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China's Economy

Regulations in the Chinese Capital Market

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In recent years, the capital market in China has grown rapidly to a scale that follows that in the U.S. Such a remarkable development of the market is thanks to Chinese economic growth. However, it also goes without saying that deregulation by the Chinese monetary authorities played a very important role in the process of this market growth. This article will review major regulation changes related to the capital market announced in 2019, while examining the future possibilities.

Regulations in the Chinese Capital Market¹

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In the capital market in China, the balance of the bond market grew to reach USD 10.7 trillion at the end of 2018, exceeding that of Japan and becoming the second largest in the world. At the same time, the total market capitalization of the three stock markets in Shanghai, Shenzhen, and Hong Kong exceeded USD 12 trillion as of the end of November 2019, exceeding the size of the Tokyo stock market.

The Chinese market grew remarkable, mainly thanks to the economic growth of China. However, it goes without saying that deregulation by the Chinese monetary authorities played a very important role in the process of this market growth. This article will review the major regulation changes related to the capital market announced in 2019, while examining the future possibilities.

1. Regulation changes in the Chinese capital market in 2019

1) Bond market

As the moniker of “one bank and three commissions” represents, the authorities in the monetary and capital markets in China used to be separately controlled by three supervisory commissions specialized in the banking, insurance, and securities industries under the overall authority of the People’s Bank of China (PBOC). Due to concerns over the vertically divided administration that resulted from the parallel structure of the financial supervisory commissions, the banking and insurance sections were integrated, and the China Banking and Insurance Regulatory Commission (CBIRC) was created. However, in the securities section, the China Securities Regulatory Commission (CSRC) will be maintained in order to further develop securities companies while promoting the further growth of the capital market. The structure of the capital market in China has thus been slightly distorted.

Under such circumstances, [in December 2018, the PBOC, the CSRC, and the National Development and Reform Commission announced that the supervisory authority would be centralized in the CSRC, dealing with corporate bonds in both the interbank and exchange-traded bond markets.](#) The bond market in China is divided into the interbank bond market and the exchange-traded bond market, and previously, the CSRC had supervisory authority over only the latter, while the interbank bond market that accounts for the majority of the bond market in China was supervised by the National Association of Financial Market Institutional Investors (NAFMII) under the umbrella of the PBOC. In the times ahead, it is likely that the CSRC will have a stronger supervisory function, unitarily supervising both markets based on the Securities Law.² The CSRC will play a role as a market surveillance authority, much like Japan’s Securities and Exchange Surveillance Commission does.

[Furthermore, on August 2, the CSRC, the PBOC, and the CBIRC together announced the reopening of bond transactions by banks in the exchange-traded bond market.](#) As the bond market remained divided, banks were previously not able to

¹ With regard to the development of the bond market in Mainland China as well as the overview of its deregulation, please also refer to Mizuho Financial Group’s *Practice in the bond market in China*, Kinzai Institute for Financial Affairs Inc. (2017).

² A law equivalent to the *Financial Instruments and Exchange Act* in Japan

trade in the exchange-traded bond market. However, with this announcement, banks were admitted to the spot bond exchange market. In the times ahead, market participants would be interested to know whether banks will be admitted to the listed government bond futures, which are seen to be an important method for interest rate hedging.³

[On October 16, the PBOC and SAFE released the “Notice regarding the further enhancement of convenience for foreign institutional investors in investing in the interbank bond market,” allowing investors to move bonds \(i.e., change the owner’s name through a non-transaction\) and funds between an OFII or RQFII account and a direct investment account owned by the same person.](#)

QFII/RQFII is originally a method used to invest in the exchange-trade market, but it was accepted for the investment in the interbank bond market in 2012 with the approval of the PBOC. As a result of this change, it can be considered that investors that are already investing in the interbank bond market with the approval of the PBOC will no longer need to ask for approval from the PBOC once again in order to invest in the interbank bond market, through the QFII and RQFII schemes.

2) Stock market

In April 2018, the Hong Kong Exchanges and Clearing (HKEX) approved the listing of class shares. At the beginning, the HKEX was against class shares, as being for them would go against the principle of equality for stockholders. However, as major Chinese IT companies, such as Alibaba, chose to be listed in the U.S., discussions continued. In December 2018, [the listing of class shares was also approved in both the Shanghai and Shenzhen markets, which have been integrated through the stock connect schemes, while the listing of class shares was approved at the HKEX.](#) China has been vigorously engaged in the development of emerging companies that can reinforce the country’s industrial base, and this decision is to make effort in calling back IT companies that chose to be listed in the U.S. in the past, as it was not possible to issue class shares.⁴ On the other hand, it should also be kept in mind that the U.S. stock market remains robust, mainly with emerging and major IT companies. It is thus important for China to encourage a large number of “unicorn” companies in China to be listed in China. The approval of the listing of class shares in exchanges in Mainland China is also expected to stop major companies from leaving the country.

[Moreover, the Communist Party of China announced the opening of a new market, the “Sci-Tech innovation board,” specialized in companies related to high-technology and innovation, at the Shanghai Stock Exchange, as decided at the sixth meeting of the Central Comprehensively Deepening Reforms Commission held on January 23 in Beijing. At the same time, the pilot introduction of the shelf registration scheme for the issuance of stocks was also approved at this conference.](#) The “Sci-Tech innovation board” is the equivalent of the so-called “emerging market,” targeting high-technology companies, and can be compared with the NASDAQ market in the U.S. In the stock market in China, the system based on listing approval by the CSRC has thus been abolished, and the registration system is now in place, being considered as a means to guarantee freer activities for companies and supporting their efforts to be listed.⁵ It should also

³ There are no futures in the interbank bond market, and banks are mainly using interest rate swaps in order to hedge interest rate risks on their bond holdings.

⁴ Measures to call back those companies other than the approval of class stocks include Chinese Depositary Receipts (CDR), through which stocks listed abroad are listed in the domestic market.

⁵ For the “Sci-Tech innovation board,” the use of class stocks is approved.

be mentioned that, as a result of this deregulation, the Growth Enterprise Market, which is the equivalent of the emerging market at the Shenzhen Stock Exchange, is also taking some measures of deregulation, such as in the approval for companies with class share.

3) Revision proposal for the *Securities Law*

On April 20, the tenth session of the Standing Committee of the 13th National People's Congress ("NPC," the equivalent of Japan's Diet) was held, discussing the revision of the *Securities Law*.

The revision of the *Securities Law* has been discussed for many years, and the major discussion was on whether or not to move to the registration system (post facto approval). The revision proposal submitted this time referred to the introduction of the registration system only for the "Sci-Tech innovation board" and did not propose the scheme transfer for the main board.

It should also be mentioned that other important points discussed include the raising of the upper limit for fines on frauds, collective-action clauses, and the introduction of the *Funds Law*, in order to remove matters related to asset management business from the *Securities Law*.

4) Investment methods for Mainland China

The State Administration of Foreign Exchange (SAFE) announced its decision to double the investment limit for the Qualified Foreign Institutional Investors (QFII) scheme from USD 150 billion to USD 300 billion, in order to prepare for capital inflow based on the inclusion of A-stocks into the international stock index. Furthermore, at the end of January, the CSRC announced its principle to integrate the QFII scheme and the Renminbi Qualified Foreign Institutional Investor (RQFII) scheme, while deregulating entry into the market and expanding the target investment outlets. As A-stocks were included in stock indices such as that of MSCI, the global demand for A-stocks has been steadily growing. However, the proportion of A-stocks in the indices remains low compared to actual market capitalization, due to the level of the market liquidity. The Chinese monetary authorities hope to normalize the Chinese stock market, which is currently occupied by individual investors, via the participation of foreign institutional investors. However, it is uncertain if investment in A-stocks by foreign institutional investors will increase as is expected.

On September 10, the SAFE announced the abolition of the upper limit on investment for QFII and RQFII. Concerning QFII and RQFII, it had been pointed out that there are two types of procedures from the CSRC and the SAFE, while the management of the upper limit was complicated. With this decision, it was made less complicated to be qualified, and the scheme was made more flexible. As China continues to open to foreign institutional investors, there is fiercer competition among different schemes, as there are many investment methods available, such as the stock connect schemes. Under such circumstances, the maximum possible deregulation was announced for the QFII and RQFII schemes. Some media reported that restrictions on the covered countries and regions for the RQFII scheme will be lifted in the times ahead. If that happens, qualified foreign institutional investors will be able to invest in securities in Mainland China using Chinese yuan abroad, regardless of where they are.

On December 13, the SAFE and the PBOC together released a call for opinions regarding the proposed "regulations on the

[management of domestic securities investment funds from foreign institutional investors,” which will integrate the fund management for QFII and RQFII and abolish the upper limit on custodians.](#) If this proposal is approved, it would be unnecessary for foreign institutional investors to submit documents such as an accounting report on investment returns issued by an approved accountant in China and a taxation report when sending investment returns abroad. Instead, they need to submit approval for the full payment of taxes. Furthermore, the registration form for foreign institutional investors would be made easy through the reduction of contents in the registration form.

[Also, the CSRC and the Financial Conduct Authority \(FCA\) in the U.K. approved the opening of the so-called “Shanghai-London Stock Connect scheme,” i.e., the mutual listing of Depository Receipts \(DR\) between the Shanghai Stock Exchange and London Stock Exchange \(LSE\).](#)

The Shanghai-London Stock Connect scheme is different from other existing stock connect schemes as only DR is mutually listed. Through this scheme, a subsidiary of Huatai Securities Co., Ltd., which is a major securities company in China, issued a Global Depository Receipt (GDR) at the London Stock Exchange with the approval of the Chinese monetary authorities. The listing of DR has the advantage in that it does not require a special system and the existing infrastructure can be used, while it also has the disadvantage in that the transactions are only limited to securities that issue DR, making it harder to expand transactions and manage indices.

It should also be mentioned that the China Europe International Exchange jointly established by China and three exchanges in Germany is also considering introducing a “Shanghai-Germany Stock Connect scheme” in order to approve the mutual listing of DR in Shanghai and German markets.

2. Conclusion

Under the title of “Regulations in the Chinese Capital Market,” this article introduced issues related to regulations and schemes in the capital market in China.

Facing low interest rates in developed countries and stable economic growth in China, the investment appetite of foreign institutional investors to invest in China has increased significantly. In order to encourage foreign institutional investors to enter the Chinese market, the Chinese monetary authorities have been engaged in maximum possible deregulation while also making efforts to enhance the attractiveness of the Chinese capital market as a whole, through the integration of the bond market as well as through the callback of companies listed in the U.S.

The weakest point about the Chinese capital market is that the stock market is mainly occupied by individual investors. The Chinese monetary authorities seem to expect positive change in the market structure through the participation of foreign

institutional investors. We should continue observing the outcomes of such efforts.

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