

CHINA

SECURITIES

SUMMARY

Although still in their infancy, the reestablishment of securities markets in China has been one of the most dramatic aspects of China's financial reforms. After a hiatus of more than 40 years, the Shanghai Securities Exchange reopened on November 26, 1990, and on July 3, 1991, Shenzhen, in China's southeastern Guangdong province, opened the country's second exchange.

Partly because the equity market is so new, China's regulatory structure is still in flux. Overlapping agencies with ill-defined responsibilities make the regulatory process unclear. At present, interim regulations issued by the State Council in May 1993 govern the activities of domestic investors, but there is still no law explicitly covering the presence or activities of foreign firms. Foreign firms comment that this lack of transparency of regulations represents a significant problem.

Foreign securities firms may establish representative offices, but they cannot establish local branches or subsidiaries. Foreign firms may purchase seats on both the Shanghai and Shenzhen exchanges to broker "B" shares (explained below), but they must work with domestic brokers for all of their transactions on the basis of a shared commission. Foreign firms cannot underwrite local securities issues or act as dealers or brokers in renminbi (RMB) denominated securities. U.S. firms' major involvement in China is in underwriting offshore equity and bond issues for domestic companies. However, each offshore issue must receive prior approval from the government.

Publicly offered stocks are segregated into two types of shares: "A" shares and "B" shares. "A" shares are issued by Chinese companies for sale exclusively to Chinese individuals and Chinese legal persons. "B" shares, which are denominated in RMB but must be purchased with foreign currency, are issued by Chinese companies for sale exclusively to non-Chinese. The combined aggregate capitalization of equity securities on both markets as of end-1997 was approximately RMB 1,753 billion (US\$212 billion). Aggregate market capitalization of shares available for purchase by non-Chinese was approximately US\$4 billion as of end-1997.

DESCRIPTION OF THE MARKET

China's equity market has grown rapidly since its reopening in November 1990. The Shanghai Exchange opened with 46 seats and two trading counters. At the end of its first full year of operation, total trading turnover on the Shanghai Exchange was RMB 11 billion (US\$2.1 billion). By the end of 1992, there were 73 listed securities and turnover was RMB 65 billion (US\$11.8 billion). As of May 1998, there were 407 listed shares traded in Shanghai and 467 seats on the exchange.

Similar growth has occurred on the Shenzhen Exchange. At the end of 1992, 33 listed securities were traded and total trading volume on the exchange amounted to RMB 43.8 billion (US\$7.9 billion). As of May 1998, 384 listed securities were traded in Shenzhen, with 397 seats on the exchange.

Chinese companies seeking to issue shares must undergo different levels of review by the China Securities Regulatory Commission (CSRC). Companies seeking to issue "B" shares must be limited liability shareholding companies that have been profitable for at least two consecutive years, possess sufficient foreign exchange revenues to pay dividends and cash bonuses, and provide financial statements and earnings forecasts for three consecutive years. The price to earnings ratio must be below 15 at the time of listing.

Foreign investors seeking to purchase "B" shares must open an account with a foreign clearing house through an approved foreign broker. The overseas broker can then pass customers' orders to traders on the exchange floors or to a related local broker. In Shanghai, all qualified domestic brokers can now trade "B" shares. Eighty or so "franchise B share brokers" currently trade in Shenzhen, of which 10 are foreign firms. All orders are executed in the central order matching system in either market. In Shenzhen, settlement takes place three days after the day of trade. In Shanghai, to increase market liquidity, the exchange replaced the T+3 rule with a T+0 rule. Off-market trading and short selling are not allowed in either market.

In addition to the two officially recognized exchanges, there are "securities exchange centers" in 19 of China's larger cities and two electronic trading systems, the National Electronic Trading system (NET) and the Securities Trading Automatic Quotation system (STAQ). Trading at "securities exchange centers," in Wuhan, Shenyang, Tianjin, and other cities, is limited to government and corporate debt securities only. In late 1997, however, these markets were virtually shut down by the CSRC due to suspicion of fraud, and there were indications that they would be abolished altogether. (NET and STAQ provide secondary markets for a small number of "legal person shares" – corporate shares that can be traded by China's "registered legal persons," mostly government agencies and state-owned enterprises.)

China's "A" share market has remained volatile. Shanghai's "A" share index tumbled to a low of 328.85 at the end of July 1994, prompting the CSRC to announce several measures to boost public confidence in the stock market. The measures included: (1) canceling all "A" share listings scheduled for 1994 until the end of the year; (2) announcing the authorities' intention to gradually allow foreign institutional investors to buy "A" shares; (3) encouraging the development of mutual funds; and (4) tightening control over rights issues. However, the authorities appear to have backed away from opening the stock market to foreign investors in the near term as the "A" share index has rebounded. The measures announced by the CSRC do not address other underlying problems in the stock markets, including a lack of standard accounting practices, shortage of information, and the perception of poor management.

CHINA – SECURITIES

Initial reaction to the opening of China's securities markets to foreign investors in the form of "B" shares in 1991 was frenzied buying. In the first half of 1992, 20 China funds were launched, raising more than US\$1 billion for investment in both listed and unlisted companies. Most of the initial "B" share issues were many times oversubscribed. In mid-May 1992, after share prices reached more than 200 percent above their initial listing price, the market plunged. Since then, "B" shares have generally performed worse than "A" shares, generally tracking the Hong Kong market.

Prices of Shenzhen "B" shares have generally outpaced those in Shanghai, but both markets have been volatile. The relatively weak demand for "B" shares is attributable to China's nonstandard accounting practices, the shortage of information on listed companies, and the variety of alternative China investment strategies available to foreign investors. In an attempt to address the former concerns, the CSRC issued provisional regulations in 1993 requiring all "B" share companies to issue annual reports audited by certified accountants. This was followed in 1994 with a requirement for all listed companies to file semiannual reports.

Many foreign interests have chosen to invest in China indirectly through Hong Kong and other Asian companies with major investment and trading interests in China, through more than two dozen Hong Kong-listed "red chips" – companies primarily owned by mainland interests, or through "H" shares – Hong Kong listings of mainland companies. In 1993, nine Chinese state enterprises were selected to float "H" shares in Hong Kong, 22 others were selected to list in 1994. Other investors chose to buy American Depositary Receipts (ADRs) of five Chinese companies listed on the New York Stock Exchange. The number of overseas listings reached 42 firms by the end of 1997.

One feature of the domestic securities market is that companies are only allowed to issue once at the time of the initial listing. Companies know that they cannot go back to the market and therefore have little incentive to consider shareholder interests or to manage the firm in a way that will increase shareholder value and the stock price. China is thus not receiving the benefit of market discipline, and many companies seem to believe that equity is "free."

China has 14 futures exchanges, including Shanghai and Shenzhen. Physical deliveries amounted to only RMB 17.4 billion (US\$2.1 billion) in 1996, down sharply from 1995, and continued to plummet in 1997 as the government struggled to clean up abuses in the market. In mid-1998, there were rumors that the government would move to shut down completely all of the futures exchanges and only gradually move to reopen them under a new set of strict regulations.

Fund Management

China began a fledgling domestic mutual funds market in early 1998, in accordance with "interim procedures" published in October 1997. Each of the four closed-end funds announced as of mid-1998 was capped at a total issue volume of RMB 2 billion (US\$242 million) and did not include

foreign partners. Reports have circulated that foreign firms may soon be allowed to jointly manage at least some of these funds.

The overwhelming majority of investors, however, trade on their own accounts. Foreign banks may not sell foreign mutual funds or any other form of foreign securities to Chinese citizens or institutions.

Pension fund development is moving forward in China. Foreign banks might be allowed to manage domestic pension funds in the future, but at present all pension funds remain under government control.

Regulatory Structure

The CSRC, an executive agency of the State Council, has become the supreme regulatory authority over all domestic securities markets. With offices in Beijing, Shanghai, and Shenzhen, the CSRC designates firms for listing and licenses brokerage companies. It also controls commodity futures markets.

In early 1998, the designation of the CSRC as the sole regulator initiated a new phase in the development of a regulatory system that had lacked clarity and had been plagued by overlapping responsibilities between competing agencies. According to the reform, the CSRC will take over from the People's Bank of China (PBOC) and other agencies all responsibility for regulating markets. The State Administration of Exchange Control (SAFE), now an independent agency, retains some oversight responsibility for transactions involving foreign exchange, including dividend payments on "B" shares.

The Financial and Economic Committee of the National People's Congress (NPC) has drafted national regulations for China's securities markets. But differences over key provisions of the law, including the responsibilities of national and local regulatory bodies, have delayed final passage of this important legislation. Chinese officials are hopeful that the CSRC will be able to re-draft the Securities Law in the second half of 1998, but until then securities markets will continue to be regulated by interim rules issued in May 1993. The interim regulations govern only the activities of domestic investors in securities.

U.S. PRESENCE IN THE MARKET

U.S. securities firms active in both Shanghai and Beijing include J.P. Morgan, Merrill Lynch, Morgan Stanley Dean Witter, and Bear Stearns. Prudential Securities is active in Shanghai, as are Goldman Sachs and Salomon Smith Barney in Beijing.

CHINA – SECURITIES

Securities firms in Shanghai may only conduct trades in "B" shares through domestic brokers on shared commission. There are 15 foreign seats on the Shenzhen stock exchange at a cost per seat of HK\$1 million (US\$128,000). However, clearance and settlement still must go through a local sponsoring broker. The membership fee for a special seat is RMB 1 million (about US\$121,000), the same fee paid by local brokers.

The primary involvement of U.S. securities firms in China has been through the preparation and underwriting of international offerings of both equity and debt. On October 9, 1992, China Brilliance Automotive Holding (CBA), a Chinese bus maker, made its debut on the New York Stock Exchange, becoming the first Chinese-based enterprise to list abroad. The CBA issue was lead-managed by CS First Boston, and U.S. legal and accounting firms were heavily involved in its preparation. Since then, U.S. securities firms have secured many international underwriting deals involving Chinese debt or equities. For example, CS First Boston lead-managed or co-managed equity issues totaling over US\$1.9 billion in 1997.

Introduction of new domestic financial products is prohibited, but offshore derivatives is an attractive business for foreign banks operating in China.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Although U.S. firms have competed successfully for many of China's overseas underwriting deals, within China their business continues to be severely restricted by discriminatory regulations and lack of market transparency. Foreign securities firms cannot establish local branches or subsidiaries. They may establish only representative offices. Representative offices are limited to offshore activities and, for stock exchange members, to transactions in "B" shares only.

Foreign firms are required by Chinese regulations to hire their Chinese staff through an "approved labor supplier." Subsidiaries, branches, and joint ventures are not governed by the same rules and may recruit employees directly.

Establishment of representative offices of all foreign financial institutions, including investment banks, is subject to the Regulations Governing Representative Offices by Foreign Financial Institutions, which was promulgated by the PBOC in 1990. A firm seeking to open a representative office applies to the CSRC (not the PBOC), which then must consult with other interested agencies and local government offices before issuing its approval. Opening a representative office, as opposed to a branch or subsidiary, is generally a relatively straightforward process, and apparently there are no current significant problems.

Even though foreign securities firms may open only representative offices in China, they can participate in "B" share brokerage business and have seats on exchanges. However, they cannot

underwrite "A" shares, government securities, or nongovernment bond issues, nor can they purchase or act as dealers in the secondary markets for any form of RMB denominated security. In Shenzhen, a limited number of foreign firms have been permitted to purchase seats on the exchange, but their trades must still be cleared and settled through a sponsoring local broker. In Shanghai, foreign firms also may purchase exchange seats, but they must enlist domestic brokers to conduct "B" share trades, and they must share commissions.

Foreign firms may underwrite international equity and bond issues, but approval by the State Council and relevant ministries is required before any domestic enterprise may list securities in an overseas market. Residents may not invest onshore dollars overseas without government approval, which eliminates an area of securities business in which U.S. securities firms are traditionally strong. For capital account purposes, the Chinese currency is not convertible.

China still has not passed a national securities law. Official press commentary on the law regularly espouses reform of the securities sector, particularly opening "B" share sales to domestic investors or eliminating the "B" share market entirely. There is no indication that such moves are imminent.

China's existing securities and accounting regulations lack transparency, although timeliness of notification of changes has improved. Lack of enforcement of settlement payment procedures and insufficient requirements on disclosure of information by listing companies also increase the risk of foreign investors and brokers. Regulations mandating capital gains tax on investment income have been promulgated, but enforcement is spotty. A stamp tax on share transactions has been implemented instead.

Repatriation of profits requires government approval, but this is generally a formality. Dividend payments on "B" shares do not require special approval.

Despite these restrictions, and the still relatively underdeveloped state of the Chinese securities market, most U.S. securities firms remain optimistic about the longer-term prospects for the Chinese market. They note that progress has been made both with regard to domestic exchanges and the introduction of companies to overseas markets, and they remain hopeful that conditions for doing business will improve significantly as further securities market reforms are introduced.

Financial Policy Discussions

In numerous bilateral and multilateral discussions, including in the context of China's application to enter the WTO, Treasury has sought significant liberalization of China's securities market including permission for foreign financial institutions to participate in the underwriting and trading of renminbi-denominated securities. China has been reluctant to make meaningful commitments and, despite the optimism noted above, there are no indications that China will soon allow an expanded role for foreign securities firms beyond setting up joint ventures in tightly restricted

CHINA – SECURITIES

markets. Much work remains to be done, especially as commitments in the securities area would make a positive contribution to China's WTO accession commitments.

The major barriers to national treatment remain the strict separation of the “A” and “B” share markets and the lack of clear-cut prudential criteria for licensing foreign securities firms. Passage of the Securities Law currently under final revision is unlikely to remedy these deficiencies but would be a step toward greater transparency in the market.

Exchange Rates Used:

June 1998	8.28 RMB/US\$
1997 end-of-period	8.28 RMB/US\$
1996 end-of-period	8.30 RMB/US\$
1992 period average	5.51 RMB/US\$
1991 period average	5.32 RMB/US\$