

BANKRUPTCY OF FINANCIAL INSTITUTIONS: LESSONS OF
SECURITIES COMPANY INSOLVENCIES FROM CHINA

DR. ZHANG ZINIAN

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DR. ZHANG ZINIAN *

I. INTRODUCTION

Financial company bankruptcies draw attention from policymakers and academics, particularly after the 2007-2008 global financial crisis.¹ Arguably, the bankruptcy of financial companies, most of them banks, insurance firms, and securities or brokerage firms, is different from that of ordinary companies, since the former may trigger a systemic risk if handled inappropriately. Also, to protect clients/customers in financial company bankruptcies appears to be a priority, whereas the bankruptcy of ordinary companies tends to serve the best interests of creditors.²

There is growing literature shedding light on the bankruptcy of financial firms in the USA and the UK, but little has been done to examine what happens in China, especially given the importance of the Chinese economy to the world. This article is to fill the gap and ventures to investigate the bankruptcy of one particular type of financial firms: securities companies. Securities companies mainly act as broker-dealers in stock markets to trade on behalf of clients, but their businesses usually expand to trading stocks as principals. Of course, these companies also frequently underwrite and sponsor stock issuances and provide investment advisory services. In the UK, these companies are generally called investment banks.³

An empirical study looking at bankruptcy among China's securities companies is now possible, because in the past twenty years there was a wave of securities company bankruptcies. Given that many securities firm bankruptcies have been concluded in recent years, the time seems to be ripe to

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¹ See Mark G. Douglas, *The Year in Bankruptcy: 2008*, 5 PRATT'S J. BANKR. L. 113, 114-15 (2009); see also RODRIGO OLIVARES-CAMINAL ET AL., DEBT RESTRUCTURING 312 (Look Chan Ho & Nick Segal eds., 2011).

² Adam Rooney et al., *After the Storm—Is the New Special Administration Regime for Investment Banks Strong Enough?*, 5 INT'L. FIN. L. REV. 40, 42 (2012).

³ See Peter Bloxham, REVIEW OF THE INVESTMENT BANK SPECIAL ADMINISTRATION REGULATIONS 2011 9 (2013).

do a thorough investigation. This article excludes the insolvency of banks and insurance companies, because their insolvency has not yet been tested before Chinese courts. Also, it is more or less the intention of the Chinese government to use the bankruptcy of securities companies to gain experience so as to prepare for a comprehensive bankruptcy solution for failed banks and insurance companies. Hence, the current bankruptcy of securities companies heralds how the bankruptcy of banks and insurance companies will be dealt with in China in the foreseeable future.

To investigate brokerage firm insolvencies in China, this article attempts to answer two questions: What are the main features of the Chinese way in solving securities company bankruptcies? And are customers adequately protected in these proceedings?

To this end, the rest of the paper proceeds in three parts. Part II considers the background of the Chinese securities industry and the legal framework dealing with securities company insolvencies. Part III reports the main characters of securities company bankruptcies. Part IV examines the effectiveness of China's current securities customer protection regime. The summaries and policy recommendations are placed in the conclusion.

II. THE SECURITIES INDUSTRY IN CHINA AND THE APPLICABLE BANKRUPTCY RULES

Chinese stock markets can be traced back to the early 20th century; however, they were abruptly shut down by the Communists shortly after the year 1949 when the civil war ended in the Communists' victory, since the new republic believed that stock exchanges were a symbol of capitalism.⁴ Decades later, having learnt the bitter lessons of the planned economy, the new generation of Communists headed by the pragmatic leader, Deng Xiaoping, decided to make strategic reforms, part of which was to resume stock markets so as to channel social savings to fund economic growth. The opening of China's two stock exchanges, the Shanghai and Shenzhen Stock Exchanges, in 1991 marked a turning point of China's capital market development, thereby the emergence of securities companies became a reality.⁵

⁴ See Zhiwu Chen, *Capital Freedom in China as Viewed from the Evolution of the Stock Market*, 33 CATO J. 587, 594–95 (2013).

⁵ Zhong Zhang, *Law and Economic Growth in China: A Case-Study of the Stock Market*, 5 ASIAN J. L. & SOC'Y 333, 335 (2018).

A. The Development of Securities Companies in China and Their Businesses

There are generally three developmental stages of China's contemporary securities industry. At the first stage, during the period from 1991 to 2001, all securities companies were strictly state-owned.⁶ It was probably a necessity, since the private sector was largely too weak to take on the job during the early phases of China's market reforms. After China's admission to the World Trade Organization, at the second stage between 2001⁷ and 2012,⁸ foreign and private investors were allowed to hold minority equity in securities companies that were still controlled by the state. It was apparently a policy gesture from the Chinese government to encourage investment diversity. The current third stage, up until 2020, sees private and foreign investors holding the majority of equity in a small number of securities companies.⁹ The whole picture, however, has not been substantially changed, since the majority of securities companies in China remain state-owned or state-controlled.¹⁰

Like in the banking and insurance sectors, the securities industry is excessively regulated, and the central regulatory authority is currently the China Securities Regulatory Commission.¹¹ The number of securities licenses is jealously guarded, and up until now there are only 131 securities companies

⁶ Carsten A. Holz, *Economic Reforms and State Sector Bankruptcy in China*, 166 CHINA Q. 342, 342 n.2 (2001).

⁷ In 2001, the China Securities Regulatory Commission, for the first time, allows private investors to use the recapitalisation programme to become minority shareholders of formerly state-owned securities companies. See Guanyu Zhengquan Gongsì Zengzi Kuogu Youguan Wenti de Tongzhi (关于证券公司增资扩股有关问题的通知) [The Notice of Launching the Securities Firm Recapitalization Programme] (promulgated by the China Sec. Regul. Comm'n, Nov. 23, 2001).

⁸ In 2012, to implement the State Council's financial sector liberalisation policy, the China Securities Regulatory Commission starts permitting private investors to become the controlling shareholders in securities companies. See Guanyu Luoshi Guowuyuan Guanyu Guli He Yindao Minjian Touzi Jiankang Fazhan de Ruogan Yijian Gongzuo Yaodian de Tongzhi (关于落实《国务院关于鼓励和引导民间投资健康发展的若干意见》工作要点的通知) [The Notice of Materialising the State Council's Instruction over Encouraging and Guiding Private Investment] (promulgated by the China Sec. Regul. Comm'n, May 14, 2012), http://www.gov.cn/zhengce/2016-05/24/content_5076232.htm.

⁹ From 2018, foreign investors are allowed to hold the majority shares of securities firms in China, but this policy is only realised very occasionally. See Noah Sin et al., *JPMorgan Receives Final Approval for Majority-Owned Securities Venture in China*, REUTERS (Dec. 18, 2019), <https://www.reuters.com/article/us-china-jpmorgan-jv/jpmorgan-receives-final-approval-for-majority-owned-securities-venture-in-china-idUSKBNIYM14J>.

¹⁰ Logan Wright & Daniel Rosen, CREDIT AND CREDIBILITY: RISKS TO CHINA'S ECONOMIC RESILIENCE 77 (Centre for Strategic and International Studies, 2018).

¹¹ Zhengquan Fa (证券法) [Securities Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, effective July 1, 1999), art. 7.

virtually monopolising China's stock markets.¹² By contrast, there are more than 3,500 securities companies operating in the USA.¹³ Out of all 131 Chinese securities companies, there are thirteen companies in which foreign investors are seen and hold the minority equity in nine companies and the majority in four companies.¹⁴

Because of limited competition, the securities industry in China is considerably profitable. For example, in 2017, the total revenue of the Chinese 131 securities companies amounted to RMB312.8 billion (\$44.48 billion) and reaped the net profits of RMB112 billion (\$16 billion).¹⁵

Regarding the composition of China's securities company businesses, one survey can offer a glimpse, reporting that in 2017 traditional brokerage services generated 28 percent of the industry's overall revenue, securities underwriting and sponsorship 16 percent, and proprietary trading 32 percent, in addition to some investment advisory services.¹⁶ This survey suggests that many securities companies are active stock traders as principals, which leads to the conflict of interests with their clients examined later in this article.

Although most Chinese securities companies are well protected by the state, market downturns inevitably strike the most vulnerable and cause business failures, as was witnessed especially during the prolonged bear market between 2000 and 2006, in which some 85 percent of the national stock market value was astonishingly lost.¹⁷ Securities companies were hit hard: In 2002, there were 127 securities companies active in China,¹⁸ but the number of the

¹² CHINA SEC. INV. PROT. FUND CORP., 2020 NIAN 6 YUE TONGJI YUEBAO 9 (2020年6月统计月报) [THE MONTHLY REPORT OF JUNE 2020] (Jul. 28, 2020),

<http://www.sipf.com.cn/zjjk/tjsj/tjyb/2020/07/13177.shtml>.

¹³ SEC. INV. PROT. CORP., ANNUAL REPORT 2019 8 (2020).

¹⁴ CHINA SEC. REGUL. COMM'N, ANNUAL REPORT 2018 72 (2019) (recording that there are three companies in which foreign investors holding the majority of equity). JPMorgan was given the right to hold the majority of shares in a joint venture securities firm in China in 2019, so that in total there are four securities firms where foreign investors are the majority shareholders. See George Hammond & Don Weinland, *JPMorgan Wins Approval for Majority-Owned Chinese Securities Business*, FIN. TIMES, <https://www.ft.com/content/98b13d5a-2189-11ea-b8a1-584213ee7b2b> (Dec. 18, 2019).

¹⁵ KPMG, MAINLAND CHINA SECURITIES SURVEY 2018 3 (Oct. 10, 2018).

¹⁶ *Id.* at 11.

¹⁷ *Market Capitalization of Listed Domestic Companies*, WORLD BANK, <https://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS> (last visited Feb. 18, 2021).

¹⁸ CHINA SEC. REGUL. COMM'N, CHINA'S SECURITIES AND FUTURES MARKETS 2004 30 (2004), http://www.csfc.gov.cn/pub/csfc_en/about/annual/.

companies fell to 106 in 2010.¹⁹ Most of the failed securities companies were bankrupt and were placed in the bankruptcy procedure eventually. In fact, the 31 bankrupt securities companies studied in this article are the casualties of the 2000-2006 bear market. The bankruptcy of securities companies demands an effective bankruptcy law to tackle failures.

B. The Bankruptcy Law for Securities Companies in China

Bearing in mind the systemic risks caused by financial company bankruptcies, Chinese lawmakers were very cautious when drafting the China Enterprise Bankruptcy Law of 2006 (the EBL 2006). Article 134 of the law stipulates that if a financial company—including, among others, a bank, securities or insurance company—becomes bankrupt, the appropriate regulatory authority (for securities companies, it is the China Securities Regulatory Commission) may apply to the court for reorganization or liquidation and that a general moratorium can be issued by the court when the company is under an administrative takeover by the regulator.²⁰ No other articles of the EBL 2006 mention the bankruptcy of financial companies.

Although this article does not explicitly bar the securities company itself nor its creditors from filing for bankruptcy, the China Securities Law of 2005 Article 129 supplements that the permission of the China Securities Regulatory Commission must be sought before the bankruptcy procedure of a securities company can be opened in the court.²¹ Namely, without permission from the regulator, the China Securities Regulatory Commission, the bankruptcy procedure of a securities company cannot be commenced. This is generally in line with the law and practice in some advanced jurisdictions.²²

To provide more clarity, in 2008 the State Council, the Chinese central government, released the Securities Company Risks Regulation of 2008, Article 37 of which adds that following the administrative takeover, the China Securities Regulatory Commission or its appointed takeover team in control of

¹⁹ CHINA SEC. REGUL. COMM'N, 2010 NIAN ZHENGQUAN GONGSI FENLEI JIEGUO (2010 年证券公司分类结果) [THE 2010 CATEGORISATION RESULT OF SECURITIES COMPANIES] (Jul. 14, 2010), http://www.csrc.gov.cn/pub/zjhpublic/G00306205/201007/t20100714_182487.htm.

²⁰ Qiye Pochan Fa (企业破产法) [Enterprise Bankruptcy Law] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective Jun. 1, 2007), art. 134.

²¹ Zhengquan Fa (证券法) [Securities Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, effective July 1, 1999), art. 129 (amended 2005).

²² Dalvinder Singh, *U.K. Approach to Financial Crisis Management*, 19 TRANSNAT'L L. & COMTEMP. PROBS. 868, 899 (2011).

the securities company can apply to the court for bankruptcy liquidation if the company is found bankrupt.²³ Hence, generally speaking, it is the exclusive right of the China Securities Regulatory Commission to decide whether and when a bankruptcy application of a failed securities company can be filed to the court.

To protect customers, the China Securities Law of 2005 Article 139 states that the cash deposits and securities in the customers' accounts under the custody of the securities company are not part of the bankruptcy estate of the company, implying that these deposits and securities entrusted to the company are the properties of the customers and should be returned to them. This is in line with the general practice both in the UK²⁴ and the USA.²⁵

But the problem is that in some cases, customers' deposits and securities are misappropriated by securities companies. That is to say, in this situation, on paper, the customers' deposits and securities appear to be in their accounts, but in fact, the customer cannot withdraw the cash or trade the securities due to the misbehaviour of the securities company. To tackle such irregularities, in October 2004, the China Securities Regulatory Commission, together with other regulatory authorities, released a policy statement entitled "Individual Customer Claims Purchase and Customer Cash Deposit Guarantee Scheme." The scheme promised that any shortfalls of customer cash deposits would be fully replenished by the government, regardless of whether the customer was an individual or a business entity, but that, for the customers' claims against the securities company over misappropriated securities or other contractual breaches, the government would pay each customer that is an individual, not a business entity, up to a RMB100,000 claim in full and 90 percent of a claim over RMB100,000.²⁶ Surprisingly, the above guarantee only covered what

²³ Zhengquan Gongsì Fengxian Chuzhi Tiaoli (证券公司风险处置条例) [Rules on Risk Disposal of Securities Companies] (promulgated by the State Council, Apr. 23, 2008, effective Apr. 23, 2008) [hereinafter Regulation on Risk], art. 37.

²⁴ The Investment Bank Special Administration Regulations 2011, SI 2011/245, art.10 (Eng.); see also OLIVARES-CAMINAL ET AL., *supra* note 1.

²⁵ 11 U.S.C. § 741; see also Michael E. Don & Josephine Wang, *Stockbroker Liquidation Under the Securities Investor Protection Act and Their Impact on Securities Transfers*, 12 CARDOZO L. REV. 509, 521 (1990).

²⁶ Geren Zhaiquan Ji Kehu Zhengquan Jiesuan Zijin Shougou Yijian (个人债权及客户证券交易结算资金收购意见) [Individual Customer Claims Purchase and Customer Cash Deposit Guarantee] (promulgated by the People's Bank of China, the Fin. Ministry, the China Banking Regul. Comm., and the China Sec. Regul. Comm'n, Nov. 9, 2004) [hereinafter Individual Customer Claims Purchase], http://www.csrc.gov.cn/pub/newsite/flb/flfg/bmgf/zjgs/fxcz/201012/t20101231_189886.html.

happened before September 30, 2004, and was silent on how securities company customers would be protected after that point.²⁷

For a long-term solution, the China Securities Regulatory Commission set up a state-owned company, China Securities Investor Protection Fund Limited, in June 2005 to manage securities investor guarantee and payment issues on behalf of the central government.²⁸ After paying customers, the company steps into the shoes of the customers as an unsecured creditor in the subsequent bankruptcy distribution.²⁹ It is worth highlighting here that although customers are given some degrees of insurance guarantee by the regulator, they are still treated as unsecured creditors. Compared with bank depositors elevated to the preferential status in bank insolvencies, securities company customers are not given such a privilege in China.³⁰

After a securities company enters into a formal bankruptcy procedure, general company bankruptcy rules apply. However, the bankruptcy practice of securities companies is far more complex than what is written in the law books.

III. THE MAIN CHARACTERS OF SECURITIES COMPANY BANKRUPTCIES IN CHINA

In the past twenty years, there were thirty-seven securities company failures in China. The first failure happened on August 9, 2002, when Anshan Securities Limited's brokerage license was revoked and it was ordered to be wound up.³¹ The latest casualty is the closure of CEFC Shanghai Securities Limited by the China Securities Regulatory Commission on November 15,

²⁷ *Id.*

²⁸ CHINA SEC. INV. PROT. FUND CORP., 2017 ZHONGGUO ZHENGQUAN TOUZIZHE BAOHU JIJIN YOUXIAN ZEREN GONGSI NIANDU BAOGAO (2017 中国证券投资者保护基金有限责任公司年度报告) [CHINA SECURITIES INVESTOR PROTECTION FUND CORPORATION LIMITED ANNUAL REPORT 2017] 5 (2017) [hereinafter 2017 ANNUAL REPORT].

²⁹ Zhengquan Touzizhe Baohu Jijin Guanli Banfa (证券投资者保护基金管理办法) [The Rules of Securities Investor Protection Fund Management] (promulgated by the China Sec. Regul. Comm'n, Jun. 30, 2005, effective Jul. 1, 2005), art. 19.

³⁰ Barnabas Reynolds, *Is the Client Assets Regime on the Right Track? Trans-Atlantic Perspectives on Client Asset Post-Lehman*, 29 J. INT'L BANKING & REGUL. 67 (2014) (noting that in the USA customer asset claims have priority over unsecured creditors).

³¹ Yu Ning (于宁) & Ling Huawei (凌华薇), *Shengsi Anshan Zhengquan* (生死鞍山证券) [*The Rise and Fall of Anshan Securities Limited*], CAIJING (财经) [FINANCE] (Sept. 6, 2002), <https://business.sohu.com/16/49/article203034916.shtml>.

2019.³² Of these thirty-seven failures, thirty-one companies ultimately entered into the court-involved bankruptcy procedure (see Table 1 below), five companies were wound up by the government without using the bankruptcy law,³³ and one company, CEFC Shanghai Securities Limited, is anticipated to file for bankruptcy after the ongoing administrative takeover.³⁴ Three main features of China's securities company bankruptcies can be summarised.

Table 1: Bankrupt Securities Companies in China From 2000 to 2020

Source: China Securities Regulatory Commission

No.	Company	Bankruptcy Entry	Court	Takeover Entry	Branch Acquirer
1	Dalian	25/06/2003	Dalian	07/09/2002	Datong
2	Jiamusi	01/11/2005	Jiamusi	25/11/2003	Caida
3	Datong	30/04/2006	Dalian	n/a	n/a
4	Dapeng	24/01/2006	Shenzhen	14/01/2005	Changjiang
5	Nanfang	16/08/2006	Shenzhen	29/04/2005	Zhongtou
6	Wuzhou	04/09/2006	Luoyang	10/06/2005	Donghai
7	Kunlun	11/11/2006	Xining	15/11/2005	Guangda
8	Xibei	09/01/2007	Yinchuan	09/12/2005	Nanjing
9	Yazhou	31/05/2007	Shanghai	29/04/2005	Huatai
10	Xing'an	18/10/2007	Harbin	31/05/2005	Haitong
11	Tianyi	30/09/2007	Ningbo	07/07/2006	Guangda
12	Zhongfu	10/09/2007	Shanghai	07/07/2004	Shanghai
13	Jianqiao	05/04/2007	Xi'an	24/03/2006	Xiubu
14	Deheng	12/12/2007	Shanghai	03/09/2004	Huarong
15	Beifang	12/03/2007	Shanghai	27/05/2005	Dongfang
16	Henxing	21/08/2007	Changsha	03/08/2005	Huarong
17	Gansu	07/12/2007	Lanzhou	26/08/2005	Haitong
18	Hantang	26/12/2007	Shenzhen	03/09/2004	Xingda
19	Keji	07/09/2007	Beijing	24/02/2006	Anxing
20	Yunnan	24/07/2007	Kunming	01/06/2004	Taipinyang
21	Guangdong	31/10/2007	Guangzhou	06/11/2005	Anxing
22	Hebei	24/07/2007	Shijiazhuang	13/01/2006	Guangfa

³² Cheng Leng & Ryan Woo, *China Takes over Brokerage Arm of Troubled Energy Conglomerate CEFC*, REUTERS (Nov. 15, 2019), <https://www.reuters.com/article/china-brokerage/china-takes-over-brokerage-arm-of-troubled-energy-conglomerate-cefc-idINB9N27M01G>.

³³ They are Fuyou Securities Limited, Liaoning Province Securities Limited, Anshan Securities Limited, Diyi Securities Limited and Jutian Securities Limited.

³⁴ Gui Yanming (桂衍民), *Huaxin Zhengquan Jiepanfang Xianshen, Yongxing Zhengquan Jiesshou Qixia Zichan* (华信证券接盘方现身, 甬兴证券接手旗下资产) [*The Acquirer CEFC Securities Limited Emerged, and Yongxing Securities Limited Took Over the Assets*], QUANSHANG ZHONGGUO (券商中国) [CHINA SECURITIES TIMES] (Dec. 13, 2019), <http://news.stcn.com/2019/1213/15542694.shtml>.

No.	Company	Bankruptcy Entry	Court	Takeover Entry	Branch Acquirer
23	Tianqing	15/09/2007	Beijing	29/11/2005	Guoyuan
24	Zhongkuancun	07/09/2007	Beijing	01/02/2006	Anxing
25	Min'an	30/11/2007	Guangzhou	10/06/2005	Guoxing
26	Tiantong	15/01/2008	Jinan	17/03/2006	Qilu
27	Wuhan	08/01/2008	Wuhan	12/08/2005	Guangfa
28	Xinjiang	26/02/2008	Urumqi	17/02/2006	Hongyuan
29	Huaxia	31/07/2008	Beijing	15/12/2005	Zhongxing
30	Xinhua	10/10/2008	Changchun	05/12/2003	Dongbei
31	Minfa	29/10/2009	Fuzhou	18/10/2004	Dongxing

A. The Bankruptcy of Securities Companies can be Attributed to Both Regulatory Action and Financial Insolvency

It seems certain that securities companies' entry into a court-involved bankruptcy procedure in China is attributed to both regulatory action and financial failure. In other words, the single element of financial insolvency *per se* cannot trigger a judicial bankruptcy procedure.

Of the thirty-one securities companies in the bankruptcy procedure, as shown in Table 2 below, it is found that thirty companies' licenses were revoked by the China Securities Regulatory Commission prior to the insolvency procedures on the grounds that the company seriously misappropriated customer funds in addition to other regulatory offences. The remaining one, Datong Securities Limited, saw its brokerage license suspended by the regulator in the first place and was later placed into the bankruptcy procedure. In fact, misusing customer funds was rampant in Chinese securities companies in the early 2000s.

Table 2. Regulatory Action Against Securities Companies Before Bankruptcy
Source: The China Securities Regulatory Commission

No.	Company	Offences	Regulatory Action
1	Dalian	Customer fund misappropriation and bankruptcy	License revocation
2	Jiamusi	Customer fund misappropriation	License revocation
3	Datong	Risk management inadequacy	License suspension
4	Dapeng	Customer fund misappropriation	License revocation
5	Nanfang	Customer fund misappropriation	License revocation
6	Wuzhou	Customer fund misappropriation	License revocation
7	Kunlun	Customer fund misappropriation and illegal deposit-taking	License revocation
8	Xibei	Customer fund misappropriation and illegal deposit-taking	License revocation
9	Yazhou	Customer fund misappropriation	License revocation
10	Xing'an	Customer fund misappropriation	License revocation
11	Tianyi	Customer fund misappropriation and illegal deposit-taking	License revocation
12	Zhongfu	Customer fund misappropriation and illegal deposit-taking	License revocation

No.	Company	Offences	Regulatory Action
13	Jianqiao	Customer securities misappropriation	License revocation
14	Deheng	Customer fund and securities misappropriation	License revocation
15	Beifang	Customer fund misappropriation and market manipulation	License revocation
16	Henxing	Customer fund and securities misappropriation	License revocation
17	Gansu	Customer fund misappropriation and illegal customer financing	License revocation
18	Hantang	Customer fund misappropriation and illegal deposit-taking	License revocation
19	Keji	Customer fund and securities misappropriation	License revocation
20	Yunnan	Customer fund misappropriation	License revocation
21	Guangdong	Customer fund and securities misappropriation	License revocation
22	Hebei	Customer fund misappropriation and illegal customer financing	License revocation
23	Tianqing	Customer fund misappropriation	License revocation
24	Zhongkuancun	Customer fund misappropriation and market manipulation	License revocation
25	Min'an	Customer fund misappropriation	License revocation
26	Tiantong	Customer fund misappropriation	License revocation
27	Wuhan	Customer fund misappropriation and illegal deposit-taking	License revocation
28	Xinjiang	Customer fund misappropriation and illegal deposit-taking	License revocation
29	Huaxia	Customer fund misappropriation and market manipulation	License revocation
30	Xinhua	Customer fund misappropriation	License revocation
31	Minfa	Customer fund misappropriation and market manipulation	License revocation

More precisely, out of all these thirty-one punished companies, there are only two companies, Datong and Jianqiao, which did not abuse customer funds, with the rest of them all seriously violating the property rights of customers. A typical customer fund violator is Xinhua Securities Limited, which unlawfully removed RMB1 billion out of all RMB1.2 billion customer funds for its own proprietary trading when the company was caught by the regulator in 2003.³⁵ The worst abuser might be Nanfang Securities Limited, which secretly embezzled a total of RMB8.34 billion of customer money for its own stock investment.³⁶

Hence, to a large extent, in China, a securities company's entry into a judicial bankruptcy procedure is substantially controlled by the regulator, behind which are other government agencies at both central and local levels,

³⁵ Yu Ning (于宁), *Xinhua Zhengquan Jinji Guanbi Neimu Diaocha: Lüliang Di'er Zhongjie* (新华证券紧急关闭内幕调查: 吕梁第二终结) [*An Investigation of the Abrupt Closure of Xinhua Securities Limited: the End of Lüliang No.2 Market Manipulator*], CAIJING (财经) [FINANCE] (Dec. 22, 2003), <https://business.sohu.com/2003/12/22/50/article217255094.shtml>.

³⁶ Li Qing (李箐) & Lu Yanzheng (卢彦铮), *Nanfang Zhengquan Shanhou, Jianyin Touzi Jieru Zhizai Chengjie Yanghang Zaidaikuan* (南方证券善后, 建银投资介入旨在承接央行再贷款) [*The Aftermath of Nanfang Securities Limited, Jianying Investment Limited's Acquisition Aims to Repay the Bridge Loan of the Central Bank*], CAIJING (财经) [FINANCE] (May 16, 2005), <https://magazine.caixin.com/2005-05-16/100077419.html?NOJP>.

rather than by the company itself or its creditors. To put it another way, one key condition of a securities company's judicial bankruptcy is whether the regulator wants to do so. Such a contrast can be illustrated by the different fates of two securities companies in the Shandong province.

Tiantong and Qilu are two securities companies registered in this province, and both companies were found guilty of stealing customer funds around the year 2004; however, Qilu Securities Limited's misconduct was absolved by the regulator and the company was further supported by the local Shandong provincial government which ordered another local state-owned company to recapitalise it; on the contrary, Tiantong was left to flounder and was eventually placed into the bankruptcy procedure.³⁷

Since most Chinese securities companies are state-owned or state-controlled, probably to these companies, the regulator has lost faith in the belief that they did not deserve rehabilitation or that it was too costly to rescue them. Bankruptcy is one stone killing two birds. On the one hand, bankruptcy serves as a clear message to the market that the government takes seriously the misbehaviour of securities companies; on the other, the government can be relieved from expensive bailouts. Inevitably, the dominance of the regulator in pushing securities companies into bankruptcy affects the handling of subsequent bankruptcy issues.

B. A Two-Stage Solution to Handle Securities Company Bankruptcies

Unlike in the USA and the UK, securities companies in China are not allowed to enter into the formal bankruptcy procedure immediately after being found to be bankrupt. Instead, prior to the formal insolvency procedure, the bankrupt company will be placed under the administrative takeover by the regulator for a while; only after this, with the permission of the China Securities Regulatory Commission, a formal bankruptcy court proceeding can be commenced. Hence, it is a two-stage solution for securities company bankruptcies.

The regulator's takeover team assumes control of the company for two major purposes. The first is to maintain the continuity of the company's key services in the interests of company clients.³⁸ This purpose is usually achieved

³⁷ *Maidan 16 Yiyuan, Tiantong Zhengquan Bei Tuoguan* (埋单 16 亿元, 天同证券被托管) [At a Cost of RMB1.6 Billion, Tiantong Securities Limited Was Taken Over], CAIJING (财经) [FINANCE] (Mar. 17, 2006), <https://finance.caixin.com/2006-03-17/100064714.html>.

³⁸ Regulation on Risk, *supra* note 23, art. 22.

by hiring a third securities company to manage the company's main operations so as to minimise the disruption to customer services. The second purpose is to alleviate the losses of customers by purchasing their claims against the company.

The second purpose usually costs taxpayers dearly. Before China Securities Investor Protection Fund Limited was established in 2005, it was usually the central bank, the People's Bank of China, that provided bridge loans earmarked to compensate customer losses. For example, when Nanfang Securities Limited, China's third largest brokerage company, went bankrupt and was administratively taken over by the China Securities Regulatory Commission on January 2, 2004, the People's Bank of China lent to the troubled company RMB8.335 billion (\$1.19 billion) to assuage customer anxiety.³⁹

As noted earlier, in 2005, China Securities Investor Protection Fund Limited was set up to compensate customers on behalf of the central government, and it was obviously the Chinese government's attempt to shield taxpayers from the bankruptcy of securities companies' failures. This is because from the year 2006, securities companies have been required to pay regular levies to the China Securities Investor Protection Fund managed by the company.⁴⁰

The controversy of the regulator's administrative takeover is the legality concern. As shown in Table 1, all administrative takeovers happened before 2008. The irony was that no prior legislation authorized the China Securities Regulatory Commission to take over a bankrupt securities company.⁴¹ It is noteworthy that, although the China Securities Company Law—the highest level of securities legislation—was made as early as 1998, no provision mentioned securities company bankruptcies, let alone administrative takeovers. Thankfully, the gap was filled in 2008 by a regulation promulgated by the State Council.⁴² For legal certainty, ideally, such regulatory powers could be elevated to the China Securities Company Law in the near future.

An administrative takeover can be very lengthy. Except in the case of Datong Securities Limited, whose takeover commencement date is not publicly available—as seen in Table 1—in the remaining thirty takeovers, it was found

³⁹ Li & Lu, *supra* note 36.

⁴⁰ CHINA SEC. INV. PROT. FUND CORP., *supra* note 28, at 5.

⁴¹ Lu Zhongxing (陆忠行), *Wenti Quanshang de Chuzhi Chengxu Chutan* (问题券商的处置程序初探) [*Market Exit of Distressed Securities Companies*], 67 JINRONG FAYUAN (金融法苑) [FINANCIAL LAW FORUM] 43, 45 (2005).

⁴² Regulation on Risk, *supra* note 23, ch. 3 (stating that the regulator has the authority to take over the management of the closed securities company).

that on average it takes 762 days to complete a takeover process. The longest takeover occurred with Minfa Securities Limited, whose takeover lasted for 1,836 days—some five years, and the shortest was Dalian Securities Limited, which took 291 days to go through the administrative process.

Following the takeover, a judicial bankruptcy procedure can officially be opened. To enter into a judicial bankruptcy procedure, some restrictive conditions must be met. Again, instead of being regulated by law, these conditions appeared in a conference speech made by then deputy president of the China National Supreme People's Court, Mr. Justice Xi Xiaoming, in 2005.⁴³ Three substantial conditions can be extrapolated and summarized from Xi's speech. First, written permission from the China Securities Regulatory Commission should be obtained; second, the company's brokerage operations must have been transferred to a third-party securities company, which means that client accounts have been seamlessly maintained and that the court is free from handling complex customer account issues; and third, individual customer losses have been compensated for by the government.⁴⁴ It is not easy to meet these conditions, which is why many securities companies are stuck in administrative takeovers for years.⁴⁵

A case is cited here to help explain the transition from administrative takeover to judicial bankruptcy. Dapeng Securities Limited was closed by the China Securities Regulatory Commission on January 14, 2005, the same day Changjiang Securities Limited was commissioned by the regulator to manage the company's brokerage services. In June of 2005, as anticipated, the company's brokerage customer accounts and brokerage-related assets were sold as a package to Changjiang at a price of RMB50 million (\$7.17 million). Meanwhile, the People's Bank of China provided a RMB1.5 billion (\$215 million) bridge loan to the company paying the individual customer claims. Unsurprisingly, after the China Securities Regulatory Commission gave the bankruptcy permission on October 13, 2005, the Guangdong Shenzhen

⁴³ Xi Xiaoming (奚晓明), *Zuigao Renmin Fayuan Fuyuanzhang Xi Xiaoming Zai Quanguo Bufen Zhonggaoji Renmin Fayuan Shenli Zhengquan Gongsi Pochan Anjian Zuotanhui Shang De Jianghua* (最高人民法院副院长奚晓明在全国部分中级人民法院审理证券公司破产案件座谈会上的讲话) [A Speech at the National Securities Company Bankruptcy Conference] (Sept. 22, 2005).

⁴⁴ *Id.*

⁴⁵ Feng Guo (冯果) & Li An'an (李安安), *Wenti Quanshang Shichang Tuichu Falü Jizhi Zhi Shensi* (问题券商市场退出法律机制之审思) [*Legal Exit Mechanisms of Securities Companies*], 3 ZHENGQUAN FAYUAN (证券法苑) [SECURITIES LAW REVIEW] 449, 467 (2010).

Municipal Intermediate People's Court accepted the bankruptcy application on January, 24 2006.⁴⁶

In the judicial bankruptcy procedure, the remaining assets are liquidated and the distribution is made to creditors. After compensating customers as the policy requires, China Securities Investor Protection Fund Limited, which inherits the role played by the People's Bank of China before, will step into the shoes of customers as an unsecured creditor in the subsequent insolvency distribution. The China Supreme People's Court is very clear that customers are unsecured creditors, and that although they are largely compensated under the special insurance policy, they are still unsecured creditors, so that China Securities Investor Protection Fund Limited can only be subrogated as an unsecured creditor.⁴⁷

In fact, the most valuable assets of the bankrupt securities company—licensed branches and customer accounts—will have been sold before the commencement of the judicial bankruptcy procedure. But the status of the brokerage asset purchasers does raise concern of potentially unhealthy motivation of the Chinese securities regulator in favour of state-owned companies at the expense of private-controlled ones, which will be examined in the next section.

C. One Securities Company's Bankruptcy is Another Securities Company's Feast, and the Latter is Always a State-Owned or State-Controlled Company

Out of all thirty-one securities company bankruptcies, only one successfully used bankruptcy reorganization to rehabilitate the company.⁴⁸ The remaining thirty cases resulted in liquidation. It is rather interesting to learn that

⁴⁶ Wu Jun (吴俊), *Dapeng Zhengquan Chengwei Zhongguo Shoujia Pochan Qingsuan de Zhengquan Gongsì* (大鹏证券成为中国首家破产清算的证券公司) [*Dapeng Becomes the First Securities Company Liquidated in Court*], XINHUA WANG (新华网) [XINHUA NEWS] (Dec. 20, 2011), <https://www.yicai.com/news/1289855.html>.

⁴⁷ Xi Xiaoming (奚晓明), *Zuigao Renmin Fayuan Fuyuanzhang Xi Xiaoming Zai Quanguo Fayuan Zhengquan Gongsì Pochan Shenli Gongzuo Zuotanhui Shang de Jianghua* (最高人民法院副院长奚晓明在全国法院证券公司破产案件审理工作座谈会上的讲话) [A Speech at the National Conference over Securities Company Bankruptcy Trials in 2007] (Nov. 19, 2007).

⁴⁸ It was Datong Securities Limited that successfully restructured itself through the bankruptcy process in 2006. See *Datong Zhengquan Shoujia Pochan Chongzheng* (大通证券首家破产重整) [*Datong Securities Limited's Reorganization Is a Breakthrough*], DONGFANG ZAOBAO (东方早报) [DONGFANG MORNING NEWS] (Sept. 1, 2006), <http://finance.sina.com.cn/roll/20060902/1147900748.shtml>.

in all these thirty bankruptcy cases, it was always a state-owned or state-controlled company arranged by the regulator to acquire the brokerage assets and customer accounts of the bankrupt company. As included in Table 1, all thirty acquiring securities companies were state-owned or state-controlled; by contrast, out of the thirty acquired companies, at least twenty-two of them (73%) were privately-controlled securities companies.⁴⁹

One may ask: if the majority of China's securities companies are either state-owned or state-controlled, why are there so many privately-controlled ones targeted by the regulator and placed in the insolvency procedure? In fact, these twenty-two companies appear to be state-controlled, since in each company the majority of equity is owned by state-owned companies. Take the company Jianqiao Securities Limited as an example. 85.714% of Jianqiao's equity is held by six state-owned companies, and only 14.286% of equity left in the hands of two private companies. Jianqiao is supposed to be state-controlled, but two of the six state-owned company shareholders are actually stock market investors in partnership with the two private company shareholders. As a result, Jianqiao Securities Limited is de facto controlled by the two minority shareholders, which can substantially deploy 54% of the voting rights.⁵⁰

Meanwhile, the private party control over many securities companies whose major equity superficially remains under the state-ownership is also because of the indifference of state-owned company shareholders to company management. This paves the way for the dominance of private parties. To a certain degree, the indifference of state-owned company shareholders is attributable to the widespread false capitalisation in securities companies. At least, it can be found that many state-owned company shareholders did not inject capital as officially recorded, like in Xinjiang Securities Limited,⁵¹

⁴⁹ Those twenty-two companies are Datong, Dapeng, Wuzhou, Kunlun, Xibei, Tianyi, Zhongfu, Jianqiao, Deheng, Beifang, Hengxin, Gansu, Hantang, Guangdong, Hebei, Tianqing, Zhongguancun, Min'an, Tiantong, Wuhan, Xinhua and Minfa.

⁵⁰ Zou Yu (邹愚), *Delong Xia de Dan: Jianqiao Zhengquan Zhi Shang, Chusheng Sannian Bian Binling Yaozhe* (德隆下的蛋: 健桥证券之殇, 出生三年便濒临夭折) [*An Egg in the Delong Nest: Jianqiao Securities Limited Failed Three Years After Established*], 21 SHIJI JINGJI BAODAO (21 世纪经济报道) [21ST CENTURY ECONOMIC NEWS] (Jan. 3, 2006), <http://finance.sina.com.cn/stock/stocktalk/20060103/15252245171.shtml>.

⁵¹ Liu Hongpeng (刘宏鹏), *Xinjiang Zhengquan Beikun Feifa Xicun 182 Yiyuan Shimo* (新疆证券被控非法吸存 182 亿元始末) [*A Whole Story of the Illegal Deposit-Taking by Xinjiang Securities Limited*], ZHONGGUO ZHENGQUAN BAO (中国证券报) [THE CHINA SECURITIES DAILY] (Aug. 20, 2007), <http://finance.sina.com.cn/stock/t/20070820/05301613119.shtml>.

Wuzhou Securities Limited,⁵² and Wuhan Securities Limited.⁵³ With no real money invested, it is understandable why so many state-owned company shareholders did not pay attention to the management of these companies. This is probably exactly what private company shareholders are keen to see.

One interesting case is worth citing to explain how private company shareholders exploit every chance to control a securities company. Dongfang International Limited, a private company, was a shareholder of Beifang Securities Limited, but only owned 20% of the company's equity. To gain control of the company, it entered into a secret agreement with another shareholder, Wan'neng International Limited, a state-owned company, stating that an annual 10% return on Wan'neng's RMB150 million capital investment was guaranteed by Dongfang so long as Wan'neng always followed the instruction of Dongfang International Limited when voting at shareholder meetings. Through this and other similar plots, Dongfang International Limited effectively controlled Beifang Securities Limited.⁵⁴ One way or another, the twenty-two securities companies are controlled by private parties. It is probably because of the deep-rooted distrust of private parties in China that the regulator decided to liquidate them in favor of state-owned companies. If this is true, it feeds the most feared perception in China that in recent years the state sector advances, and the private sector is accordingly forced to retreat.⁵⁵

Does the Chinese securities regulator use the bankruptcy law to get rid of privately-controlled securities companies in favour of state-owned ones? Such a suspicion cannot be eliminated for at least two additional reasons. First, the brokerage assets of the bankrupt companies are always sold at a

⁵² Wuzhou Zhengquan Youxian Gongsi Qingsuanzu Su Guangfa Yinhang Gufen Youxian Gongsi Shenzhen Futian Zhihang (五洲证券有限公司清算组诉广发银行股份有限公司深圳福田支行) [Wuzhou Securities Limited Liquidation Committee v. Guangdong Development Bank Shenzhen Futian Branch], Sup. People's Ct. 2014.

⁵³ Ma Teng (马腾) & Zhu Jiang (朱江), *Nuoyong Kehu Baozhengjin 10.3 Yiyuan, Wuhan Zhengquan de Leiluan Zhi Wei* (挪用客户保证金 10.3 亿元, 武汉证券的累卵之危) [Misappropriating RMB1.03 Billion Customer Fund, Wuhan Securities Limited Is in a Precarious Situation], 21 SHIJI JINGJI BAODAO (21 世纪经济报道) [21ST CENTURY ECONOMIC NEWS] (Sept. 28, 2003), <https://business.sohu.com/97/74/article213787497.shtml>.

⁵⁴ Fang Hua (方华), *Yanzhong Weigui Niang Juda Jinrong Fengxian, Jinji Tuoguan Beifang Zhengquan Neimu* (严重违法酿巨大金融风险, 紧急托管北方证券内幕) [Serious Regulatory Breaches Causing Financial Risks, Beifang Securities Limited is Takeover in Urgency], FAREN (法人) [FA REN MAGAZINE] (Jul. 28, 2005), <http://finance.sina.com.cn/stock/t/20050728/12511843485.shtml>.

⁵⁵ *The Story of China's Economy as Told Through the World's Biggest Building*, ECONOMIST, Feb. 23, 2019, at 47, 50.

considerably depressed price in favour of the regulator-appointed buyers. Certain background should be explained. In China, a general license is needed to operate a brokerage company, but it is not enough. The regulator also controls how many branches a securities company can have; in reality, each branch needs a special permit from the regulator. The national number of stock brokerage branches as a whole is directly controlled by the regulator. Due to limited supplies, the permit of a particular brokerage branch is a highly sought commodity in China.

As early as 1999, the market price of a brokerage branch amounted to around RMB18 million, and most of a branch's value was its permit issued by the China Securities Regulatory Commission.⁵⁶ But the problem is that when a bankrupt brokerage company's branches are sold, especially during administrative takeovers, the value of the permits is largely ignored. Therefore, a valuable advantage is given to the acquirer. For example, during the administrative takeover of Xing'an Securities Limited in 2006, each branch was sold to Haitong Securities Limited, a state-owned company, for a meager price of RMB1 million, with many raising eyebrows in disbelief.⁵⁷ Similarly, the thirty-one branches of Dapeng Securities Limited were sold to Changjiang Securities Limited, a state-owned company, for RMB50 million, with each branch priced at some RMB1.61 million only.⁵⁸ This is probably unfair. Not only are the precious branch permits transferred to the buyers almost for free, but valuable customer accounts are also sold for nothing.⁵⁹

Although occasionally the regulator symbolically organises a bidding process, given the strict conditions imposed on the eligibility of buyers/bidders,

⁵⁶ Deng Quanlun (邓全伦), *Shanxi Jianhang Shenxian Daomai Jinrong Paizhao Niniao* (陕西建行深陷倒卖金融牌照泥淖) [*The Construction Bank Shaanxi Branch Is Implicated in the Illegal Sale of Financial Company Permits*], SHIDAI ZAIXIAN (时代在线) [TIME WEEKLY] (May 10, 2012), <http://www.time-weekly.com/wap-article/17192>.

⁵⁷ *Haitong 2000 Wan Dijia Jinggou Xing'an Zhengquan* (海通 2000 万低价竞购兴安证券) [*Haitong Securities Limited Acquired the Branches of Bankrupt Xing'an Securities Limited At a Low Price of RMB20 Million*], CAIJIN SHIBAO (财经时报) [FINANCIAL EXPRESS] (Jul. 8, 2006), <http://finance.sina.com.cn/stock/y/20060708/16132716241.shtml>.

⁵⁸ Yu Ning (于宁) & Ji Minhua (季敏华), *Dapeng Zhengquan Pochan* (大鹏证券破产) [*Dapeng Securities Limited Is Bankrupt*], CAIJIN (财经) [FINANCE] (Feb. 8, 2006), <http://finance.sina.com.cn/stock/t/20060208/11262325692.shtml>.

⁵⁹ See YAO ZEYU (姚泽宇) ET AL., ZHUTI YANJIU: CONG JIANBING SHOUGOU JIAODU KAN ZHONGXIAO QUANSHANG GUQUAN JIAZHI (主题研究: 从兼并收购角度看中小券商股权价值) [RESEARCH PAPER: EQUITY VALUE OF SMALL-AND-MEDIUM SECURITIES COMPANIES IN MERGERS AND ACQUISITIONS] (China Int'l Cap. Corp. 2019), http://pdf.dfcfw.com/pdf/H3_XB201901211287248200_1.pdf.

few can trust the fairness of such sales.⁶⁰ More controversially, many appointed buyers boast afterwards that they have dramatically expanded through acquiring the brokerage branches of their bankrupt peers at a low cost, which reinforces the suspicion raised here in terms of the regulator's favouritism in the interest of state-owned and state-controlled companies.⁶¹

Second, the sale of bankrupt securities company branches and customer accounts to the appointed buyers also raises concerns over conflicts of interest. In almost all administrative takeovers, the buyer is initially commissioned by the regulator to manage the company's branches and client accounts for the benefit of customers, and of course management fees apply.⁶² Inevitably, one has to doubt the fairness of the sale of these valuable assets to the party that has been entrusted to manage them. In some cases, disgruntled parties did challenge such problematic sales, but few have been successful.⁶³

Admittedly, the regulator's considerable favour toward state-owned and state-controlled securities companies is not given for free. The regulator's priorities are twofold. The first is the continuity of the brokerage services, which could be smoothly taken over by the buyer who is already an experienced broker. Second, the buyer is almost routinely required to reemploy all branch workers

⁶⁰ *Changjiang Zhengquan Jieshou Dapeng Zhengquan Jingji Yewu* (长江证券接收大鹏证券经纪业务) [*Changjiang Securities Limited Bought the Brokerage Services of Dapeng*], SHANGHAI ZHENGQUAN BAO (上海证券报) [SHANGHAI SECURITIES DAILY] (Jul. 1, 2005), <http://finance.sina.com.cn/roll/20050701/081687332t.shtml>.

⁶¹ Jia Haosen (贾浩森), *Dongfang Zhengquan Kuozhang Shanghai Deng Sidi, Beifang Zhengquan Chedi Gaobie Lishi* (东方证券扩张上海等四地, 北方证券彻底告别历史) [*Dongfang Securities Limited that Expanded to Shanghai, and Beifang Securities Limited Faded Away*], XIN JING BAO (新京报) [BEIJING TIMES] (May 20, 2006), <http://finance.sina.com.cn/stock/t/20060520/00372582934.shtml>; Wang Siwen (王思文), *Huatai Zhengquan: Yong Keji Chongxin Dingyi Quanshang Fuwu Quan Liantiao* (华泰证券: 用科技重新定义券商服务全链条) [*Huatai Securities Limited: A Chain of Brokerage Services Fuelled by High Technology*], ZHENGQUAN RIBAO (证券日报) [CHINA SECURITIES DAILY] (Aug. 22, 2019), <http://www.zqrb.cn/jrjg/quanshang/2019-08-22/A1566407693785.html>; Yang Lu (杨璐), *Guoyuan Zhengquan Jieli Ziben Shichang, Shixian Wandao Chaoyue* (国元证券借力资本市场, 实现弯道超越) [*Guoyuan Securities Limited Overtakes Peers Through Capital Markets*] (Aug. 10, 2020), <http://www.ahlca.org/display.asp?id=652>.

⁶² Regulation on Risk, *supra* note 23, art. 10.

⁶³ Zhang Tao (张昶), *Fagui Queshi Zhiyue Quanshang Sifa Pochan* (法规缺失制约券商司法破产) [*The Lack of Clear Rules Undermines the Fairness of Securities Company Bankruptcies*], CAIJING SHIBAO (财经时报) [FINANCIAL NEWS] (Aug. 19, 2007), <http://finance.sina.com.cn/stock/y/20070819/08323896235.shtml>.

as a condition of the purchase, which considerably eases the potential trouble of redundancies.⁶⁴

China's financial regulators' favouritism to state-owned players seems to be consistent. In 2019, when Baoshang Bank Limited, a privately-controlled bank, was in trouble, the regulator arranged two state-controlled banks, Huishang Bank Limited and Mengshang Bank Limited, to acquire its branches.⁶⁵

Overall, the strong intervention of the regulator in the bankruptcy of securities companies in China is apparent, though fairness might be at stake. Unquestionably, the regulator's intervention is also aimed to protect securities company customers that are the most innocent, but the problem is whether customers are adequately looked after under the current legal framework.

IV. ARE CUSTOMERS ADEQUATELY PROTECTED IN CHINA'S SECURITIES COMPANY BANKRUPTCIES?

Customer protection in securities company bankruptcies in China is as complex as in other jurisdictions, like the USA and the UK. The Chinese approaches in prioritising customer interests can be summarised into two main elements, which reinforce each other in forming China's unique ways of protecting innocent customers.

A. Customer Cash Deposits are Fully Protected by the Government

In general, a customer has two accounts when trading through the securities company: One is the customer cash deposit account, in which the customer places the money for the purchase of securities and for receiving payments such as dividends paid by an investee company or interests paid by a bond issuer; the second is the customer securities account in which all securities owned by the customer are held.

⁶⁴ See Xie Yanxia (谢艳霞), *Guangfa Zhengquan Shougou Wuhan Zhengquan 25 Jia Yingyebu, Kuoda Shili Fanwei* (广发证券收购武汉证券25家营业部, 扩大势力范围) [*Guangfa Securities Limited Acquired Wuhan Securities Limited's 25 Branches to Further Expand*], NANFANG DUSHI BAO (南方都市报) [SOUTHERN METROPOLIS DAILY] (Jan. 14, 2006), <http://finance.sina.com.cn/roll/20060114/1046496740.shtml>.

⁶⁵ Zhang Yan & Cheng Leng, *China's Huishang Bank to Raise \$3 Billion to Take Over Baoshang's Four Branches*, REUTERS (Feb. 6, 2020), <https://www.reuters.com/article/idUSKBN2001W0>; Cheng Leng et al., *China's Central Bank Approves Business Operations of Newly Revamped Baoshang Bank*, REUTERS (Apr. 30, 2020), <https://www.reuters.com/article/idUSKBN22C1RW>.

The customer opens these two accounts in the securities company and in effect entrusts these assets to the latter. Although the China Securities Law of 1998 Article 132 makes it clear that the securities company must store all customer money in a separate account at a designated commercial bank and is prohibited from using customer money, in practice misappropriating customer money by securities companies was widespread at least in the early 2000s.

One report estimates that in 2004 the Chinese securities industry as a whole misappropriated around RMB200 billion (\$28.776 billion) of customer money,⁶⁶ and given that there were 102 securities companies in China in 2004,⁶⁷ this means that on average each company misused RMB1.961 billion. The worst offender might be Nanfang Securities Limited, which stole RMB8 billion of customer deposits when caught by the regulator in 2004.⁶⁸

Since China has some 134 million investors active in the stock markets, most of them individuals,⁶⁹ any missteps in handling customer deposit misappropriations might not only lead to the general public's loss of confidence in the stock markets but also trigger social unrest. In October 2004, weighing the benefits against the risks, the People's Bank of China, together with other central regulatory authorities, issued a policy notice (the 2004 notice) promising to fully guarantee the safety of securities customer cash deposits. Namely in case of a securities company's insolvency, the central government will pay customers the funds that were misappropriated from their customer money accounts.⁷⁰

⁶⁶ Zhou Guangqiang (周光□) & Yuan Man (袁满), *Youxian Peifu Tanlu You Shenyi, Neidi Jinrong Jigou Pochan An Jiasu* (有限赔付探路有深意, 内地金融机构破产暗加速) [*Limited Customer Protection Is Well Balanced and the Government Accelerates Financial Firm Bankruptcy in China*], JINGJI GUANCHA BAO (经济观察报) [ECONOMIC OBSERVATION DAILY] (Oct. 23, 2004), <http://news.eastday.com/eastday/news/news/node4944/node37460/userobject1ai601545.html>.

⁶⁷ Li Haitao (李海涛) & Xia Ding (夏定), *Zhengquanfa Ying Queli Quanshang Pochan Peichang Zeren de Baoxian Zhidu* (证券法应确立券商破产赔偿责任的保险制度) [*Securities Investor Compensation Should be Established*], 1 ZHENGZHI YU FALÜ (政治与法律) [POLITICS AND LAW] 59, 60 (2004).

⁶⁸ Ma Yan (马燕) & Chen Chunling (陈春林), *Nanfang Zhengquan Zuoqi Pochan Qingsuan* (南方证券昨起破产清算) [*Nanfang Securities Limited Was Placed into Liquidation Yesterday*], YANGZI WANBAO (扬子晚报) [YANGTZE EVENING NEWS] (Apr. 5, 2007), <http://news.sohu.com/20070405/n249208928.shtml>.

⁶⁹ SEC. ASS'N CHINA, ZHONGGUO ZHENGQUANYE FAZHAN BAOGAO (中国证券业发展报告) [THE DEVELOPMENT OF THE CHINA SECURITIES INDUSTRY] (2011).

⁷⁰ See Individual Customer Claims Purchase, *supra* note 26.

To guarantee customer money accounts, the central bank does not distinguish individuals from corporate customers, and this means all customers are protected. The central bank's courage or confidence in covering the client money losses of all securities customers is perhaps because the compensation is a one-time payment. In 2005, when the China Securities Law of 1998 was amended, a new provision was inserted which required securities companies to open a separate customer money account for each customer in a designated commercial bank. As a result of this provision, securities companies stopped misappropriating customer money.⁷¹

The 2017 annual report of China Securities Investor Protection Fund Limited reveals that in the bankruptcies of 24 securities companies whose customer deposit compensation issues were handled by the company, a total of RMB16.265 billion was paid to replenish the customer money accounts due to the malpractice of these securities companies.⁷² However, for customers' losses from other causes, the compensation policy is different.

B. Individual Customers Are Given Limited Government Protection and Corporate Customers Are Not

The aforementioned 2004 notice stipulates that except for securities customer money accounts fully protected by the government, for all other losses of customers, the government only compensates individual customers to a limited extent and corporate/business customers are not given special compensation. Furthermore, the government only protects individual customers' losses which accrued before 30 September 2004.⁷³

The Chinese government's unwillingness to give a hand to corporate customers seems to be reasonable since, compared to individuals, they are supposed to be far more sophisticated and can absorb certain risks. Similarly, in the UK, generally speaking, only individual and small business customers in securities company bankruptcies are protected by the Financial Services Compensation Scheme.⁷⁴ Hence, the Chinese compensation system is relatively more conservative. Of course, the most generous compensation scheme seems to be the American one, since customers, both individual and corporate, can

⁷¹ Zhengquan Fa (证券法) [Securities Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, effective July 1, 1999), art. 139 (amended 2005).

⁷² 2017 ANNUAL REPORT, *supra* note 28, at 44.

⁷³ See Individual Customer Claims Purchase, *supra* note 26.

⁷⁴ FIN. CONDUCT AUTH., FCA HANDBOOK: COMPENSATION CH. 4, <https://www.handbook.fca.org.uk/handbook/COMP/4.pdf>.

access the statutory compensation provided by Securities Investor Protection Corporation.⁷⁵

But the scope of the Chinese securities investor compensation system appears to be the broadest, albeit only for individual customers. In both the UK and USA, strictly speaking, only the customer losses from brokerage-related services are protected by the statutory compensation schemes.⁷⁶ In China, according to the 2004 notice, the government protection scheme covers individual customer losses from: a) any securities in customer securities accounts unlawfully removed by securities companies, b) lending to securities companies, c) corporate bonds directly issued by securities companies, and d) any other contractual breaches. To a certain extent, the Chinese system does not distinguish customers from creditors when protecting individuals,⁷⁷ and arguably much should be done to provide a more targeted protection so as to seek fairness.

To alleviate moral hazards, the Chinese government imposes two restrictions on individual customer protection. One is that only the principal of customer losses can be compensated, and the second is that the amount of compensation is limited. More precisely, up to the first RMB100,000 losses of each individual customer are fully compensated, and the losses above RMB100,000 are 90% protected.⁷⁸ Presumably, the vast majority of individual customers would be well protected since one study suggests that in China 82.78 % of stock market investors hold an investment of less than RMB100,000.⁷⁹

As noted before, the 2004 notice only compensates individual customer losses incurred before September 20, 2004, but the bankruptcy of securities companies continued after that point. Thus, on January 27, 2006, the People's Bank of China, together with its regulatory partner agencies, released an additional notice adding that individual customer losses happening between September 30, 2004 and January 31, 2006 were also eligible for government compensation. However, the extent of compensation was further limited. Under

⁷⁵ Securities Investor Protection Act of 1970, 15 U.S.C. § 78lll (2010).

⁷⁶ See *Compensation Limits: Investments*, FIN. SERV. COMP. SCHEME, <https://www.fscs.org.uk/what-we-cover/investments/>; Securities Investor Protection Act of 1970, 15 U.S.C. § 78fff-3 (2010).

⁷⁷ See Stephen P. Harbeck, *Stockbroker Bankruptcy: The Role of the District Court and the Bankruptcy Court Under the Securities Investor Protection Act*, 56 AM. BANKR. L.J. 277, 286 (1982).

⁷⁸ See Individual Customer Claims Purchase, *supra* note 26.

⁷⁹ SEC. ASS'N CHINA, ZHONGGUO ZHENGQUANYE FAZHAN BAOGAO (中国证券业发展报告) [THE DEVELOPMENT OF THE CHINA SECURITIES INDUSTRY] (2011).

the updated compensation scheme, for individual customer losses, the government compensated 100% of losses up to RMB100,000, 90% of losses between RMB100,000 and RMB200,000, 80% of losses between RMB200,000 and RMB500,000, 70% of losses between RMB500,000 and RMB1,000,000, 60% between RMB1,000,000 and RMB2,000,000, 50% between RMB2,000,000 and RMB3,000,000, with no compensation for any claims above RMB3,000,000.⁸⁰

Unfortunately, the People's Bank of China does not say anything about customer compensation for losses incurred after January, 31 2006. Given that the China Securities Investor Protection Fund has been established since 2005 and that the Fund has been collecting levies and assessments from all securities companies since,⁸¹ arguably, securities customer compensation will continue to be delivered to help innocent customers. But optimism should be exercised with caution. During the recent administrative takeover of CEFC Shanghai Securities Limited in 2019, there was no information on the involvement of China Securities Investor Protection Fund Limited in providing assistance to individual customers. Hence, there are many uncertainties ahead.

In a recent official report, China Securities Investor Protection Fund Limited recorded that in handling 24 securities company bankruptcies, individual customer compensation totalled RMB6.256 billion, suggesting that on average RMB260.64 million in customer compensation was paid in each company.⁸² Of these 24 securities companies, there are 61,313 individuals benefiting from this compensation scheme,⁸³ and on average each individual customer was compensated RMB102,034, a moderate amount.

After paying individual customer losses and replenishing customer money accounts, China Securities Investor Protection Fund Limited is subrogated as an unsecured creditor in the subsequent liquidation distribution.

⁸⁰ Gongbu Guanyu Geren Zhaiquan Shougou Youguan Wenti de Buchong Tongzhi (公布关于个人债权收购有关问题的补充通知) [Additional Rules of the Individual Investor Claims and Customer Deposit Accounts Purchase Scheme] (promulgated by the People's Bank of China, the Fin. Ministry, the China Banking Regul. Comm. and the China Sec. Regul. Comm'n, Jan. 27, 2006, effective Jan. 27, 2006).

⁸¹ Zhengquan Touzizhe Baohu Jijin Guanli Banfa (证券投资者保护基金管理办法) [The Rules of Securities Investor Protection Fund Management] (promulgated by the China Sec. Regul. Comm'n, Jun. 30, 2005, effective Jul. 1, 2005).

⁸² CHINA SEC. INV. PROT. FUND CORP., 2018 ZHONGGUO ZHENGQUAN TOUZIZHE BAOHU JIJIN YOUXIAN ZEREN GONGSI NIANDU BAOGAO (2018 中国证券投资者保护基金有限责任公司年度报告) [2018 ANNUAL REPORT] 21 (2018).

⁸³ *Id.* at 45.

At the moment, as shown in Table 3 below, the recoveries do not seem to be very discouraging in the context of bankruptcy. With the unsecured debt recovery rate available in 30 securities company bankruptcies, it is found that the average recovery rate is 28.57 cents on the yuan, suggesting that around one quarter of the compensation has been recouped.

Table 3. Unsecured Creditor Recoveries in China's Securities Company Bankruptcies

Source: China Securities Investor Protection Fund Limited and Various Media Reports

No.	Company	Recovery Rate	Status
1	Dalian	Missing	Missing
2	Jiamusi	10.00%	Estimated
3	Datong	43.00%	Actual
4	Dapeng	26.51%	Actual
5	Nanfang	75.00%	Actual
6	Wuzhou	4.24%	Actual
7	Kunlun	8.48%	Actual
8	Xibei	28.86%	Actual
9	Yazhou	8.00%	Actual
10	Xing'an	100%	Actual
11	Tianyi	44.28%	Actual
12	Zhongfu	29.42%	Actual
13	Jianqiao	67.30%	Estimated
14	Deheng	0.57%	Estimated
15	Beifang	15.00%	Estimated
16	Henxing	2.81%	Actual
17	Gansu	4.80%	Actual
18	Hantang	50.16%	Actual
19	Keji	24.69%	Actual
20	Yunnan	3.20%	Actual
21	Guangdong	18.83%	Actual
22	Hebei	100%	Actual
23	Tianqing	3.56%	Actual
24	Zhongkuancun	31.00%	Actual
25	Min'an	14.21%	Actual
26	Tiantong	17.44%	Actual
27	Wuhan	15.70%	Actual
28	Xinjiang	21.52%	Actual
29	Huaxia	21.00%	Actual
30	Xinhua	1.37%	Actual
31	Minfa	67.01%	Actual
		28.57% (average)	

Overall, the main concerns over securities customer protection in China are threefold. First, uncertainties remain especially as for the compensation

scheme for customer losses taking place after January 31, 2006, since there is no clear rule regarding this situation. Second, corporate customers are totally left in the cold; even if their interests in the securities accounts are violated, they could only be supported as unsecured creditors in the final bankruptcy distribution. Third, customers and creditors are lumped together under the Chinese securities rules, and this simply undermines customer protection. Ideally, in the not-too-distant future, the Chinese securities regulators can devise a more sophisticated compensation system so as to seek fairness in the interests of securities customers.

V. CONCLUSION

Through investigating the bankruptcies of the thirty-one Chinese securities companies in the past twenty years, this article can summarise three main characteristics of the Chinese way of handling the failure of securities firms. First, the bankruptcy of a securities company is routinely controlled by the regulator, and it may even not be an exaggeration to say that the bankruptcy law has become part of the regulatory tools to liquidate unwanted securities companies in China. The pure financial trouble of a securities company usually does not end in a judicial bankruptcy procedure; the Chinese state tends to subsidize troubled securities companies by either recapitalising or offering generous loans.⁸⁴ Second, there is an emerging two-stage solution in tackling securities company bankruptcies in China. The first stage is the regulator-controlled administrative takeover, and the second stage is to distribute assets among creditors under a court-involved judicial bankruptcy procedure. Third, in liquidating misbehaving securities companies, the Chinese securities regulator uses this chance to further strengthen the dominance of state-owned securities companies by selling licensed securities company branches and customer accounts to appointed buyers at allegedly depressed prices.

Turning to customer protection, although the central government has poured billions into alleviating customer losses in the past, it is unknown why the government is hesitant to establish clear rules to enhance customer confidence. Technically speaking, after January 31, 2006, the regulator-initiated securities customer compensation scheme in China ended and is no longer

⁸⁴ See Ting-Wei Chiang, *Chinese State-Owned Enterprises and WTO's Anti-Subsidy Regime*, 49 GEO. J. INT'L L. 845, 886 (2018); see also Yueh-Ping Yang & Pin-Hsien Lee, *State Capitalism, State-Owned Banks and WTO's Subsidy Regime: Proposing an Institution Theory*, 54 STAN. J. INT'L L. 117, 158 (2018).

available. If so, why does the central government set up the China Securities Investor Protection Fund and establish the fund management company, China Securities Investor Protection Fund Limited?

For more targeted customer protection, China has much to learn from the lessons generated from both the UK and the USA, especially in relation to the establishment of the customer money pool exclusively serving the interests of customers. Overall, while it seems a celebrated breakthrough to see the use of bankruptcy law on securities company bankruptcies in China, the practice raises more questions than solutions.