

2011

# lakkyara

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**Chinese securities firms  
now pursuing business model transformation**



Chinese securities firms have started to diversify their operations in response to 2010 earnings deterioration stemming from fierce price competition in the brokerage business. Against such a backdrop, investment advisory services, which are being promoted by Chinese regulatory authorities also, have recently been in the spotlight.

### Newfound focus on investment advisory services

Chinese securities firms have started to focus on investment advisory services. The Chinese media reported<sup>1)</sup> that the number of registered investment consultants in China has soared from 710 to 7,661 between year-end 2010 and February 2011.

The Chinese securities industry has long been under pressure to rectify its overdependence on the brokerage business. In 2010, its overall earnings fell amid intensification of price (i.e., commission rate) competition, partly reflecting growth in the number of brokerage branches. The industry (106 companies) saw its 2010 aggregate net profits decrease RMB15.7 billion from 2009 to RMB77.6 billion as a result of a RMB33.5 billion decline in securities brokerage revenues<sup>2)</sup>.

In response to excessive price competition, the Securities Association of China (SAC) on October 8, 2010, issued a directive (effective January 2011) that brokerage commissions are to be based on brokerage operations' costs. Commissions have finally stabilized since January 2011.

Against such a backdrop, securities firms have started to step up diversification of their operations, a trend promoted by Chinese regulatory authorities also. On October 12, 2010, the China Securities Regulatory Commission (CSRC) issued Provisional Investment Advisory Service Regulations ("Investment Advisory Regulations") and Provisional Regulations Concerning Publication of Securities Research Reports ("Research Report Regulations"), both of which took effect in January 2011. Additionally, the CSRC's priority policies for 2011 include "continuous improvement of securities firms' specialized service capabilities, promotion of securities investment advisory services'

development, and acceleration of upgrading of brokerage operations<sup>3)</sup>."

### Newly established legal foundation for investment advisory services and publication of research reports

The CSRC's new regulations were intended to clarify previous ambiguities by establishing a legal foundation for securities investment advisory services and publication of securities research reports. They were partially modeled after advanced countries' securities regulations but also tailored to China's own circumstances and its securities industry's existing modus operandi.

First, the CSRC defined the securities investment advisory services as "one basic form of securities investment consulting, business activities whereby securities firms or securities investment consultancies directly or indirectly earn economic profits by providing customers with investment advice regarding securities and related products and helping customers formulate investment strategies at the behest of the customer and pursuant to a contractual agreement" (Investment Advisory Regulations, Article 2; see table).

The Investment Advisory Regulations state that "the customer is to determine investment policy and bear investment risk" (Article 12). Accordingly, investment consultants may not make investment decisions on behalf of customers. They are also "prohibited from promising or guaranteeing investment returns to customers in any manner" (Article 24).

Next, in light of securities firms' plans to upgrade their brokerage operations and their ongoing diversification through expansion of asset management, investment banking, and other operations, the new regulations take

Exhibit. Major provisions of China's new regulations on securities investment advisory services and publication of securities research reports

Provisional Investment Advisory Service Regulations		Provisional Regulations Concerning Publication of Securities Research Reports	
Article 2	Securities investment advisory services are one basic form of securities investment consulting, business activities whereby securities firms and securities investment consultancies directly or indirectly earn economic profits by providing investment advice to customers regarding securities and related products and helping customers formulate investment strategies at the behest of the customer and pursuant to a contractual agreement. The scope of investment advisory services includes advice on selection of investment products, portfolio construction, and financial management.	Article 6	Securities firms and securities investment consultancies that publish securities research reports must establish a specialized research department or subsidiary...and exercise centralized, unified control of the reports' publication and employees involved in their publication. Said employees may not concurrently be involved in proprietary trading of securities, securities asset management, or other such operations that pose a risk of conflicts of interest. (Remainder omitted)
Article 23	Securities firms and securities investment consultancies must set securities investment advisory service fees in writing after consultation with the customer, based on the principles of fairness, rationality, and free will. Service fees may be charged based on the length of the service period and/or scale of the customer's assets. Other fee models are also permissible, including differentiated commissions (different commission rates). (Remainder omitted)	Article 14	Securities firms and securities investment consultancies must stringently enforce a firewall between securities research report publication and other securities operations and prevent organizational subunits and employees with potential conflicts of interest from improperly profiting from publication of securities research reports.
Article 24	...[Securities firms and securities investment consultancies] are prohibited from promising or guaranteeing investment returns to customers in any manner.	Article 15	Securities firms or securities investment consultancy's securities analysts that write investment valuation research reports or assist with industry research must be vetted before being permitted to cross the firewall to temporarily participate in projects involving underwriting, endorsement of IPO applicants, financial advisory services, or other such operations. Once a securities analyst has crossed the firewall, the compliance department or related department must oversee the analyst's work activities. (Remainder omitted)
Article 27	If investment advice or similar services are provided to customers via software or information terminals, such services are to comply with these regulations. (Remainder omitted)		
Article 32	Securities investment advisers may not offer investment advice on specific securities trades via mass media, including radio, television, Internet, newspapers, etc.		

Source: NRI, based on information released by CSRC

into consideration the relationship between investment advisory services and publication of research reports on one hand and brokerage, asset management, investment banking, and other operations on other hand.

Given that some securities brokerages were already providing fee-based securities investment advisory services to add value to the services they offer customers, the Investment Advisory Regulations contain provisions regarding how fees may be charged for advisory services. Specifically, the regulations state, "Securities firms and securities investment consultancies must set investment advisory service fees in writing after consultation with the customer and do so based on the principles of fairness, rationality, and free will. Service fees may be charged based on the length of the service period and/or scale of the customer's assets. Other fee models are also

permissible, including differentiated commissions (different commission rates)" (Article 23).

In terms of research, securities firms are required to erect a firewall between their research departments and their asset management, investment banking, and other operations (Research Report Regulations, Article 14). Research department employees are barred from involvement in asset management and proprietary trading operations (Article 6). In relation to investment banking, the Research Report Regulations stipulate that securities analysts involved in underwriting, financial advisory services, or other such cross-firewall operations must be vetted beforehand and supervised while across the firewall and are prohibited from publishing reports related to the assignment (Article 15)<sup>4</sup>.



Additionally, some securities investment advisers provide software and/or information terminals with functions for timing stock trades or selecting stocks. Because such services are deemed to be tools that assist with formulation of investment strategies, they fall within the purview of management of securities investment advisory services and must comply with the Investment Advisory Regulations' requirements (Investment Advisory Regulations, Article 27)<sup>5)</sup>.

Now that investment advisory services have been given a solid legal foundation, securities firms are focusing more than ever on providing securities investment advice. Some are conducting training programs for investment consultants and also upgrading their computer systems in recognition of IT support's importance in terms of customer management, product design, risk management, and ex-post evaluation. Investment advisory services are expected to of course take a while to adapt to the Chinese equity market, but Chinese securities firms' business models have unquestionably started to change.

#### Note

- 1) Secutimes, February 18, 2011
- 2) According to Securities Association of China data.
- 3) To promote securities investment advisory services, financial advisory services, and publication of securities research reports, the SAC is reportedly considering a proposal to award bonus points to securities firms with the most net revenues from these services when ranking securities firms for classification and oversight purposes, according to the China Securities Journal (March 28, 2011).
- 4) While involved in a project related to underwriting, endorsement of IPO applicants, financial advisory services, or other such operations, securities analysts may not publish securities research reports related to the project. Even after such a cross-firewall project has ended, a securities analyst may not publish securities research reports using nonpublic information obtained through involvement in the project (Article 15). If engaged in securities underwriting, endorsement of IPO applicants, or M&A/restructuring advisory services involving a listed company, a securities firm or securities investment consultancy must establish a protocol for voluntary refrainment from publication of securities research reports (quiet periods) and mechanisms to implement the protocol (Article 16).
- 5) Companies that operate this type of securities consulting software or information terminals must obtain a securities investment consulting license (China Securities Journal, November 2, 2010).

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