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Towards a Collective Regulatory System of Private Equity Funds in China: Legislative Progress and Political Challenges

Chi Zhang*

Abstract

Private equity investment funds have been playing an increasingly significant role in the Chinese economy. Owing to the fragmented financial regulatory regime of the country, however, both the official supervision and self-regulation of private equity funds in China are still problematic, which has increased the potential risk in the market. This article investigates the political logic of the ongoing legislative and regulatory reform of private equity funds in China. It also explores a proposal for the legal reform of the Chinese private equity industry with reference to the experience of the United Kingdom and the European Union. It is suggested that a unified financial regulatory system as a fundamental institutional arrangement is a pre-requisite for establishing an effective and efficient regulatory regime for private equity funds in China. This can only be achieved when the political conflict between different regulators in the Chinese bureaucratic system is removed.

* Chi Zhang, Lecturer of Law, School of Law and Humanities, China University of Mining and Technology (Beijing); Ph.D. in Law, 2017, University of Glasgow; LL.M., 2013, Tsinghua University; LL.B., 2011, Tsinghua University. E-mail: thuzhangchi@163.com. The author acknowledges with gratitude Professor Iain G. MacNeil, Dr John MacLeod and Dr Konstantinos Sergakis from the University of Glasgow, and [Associate Professor Carsten Gerner-Beuerle from the London School of Economics and Political Science University College London](#) for their insightful comments on this research.

1. Introduction

Ever since the global financial crisis in 2008, it has been widely accepted that external protection of investors in private equity¹ funds is indispensable and it has also been proven that excessive regulatory exemption of private investment funds, including PE funds, may lead to serious market risk.² Chinese regulators have recently emphasized the need for enhancing both the official and industry regulation of the PE industry. The supreme authority of the country was made particularly aware of and appreciates the more industry-oriented proposal for financial reform proposed by the Fifth National Conference for Financial Reform held by the State Council of China from 14 to 15 July 2017.³ This implies that direct investment in Chinese industry companies will be encouraged more than financial trading in the secondary markets. Against this social background, the development of the legal and regulatory systems of PE funds in China is being promoted significantly.

In China, the regulatory system of the PE industry currently comprises two forms: (i) official regulation and (ii) self-regulation. The securities investment fund industry of China underwent comprehensive regulatory reform during 2012–2014, resulting in a new regulatory model for PE funds. However, owing to the political and departmental interests of different regulators, the effectiveness of such regulatory approach is problematic. On the one hand, a functional regulatory system has not yet been established in China and different regulatory bodies operate official regulation over private investment funds. Thus, the compliance cost is very high. On the other hand, although a self-regulatory system of PE has been established in China, however, due to the inadequate reputational mechanism in the market, further reform of the self-regulation of PE funds is also necessary.

¹ Hereinafter referred to as ‘PE’.

² US Department of the Treasury, ‘Agreement Among PWG and US Agency Principals on Principles and Guidelines regarding Privet Pool of Capital’ (Feb 2007), < https://www.treasury.gov/resource-center/fmkts/Documents/hp272_principles.pdf > accessed 19 June 2017; Financial Services Authority, *Private Equity: A Discussion of Risk and Regulatory Engagement* (Discussion Paper 06/6, 2006).

³ Zhifeng Xu, Qiuyu Wu and Jie Ouyang, *A Comprehensive Report of the Fifth National Conference of Financial Reform* (16 July 2017), < <http://finance.people.com.cn/n1/2017/0716/c1004-29407471.html> > accessed 19 July 2017.

This article reflects the research conducted into the political pattern in the development path of the official regulatory and self-regulatory systems of the Chinese PE industry, which revealed the detail of the existing problems in this field and their political roots. This article is organized as follows:

Firstly, the risk of the Chinese PE industry is overviewed in a general sense. The section that follows sheds light on the recent legal and regulatory reforms of the Chinese investment fund industry and the substantive influence on the Chinese PE industry is discussed. The landscape of the self-regulatory system of PE funds in China is sketched and the drawbacks are analysed. In order to provide a reasonable reform proposal for the Chinese PE industry, the regulatory regimes of PE in the United Kingdom (UK) and European Union (EU) respectively are examined. A possible reform directive for Chinese PE funds is proposed and its limitation in the light of the political issues in the country is reviewed. In the concluding section, the suggestion is made that although the ongoing reform of a collective and unified regulatory regime of PE in China is greatly encouraged, its substantial progress and effectiveness, however, still depend on the political compromise and co-operation between the different regulatory bodies in the Chinese government.

2. The Risk in the Chinese Private Equity Investment

Private equity as one of the most mysterious sectors of the global financial market is continually making huge profits in mysterious ways. However, the fact that PE investment is highly risky is often ignored. Briefly, regulators have identified the following risks in PE funds: first, the excessive leverage used by PE funds may be a severe burden on PE-owned companies, which may give rise to a series of public problems, including corporate distress

and massive layoff.⁴ Second, owing to the long-term lockup period of PE funds, lenders will be motivated to transfer their exposure to other market participants by means of, for example, credit derivatives, which means that the unregulated financing activities of PE funds may also significantly spread the risk to the public. In this regard, the lesson learnt from the global financial crisis in 2008 has shown that the over-use of credit derivatives can make it hard to identify and judge the ownership of the risk of underlying assets.⁵ As a consequence, default events of some individual transactions may result in the fall of the market. Third, the exemption of the disclosure requirement of PE funds may also harm PE investors: the asymmetry of information between the fund managers and investors can be serious. Hence, it is quite difficult for PE investors to monitor fund managers' investment decisions effectively.⁶

In terms of the Chinese markets, the PE investment is more risky and immature than the PE markets in developed countries. The main legal issues in relation to the Chinese PE market can be summarized as follows: first of all, the limited partnership (LP) structure is the primary but not the only organizational structure of PE funds in China. In fact, there are ten percent around of the PE funds in China are established as business trusts.⁷ From a functional perspective, however, both of the trust and LP-structured PE funds play the same function in the Chinese economy, the lack of collective regulatory system has given rise to the waste of social resources. The PE funds organized in the form of investment trust presently are exclusively regulated by the China Banking and Insurance Regulatory Commission⁸, the limited partnership funds, however, fall in the regulatory scope of the China Securities Regulatory Commission⁹. Therefore, the regulatory systems of the two regulatory bodies, for instance, the market entry policies, transparency rules and internal governance rules are quite different from each other and the severe regulatory arbitrage remarkably increase transaction cost of PE

⁴ Financial Services Authority, *Private Equity: A Discussion of Risk and Regulatory Engagement* (Discussion Paper 06/6, 2006) 89–90.

⁵ Ibid., at 90.

⁶ Iain G. MacNeil, *Private Equity: The UK Regulatory Response* 3 Capital Markets Law Journal 18, 22 (2008).

⁷ Zhi Zheng, Wentao Wang, *Decoding the Trusts*, 294 (Citic Press 2014).

⁸ Hereinafter referred to as ‘CBIRC’.

⁹ Hereinafter referred to as ‘CSRC’.

practitioners¹⁰. Secondly, the PE limited partnership funds were not regulated by a specialized regulator, therefore, the regulatory strategies are not really reasonable nor efficient.

In a nutshell, the professionalization and unification of the PE regulation in China are both necessary and important. The current wave of regulatory reform of the Chinese PE industry that started from 2012 mainly focuses on establishing a collective regulatory system of PE funds, however, the complex political conflicts of the financial regulators is the focal point in the reform.

3. Contending for the Regulatory Power of Private Equity in China: The National Development and Reform Committee versus China Securities Regulatory Committee

Basically, the official regulatory system of PE funds in China is structured on two levels: (i) the regulation of venture capital funds led by the National Development and Reform Committee¹¹ and (ii) the general regulatory system of private investment funds controlled by the CSRC. Nonetheless, owing to the political conflict between the NDRC and CSRC in financial regulation, the Chinese regulatory regime of the private equity industry actually fails to protect the economic interests of fund investors effectively. Fortunately, reform of the regulation over PE funds was launched in 2012 and further reform is expected.

Before discussing the implementation of the regulatory power, the legal status of the NDRC within China's economic and political regimes should be considered briefly. The predecessor of the NDRC was the National Planning Commission,¹² which was established in 1952. The main functions of the NPC were (i) to create macro-economic policy for different industries and (ii) to supervise the implementation of Chinese government's national economic plans at all the levels. From a legal perspective, before the institutional reform of the Chinese economy was launched in the late 1970s, the legal status of the NPC was such that it was, in effect, the

¹⁰ The details of the CBIRC's regulatory framework of private equity investment trusts are available in: Chi Zhang, *Venture Capital Investment Trusts in China: Legal Framework, Challenges, and Reform* 23 (7) Trusts & Trustees 806 (2017).

¹¹ Hereinafter referred to as the 'NDRC'

¹² Hereinafter referred to as the 'NPC'.

most powerful department of the State Council of China. Almost any proposed economic or industrial activities (e.g., industrial planning, foreign investment, price control, financial activities and infrastructure) had to be approved by the NPC; in other words, historically, the nature of the NPC was that of an extremely general social administrative body but not a professional regulator of specific economic activities. With the liberalization of the economy, however, the over-broad administrative power of the NDRC has been a barrier to Chinese economic reform. To reduce administrative intervention in the market economy, two waves of reform of the NPC led by the State Council were launched in 1998 and 2003 respectively.¹³ At present a series of the most substantive approval powers associated with financial regulation are still in the hands of the NDRC. Accordingly, the NDRC's regulation over the PE industry is also not specialized and the protection of investors is also insufficient.

Since the promulgation of the Interim Provisions for the Administration of Start-up Investment Enterprises (2005),¹⁴ the domestic PE funds in China have been regulated by the NDRC¹⁵ which obtains the power to examine and supervise the operation of PE funds at any time. In the situation where a PE firm does not comply with the law, the NDRC has the power to revoke its licence.¹⁶ However, the Interim Provision (2005) does not clarify any legal liability or substantive punishment imposed on fund managers who display inappropriate behaviour. In such a loose policy circumstance, many unqualified fund management firms were motivated to raise funds from unqualified investors and invested in risky projects.¹⁷

¹³ During the 2000s, the State Council of China cancelled or simplified 2,614 administrative approvals and the further simplification of the administrative approval power of the NDRC was proposed. For more detail, see Youliang Yan, 'A Leviathan? The NDRC is Being Powerful Again' Sina Finance News (Beijing, 30 May 2013). <<http://finance.sina.com.cn/china/20130530/082015636012.shtml>> accessed 22 April 2017.

¹⁴ Hereinafter referred to as the 'Interim Provisions (2005)'.

¹⁵ According to the Interim Provisions (2005), all PE and VC funds shall be filed with the NDRC or other related administrative departments of the provinces (s 4) and registered with the State Administration for Industry and Commerce (SAIC) or local departments of the SAIC (s 8).

¹⁶ Section 27, the Interim Provisions (2005).

¹⁷ For instance, the so-called First Judicial Case of China's PE Funds was adjudicated by the First Intermediate People's Court of Shanghai in 2010, in which a twenty-eight-year-old fund manager, Hao Huang, was accused of fraud in the financing industry and finally sentenced to fifteen years in prison. In this case, Hao Huang the general partner of the PE funds, raised around RMB 0.178 billion from as many as 720 natural persons in China. This kind of unregulated PE scandal has been more common since China's Alternative Investment Market was launched in October of 2010. Yonggang Liu, 'The First Private Equity Case in China: A Chinese Ponzi Scheme?' *China Economy Weekly* (Beijing, 29 June 2010) <<http://finance.people.com.cn/GB/12001069.html>> accessed 23 April 2017.

However, the CSRC has been actively competing with the NDRC in regulating PE funds since 2012. The revision of the Securities Investment Fund Law of China was completed by the end of December 2012. One of the key debates in the process of amending this legislation was whether PE funds should be officially regulated by the Securities Investment Fund Law of China (2012 Revision).¹⁸

According to the first version of the Consultation Draft issued by the Standing Committee of the National People's Congress,¹⁹ the new law tries to regulate PE funds formed as limited liability companies or limited partnerships.²⁰ It is evident that if this Consultation Draft can be successfully enacted into a statute, the regulator of PE funds will be changed, which means that the CSRC and courts will be able substantially to share the regulatory power over PE funds. More importantly, because the legal status of statutes issued by the National People's Congress enjoys top priority in the Chinese legislative system, both the legal force of the Provisions (2005) and the NDRC's regulatory authority of PE may be ended in the short term.²¹ As a result, the NDRC was dissatisfied with this Consultation Draft. In the process of the second and final rounds of discussion on revising the SIFL, as a consequence, the NDRC and the twenty-five professional associations in the PE industry across the country jointly signed a statement addressed to the SCNPC, arguing that the high-level regulation over PE funds would cripple the development of the Chinese PE industry.²² As a result of the departmental

¹⁸ Hereinafter referred to as 'SIFL'.

¹⁹ Hereinafter referred to as the 'SCNPC'.

²⁰ In this early version of the Consultation Draft (July 2012), private investment funds (excluding investment trusts which have been regulated by the CBIIRC since 2007) was proposed to be regulated by the CSRC, according to Arts 106 and 107 of the Consultation Draft, the investment funds whose fund managers shall bear unlimited liability will be regulated by the law and the content of the term 'securities' includes all the stocks, bonds and any other types of financial derivatives that can legally be exchanged or circulated in China. This means that the equity of private companies that can be transacted privately is also expected to be regulated by the revised SIFL; in other words, not only public investment funds, but also privately raised investment funds, including hedge funds, PE and VC funds, will also be regulated by the new SIFL. The official version of this interim legislative document is available at:

http://www.npc.gov.cn/npc/xinwen/lfgz/flca/2012-07/06/content_1729072.htm.

²¹ Clifford Chance LLP, 'The Amended Securities Investment Funds Law': Significant Changes but More Expected' (25 January 2013)

<http://www.cliffordchance.com/briefings/2013/01/the_amended_securitiesinvestmentfundslaw.html> accessed 28 April 2017; Dongying Wang, 'The Regulatory Power of PE/VC Funds: NDRC PK CSRC', *South Weekly* (2013) <<http://www.nbweekly.com/news/business/201306/33414.aspx>> accessed 28 April 2017.

²² *Supra* note, Dongying Wang; Dong Liu, 'The New Law of Securities Investment Funds: Private Equity and Venture Capital Funds Are Still Free from Regulation' *China Business News* (Beijing, 25 December 2012) <<http://finance.people.com.cn/fund/n/2012/1225/c201329-20003436.html>> accessed 17 April 2017; Sha Xiao, 'The Rent-seeking Behind the Legislative Activities Regarding Private Equity Funds: The Intense Competition

competition in the jurisdiction in the final revision of SIFL (2012 Revision), PE funds were eventually excluded from the regulatory ambit of SIFL (2012 Revision).²³

In the above circumstances, driven by the competition between the NDRC and CSRC, further regulatory reform of China's PE funds continued. In June 2013, the State Commission Office for the Public Sector Reform of China²⁴ clarified the division of powers in the PE regulatory affairs between the NDRC and CSRC as follows: (i) the NDRC should be in charge of making macro-industry policies for the development of PE funds, and coordinate the relationship between the government and PE market; and (ii) the CSRC should be responsible for the regulation of PE firms and the protection of PE investors.²⁵ Based on this administrative order, the most important regulatory reform of PE funds went further in 2014. On the one hand, the NDRC has stated that the annual review of PE funds with the NDRC was no longer required.²⁶ On the other hand, more importantly, the Interim Measures for the Supervision and Administration of Privately Raised Investment Funds (2014),²⁷ which is the first detailed administrative regulation of PE funds issued by the CSRC, came into force in August of the same year.

According to the Interim Measures (2014), the CSRC is the general regulator of all kinds of private investment funds in China with the exception of investment trust funds, which are regulated by the [China Banking Regulatory CommissionCBIRC](#).²⁸ However, because the

Between Administrative Departments' *The Rule of Law Weekends* (Beijing, 22 August 2012) <<http://finance.sina.com.cn/money/smjj/20120822/153112922035.shtml>> accessed 17 April 2017.

²³ The material compromising the final version of the law is reflected in Art. 95 of the SIFL (2012 Revision): the term *securities* therein refers to any publicly issued stocks, bonds and any other types of financial derivatives that can legally be exchanged or circulated in China. It is evident that the adjustment of the definitive scope of 'securities' through the legislative procedure of the law makes PE funds free from the CSRC's high level of regulation <http://www.pkulaw.cn/fulltext_form.aspx?Gid=191978> accessed 10 May 2017.

²⁴ Hereinafter referred to as 'SCOPSR'.

²⁵ The Notice of the Division of Regulatory Functions Regarding Private Equity Funds issued by SCOPSR, June 2013 <http://www.scopsr.gov.cn/bbyw/qwfb/201306/t20130627_227855.html> accessed 10 June 2017.

²⁶ The Notice of the Issues Regarding Further Development of Venture Capital Investment Enterprises issued by the General Office of NDRC (May 2014) http://www.ndrc.gov.cn/zcfbtz/201405/t20140514_611509.html> accessed 10 June 2017.

²⁷ Hereinafter referred to as the 'Interim Measures (2014)'. CSRC, Interim Measures for the Supervision and Administration of Privately Raised Investment Funds (2014)

<<http://wwwamac.org.cn/cms/article/preview?ID=386993>> accessed 10 June 2017.

²⁸ According to s 2 of the Interim Measures (2014), the assets of a 'private investment fund' includes, but is not limited to, stocks, equities, bonds, futures, options and fund units, in consideration of the separated financial

administrative hierarchy of the NDRC and CSRC is at the same level and the Provisions (2005) are still legally valid, currently any PE funds registered in China have to comply with the requirements issued by the two regulators, namely (i) the CSRC and (ii) NDRC. Obviously, such a dual-level regulatory system has reduced the efficiency and unnecessarily increased PE practitioners' compliance costs. Further regulatory reform of PE funds is expected to simplify the compliance requirement of PE funds reasonably by enhancing the CSRC's regulatory power in the PE market and, finally, remove the unprofessional regulatory power of the NDRC.

4. Industry Self-regulation of Private Equity Funds in China: Unification in Process

The above analysis indicates that due to the lack of a coherent and unified regulatory system of PE funds in China, the enforceability of the law and the effectiveness of the protection of investors in PE funds are unsatisfactory. Although a collective regulatory system of the investment fund industry is being built up, in order to enhance investor protection and to promote market practice of PE in China, the self-regulatory system of the PE industry is also important.

Generally speaking, the self-regulatory system of PE in China is organized on both the national and provincial levels. One the one hand, pursuant to the Interim Measures (2014), the Asset Management Association of China,²⁹ founded and led by the CSRC in June 2012, is the unified self-regulatory body of private investment funds with a nationwide scope.³⁰ As a self-regulatory body in the financial market, the primary function of the AMAC is improving information transparency and normalising the managerial conduct of the Chinese asset management industry. As a subset of private investment funds, PE funds are also required to register with the AMAC, which means that any violation of laws or regulations by the fund manager (mostly general partners) or individual practitioners may be punished by the AMAC. At present, the AMAC has developed a system of information sharing on its official website

regulatory system, investment trusts that are exclusively regulated by the CBIRC are excluded from the regulatory scope of the Interim Measures (2014).

²⁹ Hereinafter referred to as 'AMAC'.

³⁰ It is provided in Chapter 6 of the Interim Measures (2014) that 'AMAC is obliged to make self-regulatory rules and examine the performance of its member institutions and related practitioners (s 29); in the circumstance where any member institutions or related practitioners violate the laws, administrative regulations or self-regulatory rules, AMAC is entitled to take actions and publish the violations to the public via its website (s 29); AMAC shall establish a complaint-handling mechanism to accept investor complaints and mediate disputes (s 30).' |

where the public can directly access all information on violations, punishment, and blacklisting of members and individuals who have failed to comply with the laws, regulations or self-regulatory rules.³¹

On the other hand, the industry associations of PE supervised and led by the NDRC also play a role in self-regulating Chinese PE funds. By the end of March 2017, there were two main national-level self-regulators³² and twenty-two local-level self-regulators of the PE industry in China.³³ Most of these industry associations serve as information-sharing platforms for investors and financial regulators. In terms of the self-regulation, it is obvious that a single and separated reputational mechanism of self-regulation is insufficient for protecting PE investors. For example, most articles of association of the industry regulatory bodies only provide that in the circumstances where a member violates the law or the articles of association, the association may permanently revoke the membership of the non-compliant member.³⁴ In most cases, the PE associations are reluctant to expose any illegal, inappropriate or immoral behaviour of their members; in other words, the reputational deterrence of the members of PE associations is still weak.

Although the two nation-wide self-regulatory bodies of the Chinese PE and VC industries were founded in 2001 and 2002 respectively, the standardization of industry-wide self-regulation is imperfect; for instance, the China Association of Private Equity³⁵ released the Principle

³¹ Up to March 2017, AAMAC has blacklisted four fund management firms and five individuals who failed to comply with the laws, regulations and self-regulatory rules <<http://www.amac.org.cn/xxgs/hmd/>> accessed 15 June 2017.

³² China Venture Capital and Private Equity Association (CVCA) and China Association of Private Equity (CAPE).

³³ The following provinces have established their local self-regulatory associations of the PE and VC industry: Hunan Province, Hubei Province, Henan Province, Guangdong Province, Zhejiang Province, Shanxi Province, Jiangsu Province, Anhui Province, Jilin Province, Sichuan Province, Yunnan Province, Liaoning Province, Inner Mongolia Province and Fujian Province. The following big cities have also established local associations for PE or VC: Beijing, Shanghai, Shenzhen, Tianjin, Chongqing, Suzhou and Haerbin. Moreover, Beijing established ZhongGuanCun Private Equity and Venture Capital Association (ZPEVCA) in 2013. Shanghai also established a special professional association, namely the Shanghai Private Equity Association (SHPEA) in 2004, the goal of which is to enhance collaboration with international PE firms.

³⁴ For instance, s 13 of the Articles of Association of Suzhou Association of Private Equity <<http://www.szape.org/CompanyConstitution.aspx>> accessed 17 June 2017; s 12 of the Articles of Association of Beijing Association of Private Equity <<http://www.bpea.net.cn/article/ljxh/xhzc/>> accessed 17 June 2017.

³⁵ Hereinafter referred to as ‘CAPE’.

Guidelines for China's PE and VC industry³⁶ in November 2011, which is regarded as an official standard of the Chinese PE and VC industry. However, this guideline only provides a series of very general principles regarding the self-regulatory issues, without detailed and practical rules. It is evident that an effective reputational mechanism of the market may hardly be established in this way.

5. International Experience: The Collective Regulation of Private Equity in the United Kingdom and European Union

5.1 *The Regulatory Regime of Private Equity Funds in the United Kingdom: A Market-Based Model*

In the existing financial regulatory framework of the UK, PE and VC funds as unauthorized investment funds are unregulated by the Financial Conduct Authority.³⁷ In consideration of its risky nature, especially the excessive leverage used by PE funds, however, the FCA is also inclined to emphasise the regulation of the conduct of PE firms in the UK market.³⁸ However, most of such requirements have been satisfied by the existing corporate law and takeover rules;³⁹ that is, the official regulatory regime of the PE industry mostly focuses on the application of the existing laws regarding business organizations,⁴⁰ as in most cases private equity funds are involved in corporate governance issues by exercising their voting right as shareholders of investee companies, but less directly influence public markets.

By contrast, the industry association of PE and VC in the UK has moved much more quickly in this area. The British Private Equity and Venture Capital Association,⁴¹ which has been the

³⁶ China Association of Private Equity (CAPE), 'The Principle Guidelines for China's Private Equity and Venture Capital Industry' (2011) <<http://files.cbex.com.cn/bpea/201111/2011111133220846.pdf>> accessed 18 June 2017.

³⁷ Hereinafter referred to as 'FCA'.

³⁸ For example, before Brexit is completed, the authorization and on-going information transparency of PE firms in the UK are required as a compliance of Alternative Investment Fund Manager Directive of the EU which will be discussed in the following subsection.

³⁹ These mostly refer to the Companies Act 2006 and the Takeover Code of the City.

⁴⁰ For instance, investor protection for limited partners in PE funds is subject to the provisions under the Limited Partnership Act 1907, the restriction on the conduct of PE funds as shareholders in corporate governance is subject to the provisions under the Companies Act 2006 and the constraints on those buyout funds as bidders lie within the regulatory remit of the Listing Rules of London Stock Exchange and the Takeover Codes of the City of London.

⁴¹ Hereinafter referred to as 'BVCA'.

leading self-regulatory body of PE and VC funds in the UK, was established in 1983. Its membership comprises over 500 influential firms, including VC firms, professional consultancies and international associations.⁴² The primary mission of the BVCA is to promote integrity and transparency in the UK's PE and VC market, and to enhance communication between members internationally. In response to the public disquiet over the PE industry after the global financial crisis, the BVCA has been playing an increasingly important role in mitigating the risks in PE transactions. In terms of the regulatory functions of the BVCA, the Regulatory Committee of the BVCA plays an important role in the self-regulation of PE and VC firms in the UK, whose responsibility it is to ensure that all members can keep abreast of any changes of the regulatory and policy environment in a timely manner.⁴³ In order to guarantee the consistency between the practices of the PE and VC practitioners and authorities, regularly publishing consulting research reports for the regulators or policymakers is another key function of the Regulatory Committee of the BVCA.⁴⁴

In November 2007, under the leadership of Sir George Walker, the Guidelines for Disclosure and Transparency in Private Equity⁴⁵ were published which outlined the self-regulatory approach of PE funds in the UK. In the first place, PE and VC firms should timeously publish the details of their (i) investment strategies; and (ii) background of professional staff; and (iii) a description of UK portfolio companies in the portfolio of PE firms on their website, which should be accessible to the public and investors.⁴⁶ PE firms are also obliged to report on the records of the investment of their portfolios to the association, by which the BVCA is able to assess the performance of each PE firm both on an annual and industry-wide basis.⁴⁷ In the second place, portfolio companies are required to disclose the composition of their board, including the representatives of the PE firms on the board,⁴⁸ which is in support of mitigating the information asymmetry between general partners and limited partners. In order to keep the flexibility and adaptability of the soft law regulatory system, the BVCA tends to regulate the

⁴² See the official website of the BVCA: <http://www.bvca.co.uk/AboutUs.aspx>.

⁴³ See the official website of the BVCA:

<http://www.bvca.co.uk/AboutUs/CouncilCommitteesAdvisoryGroups/RegulatoryCommittee.aspx>.

⁴⁴ Ibid.

⁴⁵ Hereinafter referred to as the 'Walker Guidelines (2007)'. BVCA, *Guidelines for Disclosure and Transparency in Private Equity* (November 2007)

<http://walker-gmg.co.uk/sites/10051/files/wwg_report_final.pdf> accessed 21 May 2017.

⁴⁶ Ibid., at 26.

⁴⁷ Ibid., at 27.

⁴⁸ Ibid., at 24.

PE funds on a ‘comply or explain’ basis, which means that the PE or VC firms who do not comply with the above rules must provide the BVCA with an acceptable and reasonable statement.⁴⁹

After the publication of the Walker Guidelines 2007, the Guidelines Monitoring Group⁵⁰ was established as an independent monitoring committee. The main task of the GMG is to implement the rules in the UK PE market effectively. In practical terms, the effectiveness of the self-regulation by the BVCA mainly works on the basis of a market reputation mechanism; for instance, the GMG annually publishes a Review of Conformity with the guidelines that will name the non-compliers for the public. In this scenario, both the limited partners and any other parties in the PE market can directly judge the reputation of the non-complying firms;⁵¹ in other words, this market reputation deterrence can provide incentives for the PE management corporations who are covered by the Walker Guidelines 2007 to comply with the requirements of disclosure and transparency in the PE market.

5.2 The Regulatory System of the Private Equity Firms as Fund Managers in the European Union: An Interventionist Model

As a response to the 2008 global crisis, in June 2011, the parliament of the EU promulgated a unified regulation on alternative investment funds, namely the Alternative Investment Fund Managers and Amending Directives.⁵² Most private investment funds, including PE funds, fall within the regulatory scope of the AIFMD. In comparison with the regulatory system of PE funds in the UK, the regulatory strategy of the EU focuses more on the conduct of the fund managers of PE funds, as the definition or legal nature of the so-called investment fund may vary from country to country. Instead, a relatively unified definition of *fund manager* may be

⁴⁹ Hereinafter referred to as ‘GMG’. Joseph A. McCahery and Erik P. M. Vermeulen, *Private Equity Regulation: A Comparative Analysis* 16 Journal of Management & Governance 197, 222 (2012).

⁵⁰ MacNeil (n 6) at 30.

⁵¹ According to the Review of Conformity with the Guidelines 2014, two PE firms, namely Camelot (Ontario Teachers’ Pension Plan) and Viridian Group (Arcapita) who failed to comply with the requirement of the Walker Guidelines (2007) have been disclosed. Guidelines Monitoring Group, *Seventeenth Report*, December 2014, 24.

⁵² The full name of the regulation is ‘Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives (2003/41/EC and 2009/65/EC and Regulations (EC) No. 1060/2009 and (EU) No. 1095/2010), hereinafter referred to as the ‘AIFMD’.

easier to understand for all the EU member states. The following detailed requirements under the AIFMD regime are closely related to the regulation of PE fund managers in the EU:

First, fund managers are obliged to disclose detailed information in relation to the PE funds, including, but not limited to, a list of shareholders of the Alternative Investment Fund Managers,⁵³ organizational structure of the funds, the information in relation to the persons who are responsible for the fund management.⁵⁴ In addition, the AIFMs of all the member states of the EU are also required to provide information on the funds as regards the (i) rate and sources of leverage; (ii) fundamental strategies of investment; (iii) decision-making procedure of altering the investment strategies; (iv) detailed description of conflicts of interest; and the (v) valuation of underlying assets of the funds and other information of potential risk.⁵⁵ It can be seen that under the EU regulatory regime, the disclosure and transparency of portfolio managers are clarified in detail, which will facilitate the regulator with supervising the level of risk of the macro market in real time. Transparency is particularly significant for the PE industry, as the most PE funds involving leveraged buyouts⁵⁶ may generate high risk throughout the chain of debt, which may eventually give rise to systematic crises in financial markets. The existing EU regulator is making a particular effort to deal with information asymmetry and to improve the coherence in the unified financial market of the EU.

Second, in terms of fund management, the AIFMD requires that all fund managers have responsibility to ensure that the internal control mechanism of the fund, such as accounting procedures and electronic technology system, is adequate to identify, trace and control the records of the transactions by its employees throughout the entire process of investment.⁵⁷ More importantly, in order to manage and measure the risk in leveraged investment effectively, the AIFMD especially requires fund managers to (i) set a maximum level of leverage and (ii) restrict the use of collateral and guaranties in portfolio investment, among other things.⁵⁸

⁵³ Hereinafter referred to as ‘AIFM.’

⁵⁴ Art. 7 of the AIFMD.

⁵⁵ Arts 7 and 23 of the AIFMD.

⁵⁶ Hereinafter referred to as ‘LBOs’.

⁵⁷ Art. 18 of the AIFMD.

⁵⁸ Art. 15 of the AIFMD.

For those fund managers of specific types of alternative investment funds that may directly control the corporate governance of target companies, the AIFMD imposes particular restrictions on their conduct; for instance, the fund managers of those alternative investment funds that acquire control of unlisted companies by exercising their voting rights are obliged to comply with a series of special requirements: (i) standardized calculation methods of the voting rights attached to the shares held by the funds; (ii) timely notification of the acquisition of major holdings and control of non-listed companies; (iii) statutory annual report of exercising control of non-listed companies and (iv) strict restraints on asset stripping of target companies and so forth.⁵⁹ Obviously, such investment funds mainly refer to private equity funds, especially those public-to-private buyouts vehicles (PTP funds). The AIFMD makes an effort to normalize management of the EU-registered PE funds and to protect the interest of not only shareholders, but also other stakeholders (such as the employees and creditors) of the investee companies.

Compared to the relatively much looser regulatory environment of PE funds in the UK, the EU parliament intends to impose higher levels of obligation on the fund managers of alternative investment funds for the purpose of reducing systematic risk in the EU financial markets. One reasonable understanding of this difference is that there is much more inconsistency in domestic legislation in each of the EU member states than there is in the UK. Hence, a better approach to regulate PE or other alternative investment funds effectively is to clarify a shared standard of organizational management of the funds, instead of leaving too much leeway to the member states. It would otherwise be difficult to identify the risk of the funds and responsibilities of each fund manager across the EU.

6. The Prospect of Private Equity Regulation in China: A Reform Proposal

6.1 Developing a Unified and Practical Guideline for Private Equity Fund Managers

As discussed above, the essential problem of the ineffective regulation of the Chinese PE market is rooted in the political conflicts of various administrative bodies. In March 2016, the State Council of China launched a specific reform proposal as regards the establishment of a

⁵⁹ See details from Chap. V of the AIFMD.

collective regulatory regime of the entire financial market in China.⁶⁰ In a general sense, it can be predicted that the supreme-level regulatory arrangements will gradually be establishing a comprehensive regulatory body aimed at identifying and controlling systematic risk in the entire Chinese financial market.⁶¹ This initiative by the central government of China can be regarded as a possible and feasible direction of the regulatory reform of the entire investment fund industry, including PE and VC, because the rapidly emerging industry of buyout funds in China has been increasing the risk of leverage in the Chinese financial market.

In terms of the regulatory reform of PE funds, it is obvious that an effective and timely information-sharing mechanism across different sub-markets can facilitate the control of systematic risk in the PE industry. As a phased achievement of the reform, a collective regulatory regime that is uniformly led by the State Council is recommended as a proper way of improving the effectiveness of financial regulation. It has been recently proposed that a so-called Central Committee of Financial Stability be established by the State Council, the core responsibility of which is to comprehensively and continually control the systematic risk in the Chinese financial markets, and also to coordinate with the People's Bank of China, CSRC, CBIRC and China Insurance Regulatory Commission⁶² to enhance supervision of the conduct of market participants.⁶³ In a macro sense, it is expected that the supervision of, and restriction on, over-risky transactions of Chinese PE funds could be improved in future.

By contrast, in a micro sense, however, a unified and detailed practical guideline for the PE industry is still lacking. As already discussed, the existing Law of Securities Investment Funds (2012 Revision) has not yet covered PE funds. Private equity funds are only roughly regulated by the Interim Measures (2014). More formal and detailed legislation on all kinds of private investment funds in China is desired. Provisional improvement of the CSRC's regulation is to encourage the CSRC to promulgate specific administrative rules as guidelines for PE practitioners. The existing regulations created by the NDRC may be advocated when the political interests and relationship of the CSRC and NDRC are well coordinated, by which PE

⁶⁰ State Council of P. R. China, 'The Opinion on the Significant Issues as regard Deepening Economic Reform of 2016' (31 March 2016).

⁶¹ Lingyan Xu, *Comparative Study on Legal System of Financial Supervision: Global Financial Legal System Reform and China's Choice*, 49–50 (Law Press 2016).

⁶² Hereinafter referred to as 'CIRC'.

⁶³ *Supra* note 3.

funds will be regulated more coherently and efficiently. The last step in the reform process is to revise the Law of Securities Investment Law of China and accept PE and VC funds as regulated objects. A longer period of regulatory practices of the CSRC may someday provide more insightful and useful experience for such a legislative reform. This is so because detailed legislation on private investment funds needs more knowledge and experience and not merely an indiscriminate legal transplant from other jurisdictions.

6.2 Strengthening the Reputation Mechanism in the Chinese Private Equity Market

With reference to the regulatory experience of the UK, it is recommended that the further reform of the industry regulation of the PE market in China should focus on the establishment of a nationwide reputation system, by which public investors can access information on any violations and immoral behaviour of fund managers and PE firms, as it has been proven and acknowledged that reputational records of PE firms have a remarkable correlation with not only the scale of fundraising,⁶⁴ but also the bargaining ability of fund management firms.⁶⁵

Specifically, owing to the existence of the dual-level system of self-regulation, the functions of industry associations and the AMAC should be differentiated, by which the efficiency of self- regulation of PE funds can be improved. At a national level, the AMAC should play a leading role in the self-regulation of PE funds with a nationwide scope. According to sections 7 and 8 of the Interim Measures (2014), all private investment funds are required to register with the AMAC and (i) file main legal documents, including the articles of associations, of corporate funds or limited partnership agreements, the basic information of senior managers;⁶⁶ (ii) disclose the key information of the investment targets and prospectus (if applicable).⁶⁷

⁶⁴ Ching-Yi Chang et al, *Analysis of the Factors that Influence Venture Capital Fundraising: An Empirical Study in China* 5 (12) African Journal of Business Management 4765 (2011).

⁶⁵ Lee Harris, *A Critical Theory of Private Equity* 35 (1) Delaware Journal of Corporate Law 1 (2010).

⁶⁶ Section 7 of the Interim Measures (2014) provides that:

‘A manager of Privately-raised Funds of any type shall, in accordance with the provisions of the AMAC, apply for registration to the AMAC and submit the following basic materials: (1) Photocopies of the originals and duplicates of its industrial and commercial registration certificate and business license; (2) Its articles of association or partnership agreement; (3) The list of its major shareholders or partners; (4) Profiles of its senior management personnel; and (5) Other materials required by the AMAC.’

⁶⁷ Section 8 of the Interim Measures (2014) provides that

after the fund-raising of a Privately-raised Fund of any type is completed, the manager of the Privately-raised Fund shall, in accordance with the provisions of the AMAC, go through the record-filing procedures for the Privately-raised Fund, and submit the following basic materials: (1) Information on the main

Therefore, AMAC is able to collect the substantive information of each PE fund and will be in the advantageous position of being able to identify the potential risk in the market, and judge the violations of laws and regulations or inappropriate behaviour of PE fund managers.

At an industry level, the existing industry associations of PE and VC should play a more important role in boosting reputational pressure on fund managers and practitioners of the Chinese PE and VC market. First, it is advisable that a co-operation mechanism between the industry associations and AMAC be established, by means of which all information regarding the performance of industry associations' members are accessible on websites or other public information platforms. In such a way, the reputational mechanism in the private investment fund market can be enhanced. Second, in a technical sense, more detailed and practical guidance such as model rules for profit distribution, the recommended practices of limited partnership agreements⁶⁸ and the standards for judging the managing partner's behaviour in fund management should be advised and developed by PE industry associations in China, which may make a contribution to the standardization of legal practice.⁶⁹

7 Conclusion

The Chinese economy is experiencing a crucial period in which the macro-economic policies are shifting from encouraging financial and real estate investment to supporting industry economic development. Against this background, it is possible to see this another 'golden era' of PE in China. The recent legal and regulatory reform of the Chinese PE industry has shown

investment direction of the Privately-raised Fund and its fund category indicated according to the main investment direction; (2) The fund contract and the articles of association or partnership agreement of the company. The fund prospectus shall also be submitted if it has been provided for investors during fund-raising. Where the Privately-raised Fund is established in the form of an enterprise, such as a company or partnership, the industrial and commercial registration and photocopies of the original and duplicate of the business license shall also be submitted; (3) Where the Privately-raised Fund is placed under entrusted management, the agreement on entrusted management shall be submitted. Where the properties of the Privately-raised Fund are entrusted to a custodian, the agreement on custody shall also be submitted; and (4) Other materials required by the AMAC.

⁶⁸ Referred to as 'LPAs'.

⁶⁹ Actually, ever since the establishment of the AMAC in 2012, some professional training programmes have been launched in each local and nationwide PE/VC association, the officers of the AMAC are regularly accredited to the PE/VC associations at provincial level. Attending a given number of hours of training courses is commonly required for each member of those local associations. Moreover, such regular communication may facilitate information sharing of the self-regulators and different practitioners of PE and VC market. Such activities will be beneficial for developing a series of coherent and widely applicable standards for PE and VC investment in China.

that the authority is making concerted efforts to build up a collective and more professional regulatory regime of PE funds. In reality, however, the tension between different regulatory departments (mainly the NDRC and CSRC) has increased the difficulty and costs associated with such an institutional transformation. Moreover, a multi-level and weak industry regulatory system is also being reshaped in the current wave of reform. However, the collaboration between the nation-wide self-regulator (mainly AMAC) and the many local industry associations in the PE industry across China is still problematic. This is also closely related to the political conflicts between the regulators at the top level of the Chinese bureaucratic system. In sum, a more cost-efficient regulatory approach to Chinese PE can be expected, which should be an important part of a unified and functionalized regulatory reform of the Chinese financial market in the years to come.