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Private Equity Investor Protection: Conceptualizing The Duties of General Partners in China

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Unlike in the United States and European Union markets, where typical concerns about private equity have centered around excessive leverage, systemic risk, and short-termism, the recent market concerns in China have centered around illicit fundraising activities and misappropriation of funds. The evidence of market failure in China challenges the conventional view that private equity is a highly competitive market involving sophisticated investors and that the relationships between managers (general partners) and investors (limited partners) require no regulatory attention. After studying a hand-collected dataset of seventy Chinese private equity limited partnership agreements, this article finds that contractual designs on partners' duties fail to effectively constrain misconduct by general partners. Although Chinese regulators are strengthening the regulation of the private equity sector to address managerial abuse, the large majority of the measures are piecemeal and have come in the form of temporary provisions. There is no equivalent concept of equitable fiduciary duties in Chinese partnership law and the statutory provisions imposing duties on partners are wholly inadequate. Also, attempts to rely on administrative measures and self-regulation by the relevant bodies to close the gaps have proven to be ineffective. Therefore, I advocate that the regulatory focus should be on imposing specific statutory duties on fund managers to enhance protection in response to an ever-changing industry.

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† Assistant Professor, Faculty of Law, National University of Singapore (NUS). I am grateful to the interviewees from China and Singapore, who have generously shared their knowledge and insights with me. They are the fund managers, private equity lawyers, legal counsels of private equity firms, venture capitalists, entrepreneurs, individual investors and representatives of institutional investors who were willing to answer my questions and, in some cases, provide the limited partnership agreements that are the focus of this Article. Interviews were conducted on an anonymous, background basis. I would like to thank Zenichi Shishido, Dirk Andreas Zetsche, Wu Wei, Wang Mengjiao and Walter Wan Weiqi for their comments. The research is supported by the NUS Start-up Grant (WBS No: R-241-000-134-133). All errors remain my own.

PART I: INTRODUCTION

Private equity typically refers to the asset class of equity securities in companies that are not publicly traded on a stock exchange.[1] This includes investments in venture capital, as well as late stage mezzanine, turnaround, and buyout investments.[2]

China's private equity industry is expanding at an unprecedented pace. In terms of fundraising amounts, China has become Asia's largest private equity market (See Figures 1 and 2). As of 2016, China has raised USD 72.51 billion in private equity funding,[3] an amount that is larger than the cumulative sum raised by South Korea (USD 11.0 billion), India (USD 10.5 billion), Australia and New Zealand (USD 5.0 billion), and Japan (USD 4.3 billion).[4] In 2016, 2,438 new private equity funds were established in China.[5] Total fundraising reached a record high of RMB 1,370 billion (USD 198.4 billion), a nearly tenfold increase from 2006 (see Figure 1).[6] There have been 9,124 private equity investments worth RMB 744.9 billion (USD 80 billion)[7] and there were 4,871 exits.[8] As of February 2017, the Asset Management Association of China (AMAC) oversees 8,621 private equity management firms, and approximately 16,900 private equity funds managing a total paid-up capital of RMB 4,888 billion (USD 709.33 billion) (see Table 1).[9]

As a result of the explosive growth of the Chinese private equity market, numerous concerns have surfaced regarding the lack of a clear regulatory framework governing the private equity sector prior to 2014. In particular, many investors endured huge losses as a result of private equity managers' involvement in illegal fundraising activities. A typical example is when the fund manager misleads retail investors to make private equity investments by publishing false information, fabricating non-existent projects, and guaranteeing returns that would not materialize. There have also been cases involving the

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1. THE OXFORD HANDBOOK OF PRIVATE EQUITY 3 (Douglas Cumming ed., 2012).
2. *Id.*
3. Pricewaterhousecoopers, China Private Equity/Venture Capital 2016 Review and 2017 Outlook (2016), https://www.pwccn.com/en/private-equity/pe-china-review-feb2017.pdf.
4. *Id.*
5. PowerPoint Presentation on China's Equity Investment Market from the Zero2IPO Res. Ctr., PE DAILY (Jan. 22, 2017), http://research.pedaily.cn/201701/20170122408335.shtml (China) [hereinafter Zero2IPO Res. Ctr. Presentation]. This figure includes venture capital.
6. *Id.*
7. *Id.*
8. *Id.*
9. Wu Haiyan, Private Management Scale Exceeded 11 Trillion RMB, here is a Copy of the Latest Billions of Private Distribution, "Golden Lord" is Here! (With Table), WEI XIN, Mar. 23, 2017.

misappropriation of funds.[10] For example, in a recent case, Harvest Capital Management Company raised funds from investors by promising exceedingly high monthly returns. Harvest's Fund manager Chen Wei later absconded with the funds raised, causing losses of more than one billion RMB (USD 151.46 million) across nearly one thousand investors.[11]

As illustrated from the example above, concerns in the Chinese private equity market are centered around illicit fundraising activities.[12] The issue arises from the relationship between equity managers (general partners, or GPs) and investors (limited partners, or LPs). This is unlike the situation in the US and EU markets where typical concerns about excessive leverage, systematic risk and short-termism arise from the relationship between GPs and the portfolio companies they control.[13] The unique problem seen in the Chinese market has been neglected by Chinese law[14] and current regulatory responses fail to adequately address the relationship between managers and investors.

The evidence of market failure in China challenges the conventional view that the relationship between managers and investors requires no regulatory attention since the private equity sector is a highly competitive market involving sophisticated investors.[15] This paper focuses on investor protection and the relationship between fund managers and investors.[16] It finds that although Chinese regulators are strengthening the regulation on the private equity sector to curb managerial abuse, this has been executed in an inadequate piecemeal fashion using temporary provisions. The current focus on disclosure obligations and transparency not only fails to address market failure, but also increases operation costs for market participants and reduces market efficiency.

In addition to the deficiencies plaguing the current regulatory response, the situation is worsened by the lack of fiduciary duties in Chinese partnership law.

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10. Biao Feng, *Increase in Private Equity Fund Absconding Incidents: CSRC Highlights Four Regulatory Principles*, NAT'L BUS. DAILY (Apr. 29, 2016), http://www.nbd.com.cn/articles/2016-04-29/1001751.html (China).

11. Li Xiaxou, Shenzhen Private Equity Fund Attracted Billions in Investment: Managers Absconded Leaving Thousands of Investors With No Recourse, SINA FIN. (Jul. 2, 2014), http://finance.sina.com.cn/money/smjj/20140702/052319582014.shtml (China).

12. *See Curbing the Illegal Fundraising Activities*, CHINA SEC. REG. COMM'N (April 25, 2016), http://www.csrc.gov.cn/pub/shanxi/xxfw/sxgzjx/201604/t20160425_296446.htm (China).

13. *See* Peter Morris & Ludovic Phalippou, *A New Approach to Regulating Private Equity* 2 (2012), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1762840; *see also* FIN. SERVS. AUTH., PRIVATE EQUITY: A DISCUSSION OF RISK AND REGULATORY ENGAGEMENT 59-60 (2006), https://www.treasurers.org/ACTmedia/dp06_06.pdf.

14. There is no specific national law on private equity in China.

15. *See, e.g.*, Steen Thomsen, *Should Private Equity Be Regulated?*, 10 EUR. BUS. ORG. L. REV. 97, 104 (2009); Ian MacNeil, *Private Equity: The UK Regulatory Response*, 3(1) CAP. MKTS. L.J. 18, 18-31 (2007).

16. Although there are emerging concerns on systematic risks and excessive leverage in the Chinese private equity market, this article does not address that issue.

Unlike its common law counterparts, Chinese partnership law does not have any equivalent concept of fiduciary duties which can be imposed on partners. Furthermore, the Partnership Enterprise Law of the People's Republic of China (PEL) fails to clearly and adequately stipulate the partners' statutory duties. As a result, GP's duties are largely left for partners to specify in the partnership agreement. In this Article, I use a hand-collected dataset of private equity limited partnership agreements (LPAs)[17] to examine how GP's duties are contracted in China. Additionally, I supplement the LPAs with interviews of numerous industry participants – managers of private equity firms (fund manager), legal counsels of private equity firms, individual investors, representatives of institutional investors, entrepreneurs and lawyers.[18] I find that most of the Chinese LPAs are not sufficient to constrain GPs' conduct. There are legal, institutional and social barriers for LPs to negotiate before they can contractually impose comprehensive duties on GPs in China. I argue that common contractual designs have severe shortcomings and do not function effectively in anticipating and mitigating managerial abuse of GPs in the context of China. This special feature of the Chinese private equity market challenges the view that qualified investors are always able to write optimal contracts to protect themselves.

Investors in China receive insufficient protection when dealing in the private equity market. This article argues that changes in the law are required. It advocates that addressing the relationship between fund managers and investors

17. My main dataset is hand-collected and consists of partnership agreements of domestic Chinese RMB private equity funds raised by domestic Chinese private equity firms, including, *inter alia*, Banyan Capital, Shiyue Hualong Capital, etc. All funds are China-based limited partnerships established under the Partnership Enterprise Law of the People's Republic of China (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007), INV. PROMOTION AGENCY OF THE MINISTRY OF COM., http://www.fdi.gov.cn/1800000121_39_4109_0_7.html (China) [hereinafter PEL]. All contractual duties of partners discussed in this article come from this dataset. The funds in my sample were raised between 2014 and 2016. Funds and firms are diverse in size, age, and performance. Limited partnership agreements are confidential documents. These agreements are collected principally from leading Chinese law firms and venture capital firms, including, *inter alia*, Gaorong Capital, Chengwei Capital, Shiyue Hualong Capital, Jieyi Capital, Fangda Partners, King & Wood Mallesons, Zhonglun Law Firm, DHH Law Group, Global Law Office, Jincheng Tongda & Neal Law Firm, Guangzhou Yingke Law Firm, Guangzhou Zhuoxin Law Firm, Chongqing Zhonghao Law Firm, Shanghai Yuantai Law Firm, Shenzhen Huashang Law Firm, Shanghai Tongli Law Firm, Shanghai Yingmin Law Firm, and Tianyuan Law Firm.

18. Interviewees are from leading Chinese law firms, venture capital firms, incubators, national high-tech parks, and investment banks, including, *inter alia*, Gaorong Capital, Chengwei Capital, Jieyi Capital, Shiyue Hualong Capital Management Company, Island Peak Innovation, Shenzhen Hualin Securities, Citic Investments, Fangda Partners (Shanghai office), King & Wood Mallesons (Shanghai and Guangzhou offices), Zhonglun Law Firm (Beijing and Shenzhen offices), DHH Law Group (Shenzhen offices), Global Law (Beijing office), Jincheng Tongda & Neal Law Firm (Beijing office), Guangzhou Yingke Law Firm, Guangzhou Zhuoxin Law Firm, Chongqing Zhonghao Law Firm, Shanghai Yuantai Law Firm, Shenzhen Huashang Law Firm, Shanghai Yinigming Law Firm, Hainan Development Investment Holdings Co., Ltd., Sichuan Development Investment Holdings Co., Ltd., Zhangjia, Zhangjiang Hi-Tech Park, China-Singapore Suzhou Industrial Park Development Co., Ltd., China CITIC Bank (Shenzhen), and China Development Bank Capital.

(GP and LPs) would be a more effective and less expensive way to achieve regulatory aims. I suggest that the key to regulating the Chinese private equity market should be focusing on the fund manager. Private equity fund managers play an essential role in the private equity cycle. This article's proposed specific statutory duties would enhance investor protection in the ever-changing industry.

This article contributes to the literature on the private equity industry, and on duties of partners by analyzing the duties of GPs in Chinese private equity limited partnerships. It will be helpful in other civil law jurisdictions where there is no equivalent concept of fiduciary duties on partners, such as Korea and Taiwan.[19] My findings have policy implications for future law reforms in civil law jurisdictions that are considering introducing fiduciary duties on partners in order to regulate the relationship between GP and LPs. It would also be helpful to other jurisdictions that are reviewing their regulatory framework to facilitate private equity developments.[20]

This Article proceeds as follows. Part II justifies the need for strengthening investor protection by offering evidence that China's private equity industry shows signs of market failure. Part III empirically examines the "law in action" and evaluates how partners' duties are contracted in China. Part IV discusses the existing problems in Chinese legislation and enforcement of law relating to investor protection in the private equity market. It advocates that the current regulatory efforts are misguided and fail to adequately address investor protection. Part V suggests future legislative reforms on statutory duties of partners. Part VI offers a brief conclusion of the paper.

19. For further discussion on adopting fiduciary duties in civil law jurisdictions where there are no equivalent principles of fiduciary law, see Chong Kee Lee, *How to Adopt and Develop Anglo-American Concept of Fiduciary Law in a Civil Law System: A Korean Perspective* (NYU Sch. Law, 2017), http://www.law.nyu.edu/sites/default/files/ECM_PRO_071736.pdf.

20. For instance, the United Kingdom is currently reviewing its limited partnership law. *See* DEP'T FOR BUS., ENERGY & INDUS. STRATEGY, REVIEW OF LIMITED PARTNERSHIP LAW: CALL FOR EVIDENCE (2017), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/583800/review-of-limited-partnerships-law-call-for-evidence.pdf (U.K.).

Figure 1: Private Equity Fund-raising in China 2006-2016 (RMB)[21]

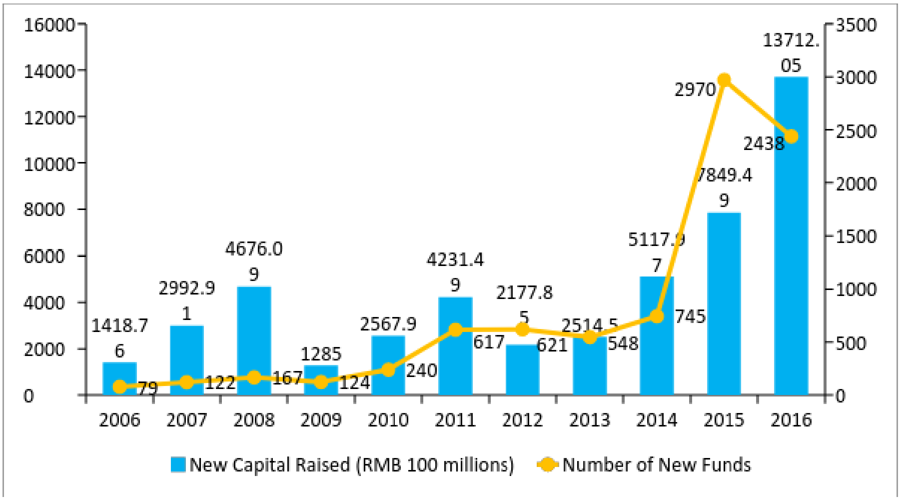
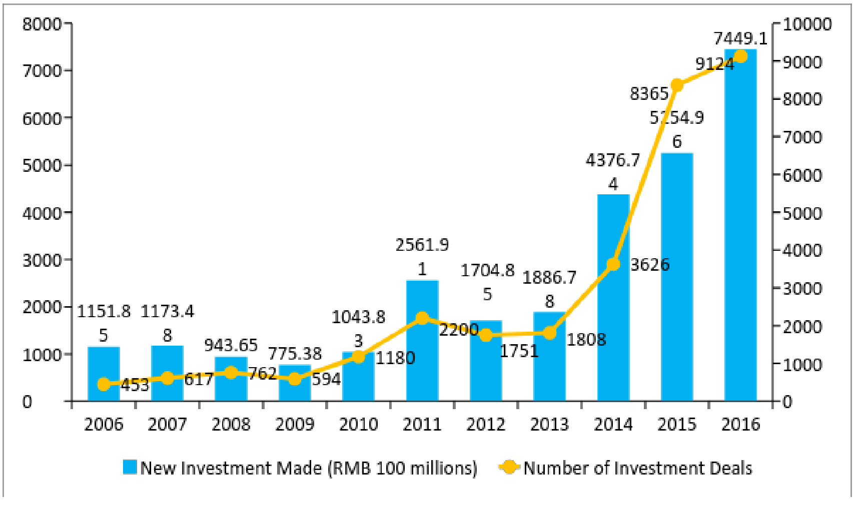


Figure 2: Private Equity Investments and the Number of Investment Deals in China 2006-2016 (RMB)[22]



21. Zero2IPO Res. Ctr. Presentation, *supra* note 5; ZERO2IPO RES. CTR., CURRENT STATUS QUO OF CHINA'S PE BOOM: 10,000 FUNDS, 7 TRILLION RMB, 200,000 INVESTORS (2017), http://research.pedaily.cn/201701/20170109407767.shtml (China).

22. ZERO2IPO RES. CTR., *supra* note 21.

Table 1. Alternative Investment Fund Market in China (as of Feb 2017)[23]

	Number of fund managers	***Number of registered funds***	***Paid up capital (100 million Yuan)***
Private equity fund	***8621***	***16912***	***48883***
Venture capital fund	***1250***	***2203***	***3818***
Securities Investment fund	***7978***	***27894***	***28014***
Others	***457***	***1617***	***4822***
Total	***18306***	***48626***	***85537***

PART II: THE NEED FOR INVESTOR PROTECTION IN PRIVATE EQUITY

There has been an increasing desire to regulate the private equity market since the 2007-2008 Financial Crisis. Proponents of regulation generally warn of systemic risk and the need to increase transparency in the industry.[24] The Alternative Investment Fund Managers Directive (AIFMD) in Europe and the Dodd-Frank Act in the United States (US), both adopted in the aftermath of the 2007-2008 crisis, contain specific provisions intended to reduce leverage, monitor systemic risks, and curb short-termism. In order to address risks in relation to investors, other market participants and markets, AIFMD imposes extensive transparency and disclosure obligations and requires funds to institute, *inter alia,* remuneration policies and practices designed to promote effective risk management.[25] Funds are also mandated to use depository and valuation mechanisms.[26] Notably, AIFMD has been criticized for having the wrong regulatory target as any systemic risk brought by the widespread failure of

23. Haiyan, *supra* note 9.
24. Jennifer Payne, *Private Equity and Its Regulation in Europe*, 12 EUR. BUS. ORG. L. REV. 559, 560 (2011).
25. *Id.*
26. *Id.*

private equity-backed companies would be on the banking system, which extends credit to private equity buyers, instead of the private equity sector.[27] Thus, AIFMD imposes significant and undue compliance costs on the private equity industry.[28] In contrast, instead of focusing on regulating the private equity industry, the US's Dodd-Frank Act prohibits banking entities from acquiring or retaining any interest in private equity funds so as to reduce excessive risk taking by the banking sector (the specific provision is often referred to as the Volcker Rule[29]). As such, the Dodd-Frank Act's measures to curb systemic risk focus on the correct contributor (banks) instead of needlessly penalizing private equity funds. The limited disclosure requirements under the Dodd-Frank Act are also far more circumscribed than the wide-ranging disclosure requirements under Europe's AIFMD.[30] Overall, the US adopted a softer approach than Europe in its regulation of private equity.[31]

AIFMD identified investor protection as one of its objectives after the Financial Crisis demonstrated that even professional investors require reliable and comprehensive information.[32] However, there has undoubtedly been a shift in the policy focus from investor protection to a stronger emphasis on the stability and integrity of the financial system.[33] As compared to the focus on leverage, systemic risks and short-termism, investor protection appears to have received relatively little public and academic attention.[34]

The traditional laissez-faire regulatory approach assumes that those who invest in private equity funds are aware of the risks involved and will safeguard their interests via contractual negotiations.[35] This section argues that this traditional view is overconfident about investors' ability to protect themselves. The assumption that private equity investors are always able to protect themselves by means of contract in an arm's length bargain is especially flawed in China, where most investors are financially unsophisticated individuals and

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27. Alexandros Seretakis, A Comparative Examination of Private Equity in the United States and Europe: Accounting for the Past and Predicting the Future of European Private Equity, 18 FORDHAM J. CORP. & FIN. L. 612, 659 (2013).

28. Id. at 660.

29. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620-31 (2010).

30. Seretakis, *supra* note 27, at 662.

31. *Id.*

32. Commission Staff Working Document: Impact Assessment Accompanying the Document Commission-Delegated Regulation Supplementing Directive 2011/61/EU of the European Parliament and of the Council with Regards to Exemptions, General Operating Conditions, Depositories, Leverage, Transparency and Supervision, at 8, SWD (2012) 386 final (Dec. 19, 2012).

33. Dirk Zetzsche, *Investment Law as Financial Law: From Fund Governance Over Market Governance to Stakeholder Governance*, *in* THE EUROPEAN FINANCIAL MARKET IN TRANSITION 339, 339 (Hanne S. Birkmose et al. eds., 2011).

34. Morris & Phalippou, *supra* note 13, at 2-3. Thomsen, *supra* note 15.

35. Thomsen, *supra* note 15.

not institutional investors. Thus, there is a strong case for investor protection in China.

The Agency Problem

The root of the investor protection problem in the private equity context is the agency problem. Investors expect managers to maximize returns on their investments, whereas managers may be primarily motivated by self-interest. Agency problems are further exacerbated by the structure of limited partnerships. A typical private equity fund is structured as a fixed-term limited partnership and is managed by a professional management firm ("the private equity limited partnership"). The firm serves as the GP and actively manages the fund's activities. The investors act as LPs who passively provide capital to the fund and enjoy the protection of limited liability from the debts and obligations of the firm. However, the LPs are not allowed to participate in the fund's management under the default rule of the limited partnership[36] and this provides opportunities for managerial abuse.

Since the LPs (the principal) cede control and delegate the decision-making authority to the GP (the agent), the GP may not always act in the best interests of the LPs and could abuse his managerial position.[37] As a result, agency costs could easily arise. Limited partnership law further constrains the ability of LPs to curb managerial excesses due to the 'control rule,' which renders LPs liable for the limited partnership's liabilities if they attempt to intervene in the partnership's management.[38] Unlike shareholders in a company who can constrain managerial misbehavior by exercising voting rights in the shareholder meeting, LPs do not have similar rights to participate in the management or control of the partnership. Furthermore, unlike shareholders who can select and change the management of a company by exercising their powers in a shareholder meeting, it is more difficult to change a GP in a limited partnership since doing so generally requires the partners' unanimous consent.[39] In view of the above, the agency problem exists in the limited partnership in a more extreme form than in a company.

In essence, there are conflicts between (1) the self-interests of GPs to collect management fees, carried interests, and other compensation; and, (2) the self-interests of LPs to obtain high risk-adjusted performance at a low cost and to

36. PEL, art. 68.

37. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3(4) J. FIN. ECON. 305, 308 (1976).

38. Lin Lin, *Managing the Risks of Equity Crowdfunding: Lessons from China*, 17(2) J. CORP. L. STUD. 327 (2017).

39. Lin Lin, *Private Equity Limited Partnerships in China: A Critical Evaluation of Active Limited Partners*, 13(1) J. CORP. L. STUD. 185 (2013).

profit from their investments. For example, the GP may engage in opportunistic behavior and exploit the LPs by disclosing misleading information, omitting materially adverse information, or artificially inflating reported values of portfolio companies with the intent to exaggerate fund performance, allowing him to receive benefits. Apart from overvaluing assets, the GP may also act myopically in an attempt to maximize its collectible carried interest at the expense of the long-term interests of the LPs. High-potential investments may be prematurely exited to reduce monitoring costs while underperforming investments may be continued in the hope of increasing value.[40] There is also the problem of moral hazard where the GP misuses the raised funds and engages in excessively risky investments.

The problem of information asymmetry is also present in an extreme form in the context of private equity limited partnerships. While the GPs are generally contractually required to disclose information to LPs, most limited partnership agreements do not provide the LPs with sufficient rights to access information.[41] The significant information asymmetry that exists between the GP and the LPs causes difficulty for investors to obtain updated and accurate information about an investment, confirm the fund's exact success rate, and evaluate the diligence of the GP.[42] This information asymmetry is further amplified by the inherent difficulties in valuing private equity investments. Private equity funds are not traded on the public market and, hence, the market prices of portfolio companies are not readily available.[43] Investors can, at best, guestimate the true value of portfolio companies. In these circumstances, they have to rely on the unilaterally determined valuation made by the fund manager.

One could argue that the personal liability borne by GPs may sufficiently deter them from pursuing risky activities (such as excessive borrowings and overleveraged activities) and thus reduce agency costs.[44] However, such optimism is misplaced.[45] First, the GP effectively sidesteps the issue of unlimited liability once it is organized as a company. Second, this device only reduces creditors' risks without alleviating the concern of LPs. In China, due to regulatory restrictions on using bank loans to fund merger and acquisition transactions,[46] a Chinese private equity fund usually does not use highly

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40. Christopher Brown & Roman Kraeussl, *Risk and Return Characteristics of Listed Private Equity*, *in* THE OXFORD HANDBOOK OF PRIVATE EQUITY, *supra* note 1, at 614.

41. Julia Khort, *Protection of Private Equity Fund Investors in the EU*, 12 EUR. CO. L. 97 (2015).

42. Lin, *supra* note 39, at 214.

43. Khort, *supra* note 41.

44. Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 EMORY L.J. 835, 848 (1988).

45. Larry E. Ribstein, *Unlimited Contracting in the Delaware Limited Partnership and Its Implications for Corporate Law*, 17 J. CORP. L. 299, 304 (1991).

46. China's limited partnership funds cannot engage in large scale debt-financed investments and cannot publicly issue corporate bonds. In addition, they are subjected to further restrictions under the

leveraged debt financing on the fund level. Therefore, insolvency of those funds rarely exists.[47] Also, since an implication of the holding company nature of the typical limited partnership is that such a firm is unlikely to have significant debts to outside creditors, the GPs' personal liability probably will be insignificant.[48] Personal liability alone is thus unable to prevent the GPs from pursuing opportunistic behaviors or to ensure that they act for the best interests of the partnership.

Unsophisticated "Qualified Investors"

A popular consensus, which has led to the longstanding lack of regulation of the private equity sector, is that investors are capable of protecting themselves because they are "sophisticated investors."[49] It has been assumed that they are well counseled before entering into an agreement and are capable of making demands in an arm's length bargain.[50] However, in practice, this may not always be the case and investors in China need to be protected by more robust laws.

As rightly pointed out by Morris and Phalippou, using the phrase "sophisticated investors" interchangeably with technical terms, such as "accredited investors"[51] and "qualified investors,"[52] is confusing and unideal.[53] Doing so pre-judges the question of whether "accredited investors" or "qualified investors" are, on average, actually sophisticated in the ordinary sense of the word.[54] They also argue that the private equity market shows signs of "price

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Lending General Provisions cannot obtain bank loans easily. There is thus little external debt for limited partnership funds. As such, the fact that GP bear unlimited liability for obligations of the limited partnership is insufficient to constitute an effective constraint on the GP. Gaoyuan Bo, *Fiduciary Duties of General Partners in Limited Partnership Venture Capital Funds,* 1(1) LAW & SOC'Y 115 (2010); *see also How Do M&A Funds Obtain Commercial Bank M&A Loans?,* CHINA CAP. UNION, MAR. 30, 2017; *accord*. Lending General Provisions (promulgated by the People's Bank of China, June 28, 1996, effective Aug. 1, 1996), Decree No. 2 [1996] of the People's Bank of China (China).

47. Bo, supra note 46; see also Ruo Shui, Interpretation on the Unlimited Liability of General Partner (Interview with Zhang Ying, the Representative of the Beijing Office of the Akin Gump Strauss Hauer & Feld LLP Chinese Venture), CHINA VCPE (Sep. 14, 2009), http://www.chinavcpe.com/news/hot/2009-09-14/47d851398d3df741.html (China).

48. Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927, 935 (2004).

49. Payne, *supra* note 24, at 571.

50. *Id*.; David Walker, Disclosure and Transparency in Private Equity: Consultation Document July 2007 (2007).

51. In the U.S., it would be "accredited investor," as defined in Rule 501 of Regulation D of the Federal Securities Laws. *See* 17 C.F.R. § 230.501(a) (2017).

52. The U.K.'s equivalent is "qualified investor," as exemplified by the Qualified Investors Register of the Financial Conduct Authority (FCA). Qualified Investors Register 2005, P.R. 5.4, FIN. CONDUCT AUTH., https://www.handbook.fca.org.uk/handbook/PR/5/4.html?date=2012-02-06 (last updated Feb. 6, 2012) (U.K.).

53. Morris & Phalippou, *supra* note 13, at 3-4.

54. *Id*. at 4.

shrouding,"[55] such that private equity firms are able to avoid competition by shrouding information and increasing the complexity of contracts.[56] This "price shrouding" affects even "sophisticated investors."[57]

Moreover, performing due diligence on private equity investments is more challenging than performing due diligence on traditional investments, since private equity funds are long-term investments that are not actively traded, and thus more difficult to accurately value.[58] While disclosures to investors are adequate during due diligence investigations,[59] the problem is that investors may be unable to process such information meaningfully as disclosures become increasingly complicated and voluminous. When investors are overloaded with information, their decision-making quality may suffer.[60] These deficiencies suggest that even sophisticated investors are fallible.

Furthermore, institutional investors are heterogeneous.[61] Smaller institutional investors do not have sufficient resources to conduct adequate due diligence and lack the sophistication to invest in a completely unregulated market. It should also be emphasized that institutional investors often represent investments from many indirect retail investors and it is "these small investors [that] ultimately bear the cost" for the failure of institutional investors.[62]

Additionally, there are several factors that contribute to the vulnerability of "sophisticated investors" in China.

In China, a "qualified investor" in private funds (which include private equity funds) is defined as an individual or institution who has appropriate risk identification and risk tolerance abilities and invests at least RMB 1 million in a single fund. An institution needs to possess net assets of at least RMB 10 million. Individuals need to possess net financial assets[63] of RMB 3 million or have an

55. *Id.* at 1.

56. *Id.*

57. *Id.*

58. U.S. Gov't Accountability Off., GAO-08-885, Private Equity: Recent Growth in Leveraged Buyouts Exposed Risks That Warrant Continued Attention 43 (2008).

59. Louise Gullifer & Jennifer Payne, Corporate Finance Law: Principles and Policy 787 (2d. ed. 2015).

60. Troy Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81(2) WASH. U. L.Q. 417, 441-42 (2003).

61. Josh Lerner et al., *Smart Institutions, Foolish Choices: The Limited Partner Performance Puzzle,* 62 J. FIN. 731 (2007). Marco Da Rin & Ludovic Phalippou, *The Importance of Size in Private Equity: Evidence from a Survey of Limited Partners*, (Eur. Corp. Governance Inst. Fin. Working Paper, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2379354##.

62. Luis A. Aguilar, Comm'r, SEC, Financial Regulatory Reform: The SEC Moving Forward, Speech at Loy. Marymount U. (Sept. 21, 2010) (transcript available at the SEC website, https://www.sec.gov/news/speech/2010/spch092110laa.htm) (last updated Sept. 24, 2010); Cary Martin, *Private Investment Companies in the Wake of the Financial Crisis: Rethinking the Effectiveness of the Sophisticated Investor Exemption*, 37 DEL. J. CORP. L. 49, 75 (2012).

63. Financial assets include bank deposits, stocks, bonds, fund shares, asset management plans, bank financial products, trust plans, insurance products, future rights, etc. Financial assets do not include real

annual income of at least RMB 500,000 (about USD 75,000) during the past three years.[64]

While the investor is required to have the "appropriate risk identification and risk tolerance abilities,"[65] the use of this imprecise definition and the lack of any calculation formula means that fund managers have ample discretion to determine the eligibility of any potential investor. For instance, fund managers may set up cursory online questionnaires on their home webpage to assess the risk identification and risk-taking abilities of the investor.[66] Since these online questionnaires are rather perfunctory and entirely based on self-reporting, they are an unreliable assessment method. Some fund managers may also allow investors to guarantee in writing that they fulfill the "qualified investor" requirement without the need to produce proof of net assets.[67] Others even assist with fraudulent reporting of net assets by either encouraging interested investors to make temporary transfers to their deposit accounts or allowing multiple individuals to pool together their investment amounts so as to satisfy the prescribed RMB 1 million investment threshold.[68]

Even amongst the legitimately wealthy investors in China, many so-called "qualified investors" are not sophisticated. As wealth surged over the past decade due to the rapid economic development, China has a large number of high net-worth individuals with substantial investable assets. According to the China Wealth Report, "China will become one of the largest markets of high-net-worth individuals[69] in the world, with the number of high-net-worth families rising from 2.07 million in 2015 to 3.88 million at the end of 2020."[70] A recent survey also shows that the majority of LPs in Chinese private equity funds are wealthy individuals and families, instead of institutional investors.[71] As of June 2016,

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estate. *Private Fund Investment Question & Answer (1)*, CHINA SEC. REG. COMM'N (Mar. 23, 2016), http://www.csrc.gov.cn/pub/heilongjiang/xxfw/tzzsyd/201603/t20160328_294848.htm (China).

64. Simu Touzi Jijin Jiandu Guanli Zhanxing Banfa [Interim Measures for Supervision and Administration of Privately-Raised Investment Funds] (promulgated by the China Sec. Reg. Comm'n, Aug. 21, 2014, effective Aug. 21, 2014), Decree No. 105 of the China Sec. Reg. Comm'n, art. 12 (China) [hereinafter CRSC Interim Measures], *read with* Simu Touzi Jijin Muji Xingwei Guanli Banfa [Private Investment Fundraising Behavior Management Approach] (promulgated by the China Fund Industry Ass'n, Apr. 15, 2016, effective July 15, 2016), art. 28, CHINA SEC. REG. COMM'N, http://www.csrc.gov.cn/tianjin/xxfw/scyw/201606/t20160608_298472.htm (China) [hereinafter Private Investment Fundraising Behavior Management Approach].

65. Private Investment Fundraising Behavior Management Approach, *supra* note 64.

66. For example, this is done by Geshang Financial Management. *See Qualified Investor Confirmation,* LICAI, https://www.licai.com/pe/ (last visited May 5, 2017) (China).

67. Telephone Interview with Ms. Lu, Legal Couns., Chinalin Sec. Holdings (Apr. 5, 2017).

68. *Id.*

69. High-net-worth individuals are those with more than 10 million RMB (1.5 million USD) in investible assets.

70. Jiang Zueqing, *China to Become Largest Market of High-Net-Worth Individuals*, CHINA DAILY (Jun. 23, 2016), http://www.chinadaily.com.cn/business/2016-06/23/content_25814849.htm.

71. ZERO2IPO RES. CTR., *supra* note 21.

there were 8,330 wealthy individuals and families investing in the private equity market, accounting for 49.4% of the surveyed 16,849 LPs.[72] In contrast, there were only 2,522 enterprises (15.0%) and 1,668 investment companies (9.9%) investing as LPs.[73]

While these individuals may appear to have substantial wealth and high-risk tolerance, they remain financially unsophisticated[74] and do not have the requisite ability and experience to screen and invest in high-risk funds. In fact, most of them are the first generation of wealthy individuals in the history of the People's Republic of China (PRC). They received little education due to the Cultural Revolution in the 1960s and the 1970s but were able to generate wealth within a short period due to the economic reform in the 1980s. They are inexperienced with handling the high-risk nature of private equity investments or the operation of the funds.[75] They are also unable to bargain for the information they need in order to assess whether to invest.[76] Hence, these private equity investors are generally inexperienced and shortsighted.[77] They are interested in short-term, pre-IPO projects so as to obtain quick returns. Thus, they are easily misled.[78] This situation is very different from that seen in in the US or EU, where LPs generally have plenty of experience in private equity investments.

In acknowledgement of these issues with the present "qualified investor" regime, the CSRC has proposed a more restrictive definition. Under the new "professional investor" classification,[79] an institution needs to possess net assets of RMB 20 million or net financial assets of RMB 10 million in the past year. In addition, the institution needs to have at least two years of investment experience in securities, funds, futures, gold or foreign exchange. An individual is required to possess net financial assets of RMB 5 million or have an annual income of at least RMB 500,000 during the past three years. The individual must also have at least two years of relevant investment experience, or two years of working experience relating to financial product design, investment and risk management,

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72. Meng Yu, Zero2IPO LP Research Report H1'16: Institutional LPs Account for Over 50% of the Total in 2016, 60% of GPs in Survey Have Applied for or Prepared to Apply for Government Guidance Funds, PE DAILY (Aug. 25, 2016), http://en.pedaily.cn/Item.aspx?id=221062.

73. *Id.*

74. Gordon Orr, *A Pocket Guide to Doing Business in China,* MCKINSEY & CO. (Oct. 2014), http://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/a-pocket-guide-to-doing-business-in-china.

75. Lin, *supra* note 38; Telephone Interview with Ms. Lu, *supra* note 67; Telephone Interview with Mr. Kai Xi, Assoc., Shiyue Hualong Cap. Mgmt. Co. (Apr. 6, 2017); Telephone Interview with Ms. Chen, Senior Assoc., Fangda Partners (Mar. 6, 2017).

76. *See* JOHN ARMOUR ET AL., PRINCIPLES OF FINANCIAL REGULATION 169 (2016).

77. Lin, *supra* note 39.

78. *Id.*

79. Measures for the Suitability Management of Securities and Futures Investors (promulgated by the China Sec. Reg. Comm'n, Dec. 12, 2016, effective July 1, 2017), Order of the China Sec. Reg. Comm'n [2016] No. 130, art. 8 (China) [hereinafter CSRC Measures on Investor Suitability].

or have experience as a senior manager of a professional investment entity, or a certified public accountant or lawyer providing finance related services. However, the "professional investor" regime only recently came into effect starting 1st July 2017.

Moreover, given the importance of *guanxi*[80], within Chinese society, many LPs select funds based on recommendations from friends.[81] However, they may not be able to obtain the fund's true and full information from these personal associates. Some funds even deliberately up the ante by holding road shows, creating the illusion that the fund has many potential investors through means such as finding temporary LPs to participate in the fund subscription ceremony in order to attract real LPs to invest in the fund.[82] There are also funds that plant audience member to ask specific questions during the Q&A segments of the seminar to allow the spokesperson of the fund to elaborate on the fund's strengths and advantages to further lure potential LPs to invest with them.[83]

In addition to such measures, it is common for private equity fund managers to hire an agent for fund raising, such as banks and financial institutions.[84] However, since banks and financial institutions are paid by the funds for successful fundraising, the interests of the banks and financial institutions diverge from the interests of the investors. Therefore, severe information asymmetry exists. Certain banks and financial institutions also lack the expertise and experience in private equity industry and thus do not have the ability to conduct effective due diligence on GPs in such funds.[85]

One could argue that wealthy investors can seek their own financial advice and bear the associated costs before making investments. However, due to the absence of a well-designed entry licensing mechanism for fund managers before 2014 and the ineffective reputational mechanism on GPs,[86] many existing financial intermediaries are incompetent and unable to provide neutral advice.

Furthermore, due to the Chinese private equity industry's short history, China

80. "*Guanxi*" means personal networks and relationships.

81. Telephone Interview with Mr. Kai Xi, *supra* note 75; Telephone Interview with Mr. Chen, Vice President, Linyi Cap. (Mar. 6, 2017).

82. Yubin Shi, *Present Chaos and Crisis Faced by Chinese LPs When Choosing PE,* SOHU BUS. (Aug. 9, 2016), http://business.sohu.com/20160809/n463422391.shtml (China).

83. Telephone Interview with Mr. Yuan, Partner, Jingtian & Gongcheng (Apr. 16, 2017).

84. Telephone Interview with Mr. Kai Xi, *supra* note 75; Telephone Interview with Ms. Lu, *supra* note 67.

85. Shi, *supra* note 82.

86. Lin, *supra* note 38; Lin, *supra* note 39. Rosenberg, in the context of the U.S.-Delaware limited partnership, highlights "the importance of reputation in the venture capital industry, made possible by the cyclical nature of investment in venture capital limited partnerships." *See* David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract,* 2002 COLUM. BUS. L. REV. 363, 366 (2002). LPs can choose to invest only with reputable GPs and shun those GPs who are lacking in credibility. *See id.*

lacks experienced and competent GPs. Most of the GPs are first-time fund managers raising their maiden funds. Many GPs were previously lawyers or investment bankers and do not have any private equity experience.[87] This is different from more mature markets, where GPs have long track records in the private equity sector. China also lacks a sound credit system.[88] These problems increase the investment risks and reduce the effectiveness of reputation mechanisms in mitigating managerial abuse.

Market Failure

Despite many commentators' beliefs that the private equity market is working fine with effective private ordering and shows few signs of market failure,[89] there is clear evidence of severe managerial abuse by fund managers in China. This is shown in the scandals discussed in Part I and demonstrated by the results of China Securities Regulatory Commission' (CSRC)'s special inspections in the last two years.

In the first half of 2016, CSRC investigated 305 private funds.[90] The inspected institutions were linked to 2,462 funds, which cumulatively managed RMB 900 billion and accounted for 14% of the entire industry's assets under management.[91] The inspection focused on compliance with fundraising rules, security of fund assets, timeliness with information disclosure, extent of leverage, and whether there is investor exploitation. The findings revealed that non-compliance was endemic. Some of the inspected institutions even engaged in criminal activities. In particular, four private equity institutions were suspected of illegal fundraising and securities activities while six private equity institutions committed serious violations such as guaranteeing returns, misappropriating or converting fund assets, commingling client funds with personal funds, and publicizing fictitious investment projects to fraudulently attract capital.[92] Sixty-five private equity institutions engaged in moderate non-compliance acts such as unauthorized public fundraising, failure to abide by contractually stipulated

87. *See* Org. for Econ. Co-Operation & Dev. [OECD], *OECD Reviews of Innovation Policy: China Synthesis Report*, at 18 (Aug. 2007), http://www.oecd.org/dataoecd/54/20/39177453.pdf; Telephone Interview with Mr. Yuan, *supra* note 83; Telephone Interview with Mr. Lin, Vice President, Ceda Cap. (Apr. 18, 2017); Telephone Interview with Mr. Chen, *supra* note 81.

88. There is no personal bankruptcy law in the P.R.C. Neither debtors nor creditors obtain sufficient relief when insolvency happens. In addition, the P.R.C. lacks a nation-wide private credit record system which can assess consumer credit risks and set rating standards.

89. Thomsen, *supra* note 15.

90. Private funds include securities investment funds, private equity funds, venture capital funds, hedge funds, and other funds that are privately raised in China.

91. *CSRC Offices in Five Provinces Initiate Inspections for Private Equity Funds: Involves Over a Hundred Organizations*, SINA FIN. (Feb. 28, 2017), http://finance.sina.com.cn/money/smjj/smdt/2017-03-01/doc-ifyavwcv9260565.shtml?cre=financepagepc&mod=f&loc=2&r=9&doct=0&rfunc=100 (China).

92. *Id.*

investment strategies, and other contractual breaches.[93] The majority of the inspected institutions (199 out of 305) failed to provide accurate and timely disclosures and did not have adequate risk assessment systems in place.[94] As a result, a total of 73 private equity institutions and individual fund managers were administratively sanctioned by the CSRC for their non-compliance acts.[95] Furthermore, in 2016, AMAC also had to deregister 12,834 private equity institutions which were mostly dormant shell entities.[96]

While most frauds have been committed by peer-to-peer (P2P) and private mutual funds masquerading as private equity funds,[97] investors have nevertheless associated the frequent instances of fraud and non-compliance with the private equity market, resulting in severe reputational damage for the industry. The lack of investor confidence clearly illustrates significant market failure, therefore justifying the need for more robust regulation.

PART III: A QUALITATIVE ANALYSIS OF CONTRACTUAL DUTIES OWED BY GPS IN CHINA

A private equity fund is typically organized as a limited partnership, where the firm serves as the GP, and investors serve as the LPs.[98] In common law jurisdictions, there are two basic mechanisms governing the internal relationships among partners: 1) the fiduciary duties arising out of the fiduciary relationship and 2) contractual duties and obligations arising from the partnership agreement.[99] However, under Chinese partnership law, there is no concept equivalent to the fiduciary duties. The question then arises: how are fund managers in China constrained in the absence of fiduciary duties requirements?

Arguably, an effective LPA tailored by the partners is one of the principal

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93. *Id.*

94. *Id.*

95. *The 11th Batch of 106 "Missing" Private Fund Institutions Published: Private Fund Integrity System is Improving*, XINHUANET (Jan. 16, 2017), http://news.xinhuanet.com/finance/2017-01/16/c_1120316335.htm (China).

96. *Id.*

97. *How Should Investors Distinguish Between Legitimate and Fake Private Equity Funds*, IPR ACTION (Dec. 9, 2016), http://www.ipraction.gov.cn/article/xxgk/sjbj/jrtz/201612/20161200117512.shtml (China).

98. Lin, *supra* note 39.

99. *See* GEOFFREY MORSE, PARTNERSHIP LAW 160 (6th ed. 2006); YEO HWEE YING, PARTNERSHIP LAW IN SINGAPORE 167 (2000). For further discussion on fiduciary duties in partnerships, see generally J. Dennis Hynes, *Freedom of Contract, Fiduciary Duties, and Partnerships: The Bargain Principle and the Law of Agency*, 54 WASH. & LEE. L. REV. 439 (1997); Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 WASH. & LEE. L. REV. 537 (1997); Robert W. Hillman, *The Bargain in the Firm: Partnership Law, Corporate Law, and Private Ordering within Closely-Held Business Associations*, 1 U. ILL. L. REV. 171 (2005).

ways of mitigating agency costs in a partnership.[100] Various covenants have been used in LPAs to address the agency problems within the fund. Typically, these covenants include those concerning the overall management of the fund, those addressing the opportunities for conflicts of interest, and those delineating the permissible types of investments.[101]

Nevertheless, the theory of incomplete contracts[102] argues that parties cannot negotiate terms specifically to cover all contingencies because they cannot foresee every future event or know precisely how their own purposes may change.[103] As LPAs are generally long-term investment agreements, partners may not properly conceive future events when the contract was made. Thus, the drafted duties may not adequately address future problems in a long-term relationship.[104] Other factors such as the "risk of negotiating or drafting error, uncertainty regarding the terms' validity, lack of judicial precedent concerning the terms' meaning or effect, and lack of investor or other third-party familiarity with the terms"[105] would also affect the efficiency of contractual duties in managing the partnership relationship.

My empirical studies also indicate that leaving partners to tailor their contractual duties has not prevented agent abuse in China.[106] In another paper, I discussed the effectiveness of several contractual arrangements in addressing the agency problem in the context of Chinese private equity funds.[107] These arrangements include remuneration paid to GPs, GPs' contributions and co-investment rights. However, these explicit terms are ineffective due to the short history of the private equity market and a lack of awareness and sophistication

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100. Stephen E. Roulac, *Resolution of Limited Partnership Disputes: Practical and Procedural Problems*, 10 REAL PROP. PROB. & TR. J. 276, 279 (1975). Private contract is also an effective way of mitigating agency costs in the corporate context. *See generally* Ann E. Conaway, *Lessons to Be Learned: How the Policy of Freedom to Contract in Delaware's Alternative Entity Law Might Inform Delaware's General Corporation Law*, 33 DEL. J. CORP. L. 789 (2008).

101. PAUL A. GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 38 (1999); *see also* Rosenberg, *supra* note 86, at 381.

102. *See generally* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: A Theory of Default Rules*, 99 YALE L.J. 87 (1989); Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation,* 56(4) ECONOMETRICA 755 (1988); Jean Tirole, *Incomplete Contracts: Where Do We Stand?,* 67(4) ECONOMETRICA 741 (1999); H.L.A. HART, THE CONCEPT OF LAW 125 (1961); PATRICK BOLTON & MATHIAS DEWATRIPONT, CONTRACT THEORY 487 (2005).

103. Randy E. Barnett, *Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821, 822 (1992); *see also* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 70 (1985).

104. Letter from Melvin A. Eisenberg, Professor Emeritus, U.C. Berkeley Sch. of Law, to the Comm'rs on Uniform State Laws 2 (July 17, 1992) (cited in Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. Rev. 523, 560-61 (1993)).

105. J. William Callison, *Venture Capital and Corporate Governance: Evolving the Limited Liability Company to Finance the Entrepreneurial Business*, 26 J. CORP. L. 97, 116 (2001).

106. *See* Lin, *supra* note 38.

107. *See* Lin, *supra* note 39.

of private equity practitioners in China.[108] Therefore, this part focuses on the effectiveness of contractual duties in constraining partners' misbehavior based on empirical data.

The empirical data is based on a hand-collected dataset of 70 private equity agreements.[109] These agreements are obtained from leading Chinese law firms and private equity firms.[110] Insight is also gleaned from interviews with 70 interviewees.[111] These consists primarily of fund managers, lawyers, investors and policy makers from the main private equity hubs in China, i.e. Beijing, Shanghai, Tianjin, Shenzhen, Chongqing, Guangzhou, and Hong Kong.

The following sections highlight the typical clauses found in the investigated LPAs.

Clauses Addressing Conflicts of Interest[112]

Conflicts of interest give rise to significant risks in the private equity market.[113] There are several examples of when conflicts can arise between the interests of the fund manager and the investors. First, while it is common for fund managers to co-invest alongside the fund, conflicts of interest can occur if the fund manager can invest on a deal-by-deal basis (cherry-picking) and/or on preferential terms (such as sweet equity or loan finance) to those offered to investors.[114] Fund managers could also unfairly steer more lucrative deals into these co-investment vehicles to enhance the weight of these companies in their personal portfolios.[115] Since it is common for a fund manager to manage multiple funds at the same time, there may be a conflict of interest when the fund manager is distributing reinvestment opportunities among the various funds.

Second, conflicts of interest could also arise in a limited partnership with a corporate GP. It is very common for private equity fund managers to form a

108. There are many restrictive covenants that can be used to deal with the relationship between investors and fund managers, such as restrictions on management of the funds, on the activities of the GP, and on the types of investments. *See generally* Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J.L. & ECON. 463 (1996); Joseph A. McCahery & Erik P.M. Vermeulen, *Private Equity Regulation: A Comparative Analysis*, 16(2) J. MGMT. & GOVERNANCE 197, 213 (2012).

109. *See supra* notes 17-18. It must be noted that a selection bias may be a limitation of the dataset. One possibility is that I over-sampled good funds, as most of my agreements came from the large and reputable Chinese law firms. However, this does not seem to be a significant problem in this paper. The findings show that even the contractual duties drafted by the firms in the dataset are insufficient to constrain the behavior of the general partners.

110. *See supra* notes 17-18.

111. *Id.*

112. Observations based on the investigated sample contracts.

113. FIN. SERVS. AUTH., *supra* note 13, at 10, para. 1.16.

114. Tech. Comm., Int'l Org. of Sec. Comm'ns [IOSCO], *Private Equity Conflicts of Interest: Consultation Report*, at 16 (2009), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD309.pdf.

115. FIN. SERVS. AUTH., *supra* note 13, at 72.

company to act as GP(s) in a limited partnership. This hybrid vehicle combines the advantages of corporate identity and limited liability of companies with the contractual flexibility and tax advantages of partnerships. However, the corporate GP may consider its own interest above the interest of the fund it manages when dealing with a potential investment project. It may invest on its own behalf in a particularly promising portfolio company without disclosing the information to the other funds it managed.[116] Unlike a natural person GP who is able to make autonomous decisions, a corporate GP can only act through its directors and corporate officers. In the US and UK, where partners are subject to fiduciary duties, conflicts of fiduciary duties may arise when the corporate GP (acting through its directors) owes fiduciary duties to the partnership firm while its directors owe fiduciary duties to their own companies. Although there is no equivalent concept of fiduciary duty under PRC law and the PEL does not address this issue, similar conflicts of interest may still arise for Chinese corporate GPs. These conflicts ought to be dealt with.

Many of the investigated LPAs do not adequately address the potential conflicts between GPs and LPs. Only a few agreements prohibit the GP from setting up funds that are in direct competition with the partnership before the partnership's investment portfolio has met certain conditions. For example, such provisions might read as follows *"Unless the (Advisory) Committee agrees or this Agreement otherwise specifies, before 70% of the total paid-up capital of all partners is used or going to be used with certainty for portfolio investment, general partners shall not set up any new fund which is in the same investment industry, with the same investment targets and at the same investment status."*[117] Only a few LPAs provide that the GP shall distribute investment opportunities fairly and in a bona fide manner.[118] Furthermore, none of the investigated LPAs deal with conflicts of duties in the context of a corporate GP.[119]

In addition, most of the investigated LPAs allow the GP to enter into related-party transactions with the partnership[120] with minimal restrictions imposed. These transactions typically included: (i) investing in the portfolio companies, which the GP, management, or key persons have invested in, but are holding less than 5% of such portfolio companies' shares; (ii) investing in the portfolio companies, which the GP's related funds are investing in; (iii) investing together with the GP's related funds; and (iv) investing in portfolios held by certain

116. It has been reported that such practice is an unwritten rule in China's private equity market. *See* Ye Kuang Ye & Nuo Luo, *Investigation on China Private Equity Market Status*, JRJ FIN. (Apr. 18, 2009), http://finance.jrj.com.cn/2009/04/1801224157180.shtml (China).

117. 5 out of the 70 investigated sample contracts.

118. 10 out of the 70 investigated sample contracts.

119. All 70 investigated sample contracts.

120. 50 out of the 70 investigated sample contracts.

categories of LPs.[121] Some LPAs also allow related-party transactions if the transactions are approved by the investment committee or at the partners' meeting during which the related parties shall abstain from voting,[122] provided that related transactions shall be arm's length transactions.

A few of the LPAs[123] allow the advisory committee to determine whether to allow the GP to set up funds that are in conflict of interest with the partnership's investment portfolios.[124] For matters within the agreed scope of power of the advisory committee, the LPAs state clearly that the LPs will not be considered as carrying out business of the partnership by executing power on such matters.[125]

However, none of the investigated agreements impose a duty of disclosure[126] on the GP when there is a conflict of interest between the GP and the partnership or the LPs. Although the investigated LPAs generally impose requirements for GP to disclose information, such as periodic reports and material matters reports to LPs,[127] the disclosure duties are mainly related to the utilization and management of partnership's assets. This is far less comprehensive than a GP's disclosure duties found under common law.[128]

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121. *Id*.

122. 40 out of the 70 investigated sample contracts.

123. This committee is responsible for the supervision of the GP's management, the scope of investment, related-party transactions, key personnel changes, the costs of the partnership, and the distribution of profit.

124. It should be noted that not all partnerships have advisory committees. Only half of the sample LPAs agreed on forming the advisory committee. The advisory committee is authorized to review the GP's conduct in matters such as the scope of investment, related-party transactions, key personnel changes, the costs of the partnership, and the distribution of profit. A small minority of the LPAs required approval from the advisory committee before the GP can establish a separate fund that may be in conflict with the existing fund's investment projects.

125. Some LPAs stipulate that the advisory committee shall be comprised of the largest (by contribution amount) three or five LPs. The GP shall comply with the decision of the advisory committee for matters that fall within the committee's scope of authority. For matters that are beyond the committee's scope of authority, the GP should seriously consider the advisory committee's recommendations, but there is no obligation for the GP to implement the advisory committee's decisions. For matters within the agreed scope of power, the LPAs clearly state that the LPs will not be considered to be participating in management of the partnership.

126. Investigated sample contracts.

127. The Asset Management Association of China ("AMAC") issued the Measures on the Administration of Private Investment Fund Disclosure on February 4, 2016. *See* Measures on the Administration of Private Investment Fund Disclosure (promulgated by the Asset Mgmt. Assoc. of China, Feb. 4, 2016, effective Feb. 4, 2016) (China). As a result, all the recent LPAs have introduced materially similar information disclosure requirements for the GP, such as monthly, quarterly, annual, and major event reports. These disclosure provisions help to protect LPs' right to information and facilitate the LPs' supervision of the GP.

128. It should be noted that the disclosure requirements largely focused on the use, management, and profit of the partnership. The method of disclosure is typically through periodic reports and various financial statements. This standard of disclosure is still lower when compared to the common law requirements of disclosure, which require the GP to disclose conflicts of interest, related-party transactions, etc.

Clauses Addressing Duty of Care

A few investigated LPAs impose a duty of diligence on the GP.[129] This can take the form of clauses such as "*the GP shall devote reasonable time and effort in managing the partnership's business*"[130]; "*the GP shall manage and operate the fund assets with responsibilities, honesty, care and diligence*"[131]; "*key persons (guanjian renshi) shall spend reasonable time and effort in the management of the partnership*."[132] However, all investigated LPAs fail to specify the standard of the GP's duty of diligence and care. Some LPAs simply provide that "*the GP and its management are only liable for damages caused by their intentional acts or gross negligence*." Arguably, these contractual standards for the duty of diligence are low.[133]

Moreover, many interviewees opined that individual LPs generally do not apprehend what duties a GP should owe and they seem to not care about the duties owed by a GP.[134] Instead, LPs focus more on the distribution of profits and remuneration of GPs during the negotiation of LPAs.[135] Some interviewed LPs said that they have never heard of fiduciary duties and the draft LPAs are provided by the GPs, with the GP's lawyers ensuring that the provisions protect the GPs' interests while deliberately omitting protection for the LPs.[136]

Further, many interviewees argued that it was difficult and costly to have an exhaustive list to cover all the possible duties.[137] Another hurdle is that partners have to spend much more time negotiating the content of these duties in China since the law is uncertain and unclear.[138]

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129. 23 out of 70 investigated sample contracts.

130. While a small minority of the LPAs state that the GP should devote reasonable time and effort in managing the partnership, none of the LPAs directly discussed the issue of distribution of the GP's time and energy in a context in which the general partner is general partner to multiple partnerships.

131. These are in line with AMAC's regulatory requirements.

132. 5 investigated LPAs contain a "key personnel" clause which provides that any change or increase in key management personnel will require the consent of either the investment decision committee, the advisory committee, or the LPs at the partnership meeting. When key personnel can no longer manage the partnership's affairs and a suitable replacement cannot be found, the partnership will be dissolved. Some LPAs also state that key personnel of the GP or the management team should expend reasonable time and effort on the management of the partnership business.

133. The LPAs' clauses on the GP's duty of care and duty of diligence are largely similar to Article 35 of the PEL. The GP and its management team will only be liable for losses caused either intentionally or by gross negligence. However, given that the GP is the professional fund manager to whom investors entrust their capital, it is argued that the present standard of care is too low.

134. Telephone Interview with Mr. Yuan, *supra* note 83.

135. Telephone interview with Mr. Lin, Vice President, *supra* note 87; Telephone Interview with Mr. Yuan, *supra* note 83.

136. Telephone Interview with Mr. Yuan, *supra* note 83.

137. *Id.*

138. Delaware lawyers have also expressed such view. *See* MARTIN I. LUBAROFF & PAUL M. ALTMAN, LUBAROFF & ALTMAN ON DELAWARE LIMITED PARTNERSHIPS § 11.2.2 (2017 Supp., 1995).

PART IV: DEFICIENCIES IN THE STATUTORY FRAMEWORK

Problematic Regulatory Responses

For years, the Chinese private equity sector operated in a regulatory vacuum without a clear regulatory and legal framework governing the market.[139] In order to tackle the perceived market concerns, government intervention commenced in 2014. CSRC has issued the Interim Measures for the Supervision and Administration of Privately-Raised Investment Funds ("CSRC Interim Measures")[140] and the Asset Management Association of China ("AMAC") has issued the Measures for the Registration of Private Investment Fund Managers and Filing of Private Funds.[141] Under the new regulatory framework, the CSRC is the key regulator of the private equity sector.[142] All private equity funds have to be registered with the AMAC and comply with the rules or measures made by CSRC.[143] AMAC issues self-regulatory rules on private equity.[144]

In the past two years, AMAC has issued a whole series of self-discipline regulatory measures, directives, and Q&A explanations dealing with registration, fundraising, internal control and information disclosure, as well as fund contracts guidelines to improve risk management and market compliance (see Table 2). Specifically, the AMAC imposed substantive entry requirements, sought to deregister dormant shell entities, imposed severe sanctions on institutions that failed to provide timely information disclosure, referred non-compliant entities to the relevant bureaus for investigation, and increased qualification requirements for senior management of funds.

Unfortunately, despite CSRC and AMAC's best efforts, the newly introduced regulatory framework is still unable to adequately address the issue of investor protection in China.

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139. *See* Dean Collins et al., *A New Era for Private Funds in China?*, DECHERT LLP, https://info.dechert.com/10/3730/landing-pages/a-new-era-for-private-funds-in-china.asp (lasted visited Apr. 28, 2017).

140. The CSRC Interim Measures set forth the regulatory regime for private funds under five key topics: (i) registration and filing; (ii) qualified investors; (iii) fundraising; (iv) fund operation; and (v) special rules for venture capital funds. *See* CRSC Interim Measures, *supra* note 64.

141. In Chinese pinyin, "*Simu Touzi Jijin Guanliren Dengji He Jijin Beian Banfa*." This measure came into effect on February 7, 2014.

142. In June 2013, the Central Government issued the Guanyu Simu Guquan Jijin Guanli Zhizhe Fengong De Tongzhi [Notice on the Division of Responsibilities of Private Equity Fund Management] (June 27, 2013), Zhongyang Bianbanfa [2013] No. 22, SCOPSR, http://中央编办.政务/bbyw/qwfb/201306/t20130627_227855.html (China) [hereinafter Notice on the Division of Responsibilities of Private Equity Fund Management], specifying that the CSRC will be responsible for the supervision and administration of private equity funds.

143. *Id.*

144. AMAC's role is criticized. *See* Naijin Liu, *Management Responsibilities of AMAC and the Evolution of Private Equity Supervision*, CHUANSONGMEN (May 2, 2016), http://chuansong.me/n/717237352463 (China).

First, the rapid introduction of a large number of regulations in a compressed timeframe (see Figure 3), coupled with the different, and at times, contradictory regulatory opinions and directions of the various authorities, have caused immense practical difficulties and greatly increased compliance costs. In 2016, CSRC and AMAC issued new regulations and frameworks almost on a monthly basis. AMAC issued over 70 measures, guidelines, and notices in 2016 alone.[145] The interviewed lawyers expressed the view that CSRC and AMAC had differing interpretations and explanations for certain regulations.[146] On top of abiding by the various administrative regulations, self-discipline rules, and window guidance, practitioners have to attend training courses and seek advice on the different guidance opinions. Oftentimes, regulators do not provide clear answers to these questions. Meanwhile, many notices are temporary in nature and cannot be used as long-term guidelines for fund managers. Furthermore, as AMAC is an ordinary self-regulated organization, its notices and measures are not formal legal sources and cannot be the direct basis upon which judgments are made. Hence, AMAC's notices and measures have minimal legal effect.

Second, China's identity-based, classified supervisory framework requires extensive reform. Legitimate private equity organizations are subject to overly onerous requirements, especially disclosure obligations. The CSRC has stated that its foundational regulatory principle for private funds is "Unified Regulation, Classified Supervision (*tongyi jianguan, fenlei jiandu*)". All types of private funds are handled under the same information disclosure system and are subject to monitoring and on-site inspections by AMAC and CSRC's local offices. The funds are then reclassified into private mutual funds, private equity funds and venture capital funds. They are then subject to varying substantive regulatory requirements, such as daily valuations, risk ratings, and periodic information disclosure. For private funds that previously registered under the classification of the now-defunct multi-services category, AMAC requires the fund manager to submit a new filing application after confirming the change of the fund type and business type.[147]

However, classified supervision has yet to be effectively implemented. Private equity funds are required to disclose information (including details on fund managers, fund operation, and breakdown of fees) on a six-month basis, submit audited annual reports (including detailed project information, exits

145. *Analysis on the Current Supervisory System for Private Equity*, ONEMAY CAP. (Dec. 19, 2016), http://www.onemaycapital.com/article/tag/%E4%B8%AD%E5%9B%BD%E5%9F%BA%E9%87%91%E4%B8%9A%E5%8D%8F%E4%BC%9A (China).

146. Telephone Interview with Mr. Kai Xi, *supra* note 75; Telephone Interview with Ms. Lu, *supra* note 67.

147. *Private Fund Registration and Filing Question & Answer (13)*, ASSET MGMT. ASSOC. OF CHINA (Mar. 31, 2017), http://www.amac.org.cn/xhdt/zxdt/391907.shtml (China).

information, distribution of profits, reports of fund managers, audited financial reports, etc.), and deliver any requested information to local financial regulatory authorities. When disclosing information, fund managers have to provide financial data and statements for investment projects. This is practically unfeasible as some smaller funds have only recently commenced investment projects and are unable to provide such information.[148] The disclosed information can also include trade secrets. This increases moral hazard as AMAC insiders now have access to confidential information. Given that AMAC does not have a secure information system, it is doubtful that confidentiality can be maintained.[149]

Third, excessive administrative supervision has led to high law enforcement costs. Since 2016, CSRC and its various local offices have commissioned dozens of random on-site inspections. Due to the large number of registered fund institutions, the spot checks on the small proportion of inspected fund entities have been inefficient in affecting real change in the industry. On-site inspection also requires high levels of human and financial resources. Inspections worsen regulatory agencies' already existing manpower constraints[150] and is a high-cost, low-efficiency method of law enforcement. Practitioners' compliance costs also increase, as they have to accommodate such inspections. These costs are then passed on to investors, thus reducing returns and hindering market efficiency.

Most critically, the present regulatory regime has failed to achieve investor protection. Most regulations were passed haphazardly and without a thorough analysis of the potential impact of these reforms. Given that the Chinese market's main problem is fraudulent fundraising, regulation should focus on fund managers instead of heightened disclosure requirements. Disclosure alone is unlikely to constrain fraudulent behavior by rogue fund managers and will only increase compliance and operational costs. By hindering market efficiency without improving on market integrity, these temporary and self-regulatory measures create additional costs without bringing commensurate benefits.

Nevertheless, on 30th August 2017, the State Council issued the Interim Regulation for Private Investment Funds (For Consultation) ("Consultation Draft").[151] The main purpose of the Consultation Draft is to *improve the status*

148. Telephone Interview with Mr. Shao, Partner, Yuan Tai Law Offices (Mar. 6, 2017); Telephone Interview with Mr. Kai Xi, *supra* note 75.

149. Telephone Interview with Mr. Kai Xi, *supra* note 75; Telephone Interview with Mr. Chen, *supra* note 81.

150. *Id.* All of China's financial regulators have suffered severe man-power loss. Talents recruited from overseas by the CSRC's so-called "Hundred Talents Program" have mostly left the organization.

151. Simu Touzi Jijin Guanli Zhanxing Tiaoli (Zhengqiu Yijian Gao) [Interim Regulation for Private Investment Funds (For Consultation)] (promulgated by the Legal Aff. Off. of the St. Council, Aug. 30, 2017), CHINA LAW, http://zqyj.chinalaw.gov.cn/readmore?id=2061&listType=1 (China) [hereinafter Consultation Draft]. The consultation period is one month long, until September 30, 2017.

of legislation for private fund regulations as administrative regulations promulgated by the State Council are legislatively superior to the CSRC rules and AMAC's measures.[152]

The Consultation Draft's substantive content is largely derived from the existing relevant laws and regulations, such as the PRC Securities Investment Fund Law, CSRC's Interim Measures for the Supervision and Administration on Privately-Raised Investment Funds, and AMAC's self-regulatory rules.[153] It consolidates the present laws and regulations into a single administrative regulation and attempts to provide a clear and unified regulatory regime for private investment funds. In addition, the Consultation Draft imposes further restrictions for fund managers. Under Article 7 of the Consultation Draft, individuals and entities are prohibited from becoming fund managers or major shareholders in corporate fund managers if (1) they were convicted for intentional crimes in the past 3 years, (2) they were subjects of administrative penalties the past 3 years, (3) their net assets are less than 50% of the paid-in capital, or their contingent liabilities are or exceed 50% of the net assets, (4) they failed to pay due debts, or (5) they fall under any other circumstances as prescribed by laws, administrative regulations, and CSRC rules.

Despite the improvements, the Consultation Draft still has flaws. First, it uniformly applies to all private funds and no distinction is made between private equity funds and private securities investment funds.[154] This is not ideal as private equity funds make investments into shares of privately-held companies while private securities investment funds make investments into publicly listed securities (which include publicly traded shares, bonds, and other financial derivatives). These two types of funds should not be regulated together without differentiation.

Second, the Consultation Draft only expressly referred to corporation-type funds and partnership-type funds.[155] It failed to cover contract-type funds that are commonly found in practice.[156] Such contract-type funds should also be subjected to the same regulatory regime.

In short, the regulatory framework governing private equity in China is rapidly evolving and will continue to do so as China seeks to strengthen and

152. Wang Yong et al., "Simu Touzi Jijin Guanli Zhanxing Tiaoli (Zhengqiu Yijian Gao)" Jiedu ["Interim Regulation for Private Investment Funds (For Consultation)" Interpretation], SOHU FIN. (Nov. 9, 2017), http://www.sohu.com/a/191234136_617138 (China).

153. *Id.*

154. The Consultation Draft defines private funds to be P.R.C. funds that raise funds privately from qualified investors. Consultation Draft, *supra* note 151, art. 2.

155. Yong et al., *supra* note 152.

156. *Id.*

streamline its financial regulation regime.[157] As shown in Table 2, there are different categories of law on different ranks of the legislative hierarchy governing the private equity sector: (1) national laws promulgated by the National People's Congress and its Standing Committee, such as the Securities Investment Fund Law,[158] (2) administrative regulations promulgated by the State Council,[159] (3) rules and regulations promulgated by the CSRC and other ministries and commissions,[160] and (4) local regulations promulgated by the local legislature.[161] While the State Council's Consultation Draft represents an important step forward in ensuring a well-structured regulatory regime for the private equity industry, its two major flaws as discussed above should be addressed. The Consultation Draft is also not yet in force and has no legislative effect until further notice.

157. On November 10, 2017, China established a financial stability and development committee under the State Council to oversee financial stability and related reform and development. *See* Yan, *China Focus: China Establishes Financial Stability and Development Committee,* XINHUANET (Nov. 8, 2017), http://news.xinhuanet.com/english/2017-11/08/c_136737949.htm (China).

158. It is worth noting that, although the Securities Investment Fund Law of the People's Republic of China (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 28, 2012, rev'd Dec. 28, 2012, effective June 1, 2013), ST. COUNCIL, http://english.gov.cn/services/investment/2014/08/23/content_281474982978075.htm [hereinafter SIFL], stipulates some principles for private funds ("*simu jijin*") and some duties of fund managers, these provisions are only applicable to public funds and do not apply to private equity funds directly. Furthermore, since the supervisory authority for private equity funds was unconfirmed at the time when the legislation was passed, private equity funds are still not covered by any further amendments to the SIFL.

159. *See, e.g.*, Consultation Draft, *supra* note 151.

160. *See, e.g.,* CRSC Interim Measures, *supra* note 64; CSRC Measures on Investor Suitability, *supra* note 79.

161. *See, e.g.*, Tianjin Guquan Touzi Qiye He Guquan Touzi Guanli Jigou Guanli Banfa [Measures for the Administration of Equity Investment Enterprises and Equity Investment Management Entities in Tainjin] (promulgated by the Tianjin Mun. Comm'n for Dev. & Reform et al., July 11, 2011, effective Sept. 1, 2011), Tianjin City Fagaiwei [2011] No. 675.

Figure 3. Timeline of Private Equity Regulation in China

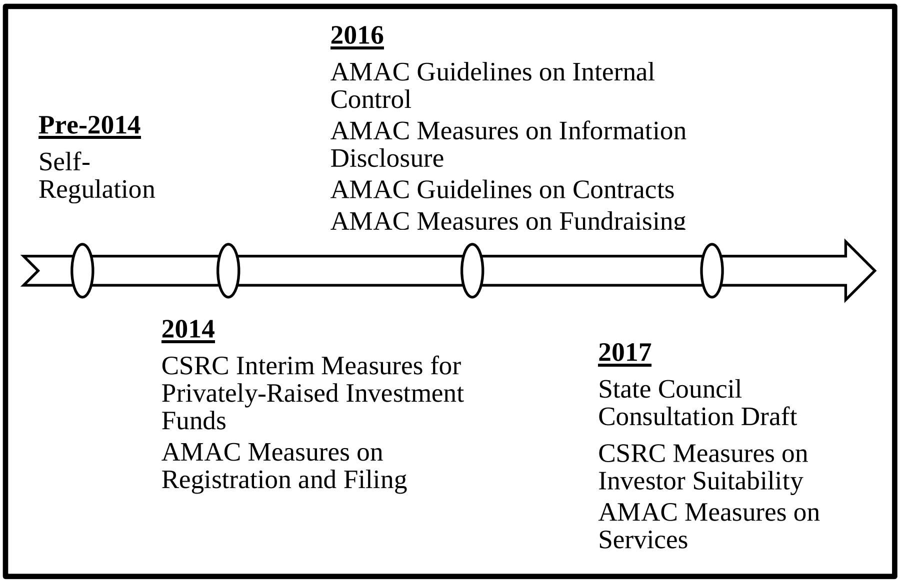

Table 2. The Evolving Regulatory Framework of Private Equity in China

Legislation	**Date of Promulgation**	**Highlights**
	National Laws	
Securities Investment Fund Law	1st June 2013	The amended legislation now subjects private funds to regulatory purview. (Note that private fund is broader than private equity)
	State Council Administrative Regulation	
Interim Regulation for Private Investment Funds (For Consultation)	30th August 2017	This consolidates the present laws and regulations into a single administrative regulation. It imposes comprehensive regulatory requirements on fund managers, fund custodians, fundraising behavior, investment operations, information disclosure, industry self-discipline, and other aspects of the private fund industry.
	CSRC Rules	
Interim Measures for the Supervision and Administration of Privately-Raised Investment Funds	21st August 2014	This is one of the key regulations in the field of private fund supervision. It established a regulatory system that takes into account the operational characteristics of the private fund industry.
Measures for the Suitability Management of Securities and Futures Investors	Issued 12th December 2016 and will be in effect on 1st July 2017	This sets out the definition for “professional investor” which is more stringent than the previous “qualified investor” classification. Funds are also now required to provide suitability matching opinions according to different risk tolerance capability of investors and different risk levels of products.
	AMAC Measures	
Measures for the	7th February 2014	This specifically applies the

Registration of Private Investment Fund Managers and Filing of Private Funds		CSRC's Interim Measures' section on registration and filing, thereby establishing a national private fund registration and filing system.
Measures on the Administration of Private Investment Fund Information Disclosure	4th February 2016	This established a preliminary industry self-discipline framework for information disclosure of private funds. It sets forth, inter alia, the extent, content, and manner of information disclosure required when private funds conduct fundraising and operational activities.
Administrative Measures on Fundraising of Private Investment Funds	15th July 2016	This imposes more stringent and detailed rules on private fund fundraising activities. It sets out the following requirements: specific target confirmation, investor suitability management, risk disclosure and explanation, qualified investor confirmation, cooling-off period, and return visit. It imposes restrictions on marketing and promotion and requires funds and their personnel to satisfy certain qualifications.
Administrative Measures on Services of Private Investment Funds	1st March 2017	This includes the main provisions of AMAC's previous 'Outsourcing Guidelines', including the legal status of the service organization, fund manager's legal responsibilities when outsourcing and security mechanism for settlement of funds. It also adds the definition of services, separation of powers and duties, exit mechanism, etc.
AMAC Guidelines		
Guidelines on the Internal Control of	1st February 2016	This attempts to create an internal control self-regulatory framework

Private Investment Fund Managers		by focusing on internal control objectives and principles, internal environment, risk assessment, control of activities, internal supervision, etc. Fund managers shall not manage businesses where potential conflicts of interest may arise; Fund managers shall avoid improper related transactions and establish a mechanism for prevention of tunneling and conflict of interests; At least two senior management members must be appointed; The compliance manager shall be liable for any losses caused by internal control ineffectiveness.
Guidelines on Private Investment Fund Contracts	18th April 2016	This is meant to provide unified, standard contractual terms for all private fund products such as private mutual funds, private equity funds and venture capital funds.
CSRC and AMAC Notices and Announcements		
CSRC and AMAC Notices	Published by CSRC and AMAC on an ad-hoc basis	The CSRC and AMAC often publish self-discipline rules and operational standards through notices, announcements, Q&A with reporters, etc. Of particular importance is the AMAC's Notice on Registration of Private Fund Managers and the associated Explanation (1-13), which set out in detail AMAC's regulatory trend and enforcement standards regarding the issue.

Statutory Duties in Existing Law

A unique characteristic of Chinese partnership law is that it does not impose detailed statutory duties on partners or contain any concept of equitable fiduciary duties owed by partners in a manner equivalent to that present in common law jurisdictions.[162] This section reviews the statutory duties of GPs under the Chinese law.

Duties of Partners under the PEL

The law regulating partnerships, the PEL, only outlines the following provisions on the duties of partners.

- The partners should not engage in activities which may harm the interests of the partnership.[163]
- The general partners should not carry out any business competing with that of the partnership solely or cooperatively.[164]
- The partners should not engage in any self-dealing business with the partnership.[165]
- The partner should not abuse any benefit of the partnership by taking advantage of his position or misappropriating any property of the partnership by other illegal means. If he does so, he shall return the benefit or property to the partnership. If his act results in any loss to the partnership or to other partners, he shall be liable for compensation.[166]
- The partner owes a duty to account to the firm for any benefit derived by him from any transaction competing with that of the partnership, or from any self-dealing business by him with the partnership. The partner shall bear compensation liabilities if any loss is caused to the partnership or to other partners.[167]

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162. The lack of fiduciary duty in Chinese partnership law is readily understandable. The fiduciary duty is a longstanding concept originally developed out of equity and trust in common law jurisdictions. However, as a civil law jurisdiction, China does not have the equivalent concept of equity and trust. Moreover, the PEL was drafted during the economic transitional period in the 1990's, when there was limited judicial and practical experience in partnerships as well as an inadequate understanding of fiduciary duties. Further legislative background on the promulgation of the PEL is available. *See* Yicheng Huang, Explanations on the Draft Partnership Enterprise Law of the People's Republic of China (Oct. 23, 1996), *in* 1 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 12 (China).

163. *Id.*

164. "No partner may, solely or jointly with others, operate any business competing with the partnership enterprise. Unless it is otherwise prescribed in the partnership agreement or is unanimously approved by all partners, no partner may have any trade with the partnership enterprise. No partner may engage in any activity that may impair the interests of the partnership enterprise." PEL, art. 32.

165. *Id.*

166. "Where any partner executing the partnership affairs or any practitioner of a partnership enterprise occupies any benefit that attributes to the partnership enterprise by taking the advantage of his position, misappropriates any property of the partnership enterprise by other illegal means, he shall return the benefit or property to the partnership enterprise. In case his act results in any loss to the partnership enterprise or to other partners, he shall bear the compensation liabilities." PEL, art. 96.

167. "Where any partner, in violation of the provisions of this Law or the stipulations of the partnership agreement, undertakes any business competing with the partnership enterprise or trades with

- The managing partner (*zhixing shiwu hehuoren*) should regularly report to the other partners on the process of partnership activities as well as the business and financial status of the partnership.[168]

Arguably, the above rule stipulating non-competition (Article 32(1), Article 99), the duty not to misappropriate company property (Article 96), and the duty to not engage in self-dealing (Article 32(2), Article 99) are similar to the duty of loyalty found in the US and the UK. However, the provisions listed above are limited and inadequate in addressing the whole range of fiduciary concerns and improper conduct by the partners. In particular, the standard provided in Article 32 is that "the partners should not harm the interests of the partnership." This is far lower than the duty of loyalty in common law, which requires partners to act in the best interest of the partnership.[169]

The English Partnership Act provides a strict duty on partners to "*render true accounts and full information of all things affecting the partnership to any partner or his legal representative"* which allows partners to be held liable even without proof of common law fraud or negligence.[170] In contrast, the PEL fails to ensure that partners deal with fellow partners honestly and disclose any relevant fact when dealing with them. The duty of disclosure under the PEL (Article 28) is too limited and does not apply to all information affecting the partnership.[171] The limitation in scope perpetuates information asymmetry and effectively prevents LPs from monitoring the investment decisions made by GPs.

Moreover, these provisions apply to both general partnerships and limited partnerships.[172] In other words, the duties of the partner in the general partnership are the same as the duties of the GP in a limited partnership. However, in common law, the GP in a limited partnership has substantially more management rights than the passive LPs. Thus, in the US and EU, the fiduciary duties imposed on the GP are usually stricter than those of a partner in a general

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the partnership enterprise, the relevant proceeds shall attribute to the partnership enterprise. If any loss is caused to the partnership enterprise or to other partners, he shall bear the compensation liabilities." PEL, art. 99.

168. PEL, art. 28.

169. *Cf.* F&C Alt. Inv. (Holdings) Ltd. v. Barthelemy [2011] EWHC (Ch) 1731 (Eng.). Justice Sales identified the typical fiduciary duties: a fiduciary must not put himself in a position of conflict, a fiduciary must not make a profit from his position without informed consent, a fiduciary is required to act in the best interests of his beneficiary, and a fiduciary must act in good faith. *See id.* The duty to act in good faith is a compendious expression of duty and encompasses each of the first three duties. *Id.*

170. Partnership Act 1890, 53 & 54 Vict. c. 39, § 28 (Eng.).

171. *Cf.* Law v. Law [1905] 1 Ch 140, 150-59 (Kekewich J) (Eng.).

172. Article 60 of PEL provides that the P.R.C. LP is regulated under Chapter III of the PEL, which contains 25 provisions. Where Chapter III does not specifically provide for the relevant situation, there is a fallback clause, which states that the provisions on general partnership and its partners shall be used.

partnership.[173] Common law also generally imposes higher standards on the GPs than the LPs in a limited partnership.[174] Furthermore, these provisions fail to specify the liability for a partner's violation of each type of duty. The current state of the law allows opportunistic partners to easily escape sanction if the statute does not specify one as judges will not have guidance on the appropriate sanction that should be levied in case of breach.

Notably, Article 5 of the PEL specifies a general principle of good faith: "*The principles of willingness, equality, fairness and good faith shall be followed in the conclusion of a partnership agreement and in the establishment of a partnership enterprise*."[175] Arguably, this can be used as an overarching principle governing internal relationships between partners in partnerships and provide the much-needed flexibility to the courts in a rapidly developing area of law. However, this article does not apply at all times in the course of partnership business. It only applies to situations in "the conclusion of a partnership agreement and in the establishment of a partnership enterprise".[176]

While the principle of good faith (*chengshi xinyong yuanze*) is an overriding principle (*diwang tiaokuan*) in PRC civil law,[177] the current state of law remains unsatisfactory due to its many lacunas. Courts may only apply this principle when there is no specific legal provision governing a particular civil issue,[178] making the application of the principle of good faith limited. In this context, it would be misconceived to rely on the principle of good faith as a catch-all safety net and more specific laws will be required.

Duties of Fund Managers under CSRC Measures

To strengthen regulation of the private equity industry, the 2014 CSRC Interim Measures[179] provide several statutory duties and obligations governing fund managers in private equity funds.[180]

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173. *See, e.g.*, Palmer v. Fuqua, 641 F.2d 1146, 1155 (5th Cir. 1981) (holding that the sole general partner of the limited partnership, having exclusive power and authority to control and manage partnership, owed limited partners an even greater duty than is normally imposed on partners); Bassan v. Inv. Exch. Corp., 83 Wash. 2d 922 (1974) (holding that limited partners had no effective voice in the decision-making process and were entitled to rely on a high standard of conduct from the general partner).

174. *See* J. William Callison & Maureen A. Sullivan, Partnership Law and Practice: General and Limited Parnterships § 12:4 (2017).

175. PEL, art. 5.

176. *Id.*

177. Huixing Liang, *Principle of Good Faith and Gaps Filling*, 2 CHINESE L.J. 23 (1994).

178. Dong Fang, *Chengshi xinyong yuanze yu xinhetongfa* [*Good Faith Principle and New Contract Law*], 14(5) SHENHUI KEXUEJIA [SOCIAL SCIENTIST] 63 (1999).

179. CRSC Interim Measures, *supra* note 64.

180. Pursuant to the CRSC Interim Measures, the private equity investment funds (the "PE Funds") refers to the investment funds established within the People's Republic of China that conduct private offerings and target qualified investors during fundraising. *Id.*

- In the case of a fund manager managing multiple funds simultaneously, the same fund manager should adhere to the principles of professional management. The fund should also establish a mechanism to prevent conflicts of interest.[181]
- Article 23 stipulates nine prohibitions for fund managers, including, inter alia: "*not to treat the assets of different funds under management in an unfair manner*," "*not to take advantage of fund assets or their positions to seek benefits for, or transfer benefits to, themselves or persons other than investors*," "*not to divulge undisclosed information obtained by virtue of their positions, or make use of such information to engage in, or expressly ask or imply others to engage in, related trading activities*," "*not to engage in investment activities detrimental to fund assets and investor interests*," "*not to neglect duties, or fail to perform duties as required*," and "*not to engage in insider trading, market manipulation or other improper trading activities*."
- Fund managers have to disclose fund information to investors.[182]
- Considering that fund managers can contract out some of the duties in the agreements, Article 20 provides that fund managers in a closely held fund shall bear unlimited liability for the debts of the fund when the assets of the fund are insufficient to pay the debts of the fund according to Articles 93 and 94 of the PRC Securities Investment Fund Law.
- Fund managers owe a duty of good faith (*chengshi xinyong*) and care (*jinshen qinmian*).[183]

While the duties laid out above overlap with the duty of loyalty (e.g. Article 23) and duty of care (i.e. Article 4) under common law, there exists some important defects.

First, apart from the fact that the CSRC Interim Measures is an interim measure, the effectiveness of the Measures is undermined and of limited use in judicial practice. It is promulgated by the CSRC, which is a department under the State Council. It is ranked relatively low in the hierarchy of legal sources under Chinese law. The People's Courts have the discretion whether to refer to departmental regulations in relation to cases addressing private equity but cannot directly apply these measures in making judgments.[184]

181. *Id.* art. 22.

182. *Id.* arts. 64-65.

183. *Id.* art. 4.

184. According to Article 4 of the Provisions of the Supreme People's Court on Citation of Such Normative Legal Documents as Laws and Regulations in the Judgments (promulgated by the Sup. People's Ct., Oct. 26, 2009, effective Nov. 4, 2009), Interpretation No. 14 [2009] of the Sup. People's Ct. (China) [hereinafter Provisions on Citation], "the Judicial Administration shall use law, legal interpretation or judicial interpretation. Where suitable administrative regulations, local laws or autonomous regulations are concerned, they may be directly applied." Article 6 of the Provisions on

Second, it remains vague as to the standard applied in determining if the fund manager has breached his duties. Since the Chinese judiciary does not have law making power and there is no formal interpretation of the CSRC Interim Measures, it creates difficulties for practitioners as to that what kind of behavior will be deemed as a breach of duties.

Third, these duties apply to fund managers of all private funds such as private mutual funds, private equity funds, venture capital funds and hedge funds.[185] This 'one size fits all' approach fails to differentiate the relative risks posed by different types and sizes of fund managers and different types of funds.[186]

Other Remedies Available to LPs under the PEL

Although LPs have other remedies available under the PEL to protect their interests against GPs' potential wrongdoings, evidence shows that these remedies are not always effective.[187]

First, according to Article 49(1) of the PEL, a partner can be removed from the partnership when he fails to meet capital contribution obligations, causes losses to the partnership through intentional or gross negligence, or conducts himself improperly while carrying out partnership business. However, as discussed in my other paper,[188] removing a partner is not easy as it requires unanimous approval from all partners.[189] A large private equity fund that has many partners will find it even more difficult to obtain the requisite unanimous consent needed to expel a GP. Even if the LPs were able to reach a unanimous consensus and decide to pursue such a claim against the GP, existing cases show that Chinese courts are reluctant to order the removal of partners.[190] Furthermore,

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Citation states that "in relation to Article 3, 4 and 5, they may be used as valid legal bases if they are so found to be upon examination and in accordance with the requirements of the case."

185. Notably, the CSRC itself has stated that the rationale as to why fund managers of all private funds must report to the AMAC on the use of leverage is the systemic risks posed by leveraged buyout funds and hedge funds. Instead of carving out an exception, a "one-size-fits-all" approach is taken. *See* China Sec. Reg. Comm'n, *Explanations to the Drafting of Private Investment Fund Guidance Management Interim Measures (For Consultation),* SINA FIN. (Jul. 11, 2014), http://finance.sina.com.cn/money/smjj/20140711/181619680780.shtml (China).

186. This same criticism has been made with regards to the Alternative Investment Fund Managers Directive ("AIFMD"). *See* Eilís Ferran, *After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU*, 12 EUR. BUS. ORG. L. REV. 379, 398 (2011); *accord.* Directive 2011/61/EU, 2011 O.J. (L 174) 1 (EU) [hereinafter AIFMD].

187. For further discussion on the enforcement issues in the context of private equity limited partnerships in China, see Lin, *supra* note 39.

188. See generally Lin Lin, The Limited Partner's Derivative Action: Problems and Prospects in the Private Equity Market of China, 41(2) H.K.L.J. 517 (2011).

189. PEL, art. 49(1).

190. In the case of *Zhang Liming v. Shijiazhuang Long Run Investment Management Centre*, 2016 JI 1 MINZHONG 101, the limited partner applied to the court under Article 49 of the PEL for the removal of the general partner on the grounds that the latter failed to meet capital contribution obligations in accordance with the partnership agreement. It was held in that case that the court should not direct the

removing a GP will have a significant impact on the private equity fund as the GP is the manager that designs and executes the long-term investments.

Second, Article 68(6) of the PEL provides that a LP has the right to initiate a suit against a partner where the interests of the limited partnership have been violated.[191] However, as discussed in my other paper,[192] this law is very general and functions solely as a provision of principle. There are no supporting provisions of this article detailing how to bring the derivative action. For example, it is unclear whether a minimum percentage of ownership is required before LPs can initiate legal proceedings. Due to the absence of legal procedural clarity, some courts have adopted a conservative approach and require consensus by all the LPs before a derivative action will be granted.[193] However, due to the high costs and the lack of trust amongst all the investors, it is difficult to gain the approval of all LPs.[194] It is also unclear how litigation costs will be calculated and apportioned. Are litigation costs calculated based on the entirety of fund's assets under management or the investment amount committed by the LPs that are initiating the lawsuit? If it is the former, the costs incurred by the LP initiating the suit will be substantially higher and the free rider problem will also occur. The LPs that are initiating the derivative action will be liable for the high costs of litigation while any benefit arising from the litigation will be shared between the partners, thus dis-incentivizing LPs from pursuing litigation.

Furthermore, Article 68(7) of the PEL stipulates that the LPs can bring a lawsuit in their own names in the interest of the enterprise when the GP has "neglected the exercise of his rights (*daiyu xingshi quanli*)." However, LPs can rarely obtain the evidence required to prove such misbehavior. Key evidence is often retained by the GP and since LPs have no right to participate in the actual

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determination of whether an individual remains a partner in a partnership since that is a matter between parties within the autonomy of the partnership in accordance with the partnership agreement. The limited partner's claim was consequently dismissed. In *Cao Ruofu v. Guo Hua*, 2014 1 TAMIN 185, which concerned an application to remove a partner from a partnership enterprise, the court held that, because the removal of a partner is deemed to be a form of termination, it is used as a last resort in place of settlement and should thus be affected with great caution. According to Article 96 of the PEL, "[w]here a partner, when managing partnership affairs, or an employee of a partnership, by taking advantage of his position, takes into his own possession the interests that should go to the partnership or takes illegal possession of the property of the partnership by other means, he shall return such interests or property to the partnership; where he causes losses to the partnership or the other partners, he shall be liable for the losses according to law." In the aforementioned case, Cao Ruofu had, *inter alia*, sold partnership assets (red bricks) for his own interests and refused to hand over the sale proceeds of RMB 1 million to the partnership enterprise. *See Ruofo*, *supra* note 190. The claim against him was denied, however, because the LPs failed to exhaust all other means of settlement and the removal of a partner was allowed only as a last resort. *Id.*

191. Lin, *supra* note 39.

192. *Id.*

193. Interview with Mr. Zhong, Partner, DHH Law Group, in Singapore (Nov. 24, 2016); Interview with Mr. Deng, Senior Assoc., DHH Law Group, in Singapore (Nov. 24, 2016).

194. Telephone Interview with Mr. Chen, *supra* note 81.

management and operation of the partnership, it is difficult for LPs to collect relevant evidence through legitimate channels.[195] In addition, the fund manager is often a shell company with few assets. Even if the LPs successfully obtain a favorable judgment or arbitration award, it is likely that no property will be available for execution. There is a lack of judicial precedence in which LPs in a private equity fund have successfully litigated against the GP. The first successful derivative action lawsuit only occurred on 29 March 2017, whereby the Supreme Court ruled in favor of the LPs in *Anhui Ruizhi Real Estate Development Co. Ltd v. Jiao Jian and others.*[196] Apart from failing to initiate any legal proceedings on behalf of the partnership after two entrusted loans were due for collection, the GP also ignored LPs' repeated requests to exercise the partnership's creditor rights, failed to respond to subpoenas and did not appear before the Court of First Instance. Given that the GP had *de facto* abandoned the partnership's debt claims, China's apex court held that the GP had "neglected the exercise of [its] right." However, the law remains silent as to whether LPs have to exhaust other remedies before bringing a derivative action.[197]

PART V: MOVING FORWARD

In common law jurisdictions, partners have long been regarded in equity as fiduciaries among themselves.[198] Fiduciary duties play an essential role in governing the internal relations among partners.[199] Fiduciary duties have a prophylactic function. Imposing fiduciary duties on a specific party "[encourages] good behavior in persons other than the parties in the instant case."[200] Additionally, fiduciary duties serve an exemplary function for the purpose of the "safety of mankind."[201] Thus, anyone who breaches his fiduciary duties must bear the consequential legal liability. Fiduciary duties protect

195. Interview with Mr. Zhong, *supra* note 193; Interview with Mr. Deng, *supra* note 193.

196. Anhui Ruizhi Real Estate Development Co. Ltd. v. Jiao Jian, 2016 SUP. PEOPLE'S CT. GAZ. 756 (China).

197. Lin, *supra* note 188, at 538-42.

198. The very early description of a fiduciary duty in partnerships can be found in *Helmore v. Smith* [1885] 35 Ch D 436 (Eng.) (cited in LAW COMM'N & SCOT. L. COMM'N, PARTNERSHIP LAW, 2003, Cm. 1605, at 11 (UK)) and *Aas v. Benham* [1891] 2 Ch 244 (cited in *Boardman v. Phipps* [1966] UKHL 2, [1967] 2 AC 46 (appeal taken from Eng.)). The leading cases in this area include *Charles E. Corley, III v. Fred E. Ott*, 326 S.C. 89 (1997) (duty of loyalty during formation of partnership), *Latta v. Kilbourn et al.*, 150 U.S. 524, 541 (1893) (the partners must refrain from self-dealing), and *Meinhard v. Salmon*, 249 N.Y. 458 (1928). GEOFFREY MORSE, PARTNERSHIP AND LLP LAW 159 (8th ed. 2015). However, it must be noted that there are scholars arguing for the ability to contract out of fiduciary duties by partners. *See* Ribstein, *supra* note 99. Ribstein characterizes fiduciary duties as a "hypothetical bargain," arguing that fiduciary duties are a form of implied term in the contract between partners. *See id.*

199. *See* Stephen I. Glover & Craig M. Wasserman, Partnerships, Joint Ventures and Strategic Alliances § 5.02 (2003).

200. *See* GARY WATT, TRUSTS AND EQUITY 338 (2008).

201. *Id.*; *see also Parker v. McKenna* [1894] LR 10, Ch App. 96 (Eng.)

vulnerable parties by restraining opportunistic behavior.[202]

In the context of partnerships, fiduciary duties "fill in the gap" when there is no express duty specified in the partnership agreement or in the Partnership Act. As to the limited partnership, fiduciary duties are imposed on the GP for the purpose of protecting the non-controlling LPs.[203] In the US and the UK, apart from equitable fiduciary duties, many partnership statutes provide default rules governing the internal relationship among partners which come into effect whenever the partners fail to set out relevant terms.[204]

The legislative gap discussed in Part IV of this article suggests duties owed among partners is an area of law that requires reform in China. Arguably, the absence of fiduciary duties contributes to opportunism and misbehavior by GPs. Without strong duty constraints on GPs, GPs are more likely to pursue opportunistic behavior.[205] As a result, LPs may be less willing to entrust their investments to a GP or invest in the private equity market as a whole.

Transplanting the equitable doctrine of fiduciary duties found in common law jurisdictions into China is not feasible. Instead, a clear provision of statutory duties on partners under the PEL will bring much needed certainty and clarity into this area of law in China.

First, the theory of incompleteness of law proposes that "the more incomplete the law, the less effective the transplant will be."[206] An open-ended concept "cannot provide clear guidance for actual behavior or (act) as an effective deterrent against violations."[207] The doctrine of fiduciary duties is deemed to be one of the most elusive concepts in Anglo-American law.[208] Since it has not been fully defined even in common law jurisdictions, it would be very difficult to adopt in China. Moreover, the considerably different legal traditions and judicial cultures between common law and Chinese law would make the transplantation

202. *See* Antony I. Ogus, *Regulatory Arrangements and Incentives for Opportunistic Behavior*, *in* ECONOMIC ANALYSIS OF LAW IN CHINA 153 (Thomas Eger et al. eds., 2007); Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*. 55 VAND. L. REV. 1399, 1402 (2002).

203. Kenneth Jacobson, *Fiduciary Duty Considerations in Choosing Between Limited Partnerships and Limited Liability Companies*, 36(1) REAL PROP. PROB. TRUST J. 1, 6-8 (2001); Ribstein, *supra* note 48, at 939.

204. *See* HWEE YING, *supra* note 99, at 187. The Uniform Partnership Act (1997) also provides that "relations among the partners and between the partners and the partnership are governed by the partnership agreement. To the extent the partnership agreement does not otherwise provide, this Act governs relations among the partners and between the partners and the partnership." Nat'l Conf. of Comm'rs on Uniform St. L., Uniform Partnership Act § 103 (1997).

205. Lin, *supra* note 38.

206. Katharina Pistor & Chenggang Xu, *Fiduciary Duty in Transitional Civil Law Jurisdictions: Lessons from the Incomplete Law Theory* (Eur. Corp. Governance Inst., Working Paper No. 1, 2002), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=343480##.

207. *Id*.

208. *See* Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 37 DUKE L.J. 879 (1988).

unsuccessful. In common law jurisdictions, the scope and standard of fiduciary duties is greatly enriched by abundant case law. However, there is no principle of *stare decisis* in China and Chinese courts are not entrusted with lawmaking powers. This serves as a strong barrier to successful transplantation.

On the other hand, codification increases certainty, predictability, and accessibility of the law.[209] Statutory duties play an *ex ante* informative and preventive role by specifying what parties may or may not do. This may bolster investor confidence by assuring investors that their investments are properly protected by clear laws. Unlike the equitable doctrine of fiduciary duties, which is context specific, broad and open-ended, statutory duties are more certain and accessible. In almost all cases, it will be clear that the statutory obligations will apply to the partnership relationship. Apart from being consistent with China's legal culture and tradition of codification,[210] regulating partners' duties in statutory form is also consistent with the international trend. In the US and the UK, several fiduciary duties have been recently codified in the Partnership Acts.[211] The codification of the duty of good faith and the duty of disclosure owed by partners has also been proposed in the UK.[212]

Third, setting out partners' basic duties in statutory form will minimize transaction costs.[213] As discussed in Part III of this article, small Chinese firms are unable to construct tailor-made agreements due to their lack of experience and sophistication. Individual investors are unlikely to pay attention to the language of the partnership agreement due to information asymmetry.[214] With a clear set of statutory duties, GPs would be able to carry out their business with confidence instead of aimlessly navigating through multiple laws, regulations, and directives. In particular, in the Chinese market where LPs are relatively active in the management of the firm,[215] if a GP is subject to comprehensive statutory duties, LPs may have less desire to directly participate in management and this could reduce the potential internal conflicts between LPs and GP.[216]

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209. HART, *supra* note 102, at 126.

210. Codification exercises in China can be traced back to 536 B.C.E. in Chinese history. *See generally* John W. Head, *Feeling the Stones When Crossing the River: The Rule of Law in China*, 7 SANTA CLARA J. INT'L L. 25 (2010).

211. *See, e.g.*, Uniform Partnership Act § 404 (1997); Partnership Act 1890 §§ 29-30. It must be noted that the connotations of fiduciary duties differ between the U.S. and the U.K.

212. *See* LAW COMM'N & SCOT. L. COMM'N, *supra* note 198, at 189-92.

213. The costs of fiduciary duties may even outweigh the benefits. *See* Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 213 (2005).

214. Empirical studies show that, for partnership agreements where the LPs are natural persons, the section on the GP's disclosure duty is relatively brief and simple. On the contrary, when LPs are institutional investors, the disclosure duties on the part of GP are more comprehensive.

215. Lin, *supra* note 39.

216. Christopher Gulinello, *Venture Capital Funds, Organizational Law, and Passive Investors*, 70 ALB. L. REV. 267, 303 (2006).

However, over-policing through the imposition of excessive duties would cause the law to become out of tune with commercial realities and discourage individuals from accepting positions as GPs. The Chinese legislature has to ensure adequate regulation without undue alienation of industry players. Hence, aside from the general duties, it would be neither possible nor practical to prescribe any overtly specific duties. Instead, it would be more appropriate for the legislature to prescribe basic duties of partners and impose the minimum standard to ensure that the partners do not act in an unconscionable manner. Any further protection will have to be negotiated as between the partners in a manner tailored to the specific partnership arrangement intended.

The following statutory duties may be considered.

Duty of Loyalty

The duty of loyalty ensures that the GPs act in the best interests of the partnership. Under the Uniform Partnership Act (UPA) 1997,[217] and the Uniform Limited Partnership Act (ULPA 2001),[218] the duty of loyalty imputes liability when the partner misuses or misappropriates partnership property, abuses his position, or competes with the partnership.[219] Under the Delaware Code, the partner is accountable to the partnership and holds, as a trustee, any property, profit or benefit derived in his position as partner.[220] The partner must also refrain from competing or dealing with the partnership.[221]

The position in English Law is found in section 29 (duty to avoid conflicts)[222] and section 30 (duty not to compete)[223] of the Partnership Act 1890.[224] Section 29 contains the no-conflict rule and the no-profit rule.[225] This section forces a

217. In the U.S., apart from common law, partnership agreements, and state law, there are model laws proposed by the National Conference of Commissioners on Uniform State Laws for the governance of business partnerships by U.S. states. Although these model laws are not binding, they remain persuasive, as most of states have adopted the model laws.

218. Nat'l Conf. of Comm'rs on Uniform St. L., Uniform Limited Partnership Act § 408(b) (2001).

219. Uniform Partnership Act § 409(b) (1997); *see also* Uniform Limited Partnership Act § 409(b).

220. DEL. CODE ANN. tit. 6, § 15-404(b) (West 2017).

221. *Id.* The Delaware Court of Chancery also held in *In re USACafes, L.P. Litigation*, 600 A.2d 43 (Del. Ch. 1991), that, when the GP is a corporation, the corporation's board of directors will owe duty of loyalty to the LPs.

222. "Every partner must account to the firm for any benefit derived by him without the consent of the other partners from any transaction concerning the partnership, or from any use by him of the partnership property name or business connection." Partnership Act 1890 § 29.

223. "If a partner, without the consent of the other partners, carries on any business of the same nature as and competing with that of the firm, he must account for and pay over to the firm all profits made by him in that business." Partnership Act 1890 § 30.

224. Liability arises once it is shown that the business is in actual competition with the firm. Rochwerg et al. v. Truster et al. (2002), 58 O.R. 3d 687 (Can. Ont. C.A.).

225. *See* MORSE, *supra* note 198, at 170. The no-conflict rule applies to transactional conflicts (when the partner has an interest in the transaction the firm is undertaking) and situational conflicts (when the partner holds an interest that involves those of the firm). *Id.*

partner to account for any benefit "which was obtained or received by use of his fiduciary position or of opportunity or knowledge arising from it."[226] This is a wide provision that would work to prevent almost all cases of unduly profiting from one's position as a partner.[227]

In China, as discussed in Part IV of this article, a similar overarching principle is found in Article 32(3) of the PEL, which provides that partners shall not engage in activities that damage the interests of the enterprise. The problem is that the PEL's standard is much lower and more general than the duty of loyalty in the US and the UK. Although the CSRC Interim Measures supplement the PEL with a list of scenarios which are similar to the duty of loyalty, they are interim rules and are too vague to be of use.

Some argue that the current regulatory approach is misguided. On the one hand, the *lex superior* legislation (e.g. the PEL) suffers from substantial uncertainty and fails to include adequate statutory duties. On the other hand, the CSRC Interim Measures and AMAC's self-disciplinary rules are excessive and needlessly repetitive.

As such, China should reexamine the *lex superior* legislation, especially the PEL, to clearly establish the GPs' duties and responsibilities. Private equity regulation cannot solely rely on piecemeal and paternalistic intervention by the CSRC and AMAC. Rather, it should be integrated into a broad, streamlined financial supervision framework. A better approach would be to frame the scenarios found in Article 23 of the CSRC Interim Measures as a non-exhaustive list under a general duty of loyalty of the PEL. Aside from the clarity of this approach, this would also allow judges to apply the national law, i.e. the PEL, properly even when the facts of the case do not fall neatly into the scenarios listed.

Duty of Care

The concept of a duty of care helps ensure that GPs take proper care in the course of management. Generally, the US duty of care requires partners to refrain from engaging in "grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law."[228] The duty of care is taken from the development of the tort of negligence in common law.[229] Unlike the duty of loyalty, which requires the fiduciary to act in the best interest of the beneficiary,

226. *Chan v Zacharia* (1984) 154 CLR 178 (Austl.).
227. *See* MORSE, *supra* note 198, at 171.
228. Ribstein, *supra* note 48, at 962.
229. *See* Donoghue v. Stevenson [1932] AC 562 (HL) (appeal taken from Scot.).

the duty of care is a management duty.[230]

The PEL does not specify any duty of diligence/care. Article 35 of the PEL simply states that the "management of the partnership shall fulfill his responsibilities within the scope authorized by the partnership".[231] It also fails to define the standard of care owed and merely provides that "the management of the partnership shall bear the legal liabilities if he exceeds his authority or he incurs such liabilities due to his intentional or material negligence."[232] These general statements have created difficulties in judicial practice. As a result, the Chinese judicial case database[233] reports very few cases relating to breach of duty by partners (e.g. Article 32 and Article 35 of the PEL).[234]

A similar duty of care is found in Article 3 of the CSRC Interim Measures, which requires that parties abide by the principles of "honesty and trustworthiness (and) protection of the legitimate rights and interests of investors." Article 6 of the "Administrative Measures on Private Investment Fundraising Activities" also imposes a duty to act with "diligence."[235]

Hence, the question revolves around what standard of care should be applied in determining if there has been a breach of this duty. The standard of care has been evolving and varies from jurisdiction to jurisdiction.[236] Lord Hamilton in the case of *Ross Harper and Murphy v. Banks* stated that under the UK tort of negligence, the test should be objective and dependent on the context of the partnership.[237] Generally, the court considers whether the partner can show that he has acted as a reasonable businessman would under the circumstances.[238] However, the court will also take into account special skills or experience that

230. J.C. SHEPHERD, THE LAW OF FIDUCIARIES 48 (1981). It must be noted that the nature and connotation of the partners' duty of care is different in the U.S. than it is in the U.K.

231. PEL, art. 35.

232. While the PEL does not directly stipulate the GP's duty of care and duty of diligence, it imposes such duties on the management personnel of the partnership. The standard of care is low and managers are only liable for intentional or gross negligence.

233. Peking University Legal Case Database.

234. *See, e.g.*, Cheng v. He Jinming & Li Chongying, 2016 ZHEJIANG 41; Tin Li v. Yu Guanghai, 2014 ZIBO 143; Cheng Shixuan v. China No 4. Metallurgical Construction L.L.C., 2014 SUZHOU INTERM. PEOPLE'S CT. 01002. There are other related cases in the context of general partnerships.

235. This is also mentioned in Article 4 of the CSRC Interim Measures.

236. Initially, American courts tended to use the "reasonable care standard" as the test for finding a duty of care in partnerships. Under the reasonable care standard, a partner is held to be liable if his or her conduct is unreasonable. Later the "good faith standard" prevailed and became the accepted standard for determining partners' duty of care. Under the good faith standard, a partner is not liable to the partnership or his or her co-partners for acts which are not fraudulent or wanton and which are undertaken in good faith. In recent years, there has been a trend toward using the business judgment rule in defining gross negligence in partnerships.

237. *See* Ross Harper & Murphy v. Banks [2000] SLT 699 (CSOH) (Scot.).

238. *Id.*

the partner claims to possess.[239] To promote clarity and certainty, the UK Law Commission provisionally proposed the following standard to determine the duty of care in general partnerships: *"partners are expected to act with such care and skill as can reasonably be expected of those with the general knowledge, skill and experience that the partners have or purport to have."*[240]

In contrast, in evaluating whether there has been a breach of the duty of care, the American UPA[241] and the Delaware Code[242] considers whether the partner has engaged in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of the law. The US courts have also adopted the business judgment rule to determine the general partner's liability for duty of care breaches.[243] A GP will be entitled to the protection of the business judgment rule. To counter this protection, LPs will have to rebut the presumption that the GP was acting with the care that a person in a like position would reasonably exercise under similar circumstances when making a business decision.[244] Notably, in the context of corporate directors, local Chinese courts have adopted different standards of care, with one adopting the business judgment rule while others preferring the objective standard of care under the English law.[245]

It is submitted that China should follow the "gross negligence" standard set by the UPA and the Delaware Code. As highlighted above, the aim of this duty is only to protect against bad behavior and not to find liability for business mistakes. Additionally, the higher threshold would be consistent with business realities in China. A test that is too strict may cause partners to be overly cautious with their business decisions, resulting in a cooling effect and further market failure. At the same time, the statutory provision of duty defined by the UPA and the Delaware Code is clearer than the common law test found in the UK. Thus, they would be more suitable for transplant into a civil law jurisdiction.[246]

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239. *Winsor v. Schroeder* [1979] 129 NLJ 1266 (cited in LAW COMM'N & SCOT. L. COMM'N, *supra* note 198, at 198).

240. LAW COMM'N & SCOT. L. COMM'N, *supra* note 198, at 186.

241. Uniform Partnership Act § 409(c) (1997); *see also* Uniform Limited Partnership Act § 409(c). Under the UPA, the duty of care imputes liability when the partner engages in "grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of the law."

242. Uniform Partnership Act § 409(c) (1997); DEL. CODE ANN. tit. 6, § 15-404(c) (West 2017).

243. *See generally* Jackson v. Marshall, 140 N.C. App. 504, 537 S.E.2d 232 (2000); Rosenthal v. Rosenthal, 543 A.2d 348 (Me. 1988).

244. *See generally* Rosenthal v. Rosenthal, 543 A.2d 348 (Me. 1988).

245. *See generally* Tianshu Zhou, *Standard of Care Required for Directors' Duty of Diligence*, 10 LEGAL MAG. 93 (2014).

246. The fact that Chinese judges do not have rich experiences and sophisticated techniques in applying precedents should not be an excuse for not adopting the business judgment rule in the P.R.C. partnership law. In fact, the Japanese experience also shows that the practical significance of the statutory fiduciary obligation depends on how prepared the legislature and judiciary are to create a favorable legal infrastructure for the invocation of the fiduciary principle. It is therefore suggested that the Chinese

However, the business judgment rule, which acts strongly in favor of GPs, is a development that should be postponed in China, given the discussed ineffective market mechanisms. In principle, it is a desirable doctrine, as partners who have exercised their management duties in good faith should not be penalized. However, the main concern in China is the lack of protection for investors. If the PEL codified the business judgment rule at the same time the statutory duties are imposed on the GPs, it would send conflicting messages to the market. If the business judgment rule is implemented, this should occur following a periodic review by the appropriate authorities.

Given that China lacks an existing set of case law that judges can rely on to comfortably determine with certainty whether there has been a breach, having broad definitions under a proposed business judgment rule may result in judges absolving wrongdoing partners from liability due to uncertainty in the law. If the business judgment rule is adopted, a proposed solution is to impose statutory presumptions of a breach when the more common situations involving breaches of duty are involved. This shifts the evidential burden onto GPs who tend to be more sophisticated and better placed to disprove any wrongdoing when there is an alleged breach of duty and appropriately limits the scope of the business judgment rule.

Mandatory Statutory Duties

In Delaware, the main policy is to "give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements."[247] Hence, parties to the partnership agreement can contract out of the default duties prescribed by the Delaware Code. This position is not followed in the UPA, which provides special protection to certain duties. Under the UPA, the partnership agreement may not eliminate the duty of loyalty and the obligation of good faith or unreasonably reduce the duty of care.[248]

China should adopt the approach taken in the UPA and the statutory duties prescribed should be mandatory duties rather than default duties. This is in line with the objective (outlined in this article) of providing a minimum standard of protection to Chinese investors, who are mostly unsophisticated. As shown in Part III of this article, draft LPAs tend to be provided by the GPs and there is no guarantee that the LPAs will be structured in a way that will offer the minimum standard of protection that is deemed desirable. By ensuring that basic duties are enforced in all partnerships, the regulator would not only be able to maintain

legislature and judiciary can take steady steps toward introducing the concept of the business judgment rule in the context of the P.R.C. limited partnership.

247. DEL. CODE ANN. tit. 6, § 17-1101(c) (West 2017).

248. Uniform Partnership Act § 103 (1997).

minimum standards of conduct, but also respond to public concerns that have arisen due to the recent fundraising scandals. If the duties are contractually waivable, there could be some scrambling to undo the damage when GPs find means to creatively abuse the partnership agreement.

Duties Alone Are Insufficient

When attempting to impose duties on GPs in China, the compatibility of these duties with the existing legal system, including the degree to which judges are competent in applying complex doctrines, must be considered.

China currently has a rudimentary legislative framework to govern GP's behavior. Most regulatory measures are self-disciplinary rules that may not be judicially recognized in practice. There has been no court case regarding the duties owed by private equity fund managers.[249] Even in the relatively mature field of Chinese corporate law, aggrieved parties rarely assert their rights by initiating claims against directors for breach of duties.[250] With regard to the statutory duties of loyalty and duties of diligence owed by directors under Chinese company law, Xu et al. also found that there is a lack of flexibility in judicial decisions.[251] Chinese courts have taken a rigid approach to enforcing the prescribed statutory duties and are likely to relieve managers of liability unless the alleged breach is expressly proscribed in statutory form.[252] As a result of their limited competence, restricted power of legal interpretation and bureaucratic incentive structure, "the role of Chinese judges in implementing fiduciary duties is [restricted] to those cases where the current legal provisions can almost automatically apply."[253] The Chinese courts' focus on the text of the statute may invite managers to creatively structure unfair transactions that conform to the letter of the law but substantially harm the interests of investors.[254] Due to the institutionally weak judiciary and legislative gap in interpreting the duties, enforcement of breach of duties remains problematic. As such, before judicial enforcement of duties can play an active role in constraining the behavior of fund managers, drastic improvements are required in both investor awareness and the

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249. Peking University Legal Case Database.

250. Guangdong Xu et al., *Directors' Duties in China*, 14 EUR. BUS. ORG. L. REV. 57, 64 (2013). For a discussion on judicial enforcement of duties in China, see Xiaoyu & Xuke, *Simu guquan jijin guanliren xinyi yiwu yanjiu* [*Studies of the Fiduciary Duties of Private Equity Fund Managers*], 37(6) MOD. L. SCI. 86 (2015) (China), and Luo Peixin, *Zimaoqu shangshi caipan jingyan kefuzhi, ketuiguang zhi kunjing bianxi: yi xinyi yiwu anjian de shizheng fenxi wei shijiao* [*Commercial Judgment Experience: Empirical Studies of the Cases Relating to Fiduciary Duties*], 2014(5) XUESHU YUEKAN [ACAD. MONTHLY] 46, 46-49 (2014) (China).

251. Xu et al., *supra* note 250, at 66.

252. *See* Xu et al., *supra* note 250, at 68.

253. *Id.*

254. *Id.* at 69.

professional quality of lawyers and judges.

Moreover, other regulatory measures must also be introduced. While AMAC has established the filing system and the information disclosure system, further work needs to be done to improve the private equity industry's market integrity. In particular, investor education should be strengthened to increase risk awareness and investor sophistication.[255] Other market mechanisms, such as credit rating and the 'dishonest persons subject to enforcement' mechanism, should also be enhanced to rescue the lost investor confidence.[256] In light of the talent shortage,[257] development of private equity professionals should be another priority for the industry. Lastly, training should be conducted to allow present practitioners to fully understand the regulatory history, status quo and any regulatory changes.

PART VI: CONCLUSION

Private equity fund managers completely fall outside the scope of regulation in a number of major financial centers (including jurisdictions where the private equity market is highly developed). This Article finds that while the laissez-faire approach is regarded as the optimal policy choice in other jurisdictions,[258] it is not suitable in China due to the prevalence of unsophisticated individual investors and inexperienced fund managers. The perceived market failure in light of the fundraising scandals and previous lack of regulation have caused the Chinese market to be a fertile ground for fraud. Additionally, there are legal and institutional barriers preventing investors from legally safeguarding their interests.

Although regulators have taken proactive steps to strengthen regulation of China's private equity industry, the intrusive approach has substantively increased operational costs while failing to adequately protect investors. It is argued that the current regulatory approach is misguided and the focus should instead be on the fund managers.

This paper argues that in formulating the preferred regulatory approach for the private equity market in China, one should be mindful of the unique characteristics of the Chinese market such as the large number of individual

255. Telephone Interview with Ms. Lu, Legal Couns., Chinalin Sec. Holdings (Mar. 29, 2017).

256. Telephone Interview with Mr. Chen, *supra* note 81; Telephone Interview with Mr. Chen, Vice President, Linyi Cap. (Dec. 20, 2016).

257. For more information on the lack of experienced GPs in the Chinese private equity sector, see Lin, *supra* note 39. Interviewees also pointed out that Chinese GPs are generally inexperienced. Most of them were previously investment bankers without any experience in private equity. Telephone Interview with Mr. Chen, *supra* note 81; Telephone Interview with Mr. Chen, *supra* note 256.

258. Thomsen, *supra* note 15. Thomsen argues that the market force is working well in the PE context. Banks and labor unions appear to have both the ability and the incentives to safeguard against managerial conflicts of interest, excessive debt, and other maladies.

investors, the lack of effective legal protection due to the absence of duties owed by GPs, as well as the defective private enforcement of these duties by LPs. The proposed form of regulation aims to address these unique problems while striking a balance between investor protection and market efficiency.