

activities. Both inward and outward investment quotas under QFII and QDII programs will be increased. The shareholding limits for foreign capital in listcos will be relaxed. Domestic capital market will be steadily opened up for the direct investment of foreign individuals, and the domestic individuals investing in foreign capital market will be orderly pushed forward. Moreover, Xiao Gang, chairman of CSRC said this March that the potential QFII expansion is huge, and he mentioned that CSRC has been working on the QFII tax policy with other government agencies, as part of the effort to help facilitate QFII expansion this year.

We believed that this proposal will help inject more liquidity into China A share market, as well as expedite China's progresses in capital account liberalization in a boarder sense, including a) further relaxing the foreign investment management like holding period and remittance; b) implementing and expanding the Stock Connect scheme (see our Apr 11 note "A leap in China's efforts to liberalize capital accounts"); c) establishing capital account convertibility in SHFTZ and developing a domestic RMB offshore market; d) permitting cross-border RMB remittances by individuals and broadening channels for offshore banks to borrow/lend RMB in domestic market.

#### Promoting direct-financing

To develop a multi-layer capital market with proper structure, complete function and effective regulation by 2020, the Guideline highlighted the development of direct financing, which includes three major areas of bond market, equity market and private equity.

- On bond market, the Guideline aimed to a) develop a scheme of local government bond issuance; 2) enrich bond products suitable for various investors; 3) develop bond types for SMEs; 4) connect different bond exchanges and 5) improve issuance procedure, rating mechanism as well as 6) promote asset securitization. To develop a multi-layered equity market and cultivate a healthy private equity market are other two major areas in promoting the direct-financing.
- In A share stock market, the approval-based stock issuance system will be replaced by a registration-based one, and such move will be accompanied by the new IPOs governing rules published by the Securities Association of China the same day of the Guideline. Regulators will crackdown insider trading, enhance information disclosure, improve delisting regime, and support pension funds investments into capital markets by preferential tax policies.
- The State Council also said it will foster the market for private equity funds and venture capital funds. Going forward, the placement of private equity won't be subjected to administrative approval and funds of private equity and venture capital will be encouraged to support SMEs and newly-emerging industries.

We believe that such reforms will substantially help to improve financial stability and capital allocation in China. According to CSRC, 42.3% of financing in China belonged to the direct-financing category by end of 2012, lower than that of developed economies like the US (87.2%), Japan (74.4%), Germany (69.2%) and emerging markets like India (66.7%) and Indonesia (66.3%). As a result, risks are highly concentrated in banking system. And financing is expensive and hard to access for small borrowers. We expect that the reforms of promoting direct-financing will help enrich the investment channels for individuals and corporate, disperse risk in financial system, meet financing needs of SMEs and lower the funding cost for them.

Under such endeavor, China capital markets will be much more diverse, structured and transparent in the future, and will a) mobilize massive private savings; b) encourage inward portfolio flows; and c) lift market sentiment and valuation.

#### Promoting mixed ownership reform

Echoing the on-going SOE reform, the statement said to "actively" develop a mixed ownership economy, to improve the modern enterprise system and corporate governance structure, and to promote equity transfer. Specifically, it encouraged the employee stock ownership as well as M&A among companies of different ownership. Entry barrier and acquisition restriction on private companies will be further removed.

In our view, the mixed ownership reform is the key for China reform package on corporate level, which will help enhance SOEs' performance, unleash potential of private companies, better allocate resources as well as boost economic potential growth. According to our calculation, by Feb 2014, 62% of all Chinese listcos' market cap was SOEs either central or local ones, while private-owned only accounted for 38%. Among listed SOEs, 54% operated in monopolized sectors like oil & gas, banking, telecom and transportation, 42% operated in competitive sectors like food & beverage, auto, equipment, etc. Going forward, we expect 1) more monopolized central SOEs, in oil & gas, telecom and transportation, to open up for private capital investment with minority shares; 2) large chunk of local SOE shares in competitive sectors like F&B, apparel, electrics and healthcare will be taken over by private capitals; 3) more local SOEs assets to be listed or injected into listcos. More details of this reform will be elaborated in the upcoming SOE reform plan.

#### Managing a balance between innovation, development and financial risk prevention

While encouraging the innovation and modernization in China capital market, the authorities still keep the financial stability as paramount. Risk control, monitoring, reporting and disposal will go side by side with financial market evolvement. And most importantly, the bottom line of "no systemic or regional risk" will be firmly held, as per the Guideline. The policy also requires good management on the relationships of market vs. government, and investors at their own risk vs. investor protection. Investors should have a rational investment principle, awareness of risks,