

PRC Financial Regulation: Annual Report (2021) – Securities



2020 Key Dates

March 1 ●

The amended *Securities Law* came into effect.

April 1 ●

Foreign ownership limitation in securities companies was officially lifted.

June 18 ●

The CSRC approved the change of equity structure for JP Morgan Futures, making it the first wholly foreign-owned futures company in China.

July 19 ●

The PBOC and the CSRC agreed to connect the infrastructures of interbank and exchange bond markets.

October 10 ●

The CSRC announced to have received the application for establishing the first wholly foreign-owned securities company, Standard Chartered Securities, in China.

December 26 ●

The NPC Standing Committee adopted *Amendment XI to the Criminal Law*, substantially sharpening criminal penalties for securities- and futures-related crimes.

● **March 27**

First batch of six securities companies, including CICC, were included in the pilot “consolidated regulation” program.

● **June 12**

The China Securities Regulatory Commission (CSRC) issued a series of measures to reform ChiNext and pilot the IPO registration system.

● **July 17**

The CSRC took over New Times Securities, Guosheng Securities, and Guosheng Futures.

● **July 31**

The Supreme People’s Court issued *Provisions on Several Issues Concerning Representative Litigation in Securities Disputes*.

● **November 1**

The *Administrative Measures for Domestic Securities and Futures Investments by Qualified Foreign Institutional Investors (QFII) and RMB Qualified Foreign Institutional Investors (RQFII)* and supporting rules came into effect.

● **December 31**

Hangzhou Intermediate Court issued the first instance judgment for the Wuyang bond fraudulent issuance case, ruling that intermediary agencies must also bear joint and several liabilities.

2020 Regulatory Observations

1

The amended *Securities Law* officially came into effect and, together with the supporting regulations, strengthening the foundation of the rule of law in the securities market

On March 1, 2020, the amended *Securities Law* officially came into effect. The CSRC thereafter made significant amendments and improvements to the supporting regulations, with a total of 68 securities and futures-related regulations amended in 2020. At the same time, the CSRC continued to publish new rules or consultation papers to support the implementation of amended *Securities Law*. Such supporting regulations cover various securities-related areas, such as securities issuance, trading, information disclosure, refinancing, ongoing supervision and delisting. For example: the CSRC issued a series of measures to reform ChiNext, a subsidiary board under the Shenzhen Stock Exchange, to pilot the registration system for IPOs, and promulgated the *Measures on the Administration of Convertible Corporate Bonds*; the CSRC also sought public opinion on consultation papers such as the *Measures on Administrative Penalties for Securities and Futures-Related Violations of Law*, *Implementation Measures for Securities and Futures-Related Administrative Settlement Mechanism*, and the amended *Regulation on the Administration of Equities of Securities Companies*; and the CSRC amended the *Rules on Procedures for the Formulation of Securities and Futures Regulations* with the goal of improving the securities and futures legislation framework. Other bodies adjusted their rules to become synchronized with the overall revisions, including the CSRC local branches, the Shanghai and Shenzhen Stock Exchanges, and the Securities Association of China (SAC).

The implementation of the amended *Securities Law* has introduced or improved a number of key fundamental systems or procedures of China's capital markets, further strengthening the foundation of the rule of law, including:

- implementing in full the registration-based system for securities issuance, based on the example of reforms introduced by the Shanghai Stock Exchange STAR board (see also 4. below);
- requiring higher levels of information disclosure for listed companies, covering disclosure of “material matters”, disclosure of changes in equity, and short-term trading, aligning requirements with those needed by the Shanghai and Shenzhen Stock Exchanges;
- adjusting the regulations and specific arrangements applying to different types of securities service providers from approval to filing, with detailed rules set out in the *Regulation on the Administration of Filing of Securities Service Providers Engaging in Securities Service Business*;
- substantially increasing costs for those carrying out securities-related violations, with the *Amendment XI to the Criminal Law* adopted in late 2020 also substantially increasing the criminal penalties for securities-related offences; and
- enhancing investor protection through a number of measures, including ensuring investor suitability management, advance compensation to investors before litigation is complete, allowing for “representative litigation” (China's class action-type litigation) in securities disputes, and introducing multi-forum dispute resolution.

The amended *Securities Law* is an integral part of China's capital markets structure, addressing all aspects of the operating and organization of the market and thereby offering far-reaching impact.

2

Regulators refining the classification of different types of securities companies, and encouraging greater specialization

Following on from the 2019 *Regulation on the Administration of Equities of Securities Companies*, regulators took further steps in the new *Securities Law* to complete the categorization of the different types of securities companies, with the aim of encouraging the specialized development of securities companies and therefore the market as a whole. This is the first time that the CSRC has classified securities companies according to business risk and capital requirements.

The 2019 *Regulation* classified securities companies into “professional” and “comprehensive” securities companies, depending on which business they are in. The shareholders of professional securities companies need to satisfy all basic statutory conditions, while the major and controlling shareholders of comprehensive securities companies are required to have a higher level of governance and risk compensation capability than those of professional securities companies. In line with such classification, the amended *Securities Law* listed “securities lending/borrowing” and “market-making” as “base securities business types”, alongside other base securities business types such as “brokerage” and “underwriting”.

In May 2020, the CSRC solicited public opinion on the draft amended *Regulation on Classified Regulation of Securities Companies*, where the classification system emphasized/recognized the business capacities in niche areas and the revenue of securities companies. The purpose was to encourage greater specialization by different securities companies, especially small and medium-sized companies, who could develop niche areas of business.

Leading and larger securities companies were also given regulatory support. In particular, under the *Provisions on the Calculation Basis for Risk Control Indicators of Securities Companies*, companies with Class A, Rank AA ratings or above for three consecutive years had their risk capital reserve adjustment ratio lowered (from 0.7 to 0.5). In April 2020, under the pilot “consolidated regulation” program, securities companies taking part in the program were permitted to operate on the basis of more flexible risk control indicators, which would take into account the consolidated data of any parent company and subsidiaries when filing regulatory statements of risk control indicators, as well as lower the relevant ratios.

3

Regulators simplifying ex-ante regulation of the securities institutions

As the CSRC has continued to refine and improve the regulations governing companies operating in the securities market, developments in 2020 focused on the streamlining of administration, creating more efficient government services, and generating greater delegation of responsibilities. The amended *Securities Law* eliminated many regulatory approvals that securities institutions previously had to obtain, requiring filing instead, and simplified other regulatory processes. The intention is to work towards an efficient operation of the capital markets, improved regulatory transparency and greater predictability for market players.

These reforms were manifested in many ways, including:

- Several matters previously requiring approvals need now only to be filed, including: the qualification of directors and supervisors of securities companies; the establishment, acquisition or revocation of branches of securities companies; securities companies' overseas establishment, acquisition of, or investment in, securities institutions; changes of registered capital and equity that do not involve changes in the major shareholders or the actual controller; and changes of important provisions of the articles of association;
- Filing procedures were made simpler, as their legal character of filing rather than licensing was clarified, and all qualification conditions were removed. For example, the *Regulation on the Administration of Filing of Securities Service Providers Engaging in Securities Service Business* (effective August 2020) simplified filing procedures; and
- Existing regulations were made clearer, by style, structure, and categorization to aid compliance by market players. For example, in July 2020, the CSRC consolidated all "Regulatory Q&As" addressing day-to-day regulation and M&A/restructuring review for listed companies.

4

Registration system being applied to existing securities markets, starting with ChiNext market IPOs and bond issuances

The STAR board, launched in 2019, became the testing ground for reform of China's capital markets by setting up a registration-based IPO system. The pilot was successful, leading to a similar system on the ChiNext market in June 2020. Apart from the ChiNext market, on the first day of the implementation of the amended *Securities Law*, the National Development and Reform Commission (NDRC) and CSRC both issued new regulations providing that enterprise bond and corporate bond issuance which previously were subject to NDRC or CSRC approval should move from needing prior approval of regulators to a registration-based system.

As well carrying out reforms on the issuance side, regulators took stronger action to enforce regulations. The regulation of ChiNext market was tightened substantially: in September, the CSRC investigated perceived abnormal trading behavior of Tianshan Biological and other stocks; in December, following an investigation on securities companies, the IPOs of two companies on ChiNext were cancelled; on

the last day of 2020, the CSRC reported the alleged major financial fraud of ChiNext-listed company, Zhengzhou Sino-Crystal Diamond.

The Supreme People's Court, Guangdong High Court and Shenzhen Intermediate Court all stated to safeguard for the ChiNext market pilot registration system.

In addition, the CSRC moved to improve the delisting process. A total of 16 listed companies were delisted from A-shares in 2020, more than in any previous year. The CSRC stated that the delisting system shall be more rigid, and the Shanghai and Shenzhen Stock Exchanges also released draft amended delisting-related rules to solicit public comment in late 2020.

These efforts all lay the groundwork for the introduction of registration-based system in China's other securities markets.

5

Regulators strengthened the workings of the market by stricter regulation and ex-post enforcement, and implemented a policy of zero tolerance

For the registration-based system as well as streamlined administration and delegation of powers to be effective, there needs to be in place enhanced law enforcement and supervision, more severe penalty for violations and comprehensive civil, administrative and criminal accountability.

The amended *Securities Law* significantly increased the administrative penalties for many violations (e.g. fraudulent issuance and disclosure-related violations) and introduced other processes, such as ordering buybacks, advance compensation to investors before litigation is complete and class action-type “representative litigation”. For example, the amount of fines levied on issuers in fraudulent issuance cases was increased from 1%-5% to 10%-100% of the amount of illegally raised funds; the maximum amount of fines on sponsors issuing sponsorship letters using false information, misleading statements or material omissions was increased from five times to 10 times business revenue. The *Amendment XI to the Criminal Law* significantly increased criminal penalties in respect of four types of securities and futures offences, including fraudulent issuance, fraudulent information disclosure, provision of false supporting documents by intermediaries, and market manipulation. On top of that, the CSRC, in its *Implementation Measures for the Regulatory Measures in the Securities and Futures Market (Consultation Draft)*, listed 16 common regulatory measures, other than administrative penalties, as effective supplements to financial regulatory tools.

All applicable departments were committed to vigorously cracking down on illegal activities in the securities and futures markets:

- in 2020, the CSRC carried out targeted attacks on illegal activities including on “black mouths” (disseminators of false market information), “illegal stock recommendations”, “off-market financing”, and chat groups APPs related to the illegal activities.
- the CSRC continued to target instances of financial fraud by listed companies.
- the CSRC, together with the Supreme People’s Procuratorate, listed 12 typical securities offences, including market manipulation, insider trading and dissemination of false information on securities trading.
- the Supreme People’s Court issued a notice requesting the courts nationwide to strictly punish securities and futures crimes, adopting a policy of zero tolerance.
- in the Wuyang bond issuance case in late 2020 involving fraud, 496 eligible investors jointly elected four investors to bring legal action on behalf of all of them, claiming a total amount of more than RMB810 million. The Hangzhou Intermediate Court, in its first instance judgment, ruled that the intermediaries such as lead underwriters, law firms, accounting firms, and rating agencies should be jointly and severally liable for compensation, causing much consternation in the market.

6

Compliance management and risk control of securities companies remaining the focus of regulation and enforcement

As the capital markets' reforms speed up, there has been a tightening of regulation of securities institutions. The number of penalties issued by financial regulators against securities companies (including branches and trading outlets) and relevant practitioners in 2020 far exceeded that of the previous year.

One of the main focuses of enforcement was on internal governance and equity management. For example, for the purpose of rectifying poor equity management and corporate governance structure, the CSRC took over New Times Securities, Guosheng Securities and Guosheng Futures in July 2020. For corporate governance failures and internal management issues, Zhongshan Securities was suspended from carrying out some of its businesses, including the filing of new asset management products, conducting some new capital-intensive businesses (stock-pledged

repo, stock lending/borrowing, etc.), and trading with related parties with its own funds or asset management funds (such as bond-pledged repo transactions).

Another enforcement focus was on compliance and risk control of securities companies' day-to-day operations. On July 10, the CSRC took action against GF Securities, including suspending its sponsor qualification for six months and suspending the acceptance of documents related to bond underwriting business for 12 months, for its failure to exercise due diligence in connection with investment banking business related to Kangmei Pharmaceutical. For failures such as major errors in their research reports, Zhongtai Securities, Founder Securities and China Securities were all punished.

7

The securities market continuing to open up

Opening up has long been central to reform of China's financial services sector. Both the securities and futures sectors saw increased liberalization over the past year.

The opening up of the securities sector accelerated during 2020, with the restrictions on foreign ownership of China's securities institutions being lifted on April 1. Since then, approval was given to Goldman Sachs, Morgan Stanley, Credit Suisse, Daiwa Securities and DBS Securities to become the controlling shareholders of their domestic joint venture securities companies; in October, the CSRC announced to have received the application by Standard Chartered Securities to establish the first wholly foreign-owned securities company; and in June, the CSRC approved JP Morgan Futures to become the first wholly foreign-owned futures company.

Cross-border transactions were more easily facilitated, with the removal of the restrictions on qualified foreign institutional investor (QFII) and renminbi qualified institutional investor (RQFII) investment quotas, the simplification of cross-border fund remittances, the combining of the QFII and RQFII qualifications and regulations, expanding investment scope, lowering entry qualifications, and lifting the limit on the number of intermediaries. The first QFII securities lending and borrowing transactions were completed at the end of 2020. In October 2020, the CSRC gave its approval to the Shanghai International Energy Exchange to conduct international copper futures trading, as well as allowing foreign traders to participate. In addition, the regulators issued the *Announcement on Foreign Institutional Investors' Investment in China's Bond Market (Consultation Draft)* in September 2020, which will connect the exchange and interbank bond markets, allowing foreign investors to access exchange-traded bonds.



Legislation on futures accelerating, legal framework for futures derivatives continuing to develop

Another legislative highlight in 2020 was the proposed dedicated legislation covering the futures market. Futures market is an integral part of the capital markets, whilst as yet, the legal basis only extends to administrative laws and regulations such as the *Regulations on Futures Trading*. According to the Chinese legislative hierarchy mechanism, there should be a “Futures Law” as the framework document of futures market.

The “Futures Law” was first proposed at the NPC meeting in 2014 and was included in the 2020 legislative work plan of the NPC Standing Committee. The draft is basically ready and will soon start the process of being reviewed. This will entail removing clauses dealing with securities derivatives contracts from the amended *Securities Law*

and potentially moving them to the proposed *Futures Law*. The *Futures Law* will provide an overall legislative framework for futures and derivatives in China. The legislation will become the top level legislation of China’s futures market and set out the legal status of the participating entities, establish basic legal relationships, civil rights and obligations and legal liabilities, clarify the regulation of the over-the-counter market, set out clear rules for market access, investor protection and opening-up to foreign participation, and provide a system of rules to safeguard the opening-up of the futures market, as well as cross-border regulation.

2021 Regulatory Outlook

1

Investment-side reforms will encourage greater long-term investments

In 2020, regulators repeatedly emphasized investment-side reform and the desire for entry of medium and long-term capital into the capital markets, as well as strengthening coordination and balance between the investment-side and the financing-side of the capital markets, in order to create a mature market for medium and long-term investors.

Throughout 2020, there have been many initial signs of these investment-side reforms, such as the lifting the quotas for QFII and RQFII, the moderate “loosening” of securities companies’ investment in financial bonds issued by policy banks, index funds, and constituent stocks, the support given by the CBIRC to wealth management subsidiaries to increase their proportion of equity investments, and the ongoing relaxation of conditions imposed on insurance funds’ investments.

As the financing-side reforms such as launching of registration-based system constantly deepen, the investment-side reforms will develop too in parallel with it. In this regard, we expect the following to be considered or introduced in 2021:

- so far as trading is concerned, regulators may pilot single T+0 trades and may lift limits on price fluctuation;
- the regulators will focus on expanding the pool of mutual fund managers, improving investment advisory business rules and developing the professional capabilities of asset management companies;
- in terms of market access, the Shanghai-Hong Kong Stock Connect, Shanghai-London Stock Connect, Bond Connect and foreign direct investment in the interbank bond market will continue to develop to further bring China’s capital markets in line with international standards; and
- the financial derivatives market will continue to develop and broaden, allowing for the trading of more ETF products and more commodities and stock index futures/options, among others.

2

Fintech in the securities and futures sectors will be rolled out

Fintech is having wider applications in the securities and futures sectors. Blockchain infrastructure for regional equity markets' registration and custody, big data, cloud computing functions and program trading are increasingly being used. Fintech is also used in regulation: for example, the Shanghai Stock Exchange's new generation monitoring system is based on a big data platform, and the Shanghai Financial Court has used sophisticated IT calculation models and the "yield curve synchronized comparison" method to accurately assess investors' losses.

We expect that regulation of the application of Fintech to become standardized in 2021. The Technology Regulation Bureau, established by the CSRC in June 2020, will serve as an overall coordinator of regulatory functions related to the use of technology in the securities and futures sectors, such as coordinating the technology resources of regulators, guiding the technology development of the financial market infrastructure of the industry, carrying out data

standardization governance, and taking charge of the filing of securities IT system service providers. The two batches of "filed securities IT system service providers", announced at the end of 2020, will mark the start of a routine filing procedure and regulation for such service providers.

Regulations may be introduced to regulate the practice of securities companies renting third-party online platforms to conduct securities business. Regulators will work towards establishing a mechanism aimed at preventing risks in Internet-based services. Third-party online platforms will fall within the category of IT system service providers for the purposes of unified regulation. The regulatory approach for program trading is also being explored, and we expect progress to be made in 2021. Fintech-related incentive measures are also being formulated, for example, in order to introduce more Fintech professionals into the CSRC, the CSRC intends to relax the level of work experience requirements of such Fintech professionals.

3

Securities laws enforcement will be carried out with zero tolerance, focusing on cases involving listed companies; regulators will further emphasize the intermediaries' duty to act as "market gatekeepers"

We expect that, in 2021, the focus of enforcement of securities laws will be on cases involving listed companies. This is one of implementation measures to support the registration-based system reform and other provisions of the amended *Securities Law*. The CSRC will continue to pay attention to problems caused by governance failure, management and control failures, and operational irregularities, such as illegal capital occupation, illegal guarantees, financial fraud, and manipulation of mergers and acquisitions. The CSRC may require listed companies to conduct self-inspection and it will step up on-site inspections and supervise the process of companies addressing and correcting internal failures. The regulators will also

continue to pay close attention to insider trading, market manipulation, illegal information disclosure, and other securities violations.

Together with the amended *Securities Law*, the Wuyang bond issuance fraud case at the end of 2020 sounded a warning bell for many types of intermediaries who have a role in such activities by making them potentially jointly and severally liable. In 2021, intermediaries will face more comprehensive and stricter regulation, and their duties as "market gatekeepers" will have to be more rigorously performed.

4

Administrative settlement may play a more significant role in the securities and futures sectors

In February 2015, with the State Council's approval, the CSRC issued the *Implementation Measures for the Pilot Program of Administrative Settlement* and the *Interim Measures for the Administration of Administrative Settlement Payments*, thus officially beginning the pilot program of "administrative settlement" in the securities and futures sectors. In 2019, the CSRC reached and made public its first administrative reconciliation. The amended *Securities Law* provides more clarity on the administrative settlement at the legislative level, and the CSRC has also set up an internal structure, including the establishment

of an Administrative Settlement Committee. Currently, the CSRC is pushing forward the development of supporting regulations, and the *Implementation Measures for Securities and Futures-Related Administrative Settlement consultation* paper were published to solicit public opinion in August 2020. We expect that, against the background of strengthened securities law enforcement, administrative settlement is likely to be more effective, striking a balance between efficiency and cost of law enforcement.

5

Judicial practice may be increasingly active in supporting the implementation of key regulations, with better and earlier involvement in major cases

The Wuyang bond issuance fraud case, where the various intermediaries were held to be jointly and severally liable, offered judicial support for the implementation of the amended *Securities Law* and current capital market policies. We expect that in 2021 the judicial system will continue to act in this vein, becoming more involved in major cases earlier and more decisively, and contribute typical case judgments in a number of specific areas.

We may witness the outcome of the first securities representative litigation in 2021. The *Amendment XI to the Criminal Law* also provides possibility of significant criminal liability cases in the securities sector.

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