
A brief analysis of the “Interim Provisions on Securities Investment Advising Business” and “Interim Provisions on Securities Research Report Issuance”

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On October 2010, China Securities Regulatory Commission issued “Interim Provisions on Securities Investment Advising Business” and “Interim Provisions on Securities Research Report Issuance” in relation to securities investment consultancy services (hereinafter, the “interim provisions”) , which will come into effect on January 1st, 2011. The promulgation of such provisions clarifies the scopes and values of investment consultancy services and traditional channel services, facilitating the regulatory development of securities investment business, the protection of investors’ legitimate rights and interests, and the maintenance of securities market order.

1、 Backdrop

The securities investment consultancy industry of China arises, develops and grows along with the development of securities market. Its development may be divided into three phases:

(1) Budding. During the early days of 1990s, and with the establishment of Shanghai and Shenzhen stock exchanges, the “stock commentators” appeared, as the earliest professional stock commentators of China, their main tasks are providing information about individual shares and advice on transactions.

(2) Arising and developing. In mid-term of 1990s, specialized securities investment advisory bodies appeared, meanwhile, comprehensive securities companies commenced to expand investment consultancy business and establish special securities research divisions.

Regulating. In December 1997, the Securities Commission of State Council issued the “Interim Measures of Securities and Futures Investment Consultancy Management” and its Implementation rules, which came into force on April 1998. A business licensing system was applied to securities investment consultancy business, indicating a new era of legitimate and standardized operation. The principal business model of early securities investment consultancy is “financial workroom”, which was replaced by membership business. However, the membership business caused various problems and violations, as a result, the CSRC issued “Interim Provisions on Membership Securities Investment Consultancy Business Management” on January 2006.

The contents, forms and vehicles of securities consultancy market have changed and multiplied thoroughly after the development of years, however, the current legal system concerning securities investment consultancy management of China excessively regulates certain issues as well as fails to regulate many fields. At present, China's securities investment consultancy industry faces with a serious crisis, the improvement of relevant laws and regulations are required urgently to identify a feasible business model. The problems generally in connection with securities investment consultancy industry are the narrow business space, single source of revenue, terrible reputation, overflow of illegal consultancy and the securities analysts' lack of independence, which in essence originate from the defective legal system.

(1) Failure to identify a feasible business model and profit model is the root cause for the gloomy operation of securities investment advisory companies. The securities advisory bodies may be divided into two categories: a specialized securities investment advisory body and a securities company who concurrently carry out securities investment consultancy business. The existing market conditions cause the securities investment advisory bodies have difficulties in practices, on one hand, an independent fee-charging channel is not clearly identified in practices, resulting in the investment consultancy business's difficulty in finding a valid profit model. Companies concurrently perform securities investment consultancy businesses commonly deem the consultancy as means to increase clients and amplify influences, and prefer consultancy for free or charging from certain groups; on the other hand, a risk-prevention system for securities investment consultancy is not specified, the honesty and integrity and specialty of securities investment consultancy business are damaged seriously.

(2) The defective business separation systems cause the securities analysts' lack of independence. On basis of the securities companies' failure to establish effective separation barrier systems, the research and advising divisions of securities companies are not independent from other business divisions in respect of business premises, personnel, management systems and salary appraisal, and the interests of such different divisions are usually in conflict, as a result, the securities analysts may mislead the public investors in favor of securities traders, as well use information obtained due to their participation in other businesses in their securities research and consultancy.

(3) The insufficient advisory services as regards to medium and small investors, is an important reason for incessant illegal consultancy. The securities companies, under pressures such as market shares and operating performances, commonly focus their business expansion and services on high-end clients, and require a relatively large amount of investors' funds, while evidently ignore services to medium and small investors by entrusting client services to stock brokers or providing information contrary to clients' risk tolerance to medium and small investors. However, provided

that medium and small investors have pervasive requirements for advisory services, the imbalance between supply and demand creates opportunities for illegal consultancy.

In conclusion, the current “Interim Provisions on Securities and Futures Investment Consultancy Management” and other relevant regulations and rules have to be amended, supplemented and merged for purposes of the settlement of conflicts and problems arising from the development of securities investment consultancy industry, provision of business standards and system safeguards, formulation of legal bases for various problems within the field of securities investment consultancy, and direction of the business transition and development of securities investment consultancy industry. The issuance of Interim reflect such requirements and have positive significances.

2. The significance of Interim Provisions

2.1 Identify the principal forms of securities investment consultancy business: securities investment advising business and securities research report issuance.

The definition of securities investment consultancy in the “Interim Measures of Securities and Futures Investment Consultancy Management” as issued by the former Securities Commission of State Council in 1997 was: activities that institutions engaging in securities investment consultancy business and their personnel provide consultancy services with direct or indirect compensations to investors or clients such securities investment analyses, predictions or suggestions. Such definition reflects the market characteristics of China’s securities investment consultancy industry during early period of its development, i.e. features stock comments rendered by public media and stock exchange divisions. However, along with the open and deepening of securities market, the structure of market participants and investors’ requirements have altered, the two basic forms set forth in Interim Provisions are in conformity to the requirements for the development of securities market.

(1) An inevitable outcome of the securities companies and securities investment advisory bodies’ incessant seeking and market selection. Firstly, since 1998, securities operation agencies have successively seek for independent securities researches and the provision of securities research reports to institutional investors such as funds for the purpose of adaption to institutional investors’ requirements for professional researches on securities assessment; presently, most securities companies and part of securities investment advisory bodies have established securities investment research divisions, and the words of securities research reports published per annum are in excess of 300 thousands; secondly, the main functions undertaken by stock comment such as the dissemination of securities knowledge have disappeared gradually and the media stock comments are unable to satisfy the personal and diverse requirements of investors, and even violate regulations, e.g. high

sounding publicity and misleading. In recent years, in response to the alterations of investors' requirements, part of securities companies have established professional teams of investment consultancy and actively seek for face-to-face and pertinent advisory services in association with the deepening of stock brokering; some securities investment advisory bodies have commenced to transform to a business model of securities investment consultancy business getting rid of media stock comments.

(2) The demonstration of foreign mature capital market. Investment advisory services and independent research reports are two principal services of international investment banks. For example, USA regulates such two kinds of businesses with separate laws, regulations and rules. The investment advisory business is provided in "Investment Advisers Act 1940" and rules in connection therewith, and the research report and analyst are provided in Securities Exchange Act 1934 and FINRA 2711 Rule.

2.2 Identify the basic business specifications of the securities investment consultancy business

The Interim Provisions clearly regulate the securities investment consultancy business in respect of business qualifications, personnel specifications and the formulation and issuance of research reports, which resolve the undefined orientation of current securities investment consultancy industry to a relatively large extent, and promote the formation of a clear profit model largely.

The laws fail to define the scope of securities investment consultancy business explicitly prior to the issuance of the Interim Provisions. The "Securities Company Management Measures" in general provides that "securities investment consultancy business (financial advisory business)" is a basic business of securities companies. However, the intensions and extensions of securities investment consultancy business and financial advisory business and the relationships between them are not defined. "Interim Provisions on Securities and Futures Investment Consultancy Management" and other appropriate laws and regulations, involving the securities investment consultancy, fail to determine a business space. Due to the absence of legal supervision and control, the securities investment consultancy bodies are difficult to maintain a reliable profit model, as well as defective internal management and control systems, and the business homogenization. The effectiveness of the Interim Provisions are expected to end the disorder of the market.

The legal supervision is required and necessary, from a speciality perspective, the securities research institutions shall be independent, while from a economic perspective, they shall be profitable, the reliance upon their self-discipline is fragile. The Interim Provisions are compulsory, directing and supervising the securities investment consultancy institutions

2.3 The establishment of separation barrier, separation barrier crossing and silent period ensures the independence of securities analysts

(1) A separation barrier is an internal control system centered on the information separation, the dissemination of confidential information or non-public information among departments whose interests are in conflict is prevented due to such separation. Separation barrier system is also a trade practice worldwide.

In the process of securities research report issuance, the interested parties include: securities companies or securities investment advisory bodies; securities analysts; investors; and affiliates of securities companies and securities analysts such as the shareholders, the actual controllers and relatives. The information asymmetry among the said parties may be harmful, which can facilitate the insider dealings, the separation barrier fundamentally prevent the securities companies' research divisions and the securities investment advisory bodies from seeking improper interests for the companies and the bodies. The securities analysts are totally independent, they work for investors only.

“Interim Provisions on Securities Research Report Issuance” expressly provides that: **“ a strict separation barrier system shall be carried out between the securities research report issuance and other businesses of the securities companies and the securities investment advisory bodies, to prevent divisions and personnel whose interests are in conflict from seeking improper interests in advantage of the securities research report issuance”**.

The establishment, operation and implementation of separation barrier systems shall be imminent for all Chinese securities companies and securities investment advisory bodies. References shall be made to foreign practices, and the actual conditions. of China's capital market shall be considered.

(2) A silent period means that in the event that a securities company or securities investment advisory body engages in securities research issuance and securities underwriting and sponsoring and financial advising business for listing companies' M&A and reorganization simultaneously, their research personnel shall remain silent during a certain period prior to or after the securities underwritten or managed by them. The establishment of a silent period may prevent the analyst from issuing misleading and reports.

3. How do the securities investment advisory bodies respond the Interim Provisions?

3.1 Accelerate the business reform. Securities companies and securities investment advisory bodies

in capacities of securities investment consultancy business have experienced a complex and long development. The media stock recommendation and membership business used to be prosperous. However, the issuance of the Interim Provisions require a business reform for the securities investment advisory bodies, who shall gradually abandon the media stock recommendation and excessive marketing, and develop professional and personal investment advisory services, and furthermore, securities research report issuance services.

The Interim Provisions impose strict restrictions on the securities investment advisers and analysts with respect to participation in media securities programmes, rendering opinions or comments, the advisers may not give specific advice on investment through public media, the analysts' issuance of comments and reviews or interpretation of the research reports shall be arranged by the companies or bodies, and no assurance, whether express or implied, shall be made.

The business reform of securities investment advisory bodies shall be aimed at independent securities research report services catering to high-end clients, and securities investment advisory services, including financial planning services catering to common clients and portfolio management advisory services catering to high-end clients, and if appropriate, securities information services such as data service platforms or tools and information products, financial products sales by proxy and financial advising.

3.2 Realize the specialization of the advisory bodies. Entities engaging in investment advisory business in current securities market of China are in various categories: sub-departments of securities companies including independent subsidiaries and dependent divisions, auxiliary research divisions of fund management companies, public institutional research bodies, independent advisory bodies etc. the professional and completely independent securities investment advisory bodies are few.

However, such a disorder may be ended after the issuance of the Interim Provisions, which provides a number of limitations and requirements for these securities investment advisory bodies. As a result, such bodies shall seek mercerization and specialization, and have to take measures, such as 1) transform into enterprises or reform the shareholding 2) the personnel shall be professional, which requires appraisal and qualification provisions.

4.How do investors treat the Interim Provisions?

All provisions in the Interim Provisions with respect to the securities companies and securities investment advisory bodies also protect the legitimate rights and interests of the investors. However,

the clients have to rationally make investments and take notes of:

(1) The Interim Provisions expressly provide that the securities investment advisers and securities analysts shall be qualified for securities investment consultancy business, and be registered with Securities Association of China. The investors shall identify the qualifications of relevant bodies and personnel by means of access to the websites of Securities Association of China or bodies concerned, and information acquisition at the business premises.

(2) The investors shall be aware of risks, and cooperate with legal and proper securities companies and securities investment advisory bodies. For example, the “Interim Provisions on Securities Investment Advising Business” provides that the charges for securities investment advisory services shall be remitted into the corporate accounts, while illegal consultancy always charge fees through personal accounts.

(3) The investor shall be clearly aware that, the securities investment consultancy shall be assistances to investment, and help to make investment decisions. However, the risks shall be borne by the investors, even the decisions are made by the advisers on behalf of the clients