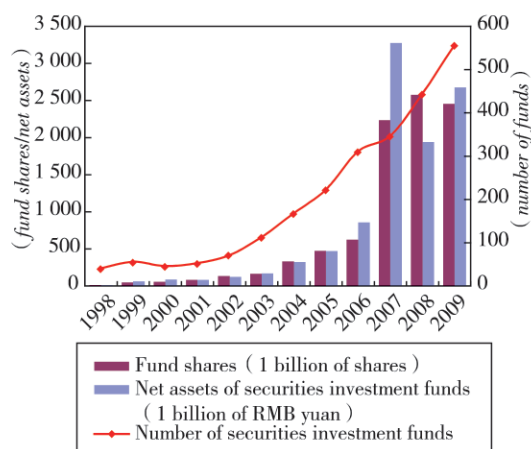
Source: CSRC.

The Fund Management Sector Expanded Fast while Internal Control System of Fund Management Companies Needed to Be Improved

The fund management sector developed rapidly in recent years. The number of fund management companies and the assets under these companies' management witnessed a rapid increase (Figure 3.2). To date, fund management companies had evolved into the most important institutional investors in China's capital market and had provided investors important channels to share the benefits of China's economic growth through capital market. However, in the course of rapid development, some fund management companies still put more focus on the expansion in asset size and ignored

the management quality, causing losses to the fund investors and deteriorating the public credibility of the whole sector. In 2009, some fund management companies suffered from the failure to subscribe IPO shares due to bugs in the system or deficiencies in operation, and several fund management companies were disclosed to have scandals of "rat trading" of fund managers. As the specialized financial institutions that "manage others' money as trusted", the fading of investor confidence will lead to fund redemption in a large scale and consequent liquidity risks, threatening the stability of the capital market. Therefore, it's important for fund management companies to improve their internal control system and prevent the operational risk and reputation risk.

Figure 3.2 Development of Fund Management Sector



Source: Wind.

The Investor Appropriateness System Was Preliminarily Established with the Relevant Measures Needed to Put into Effect

The investor education was strengthened obviously in recent years and the investor appropriateness system had been carried out in securities and futures market. In 2009, the business and product innovation of operational institutions in the securities and futures sector continued. Compared to traditional counterparts, the innovative businesses and products were more complicated and aggressive in risk-taking. There was a need to establish the investor appropriateness system, ensuring appropriate products could be sold to appropriate investors. The *Interim Provisions for the Administration of Investor Appropriateness on the Growth Enterprise Board* and the *Provisions of*

Asset Management Business for a Specific Number of Clients by Fund Management Companies were issued by the regulatory authority, which prescribed the concrete standards and requirements for investor appropriateness in the related business. The regulator had taken the investor appropriateness issues into consideration when making rules and regulations for margin trading and short selling and stock index futures. However, regarding most small and medium investors in China are still not risk-sensitive, once there were any failure in the operation of new businesses and products, the market risk may cause losses to investors. Therefore, more effective measures should be implemented in the future to urge market participants aware of their role in implementing the investor appropriateness system and protect small and medium investors' interests.

Issues Worth Attention and Reform Measures

Promote the Reform of the Issuance System, and Enhance Financing Efficiency of the Capital Market

The reform of IPO system launched in 2009 and was welcomed by the market. However, there is still a long way to go in this area, in light of the characteristic of the "emerging and transitional" China's capital market. Adjustments and dynamic optimization were indispensable and efforts based on the practical ex-

periences should be continued to be made to reform and improve the IPO system. Reform measures following the reform of IPO system in the next phase include strengthening the monitoring of price inquiry and pricing to improve price discovery mechanism in the primary market, making amendments to the current *Administrative Measures on Initial Public Offering and Listing of Stocks* and *Administrative Measures on Securities Issuance of Listed Companies*, optimizing the stock issuance procedures and requirements to further enhance financing efficiency of the capital market, and issuing the *Guidelines on Internal Control in Sponsor System* to require sponsors to further enhance their internal control system.

Improve the Construction of the GEB and OTC Market, and Strengthen the Multi-tiered Capital Market System of China

The multi-tiered capital market system has been constantly improved in recent years. However, the price discovery mechanism and liquidity efficiency of markets in different tiers need to be further improved, the demands of different types of investors and enterprises were not yet effectively fulfilled and the role of securities market in promoting transition of economic growth pattern was not fully brought into play.

In the next phase, first, improve the institutional infrastructure of the GEB. Manage the quality of the GEB listed companies based on an accurate understanding of the role and function of the GEB. Improve the regulations on issuance on the GEB and formulate adminis-

trative measures on secondary offerings of the GEB listed companies. Improve the stock issuance review criteria on the GEB and improve the efficiency of the listing process. Build up the coordination mechanism with Main Board to prevent any regulatory arbitrage. On the basis of efficient regulation, expand the market capitalization of the GEB when the market conditions permitted.

Second, establish and improve the delisting and board-transfer mechanism for listed companies. The delisting mechanism of Main Board should be reformed and the delisting mechanism of the GEB should be established and improved. Intensify the supervision on listed companies' financial reporting, prevent and crack down on any manipulative behavior including profit manipulation on purpose of avoiding being delisted, enhance the connection and coordination between different links of the delisting process as well as enhance the market discipline for listed companies. Make comprehensive consideration for board-transfer mechanism among markets of different tiers.

Third, speed up the development of OTC market. Formulate the detailed plan for the extended pilot program for stock transfer agent system and implement the plan. Make rules in terms of administrative measures on non-listed public companies to establish the centralized regulatory regime. Establish the basic framework for management of the stock transfer agent system and make a comprehensive development scheme for the OTC market.

Improve the Institutional Infrastructure and Promote the Innovative Development of Securities Companies

Though the securities companies' capital strength and risk-resilience had been enhanced greatly after the Comprehensive Restructuring of the sector in the previous years, the risk management and innovation capacity were yet to be further advanced, and the institutional infrastructure for sustainable development of securities companies needed to be improved to boost the sector's core competitiveness. First, further improve the net capital-based risk regulation system of securities companies, introduce the dynamic-adjusting mechanism for the venture capital reserves in line with different business categories of securities companies, and strengthen the counter-cyclical function of risk control indicators. Guide securities companies to adjust their business mode based on net capital constraints and improve operating efficiency. Second, consolidate the classified regulatory system based on risk management capacity of the regulated institutions, make securities companies' innovation consistent with their ability to control risks, and lay a solid foundation for financial innovation. Third, urge securities companies to take advantage of the pilot of margin trading and short selling to conduct IT system testing, risk warning and investor appropriateness management, ensuring the development of margin trading and short selling in a normal and orderly manner.

Strengthen Supervision and Improve Corporate Governance of Fund Management Companies, so as to Promote the Stable and Rapid Development of the Fund Management Sector

The fund management sector has grown rapidly in recent years with fast expansion of the assets and active innovations. To ensure the fast and healthy development of the sector, the market-based reform should be insisted, in combination with the policy of "encouraging innovation, intensifying supervision and improving the sector's service capacity".

First, urge fund management companies to build internal control system with the priority on fund holders' interests, based on the features of fund management companies' corporate governance. Guide fund management companies to explore effective governance structure to protect the interests of fund holders and take concrete measures to protect investors' interests.

Second, require fund management companies to strengthen internal risk control capacity and set up accountability system of fund management practitioners. Guide fund management companies to explore diversified ownership structure including possible share holding by professional staff.

Third, encourage innovation in the sector (including product innovation, organizational innovation and institutional innovation) to better meet clients' needs and market challenges based on the precondition that risks can be controlled.

Intensify Classified Supervision of Futures Companies and Prepare for the Steady Operation of Stock Index Futures

With the introduction of more new products like stock index futures to the market, the business mode and operating mechanism in the futures market will change substantially, which requires futures companies to meet demands of market changes, speed up the integration of systems, strengthen investor education and upgrade their services, so as to prevent and resolve risks. First, efforts should be made to further consolidate the classified supervision system of futures companies, and to intensify the net capital regulation and margin regulation in support of sector's business innovation. Second, efforts should be made to implement the investor appropriateness system on the stock index futures market to ensure its stable operation. Third, the cross-market regulatory coordination mechanism between stock market and futures market should be built to further strengthen the risk surveillance from a cross-market view and maintain the stability of capital market.

Consolidate the Legal Institutional Framework and Strengthen the Investigation and Punishment on Violations of Law

In spite of the speedy expansion of the capital market in recent years, the market discipline was yet to be strengthened and the market participants were yet to be improved. Insider-trading in the M&A process, "rat trading" and other significant illegalities occurred frequently. In the next step, efforts should be delivered to consolidate the legal framework of the market, strengthen the investigation and punishment on violations of law, enhance the credibility of the market and maintain the market stability. Revisions to the *Securities Investment Fund Law* and the *Regulations on Administration of Futures Trading* should be promoted. The authority should continue to make efforts to improve the discovery and disposal system of illegalities' clues and promote the efficiency and pertinence of filing cases. The focus of crack-down policy should be on insider-trading, "rat trading" and illegalities that harm interests of listed companies. Efforts should also be delivered to bring major cases to the public so as to enhance the social effect of enforcement.