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Review Commission

"CHINA'S CAPITAL MARKETS"

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The Securities Industry Association[1] is pleased to submit this testimony about China's capital markets and the opportunities for U.S. firms, our clients, and the U.S. economy to do business in China. Our testimony will focus on the goals and objectives of the U.S. securities industry in our growing relationship with China's economy. As such, this testimony delves into some key issues related to China's capital markets.

SIA has long supported more open, fair and transparent markets, and has strongly advocated liberalization in U.S. multilateral and bilateral trade. The economic benefits of financial services sector liberalization reverberate throughout the world in the form of higher growth and greater opportunities. Financial services liberalization leads to new entrants, innovative products and services, and capital markets with greater depth and efficiency.

In the global economy, open and fair markets are essential to ensuring that markets operate efficiently so that capital can move seamlessly across borders and investors can easily and quickly buy and sell securities anywhere, while businesses can access capital at the lowest price. The international financial system has been a major contributing factor in the marked increase in living standards of those countries that participate in it.

China's WTO accession commitments for financial services, and more specifically for the securities industry, demonstrated a reluctance to open this sector fully to foreign competition. China's reluctance to open its securities markets fully to foreign investment has stymied the interest of foreign securities firms, and has slowed the pace of reforms in China's capital markets. Since China's accession to the WTO, nearly $24 billion has been committed to China's financial services sector, and according to SIA estimates less than $600 million of this total has found its way to China's securities firms. We believe China should improve and accelerate its financial sector reform so that it will have the financial tools necessary to sustain and improve the quality of its economic growth.

We also wish to take this opportunity to commend the U.S. Treasury Department for its continuing work and active engagement in seeking open and fair markets for securities firms in China. Through the establishment of the U.S.-China Financial Markets Dialogue, and the establishment of a Treasury Financial Attaché in Beijing, Treasury has put in place the framework for continued and active advocacy on behalf of the U.S. financial services sector.

Expanding Business Opportunities for U.S. Financial Services Firms

Many of SIA's leading member-firms have identified China as the largest single emerging market opportunity in the next few decades, with some measures indicating that China will be the world's largest economy within the next 40 years.[2] To achieve this, China will need an enormous supply of capital and a market that can efficiently allocate savings. Analysts predict that over the next five years China will need to invest more than $1.5 trillion in improvements to physical infrastructure. In addition, China will step up its privatization program, and hopes to encourage foreign investors to participate.[3]

At the same time, China will accelerate its ambitious reform program even while its nascent pension system begins to address the needs of a huge and rapidly aging population. In 2005, 7.6 percent of China's population was over 65; by 2025 that number is projected to reach roughly 14 percent. The country's infrastructure, privatization, and social welfare demands will require an increasingly more efficient and sophisticated deployment of capital.

To meet these demands, China will need to modernize its capital markets more rapidly. China's first stock market only opened in 1990. Between 1998 and 2000, market capitalization more than doubled from $231 billion to $581 billion; market capitalization peaked at $681 billion in 2003. Despite losses in recent years — market capitalization fell to $640 billion at the end of 2005 — China has the second-largest emerging stock market in the world after South Korea.[4]

The PRC government has acknowledged the need to reform the securities industry and has stated that it wants foreign investors and foreign firms to participate. China's domestic capital markets will benefit from the entry of U.S. securities firms and their technology, capital, innovative products and services, and best practices. As local firms prepare for this increased competition, they will adopt new technologies and improve the quality of products and services they offer. More competitive and efficient capital markets will also improve the allocation of capital to borrowers and users, facilitate the hedging and diversifying of risk, and assist the exchange of goods and services.

As China's capital markets develop, Chinese firms will be able to raise more capital at lower costs to grow their businesses and create more products, services, and jobs. Since financial markets are inextricably linked to increased investment and economic growth, strengthening China's domestic capital markets will help to alleviate the significant financing constraints that Chinese firms currently face.[5]

China's private and public sectors alone cannot mobilize the massive financial resources, advice and expertise that are necessary to sustain its economic growth. Much of the infrastructure development will, by necessity, be funded through foreign sources, and this opportunity. has generated substantial interest by the U.S. securities industry. Indeed, despite difficulties entering and operating in China, numerous U.S. securities firms have established offices in China and have participated in China's international securities offerings.

China's WTO Commitments For Foreign Securities Firms

China's 2001 World Trade Organization (WTO) entry commitments in the securities and asset management sectors marked the country's first step toward liberalizing its capital markets. The commitments permit foreign firms to participate in the securities sector only through joint ventures (JVs) in which foreign ownership is capped at 33 percent – though as more fully described below the scope of securities activities in which these joint ventures can participate is limited. China's WTO commitments also limit foreign participation in China's asset management sector to ownership of no more than 49 percent of domestic fund management firms. These WTO commitments make no provision for further increases in foreign ownership in either securities or asset management firms. Instead, the commitments suggest that without a change in policy, foreign investors will remain minority shareholders in local securities firms for the foreseeable future.

China's WTO commitments in the securities sector also limit these minority owned JVs to underwriting the A shares of Chinese corporations, and to underwriting and trading government and corporate debt, B shares and H shares. The fundamental right to trade in A shares was not conferred on these minority JVs. (A shares are renminbi [RMB]-denominated shares limited to domestic investors, foreign financial firms with qualified foreign institutional investor [QFII] status, and foreign strategic investors; B shares are foreign-currency denominated shares listed on PRC exchanges and are open to both domestic and foreign investors; and H shares are shares of PRC companies listed in Hong Kong.)

Though foreign industry involvement can improve many aspects of the securities industry, we would urge China to move forward in two distinct, but reinforcing, areas to modernize and strengthen its capital markets. First, improvements in market access would improve the ability of foreign securities firms to compete in a fair manner with local firms. Second, steps in market reform would better regulate the industry and increase transparency.

However, there remain significant market access barriers. SIA strongly urges China to make the following additional commitments, in the context of the ongoing WTO financial services discussions, in other trade forums, or government-to-government discussions:

1) Permit Full Ownership and the Right to Choose Corporate Form

The PRC government should allow foreign firms to establish securities companies in China, including wholly owned entities, with the ability to engage in a full range of securities activities, including underwriting, secondary trading of government and corporate debt and all classes of equity, hybrid mortgage products, derivatives trading, and asset management. The right to enter a market and establish a wholly owned presence in a form of the firm's own choosing is relatively common in today's global markets. Currently, foreign investors can enter China's securities markets in two ways: by establishing a new JV with a Chinese partner or by taking a stake in an existing brokerage — the path that a number of foreign securities firms have chosen. Because in most cases the negotiations that result in a JV or a foreign stake are opaque, however, potential entrants have little available in the way of guidance on how to arrange such JVs. Similarly, foreign asset management firms should be permitted to manage money for Chinese investors, both retail and institutional, as well as to sell internationally diversified mutual funds to individuals through qualified local distributors.

2) Liberalization of Qualified Foreign Institutional Investors (QFII) Standards

China's decision to permit foreign investment in A shares through QFIIs beginning in 2003 was a landmark step in the development and liberalization of China's capital markets. More recently, PRC authorities have taken steps to increase the number of QFIIs and the amount invested by QFIIs. Nevertheless, a few QFII requirements are onerous and have substantially limited the utility of the program, as well as the number of investors that can take advantage of it.

Along with the QFII program, China has recently taken steps to allow certain large foreign investors to purchase shares in domestic companies. These new rules will allow foreign investors to buy stock in Chinese companies that have completed the share-reform program (exchange of nontradable shares to common A shares). Foreign investors that meet certain government standards can buy existing shares or purchase new shares that might be issued. But requirements that an investor purchase at least 10 percent of the company, and hold the stake for at least three years, could limit the desirability of the program.

China would make its securities markets more attractive to investment through the liberalization of QFII restrictions. Such progressive liberalization, done in consultation with foreign and domestic capital markets participants, would almost certainly result in greater foreign investment in China's securities markets, deepen and broaden trading in those markets, and increase capital availability to Chinese issuers.

3) Implement a QDII program

China is in the process of launching its long-awaited qualified domestic institutional investor (QDII) program to promote Chinese investment in foreign stocks and bonds. The People's Bank of China (PBOC) announced the launch of the program in April 2006, and PBOC, the China Banking Regulatory Commission, and the State Administration of Foreign Exchange released interim measures that permit qualified commercial banks to pool RMB from domestic institutions and individuals and convert them into foreign exchange for investment overseas in fixed-income securities. Other implementation rules will eventually expand the program to qualified mainland insurance companies, fund management firms, and securities brokerages to convert RMB into foreign currency, raise funds in RMB or foreign currency, and invest in overseas securities. Such a program will further liberalize China's capital accounts. It may also help familiarize Chinese domestic investors with international best corporate and brokerage practices and give them access to top-quality research under conditions that would respect officials' concerns about currency flows.

4) Promote Regulatory Transparency

A transparent industry is generally one in which the public and industry participants have the opportunity to be involved in the rulemaking process, access information about proposed rules, question and understand the rationale behind draft rules, and have sufficient opportunity to review and comment on them. Transparent and fair regulatory systems play an integral role in the development of deep, liquid capital markets that attract participants, increase efficiency, and spur economic growth and job creation. The absence of transparency in the implementation of laws and regulations can seriously impede the ability of firms to compete fairly and often distorts the market. Though CSRC has improved its policies on prior consultation and has presented many proposed regulations for public comment, much progress is still needed. Short comment periods are insufficient to review complex new regulations, particularly those intended to affect foreign firms whose ability to comment is hampered by distance and language.

SIA has published a paper (Appendix I) that serves as a blueprint for a transparent regulatory regime. The paper underscores the key guiding principles of fair and transparent regulations as follows: 1) rules, regulations and licensing requirements should be considered and imposed, and regulatory actions should be taken, only for the purpose of achieving legitimate public policy objectives that are expressly identified; 2) regulation should be enforced in a fair and non-discriminatory manner; 3) regulations should be clear and understandable; 4) all regulations should be publicly available at all times; and 5) regulators should issue and make available to the public final regulatory actions and the basis for those actions.

5) Liberalize Derivatives Regulation

Interim derivative rules, which took effect in March 2004, have prohibited securities firms from creating and distributing derivative products. The inability of securities firms to engage in these activities hampers the development of these markets. Foreign firms hope that China's newly revised Securities Law will lead the State Council to formulate measures on the issuance and trading of derivatives.

Continued liberalization of China's capital markets has clear benefits for China and the global economy. Long-established U.S. policy seeks to promote economic growth through open financial services markets. Global economic integration facilitates the importation of capital and intermediate goods that may not be available in a country's home market at comparable cost. Similarly, global markets improve the efficient allocation of resources. Countries gain better access to financing, and the suppliers of capital – institutional investors or individual savers – receive better returns on their investments.

The most reliable and expedient way for China to meet its massive capital demand is to access the larger pools of capital available in the global markets. Foreign securities firms can contribute to the development of China's financial markets by sharing their expertise on the infrastructure needed to effectively serve a sophisticated and globally oriented client base. Foreign players can also provide new financial products and services that meet the changing needs of Chinese investors, demonstrate the benefits of high corporate governance standards, and consult on legal issues that must be addressed to help domestic equity and capital markets flourish. Ultimately, the modernization of China's financial system, especially its capital markets, will benefit both China and the world.

Finally, open, fair markets help to increase living standards. We look forward to working with the Commission, the Congress and the Administration to further expand the U.S. securities industry's access to China through the use of bilateral and multilateral trade forums. A coordinated U.S. government effort, including all relevant agencies, will be critical in helping U.S. securities firms to gain full access to these crucial markets.

APPENDIX: Promoting Fair And Transparent Regulation Discussion Paper - pdf

1) The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals and its personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift and pension plans. In 2005, the industry generated an estimated $322.4 billion in domestic revenue and an estimated $474 billion in global revenues. (More information about SIA is available at: www.sia.com.)

2) Goldman Sachs' Global Economics Weekly, Issue 03/34, 1 st October 2003

3) China Accelerates Privatization, Continue Shift From Doctrine, Philip P. Pan, Washington Post, November 12, 2003.

4) However, according to McKinsey Global Institute, once these figures are adjusted for nontradable shares, China's stock market capitalization as a percent of GDP is among the world's smallest, about 17 percent. Corporate debt issuance lags too, with issuance equal to about only 1 percent of GDP. "How Financial System Reform Could Benefit China," 2006 Special Edition: Serving the New Chinese Consumer, *The McKinsey Quarterly.*

5) Financial Liberalization and Financing Constraints: Evidence From Panel Data on Emerging Economies, Luc Leaven, World Bank, October 2000