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The Impact of 2015-2016 Chinese Stock Market  
Crash on Development of Chinese Securities

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# **The Impact of 2015-2016 Chinese Stock Market Crash on Development of Chinese Securities Regulation**

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## 1. The Introduction

In summer 2015, Chinese securities market experienced a black month. From 12<sup>th</sup> June to 8<sup>th</sup> July, the SSE composite Index fell from 5178.19 to 3421.53, and a double-dip in the August to 2850. Although the government published several urgent polies to contain the declining tendency, the aftermath of stock-market turbulence had not smoothed down until the beginning of 2016. During this market crash, over ¥ 1 trillion market value evaporated. Both the regulatory authority and the market agreed that the leverage was the reason of the market crash.

This article is divided into six sections. In the next section, the research mainly focuses on the theory of the securities regulation and the history of Chinese securities regulation. The third section talks about several paths for stock financing and how those agencies tried to avoid the regulation. Section four talks about the legal, technical and market supporting of stock leverage financing. Section five discusses the legal foundation and the regulatory logic of the CRSC. The last section gives some suggestions to improve the current Chinese regulatory framework.

## 2. The theory of securities regulation

### 2.1 The general principle of securities regulation

According to Black's Law Dictionary<sup>1</sup>, 'regulation' means 'control over something by rule or restriction'. Therefore, in this dissertation, 'regulation' is defined as 'restriction and

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<sup>1</sup> A Garner Bryan, *Black' s Law Dictionary*, vol 9 (2009).

interference conducted by regulator to the targets by law, economic and administrative enforcements<sup>2</sup>.

Although securities regulation is an important part of financial regulation, there are different explanations to the definition of 'securities regulation'. Nicolaisen believed that the securities regulation is restriction, interference and guidance conducted by the government and regulatory authority to securities market by law, economic and administrative enforcements in aim of adjusting the problem in the securities market.<sup>2</sup> While Avgerinos declared that securities regulation means that a regulatory authority supervises and control the issuing and trading of the securities according to the securities law in order to ensure the markets function properly.<sup>3</sup> Although there are different explanations to securities regulation, the essence of it is similar, which contains regulator, jurisdiction of securities regulation, aim of securities regulation and method of securities regulation.

### 2.1.1 Securities market regulator

The regulator generally contains government, relative institution and individual. In the case of securities markets, the regulator can be governmental organisation or self-regulation institution. The diversity is based on the development of nations and the differences in political and economic systems. In addition, the emergence and development of securities regulation are alongside the securities markets. In the stage of emergence of securities markets, the regulation is based on the market itself and the emergence of exchange reflects the institutionalisation and normalisation of self-restraint and self-regulation. In the early development stage of securities markets, institutions like securities exchanges and

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<sup>2</sup> Donald T Nicolaisen, 'Securities Regulator Looks at Convergence, A' (2004) 25 Nw. J. Int'l L. & Bus. 661.

<sup>3</sup> Yannis V Avgerinos, 'EU Financial Market Supervision Revisited: The European Securities Regulator' [2003] Jean Monnet Working Papers.

securities associations become the executor of the market regulation. However, with the further development of securities markets, economic crisis and financial crisis force the governments to step in the markets and conduct the role of regulation. In some countries like America, the status of governmental regulation has surpassed the self-regulation and become the theme of securities regulation. Even in the United Kingdom, whose securities regulation is mainly based on self-regulation, the government has started to step in. However, the governmental regulation has not been overemphasised at the expense of the self-regulation, they are both mainstream in securities regulation.

### 2.1.2 The aim of securities regulation

The International Organization of Securities Commissions (IOSCO) sets out three aims of securities regulation. They are: (1) protecting investors; (2) ensuring that markets are fair, efficient and transparent, and; (3) reducing systemic risk.<sup>4</sup> Although we have a unified international standard, the expressions of the aim of securities regulation in countries around the world are very different. For example, the Securities Act of 1933 contained two fundamental aims: (1) providing related material information in public offering to investors, and; (2) prohibiting any actions related to misdirection and fraud in securities trading.<sup>5</sup> On the other hand, according to the newest Chinese Securities Law, the aims of this law are: (1) standardising the issuing and trading of the securities; (2) protecting the interest of investors; (3) safeguarding the socioeconomic order and public interest and; (4) promoting the development of the socialist market economic system.<sup>6</sup>

In the view of developed and emerging markets, the aim of securities regulation can be summarised into two levels. The first level focuses on short-term objectives, which are

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<sup>4</sup> 'OICV-IOSCO - losco.org'  
<[https://www.iosco.org/about/?subsection=key\\_regulatory\\_standards](https://www.iosco.org/about/?subsection=key_regulatory_standards)> accessed 1 August 2016.

<sup>5</sup> Securities Act of 1933.

<sup>6</sup> Securities Law of The People's Republic of China 2005.

preventing market failure, protecting the interest of investors (especially minority investors), maintaining the just of the market and facilitating the market to function normally. However, the second level sets up long-term objectives, which pay more attention on macro-economic level. Thus, they contain the objectives to ensure the stability and efficiency of securities markets to improve the growth of national economy.

### 2.1.3 The jurisdiction of securities regulation

According to Fabozzi and Modigliani,<sup>7</sup> the jurisdiction of securities regulation can be divided into four parts. (1) **Disclosure regulation** requires the issuers of securities to disclose relative financial information to actual and potential investors. (2) **Financial activity regulation** contains provisions about securities traders and trading in the securities markets (e.g. provision against insider dealing). (3) **Regulation of financial institutions** restricts activities like lending, borrowing and funding. (4) **Regulation of foreign participants** mainly limits the controls and ownership of financial institutions by foreign firms in domestic markets.

### 2.1.4 Methods of securities regulation

The methods of securities regulation consist of law, economic and administrative enforcements. Among these methods, the law enforcement means that the government regulates the markets through legislation to control and eliminate fraud, manipulation of the markets, insider dealing and speculation.

The second method is economic enforcement. The government use this method to

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<sup>7</sup> Frank J Fabozzi and others, *Foundations of Financial Markets and Institutions* (2014) 13–14.



indirectly influence the markets and its participants by two main approaches: (1) **Credit financing**. By adjusting deposit reserve ratio, discount rate and open market operations, the government has a significant influence on the market and can stimulate or restrain it in order to stabilise any irrational fluctuations. (2) **Taxation**. By adjusting capital gains tax or securities transactions tax, the cost of securities will float, accordingly, the markets are stimulated or restrained by the government.

In contrast to the second method, the administrative enforcement means the direct interference and control by the government on the markets through policies. For example, in the stage of issuing of securities, a licensing system is set up to control the classification and scale of public companies; or temporary speed bump while trading. Although administrative enforcements are commonly adopted by the most of countries, the implement are more often in the emerging markets than developed markets. In the early stage of securities markets, it is understandable to use administrative enforcement due to unsound legislation and inefficient supervision. However, with the development of market economy and securities markets, too much administrative interference may cause over-regulation and distortion in market mechanism.

## **2.2 The theory and characteristic of emerging securities market regulation**

### 2.2.1 The review of the theory of emerging market regulation

Back to 1950-1960s, many economists emphasise on the importance of government interference. Paul Rosenstein-Rodan declared that the market mechanism had its drawback even in the perfect competition, and in order to maximise and optimise the national income,

the government must interfere the economy according to plan.<sup>89</sup> Likewise, the Neoclassical Synthesis suggested to apply macro fiscal and monetary policies to adjust economic activities in capitalism society, in order to have a stable growth and avoid crisis.<sup>10</sup> These theories gave strong support to emerging market regulation and became its theoretical background.

However, some scholars also believed that the existence of market failure and the demanding enforcing power from economic society to the securities market determined the necessity of the existence of regulation. To achieve the equilibrium between market failure and government failure, and evaluate the cost between the laissez-faire and government interference, while the government's dealing the relation with the market, the Chicago School stated the theory of interest group and rent-seeking theory.<sup>1112</sup> The idea is that economic regulation is result of the interaction between the political power and the economic interest of regulated sector, in addition, the rent-seeking from the interest group is also an important reflection of regulation failure. The regulation systems of emerging countries are very different from the developed countries', the vulnerabilities of the system and many institutional arrangements in the early stage of markets will cause the rent-seeking problem more severe. Ultimately, this activity leads to huge amount waste of economic resource, and on the other hand, distortion of the market mechanism.

Actually, the type of securities regulation that emerging countries should choose is based on the objective that country wants to reach and the cost of implementing such kind of

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<sup>8</sup> Paul N Rosenstein-Rodan, 'Notes on the Theory of the "big Push" ', *Economic Development for Latin America* (Springer 1961).

<sup>9</sup> Paul Narziss Rosenstein-Rodan, *Pricing and Fiscal Policies: A Study in Method*, vol 3 (MIT Press 1964).

<sup>10</sup> Paul Anthony Samuelson, *Foundations of Economic Analysis* (1948).

<sup>11</sup> Theo Surányi-Unger and Marver H Bernstein, *Regulating Business by Independent Commission* (1955).

<sup>12</sup> George J Stigler, 'The Theory of Economic Regulation' [1971] *The Bell journal of economics and management science* 3.

securities regulation. In other words, the optimal scheme of deciding securities regulation system is: on the premise that fulfilling the government's objective in a certain period of time, pursuing the lowest cost to implement such regulation system. For example, many emerging markets adapt licensing systems in initial public offerings (IPO), the reason is that the investors there are irrational and lack of the knowledge compared to the developed market, so the governments pay more attention on 'educating investors rationality and knowledge'. The differences in objectives of different countries cause different choices in securities regulation.

### 2.2.2 The comparative analysis between emerging markets and developed markets

From the empirical perspective, whether in developed markets or emerging markets, there are several common fundamental principles that complied by both side, such as fair-and-square.<sup>1314</sup> However, there is no single standard in all aspects and links of different securities markets, each market may be different in aspects like trading, clearing, transfer or issuing. In the level of regulation, there are three main difference between emerging markets and developed markets:

**The differences in functions of governments.** In developed markets, the main function of the government is to clear obstacles that cannot be smoothed away by market itself, such as manipulations or information failure. In addition, the problems like amount of financing or volatility of index tend to leave to the market itself, the role of government is more focused on 'standard' than 'development'. While the governments in emerging markets have not only role of 'standard', but also 'development' (where the latter is often prior to the former). Here the role of 'development' contains two meanings: On one hand, it means the efforts of governments in growing macro economy and securities regulation

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<sup>13</sup> Chinese Securities Law 2015.

<sup>14</sup> Securities Act of 1933 (n 5).

innovation to develop the securities markets. On the other hand, the government pays more attention to social economy related to the market, which means stricter rules choice in securities regulations.

**The tendency of avianization in government interference.** For the emerging markets, the developing direction should be ‘developing into standardisation’. With the establishment of market system, the role of ‘development’ of government will gradually resign and the role of ‘standard’ shall be strengthened. The more mature the market is, the more direct interference will be considered as over-regulation, especially in the aspects of capital financing.

**The differences in regulation objective and idea.** From the history in regulation of developed markets, protecting the interest of investors is always the mainstream. Based on this objective, the governments emphasise more on the fair competition and fair treatment among the market participants; control on the fraud, monopoly, manipulation and insider dealing; diversity of the risk and; confidence protection. Nevertheless, the governments in the emerging markets appeal to interfere the markets more directly extensively and specifically. Compared to developed markets, they often put objectives like quantity of capital, improving of corporate governance, education for the investors and the externality of securities market on the priority.

### **2.3 A review of the development of Chinese Securities Regulation before 2015 —**

#### **In the view of governmental regulation and self-regulation**

In 1990, after the applications of Shanghai and Shenzhen local governments, the central government approved their plan. On 26<sup>th</sup> November 1990, the Shanghai Stock Exchange (SSE) was set up and on 1<sup>st</sup> December 1990, the Shenzhen Stock Exchange (SZSE) started its soft opening. The establishment of SSE and SZSE turned a new page in the Chinese

capital market and China has also experienced ups and downs with the world in last two decades.

Backing to 1990s, the SSE and SZSE were the result of the policy of reform and opening, and the Shanghai and Shenzhen local governments were the key enablers during the establishment. In the last 20 years' development of securities markets, the path of institutional transition was led and pushed by the government. In one word, like other emerging markets, China's securities regulation is government-oriented and there are many administrative interferences in securities regulation. The development of securities regulation in China in past two decades can be divided into three periods: local government in dominance, collegiality by local government and central government and central government in dominance. Accordingly, the rights and space of self-regulation has experienced four stages: rising, decline, bottom and recover.

### 2.3.1 Local government in dominance (1990-1992)

In this period, the securities markets were considered as local experiments, most listed companies, investors and securities institutions were from Shanghai and Shenzhen. Before 1992, there was no unified regulation on Chinese securities regulation, nominally the financial management department of People's Bank of China<sup>15</sup> (PBC) should be responsible for the regulation, however other government departments, like the State Commission for Restructuring the Economic System, National Development and Reform Commission, and State Administration of Foreign Exchange, all could regulate the securities and securities market in their jurisdiction.

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<sup>15</sup> In early development of capital market, the PBC was appointed as supervisor. According to *Provisional regulations on the banks of People's Republic of China, Article 5, section 11*, one of the duties of PBC was 'regulate securities like stocks and bonds and regulate financial markets' .

In the establishment period, SSE and SZSE were local securities exchanges and regulated by local governments. In this period, due to lack of experience in securities regulation, the local governments relied on the exchanges in manage, regulate and organise markets and many institutional innovations were carried by the exchanges as well. The self-regulation and the independence of the exchanges were relative high at this stage, they had a wide range of market management power and had set up a series of rules to adjust and standardise the operations in the markets.

### 2.3.2 Collegiality by local government and central government (1993-1996)

In October 1992, the Securities Commission of State Council <sup>16</sup>(SCSC) and China Securities Regulatory Commission (CSRC) were established. In 1993, both Commissions started operation, which meant the central government began intervene and regulate the securities markets, the period of collegiality began. In this stage, the SCSC was the decision maker in securities regulation and the CSRC was the executing agency and actual regulator. Parallel to the changes in the regulator, the SSE and SZSE started to break the area limit and spread to the whole country. At this period, a national wide securities law system gradually set up, the rules of issuing, IPO and transactions trended to unify.

After the interference of central government, the space of self-regulation started to decline. For example, firstly, the ability of exchanges to design the institution for the securities markets was weakened. Meanwhile the SCSC and CSRC issued a series of laws and rules, such as *Provisional Regulation on stock issuing and trading* and *provisional regulation on the securities exchanges* in order to establish a unified national wide securities market. On one hand, the issue of these rules restrain the ability of exchanges to design and provide the institution.

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<sup>16</sup> On 17<sup>th</sup> December 1992, the State Council published *Notice of the State Council on further strengthening the macro-regulation on the securities markets*, and appointed SCSC as the supreme authority on securities regulation.

On the other hand, the rules also limited some regulatory power belonged to exchanges. Secondly, the independence and autonomy of exchanges gradually went down. According to the *provisional regulation on the securities exchanges*, the exchanges were regulated under dual system — the local government and the SCSC. However, the SCSC and CSRC paid more attention on the stock issue and IPO at this period, and the dual system had not intervened the core activity of exchanges, which was organising and managing the securities market. (The exchanges still had some extent of flexibility on product innovation and trading mechanism)

### 2.3.3 Central government in dominance (1998-now)

In August 1998, the State Council put SSE and SZSE under the regulation of the CSRC, integrated the SCSC and CSRC into a new CSRC and declared the CSRC as the only regulatory authority to the securities markets. Through these three steps, the regulation of the exchanges was totally controlled by the central government. In December, the first Chinese Securities Law was enacted, according to Article 1 Section 7,<sup>17</sup> the securities markets shall be under a centralised and unified regulation. So far, a vertical regulation system led by the CSRC was formed, the CSRC became the leader and regulator of the Chinese securities markets.

With the establishment of unified regulatory system, the development of securities markets relied more and more on the will of the government, the self-regulation fell into bottom. There are five main aspects that reflected this change: (1) the appointment of management in exchanges must be approved by the CSRC. (2) The formulation and adjustment of the operational rules in exchanges must be led, involved and approved by the CSRC. (3) The decision-making power of new products and adjustment of standards of charge also controlled by the CSRC. (4) The adjustment of some trading mechanisms

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<sup>17</sup> Securities Law of The People' s Republic of China 1998.

like methods of reporting needed to be approved by the CSRC. (5) The power of deciding public offering, suspension or termination became legitimate power of the CSRC.

The situation continued until October 2005, the new Chinese Securities Law was enacted. Unlike the former one, this edition recovered some functions of self-regulation to exchanges and defined the legal status of exchanges as self-regulation organisations, so this period was called as a recover stage of self-regulation. The recover can be summarised into five points:<sup>18</sup>

Establishing the exchanges as the legal person to self-regulation and defining the legal status and nature of self-regulation. (Article 102)

Reverting the ‘administrative power’, such as the power of deciding public offering, suspension or termination to ‘self-regulation power’. (Article 68, 55, 56, 60 and 61)<sup>19</sup>

Granting ‘residual legislative power’ to the exchanges, allowing them to amend the rules of deciding public offering, suspension or termination. (Article 50, 55, 56)

Abolishing some legal limitations in securities trading, such as extending the scope of market participants, making it possible for further participants other than securities companies to become members. (Article 110)

Extending the statutory limits of the exchanges in trading regulation, as needed, the exchanges had power to restrict the transactions of some accounts with severe unusual trading activities. (Article 115)

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<sup>18</sup> Securities Law of The People’s Republic of China (n 6).

<sup>19</sup> In reality, as the CSRC still controlled the power of securities issuance, so the exchanges were given back the power of listing securities nominally and could not execute it in practice.



Although the new Chinese Securities Law recovered some powers of self-regulation, in practice, the implement of the powers could only stay in the legal provisions. From legal perspective, exchanges are regulated by the CSRC according to *Chinese Securities Law* and *Provision about regulating securities exchanges*<sup>20</sup>, the relationship should be regulator and regulatee. However, from the reality, the relationship between them are like superior and subordinates. In one word, the status of self-regulation has not been improved essentially.

## **2.4 The allocation of regulatory power in Chinese securities markets**

### 2.4.1 The regulatory duties and powers of the CRSC

The China Securities Regulatory Commission has a variety of powers in securities regulation, they can be summarised as followed:

Regulatory powers on the listed companies

(1) The power of rule-making. Authorised by the Chinese Securities Law, the CRSC has the power to formulate regulatory rules and codes on listed companies.

(2) The administrative permissions. The CRSC has the power to examine and approve the listed companies to issue securities, acquisitions, assets reorganisation; and exchanges to enact rules stricter than the Chinese Securities Law for company listing.

(3) Regulation on disclosure. The CRSC has the power to regulate the disclosure with listed companies and relative obligors and set up standards reports like annual reports, interim reports and changes in shares held by relative obligors.

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<sup>20</sup> Provision about regulating securities exchanges 2001.

(4) Regulation on corporate governance. The CRSC has the power to raise an objection to the candidate of a director in the listed company, to set requirements on essential provisions in articles of association of listed companies and to establish regulatory credit file.

(5) Examination, investigation and disclosure of the result of investigation. The CRSC has the power to conduct on-site inspection to the listed companies; to investigate the company if the CRSC finds out activities which damaged interest of the company or finds out that the company faces significant risks, severe loss or other severe consequences, and; to choose to disclose the results of examination or investigation, which are based on the severity of the activities.

(6) Punishment. The CRSC has the power to punish the listed company and its controlling shareholders and executives based on their illegal activities. For the activities involved the crimes will be turned over to judiciary authorities. The CRSC also has the power to demand the exchanges to punish the listed companies.

#### Regulatory powers on the securities companies

(1) The power of rule-making. Authorised by the Chinese Securities Law, the CRSC has the power to formulate regulatory rules and codes on securities companies.

(2) The administrative permissions. The CRSC has the power to examine and approve the establishment of securities company and its branch; scope of business and; qualification of senior managers.

(3) Examination. Based on the principles of compliance and prudential regulation, the CRSC has the right to conduct examinations on securities companies.

(4) Investigation and punishment. The CRSC has the power to investigate securities companies and employee on the activities like damage to the interest of clients or disrupting the order of the securities markets and; to conduct administrative punishment or form a lawsuit once the illegal activities are confirmed.

#### Regulatory powers on the securities trading

(1) The power of rule-making. Authorised by the Chinese Securities Law, the CRSC has the power to formulate regulatory rules and codes on securities trading.

(2) The administrative permissions. The CRSC has the power to examine and approve the new products and the rules about securities registration, deposit and clearing.

(3) Day-to-day examination. The CRSC has the power to examine the business and other status of the securities exchanges.

(4) Investigation and punishment. The CRSC has the power to investigate the securities trading on the activities like damage to the interest of clients or disrupting the order of the securities markets; to collect evidence, to enquire, to consult and copy relative materials, to apply to freeze and; to conduct administrative punishment once the illegal activities are confirmed, or turned over to judiciary authorities if they are involved with crimes.

#### Others

According to the Chinese Securities Law, The CRSC has some other powers, including: regulating securities exchanges and their executives; regulating securities association and guiding it with qualification examinations among securities employees and; regulating other securities organisations, such as securities fund management companies, securities consulting companies and securities credit rating agencies.

## 2.4.2 Securities exchanges and other organisations

### Securities exchanges

According to the Article 102, Chinese Securities Law, the definition of securities exchange is *'A legal person, which is set up according to the relative laws and administrative legislations and approved by the national regulatory authority, provides a place for centralised bidding for the securities without profiting objective'*. In addition, the Article 11, Provision about regulating securities exchanges has clearly stipulated the 6 functions of securities exchanges:

- (1) Providing place facility for securities trading.
- (2) Formulating operational rules, organising and regulating securities trading.
- (3) Approving the applications of company listing and arranging the issuance of securities.
- (4) Regulating and publishing market information.
- (5) Regulating the listed companies and securities companies.
- (6) Establishing securities clearing system.

### Securities association

According to the Constitution of Chinese Securities Association<sup>21</sup>, 7 functions can be summarised:

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<sup>21</sup> Constitution of Chinese Securities Association 2011.

- (1) Formulating the legislations of self-regulation, practice standards and conducting self-regulation to the members and their employees.
- (2) Examining and assessing the credit condition of the disclosure of information.
- (3) Educating and training the investors and the employees, and organising examinations for the qualification of the employees.
- (4) Conducting security risk assessment to the vital information systems of securities companies.
- (5) Conducting self-regulation including reviewing the securities companies and regulating securities investment funds and securities investment consulting companies.
- (6) Reflecting the suggestions and demands of the members to the CRSC and mediating disputes between the members and clients.

#### Securities intermediary

Securities intermediaries like securities companies, investment counsellor, accountant and lawyer play an important role in the operation of securities market. It is inefficient for the regulatory authority alone to conduct securities regulation, any securities regulation systems must base on the self-restraint and self-regulation of the participants of the markets.

### **3. The main paths of stock leverage financing**

This section will discuss different paths of stock finance before 2015 Chinese Stock Crash.

#### **3.1 Securities companies**

The stock financing transactions led by securities companies contained margin trading and stock return swaps. According to the statistical material, the peak amount of stock financing transactions was ¥2.27 trillion and the amount of stock return swaps was ¥421.8 billion, accounting for 50% of total leverage funds.

##### **3.1.1 Margin trading**

In 2005, the new Chinese Securities Law lifted its ban on securities margin trading and short selling. In March 2010, the SEE and SZSE officially started the business with margin trading and short selling.

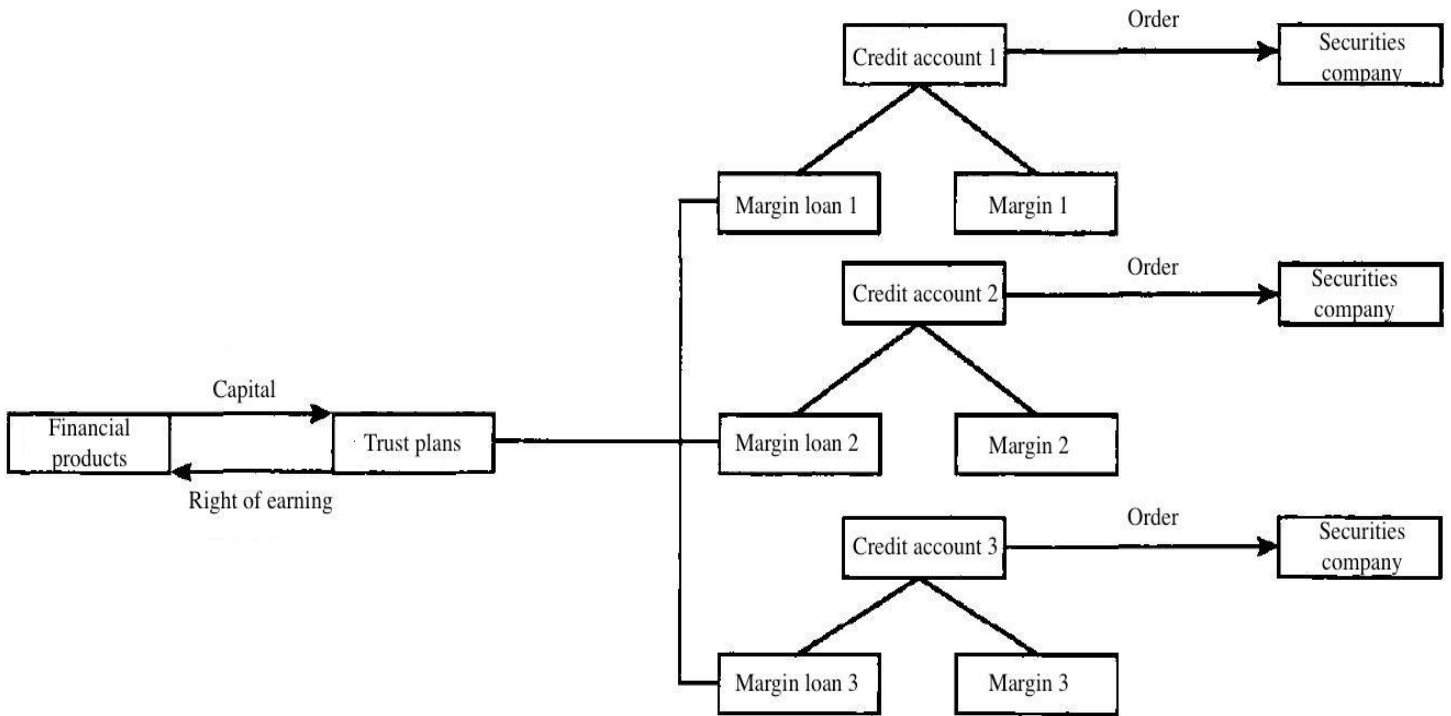
Considering the risk of leverage trading, the Chinese Securities Law has a strict regulation on it. The investors need to apply for this operation and take credit standing examinations from multiple agencies. In addition, they can only conduct transactions with appointed securities companies and the amount of securities assets in the account must beyond ¥500,000. Nevertheless, the requirements set by the exchanges include: the leverage ratio shall not exceed 100%; investors take the purchased stock and retained funds in credit account as collateral, once the net asset value is below 130% of the principal and interest of the leveraged funds, the securities company will conduct forced liquidation.

With the development of securities margin trading and short selling, the securities companies found that the equity fund and borrowed fund cannot fulfil the clients' demands. Then the securities companies started to receive capital from the financial products of banks. In practical terms, the securities companies packaged the earnings of underlying securities and sold it to the banks. On the other hand, the banks would purchase the earning right with the capital raised from financial products. After that, securities companies would repurchase the earning right with a set price and return the capital to the banks.<sup>22</sup> The reason they use repurchase transaction is for avoiding the regulation. According to the requirements proposed by China Banking Regulatory Commission (CBRC), there is a limit for banks to keep 'non-standard' credit assets, and the earning of securities margin trading and short selling will be very likely to be classified into 'non-standard' credit assets. However, through packaging the transactions to repurchase agreements, the Notice<sup>23</sup> will not affect them.

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<sup>22</sup> Notice about standardising the operations in financial product investments of commercial banks 2013.

<sup>23</sup> *ibid.*



Picture 1 The connection between financial products to financing business

### 3.1.2 Stock return swaps

Stock return swaps is a kind of derivative transactions, contract parties agreed to swap the earning of underlying stock and fixed interest for a certain of time in the future. After 2013, this transaction has changed from a traditional risk management tool to another path in providing capital to private placement.

From the economic perspective, the essence of stock return swaps is borrowing, that is to say, the securities companies lend money to clients and the clients pay the fixed interest (which can be viewed as interest of the loan) to securities companies. Before the stock market crash, the leverage of stock return swaps was 3 times to 5 times, far exceeds the securities margin trading and short selling. In November 2015, this kind of transactions were suspended by the CRSC.



### 3.2 Trust Company: umbrella structured trust

The umbrella structured trust managed by the trust companies are the main way in capital financing before the stock crash. Since 2009, the trust companies have invented ‘umbrella structured’ securities investment trust to deal with the temporal regulatory limits on opening securities accounts as trust plans. Compared to single structured trust, the umbrella structured trust has several trust units under one trust plan, while every unit following different investment advices invest respective securities, they all share one securities account from the trust plan.<sup>24</sup>

As the main clients of the securities investment trust are private funds and institutional investors, so the trust often also has the characteristic of ‘structured’. Specifically, the capital in every unit is divided into first and normal class: For the first class capital, commonly it is subscribed by the investors of the private funds and financial products from the banks. For the normal class capital, it is subscribed by the managers of the private funds and institutional investors. The investors of normal class capital (borrower) will be delegated as investment advisors for each trust unit by the trust companies and the investment of all the capital (including first and normal class capital) in each unit will be decided by the advisors and executed by the trust companies. Every unit has initial margin requirement and maintenance margin requirement. If the value falls below the initial margin requirement, the investor of normal class will receive a margin call for additional capital to reach the initial margin requirement. Once the value falls below the maintenance margin requirement or the investor fail to deposit additional capital timely, the trust companies will close the position to prevent the further loss and secure the interest and principal of the first class.

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<sup>24</sup> Although the CRSC abolished the limit in 2011, the umbrella structured trust continued to be applied in the market due to its convenience and low-cost to set up.

In 2014, the umbrella structured trust had been applied more extensively and showed two new characteristics:

Firstly, the capital from the financial products of banks started to subscribe the first class capital of each trust unit at 1:2 to 1:3 percentage, and the Directional Asset Management Plans (DAMPs) provided by the securities companies became the channel between the trust companies and the banks. The reason for this extra step is to avoid regulation from the CBRC as there was a limit in 2010 on cooperative financial products between trust companies and banks. In the notice, the CBRC required the banks to include such products into balanced sheet and stipulated the proportion value of such products cannot exceed 30% of total cooperative business.<sup>25</sup> Therefore, with the help of DAMPs and channels provided by the subsidiary of private funds, the banks could subscribe the first class capital in umbrella structured trust.

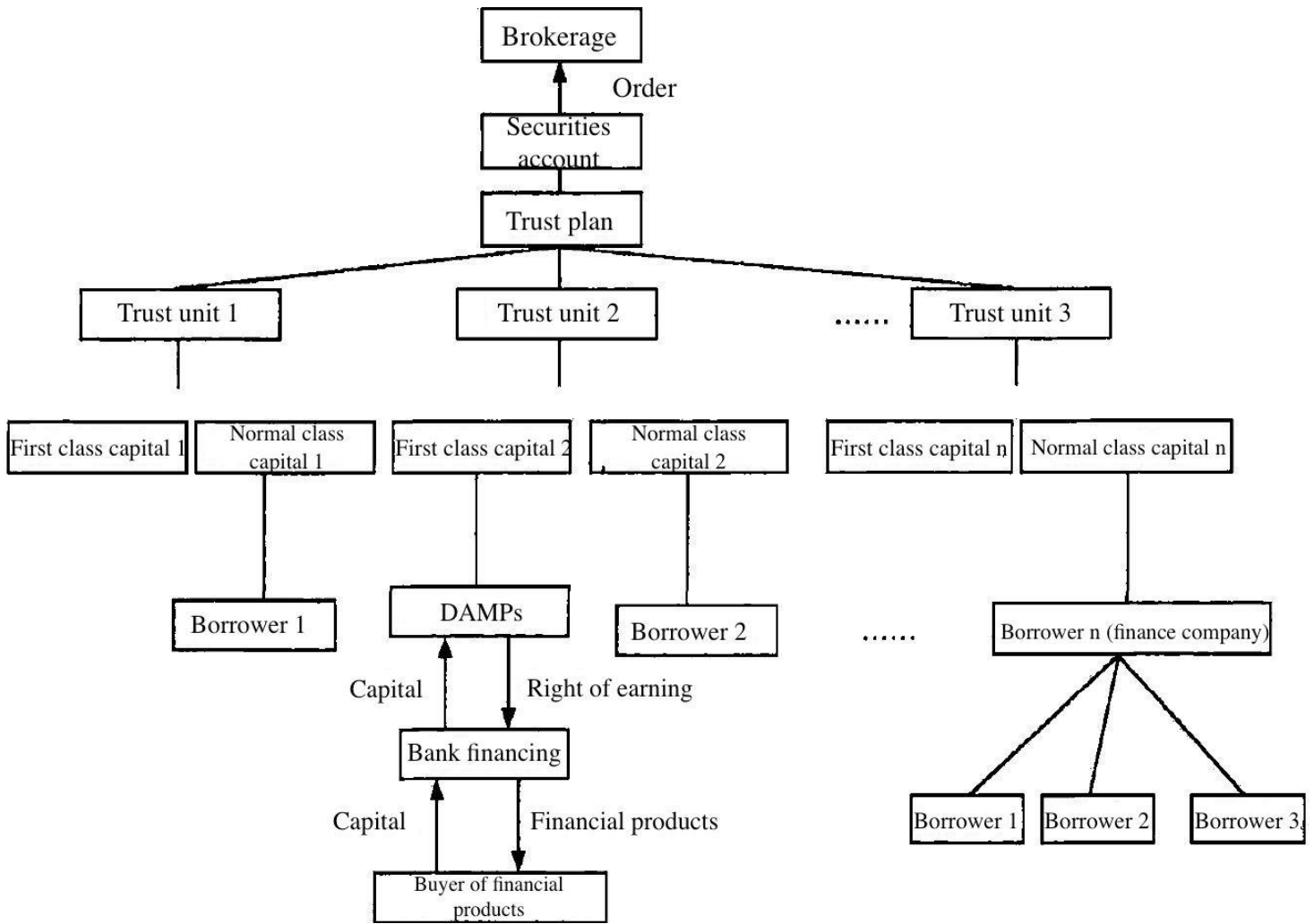
Secondly, in 2014-2015, not only the traditional institutional investors, but also the private finance companies became the investors of the normal class capital. Due to the relatively low cost in capital, the private finance companies structured the capital again into so-called 'small umbrella' and provided to their clients as financing, the leverage was extended further. Last but not least, as the nature of umbrella structured trust still belongs to collective fund trust, there are some conditions for the investors to invest according to *The rules of trust company on collective fund trust*.<sup>26</sup> However, as the private finance companies providing these services, many small investors can also use leverage to invest which somehow overthrew the conditions of investors.

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<sup>25</sup> Notice about standardising the cooperative financial products between trust companies and banks 2010.

<sup>26</sup>Please Article 6, *The rules of trust company on collective fund trust* 2009.

One of the most important conditions is 'each investment shall be at least 1 million RMB', thus, most of the small investors are not qualified to invest.



Picture 2 Umbrella Structured Trust

### 3.3 Fund Manager

#### 3.3.1 Directional Asset Management Plans (DAMPs)

In 2012, the government restarted the plan of securitisation of asset and financial innovation. One of the results was that the structured accounts under the DAMPs became a new path for stock finance. Among them, the DAMPs issued by subsidiaries of mutual-funds were the most successful, and the structure of this single structured fund product was very similar to structured securities investment trust.

In practice, according to *Provision about asset management plans issued by funds*<sup>27</sup>, the subsidiaries of funds issued DAMPs and invested into securities market. Then the DAMPs divided the clients into first and normal class, likewise, the first class is for the financial products of the banks, who in fact became the borrower of the normal class clients. In addition, the leverage ratio was 5 times, and the investment could be decided by normal class clients or the fund.

### 3.3.2 Structured funds

Structured fund is a portfolio for the fund of funds (FOF). After dividing the earning of the FOF and net asset, two portion (or more) of different risk returns are formed. (e.g. portion A and portion B) In this portfolio, portion A takes fixed return and portion B takes the residual earning and net assets of the FOF. In fact, it is a leverage mechanism that the holder of portion A provides money to the holder of portion B to buy the portfolio of the FOF, while the holder of portion B pays interest of financing.

The leverage mechanism of structured fund, which affects the stock markets, is different from other leverage mechanisms mentioned in this article. For example, on the aspect of downside momentum of stock market due to deleveraging, the reflection of other leverage mechanisms is about closing the position (selling the stock), while the structured funds use 'adjustment mechanism and redemption of holder of portion A' to force FOF sell the stock in portfolio. Specifically, in the establishment of FOF, the net portion value per unit of both portion A and B shall be ¥ 1, and the proportion shall maintain around 1:1. Due to the existence of leverage, the decline of stock market will cause the portion value of portion B dropping rapidly. In this case, to secure the interest of holder of portion A, the adjustment mechanism applies: for instance, when the net portion value of portion B falls from ¥1 to ¥ 0.25, the portion B will be merged in order to recover its net value back to ¥ 1. As the number of portion B declines due to the merge, accordingly, to maintain the

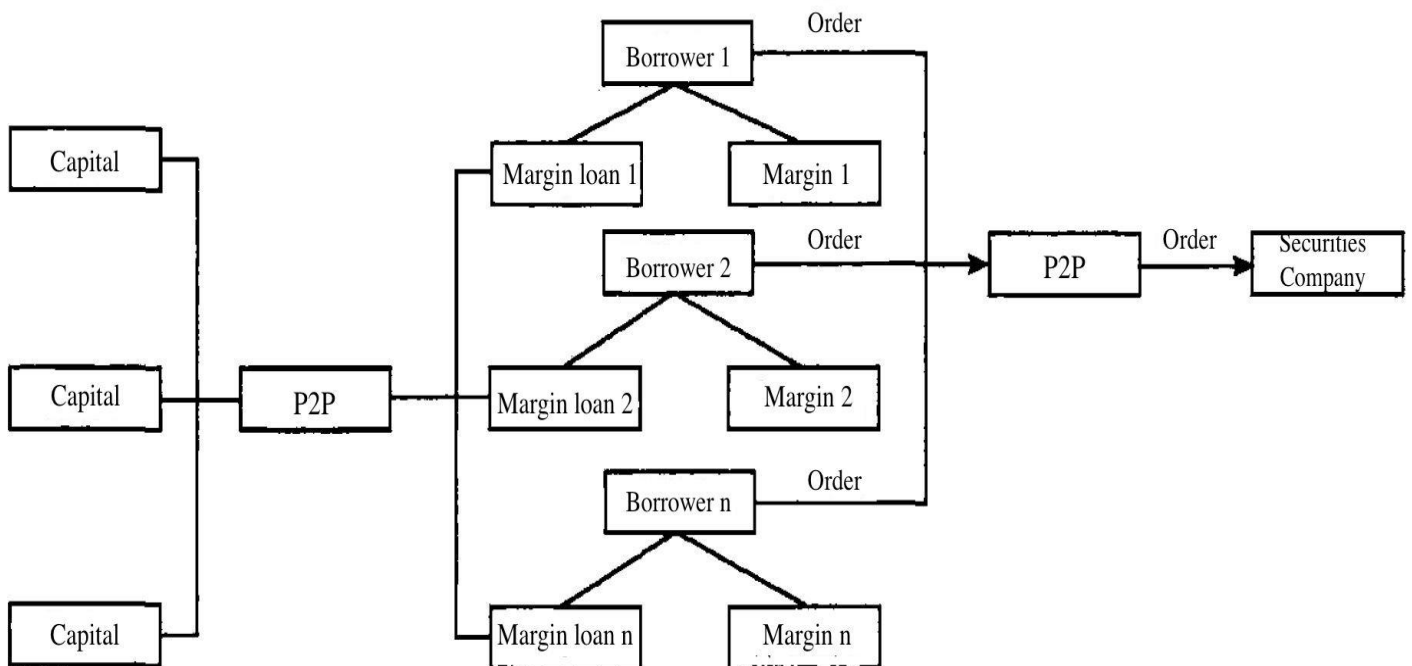
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<sup>27</sup> Provision about asset management plans issued by funds 2012.

proportion, the number of portion A will also be reduced to the same number of portion B, the excess portion A will convert to FOF and return to the holder of portion A. In the background of continues decline in the stock market, the holder of portion A will commonly choose to redeem the FOF to prevent further loss, which gives pressure to the FOF to sell the stock in the portfolio and increase the downside momentum in the stock market.

### 3.4 Private finance company and P2P financing

Private finance companies belong to the most typical over-the-counter (OTC) financing; in some scholars' paper it is synonymous with the term 'OTC financing'. Before 2014, the size of private finance companies was relatively small. After 2014, with the development of the Internet financing, the P2P mode was integrated into private finance business, then P2P financing became the most aggressive leverage tool to invest into the stock. A typical case in the procedure of P2P financing is: Investors only need to deposit initial margin and choose the leverage and time limit, then the P2P financing platform will provide margin



Picture 3 Private financing and P2P financing

loan to the account. The leverage is often 1:1 to 1:5, in some private finance companies, the leverage could be 1:10. By no accident, P2P financing was the first one having problem during the stock crash.

## **4. The legal, technical and market supporting of stock leverage financing**

### **4.1 The legal supporting — the establishment of right of forced liquidation**

The main method to protect the right of creditors is forced liquidation in stock financing, especially the OTC financing. However, there were arguments about the right of creditors to conduct forced liquidation in earlier years.

Commonly, the period of stock financing lasts for 6 months to 1 year. During this period, the securities and capital of the debtor in the agency's account shall be viewed as collateral, once the market value of the capital and securities fall below the maintenance margin requirement, the agency has the right to sell all the securities of the debtor immediately. But according to Chinese Real Right Law and Chinese Guarantee Law<sup>2829</sup>, when the securities are treated as collateral, the creditor must discuss with the debtor before the transfer of the collateral. On the other hand, the institutional arrangement of the forced liquidation declares that the disposal of the collateral is totally controlled by the creditors.

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<sup>28</sup> Real Right Law of the People's Republic of China 2007. See Article 219

<sup>29</sup> Guarantee Law of the People's Republic of China 1995. See Article 87

The concerns stated above once became a great opposition for China to launch the securities margin trading and short selling business. To solve this theoretical obstacle, the regulatory authority tried to introduce the trust structure.<sup>30</sup> To be more specific, all the money and securities in the credit account are taken as trust asset, which are held by trustor (debtor) and entrusted to trustee (securities company), while the debtor has income right and the securities company has security interest. Under this legal framework, because the securities company is trustee, so it has right to dispose the securities in the credit account, thereby avoiding the argument about forced liquidation. However, the arrangements of setting securities company as trustee and debtor as trustor and trust beneficiary are against the fundamental principles of the trust. In a normal trust structure, trustee has the duty to actively manage the trust asset to achieve maximum interest for the trustor, while the trustor passively receives incoming. But in margin trading and short selling, the situation is just the opposite, the debtor as beneficiary actively manage the asset while securities company as trustee just passively keeps the asset and enjoys security interest.

Of course, from the perspective of legislation, the limitation set upon the disposal of the collateral to creditor is mainly to prevent the situation that the creditor ignores the interest of debtor and undersell the collateral while the value of collateral is much higher than the right of creditor. However, when the collateral is cash equivalents like the stock of list company, the selling price is the market price, the worry about selling the collateral in an unfair price does not exist. On the other hand, from the perspective of protecting the interest of creditor, taking securities as collateral, its value is easily affected by the market fluctuations and the uncertainty of protecting the right of creditor is high. When the market falls sharply, if the creditor does not have the right, such as forced liquidation, to dispose the collateral timely, the mortgage in the first place loses its meaning.

Therefore, in 2008 the State Council published *Regulations on Administration Supervision of*

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<sup>30</sup> Measures for the Administration of the Margin Trading and Short Selling Business of Securities Companies 2011. Article 13

*Securities Company*, the article 54 stipulates:<sup>31</sup> When the value of collateral of the client is below the maintenance margin requirements, the securities companies should inform the clients to deposit the margin. If the client fails to deposit the margin timely or fails to repay the debt of margin trading and short selling, the securities should dispose the collateral immediately according to the agreement. So far, the arguments about the legality of forced liquidation came to an end.

#### **4.2 The technical supporting —account opening, stock screening and forced liquidation**

In modern securities transactions, the conduct of rights must rely on the technical supporting. In recent years, the success of financial software like Mecrt, Straight flush and Hundsun HOMS systems overcame the technical obstacle. Taking HOMS system for example, it is a software invented by Hundsun limited company, and published to market in May 2012, the main clients are private equity and trust company. There are two key functions of the HOMS system: The first one is compartment. The system can divide the assets managed by private equity and trust company and gives to different traders to manage. In addition, different assets managed by the same trader can also be divided. The second one is risk management, which means the system can send instructions to manage and control the amount of capital in market. With these two functions, the basic demand of financing companies is fulfilled. General speaking, the financing companies used the compartment function of HOMS system to arrange accounts opening in financing companies, which avoided the franchises of securities companies in account opening. The virtual accounts opened by compartment function are not securities accounts that registered in the securities companies. But for the investors, the functions of virtual accounts have no difference with the securities accounts registered in securities companies, both of the accounts can realise functions of ordering, clearing, deposit and withdrawing

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<sup>31</sup> Regulations on Administration Supervision of Securities Company 2008. See Article 54



cash. On the other side, as the accounts are registered in the financing companies, technically speaking, the accounts can be controlled by the financing companies. Especially the function of risk management in HOMS system enables the financing companies to set up initial margin requirement and maintenance margin requirement. Once the net value of the account is lower than the maintenance margin requirement, the financing company can conduct forced liquidation to secure the principal and interest of the leveraged capital without stock screening which saves the cost and greatly improves the efficiency.

Under the supporting of systems like HOMS, the DAMPs issued by subsidiaries of mutual-funds, the umbrella structured trust and P2P financing platform all pick up the train of 2014 bull market. Financing companies use compartment function to set up umbrella structured accounts, which is equal to set up secondary accounts to investors. Each investment instruction and liquidation order conducted by the investors are independent from each other, all the instructions will be gathered to financing company and then then financing company will send collective instructions to securities company. Of course, under this system, the securities regulatory authority can only see the financing agencies, and the ultimate investors are covered which is violate the law of real-name securities system.

### **4.3 The market supporting — the capital from the banks**

After 2013, with the decline of real estate market, the banks found out that the first class capital in securities financing business is the ideal investing target for banks' financial products: under the protection of forced liquidation, the first class capital has a high level of safety and return. In practice, there are mainly three ways for the banks' financial products to connect to financing: (1) accepting the income right of margin trading and short selling from the securities companies; (2) subscribing the collective trust capital plan or the first class capital from the DAMPs issued by subsidiaries of mutual-funds. (3)

investing into private financing companies through trust plan.

Banks as the most important financial institutions are always under a strict regulation in China, while the regulation on trust companies is not as strict as the banks. In this situation, there were a lot of cooperation between banks and trust companies, then many bank-trust cooperative financial products (BTCFPs) were sold to the society. In the early period, there was nearly not regulation on the BTCFPs and the banks avoided many regulations through BTCFPs. However, the risk of this kind of cooperation and the activities of avoiding regulations gradually captured regulatory authority's attention, in 2010, the CBRC started to strengthen the regulation on the BTCFPs and demand the banks to put this kind of product into balance sheet. After that, the banks also sought to cooperate with the asset management plans (AMPs) where the regulation was still weak, such as the securities AMPs, insurance AMPs and DAMPs issued by subsidiaries of mutual-funds.

Chinese financial sector applies separate operation, banks, securities companies and insurance companies could only operate their main business. But the fiduciary activity is different, it is legal structure: trustor entrusts trustee with independent trust asset, trustee has the duty to actively manage the trust asset to achieve maximum interest for the trustor, while the trustor passively receives incoming. The trust asset could be any form of asset. Therefore, the trust structure is a 'natural' tool to break down the separate operation. Generally speaking, the condition of the AMPs for clients is high and the source of clients is limited, so the AMPs did not develop well in period of independent development. However, the banks' financial products can concentrate a huge amount of small capital to purchase AMPs and provide resource of institutional investors, so the combinations of financial products with any AMPs will stimulate rapid growth in this area. In practice, when the banks found out that the first class capital in financing business is the ideal investing target for banks' financial products, all other AMPs sectors took rapid actions to design financial products for the banks to connect.

Of course, while the changes in legal, technical and market aspects activated the leverage mechanism, the systemic risk is also activated. The result of lacking macro-level regulation and legislation will be exposed in the stock crash in summer 2015.

## **5. The arguments on the foundation of the CRSC's regulation and enforcement**

### **5.1 The purge path of the CRSC —from safety of information, illegal securities brokerage business to real-name account system**

In the beginning of 2015, the CRSC stated to pay attention to the OTC leverage. Constrained by the regulatory rights, the first target that the CRSC decided to purge is the external system management of the securities companies. On 13<sup>th</sup> March 2015, the CRSC published the *Technical instructions on the online securities information system of the securities companies*,<sup>32</sup> the Article 54 demands that ‘Securities companies should not provide the third-party clients with the interfaces related to the online securities server and securities trading; All the securities trading orders must be settled in the system controlled by securities companies.’ According to the article, all the systems with compartment shall be closed. However, there is no actual enforcement to this article until 12<sup>th</sup> June 2015. On that day, the CRSC published *Notice about strengthening the regulation on external systems of securities companies*<sup>33</sup>, and prohibited the securities companies from providing securities trading interfaces to the OTC leverage, after that, the increment of financing through third-party online securities trading systems was cut off.

From the operational level, as the securities trading orders must give through the securities

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<sup>32</sup> Technical instructions on the online securities information system of the securities companies 2015.

<sup>33</sup> Notice about strengthening the regulation on external systems of securities companies 2015.

companies, the action of prohibiting the securities companies from providing securities trading interfaces to external systems is the most effective way to control the OTC leverage. Especially when the CRSC does not have jurisdiction over the OTC agencies like trust companies and P2P financing platforms, the action is the most effective and timely way under that circumstance. Because the external information systems provided by the securities companies are only the tools for providing convenience to the financing agencies, and the securities companies themselves should not take responsibility to the activities (forced liquidation) which caused market crash, so the CRSC chose an ambiguous reason — safety of information as legal foundation of the enforcement. However, the reason ‘safety of information’ cannot support the CRSC to further purge OTC leverage, so the CRSC began to find new legal foundation.

On 12<sup>th</sup> July 2015, the CRSC published *Suggestions about purging and re-organising illegal activities in securities operations*<sup>34</sup>, and purged the activities including opening virtual securities account, borrowing and using other’s securities account, lending securities account and acting trading securities. After that, the AMPs issued by subsidiaries of mutual-funds, securities companies and futures companies are also included into the list of purge.

Finishing purging the AMPs in its own jurisdiction, the CRSC started to seek cooperation with the CBRC to deal with an important part of this market crash — trust plan leverage. On 17<sup>th</sup> September 2015, the CRSC again published *Notice about continuing purging and re-organising illegal activities in securities operations*,<sup>35</sup> and required securities companies to purge three kinds of trust product accounts, including: sub-accounts, operating accounts, virtual accounts, umbrella structured trust accounts and structured securities investment accounts. However, at this time, the resistance that the CRSC faces seems to be harder to deal with, it is more difficult to investigate the public information. In other words, the strength of

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<sup>34</sup> Suggestions about purging and re-organising illegal activities in securities operations 2015.

<sup>35</sup> Notice about continuing purging and re-organising illegal activities in securities operations 2015.

enforcement of the CRSC seems to decline.

Notably, although the industry summarised the purge actions of the CRSC as purge leverage. The leverage itself has never been official legal foundation of enforcements. The legal foundations of purging leverages are Chinese Securities Law, Article 122<sup>36</sup> and Article 166<sup>37</sup>. Although the CRSC did not refer to specific securities business, the illegal operational business should be securities brokerage business.<sup>38</sup> From two articles, activity that the CRSC accuses should be the same, that is opening virtual accounts.

## 5.2 The dilemma of the logic of real-name regulation

Under the situation of lacking legislation to limit the OTC leverage, using the legal foundation of purging virtual accounts to purge leverage, the logic of the regulation cannot prosecute to the end. For example, in the logic of real-name regulation, the umbrella structured trust is prohibited while single structured trust is still permitted. However, there also are many structured accounts in single structured trust, they are the real leverage capital even it is in the single structured trust. On the contrast, some part of sub-trust in the umbrella structured trust is management trust without leverage. So, for the objective of purging leverage capital, it seems that the single structured trust should be prohibited and the management trust shall be permitted.

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<sup>36</sup> Article 122: Any organisation and individual are not allowed to manage securities business unless the approval of the regulatory authority of the State Council.

<sup>37</sup> Article 166: Investors who authorise the securities companies to conduct securities trading should apply for registering securities accounts.

<sup>38</sup> The leverage business can only be related to secondary market and all the decisions of investments are decided by the investors, so it also cannot be related securities asset management business, securities investment consult or financial consult.

## **6. Facing the leverage: the new situation in stock secondary market and adjustment of the regulatory ideas**

The 2015 stock crash reveals that the unregulated OTC leverage could cause systemic risk, it is reflected as the overlap of three phenomena: (1) the liquidity risk embedded in the system of forced liquidation. (2) the enlargement of the high-leverage transactions on the risks. (3) the capital of bank's financial products almost involved all the financial institutions and spread the risk from the capital markets.

### **6.1 The evolution of the risk under the stock leverage transactions**

From the legal structure, all the leverage paths except the structured funds are belong to stock collateral loans, the key arrangement is that the creditors protect their interest on basis of forced liquidation. This innovation eliminated the information asymmetry in the process of society financing, creditors do not need to investigate the credit status of the debtors, instead, they only need to make sure there is enough collateral to realise timely. However, this safeguard mechanism is procyclical. When the price of stock rise, the price of collateral will rise with it, and this will attract more capital into the stock market to further push up the stock price; But this circulation will not last forever, once there is no new capital, the price of stock falls to maintenance margin requirement, the debt reaches maturity immediately. When a huge amount of debts reaching maturity at the same time, this could cause a liquidity risk in the capital market. The situation has nearly no difference with the run on the bank.

Tracing back to this stock crash, after publishing the notice<sup>39</sup> on 12<sup>th</sup> June 2015, the price

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<sup>39</sup> Notice about strengthening the regulation on external systems of securities companies (n 33).

of stock stated to fall due to no support from new capital. Because the leverage ratio can reach 1:10, at this time, the price of the stock only needs to decline to 93.6% of the bid price, the forced liquidation could trigger even without a limit down. Therefore, after cutting the new capital, the price of stock falls to the maintenance margin requirement with the highest leverage ratio account. In the process of forced liquidation, the short selling of stock leads to a further drop, and trigger the second highest leverage ratio account to forced liquidation. Due to the information of OTC leverage is not clear, neither regulators nor market participants know the amount of downside momentum. Furthermore, the continuous decline of the stock price causes many non-leveraged investors to join the short-selling. Nevertheless, in some extreme cases during continuous decline of the stock price, the protection of forced liquidation to the creditors may also fail, even for those leveraged project fit the requirements, the loss of creditors is inevitable. Finally, the safety of the first class capital, provide by banks' financial products, was endangered by the process of deleveraging and nearly caused systemic crisis.

## **6.2 Some suggestions to improve the regulation**

From the experience of International markets, neither the 1929 Wall Street crash nor 2008 financial crisis had directly prohibited the leverage mechanism in the securities markets. Instead, more active regulations including disclosure of information and limit on the leverage ratio were applied. The idea of Chinese regulatory authority needs to adapt the new situation that leveraged transactions will exist in the secondary stock market.

Some suggestions are made as followed to help improve the regulation on the business leverage:

1. Put the OTC private financing agencies and business into the securities regulatory framework.

According to the nature of the activities of the OTC private financing agencies, they can be under the jurisdiction of the CRSC, and only those agencies approved by the CRSC could start relative business. Meanwhile, it is suggested to establish an OTC financing condition system, the system is similar to the stock market system while the condition of amount of capital and ratio of leverage will be matching with the risk tolerance of the investors, thus having a multi-level and contained risk group of stock investors.

2. Establish a reporting system on the institutional investors to increase the market transparency.

This reporting system is the institutional arrangement for controlling the system risk in the futures markets. When the member or client has reached certain amount of position, he or she must report to the exchange about the condition of account, condition of transactions, source of the funds and the motive of transactions. Therefore, the exchange will know if there is over speculation or manipulation in the markets.

3. Cooperation among the regulatory authorities to control the source and amount of leverage capital

Establishing a regulatory cooperative framework, including joint conference, consultation mechanism, information sharing platform and contingency plan to deal with extreme situations.



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