SUGGESTED POINTS FOR DISCUSSION

International Round Table on Securities Markets in China

Meeting to be held at the Shangri-La Hotel, Beijing, on 24-25 October 2000.
Suggested Points for Discussion

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24-25 October 2000, Beijing

Session I: Opportunities and Challenges for China’s capital markets in the WTO framework and related issues

Review of present state and potential of the Chinese capital markets, Opportunities and Challenges brought by entering WTO

Since the establishment of the Shanghai Stock Exchange and the Shenzhen Stock Exchange in 1990, China’s capital market has enjoyed rapid development. At the end of 1999, China had 949 companies listed and a market capitalisation of RMB 2.64 trillion yuan, or 31% of GDP. Progress has been made in a number of areas of the securities market.

The China Securities Regulatory Commission (CSRC) is now being granted sole power in securities market regulation and supervision after being merged with the State Council Securities Commission (SCSC).

China’s first Securities Law became effective in July 1999. The passage of the Law represented a major step toward well-regulated, transparent securities markets in China. Among others things, the Law imposes greater discipline on, and more clearly defines the obligations of, market participants, including listed companies, their directors, underwriters, brokers, dealers and law and accounting firms. It also stipulates transparent procedures for examining and approving applications for stock issuance and listing, toughens penalties on false disclosure and improper trading activities, and forbids brokerage firms from mixing their own and clients’ money to trade shares. Reforms in various areas of the capital market have also been progressing fairly rapidly.

However, judging from the importance of the capital market in the national economy, especially its importance in transmitting people’s savings into efficient investment, there are still a number of changes to be introduced in the capital market area. It is also very important to appropriately address the issues in the capital market in the context of the forthcoming entry into the WTO.

The following are some examples of the policy issues China may have to address in the coming years. In fact, the importance of these issues has already been somewhat recognised by the relevant authorities and parties in China. However, each issue involves a number of problems to be solved and it may take time to address them effectively and reap the fruits of the reforms. Therefore, it is important that all the relevant parties recognise the importance of these issues, identify the areas they have to tackle and make constant efforts in their respective areas of responsibility.

Securities companies are one of the main players in the capital market. Unless they provide appropriate services to customers, (investors and firms) on a sound financial basis and with appropriate expertise, the capital markets cannot fulfil their roles in the national economy. In addition, they need to develop sound risk management systems including a proper governance structure. Though there are some firms with such a capacity in China, many efforts are still needed to increase the competitiveness of domestic securities firms. In this regard regulators have to think about how to deal with the possible event of failure of a domestic firm especially from the viewpoint of investor protection.
Market mechanisms should be fully activated. In every aspect of the capital market, listing, trading etc., the normal function of the market has to be activated as much as possible. The existing regulations should be scrutinised carefully from this viewpoint. Of course a securities market needs appropriate regulation to ensure investors protection, as well as market efficiency, transparency etc., all of which are well-described in the IOSCO Principles on Securities Regulation. Therefore what has to be done is to check the purpose and the reasoning of the existing regulation from the viewpoint of appropriate securities regulation. In this regard the abolishment of the quota system on initial offering is highly welcomed. The decision to allow investment by insurance companies in the equity market, as well as to allow state-owned enterprises to invest in the stock market under certain conditions are also good news. The continuation of these kinds of efforts would be very positive. In this regard the rationalisation of many classes of shares has to be high on the agenda.

To secure proper functioning of capital market, the transparency of market is essential. In this regard, disclosure has to be strengthened in order to secure the correctness and the timeliness of disclosed information. In this context, the issue of accounting and auditing is also crucial. Efforts have already been made to bring China’s accounting and auditing standards up to international standards. Of importance would be the education of directors of companies on these matters, as would the actual implementation of these principles.

The above-mentioned point leads to the issue of strengthening investor protection. Investor protection is one of the basics of securities regulation and continuous efforts, including investor education, have to be made.

Corporate governance is another important subject. In the capital market it is essential that the rights of shareholders are appropriately protected. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently. This requires the management and the board of directors to ensure that all business decisions are taken in the best interests of the company and after due consideration of both the risks and rewards. The OECD Principles of Corporate Governance are a key reference guide in this regard. The capital market plays an important role in this regard by imposing many standards of corporate governance in its listing requirements.

The activities of institutional investors need to be further promoted. It is important that the market should have a group of investors who have the means and ability to make investments with longer time horizon as well as means to make informed judgements from company, industry and general economic data. Though the number of investment funds has been increasing recently, judging from the traded volume of shares, institutional investors still accounts for only a small percentage of the market when compared with other countries. As mentioned before, insurance companies have already been allowed to buy shares in the market. In time, pension funds would be allowed to enter the stock markets as well. Together with these two kinds of players, policy measures to promote mutual funds have to be examined further.

As financial asset management takes root, the range of investment products will naturally widen. In line with it, it will become necessary to consider establishing financial derivative markets for proper risk management on a market basis. In fact derivative products are indispensable for proper risk transfer in asset management and a study on it is indispensable for the further development of capital market.

As for exchanges, currently there is no secondary market or OTC market in China. The forthcoming establishment of the second board in Shenzhen is expected to play a favourable role in channelling capital into promising new enterprises, while due consideration has to be paid to investor protection.
Bond markets are still in a stage of infancy. A well-developed bond market is one of the key elements for the further development of financial markets. Though a number of efforts have been undertaken in this area especially for government bond market, there is still much work to be done.

The efforts for market oversight have to be sustained. There are still examples of market manipulation, fraudulent conduct and insider trading. These kinds of conduct are common matters of concern for securities market regulators all over the world. Though China has been putting emphasis on cracking down on these types of conducts, these kinds of conducts still exist in the market. In this regard, there are also new challenges in relation to the globalisation and the progress of technology in financial services, which will be discussed in the following sessions.

In order to implement the above-mentioned policy measures, the legal framework of the Securities Law has to be further developed and improved.

The prospective entry of China into the WTO will bring a new challenge for the capital market in China. However, it will also provide China with a very good opportunity to promote the reform of her capital market and securities industry. China is expected to use this opportunity positively, while learning from the experiences of OECD countries as well as other emerging economies and further strengthen her capital market as an important infrastructure for economic growth.

Opportunities and Challenges to Emerging Markets in the WTO framework in financial services.

According to the study of the WTO Secretariat, financial services trade liberalisation, which promotes the use of a broad spectrum of financial instruments and allows the presence of foreign institutions, whilst not unduly restricting their business practices, promotes financial sector stability. This would complement other policies, including financial regulation. Even in countries where the financial system is weak, and where immediate full-fledged financial sector liberalisation is not achievable, certain types of financial services trade could be liberalised, as such trade strengthens the financial system.

The emphasis of the liberalisation of services under the WTO is on allowing a commercial presence to firms rather than on capital account liberalisation. In this regard it should be noted that the economic gains of liberalisation must be underpinned by appropriate regulation, adequate supervision, and improved transparency.

Securities Markets and International Standards

The IOSCO Objectives and Principles of Securities Regulation are the international principles in this area. They were adopted in 1998 at the IOSCO annual conference. The Core Principles document sets out 30 principles of securities regulation, which are based upon three objectives of securities regulation. These objectives are:

- the protection of investors;
- ensuring that markets are fair, efficient and transparent; and
- the reduction of systemic risk.

The 30 principles give practical effect to these three objectives and are grouped into categories that cover the topics that are central to securities regulatory systems: the regulator, self-regulation, enforcement, cooperation with other domestic and foreign regulatory authorities, issuers, collective
investment schemes, market intermediaries and the secondary market. The Core Principles document provides guidance to regulators, and is a yardstick against which progress towards effective regulation can be measured.

Two points have to be noted here. First, while the establishment of the objectives and principles of regulation is very important, similarly critical are the interpretation, application and enforcement of these principles and objectives. The role of IOSCO in doing this is essential.

Second, regulators of securities markets and IOSCO take a broad approach to the topics that fall within their responsibility. For example, while historically it might have been thought that the issues of corporate governance and the development of bond markets were beyond the purview of securities market regulators, such an approach is not desirable now.

The IOSCO Objectives and Principles of Securities Regulation would serve as good reference material to examine the relevance of the existing regulations in the capital market in China.

Session II: The challenges posed and the opportunities provided by globalisation and technology.

The process of globalisation and technological developments in financial services has brought about big challenges as well as opportunities to the financial industries. On the one hand, it may increase the quality of services firms and individuals can enjoy. On the other hand, existing institutions need to consider taking on new strategies in their operations. It also poses challenges for regulators as under the new situation the level of risk involved may increase and new types of risk may emerge; thus regulators have to address the new challenges appropriately. The following are some of the examples of such challenges.

Mergers and demutualization of stock exchanges

There have been numerous examples of mergers, demutualization and listing of stock exchanges. In Europe the recently created Euronext is a typical example. In Europe, considerable additional consolidation is expected with several large trading systems spanning many countries and a number of ancillary trading systems as well. In the Asia Pacific region, after the merging of six separate stock exchanges into the Australian Stock Exchange in 1987, the Australian Stock Exchange was demutualized and listed in 1998. Another example is Hong Kong. The Asian financial crisis and regional competition made Hong Kong merge all its exchanges and clearing houses into one single holding company, which became a listed company.

There is also bitter competition among existing exchanges and new ‘markets’. The traditional idea on exchanges was that the efficiency of transactions could be achieved through concentrating all transactions on one specific exchange. Now, competition among exchanges and new trading systems is regarded as a good means to increase the efficiency of the securities market as a whole, and thus would be beneficial to the investors and firms. At the same time, many market participants and regulators note a danger of market fragmentation, which might lead to diminished transparency and heightened systemic risk.

As exchanges become more and more commercial in nature, their traditional role of supervising market conduct is susceptible to perceived conflicts of interest. The Australian experience tells us that the demutualisation and listing of the Australian Stock Exchange had been a significant success. However, it should be noted that this has required a substantial revision of the regulatory relationship between the
commission and the exchange, as there has been great pressure on the exchange to reduce the amount of money it spent on regulation.

The experience in different markets will be introduced and discussed from such viewpoints as: whether these events actually enhanced the welfare of markets and what points the securities market regulators have in mind to cope with these new situations.

**Alternative Trading Systems and their Regulation**

With the progress of new technology in financial services, securities companies are now operating alternative trading systems. Alternative trading systems are automated systems that match orders of selling and buying shares on a computer network. The functions they undertake are, in fact, quite similar to the functioning of existing exchanges. This is another challenge for regulators.

As for alternative trading systems, the US SEC adopted a new regulatory framework. The low cost of technology has allowed new, automated markets -- or alternative trading systems -- to develop. These systems compete directly with the more traditional exchanges, and account for a fair amount of transactions in listed securities. Although these alternative trading systems are markets, they have been regulated as traditional broker-dealers, which results in certain regulatory gaps. The framework adopted by the SEC better integrates alternative trading systems into the regulatory framework for markets and is flexible enough to accommodate the business objectives of, and the benefits provided by, alternative trading systems. The reasoning behind the rule and future regulatory trends (including the potential of outsourcing of regulation) will be explored.

**On-Line Trading and Challenges for Regulators**

There has been a remarkable increase of trading on the Internet in securities market. Whilst the Internet brings new opportunities, it creates new risks as fraudsters take advantage of the low cost and speed that it provides. Investors must be mindful of those risks and regulators must be ready to act where necessary.

Traditional types of fraud and manipulation migrated to the Internet while new types of fraud are now developing, which are unique to the Internet. These pose new challenges for regulators. Regulators have to cope with them effectively and have to fulfil their responsibility for investor protection appropriately.

In a global marketplace, effective enforcement requires co-operation among regulators around the world. The IOSCO Technical Committee conducted an International Internet Surf Day in March 2000, which aimed at increasing investor protection and market confidence. This initiative demonstrates the determination of the international regulatory community to work together to address the challenges posed by new technology.
Investor education is also very important in this regard. It is essential not only for protecting investors from investment fraud. In fact, how to apply the suitability doctrine to on-line trading is a rather difficult question. As a well-established doctrine, suitability refers to a broker-dealer's obligation to recommend only those investments that are suitable for a customer. In the on-line environment, pinpointing what constitutes a recommendation can be difficult. At the same time it is also true that the Internet provides a valuable resource for the regulator to more widely disseminate investor education materials.

Another important issue is the capacity of systems. Over the past year, many on-line firms have experienced some type of systems delay or outage that affected the ability of their customers to place orders. Despite the industry’s efforts to improve capacity, in the case of the US, the highest number of complaints about on-line trading comes from customers who cannot access their firms' systems. Regulators have to find appropriate measures to address this issue.

**Integrated regulatory regime**

In the face of globalisation and technological development, a regulatory regime also has to implement necessary reforms to accomplish its mission effectively. As the distinctions between different types of financial institution - banks, securities firms and insurance companies - are becoming increasingly blurred, there has been a strong trend to have a single integrated regulator.

One famous example is the creation of the integrated regulatory regime, the Financial Services Authority, in the UK. Its origin is the Securities and Investment Board and it has already taken over the responsibilities of bank supervision and insurance supervision. The process is still on the way and it will acquire its full range of powers as the single statutory regulator for all financial business in the course of the year 2000. Japan and Korea have also decided to introduce a single financial regulator.

Australia made a similar reform in its financial regulation framework and, abolishing an industry-based regulatory structure, shifted to a regulatory structure that works on a functional basis. The framework is now based on the “Australian Securities and Investment Commission” – with responsibility for market integrity, consumer protection and corporate regulation (incl. Fundraising) and the “Australian Prudential Regulation Authority” – with responsibility for prudential regulation of deposit taking, insurance and superannuation/pension funds, while the Reserve Bank of Australia is in charge of monetary policy, systemic stability and payments system.

In the context of China, two issues are involved here. First, how China should operate the cross-sectoral prohibition in its financial services. Second, under the current situation in financial services, it is important to determine what each regulator should do from the viewpoint of co-ordination among regulators and the merger of regulatory bodies in China. One thing is certain: each regulator should strive to ensure that regulation is well-coordinated in all fields, because the markets do not always take account regulatory boundaries.

**Session III: Challenges posed by an ageing population to the capital markets**

**Global review of pensions reforms and institutional investment**

An ageing population has already posed challenges to the capital market especially through the development of pension funds. OECD pension funds are already key players in many financial markets and their importance seems clearly set to increase.
Contractual savings (Pension funds and life insurance) are powerful instruments for increasing the supply of long-term funds in the economy. In fact, because of their long-term liabilities, they increase demand for stocks and long-term bonds. They would have the highest impact on the development of capital markets, when regulations allow investments in shares appropriately.

The benefits of advance-funding hinge crucially on the performance of financial markets. Financial rates of return on private pension funds have varied significantly across countries in the past, but ageing may adversely affect returns in the future.

Gains in performance may be obtained by strengthening the financial market and pension system infrastructures. One of the major policy issues in this area is the regulatory environment surrounding pension funds. There are two different types of approaches, namely “prudent person” approach and “quantitative restrictions”. The principle of the prudent man management means that it is up to the manager and not to statutory provisions to determine the investment policy. Thereby one is trusting the manager’s expertise in financial strategy and his prudence. In general, this principle requires managers to follow high fiduciary standards in investing funds. Which approach results in better financial performance is as yet tentative and hardly conclusive. What is certainly true is that “prudent person” countries, in general, allocate a higher percentage of their portfolio to equities than countries that apply quantitative restrictions.

The appropriate regulatory framework might well differ between developing countries and developed countries. A "relaxed" regulatory regime would be more appropriate for countries with developed capital markets and a long tradition of private pension funds. Relatively strong regulatory regimes may appear more suitable for less developed countries that have underdeveloped capital markets and little or no tradition in operating private pension funds. There are several determinants of the appropriate regulatory framework of private pension funds, including the country–specific philosophy of regulation, the nature of private pension funds, as well as the degree of individual choice.

What is equally important is effective governance mechanisms to solve conflicts of interest and ensure professional fund management based on diversification and asset-liability management. Such regulations can and are introduced completely independently of the choice of investment regulation instrument.

As important as the regulatory framework per se is the presence of an adequate supervisory regime, based on regular, reliable, and transparent information disclosure by the pension funds about their activities. Such an approach is reflected in the OECD regulatory policies for private pensions as well as in the OECD principles for regulating investment by insurance and pension funds. They are currently developed by the relevant OECD bodies and the International Network of Pension Regulators and Supervisors, which was created last April to promote the exchange of information and discussion on private pension systems throughout the world.

Growing flows of savings into retirement accounts should promote increased breadth and depth of financial markets and encourage the creation of more financial instruments, including better retirement products. These developments can be expected to lead to more efficient allocation of resources and risks.

**The Chinese issue in pension reform and capital market development**

China’s demographics alone pose a formidable problem for its pension programmes. The proportion of the population above the age of sixty is expected to increase by nearly fifty per cent over the next 10 years. Public pension plans, which presently cover SOE workers together with government employees and the military, are virtually entirely pay-as-you-go.
Since 1993, authorities have been instituting major pension reforms in order to achieve three basic objectives, namely, to provide more sustainable funding mechanisms, to reduce overall SOE pension burdens, to extend the coverage of pension programmes to the non-state sector.

The system that has emerged since 1993 is based on three ‘pillars’. The first is a basic defined benefit plan financed by contributions proportional to a worker’s salary. The second is an individual pension account financed by (compulsory) contributions from workers; while the third is a voluntary supplementary plan financed by individual firms or insurance policies purchased by workers. In 1997, the financing of the first two pillars were integrated and the separate funds were unified and placed under the management of agencies of the provincial and local governments. This process is still on the way. Supplementary pensions are voluntary but growing slowly, as a result of the already heavy burden imposed by social security contribution rates of over 30%. However, the development of private pensions can be expected to continue.

By the end of June 1999, the new pension network had been expanded to cover 110 million retirees, 26 million more than in 1998. Beginning in 1999, the coverage of pensions is being gradually extended to include the non-state sector. Though a number of issues still have to be addressed, the development of pension funds is a good opportunity for the development of capital market in China. As the lack of institutional investors has been pointed out as one of the main reasons of the volatility of stock market in China, a well managed pension funds system can be a solution of this problem.

Chile experience of pension fund reforms

Chile, in 1981, became the first country to radically change its pension system, replacing its public pay-as-you-go (PAYG) system with a privately-managed, fully-funded model. Upon introduction of the system, persons already employed were presented with the option of remaining with the public system or switching to the private one. The great majority of the working population is enrolled in private pension fund companies known as AFP. The Chilean pension fund system (AFP) has attracted much attention not only in Chile, but also abroad.

Chilean-style pension reform, leading to the creation of a fully-funded privately-managed pension system may have significant positive direct effects on savings, growth, and welfare. However, the indirect link, via capital market development, may be as important. This indirect link can be facilitated through accumulation of institutional capital, increased specialisation in the investment decision-making process, higher incentives to invest in financial innovation etc.

The question to be answered is what lessons can be drawn from the Chilean experience for the development of the capital market and pension reform in China.

Introduction to European pension system

In European financial markets, including pensions, the increase of competition due to the introduction of the euro, as well as the progress of technology, is now leading the change of the landscape. In the area of pensions, insurance companies, pension funds and investment funds have now become major players and this also causes a change in the situation. The current situation of European pension system as well as its future prospect including the its regulatory framework will be introduced and discussed.

Investor protection in the face of an increasingly wide range of investment products from fund managers, insurance companies and pension funds.
In line with the development and liberalisation in financial services, quite a wide range of investment products are now available to investors. Though this enhances opportunities for investors, it also poses a problem from the viewpoint of investor protection. The spread of Internet trading can also cause various problems as mentioned before. Under such a new landscape, securities regulators, self regulatory organisations and other relevant authorities have to put further emphasis on investor protection.

Investor education is still a key for investor protection. This should help investors make informed choices and manage their finances better. It is also important to respond to public enquiries appropriately. Through enquiries investors can better understand their rights and responsibilities. In this regard the Internet is an important channel for the promotion and distribution of information about financial services to investors.

Session IV: Market Opening and Foreign Institutional Investors:

Institutional pre-requisites for encouraging institutional investment: exploring the regulatory, market and currency management issues

Institutional investors (insurance companies, collective investment schemes (CIS) and pension funds) have been gaining in importance in both OECD and non-OECD countries.

A number of common factors have been of crucial importance in driving the growth of institutional investors as a group. Among these factors are aging populations and pension reform, technological progress in communications and information processing, deregulation of the banking and securities industries since the beginning of the 1980s and investors’ shift in favour of more performance-oriented instruments like money market funds and equity mutual funds.

Rising institutionalisation has a profound impact on the structure and functioning of capital markets. A strong community of institutional investors has a number of positive feed-back effects on financial markets. For example, countries with an important institutional sector (e.g. the United Kingdom, United States, Canada) tend to have highly developed securities markets. Also, the process of financial innovation may be stimulated as sophisticated trading arrangements and trading techniques are developed. The institutionalisation of savings has led to an increased supply of long-term funds. Consequently, the growth of the number of institutional investors may also lead to an increase in the supply of risk capital. However, despite the welcomed side-effects, a number of new policy challenges arise as well. In particular, it will increasingly be necessary for policy makers to take a closer look at the functioning and regulation of institutional investors, as they have a growing influence on the structure and modus operandi of capital markets, the role and importance of capital markets for the real economy, corporate finance, and income security.

There appears to be a tendency among institutional investors to increasingly delegate the management of their portfolios to professional fund managers. The role of the fund management profession is therefore a key factor in analysing the relationship between institutional investors and financial markets.

In the context of China, the entry of foreign institutional investors will surely have a big impact on the capital markets and facilitate the development of capital markets. The innovation in financial services will be stimulated and trading techniques will be developed. The profession of fund management will also be spurred through the entry of foreign institutional investors.
Regulation of institutional investors’ activities differs both across types of institutional investors and across countries. Typically, a number of reasons are cited for public intervention in the operation of markets. They concern potential market failures related to information asymmetry, externalities and situations where some monopoly power prevails.

As for the regulation of investments by insurance companies, there have been significant changes in the investment regulation of insurance companies in many OECD countries. The widening of the range of permitted classes of investments, especially during the last five years, has removed constraints in some countries. In most OECD countries, however, there are limits on particular classes of investment in which life insurance companies can invest. In recent years, there has been reconsideration of the adequacy of detailed quantitative restrictions on investment choice. Many of the "old" risk controls (e.g. investment only in high-grade securities, currency risk, hedging guidelines, etc.) seem to have shown some inefficiency in the recent past. Uni-dimensional risk measures appear to be unsatisfactory. Guidelines on risk management measurement systems and risk management practice appear to require constant reviewing.

Experience in market opening from emerging markets

The experiences with market opening in Malaysia, India and Thailand will be introduced and discussed.