The impact of China's regulatory investigations following the recent stock market crash

What's the background?

China's stock market crashed at the end of June 2015. By early July, around a thousand of the shares listed on PRC stock exchanges were suspended for trading and the A share index fell by a third in a few weeks, losing over RMB20 trillion (roughly USD3.5 trillion).

Fearful of the potential impact on the Chinese economy, PRC regulators have adopted a series of bail-out measures in a bid to stop the stock market from falling further. Some of these measures are unusual, such as asking PRC securities companies to purchase A shares with their proprietary funds and banning major shareholders and all shareholders with over 5% shareholding of a listed company from selling the company's shares on the secondary market within a period of 6 months from 8 July 2015. In addition, the Chinese Securities Regulatory Commission (**CSRC**), has initiated an investigation into illegal trading activities including "malicious shorting" and market manipulation which are regarded as among the main causes of the stock market turmoil. Subsequently other PRC regulators and relevant exchanges including the PRC Ministry of Public Security (**MPS**), the China Financial Futures Exchange (**CFFEX**), the Shanghai Stock Exchange (**SSE**) and the Shenzhen Stock Exchange (**SZSE**) are also carrying out investigations.

Foreign investors have expressed concern about the intervention of PRC regulators which appears inconsistent with the government's stated aim to "let the market play a decisive role."

What are the regulators doing?

On 26 June 2015, after the stock market decreased 1,000 points over ten trading days, the CSRC announced at its weekly press conference that it was cracking down on insider trading and market manipulation.

On 2 July 2015, the CSRC said that it would carry out a special examination of market manipulation and in particular, cross-market manipulation. It added that it was going to take serious measures against market manipulation and if criminal activities were discovered, it would transfer the cases to the public security department. The CSRC also asked the CFFEX to cooperate in the special examination. In response to abnormal trading of stock option futures, the CFFEX has taken several regulatory measures including restricting the opening of positions by some futures accounts.

On 9 July, the MPS announced that it would work with the CSRC to deal with criminal activities in securities and futures trading such as the "malicious shorting of stocks," market manipulation and the dissemination of false information on securities and futures trading.

Investigations against foreign investors

Since the beginning of the stock market crash, some in the Chinese market have blamed the situation on hostile foreign investors seeking to make profits from a falling A share market. According to press reports, some foreign investors, including foreign-invested onshore companies trading in PRC securities or futures, have become targets of the regulatory investigations.

Stock index futures trading by QFIIs and RQFIIs were among the first in the spotlight. On 1 July 2015, in response to accusations in the market that QFIIs and RQFIIs were shorting stock index futures, the CFFEX announced that all the stock index futures trades conducted by QFIIs and RQFIIs on the CFEEX were for hedging purposes only.

Reportedly, the CSRC is also paying attention to foreign investors' trading under the Shanghai – Hong Kong Stock Connect program and the shorting of A shares or the A share index (such as the SGX FTSE China A50 Index Futures) via offshore transactions.

Since 31 July 2014, the SSE and the SZSE have suspended trading (for three months) on 34 securities accounts which have been involved in frequent order routing and cancelling. According to news reports, one of the suspended securities accounts belongs to a trading subsidiary of an international hedge fund.

Key regulatory issues

As yet, there has been no official result of the investigations, so it remains unclear how the CSRC or the MPS will identify and determine illegal trading activities related to the stock market crash. One of the key issues is what activities will be viewed as "malicious shorting" – this seems to be the focus of the investigations. It is worth noting that "malicious shorting" is not a defined term under any PRC securities or futures regulation.

In addition, the SSE and the SZSE suspended trading of the 34 securities accounts mainly on the grounds of "abnormal trading." Unlike market manipulation or insider trading, for which the relevant PRC regulations have provided relatively specific fact patterns, "abnormal trading" operates under the trading rules of relevant exchanges as a catch-all provision to address trading which may have an unusual impact on market prices or trading volumes of A shares. In practice, the abnormal trading rules give the exchanges a high degree of discretion to determine what constitutes abnormal trading and to take action accordingly.

Outlook

Since the A-share market is yet to be "stabilised" and the investigations are still on-going, it remains to be seen whether and how the regulators will take further action. The final results of the investigations may provide some guidance on understanding what may constitute malicious shorting and other market manipulative activities under PRC laws. In the meantime, foreign investors should be aware of the unusual action taken by PRC regulators and expect more scrutiny from PRC regulators on their trading related to China A shares. Clifford Chance is keeping a close eye on the market and policy developments in China and is helping to guide clients through this new regulatory environment. We will provide further updates as the situation develops.

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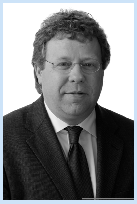

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