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Modernization of European (and Swiss) Capital Market Law – Lessons for China?

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1. European and Swiss capital market law developments

The term *capital market* in this contribution encompasses a wide variety of functions: (i) the corporate financing and capital raising (long term), (ii) the offering of various investment products (financial market) and also (iii) the securities market with its relevant trading venues. Looking at these markets from a regulatory perspective, the purpose of ensuring systemic stability and investor protection calls for functional safeguards especially in form of banking regulation, of supervised adherence to a code of conduct by all financial intermediaries and of respective enforcement procedures. Therefore, this contribution looks at all kinds of financial products (but excluding the insurance sector) traded on the various markets for seeking or providing capital directly or through intermediaries like banks and/or trading venues.

1.1 Banks: Basel III, CRD IV/CRR and the „Swiss Finish"

Basel III, developed by the *Basel Committee on Banking Supervision* (BCBS) in the aftermath of the global financial crisis, introduced a big regulatory change. In order to include the regulatory BCBS standards on bank capital adequacy and liquidity into European law, the European legislator enacted a set of regulatory requirements[1] that comprises a directive (*Capital Requirements Directive* 2013/36/EU, CRD IV) and a regulation (*Capital Requirements Regulation* 575/2013, CRR). Since the finalization of Basel III as the new global regulatory framework in December 2010[2] its implementation and impact is monitored[3] by both, the *Basel Committee* itself at a global level and by the *European Banking Authority* (EBA) at the European level.[4]

The CRR launches a *single rulebook*, consisting of a set of prudential rules for credit institutions and investment firms that are directly applicable in the Member States to ensure uniform application of Basel III in Europe. Therefore, CRR partially removes former national options and possible deviations but still allows Member States to apply stricter requirements where these are justified by national circumstances, like financial stability needs or specific risk profiles.

An important new requirement is the generation of recovery and resolution plans (Art. 74(4) CRD IV). Additionally, with CRD IV the transparency of business activities is improved by requiring annual disclosure of profits, taxes and subsidies. CRR supports strengthened gov-

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1 Similar to Basel III the currently applicable requirements of the CRD IV / CRR differ from the full implementation due to a number of transitional arrangements.

2 Basel Committee on Banking Supervision, Basel III: A global framework for more resilient banks and banking systems, December 2010 and revised June 2011; Basel Committee on Banking Supervision, Basel III: International framework for liquidity risk measurement, standards and monitoring, December 2010.

3 The data uses are provided by participating banks on a voluntary and confidential basis.

4 Assuming full implementation of the CRD IV / CRR package the Common Equity Tier 1 (CET1) capital ratios of Group 1 banks would decrease from an average CET1 ratio of 11.7% under the current CRD IV /CRR rules (i.e. considering the transitional arrangements applicable in 2014) to an average CET1 ratio of 10.8%. All of the Group 1 banks would be at or above the 4.5% minimum while 94% of Group 1 banks would be above the 7.0% target level (i.e. including the capital conservation buffer). The CET1 capital shortfall for Group 1 banks would be none with respect to the minimum requirement of 4.5%, and EUR 2.8 billion with respect to the target level of 7.0%. The latter shortfall includes, where applicable, the additional regulatory surcharge for G-SIB (global systemically important banks). See EBA, CRD IV – CRR / Basel III Monitoring Exercise, Results based on data as of 30 June 2014, 3 March 2015; <www.eba.europa.eu/documents/10180/950548/CRDIV-CRR+Basel+III+monitoring+Report+-+Results+as+of+June+2014.pdf/92bc3251-f527-4f6f-9dc0-5edd5132f65d>.

ernance provisions by requiring increased *Pillar Three* disclosures in relation to the risk management objectives and policies and leverage ratios from 2015.[5]

Already through a set of measures known as Basel II.5 the BCBS reacted to the crisis and raised the risk weights for particular problematic asset classes: higher risk weights for (re)-securitizations, higher capital requirements for trading book positions and counterparty credit risk exposures arising from derivatives, repo-style transactions and securities financing activities.[6] With Basel III the insufficient loss-absorbing capacity of other forms of capital than common equity was addressed by new and stricter capital definitions. Looking at the quality, consistency and transparency of the capital base in combination with some adjustments regarding the total level of required capital more common capital is necessary.

Certain provisions of the *Swiss Capital Adequacy Rules* result in stricter requirements than those required by Basel III since in the area of regulatory capital requirements some additional capital buffers are required.[7] The new regulation is particularly restrictive for the banks that have been deemed *Too Big to Fail* (TBTF) by the Swiss authorities. TBTF Swiss banks must now hold a minimum of 3% of *Risk Weighted Assets* (RWA) in the form of high-triggering *Contingent Convertible Bonds* (CoCos) and up to 6% of RWA in the form of low triggering CoCos.[8] If this requirement fully applies, then the total capital ratio for a TBTF Swiss bank (even without a countercyclical buffer which may add an extra capital requirement of up to 2.5% of RWA to these figures) amounts to 19% of RWA.[9]

Hereinafter, the various aspects of banking regulation cannot be discussed in depth; however, a fixed leverage ratio above the 3% stated in Basel III would certainly work against the shortcomings of the risk models used to calculate the RWA. In times of crisis liquidity matters in order to stay in business; therefore, the new liquidity requirements under Basel III will certainly help. Whenever it comes to a situation a bank fails, the chance of a continuation regard-

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5 Pillar 3 complements the minimum capital requirements (especially with regard to the risk weighted assets) and the respective supervisory review process with certain disclosure requirements to allow the market to judge the capital adequacy of a bank.

6 See for further details Jean Charles Rochet, The Extra Cost of Swiss Banking Regulation; <www.swissfinanceinstitute.ch/the_extra_cost_cost_of__swiss_banking_regulation.pdf>.

7 For details see Ross P. Buckley/ Rolf H. Weber/Mary Dowell-Jones, A Swiss finish for Australia? Approaches to enhancing the resilience of systemically important banks, 10 *Capital Markets Law Journal*, 2015, 41-70.

8 Alternatively to Contingent Convertible Bonds (CoCos) write-down bonds can be used.

9 Buckley/Weber/Dowell-Jones (supra note 7).

ing relevant systemic functions depends on resolution plans and a competent authority stepping in and managing the default.[10]

Due to the fact that all statistical calculation methods are based on historical data and the inherent problem to incorporate tail risks within those calculations, some legislations already doubled the Basel leverage ratio. In Britain, Switzerland and the United States the banks' leverage ratio is meant not only to be a simple backstop to the defined RWA-based core buffers; the banks have to comply with higher leverage ratios than what has been globally agreed so far by the Basel Committee.

1.2 European regulation of trading venues

In realizing the statements from the Pittsburgh summit, MiFID II[11], MiFIR[12] and EMIR[13] are reshaping the European trading venue markets.[14] In addition to the categories *regulated market* and *multilateral trading facility* (MTF), MiFID II introduced a new trading venue category for non-equities: *Organized Trading Facility* (OTF).[15]

Regulated market (RM):

The traditional "old-school" exchanges are subject to strict requirements and in addition the national supervisor might enact specific rules. The requirements grant open access to all market participants and based on the respective listing rules all kinds of securities are listed. In

[10] On 10 November 2014, the FSB published its consultative document entitled *Adequacy of loss-absorbing capacity of global systemically important banks (G-SIBs) in resolution*; <www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf>. The TLAC (Total Loss Absorbing Capital) proposal addresses the world's 30 most systemically important banks and intends to set standards to allow their stabilization and/or winding up in a way that avoids taxpayer bailouts.

[11] MiFID is the Markets in Financial Instruments Directive (Directive 2004/39/EC). It replaced the Investment Services Directive (ISD) adopted in 1993. MiFID was adopted in April 2004 and came into force in November 2007. In August 2006 the Commission released implementing measures (a directive and a regulation) to develop a number of the provisions set out in the framework directive 2004/39/EC: (i) Commission Directive 2006/73/EC implementing Directive 2004/39/EC as regards organizational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive; (ii) Commission Regulation (EC) No 1287/2006 implementing Directive 2004/39/EC as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive. In June 2014 the new Directive on Markets in Financial Instruments (MiFID II) repealing Directive 2004/39/EC was published in the EU Official Journal. Member States have two years to transpose the new rules which will be applicable starting January 2017.

[12] In June 2014 the Regulation on Markets in Financial Instruments (MiFIR) was published in the EU Official Journal. Member States have two years to transpose the new rules which will be applicable starting January 2017.

[13] European Market Infrastructure Regulation (EMIR) is a European Union regulation designed to increase the stability of the over-the-counter (OTC) derivative markets throughout the EU Member States. It is designated Regulation (EU) 648/2012, and it entered into force on 16 August 2012.

[14] For an overview of the development see Niamh Moloney, EU securities and financial markets regulation, 3rd ed. Oxford 2014, 446 seq.

[15] For a good overview regarding the European developments see Peter Gomber/Axel Pierron, MiFID - Spirit and Reality of a European Financial Markets Directive, September 2010; <deutsche-boerse.com/dbg/dispatch/de/binary/gdb_content_pool/imported_files/public_files/10_downloads/11_about_us/Public_Affairs/MiFID_report.pdf>.

order to ensure optimal pre- and post-trade transparency, continuously courses, trading volumes and data on supply and demand have to be made public.[16]

Multilateral Trading Facility (MTF):

According to Art 4 (1) No. 21 MIFID II a „*'multilateral trading facility' or 'MTF' means a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with Title II of this Directive*".[17] Some MTF are as transparent as a RM. However, even when regulated in principle, due to specific *transparency waivers*[18] some MTF are considered to be *dark pools* (also according to IOSCO); at some MTF *dark orders* are allowed parallel to *lit* ones, some MTF are completely dark. One MTF, *BATS/Chi-X*, underwent an upgrade and became a RM.

Systematic Internaliser (SI):

According to Art 4 (1) No. 20 MIFID II a „*'systematic internaliser' means an investment firm which, on an organised, frequent systematic and substantial basis, deals on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system*". Traditionally market makers (investment firms) are matching orders from clients in-house also with other orders on their own books; an SI has to conform to certain criteria and they have to show a price before a trade is made and also make such dealings transparent, just like conventional trading exchanges.[19]

Organized Trading Facility (OTF):

According to Art 4 (1) No. 23 MIFID II a „*'organised trading facility' or 'OTF' means a multilateral system which is not a regulated market or an MTF and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system in a way that results in a contract*". The idea of OTF (similar to a swap execution facility, SEF) created by the Dodd-Frank Act in the U.S.) is to bring transparency and structure to OTC derivatives trading; OTF operators, like broker-

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16 See ESMA, Regulated Markets; <mifiddatabase.esma.europa.eu/Index.aspx?sectionlinks_id=23&language=0&pageName=REGULATED_MARKETS_Display&subsection_id=0>.

17 See also European Commission, Review of the Markets in Financial Instruments Directive (MiFID), Public Consultation, 8 December 2010; <http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf>.

18 Regarding the various waivers see Moloney (supra note 14), 486 seq.

19 See Moloney (supra note 14), 467, 479.

dealers, are not allowed to trade against their own capital. However, it remains to be seen whether there will be enough liquidity in such markets.

In consequence, under MiFID II, *broker crossing networks* (BCN) have to be in compliance with one of three categories or shut down. Because all platforms are subject to limits on how much of a given stock can be exempted from pre-trade transparency, the affected actors try to find an alternative. A project called *Plato Partnership*[20] was established, a consortium of asset managers and broker-dealers; they plan to create a non-profit equities trading utility as a one-stop-shop for anonymous block trades which is open to all market participants. Other established players will also try to circumvent the new regulations by using the large-in-scale loophole.[21] Despite the fact that trading in the dark has never been as popular in Europe as in the U.S.[22] trading venues are in favor of loose regimes regarding exceptions to post pre-trade bid and offer prices as well as trading volumes. The main problem has to be seen in (i) the option for platform operators to allow high-frequency-trading firms clandestine access into their pool and (ii) conflicts of interest in combination with proprietary trading desks seem to be unavoidable.[23]

1.3 Point of sale regulation

With the adoption of the MiFID II/MiFIR-package various aspects regarding the communication with customers will have to be addressed in more detail.[24] While MiFID II at level 1 (accompanied by level 2 implementing directives and level 3 regulatory as well as implementing technical standards) focuses on suitability and conflicts of interests, the PRIIP regulation (*Packaged Retail and Insurance-Based Investment Products*) addresses the KID (*Key Information Document*).

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20 Plato—unlike existing dark pools—will be operated as a not-for-profit, with any money left over after expenses committed to academic research into market structure.

21 London Stock Exchange Group Plc will introduce a midday auction with hidden order sizes (<www.lseg.com/resources/media-centre/press-releases/london-stock-exchange-launch-midday-auction>) and Turquoise, a trading venue majority-owned by the LSE, launched its own block-trading service; see Financial Times, Philip Stafford, Turquoise aims to lure institutions' block trades to dark pool, 20 October, 2014; < www.ft.com/intl/cms/s/0/88294b24-585a-11e4-b331-00144feab7de.html#axzz3ghu271ji >.

22 Only about 9 percent of the European equity volume is traded over unlit venues compared with more than 40 percent in the U.S.; Bloomberg, Jeremy Kahn, Trading in the Dark - Under-the-radar exchanges in Europe prepare to face a potent new challenger, July 7, 2015; <www.bloomberg.com/news/articles/2015-07-06/trading-exchange-dark-pools-face-new-competition-in-europe>.

23 See Moloney (supra note 14), 525 seq.

24 According to Art. 24 (4) (b) MiFID II the information to be provided to the customer shall include guidance on and warnings of the risks associated with investments in financial instruments or in respect of particular investment strategies. ESMA´s MiFID Consulting Paper from May 2014 (311 pages, additionally ESMA published in May 2014 a Discussion paper regarding the future technical standards with 533 pages, meanwhile the consultation paper was published in December 2014, 645 pages) specifies in Section 2.13 that Article 31 (2) MiFID Implementing Directive (2006/73/EC), relating to the description of risks, should specifically address the risk of financial instruments.

Suitability and appropriateness:

One of the major topics of the POS-regulation (*Point of Sale*) is the application of the so-called *suitability test* and *appropriateness test*.[25] While *suitability* contains a link to the present (financial situation) as well as future aspects (investment objectives), *appropriateness* reflects the past asking for previous experiences and knowledge of a certain customer with respect to a specific product. The assessment of suitability determines on an individual basis whether the customers have the necessary understanding of the associated risks and also whether they are capable and willing to bear the potential risks – and all of that in line with the individual financial status and investment objectives. In connection with the conduct of business rules for investment, namely the general obligation to act fairly, honestly and professionally and in accordance with the best interests of the customer (previously known as *fiduciary duty*), these tests are customizing the services offered by the advisor or portfolio manager.[26]

Already the European regulatory approach within MiFID I provided for such tests; however, this was not preventing European private investors from losing money with *Lehman* certificates; partially this happened because of poor investment advice not taking into account the personal investment objectives as well as their individual risk-capability and risk-tolerance.

Starting from the assumption that customers hope for predictable returns and hate losses, the downside-potential has to be clearly exemplified. The customers risk attitude matters; therefore, the focus should not be on their risk absorbing capacity.[27] Under the regime of MiFID II and the new PRIIPS regulation these issues are addressed in detail.

Furthermore, the draft technical advice in ESMA´s Consulting Paper[28] recommends that the former Art. 35 of the MiFID Implementing Directive is expanded. It will be required that the

[25] In the OECD G20 High-Level Principles on Financial Consumer Protection, published in October 2011, <http://www.oecd.org/regreform/liberalisationandcompetitioninterventioninregulatedsectors/48892010.pdf>,) the principle Disclosure and Transparency is stressed in section 4; the following formulation exemplifies that this principle is clearly understood in a comprehensive manner: „*Financial services providers and authorised agents should provide consumers with key information that informs the consumer of the fundamental benefits, risks and terms of the product. They should also provide information on conflicts of interest associated with the authorised agent through which the product is sold*.“ Addressing risks it is stated: „*The provision of advice should be as objective as possible and should in general be based on the consumer's profile considering the complexity of the product, the risks associated with it as well as the customer's financial objectives, knowledge, capabilities and experience. Consumers should be made aware of the importance of providing financial services providers with relevant, accurate and available information.*“

[26] See for details Rainer Baisch/Rolf H. Weber, Investment Suitability Requirements in the Light of Behavioural Findings – Challenges for a Legal Framework coping with ambiguous Risk Perception, in Klaus Mathis (ed.), European Perspectives on Behavioural Law and economics, Dordrecht 2015, 159-192.

[27] See Baisch/Weber (supra note 26), 172-174 and 182-187.

[28] ESMA, consultation paper, May 2014, 132 seq.; <www.esma.europa.eu/system/files/2014-549_-_consultation_paper_mifid_ii_-_mifir.pdf>.

investment firm is obliged to provide for a suitability report to the retail customer; this assessment must include the information of how the recommendation provided meets the customer's objectives and is in line with personal circumstances and the customer´s attitude to risk.

Key Information Document (KID):

In combination with the latest creation of Europe´s financial markets policy makers, the PRIIP-KID[29] (Key Information Document), which intends to improve the quality and comparability of information provided to retail investors in the EU[30], a new level of consumer protection is reached.[31] With the compulsory use of the KID, which has to be supplied to retail consumers before they take the decision to invest in a financial product, not only clearly laid out information but also the comparability of investments should be granted. The KID must include risk and return opportunities that can be expected as well as any kind of costs that will be deducted and therefore will impair the investment. Already with UCITS and retail AIF[32] financial intermediaries were required to provide a UCITS-KIID (*Undertakings for Collective Investment in Transferable Securities*, *Key Investor Information Document*).

The regulation concedes that "*… retail investors have often made investments without understanding the associated risks and costs and have, on occasion, suffered unforeseen losses*."[33] A KID for products which are not simple or which are difficult to understand, must also include a *comprehension alert* stating that the consumer is "*about to purchase a product that is not simple and may be difficult to understand*".[34]

The challenging task is to provide on no more than three pages (i) the nature of the product, (ii) the risks including performance scenarios, (iii) all initial, ongoing and exit costs and (iv)

[29] On 9 December 2014, the Regulation (EU) No 1286/2014 of the Europe an Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs) has been published in the Official Journal of the European Union.

[30] The regulation covers structured deposits, structured products, insurance products with an investment element (but not pension products) and funds; Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs), OJ L 352/1, 09.12.2014.

[31] See Rainer Baisch, Nudging - Information, choice architecture and beyond, in Klaus Mathis (ed.), Nudging - theory and Applications, Dordrecht 2015, forthcoming.

[32] UCITS: Undertakings for Collective Investment in Transferable Securities; Directive 2001/107/EC and 2001/108/EC; AIFMD: The Alternative Investment Fund Managers Directive 2011/61/EU.

[33] PRIIPs regulation (supra note 29), preliminary note (1).

[34] PRIIPs regulation, (preliminary note 18): "*A product should be regarded as not being simple and as being difficult to understand in particular if it invests in underlying assets in which retail investors do not commonly invest, if it uses a number of different mechanisms to calculate the final return of the investment, creating a greater risk of misunderstanding on the part of the retail investor or if the investment's pay-off takes advantage of retail investor's behavioural biases, such as a teaser rate followed by a much higher floating conditional rate, or an iterative formula.*"

certain other information. To assist the industry the ESA´s Discussion Paper (ESA-DP)[35] highlights many issues that need to be addressed in order to balance the desire for conciseness and simplicity despite the complex nature of the associated risks and costs when purchasing a specific investment product.[36]

It is important to notice that the ESA-DP explicitly address *consumer behaviour* as one of their key issues, inter alia by envisaging that "*the KID should have a clear behavioral purpose for the retail investor*" and by stressing the fact that the KID should be easy to use by the retail investor.[37]

2. Chinese legal framework from a European perspective

2.1 Introduction: History and current status of Chinese capital markets

Following the foundation of the *People´s Republic of China*[38] in 1949 the *Communist Party* started their *socialist transformation* and private business came under collective or state ownership.[39] Due to the fact that state-owned enterprises (SOE) dominated the scene in a centrally planned economy there was no need for a capital market.[40] In 1952 all stock exchanges were closed and later the *People´s Bank of China* (PBC) remained the only operating bank, both acting as central bank and commercial bank. In addition to some basic saving and lending services the PBC funded various SOE; that situation clearly was not calling for financial regulation.

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35 Discussion Paper of the Joint Committee of European Supervisory Authorities (the ESA: EBA European Banking Authority, EIOPA European Insurance and Occupational Pensions Authority, and ESMA European Securities and Markets Authority), Key Information Documents for Packaged Retail and Insurance-based Investment Products (PRIIPs), 17 November 2014. In June 2015 the Technical Discussion Paper, Risk, Performance Scenarios and Cost Disclosures in Key Information Documents for Packaged Retail and Insurance-based Investment Products (PRIIPs) followed to collect views on the possible methodologies to determine and display risks, performance and costs in the KID; <https://www.eba.europa.eu/documents/10180/1123140/JC+DP+2015+01+(Discussion+paper+on+PRIIPs+key+information+documents).pdf>.

36 For the presentation of risk and return the ESA-DP discusses general types or ways of presenting information, considered in abstract rather than specific terms. Various concrete examples implemented or on its way to be implemented in different European countries are shown to illustrate visual elements.

37 ESA-DP (supra note 35), 17 seq.; with reference to Sunstein 2011: "*Given this, a traditional approach to disclosures focused solely on information and with little regard to its presentation, is in being superseded in policy making by an approach that is more informed by insights into consumer behaviours. For instance, the framing of information can be considered, so as to counter cognitive biases which may distort perceptions and provide information in a way that is both simple to understand but also salient for the consumer (i.e. capable of drawing the consumers' attention and appearing important for the decision to be made). The PRIIPs Regulation reflects these considerations already at 'level one'*."

38 This contribution is only looking at mainland China excluding Hong Kong, Macao and Taiwan.

39 See Robin Hui Huang, Securities and capital markets law in China, Oxford 2014, 5.

40 See Rolf H. Weber, Special Features of Corporate Governance for State-owned Companies in Investment Finance Markets, 21st Century Commercial Law Forum: 13th International Symposium 2013 (Corporate Autonomy and Government Regulation), Tsinghua University, 30-43.

The Chinese economic reform started in December 1978 by reformists led by Deng Xiaoping. The first stage also involved the opening up to foreign investment and private entrepreneurship but in general most businesses remained state-owned. Ten years later the second stage of reform led to the partial privatization of certain SOE, however, the state monopoly in banking remained. The economic growth since then was remarkable.

The separation of securities regulation from the PBC within a separate entity, the *China Securities Regulatory Commission* (CSRC), in 1992 was the first step towards a sector based regulation.[41] Later in the 1990s the financial sector was liberalized; China joined the World Trade Organization (WTO) in 2001 and banking and financial services were partially opened up to foreign investment.[42] However, China's banking sector is still monopolistically dominated by four large state-owned banks[43] that are generally rated as being not very efficient; therefore, companies raise capital through an informal financial sector consisting largely of unofficial (underground) businesses and private banks.[44] Also internal financing is quite dominant when it comes to the expansion of business activities.[45]

In the year 2003, in response to debt loads, non-performing loans, undercapitalization and non-transparent business practices, the government of China recapitalized the banks and set up the *China Banking Regulation Committee* (CBRC) as the banking regulator overseeing the banking industry.[46] In the same year *Qualified Foreign Institutional Investors* (QFII) started operating based on joint ventures with Chinese companies. In 2011, China allowed QFII to invest in Chinese stock and bond markets within a predetermined limit.[47] Since 2006, outbound China *Qualified Domestic Institutional Investors* (QDII) are allowed to invest in overseas markets.[48] Another important player that also invests in foreign countries in the Chinese sovereign wealth funds (SWF) like the *China Investment Corporation* (CIC) that was estab-

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41 There are three sector specific authorities for securities, banking and insurance.

42 PBC as China’s central bank became a separate entity and three state-owned banks took over some commercial banking business. The Bank of China (BOC) was given the mandate to specialize in transactions related to foreign trade and investment; the People’s Construction Bank of China (PCBC, later renamed in China Construction Bank, CCB) handled transactions related to fixed investments, especially in manufacturing; and the Agriculture Bank of China (ABC) managed all banking business in rural areas. Finally the Industrial and Commercial Bank of China (ICBC) took over the rest of the commercial transactions.

43 Franklin Allen/Jun Qian, China’s Financial System and the Law, 47 Cornell International Law Journal, 2014, 499-553, 501; these ‘Big Four’ banks are now publicly listed with the government being the largest shareholder and retaining control.

44 Allen/Qian (supra note 43), 545 seq.

45 Allen/Qian (supra note 43), 512.

46 Before the supervision of banks was integrated within the PBC, the CBRC has been responsible for market conduct regulation and prudential regulation.

47 Yong Zhen, China’s capital markets, Oxford 2013, 158.

48 Zhen (supra note 47), 160.

lished in 2007 and since then is responsible for managing part of China's foreign exchange reserves.[49] Several Chinese SWF are holding major stakes in numerous Chinese listed companies.

The most successful part of the financial system, supporting the economic growth, consists of various activities which must be allocated to the sector of shadow banking.[50] Such kind of services are performed by informal financial intermediaries, private investors and local governments;[51] but also of significant importance are internal financing, trade credits and coalitions among firms.[52] Neither rely these financing channels on the law nor is any specific regulation in place. These alternative financial activities led to a hybrid sector[53] that is under no public oversight. Officially, shadow banking is not condemned but "*guided*" to provide funding for the corporate sector "*in a proper and orderly manner*".[54]

In the meantime, small and medium-sized enterprises (SME) create 80 percent of the jobs; however, their access to finance by bank credits is limited.[55] SME often cannot offer any marketable collateral and of course no implicit state guarantees, therefore, state dominated banks prefer SOE. These limitations drive SME to alternative forms of financing with high interest rates. As an alternative, private placed high-yield bonds can be issued under certain conditions.[56]

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49 See Weber (supra note 40) for details regarding the different SWF.

50 Jing Jiang, Shadow Banking in China: Battling the Darkness, The Economist, 10 May 2014; <http://www.economist.com/news/finance-and-economics/21601872-everytime-regulators-curb-one-form-non-bank-lending-another-begins>. See also Rolf H. Weber, Shadow Banking as New Challenge of the Global Financial Architecture, in: Won-mog Choi (ed.), International Economic – Law The Asia-Pacific Perspectives, Cambridge 2015, 384. 385-389, 399-401.

51 The October 2014 *Global Financial Stability Report* (GFSR) found *„Rapidly growing and varied shadow banking in China" and stated that „a*s of March 2014, shadow banking (…) had risen to 35 percent of GDP and is expanding at twice the rate of bank credit"; IMF, Risk Taking, Liquidity, and Shadow Banking: Curbing Excess While Promoting Growth, October 2014, 77; <www.imf.org/external/pubs/ft/gfsr/2014/02/pdf/text.pdf>.

52 Franklin Allen/ Jun Qian/ Chenying Zhang/Mengxin Zhao, China's Financial System: Opportunities and Challenges, in Fan/Morck (eds.), Capitalization China , Chicago 2013, 63-148, 96.

53 Franklin Allen/Jun Qian/Meijun Qian, China's Financial System: Past, Present, and Future, in Brandt/Rawski (eds.), China's Great Economic Transformation, Cambridge 2008, 506-568, 506 seq.

54 Hu Xiaolian (Deputy Governor PBC), Speech at the 18th International Conference on Banking Supervisors, Tianjin, 25 September 2014, 3; <www.pbc.gov.cn/eportal/fileDir/image_public/UserFiles/english/upload/File/胡行长银行监督官大会(5).pdf>.

55 Zhen (supra note 47), 62.

56 In 2012 SSE and SZSE launched a respective pilot project; see Zhen (supra note 47), 63 for further details.

2.2 Overview of Chinese capital markets regulation

Looking from a general perspective, three levels of relevant Chinese financial market regulation can be differentiated:[57]

(i) Securities Law, Company Law, Securities Investment Fund Law, Ordinance of Supervision of Securities Companies and Ordinance of Supervision of Management of the Futures Markets;[58]

(ii) Subsidiary rules and regulations issued by CBRC and CSRC;[59]

(iii) Listing and trading rules issued by the trading venues.

In addition to these formal provisions, the informal *Window Guidance* is used by CBRC in the communications with its regulatees for instance to persuade banks and other financial institutions to comply with official guidelines.[60]

The important role of the PBC as central bank with responsibility for monetary policy and the general financial stability results in a major impact on regulatory processes.[61] The same is of course true for the *Ministry of Finance* and the *National Development and Reform Commission* which are all under the direct leadership of the *State Council* like the PBC, the CBRC and the CSRC.[62]

Due to the dominant role of the *State Council* a ertain lack of regulatory independence might be diagnozed. The CBRC, like the other agencies, is subject to the direct leadership of the *State Council*.[63] Even the PBC is not a fully independent central bank.[64] Any person with rel-

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57 See Mingyuan Zhang/Rebecca Chao, Securities Law in China, in: Best/Soulier (eds.), International Securities Law Handbook, 4th ed. Den Haag 2015, 175-190, 177.

58 Legislation enacted by the National People's Congress: *Laws of People's Republic of China on Banking Regulation* (2003), *Laws of People's Bank of China* (1995), and *Laws of Commercial Banks* (2003); an initiative of great importance regarding foreign banks are the *Regulations of the People's Republic of China on Administration of Foreign-Funded Banks* (2006) by the State Council, and from the CBRC subsequently issued interpretive rules.

59 The regulator, for instance the CBRC, sets regulatory policies reiterating legislative principles set out in legislation; additionally, CBRC issues guidance's, notices, and rules which are specific and not following a principles-based approach; therefore, „*guidances, notices, and rules are prescriptive in content and abundant in numbers*". See Wei Ping He, Banking Regulation in China: The Role of Public and Private Sectors, New York City 2014, 63.

60 For Japan see Tomoyuki Fukumoto, Effectiveness of Window Guidance and Financial Environment In light of Japan's Experience of Financial Liberalization and a Bubble Economy, Bank of Japan Review, Tokyo, 2010; window guidance and is also known as 'jawboning' - exercising the persuasive power of verbal or telephonic communications; see He (supra note 59), 65.

61 See Huang (supra note 39), 24 seq.

62 See <http://www.china.org.cn/english/kuaixun/64784.htm>.

63 Law of the People's Republic of China on Banking Regulation and Supervision, Art. 2: „*The banking regulatory authority under the State Council shall be responsible for the regulation and supervision of the banking institutions in China and their business operations*." See also Huang (supra note 39), 36.

evant authority is appointed by the *State Council* and accountable to the head of state. The same relationships consist with the top management of the big (state-owned) banks. Therefore, regulatory capture, revolving doors, and political networks does not facilitate appropriate corporate governance.

2.3 Banking regulation

In principle, the Chinese banking regime is consistent with international norms regarding systemic and prudential concerns.[65] However, the guiding and functional principles are contingent upon the socialist policy doctrines executed through the *State Council*. Without a change of political ideology Chinese banks will stay dependent from various levels of government and regulators. Only a further commercialization of Chinese banks could weaken the government's control and shift the supervisory power from the government more to independent regulators.[66]

With the already mentioned establishment of the CBRC and the separation of the banking regulatory supervision and monetary policy, an important step toward an effective banking regulatory framework was performed. CBRC executes prudential regulation and enhances the protection of depositors by reducing banking risk.[67] China used to have no deposit insurance scheme in place, however, the government provided implicit guarantee for the retail deposits.[68] Due to administrative burdens, the size of the market and other strategic restrictions, foreign banks´ market share is still very small.[69]

Keeping this basic framework conditions in mind it can be said that China accepts the Basel Framework and tries to comply with these requirements to a great extent.[70] As part of the

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64 PBC Law, Art. 7: „*The People's Bank of China shall, under the leadership of the State Council, implement monetary policies, perform its functions and carry out its business operations independently according to law and be free from intervention by local governments, government departments at various levels, public organizations or individuals*."

65 He (supra note 59), 150.

66 He (supra note 59), 155 seq.

67 He (supra note 59), 52.

68 China introduced a deposit insurance system in 2015; all banks are required to pay an insurance fee according to the size of their deposit bases and risk profiles.

69 He (supra note 59), 57. The Ernst & Young report, Future directions for foreign banks in China, 2014, 5, states in its introduction that „*consumer banking continues to be a challenging space for the foreign banks*" because of (i) limited physical distribution and (ii) the prevalence of non-banks offering online and mobile banking, such as Alibaba and WeChat, which operate outside of the regulatory setting; <www.ey.com/Publication/vwLUAssets/EY-foreign-bank-china-report-2014/$FILE/EY-foreign-bank-china-report-2014.pdf>.

70 To understand China's approach towards the BSBS-regulation the following document can help: Liu Ming Kang, CBRC Feedback on the BCBS Documents, 2010; <www.bis.org/publ/bcbs165/cbrc.pdf>. The CBRC argues that the design of supervisory standards mainly takes into consideration the banking practices in the Western economies. In consequence, the BCBS should accept that different economies are quite varied in terms of the structure of financial system and maturity of financial market and „*not make too rigid and prescriptive rules for these standards*" and „*well balance the interna-*

Regulatory Consistency Assessment Program (RCAP), the compliance of China's capital rules with the Basel capital standards was found to be closely aligned with the Basel III global standards. Some differences with the Basel framework were found but the overall framework of China's capital regulation was graded *compliant*.[71]

China is about to eliminate a cap on the loan-to-deposit ratio which was in place for many years.[72] A proposed change in banking law will remove the 75% cap on banks' loan-to-deposit ratios, which for years has limited the amount that the banks could lend. However, banks circumvented the ceiling by disguising loans as investments or moving them off their balance sheets which contributes to the boom in shadow banking. But with the reserve-requirement ratio – a tool to restrain lending – banks must park a certain percentage of deposits at the central bank.[73]

Within the last decade China's five major state-owned banks due to strong growth and increased profitability are now among the largest in the world[74], three are ranked as G-SIB by the FSB.[75] Just recently China´s performance and compliance with the international agreements was assessed in detail.[76] One of the important issues in banking regulation is that PBC and CBRC are in the process of drafting supervisory guidelines for the D-SIB in China, setting out an assessment methodology for D-SIB and relevant capital and resolution requirements.

To conclude, *„banking regulation in China is used to promote economic and social development, which is the very core interest of the central government. Banking regulation is not an*

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tional convergence and national discretions, so that national supervisory authorities have more flexibility to reflect the banking practices of their own country".

71 See BCBS report *Regulatory Consistency Assessment Programme (RCAP), Assessment of Basel III regulations – China*, September 2013; <www.bis.org/press/p130927.htm>.

72 The law limiting lending to 75 percent of deposits has been in place since 1995; See South China Morning Post, Beijing to scrap commercial banks' loan-to-deposit ratio, 25 June 2015; <www.scmp.com/news/china/economy/article/1826280/china-scrap-loan-deposit-ratio-requirement-commercial-banks>.

73 The rate differentiates between banking sectors and was reduced several times last year to stimulate lending.

74 By assets, four of the world's largest 10 banks are Chinese: Industrial and Commercial Bank of China, the Bank of China, the Agricultural Bank of China, and China Construction Bank Corp. However, China Construction Bank — the third-largest Chinese bank by assets and a Chinese domestic systemically important bank — did not meet the threshold qualifications to be deemed a G-SIB. See for details Paul Glasserman/Bert Loudis, A Comparison of U.S. and International Global Systemically Important Banks, 4 August 2015; <financialresearch.gov/briefs/files/OFRbr-2015-07_A-Comparison-of-US-and-International-Global-Systemically-Important-Banks.pdf>.

75 G-SIBs as of November 2014 allocated to buckets corresponding to required level of additional loss absorbency; <http://www.bis.org/bcbs/gsib/gsibs_as_of_2014.htm>.

76 For further details see FSB, IMN Survey of National Progress in the Implementation of G20/FSB Recommendations, China, 2014; <www.financialstabilityboard.org/wp-content/uploads/China_2014.pdf>.

end to itself. It is instead a means to pursue economic and social goals. In China, regulatory objectives are subordinated to the government's economic and social policies".[77]

2.4 Regulation of market infrastructures

The two domestic stock exchanges, the *Shanghai Stock Exchange* (SSE) and the *Shenzhen Stock Exchange* (SZSE) were established in 1990. Based on China's Securities Law, effective since July 1999, the CSRC is authorized to implement a centralized and unified regulations of the nationwide securities market, and to regulate and supervise securities issuers with the power to impose penalties for illegal activities and handles securities-related litigation directly.[78] Not in line with an approach based on the idea of division and separation of powers and therefore striking is the range of investigative measures attributed to the CSRC without any involvement of a court.[79]

There are other markets which complement the two main exchanges,[80] like a fully electronically-operated market for SME[81], a market to deal with de-listed firms (from SSE and SZSE) and over-the-counter (OTC) transactions[82], and a market for companies that are mainly from the hi-tech, electronic, and pharmaceutical industries[83]. In 2009, China launched the *Growth Enterprises Market* (GEM) mainly for hi-tech, electronic and pharmaceutical companies to provide financing for the respective SME. [84] Additionally, the *National Equities Exchange and Quotations* (NEEQ) offers an OTC-style forum for shareholding companies.[85]

SSE is one of the world's largest stock markets by market capitalization and one of the two stock exchanges operating independently in the People's Republic of China. But unlike the *Hong Kong Stock Exchange* (HKEx), the SSE is not entirely open to foreign investors. Through the HKEx it is possible to invest directly in some Shanghai-listed companies. The main reason is the tight capital account controls by Chinese authorities. The securities listed at

[77] He (supra note 59), 68.

[78] For further details see Huang (supra note 39), 30 seq.; Zhen (supra note 47), 27 seq.

[79] Huang (supra note 39), 31.

[80] Allen/Qian (supra note 43), 527 seq. with further references.

[81] *Er Ban Shi Chang,* Second-tier Market.

[82] *San Ban Shi Chang*, Third-tier Market.

[83] *Chuang Ye Ban*, Growth Enterprises Market.

[84] Zhen (supra note 47), 28 seq. GEM is also known as ChiNext.

[85] NEEQ started in 2006 to provide a way for tech start-ups in science parks to gain access to finance and in 2013; the market was opened to any innovative company from seven designated strategic sectors. Easy listing procedures attracted more than 2,500 companies; however, the liquidity is thin and the market volatile.

the SSE include the three main categories of stocks, bonds, and funds. Bonds traded on SSE include treasury bonds, corporate bonds, and convertible corporate bonds.

The Chinese stock markets experienced high volatilities, speculative behavior and major corrections during the past decade and also this year after having hit new records; partially this is due to the fact that the development of a supportive legal framework and of strong authorities has been lagging.[86] In contrast to other stock markets subject to a free market philosophy the sharp decline of Chinese share prices provoked politicians to act against the stock slide.[87]

Actually, not much has changed since the Chinese economist Wu Jinglian described the Chinese exchange as "worse than a casino". Of great concern, particularly for retail investors and pension fund managers are the questionable standards of corporate governance in Chinese companies and the high level of corruption. The key problem consists in finding a way to safeguard a transparent market.

Despite the partially invisible planned economic thinking exercised through the administrative power of the leading politicians the Chinese capital market attracts investors because the listed companies benefit from China's economic growth.[88]

2.5 Possible lessons from the EU

In any financial market system, safeguarded transparency requirements together with the respective enforcement procedures and certain criminal law provisions against market abuse play not only a dominant role but are deemed to be indispensable for the functioning of the market.[89] Despite the fact that China is not completely fulfilling these conditions, the economy performed quite well in the last four decades. However, in order to secure growth in the future some changes might help.

Looking at Europe, success and failure can be seen, and it is not easy to develop clear and straight-forward proposals which undoubtedly would generate economic wealth and material prosperity in China. However, to keep it simple all measures that build trust will facilitate attracting investors which could help to optimize capital allocation also within China. Modern

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86 Allen et al. (supra note 53), 510.

87 See e.g. Lingling Wei, China's Response to Stock Rout Exposes Regulatory Disarray, Wall Street Journal, 4 August 2015; <www.wsj.com/articles/chinas-response-to-stock-rout-exposes-regulatory-disarray-1438670061>.

88 For a good description of the problems on China's stock markets see Yong Zhen, China's Capital Markets, Oxford 2013, 39 seq.

89 Jin Sheng, China´s listed companies: conflicts, Governance and Regulation, Alphen aan den Rijn 2015, 303 seq. analyses the access to remedy in China focused on securities litigationand arrives at the conclusion that "*Chinese courts have played a weak role in supporting the victims of securities fraud*".

rules for trading venues and financial markets as established in the EU with EMIR, MiFID II and MiFIR could increase the impact of the respective financing channels. Attracting investors also means attracting know-how; China is not lacking financial resources but drivers for further economic growth; therefore, the broader opening and improvement of financial markets would foster a successful future development.

Firstly, the overwhelming market share and influence by the big state-dominated banks as well as their use by the *State Council* as means to allocate financial resources and support their political agenda should be reviewed. More competition especially by foreign banks could help to overcome some of the current problems like the size of the shadow banking sector. Secondly, transparency in all areas could be a major driver to improve the functioning of the markets. Thirdly, the free access of international asset managers and funds to all stocks and markets would also help to make markets more liquid and to establish a higher level of corporate governance.

Whether a sound prudential oversight and a reputable authority to supervise market conduct could be established without having a clearer separation of powers in place remains to be seen. Soaring wages and production costs in comparison to other Asian countries will not help on the path of economic growth. Together with the aging population and other challenges the improvement and adjustment of the capital market law could contribute solving some of the potential economic challenges. However, there is a risk to hamper potential growth when all kind of hybrid financing and alternative funding is banned by a harsh ostracism of shadow banking.

3. Consumer (investor) protection and enforcement practices

> „*The mechanism of financial consumer protection was further improved, and progress was made in the pilot program of third-party resolution mechanism for financial consumption disputes*.“ [90]

This statement exemplifies that China is interested to foster consumer protection. Within the PBC there is a special department for *Financial Consumer Protection* which further confirms the significance allotted to the relevant issues. However, the wording gives also scope for

[90] PBC, Annual Report 2014, 5; <www.pbc.gov.cn/image_public/UserFiles/english/upload/File/人民银行2014英文年报6.15（定稿）.pdf>. Further information on pages 111-113 of that report.

interpretation: if a matter was improved that implicates that a satisfying level has not been accomplished.

Some voices express serious concerns when it comes to consumer protection in China:[91] „*Under the current framework, banks abuse their market position and encroach on the rights of individual consumers*.“ An important driver for an inadequate degree of consumer protection might be seen in a conflict of interest: a banking model, where ownership interests result in an economic interest to support these banks might impair effective consumer protection because „*the various levels of government and the regulators are more inclined to act in the interest of Chinese banks*“.[92]

Together with the lack of transparency due to the failure of promoting market efficiency no satisfactory outcome for consumers can be achieved.[93] The banking sector, largely captured by the State looking for ´wider interests of the public´, is regarded more important than individual consumers' protection needs. For consumer protection needs, especially two areas are of interest: (i) fraudulent behavior of financial intermediaries like market abuse, insider dealing and alike, (ii) missselling products, e.g. products which are not suitable or giving delusive information about risk/return profiles.

The problem with all kinds of fraudulent behavior is detection and then the proof of causality with a sustained damage; however, without a chance to secure evidence and reliable enforcement procedures the concerned consumer will not be able to recover his losses. Most likely, private enforcement will only uncover the tip of the iceberg. Therefore, prudential oversight executed by independent authorities must be in place to deter the market participants. It is not beside the point to assume that in China there is a regrettable gap between the `law on paper´ and `the law in pratice´ (rights but no remedy).[94] All around the world agency problems are present, but the Chinese market and company structure are particulary susceptible for that phenomenon: (i) vertically between the State as owner of many listed companies and potentially voracious and power-obsessed managers as well as (ii) horizontally between minority and majority shareholders while the latter is often the State.[95]

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91 He (supra note 59), 152.

92 He (supra note 59), 152.

93 He (supra note 59), 153.

94 Tianshu Zhou, Controlling misrepresentation in securities markets: Is private enforcement trivial in China?, in: Philipsen/Xu (eds.), The Role of Law and Regulation in Sustaining Financial Markets, New York 2015, 150-171, 150, with further references.

95 Zhou (supra note 94), 152 seq. explains the Chinese agency problems in detail.

Despite the legal provisions providing for legal liability being in place these days, not many private enforcement procedures are initiated;[96] China traditionally relied on public enforcement, however, not much is happening in that area either.[97] „*Weak legal remedies for victims of securities fraud, the absence of an efficient enforcement regime leaves shareholders vulnerable to a wide range of abuses*."[98]

4. Outlook

The recent activities to comply with the Basel standards and perform well during the ongoing FSB assessments could promote a further opening of the markets because potentially enhanced transparency requirements will attract foreign investments.[99] Further steps towards a gradual liberalization of interest rates, a cap of lending ratios and other recent activities will help the Chinese banking market and in consequence also the financial market to become more attractive and in consequence more competitive.

Next to international efforts (e.g. FSB, Basel Accord) a key driver for such kind of positive developments is the Chinese apprehension of a further slackening of economic growth. During this year many reports have been published describing the `cooling down´ of the Chinese economy.[100] For some reason a lot of capital is flowing out of China, presumably also looking for better investment opportunities.[101] The challenges triggered by the deceleration of economic growth stimulate the *State Council* to revise gridlocked positions. Any progress towards more transparency no matter in which corner of the capital market and perhaps some other ingredients of Western recipes can help to foster confidence. In addition, banking regulation should no longer secure the monopolistic position for the big Chinese banks[102]. Another

[96] Zhou (supra note 94), 158 seq. for further data. Huang (supra note 39), describes and comments the rules regarding liability for misrepresentation (p. 141 seq.), market misconduct (p. 169 seq.), and insider trading (p. 189 seq.). He also comes to the conclusion (p. 215) that „*more needs to be done*".

[97] Zhou (supra note 94), 157 seq. for further data.

[98] Sheng (supra note 89), 303.

[99] „*Professional investors would perhaps not be so easily taken in by simple deceptions.*" See Franklin Allen/Jun Qian, China's Financial System and the Law, 47 Cornell International Law Journal, 2014, 499-533, 537.

[100] Even the "official" news do not deny this situation, see Jia Chen, Forex reserves decline by $42.5 billion in July, China Daily, 8 August 2015; <http://en.people.cn/business/n/2015/0808/c90778-8933217.html>. See also PBC, Annual Report 2014 (supra note 90), 29.

[101] Gabriel Wildau, Economists seek to ease fears on China's record capital outflow, Financial Times, 19 May 2015; <www.ft.com/intl/cms/s/0/a20a3ad8-fd2f-11e4-b072-00144feabdc0.html#axzz3jFGNfyYv>.

[102] He (supra note 59), 151.

issue is the financial literacy of retail consumers which is a problem in the Western world too;[103] however, in China this is partially also a problem within the authorities or SOE.[104]

[103] However, this is mainly true for the older population. In an OECD study among 15-year-olds the Chinese (Shanghai) scored best; OECD, PISA 2012 Results: Students and Money: Financial Literacy Skills for the 21st Century (Volume VI), 2014; <www.oecd.org/pisa/keyfindings/PISA-2012-results-volume-vi.pdf>.

[104] „*Another factor is that the enforcement of laws is questionable due to the lack of legal professionals and institutions*." See Allen/Qian (supra note 99), 537.