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Research Paper

Research on Improvement of Legal System and Policy of Regulating Chinese Institutional Investors

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ABSTRACT: *After the "extraordinary development of institutional investors" strategy issued by Chinese government in 2000, the institutional investors has developed rapidly and become a great part of financial market. However, there are still lots of lacks and defects in the regulating policy and legal system of regulating Chinese institutional investors. This paper aims to analyze the problems existing in the legal system and give some meaningful suggestion to improve the regulation of institutional investors in China.*
KEY WORDS: *Institutional investors, Regulating policy, Legal system*

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I. THE CONCEPT OF "INSTITUTIONAL INVESTOR"

Although the term institutional investor is widely used, there is no uniform standard definition over the world. Scholars in China and abroad have different definitions.Tong (2016) believes that institutional investors are financial institutions that invest in entrusted funds, borrowed funds and their own funds into securities portfolios to earn investment returns. While Jia (2017) directly took it as the relative concept of individual investors and interpreted it as investors other than individual investors.In theother countries, the new Palgrave dictionary of Money and Finance defines institutional investors as specialized financial institutions that manage long-term savings, including investment funds, life insurance funds, pension funds and unit trusts.However, the definition does not include venture capital funds, industrial funds and Banks of other civil law countries, so the definition is too narrow (Lvand Li, 2017). In the USA, Black Legal Dictionary refers to institutional investors as "big investors", such as mutual funds, insurance companies and institutions that invest money borrowed from individuals or other organizations.However, the definition of "big" is not clear due to the lack of detailed explanation. It is not sure that the"big" refers to its size, capital or social influence, and the extent to which it is large, and whether institutional investors include natural persons with large investment and smaller corporate institutions.

In China, it is generally believed that institutional investors are legal persons with professional abilities and qualifications engaged in securities investment in the financial market, including securities companies, insurance companies, Banks, pension funds, investment funds and other funds, QDII, QFII and RQFII. And this paper mainly studies institutional investors such as securities companies, QFII, Banks, investment funds and other participants in the a-share main board securities market.

II. THE SIGNIFICANCE OFREGULATING INSTITUTIONAL INVESTORS

Compared with individual investors, some characteristics of institutional investors have animportant and extensive impact on the A-share main board market. This makes to improve the regulating of institutional investors be meaningful for the development and stability of financial market.

At the macro level, from the perspective of participation of financial market, although the individual investors are still the biggest part with 86.8% shareholding ratio in the main board in 2019, which is totally different from the U.S., the institutional investors in China are keep growing and increasing its percentage of trading in financial market. According to the Securities Association of China (2013), from 2007 to 2012, the share of outstanding market value held by individual investors decreased from 60.4% to 42.8%, and the share of transaction value held by individual investors decreased relatively slowly, from 87.4% to 85.6%. The trend of increasing participations of institutional investors in China has been obvious. Their investment behaviors directly affect the development and stability of the whole A-share main board market. For example, the researchers in China found that China's QFII stocks have excellent performance and rational investment behaviors, mainly medium and large-cap stocks.(Tong and Wang, 2015). QFII shareholding enhances the liquidity of the stock and reduces the volatility of the stock price, thus contributing to the stability of the stock price.

At the micro level, the largest shareholders of A listed company are usually institutional investors. For example, according to Vanke's report on March 31, 2019, five of the top nine shareholders of Vanke are institutional investors such as An-Bang Life Insurance Co., LTD., Industrial and Commercial Bank of China, China Merchants Bank and Qianhai Life Insurance Co., LTD., who have effective control over the company. In the USA, institutional investors are also big players since in 2009, institutional investors collectively owned 73% of the issued equity of the 1,000 largest companies.Also, the positivity of many institutional investors to participate in corporate governance is becoming higher. Helwege et al. (2012) found out the evidence that institutional investors vote with activism and the increasing size of institutional investors will perhaps inhibit voting with their feet. In another word, the vote rights of institutional investors are large among many big companies and they seems to be less willing to give up that rights. Due to their information advantages and legal fiduciary responsibilities, they play a crucial role in corporate governance and decision-making, and ultimately affect corporate performance, thus affecting the main board market of A-shares.

Institutional investors in China are not as highly rational as widely expected due to their professional competence. According to the study of Lan, Hao and Lu (2019), institutional investors and individual investors in China are both noise traders with serious irrational behaviors, with decision-making errors such as confirmatory bias, sunk cost and vague aversion, and are prone to overconfidence. This goes against the rational person hypothesis, that is, it does not make the most efficient use of information to get the maximum benefit, and ultimately reduces the market efficiency. This could be explained that decisions of institutional investors come from natural human investors, which are ultimately affected by individual emotions, age and other irrational factors.

At the same time, institutional investors may have a more serious disposition effect due to their unique tendency to protect their social reputation. Therefore, institutional investors occupy a highly important position as participants in the main board market, but they do not necessarily have a matched high degree of decision-making rationality. If its behavior is not properly supervised and controlled, it is very likely to lead to the instability of the securities market.

Furthermore, institutional investors have a demonstrative effect on the investment behavior of individual investors. Since individual investors are more likely to be at the disadvantage of information asymmetry and most of them do not have the professional ability of institutional investors, they are more likely to produce herd effect, while institutional investors are more likely to become sheep due to their information advantages, asset advantages and professional level.

Also, according to the research of Liu and Zhu (2019), there is a significant positive correlation between heterogeneous beliefs of institutional investors and heterogeneous beliefs of individual investors. The greater the difference between institutional investors' expectation of the same asset, the more heterogeneous beliefs individual investors will have. Therefore, in view of the influence of institutional investors on individual investors, the regulation of institutional investors is not only limited to themselves, but also affects the imitation of individual investors, thus affecting the Main board of A-shares more broadly.

In addition, the interest can drive institutional investors to illegally participate in A-share investment and infringe the interests of small and medium-sized investors. For example, according to CSRC (2018), Guangzhou An-Zhou Investment Management Co., Ltd. manipulated the price of "energy saving wind power" by controlling 25 accounts opened in 22 trust products or funds, making a profit of about 50.574 million yuan and being fined about 100 million yuan. Compared with individual investors, institutional investors are usually more professional and have more information and they can take more risk. So, they usually have an advantage in the competition with individual investors and are more likely to encroach on their legitimate rights and interests. At the same time, small and medium-sized investors also have relatively weak awareness of law and rights protection, and the cost of rights protection is likely to be higher than the loss of interests, so that the illegal behaviors of institutional investors escape from the public supervision.

The impact of institutional investors are not always negative. They also have a distinctly positive effect on the financial market. Their professional skills, strong solvency, normative and procedural investment operation make institutional investors more rational in investing in the market and more conducive to efficient operation of the A-share main board, so as to realize its function of capital circulation and promote economic growth. Besides, institutional investors pay more attention to the long-term benefits of enterprises.Gillan& Starks(2007) believed that maximizing the return on investment would stimulate institutional investors to pay high attention to corporate governance and have high enthusiasm for improving the internal management of invested companies.

According to the "effective supervision hypothesis", if institutional investors play a strong supervisory role, they can urge the directors and senior supervisors to improve the operation and management level of listed companies, so as to produce governance effect, help to improve the internal control system of listed companies, and thus improve the effectiveness of internal control of invested enterprises. Therefore, by promoting the regulation of China's institutional investors, it is conducive to regulating institutional investors' investment behaviors in the A-share main board, amplifying their exemplary role and positive influence in the market, and promoting the sustainable and healthy development of financial market.

Overall, it is important and meaningful to regulate institutional investors well. China put forward the strategy of "extraordinary development of institutional investors" in 2000 and now they have grown fast. It is necessary to improve the regulation of institutional investors because of their large impact on the whole financial market.

The ultimate goal of improvement of legal system and policy of Chinese institutional investors on main board is to improve the efficiency of the main board market. The fairness and the legitimate rights and interests of individual investors are protected only when the regulations of financial market work well. A good regulatory system can help to maintain market in stability and ultimately improve market efficiency and promote economic development in the long run, which is also the ultimate goal of financial development. Besides, to improve regulation of institutional investors not only directly regulate the behaviors of institutional investors, but also these individual investors who are affected by institutional investors. In this way, regulations will reduce the illegal insider trading and front-running trading behavior, and provide a good environment and order to financial market. Also, the improvement of legal regulation can give full play to the deterrent and guiding role of law and prevent beforehand. This will reduce the cost of administrative punishment ofgovernment and realize the change institutional investors from passively accepting supervision to consciously abiding by the legal order, thus improving the supervision efficiency.

III. THE EXISTING LAWS AND POLICIES OF INSTITUTIONAL INVESTORS

3.1 Collection of laws and policies

The regulations on institutional investors in China are mainly *Securities Law of the People's Republic of China* and *Securities Investment Fund Law of the People's Republic of China*, and measures on investment institutions issued by the state council to formulate solutions and other laws and regulations. To better improve relative regulations, I collected laws and policies about the regulations of Chinese institutional investors as follows.

Publisher	Laws or Policies	Date	Abstract
China Securities Regulatory Commission (CSRC)	Measures for the Administration of Securities Investment Fund Management Companies(expired)	11-14-1997	It stipulates the conditions for the establishment of a securities investment fund, and its raising and trading, and regulates the qualifications and duties of the fund trustee and manager as well as the rights and obligations of the fund holders, and the investment operation, supervision and administration of the fund; it also establish the principle of diversification.
National People's Congress Standing Committee	Securities Law of the People's Republic of China	12-29-1998	It restricts the participation of employees of institutional investors in stock trading; During the underwriting period and within six months after the expiration of the underwriting period, it is prohibited to buy or sell such stocks; It bans insider trading, stock market manipulation and account interfuse; It requires securities company to not provide financing or guarantee for its shareholders or their associates; A securities company shall set aside a trading risk reserve every year to cover the losses of securities trading; Securities companies should establish and improve the internal control system; The securities company must deal with each business separately; If employees of a securities company execute the instructions of their subordinate securities company or violate the trading rules by taking advantage of their position in securities trading activities, the subordinate securities company shall bear all the responsibilities.
CSRC	Measures for The Pilot Project of Open-ended Securities Investment Funds	10-08-2000	It promotes the development of securities investment funds and standardize open-ended securities investment funds.
The State Council	Interim Measures for The Investment Management of The National Social Security Fund	12-13-2001	The investment and operation of the national social security fund shall be standardized to ensure its safety: the proportion of securities investment fund and stock investment shall not be higher than 40%.
National People's Congress Standing	Securities Investment Fund Law of the People's	10-28-2003	It relaxes the access standards for fund managers and fund trustees; The conditions of transaction of fund

Committee	Republic of China		shares, fund raising, subscription, redemption, fund operation and information disclosure, the modification, termination and liquidation of the fund contract, the rights and exercise of the fund shareholders have been made detailed rules.
China Insurance Regulatory Commission &CSRC	Interim Measures for The Administration of Stock Investment by Insurance Institutional Investors	2004	Insurance companies are allowed to engage in investment activities in the form of entrusted insurance asset management companies.
China Insurance Regulatory Commission (CIRC)	Insurance Fund Investment Stock Management Measures	2005	It severely limit the proportion of assets an insurance company can invest in stocks and the proportion invested in a company's outstanding shares.
CSRC	Provisions on Banning the Entry into the Securities Market	06-07-2006	It takes measures to prohibit the entry into the securities market of persons responsible for violation of laws, administrative regulations or relevant provisions of the CSRC;It is based on facts and follows the principles of openness, fairness and justice.
CSRC &People's Bank of China& State Administration of Foreign Exchange	Measures for The Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors	08-24-2006	It promotes domestic supervision and development of QFII institutions;QFII should entrust domestic commercial Banks as custodians of assets;It determine application conditions and procedures, as well as prudential supervision principles of itself.
Ministry of Human Resources and Social Security of the People's Republic of China,China Banking Regulatory Commission,CSRC,CIRC	Measures for the Management of Enterprise Annuity Funds	02-12-2011	It safeguards the legitimate rights and interests of all parties to the enterprise annuity and standardize the management of the enterprise annuity fund and establishes principles of caution and risk diversification, and limits them to onshore investments.
CIRC	Interim Measures for the Supervision and Administration of Privately Offered Investment Funds	08-21-2014	It standardizes the activities of private investment funds to protect the legitimate rights and interests of investors and relevant parties.
State Council	Measures for the Administration of Investment in Basic Pension Insurance Funds	08-17-2015	China's basic pension insurance fund is allowed to invest in the stock market, and the proportion of investment in stocks, stock funds, mixed funds and stock pension products is specified. The total amount shall not be higher than 30% of the net asset value of the pension fund.

3.2 Limits of existing legal system and polices

To sum up the development history of laws and policies of regulatory investors in China, it started relatively late, only more than 20 years ago, and inevitably has many problems and loopholes. Due to the rapid development of institutional investors in China, the current regulatory laws and policies have considerable limitations.

First of all, there are some problems of the expression of laws. There are some terms that has no clear definition. For example, there is no explanation and definition of term “effective management obligation”. In addition, many legal terms are too broad to be practical. As a result, relevant laws have been established, but it is difficult to have a real supervisory role. For example, taking the Securities Law as an example, in judicial practice, about 3/4 of the securities cases do not refer to the Securities Law, while 1/4 of the securities cases only refer to 7 of them, accounting for only 3% of the total provisions of the securities Law (Zheng et al., 2015).

Also, China still lacks some basic laws such as Financial Holding Company Law and other laws to protect the individual’s interests. In China, while the process of completing legislation and supervision of financial holding companies are kind of slow, financial holding companies in China are developing rapidly. The lack of laws and supervision is not conducive to the sustainable and stable development of financial holding companies. Although banking, securities, insurance and other subsidiaries are subject to comprehensive supervision, there is a lack of overall supervision at the level of financial holding companies.

Besides, within the system of regulation, the government is authorized too much rights. It issued a lot of measures or interim measures to regulate the institutional investment, without relative laws. Or, even there are relative laws, however, those laws are generally broad and simple, with many provisions in principle and weak operability. As a result, the law enforcement process can only be based on a large number of administrative rules and normative documents and this further enlarges the discretion of administrative supervision departments. As a result, administrative power affects legislation and judicature too much, and self-discipline management is relatively weak. In the field of finance, the financial supervisory departments under the civil law system have strong action ability and can quickly deal with financial risks. However, the problem lies in excessive reliance on regulatory resources, arbitrary legislation and enforcement, which cause a high cost of maintaining the financial legal framework.

Another drawback of the regulatory system is that it is too slow to update. Many of above laws have not been amended since publication, or have been amended only once. In contrast, the relevant laws of other countries and regions have been frequently improved. For example, Hong Kong's Securities and Futures Ordinance has been amended 20 times in the past 10 years since it came into force in 2003.The financial sector is growing and changing fast, as well as the institutional investors, especially in mainland China. However, the updating speed of regulatory system of China is too slow to adapt to the actual situation of institutional investors.

IV. SUGGESTIONS

4.1 Improve relevant laws and its presentation

Many problems have been summed up in the above legal and regulatory policies. Therefore, to improve China's regulatory system for institutional investors, we need to solve the above problems at first. These laws need to be expressed in a clearer way and be more executable. More detailed legal provisions should be made, and local regulations or legal interpretations should be formulated on the basis of framed laws. In addition, due to the lack of many laws in the legal system in China, many relevant regulations are dependent on administrative regulations, leading to the ineffective supervision of institutional investors. Therefore, China also needs to continue to improve the laws and issue vacant laws regulating institutional investors as soon as possible. To issue the law to protect the interests of individual investors could be useful since it restrains institutional investors from another perspective, which reduce the risk of harming individual investors in financial transactions.

The laws of China belongs to the continental law system that pays attention to legal stability, which is characterized by more emphasis on state power, administrative organs enjoy considerable legislative and executive power. It has a relatively clear legal system and a complete legislative process leading to a long cycle of legislation and revision, while judges' discretion is strictly limited by enacted laws. When dealing with the rapid development of institutional investors, China often solve the regulating problem by the government issuing temporary measures for supervision. Although this method is fast and effective, however, if the law cannot be updated, the legal effect will be disintegrated and undermined, which is ultimately not conducive to the legal governance of institutional investors. Therefore, I suggest that the legal provisions should be updated timely according to the actual situation of the development of institutional investors, and corresponding laws should be issued in line with the development of finance and diversification of investment. The regulation of institutional investors such as QFII for financial development is an example.

4.2Strengthen the supervision of key personnel of institutional investors

According to many legal cases, decision-makers or other key personnel of institutional investors in China illegally participate in securities trading and illegally obtain personal interests one after another. For example, according to CSRC (2018), from September 8, 2006 to March 26, 2018, Yi-Yu Zhu, an employee of Haitong Securities, used his wife Mou-Yuan Xu’s securities account to trade a total of 34 stocks. The account earned more than 5.4 million Chinese yuan after tax (excluding relevant taxes), and he was banned from the market for 3 years. Another example is that the deputy secretary for discipline inspection and the director of inspection office of Dong-Wu securities Wu-Yi Huang, made a total illegal profit of 290,000 yuan through an English account by October 14, 2016, and was finally sentenced to confiscation of illegal income and a fine of 887,000 Chinese yuan (CSRC, 2018).

In China, the Securities Law do have regulations on personnel in institutional investors. But the rules tend to be simple, limited to punishing employees for wrongdoing, and have proved inadequate. At present, there is not enough regulation of the practices of senior managers of institutional investors. The decisions of institutional investors ultimately come from top management. To regulate these managers’ behaviors from the origin can better regulate the market activities of institutional investors and protect the rights and interests of other investors, and stabilize the financial market.

4.3 Loose the regulation of institutional investors in corporate governance

Institutional investors are important participants in corporate governance, and their importance derives from their influence on companies in many aspects. Davis (2002) offers a literature survey on micro evidence suggesting a positive effect on equity returns of institutional investors. This could be attributed to their professional investment. On the one hand, towards the goal of achieving higher investment returns, institutional investors will make more professional analysis when choosing investment objects. On the other hand, institutional investors are also more professional than individual investors in corporate decisions. This will drive the company in a better direction. Institutional investors also provide some positive impact on limiting the managerial accruals discretion of firms which can help other investors to get a more precise financial report.

Besides, Grier and Zychowicz (1994) observed there is a significantly negative relationship between the use of corporate debt and the percentage of shares owned by institutional investors.

Overall, many studies have proved that increasing the shareholding ratio of institutional investors and increasing their participation right in corporate governance can bring positive effects to corporate governance. Therefore, in terms of giving play to the initiative of corporate governance, excessive legal restrictions do not mean that it is an improvement. In my opinion, China should give full play to the ability and freedom of institutional investors in corporate governance. Because the interests of an institutional investor are aligned with those of the company in which it invests, the situation in which it damages the interests of the company invested is extreme and rare. Legal provisions should focus on regulating the proper procedures and data of institutional investors participating in corporate governance, and protecting the legitimate rights and interests of other individual investors in corporate governance.

Besides, institutional investors have the willing to pay a premium for shares in firms with good corporate governance, especially when the companies are in countries with weak legal protection of investors (Chenet al., 2009). To encourage the influence of institutional investors in corporate governance could make a virtuous cycle. And companies will pay more attention to achieve good governance to improve its value of shares.

4.4 Play the role ofpublic scrutiny

It should be acknowledged that the mode of strict supervision from government is beneficial. But with the development of the capital market and institutional investors. The administrative regulatory resources needed take more and more costs. The scarcity of government regulatory resources will not only lead to the increase of regulatory costs, affect other governmental regulatory functions, but also reduce the quality of regulation. Besides, regulators are not in neutral places sometimes. The regulators of government are still individuals and the interest conflict can occur. For example, in the case of the conflict between Bao-Neng and Vanke in 2015, the regulatory authorities showed obvious passivity when facing the news media reports that a Vanke independent director was suspected of violating rules (Shi, 2019).Within state-owned enterprises, the regulators are in the same level in the hierarchy as securities managers of state-owned listed companies, and the personnel can also flow among each other. The independence of China's official regulators should therefore be called into question, which could provide a breeding ground for corruption.

According to SAC (2016), from 2001 to 2015, after 214 listed companies were fined for making false statements, only 65 were sued by investors, accounting for only 30%. It reflects the activism of investors. This indicates the low awareness of self-protection by laws of investors. One of the reasons could be the form of regulation mostly by government has led investors to their own inertia.

Based on the suggestion of Shi (2019), to play the role of public scrutiny is to change the monopolistic dominant form of the administrative supervision department and to stimulate the society scrutiny including social organizations, securities intermediaries, lawyers, accountants, individuals, etc. For example, the American group litigation has transferred some enforcement powers of the SEC to lawyers, courts and the reputation mechanism of the listed company.

In order to use the company's self-governance ability, the focus of investor protection can be shifted to the independent board of directors to give full play to its supervisory role over the board of directors and prevent it from serving the major shareholders unilaterally. Meanwhile, the supervisory role of institutional investors should also be played to protect the interests of individual investors.

Professionalism is a power. Strengthening thetraining of financial talents and improving the professionalism of institutional investors can actively enhance the legitimacy of institutional investors' behavior at the level of individuals and institutions, rather than passively remediation. In addition, China has been preparing to incorporate investor education into the pilot work of the national education system, which can improve the investment ability and self-protection awareness of individual investors and play a role of public supervision over institutional investors.

V. CONCLUSION

In general, the role and influence of institutional investors in China are increasing, so their supervision should be updated and diversified. An integrated and clear legal system is the foundation of regulation, and the authority of official bodies such as the CSRC can play a unique role in China. But the independence of regulators should be better guaranteed, or we should strengthen social supervision, improve the quality of investors, and give play to the ability of companies to supervise themselves. Moreover, rather than separating supervision of institutions from supervision of individuals, we should see that supervision of individuals among institutional investors also has an important impact.

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