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The Shanghai and Shenzen Exchanges: Business Operation, Governance Structure, and Regulatory Function (People's Republic of China)

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20.1 Overview

The two stock exchanges in the People's Republic of China are located in Shanghai and Shenzhen. The Shanghai Securities Exchange was established on 10 December 1990. The Shenzhen Stock Exchange was officially established in 1991, after a half year pilot period and has been in operation since 1 December 1990. As of 2000, 596 securities traded on the Shenzhen Stock Exchange, 557 of which were stocks. Market capitalization of these stocks was around CHY2,116 billion. Meanwhile, 707 securities traded on the Shanghai Securities Exchange, 665 of which were stocks. Market capitalization of these stocks was approximately CHY2,693 billion. At present, no foreign company can be listed on the stock exchange market in the People's Republic of China. In addition, foreign investors were prohibited from trading A Shares, which were only open to resident investors. However, foreign investors can trade B Shares, which were initially designed to meet foreign investment demands in 1991 and trading was opened up to resident investors in the beginning of 2001.

Over the past ten years, the securities market has developed rapidly in the People's Republic of China. The table below provides a statistical overview over the past 10 years, and clearly reflects the steady expansion. So far, stock trades are not permitted to be executed off board in the People's Republic of China under the *Securities Act*. Trades executed in the OTC market represent a very small amount (Table 20.1). Therefore,

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Table 20.1. Statistical Overview on Stock Exchanges in the People's Republic of China (1991-2000)

YEAR	NUMBER OF LISTED SECURITIES SHANGHAI	NUMBER OF LISTED SECURITIES SHENZHEN	MARKET CAPITALIZATION (BN CHY) SHANGHAI	MARKET CAPITALIZATION (BN CHY) SHENZHEN
1991	46	7	2.9	7.9
1992	87	39	55	49
1993	190	105	221	133
1994	259	212	260	109
1995	260	192	252	95
1996	368	299	548	436
1997	467	429	922	831
1998	526	483	1,064	888
1999	574	540	1,458	1,189
2000	707	596	2,693	2,116

Source: *China Securities and Futures Statistical Yearbook, Shenzhen Stock Exchange Fact Book, Shanghai Stock Exchange Annual Statistics.*

stock exchanges will play a key role in the securities market in the predictable future.

20.2 Business Operation

The business operations of stock exchanges are made up of all the aspects of the capital market infrastructure and can be divided into four categories:

In the trading area, two exchanges operate electronic cash markets based on centralized order matching systems. Through the powerful central match computer systems, two exchanges can process the average two million daily transactions. In 2000, total turnover in Shanghai reached CHY3,157 billion while Shenzhen surged to CHY2,945 billion. Currently, there are no derivatives traded on these two stock exchanges, after an unsuccessful trial period during 1993-1995 conducted by the Shanghai Securities Exchange. However, the China Securities Regulatory Commission (CSRC), the regulatory body in the People's Republic of China, is evaluating the possibilities of setting up index futures for the stock exchanges. Since 2000, the CSRC has worked on a plan to launch a new market, the second board market designed for high-tech firms, on the Shenzhen Stock Exchange.

All trades of listed securities executed in the stock exchanges are cleared and settled through relevant clearance and settlement systems. Settlement is implemented by computerized book-entry to the participants' stock accounts, without any physical movement of share certificates. Money settlement is carried by electronic payment instruction for broker-custodian accounts. The settlement time period for all trades is only T+1.

The information processing divisions in stock exchanges provide services for the processing and marketing of market information. In 2000, the Shenzhen Stock Exchange set up an independent subsidiary company, which acted as a market information provider, to explore and develop information-based products and to increase revenue generated from selling market information. However, revenue generated by the company was not as good as expected until now.

The information technology division maintains and updates the market system and the telecommunications technology.

20.3 Governance Structure

The exchanges' governance structure has gone through several stages over the past 10 years. At the beginning stage, before 1992, the local municipal government controlled the power and authority of the exchanges since most market participants were from the local area and nationwide regulations had not been built up. During the period from 1992 to 1997, the local government and the CSRC jointly administered the exchanges. At the end of 1997, the exchanges' administration was finally transferred to the CSRC while the two exchanges' markets evolved into national markets.

In accordance with the *Securities Act* enacted in 1999, the two stock exchanges are non-profit, member-owned and self-regulatory organizations with independent legal status to provide facilities for centralized auction trading. Members own the property rights, but distribution of any profits or surplus during the operation period is highly restricted. Stock exchanges are required to stipulate in their constitution rules to guide and supervise regular operations. The constitution and any amendments should be approved by the CSRC before they are put into effect.

20.3.1 Membership and General Member Meeting

Any securities firm with independent legal status and with the approval of concerned authorities can apply for membership qualification in the exchanges. Therefore, there are no individual members in stock exchanges in the People's Republic of China; all members must be corporate members. During the beginning stage in 1991, there were only local members in the two exchanges due to the weakness of communication system. With the establishment and development of the exchanges' telecommunications system in 1992, more non-local members joined. At the peak of 1995, there were 553 members in Shanghai and 532 in Shenzhen. In the same year, the *Banking Act* was enacted, which restricted banks from engaging in the securities business. Most members affiliated with banks had to withdraw, thus, the number of stock exchange members declined. In 2000, there were 310 members in Shanghai and 326 in Shenzhen. Since China entered WTO in 2001, CSRC recently amended the *Securities Exchanges Rule* to align with specific commitments as a member of WTO. Pursuant to amended Securities Exchanges Rule, foreign securities institutions may apply to be special members of two exchanges and engage directly in B-share business.

Membership is a prerequisite to exchange market access. Only members have permission to purchase trade seats in stock exchanges and access to the central match computer system. Every member should purchase at least one trading seat. Currently, there are 5,391 seats in Shanghai[2] and 1,545 in Shenzhen. Trading seats can be transferred among members.

The general member meeting is a supremely powerful body of stock exchanges. The general member meeting has authority to draw or amend the constitution and to elect or dismiss member directors of the board. At least two-thirds of the members should participate in the meeting, and at least half of the participants must agree on a draft, for validation. Each member has exactly one vote regardless of its position in the market.

2 The Shanghai Stock Exchange still has a reserved trading floor, so it has 3,001 physical seats on the trading floor. However, the Shenzhen Stock Exchange has ceased with a trading floor in 1997, so there are no physical seats. All seats in Shenzhen are invisible seats.

20.3.2 Board and Board of Directors

The exchange board is a decision-making body. The tenure is three years. The board is composed of 7-13 directors, including the chairman, president, and 1-2 deputy chairmen. The fraction of non-member directors on the board is at least one-third, and at most half. Member directors are elected by general membership meetings. Non-member directors are appointed by the CSRC. The chairman and deputy chairman are elected by the board, but nominated by the CSRC. The chairman of the board cannot simultaneously act as the president. Obviously, the CSRC has tremendous influence on the exchanges' boards of directors.

The main responsibilities of the board are to set or amend an exchange's operation rules, and to sanction or deny business plans and budgets submitted by the president of the exchange. The board holds at least one meeting each quarter.

20.3.3 President and Management Team

According to relative laws and the exchanges' constitutions, the president is empowered to manage regular operation of the exchange under the direction of the board. In reality, the president, vice presidents and assistant presidents constitute the official panel in charge of daily business. The president and vice presidents are directly appointed by the CSRC. Their tenures are three years. The appointment and dismissal of senior staff at the exchanges should be filed with the CSRC. The appointment and dismissal of the heads of the accounting and human resources departments should be approved by the CSRC. Although the CSRC has the same authority in the exchanges' management teams as does the board, it is the president and the official panel under his/her leadership that decide a wide range of issues. This fact is often taken as evidence to confirm that the president and management team play more critical roles in the exchange's governance than the board does.

20.4 Regulatory Function

The stock exchange in the People's Republic of China is a self-regulatory organization. Its self-regulatory function is complementary to government regulation by the CSRC and is a very important part of the regulatory framework in China. Before 1997, while the securities market in China was still in the early stage of market formulation, the exchanges were confronted with how to develop the market. Their efforts were focused on technology innovation, investor service and market exploration. Since the securities market in the People's Republic of China was in a stage of steady development in 1997, the power of the exchanges was transferred to the CSRC. The exchanges' self-regulatory function was then addressed. This was reflected in *Stock Exchange Rules* of 1997 and the *Securities Act* of 1999. The exchanges' self-regulatory functions include regulations on trading, the members of the exchanges and listed companies.

20.4.1 Listing Qualification Authority

If a company applies for listing on the stock exchange, this application should be approved by the CSRC in accordance with the Securities Act. Although strictly speaking, the CSRC should pass the authority to the exchanges to deal with listing applications since ability to list is dependent on ability to make a public offering and the CSRC approves public offerings, listing qualification authority is in fact vested in the CSRC rather than the stock exchange in which the stock company applies for listing. If a company is approved to publicly offer new shares, its shares are also approved to be listed on a specific stock exchange.

20.4.2 Trade Surveillance

Pursuant to the *Securities Act*, the stock exchanges should keep real-time surveillance on routine transactions. If any abnormal trading activity is detected, the exchange should promptly report it to the CSRC and assist in any further CSRC investigation. Because all transactions on the exchange are executed electronically through a computer system, real-time surveillance systems in the exchanges are also based on this system. For example, the on-time surveillance system in Shenzhen Stock Exchange automatically picks up data from the match system and the settlement system, allowing it to process 4-6 million transactions per day. Last year, the on-time surveillance system in Shenzhen detected 476 abnormal transactions, 19 of which were seriously detrimental and reported to the CSRC.

20.4.3 Self-Regulation on Members

The exchange is a self-regulatory organization and thus all members should accept self-regulation by the exchanges. Self-regulation of members focuses on their trading activities. Because almost all securities firms in the People's Republic of China are members of two exchanges, the exchanges' influence is industry-wide. The two exchanges have stipulated a series of rules and guidelines to guide members' trading and brokerage businesses. The exchanges' member departments periodically review members' trading activities.

20.4.4 Regulation of Listed Companies

Pursuant to the exchanges' listing rules, the exchanges are empowered to regulate their listed companies' routine operations, especially pertaining to information disclosure. The exchanges should supervise listed companies' relative information disclosure properly, accurately and completely. Information disclosure is a legal basis for protecting investors' interests and is also indispensable for a trustworthy exchange market.

While the self-regulatory function of the exchanges is emphasized in the Securities Act, the solvency of the exchanges is also emphasized. To cushion impacts of the exchanges' operational risks, the two exchanges are requested to set up operational risk funds in accordance with the Securities Act of 2000. The operational risk funds are extracted from the exchanges' revenues until CHY800 million are reserved.

20.5 Outlook on Demutualization

Over the past ten years, there has been a trend among exchanges to consider alternative governance structures from the traditional non-profit or cooperative models. In addition to the growing number of new for profit trading systems being developed in the securities markets, like Tradepoint in the United Kingdom and Island in the United States, many stock exchanges that have historically operated on a non-profit or cooperative basis are either contemplating transforming themselves into for profit companies, or have already done so. This is occurring in Stockholm, Denmark, Italy and the UK. Some exchanges even have listed themselves on their own markets, such as the Australia, Hong Kong, and Singapore exchanges.

Moreover, we found that the current demutualization trend should be interpreted as a natural response to a fiercer competitive environment faced by stock exchanges. Because the interests of stock exchange members are diversifying in the changing environment, the costs of collective decision-making in a non-profit or cooperative stock exchange are likely to be burdensome relative to what would be incurred by a for profit stock exchange.

Secondly, the competition among stock exchanges has forced non-profit or cooperative stock exchanges to increase information technology investment, seriously burdening these exchanges' cash flow. The for-profit exchange may be able to raise money more efficiently than the non-profit or cooperative exchange.

Thirdly, an efficient management team is now more and more important to a stock exchange in a competitive environment. A non-profit or cooperative exchange is typically allowed to pay a reasonable compensation to its management. Nevertheless, a for profit company exchange, especially a public company exchange, can establish an incentive scheme for management thereby aligning their interests as much as possible with those of the owners.

Lastly, the traditional governance structure of member-owned stock exchange only reflects interests of the members (usually financial intermediaries). However, a stock exchange that finally wins out in a competitive environment, should fully reflect the interests of brokers, dealers, investors, listed companies, regulators and other market participants. A company exchange is adaptable to negotiate such conflicts of interests. Furthermore, we believe there were also specific reasons for demutualization of different stock exchanges.

Despite the worldwide demutualization trend of stock exchanges, the two stock exchanges in the People's Republic of China are not seeking to demutualize or transform ownership structure as of yet. As mentioned above, the self-regulatory function of the two exchanges is currently being emphasized, so the concern is that demutualization or for-profit transformation may weaken the self-regulatory function. The current administrative structure of the two exchanges, the CSRC and the management team appointed by the CSRC have the capability to control the exchanges' decision-making process although the two exchanges are member-owned. The costs of decision-making are negligible. Cash flows generated by the two exchanges are strong enough to allow for investment in information technology and technology innovation. Therefore, financial pressure has not been so urgent up to now. Also, stock trades are not allowed to be executed off board in the People's Republic of China. Moreover, the securities market is isolated from the overseas' market. Actually, the two exchanges are in relative monopoly positions. Therefore, demutualization in mainland People's Republic of China is not so urgent.

The People's Republic of China is joining the WTO and the Chinese securities market will eventually join the world market sooner or later. A solid competitive environment is inevitable and the stock exchanges in the People's Republic of China will have to compete globally for a prosperous future. Therefore, we will keep a close watch on the demutualization trend worldwide.