Protecting Small Investors

People are concerned whether the investor protection mechanism can be effectively implemented By Lan Xinzhen

In 2013 there were many events in China's capital market that made investors both angry and disappointed. One such event was the fraud during the initial public offering (IPO) by Wanfu Biotechnology (Hunan) Agricultural Development Co. Ltd.

Soon after the company was listed at ChiNext, the country's growth enterprise board, in 2011, there were reports claiming that Wanfu became qualified for the IPO by overstating its business achievements, but the company denied the allegations. Under continuing investigation and condemnation by experts and the media, Wanfu admitted on March 2, 2013, that it cooked its aggregate revenues and profits during 2008-11, exaggerating revenues by 740 million yuan ($121 million) and profits by 180 million yuan ($29 million).

Wanfu's stock price dropped from 31.95 yuan ($5.23) per share at the time of its IPO to 5.65 yuan ($0.92) per share when its stocks were suspended for trading on April 22, 2013.

In the case of insider trading and IPO fraud, small investors suffer the worst losses.

On December 27, 2013, the State Council issued a statement on the protection of the interests of small investors in the capital market. This is China's first document with overall and systematic provisions in this regard.

Since the statement was issued by the State Council, the country's cabinet, instead of the China Securities Regulatory Commission (CSRC), it has attracted closer attention and is considered a guideline on investor protection and the sound development of China's capital market.

Deng Ge, spokesman of the CSRC, said the statement has made arrangements for the basic rights of investors that they are most concerned about, such as the right to returns, the right to know, the right to take part in supervision and the right to seek compensation. Therefore, it is a milestone in the development of China's capital market.

Cao Fengqi, Director of the Finance and Securities Research Center at Peking University, said methods to protect small investors used to be proposed by the CSRC, therefore State Council involvement is more authoritative.

According to Cao, experience from mature markets indicates that investor protection is the core of the capital market supervision and legal system. The statement is just the start of investor protection, with the government to also revise the Securities Law and formulate other supporting measures.

Vulnerable investors

Although they have almost no experience in wealth management or knowledge of securities, small investors constitute the majority in China's capital market.

According to a report from the Asset Management Association of China, in the present Chinese capital market, more than 99 percent of investors have an investment value below 500,000 yuan ($81,800), but contribute up to 60 percent of the total stock trading volume.

They are weak in terms of risk tolerance, self-protection and obtaining information; therefore, protecting small investors is the most crucial step in the development of China's capital market.

In the past, protection of small investors was only mentioned in the rules of stock exchanges or the CSRC and there were no detailed measures. Since the investor protection is not well implemented, most securities

Protective Measures

1. Improve the investor qualification system;

2. Optimize the investment return mechanism;

3. Guarantee small investors' right to know;

4. Improve the voting mechanism for small shareholders;

5. Establish a diversified dispute settlement mechanism;

6. Perfect the compensation mechanism for small investors;

7. Intensify supervision and crackdown on violations;

8. Strengthen small investor education;

9. Improve the organizational structure for investor protection.

GOOD FORTUNE: An investor smiles after watching stock prices at a securities company in Shenyang, capital of Liaoning Province

companies place value on business scale and performance more than investors' interests.

The report said the most important contribution of the statement is that it changes market focus from financiers to investors, from listed companies to small investors.

Wang Yong, an analyst from CITIC Securities Co. Ltd., said the number of small investors in China is much bigger than those in the capital markets of developed economies. Small investors don't have as many funds as large institutions do, but they are the foundation of the market, hence there must be mechanisms to protect them. Learning from foreign markets does not mean simply copying their systems; there should also be innovations and improvements based on China's condition. For this, the State Council's statement deserves appreciation.

Wang said this is the first time that the State Council has issued a special document on investor protection, indicating the supervising authority is stressing the development of the capital market. It will help to increase confidence of small investors. Investors hope to reap the benefits of this policy in the future.

Implementation challenge

"The policy on investor protection will be effective only when it is well implemented," Wang said. The first impetus to implement this policy may come from intermediate agencies, not listed companies, because securities companies are the first participants and beneficiaries in the event of a listing.

The State Council announcement will pose new challenges for the traditional business models of securities companies and other intermediate institutions, Wang commented. For example, it proposes the establishment of a caution money system, which will make securities companies more responsible when deciding to sponsor IPOs.

The statement also requires investment asset managers to fulfill their commitments to cash dividends and to try to create good investment returns. A company failing to fulfill the dividend commitments will not be allowed to obtain financing again. According to Wang, most of China's public investment funds are held by small investors, therefore the statement requires managers of public funds to explore a way to align themselves with the interests of investors. This will guide public fund managers to pay more attention to absolute returns on investment.

These measures impose strict requirements on intermediary agencies, and they will no longer accept IPO offers from unqualified companies. This means huge losses to the intermediary agencies, and it is hard to say whether they can withstand the temptation of interests, Wang said.

In his article in *Qiushi* magazine in August 2013, Xiao Gang, Chairman of the CSRC, wrote, "There are more than 1,200 regulations and rules for China's capital market, 200 of which are for punishment. But over two thirds of them are never used, whether they are related to criminal, administrative or economic responsibilities." The reasons they aren't used include the lack of timely and specific legislation, improper law enforcement, regional protectionism and an unwillingness to handle issues. For these reasons, many cases are not investigated. "Each year about 110 cases are filed for investigation, but less than 60 of them are adjudicated for administrative punishment. Over 30 cases are sent to court for criminal responsibilities each year, but half of them close without any judgment," Xiao wrote.

People are concerned about this situation and are worried that the State Council decision on protection of small investors will also become nothing but a scrap of paper.

According to Wang, when releasing the statement, the State Council referred it to local governments, ministries and commissions, as well as departments directly under the State Council, demonstrating its confidence and resolution for implementation.

The State Council will strengthen cooperation with stock exchanges, judicial departments and the supervising authorities where listed companies and intermediary agencies are located to severely crack down on violations.

The statement requires the establishment of a rapid response and disposal mechanism for events infringing upon the interests of small investors. Securities watchdog and public security departments should strengthen law enforcement cooperation and intervene before the infringement occurs. "That is to say, the supervising authority should intervene just when any event is likely to infringe upon investors, instead of intervening after investors have claimed for losses," said Wang. ■

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