NUS Working Paper 2017/008
NUS Centre for Banking & Finance Law Working Paper

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

Lin Lin

lawll@nus.edu.sg

[July 2017]

PRIVATE EQUITY INVESTOR PROTECTION: CONCEPTUALIZING DUTIES OF GENERAL PARTNERS IN CHINA

Berkeley Business Law Journal, forthcoming 2017

Draft as of 13 July 2017

DR. LIN LIN*

ABSTRACT

Unlike US and EU markets where typical concerns about private equity are 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 conventional views that private equity is a highly competitive market involving sophisticated investors and hence the relationship between managers (general partners) and investors (limited partners) requires no regulatory attention. By 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, most measures are piecemeal and 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, the attempts to rely on administrative measures and self-regulation by the relevant bodies to plug the gaps have also proven to be ineffective. Therefore, I advocate that the regulatory focus should be on the fund managers and, consequently, specific statutory duties should be imposed on them to enhance investor protection to respond to an ever-changing industry.

* 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 thank comments from Zenichi Shishido, Dirk Andreas Zetsche, Miu Ruobing, Wu Wei and Water Wan Weiqi. The research is supported by the NUS Start-up Grant (WBS No: R-241-000-134-133) All errors remain my own.

I. Introduction 1

II. The Need for Investor Protection in Private Equity 6

A. The Agency Problem 7

B. Unsophisticated "Qualified Investors" 9

C. Market Failure 14

III. A Qualitative Analysis of Contractual Duties Owed by GPs in China 15

A. Clauses Addressing Conflicts of Interest 17

B. Clauses Addressing Duty of Care 19

IV. Deficiencies in the Statutory Framework 20

A. Problematic Regulatory Responses 20

B. Statutory Duties in Existing Law 27

a. Duties of Partners under the PEL 27

b. Duties of Fund Managers under CSRC Measures 29

c. Other Remedies Available to LPs under the PEL 31

V. Moving Forward 33

A. Duty of Loyalty 36

B. Duty of Care 37

C. Mandatory Statutory Duties 40

D. Duties Alone Are Insufficient 40

VI. Conclusion 41

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] It includes investments in venture capital or growth investments, as well as late stage mezzanine, turnaround and buyout investments.[2]

China's private equity industry is expanding at an unprecedented pace and has now become the world's second largest[3] and Asia's largest private equity market in terms of fundraising amount (See Figures 1 and 2). As of 2016, China has raised USD 75.9 billion in private equity funding,[4] 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).[5] In 2016, 2438 new private equity funds were established in China.[6] Fundraising amounts reached a record high of RMB 1370 billion (USD 198.4 billion), nearly tenfold from in 2006 (see Figure 1).[7] 9,124 private equity investments worth RMB 744.9 billion (USD 80 billion) were made in China[8] and there were 4871 exits.[9] As of the end of February 2017, the Asset Management Association of China (AMAC) oversees 8621 private equity management firms, and approximately 16912 private equity funds managing a total paid-up capital of RMB 4890 billion (USD 709.33 billion) (see Table 1).[10]

However, due to the lack of a clear regulatory framework governing the private equity sector prior to 2014, numerous concerns have surfaced in this rapidly developing market. In particular, many private equity fund managers have been involved in illegal fundraising activities that caused investors to suffer huge losses. One typical example is where fund managers mislead retail investors to make private equity investments by publishing false information, fabricating non-existent projects and guaranteeing returns that do not materialize. There have also been

---

[1] THE OXFORD HANDBOOK OF PRIVATE EQUITY 3 (Douglas Cumming ed., 2012).

[2] *Id.* at 3.

[3] KWEK PING YONG, PRIVATE EQUITY IN CHINA: CHALLENGES AND OPPORTUNITIES (2012).

[4] PRIVATE EQUITY INTERNATIONAL, 2016 APAC FUND MANAGER'S GUIDE 4 (2016), *available at* https://www.privateequityinternational.com/uploadedFiles/Private_Equity_International/PEI/Non-Pagebuilder/Aliased/News_And_Analysis/2016/July/Magazine/PEI%20147_APAC%20Fund%20Guide%2016.pdf.

[5] *Id.*

[6] Qingke Research Center, *Qingke Research: 100 Page PPT to explain China's Equity Investment Market in 2016*, PE DAILY (Jan. 22, 2017, 2:25 PM), http://research.pedaily.cn/201701/20170122408335.shtml. This figure includes venture capital.

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] Touzijie, *Private Equity AUM exceeds 11 trillion RMB, Attached is China's latest 1 trillion RMB funds distribution graph* WEI XIN (Mar. 23, 2017), http://mp.weixin.qq.com/s?__biz=MjM5NDAzMzQ2MA==&mid=2652317266&idx=1&sn=a138f3c855e6923a3dd3ac1952f1755e&chksm=bd6e7c098a19f51f3a11ba0e58bcca5abb5850faf0a2807a16c48f25f3a54e6495356e38fc5a&mpshare=1&scene=5&srcid=0324eaNfIV756IBzJ2uLzXwt#rd.

cases involving the misappropriation of funds.[11] In a recent case, Harvest Capital Management Company raised funds from investors by promising exceedingly high monthly returns. Fund manager Chen Wei later absconded with the fund raised, causing losses of a few billion RMB to nearly a thousand investors.[12]

As seen from the example above, concerns in the Chinese private equity market revolve around illicit fund raising activities.[13] The issue here 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.[14] The unique problems seen in the Chinese market have been neglected by the national law[15] and current regulatory responses fail to address this issue adequately.

The evidence of market failure in China challenges the conventional view that the relationship between managers and investors requires no regulatory attention as the private equity sector is a highly competitive market involving sophisticated investors.[16] This paper focuses on investor protection and the relationship between fund managers and investors.[17] It finds that although Chinese regulators are strengthening the regulation on the private equity sector to address the managerial abuse, this is done in a 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, reducing market efficiency.

On top of the deficiencies of the current regulatory response, the situation is worsened by the lack of fiduciary duties in Chinese partnership law. Unlike its common law counterparts, Chinese partnership law does not have any equivalent concept of fiduciary duty which can be imposed on partners. Meanwhile, the Partnership Enterprise Law of the People's Republic of

---

[11] Biao Feng, *Increase in Private Equity Fund Absconding Incidents; CSRC highlights four regulatory principles*, NATIONAL BUSINESS DAILY (Apr. 29, 2016, 7:21 PM), http://www.nbd.com.cn/articles/2016-04-29/1001751.html.

[12] Yang Cheng Night News, *Shenzhen Private Equity Fund Attracted Billions in Investment; Managers absconded leaving thousands of investors with no recourse*, SINA FINANCE (Jul. 2, 2014, 05:23AM), http://finance.sina.com.cn/money/smjj/20140702/052319582014.shtml.

[13] See Curbing the Illegal Fundrasing Activities (April 25, 2016) Shanghai Securities News, http://www.csrc.gov.cn/pub/shanxi/xxfw/sxgzjx/201604/t20160425_296446.htm

[14] See Peter Morris & Ludovic Phalippou, *A New Approach to Regulating Private Equity*, 12(1) J. Corp. L. Stud. 59, 60 (2012). See also, FINANCIAL SERVICES AUTHORITY, PRIVATE EQUITY: A DISCUSSION OF RISK AND REGULATORY ENGAGEMENT 59 (2006), *available at* https://www.treasurers.org/ACTmedia/dp06_06.pdf ("*FSA Paper*").

[15] There is no specific national law on private equity in China.

[16] See e.g. Steen Thomsen, *Should Private Equity Be Regulated?*, 10 Eur. Bus. Org. L. Rev. 97, 104 (2009); MaeNeil, I. Private Equity: The UK Regulatory Response, (2008) Capital Markets Law Journal, 3(1), 18-31.

[17] Although there are emerging concerns on systematic risks and excessive leverage in Chinese private equity market, this article does not address these issues.

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 sample of hand-collected dataset of private equity limited partnership agreements (LPAs) [18] to examine how GP's duties are contracted in China. I also supplement the agreements with interviews with 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.[19] I find that most of the Chinese LPAs are insufficient in constraining GPs' conduct. There are legal, institutional and social barriers for LPs to negotiate before they can contractually impose comprehensive duties on GP 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 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 is required. It advocates that addressing the relationship between fund managers and investors (GP and LPs) would be a more effective and less expensive way to achieve regulatory aims. I suggest that the key of 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. The proposed specific statutory duties would enhance investor protection in the ever-changing industry.

This article further 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 also no equivalent concept of fiduciary

[18] 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 People's Republic of China. 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, Deheng Law Firm, 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.

[19] 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), Deheng Law Firm (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.

duties on partners, such as Korea and Taiwan.[20] My findings have policy implications for future law reforms in civil law jurisdictions that are considering introducing fiduciary duties on partners 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.[21]

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 crucially 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 concludes.

[20] Chong Kee Lee, HOW TO ADOPT AND DEVELOP ANGLO-AMERICAN CONCEPT OF FIDUCIARY LAW IN A CIVIL LAW SYSTEM: A KOREAN PERSPECTIVE, http://www.law.nyu.edu/sites/default/files/ECM_PRO_071736.pdf (last visited May 4, 2017, 5:37PM).
[21] E.g. Department for Business, Energy & Industrial Strategy, REVIEW OF LIMITED PARTNERSHIP LAW: CALL FOR EVIDENCE, https://www.gov.uk/government/consultations/review-of-limited-partnership-law-call-for-evidence (last visited Apr. 28, 2017, 4:13 PM).

Figure 1: Private Equity Fund-rasing in China 2006-2016 (RMB)[22]

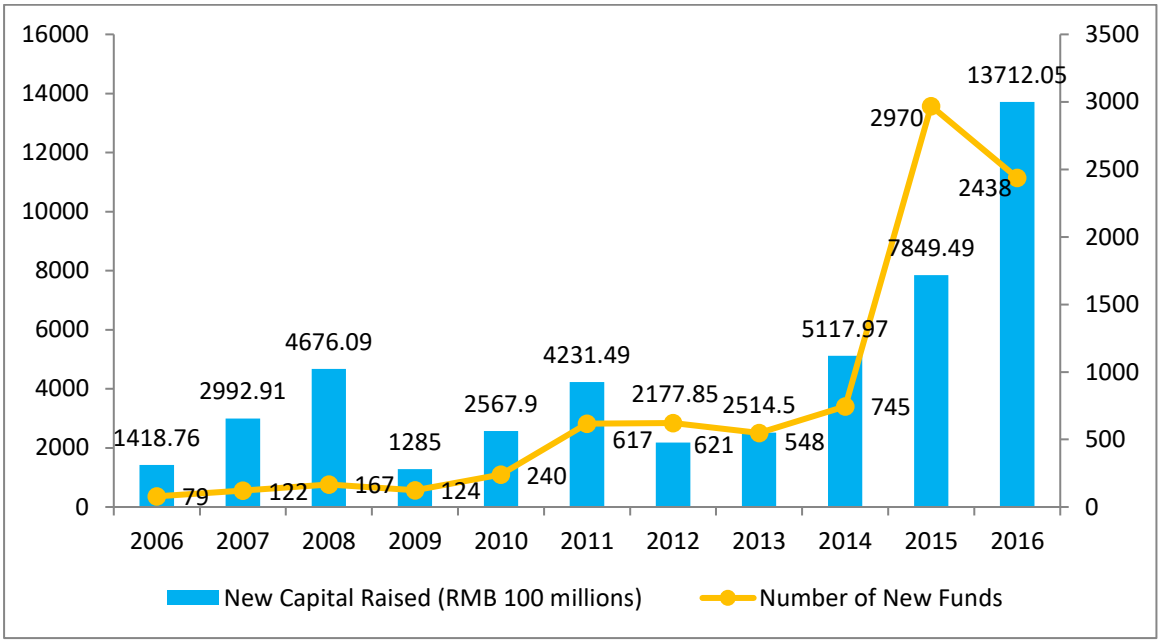
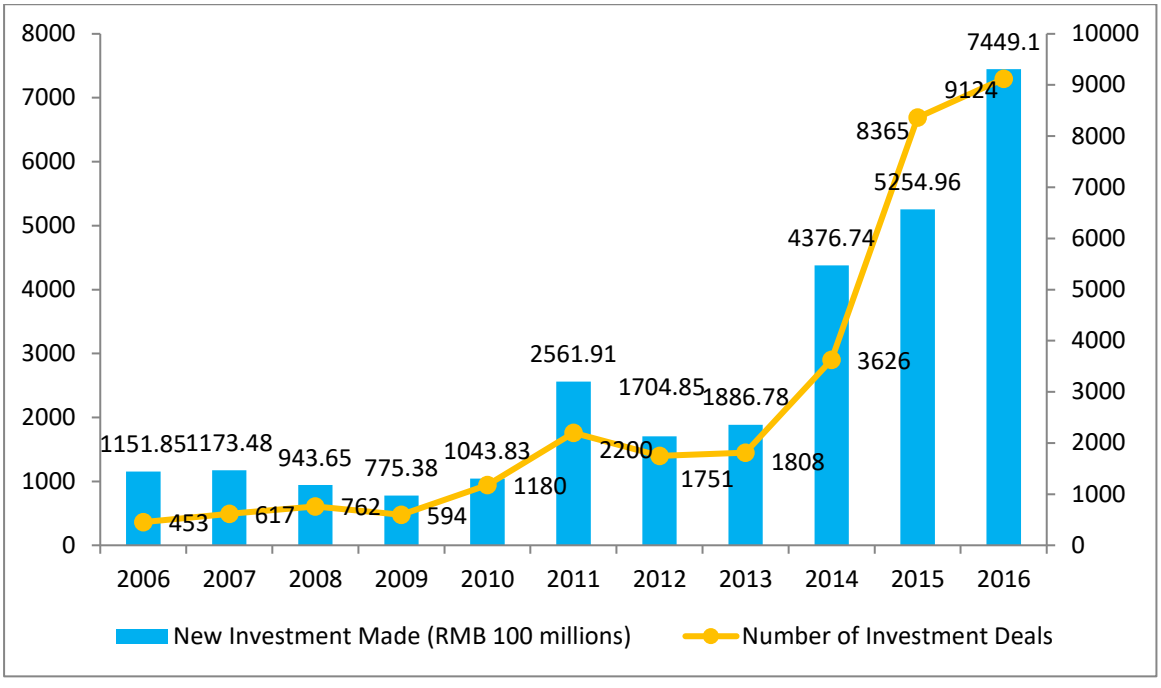


Figure 2: Private Equity Investments and the Number of Investment Deals in China 2006-2016 (RMB)[23]



[22] ZERO2IPO, 2016 CHINA PRIVATE EQUITY ANNUAL RESEARCH REPORT (2017).
[23] *Id.*

Table 1. Alternative Investment Fund Market in China (as of Feb 2017)[24]

	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

II. The Need for Investor Protection in Private Equity

Private equity has always been fraught with controversy, with calls for the regulation of private equity growing following the 2007-2008 Financial Crisis. The proponents for regulation generally warn of systemic risk concerns and the need to increase transparency in the industry.[25] Europe's Alternative Investment Fund Managers Directive (AIFMD) and United States (US)' Dodd-Frank Act, both adopted in the aftermath of the crisis, contain provisions specifically 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 put in place, *inter alia*, remuneration policies and practices designed to promote effective risk management.[26] Funds are also mandated to use depository and valuation mechanisms.[27] Notably, AIFMD has been criticised for having the wrong regulatory target as any systemic risk brought by the widespread failure of private equity-backed companies would be on the banking system, which extends credit to private equity buyers, instead of the private equity sector.[28] AIFMD thus imposes significant and undue compliance costs on the private equity industry.[29] In contrast, under the Volcker Rule,[30] banking entities in the US are prohibited from

[24] Touzijie, *supra* note 10.
[25] Jennifer Payne, *Private Equity and Its Regulation in Europe*, 12 Eur. Bus. Org. L. Rev. 559, 560 (2011).
[26] *Id.*
[27] *Id.*
[28] 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).
[29] *Id.* at 660.
[30] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, art. IV, 124 Stat. 1376 (2010), § 619.

acquiring or retaining any interest in private equity funds so as to reduce excessive risk taking by the banking sector. The Dodd-Frank Act's measures to curb systemic risk thus focus on the correct contributor (banks) instead of needlessly penalising 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.[31] Overall, the US had adopted a softer approach than Europe with regards to private equity regulation.[32]

Investor protection was one of AIFMD's objectives since the Financial Crisis demonstrated that even professional investors require reliable and comprehensive information.[33] However, there has undoubtedly been a shift in the policy rationale to a stronger emphasis on the stability and integrity of the financial system[34]. As compared to the focus on leverage, systemic risks and short-termism, investor protection appears to have received relatively little public and academic attention.[35]

The traditional laissez-faire regulatory approach assumes that investors investing in private equity funds do so knowing the risks involved and will safeguard their interests via contractual negotiations.[36] This section argues that these traditional views are overconfident about the ability of investors to protect themselves. The assumption that private equity investors can always protect themselves by means of contract in an arm's length bargain is especially flawed in China, where most investors are not institutional investors but individuals who may not be financially sophisticated. There is thus a strong case for investor protection in China.

A. The Agency Problem

The root of the investor protection problem in the private equity context is the agency problem. Investors expect managers to maximise returns on their investments, whereas managers may be primarily motivated by self-interest. Matters are exacerbated in private equity funds, with the structure of limited partnership providing opportunities for abuse. 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

[31] Seretakis, *supra* note 28, at 662.
[32] *Id.*
[33] EUROPEAN COMMISSION, 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 8 (2012), http://ec.europa.eu/internal_market/investment/docs/20121219-directive/ia_en.pdf.
[34] Dirk Zetzsche, *Investment Law as Financial Law: From Fund Governance over Market Governance to Stakeholder Governance*, *in* THE EUROPEAN FINANCIAL MARKET IN TRANSITION 339 (Birkmose et al eds., 2011).
[35] Morris & Phalippou, *supra* note 14. Steen, *supra* note 16.
[36] *Supra* note 16.

to the fund and enjoy the protection of limited liability from the debts and obligations of the firm. However, they are not allowed to participate in the fund's management under the default rule of the limited partnership.[37]

Since the LPs (the principal) cede control and delegate the decision-making authority to the GP (the agent), agency costs easily arise as the GP may not always act in the best interests of the LPs and could abuse his managerial position.[38] Limited partnership law further constrains the ability of LPs to curb managerial excesses, due to the 'control rule', which renders them liable for the limited partnership's obligations if they attempt to intervene in the partnership's management.[39] 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 as doing so generally requires the consent of all partners.[40] In view of the above, the agency problem is presented in the limited partnership in a more extreme form than that found in a company.

In essence, there are conflicts between (1) the self-interests of GPs to be paid management fees, carried interests and other compensation; and, (2) the self-interests of LPs to obtain high risk-adjusted performance at low cost and to make profits from investment. 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. There are many other ways for GPs to abuse their powers. Apart from overvaluing assets, the GP may also act myopically in an attempt to maximise its collectible carried interest at the expense of the long-term interests of the LPs. Prospering investments may be prematurely exited to reduce monitoring costs while underperforming investments may be continued in the hope of increasing value.[41] There are also problem of moral hazard where the GP misuses the raised funds and engages in excessively risky investments.

The problem of information asymmetry is also presented in an extreme form in the context of private equity limited partnership. While the GPs are generally contractually required to

---

[37] Partnership Enterprise Law of the People's Republic of China ('PEL'), Order of the President of the People's Republic of China No. 55 (2006) , Art 68.

[38] MC Jensen & WH Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3(4) J Fin. Econ. 305, 308 (1976).

[39] Lin Lin, *Managing the Risks of Equity Crowdfunding: Lessons from China*, 17(2) J. Corp. L. Stud. 1- 40 (2017).

[40] Lin Lin, *Private equity limited partnerships in China: A critical evaluation of active limited partners*, 13(1) J. Corp. L. Stud. 185 (2013).

[41] Christopher Brown & Roman Kraeussl, *Risk and Return Characteristics of Listed Private Equity*, *in* THE OXFORD HANDBOOK OF PRIVATE EQUITY 614 (Douglas Cumming ed., 2012).

disclose information to LPs, most limited partnership agreements do not provide the LPs with extensive rights of access to information.[42] The significant information asymmetry between the GP and the LPs means that it is difficult for investors to obtain any updated and accurate information about an investment, confirm the fund's exact success rate, or evaluate the diligence of the GP.[43] This information asymmetry is further amplified by the inherent difficulties in valuating private equity investments. Private equity funds are not traded on the public market and, hence, the market price of portfolio companies is not readily available.[44] 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 may 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.[45] However, such optimism is arguably misconceived.[46] First, when the GP is organized as a company, the issue of unlimited liability has effectively been sidestepped. Second, this device only reduces creditors' risks without alleviating the concern of LPs. In China, due to regulatory restrictions on taking bank loans to fund merger and acquisition transactions,[47] a Chinese private equity fund usually does not use highly leveraged debt financing on the fund level. Therefore, insolvency of those funds rarely exists.[48] Also, personal liability itself is unable to prevent the GPs from pursuing opportunistic behaviors or to ensure that they act for the best interests of the partnership.[49]

B. 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

---

[42] Julia Khort, *Protection of private equity fund investors in the EU*, 12 Eur. Company L. 97 (2015).
[43] Lin, *supra* note 40 at 214.
[44] Khort, *supra* note 42.
[45] Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 Emory L. J. 835, 848 (1988).
[46] Larry E. Ribstein, *Unlimited contracting in the Delaware Limited Partnership and its implications for Corporate Law*, 17 J. Corp. L. 299, 304 (1991).
[47] 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 Lending General Provisions (The Decree No. 2 [1996] of People's Bank of China) and 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) L & Soc'y 115 (2010), *available at* http://www.xzbu.com/2/view-687789.htm. China Capital Union, *How do M&A funds obtain commercial bank M&A loans?*, CHINA CAPITAL UNION (MAR. 30, 2017), http://www.ccuorg.com/info/info_18843.html.
[48] *Id*. See 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, 3:40PM) , http://www.chinavcpe.com/news/hot/2009-09-14/47d851398d3df741.html.
[49] Carter G. Bishop, *A Good Faith Revival of Duty of Care Liability in Business Organizational Law*, 41 Tulsa L. Rev. 477, 505 (2005).

investors'.[50] 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.[51] However, this might not be the case in real life 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"[52] and "qualified investors",[53] is confusing and unideal.[54] It pre-judges the question of whether "accredited investors" or "qualified investors" are, on average, really sophisticated in the ordinary sense of the word.[55] They also argue that private equity market shows signs of the "price shrouding"[56] such that private equity firms are able to avoid competition by shrouding information and increasing the complexity of contracts.[57] This "price shrouding" affects even "sophisticated investors".[58]

Moreover, performing due diligence on private equity investments is more challenging, since private equity funds are long-term investments that are not actively traded and thus more difficult to accurately value.[59] While disclosures to investors are adequate,[60] 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.[61] These deficiencies suggest that even sophisticated investors are worryingly fallible.

Further, even institutional investors are heterogeneous[62] and 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

---

[50] Thomsen, *supra* note 35, at 104.

[51] Payne, *supra* note 26, at 571. DAVID WALKER, DISCLOSURE AND TRANSPARENCY IN PRIVATE EQUITY: CONSULTATION DOCUMENT JULY 2007 (2007).

[52] In the US, it would be "accredited investor", as defined in Rule 501 of Regulation D of the Federal Securities Laws.

[53] The UK's equivalent is "qualified investor", as exemplified by the qualified investor register of the Financial Services Authority (FSA).

[54] Morris & Phalippou, *supra* note 35, at 61.

[55] *Id.*

[56] *Id.*

[57] *Id.*

[58] *Id.*

[59] U.S. GOVERNMENT ACCOUNTABILITY OFFICE, REPORT TO CONGRESSIONAL REQUESTERS – PRIVATE EQUITY – RECENT GROWTH IN LEVERAGED BUYOUTS EXPOSED RISKS THAT WARRANT CONTINUED ATTENTION 43 (2008), http://www.gao.gov/new.items/d08885.pdf.

[60] LOUISE GULLIFER & JENNIFER PAYNE, CORPORATE FINANCE LAW: PRINCIPLES AND POLICY 687 (2nd ed. 2015).

[61] Troy Paredes, *Blinded by the Light: Information Overload and its Consequences for Securities Regulation*, 81(2) Wash. U. L. Q. 417, 441-442 (2003).

[62] 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*, J. Fin. Intermediation (forthcoming 2016), *available at* http://eureka.sbs.ox.ac.uk/6196/1/DaRin-Phalippou-Survey-JFI-2016.pdf.

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.[63]

In addition, there are several factors that contribute to the weakness of sophisticated investors in China.

In China, a "qualified investor" in private funds (which include private equity funds) was defined to be an individual or institution who has the 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 RMB 10 million. An individual needs to possess net financial assets[64] of RMB 3 million or have an annual income of at least RMB 500,000 (about USD 75,000) during the past three years.[65]

While the investor is required to have the "appropriate risk identification and risk tolerance abilities", 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] As 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 with the rapid economic

---

[63] Commissioner Luis A. Aguilar, *Speech by SEC Commissioner: Financial Regulatory Reform: The SEC Moving Forward*, U.S. SECURITIES AND EXCHANGE COMMISSION (Sep. 21, 2010), https://www.sec.gov/news/speech/2010/spch092110laa.htm. Cary Martin, *Private Investment Companies In The Wake Of The Financial Crisis: Rethinking The Effectiveness Of The Sophisticated Investor Exemption* (2012) 37 Del. J. Corp. L. 49.

[64] 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 estate. *Private Fund Investment Question & Answer (1)*, CHINA SECURITIES AND REGULATORY COMMISSION (Mar. 23, 2016), http://www.csrc.gov.cn/pub/heilongjiang/xxfw/tzzsyd/201603/t20160328_294848.htm.

[65] Interim Measures for Supervision and Administration on Private Investment Funds (*Simu Touzi Jijin Jiandu Guanli Zhanxing Banfa*), Article 12 (enacted June 30, 2014) read with Private Investment Fundraising Behavior Management Approach (*simu touzi jijin muji xingwei guanli banfa*), Article 28 (enacted July 15, 2016)

[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, 7:19PM).

[67] Telephone Interview with Ms Lu, Legal Counsel, Shenzhen Chinalin Securities (Apr. 5, 2017).

[68] Id.

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] Recent survey also shows that the majority of LPs in Chinese private equity funds are wealthy individuals and families, instead of institutional investors, by number.[71] As of June 2016, there are 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 are 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 incapable of understanding 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 rich experience in private equity investments.

In acknowledgement of these issues with the present "qualified investor" regime, the CSRC has proposed a considerably more restrictive definition. Under the new "professional investor"

---

[69] Those with more than 10 million RMB (1.5 million USD) in investible assets.

[70] Xueqing Jiang, *China to become largest market of high-net-worth individuals*, CHINA DAILY (Jun. 23, 2016, 8:09AM), http://www.chinadaily.com.cn/business/2016-06/23/content_25814849.htm.

[71] ZERO2IPO, *supra* note 22.

[72] Yu Meng, *Qingke LP Half Year Report: 2016 Institutional Investors Contribute Up to Half of Investment Amounts, 60% surveyed GPs have applied or will apply for guidance fund*, PE DAILY (Aug. 25, 2016, 9:34AM), http://research.pedaily.cn/201608/20160825402281.shtml.

[73] *Id.*

[74] Gordon Orr, *A pocket guide to doing business in China*, MCKINSEY & COMPANY (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 40. Telephone Interview with Ms Lu, Legal Counsel, Shenzhen Chinalin Securities (Apr. 5, 2017); Telephone Interview with Mr Kai Xi, Associate, Shanghai Shiyue Hualong Capital (Apr. 6, 2017); Telephone interview with Ms Chen, Senior Associate, Fangda Law Firm (Shanghai office) (March. 6, 2017)

[76] JOHN ARMOUR ET AL, PRINCIPLES OF FINANCIAL REGULATION 169 (2016).

[77] Lin, *supra* note 40.

[78] *Id.*

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 2 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 2 years of relevant investment experience, or 2 years of working experience relating to financial product design, investment and risk management, 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 will only be in effect on 1st July 2017.

Moreover, given the importance of *guanxi* within the Chinese society, many LPs select funds based on friend recommendations and references.[80] 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.[81] There are also funds that plant audience member questions during the Q&A segments of the seminar in order to allow the spokesperson of the fund to elaborate on the strengths and advantages of the fund to further lure potential LPs to invest with them.[82]

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.[83] However, as 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. 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.[84]

[79] Article 8 of Measures on Suitability of Securities and Futures Investors, which was issued by the CSRC on 12 December 2016 and will be in effect since 1st July 2017.

[80] Telephone Interview with Mr Kai Xi, Associate, Shanghai Shiyue Hualong Capital (Apr. 6, 2017); Telephone Interview with Mr Chen, Vice President, Shanghai Linyi Capital (Mar. 6, 2017).

[81] Yubin Shi, *Present chaos and crisis faced by Chinese LPs when choosing PE*, SOHU BUSINESS (Aug. 9, 2016, 10:02 PM), http://business.sohu.com/20160809/n463422391.shtml.

[82] Telephone Interview with Mr Yuan, Partner, Jingtian Gongcheng Law Firm (Apr. 16, 2017).

[83] Telephone Interview with Mr Kai Xi, Associate, Shanghai Shiyue Hualong Capital (Apr. 6, 2017); Telephone Interview with Ms Lu, Legal Counsel, Shenzhen Chinalin Securities (Apr. 5, 2017).

[84] Shi, *supra* note 81.

One may 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,[85] many existing financial intermediaries are not competent and unable to provide neutral advice.

Furthermore, China lacks experienced and competent GPs due to the short history of the industry. 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.[86] This is different from more mature markets where GPs has long track record in the private equity sector. There is also a lack of a sound credit system in China.[87] These problems increase the investment risks and reduce the effectiveness of reputation mechanism in mitigating managerial abuse.

C. Market Failure

While many commentators believe that the private equity market is working fine with effective private ordering and little evidence of market failure,[88] there is evidence of severe managerial abuse by fund managers in China. This is shown in the scandals discussed in Part I and further proved 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.[89] 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.[90] The inspection focused on compliance with fundraising rules, security of fund assets, timeliness with information disclosure, extent of

[85] Lin, *supra* note 39. Lin, *supra* note 40. Rosenberg, in the context of the US-Delaware limited partnership, highlights "the importance of reputation in the [VC] industry" which is "made possible by the reputational mechanism." LPs can choose to invest only with reputable GPs, and shun those GPs who are lacking in credibility. See David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, Colum. Bus. L. R. 363 (2002).

[86] See OECD SYNTHESIS REPORT, REVIEW OF INNOVATION POLICY: CHINA 18 (2007), http://www.oecd.org/dataoecd/54/20/39177453.pdf. Telephone Interview with Mr Yuan, Partner, Jingtian Gongcheng Law Firm (Apr. 16, 2017). Telephone Interview with Mr Lin, Vice President, Ceda Capital (Apr. 18, 2017); Telephone Interview with Mr Chen, Vice President, Shanghai Linyi Capital (Mar. 6, 2017)

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

[88]Thomsen, *supra* note 35, at 104.

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

[90]China Fund News, *CSRC offices in five provinces initiate inspections for private equity funds; involves over a hundred organisations*, SINA FINANCE (Feb. 28, 2017, 11:31PM), 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.

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, 4 private equity institutions were suspected of illegal fundraising and illegal securities activities while 6 private equity institutions committed serious violations such as guaranteeing returns, misappropriating or converting fund assets, commingling client funds with own funds, and publicizing fictitious investment projects to fraudulently attract capital.[91] 65 private equity institutions engaged in moderate non-compliance such as unauthorized public fundraising, failure to abide by contractually stipulated investment strategies and other contractual breaches.[92] 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.[93] A total of 73 private equity institutions and individual fund managers were thus administratively sanctioned by the CSRC for these non-compliance acts[94]. Furthermore, in 2016, AMAC also had to deregister 12,834 private equity institutions which were mostly dormant shell entities.[95]

While most frauds have been committed by P2P and private mutual funds masquerading as private equity funds,[96] 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.

III. A Qualitative Analysis of Contractual Duties Owed by GPs in China

A private equity fund is typically organised as a limited partnership, wherein the firm serves as the GP while investors serve as the LPs.[97] In common law jurisdictions, there are two basic mechanisms governing the internal relationships among partners – the fiduciary duties arising out of the fiduciary relationship and contractual duties and obligations arising from the partnership agreement.[98] However, there is no equivalent concept of fiduciary duties under

---

[91] *Id.*

[92] *Id.*

[93] *Id.*

[94] Shanghai Securities News, *The 11th batch of 106 'missing' private fund institutions published; Private fund integrity system is improving*, XINHUANET (Jan. 16, 2017, 7:35AM), http://news.xinhuanet.com/finance/2017-01/16/c_1120316335.htm.

[95] *Id.*

[96] East South Business Times, *How should investors distinguish between legitimate and fake private equity funds*, IPR ACTION (Dec. 9, 2016, 8:52AM), http://www.ipraction.gov.cn/article/xxgk/sjbj/jrtz/201612/20161200117512.shtml.

[97] Lin, *supra* note 40.

[98] See GEOFFREY MORSE, PARTNERSHIP LAW 160 (6TH ED, 2006). HWEE YING YEO, PARTNERSHIP LAW IN SINGAPORE 167 (2000). For further discussion on fiduciary duties in partnerships, see 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 Illinois L. Rev. 171 (2005).

Chinese partnership law. The question then arises as to how fund managers are constrained in China in the absence of fiduciary duties.

Arguably, an effective LPA tailored by the partners is one of the principal way of mitigating agency costs a partnership.[99] Various covenants have been used in LPAs to address the agency problem 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.[100]

Nevertheless, the theory of incomplete contracts[101] 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.[102] 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.[103] 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"[104] would also affect the efficiency of the 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.[105] In another paper, I discussed the effectiveness of several contractual arrangements in addressing the agency problem in the context of Chinese private equity funds. 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 of private equity

[99] 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 in mitigating agency costs in corporate context. See e.g. 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).

[100] GOMPERS & LERNER, THE VENTURE CAPITAL CYCLE 38 (2000). See also Rosenberg, *supra* note 85, at 381.

[101] See 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); J Tirole, *Incomplete Contracts: Where Do We Stand?*, 67 Econometria 741(1999); H.L.A. HART, THE CONCEPT OF LAW 125 (1961); PATRICK BOLTON & MATHIAS DEWATRIPONT, CONTRACT THEORY 487 (2005).

[102] Randy E Barnett, *Sound of Silence: Default Rules and Contractual Consent*, 78 Va. L. Rev., 822 (1992). See OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 70 (1985).

[103] Letter from Eisenberg to RUPA drafters (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, 560-561(1993).

[104] 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).

[105] See Lin, *supra* note 40.

practitioners in China.[106] This part therefore 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 seventy private equity agreements.[107] These agreements are obtained from leading Chinese law firms and private equity firms.[108] Insight is also gleaned from interviews with seventy interviewees.[109] This consists primarily of fund managers, lawyers, investors and policy makers from the main private equity hubs in China, ie. Beijing, Shanghai, Tianjin, Shenzhen, Chongqing, Guangzhou and Hong Kong.

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

A. Clauses Addressing Conflicts of Interest[110]

Conflicts of interest give rise to significant risks in the private equity market.[111] There are several typical examples of where these conflicts can arise between the interests of the fund manager and the investors. Firstly, while co-investment by the fund manager alongside the fund is common in the private equity sector, 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.[112] Fund managers could also unfairly steer potentially more lucrative deals into these co-investment vehicles to enhance the weightage of these companies in their personal portfolios.[113] As 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.

Secondly, 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 company to act as GP(s) in limited partnerships. This hybrid vehicle combines the advantages of corporate identity and limited

[106] There are many restrictive covenants can be used to deal with the relationship between investors and fund managers, such as those restrictions on management of the funds; on the activities of the GP and the types of investments. (See Gompers, P. A & Lerner, J. (2006) The Use of Covernants: An Empirical Analysis of Venture Capital Partnership Agreements, Journal of Law and Economics, 39, 463-498; Joseph A MaCcAHERY and Erik P.M. Vermeulen, Private Equity Regulation: A Comparative Analysis, Journal of Management & Governance, Issue 2 (2012), at 213.)

[107] *Supra* note 18 & 19. It must be noted that a selection bias may be a limitation of the dataset. One possibility is that I oversampled 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 for the contractual duties drafted by these firms in the dataset, they are insufficient to constrain the behavior of the general partners.

[108] *Id.*

[109] *Id.*

[110] Observations based on the investigated sample contracts.

[111] *FSA Paper*, *supra* note 14, at 1.16.

[112] TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, PRIVATE EQUITY CONFLICTS OF INTEREST CONSULTATION REPORT 16 (2009), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD309.pdf.

[113] *FSA Paper*, *supra* note 14, at 72.

liability of companies with the contractual flexibility and tax advantages of partnerships. However, a GP may consider his own interest prior to the interest of the fund he manages when dealing with a potential investment project. He may invest on his own behalf in a particularly promising portfolio company without disclosing the information to the other funds he managed.[114] 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 where the corporate GP (acting through its directors) owes fiduciary duties to the partnership firm but then these directors at the same time owe fiduciary duties to their own company. 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 will have to be dealt with.

Many of the investigated LPAs do not address the potential conflicts between fund managers and investors adequately. 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 (consultation) 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"*.[115] Only a few LPAs provide that the GP shall distribute investment opportunities fairly and in a bona fide manner.[116] Also, none of the investigated LPAs deal with conflicts of duties in the context of a corporate GP.[117]

In addition, most of the investigated LPAs allow the GP to enter into related-party transactions with the partnership,[118] and any restrictions imposed were minimal. 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 categories of LPs.[119] 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

[114] It was 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 FINANCE (Apr. 18, 2009, 01:22AM), http://finance.jrj.com.cn/2009/04/1801224157180.shtml.
[115] 5 out of the 70 investigated sample contracts.
[116] 10 out of the 70 investigated sample contracts.
[117] All 70 investigated sample contracts.
[118] 50 out of the 70 investigated sample contracts.
[119] *Id.*

parties shall abstain from voting,[120] provided that related transactions shall be arm's length transactions.

A few of the LPAs[121] 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.[122] 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.[123]

However, none of the investigated agreements impose a duty of disclosure[124] 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 report to LPs,[125] 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.[126]

B. Clauses Addressing Duty of Care

A few investigated LPAs impose a duty of diligence on the GP. [127] This can take the form of clauses such as "*the GP shall devote reasonable time and effort in managing the partnership's*

[120] 40 out of the 70 investigated sample contracts.

[121] This committee is responsible for supervision of the GP's management, the scope of investment, related-party transactions, the change of key persons, the cost of the partnership and the distribution of profit.

[122] 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, fees incurred by the partnership and charged by the GP, and income distribution. 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.

[123]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.

[124] Investigated sample contracts.

[125]The Asset Management Association of China (AMAC) issued the Administrative Measures on Information Disclosure of Private Investment Funds on 4th February 2016. 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 LPs' supervision of the GP.

[126]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 requires the GP to disclose conflicts of interest, related party transactions, etc.

[127] 23 out of 70 investigated sample contracts.

business";[128] "*the GP shall manage and operate the fund assets with responsibilities, honesty, care and diligence*";[129] "*key persons (guanjian renshi) shall spend reasonable time and effort in the management of the partnership*".[130] 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 of duty of diligence are low.[131]

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.[132] Instead, LPs focus more on the distribution of profits and remuneration of GPs during the negotiation of LPAs.[133] 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.[134]

Further, many interviewees argued that it was difficult and costly to have an exhaustive list to cover all the possible duties.[135] 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.[136]

IV. Deficiencies in the Statutory Framework

A. Problematic Regulatory Responses

For years, the Chinese private equity sector operated in a regulatory vacuum without a clear

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

[129] These are in line with AMAC's regulatory requirements.

[130] 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, or 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 into the management of the partnership business.

[131] 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.

[132] Telephone interview with Mr Yuan, Partner, Jingtian Gongcheng Law Firm (Apr. 16, 2017); Mr Yuan, Partner, Jingtian Gongcheng Law Firm (Apr. 16, 2017).

[133] Telephone interview with Mr Lin, Vice President, Ceda Capital (Apr. 18, 2017); Telephone interview with Mr Yuan, Partner, Jingtian Gongcheng Law Firm (Apr. 16, 2017).

[134] Telephone interview with Mr Yuan, Partner, Jingtian Gongcheng Law Firm (Apr. 16, 2017).

[135] *Id.*

[136] Delaware lawyers also expressed such view. See MARTIN LUBAROFF & PAUL ALTMAN, LUBAROFF AND ALTMAN ON DELWARE LIMITED PARTNERSHIPS §11.2.2 (2005).

regulatory and legal framework governing the market.[137] In order to tackle the perceived market concerns, government intervention commenced in 2014. CSRC has issued the Interim Measures for Supervision and Administration of Private Investment Funds ("CSRC Interim Measures")[138] 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.[139] Under the new regulatory framework, the CSRC is the key regulator of the private equity sector.[140] All private equity funds have to be registered with the AMAC and comply with the rules or measures made by CSRC.[141] AMAC issues self-regulatory rules on private equity.[142]

Today, the regulatory framework governing private equity in China is rapidly evolving. 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,[143] (2) administrative regulations promulgated by the CSRC, and (3) local regulations promulgated by the local legislature.[144]

In the past two years, AMAC has also 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

[137] *See* further in Dean Collins et al, *A New Era for Private Funds in China?*, DECHERT LLP available at https://info.dechert.com/10/3730/landing-pages/a-new-era-for-private-funds-in-china.asp (lasted visited Apr. 28, 2017, 6:41 PM).

[138] On August 21, 2014, the CSRC officially released this Interim (Zhengjianhuiling No.105) which became effective on the same date. 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.

[139] In Chinese pinyin, *simu touzi jijin guanliren dengji he jijin beian banfa*, This measure came into effect on February 7, 2014.

[140] In June 2013, the Central Government issued the Notice on the Division of Responsibilities of Private Equity Fund Management (*guanyu simu guquan jijin guanli zhizhe fengong de tongzhi*) (Zhongyang Bianbanfa No. (2013) 22), specifying that CSRC will be responsible for the supervision and administration of private equity funds.

[141] *Id.*

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

[143] It is worth noting that although the Securities Investment Fund Law ("SIFL", *zhengquan touzi jijin fa*) 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.

[144] Such as the Administration Measures on Tianjin Equity Investment Enterprises and Equity Investment Management Institutions. On 11 July 2011, Tianjin NDRC, Tianjin Finance Office, Tianjin Administration of Industry and Commerce, Tianjin Commission of Commerce and Tianjin Finance Bureau jointly issued the Administration Measures on Tianjin Equity Investment Enterprises and Equity Investment Management Institutions (Tianjin Guquan Touzi Qiye he Guquan Touzi Guanli Jigou Guanli Banfa), Tianjin City Fagaiwei (2011) No. 675.

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.

Firstly, 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 even window guidance, practitioners have to attend training courses and seek advice on the different guidance opinions. Many questions, however, do not receive clear answers from the regulators. 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, they have minimal legal effect.

Secondly, China's identity-based, classified supervisory framework requires extensive refinement. 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 now requires the fund manager to submit a new filing application after confirming the change of the fund type and business type.[147]

---

[145] *Analysis on the Current Supervisory System for Private Equity*, ONE MAY CAPITAL (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.

[146] Telephone Interview with Mr Kai Xi, Associate, Shanghai Shiyue Hualong Capital (Apr. 6, 2017); Telephone Interview with Ms Lu, Legal Counsel, Shenzhen Chinalin Securities (Apr. 5, 2017).

[147] AMAC, *Private Fund Registration and Filing Question & Answer (13)*, WEI XIN (MAR. 31, 2017).

However, classified supervision has yet to be effectively implemented. Private equity funds have 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 information, distribution of profits, reports of fund managers, audited financial reports, etc.), and deliver any requested information to local financial regulatory authorities.[148] 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.[149] The disclosed information can also include trade secrets and 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.[150]

Thirdly, 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 may not be representative. On-site inspection also requires high levels of human and financial resources. It worsens manpower constrains for regulatory agencies, which are already facing brain drain pressures,[151] and is a high-cost, low-efficiency method of law enforcement. Practitioner's compliance costs also increase, as they have to accommodate such inspections. These costs will be passed on to investors, 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 the fund managers instead of simply imposing 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 integrity, the measures have done more harm than good.

In summary, these temporary and self-regulatory measures create additional costs without bringing commensurate benefit.

---

[149] Telephone Interview with Mr Shao, Partner, Shanghai Yuantai Law Firm (Mar. 6, 2017). Telephone Interview with Mr Kai Xi, Associate, Shanghai Shiyue Hualong Capital (Apr. 6, 2017).

[150] Telephone Interview with Mr Kai Xi, Associate, Shanghai Shiyue Hualong Capital (Apr. 6, 2017); Telephone Interview with Mr Chen, Vice President, Shanghai Linyi Capital (Mar. 6, 2017).

[151] *Id.* All of China's financial regulators have suffered severe manpower loss. Talents recruited from overseas by CSRCs' so-called "Hundred Talents Program" have mostly left the organization.

Figure 3. Timeline of Private Equity Regulation in China

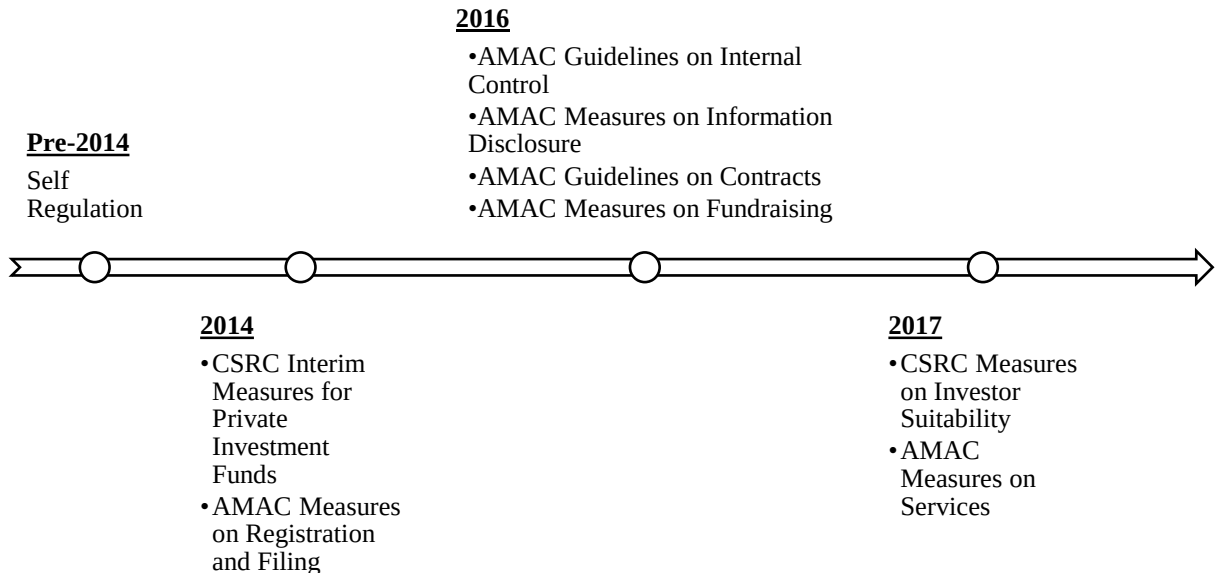


Table 2. The Evolving Regulatory Framework of Private Equity in China

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)
CSRC Rules		
Interim Measures for Supervision and Administration on Private 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 Suitability 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 Registration of Private Investment Fund Managers and Filing of Private Funds	7th February 2014	This specifically applies the CSRC's Interim Measures' section on registration and filing, thereby establishing a national private fund registration and filing system.
Administrative Measures on Information Disclosure of Private Investment Funds	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, 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	1st March 2017	This includes the main provisions of AMAC's previous 'Outsourcing Guidelines', including the legal status of the service organization,

Investment Funds		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 Private Investment Fund Managers	1st February 2016	This attempts to create an internal control self-regulatory framework by focusing on internal control objectives and principles, internal environment, risk assessment, control of activities, internal supervision, etc. a) Fund managers shall not manage businesses where potential conflicts of interest may arise; b) Fund managers shall avoid improper related transactions and establish a mechanism for prevention of tunnelling and conflict of interests; c) At least two senior management members must be appointed; d) 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.

B. Statutory Duties in Existing Law

A unique characteristic of Chinese partnership law is that it does not impose detailed statutory duties on partners nor does it contain any concept of equitable fiduciary duties owed by partners in a manner equivalent to that present in common law jurisdictions.[152] This section reviews the statutory duties of GPs under the Chinese law.

a. 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.[153]
- The general partners should not carry on any business competing with that of the partnership solely or cooperatively.[154]
- The partners should not engage in any self-dealing business with the partnership.[155]
- 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

[152] The lack of fiduciary duty in the 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 1990s. There was limited judicial and practical experience of partnerships at that time and inadequate understanding of the fiduciary duties. Further legislative background of the promulgation of the PEL is available. See Yicheng Huang, *Explanations on the Draft Partnership Enterprise Law of the PRC, delivered to the 22nd Meeting of the Standing Committee of the 9th National People's Congress on Oct. 26, 1996*, 1 Gazette of Standing Committee of the National People's Congress of the PRC 12.

[153] *Id.*

[154] Article 32 of PEL provides that: "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".

[155] *Id.*

any loss to the partnership or to other partners, he shall be liable for compensation.[156]

- 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.[157]
- The managing partner (*zhixing shiwu hehuoren*) should regularly report to the other partners on the process of partnership activities, the business and financial status of the partnership.[158]

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 too limited and are 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 interests of partnership.[159]

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.[160] 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.[161] The limitation in scope perpetuates information asymmetry and effectively prevents LPs from monitoring the investment decisions made by GPs.

---

[156] Article 96 of PEL provides that: "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."

[157] Article 99 of PEL provides that: "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 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".

[158] PRC Partnership Enterprise Law, Art. 28.

[159] *F&C Alternative Investment Holdings (Limited) v Barthelemy* (2011) EWHC 1731 (Ch). Sales J 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. The duty to act in good faith is a compendious expression of duty and encompasses each of the first three duties.

[160] UK Partnership Act 1890 (c. 39), s28.

[161] *Law v Law* (1905) 1 Ch 140.

Moreover, these provisions apply to both the general partnership and the limited partnership.[162] In other words, the duties of the partner in the general partnership are the same as the GP in a limited partnership. However, in common law, as the GP in the limited partnership has substantial management rights compared to the passive LP, the fiduciary duties imposed on the GP are generally heavier than those of a partner in a general partnership.[163] Common law also generally imposes higher standards on the GPs than the LPs in a limited partnership.[164] Furthermore, these provisions fail to specify the liability for partners' 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*."[165] Arguably, it can be used as an overarching principle governing internal relationships between partners in partnerships, providing 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 the situations in "the conclusion of a partnership agreement and in the establishment of a partnership enterprise".[166]

While the principle of good faith (*chengshi xinyong yuanze*) is an overriding principle (*diwang tiaokuan*) in PRC civil law,[167] 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,[168] 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.

b. Duties of Fund Managers under CSRC Measures

To strengthen regulation of the private equity industry, the 2014 CSRC Interim Measures[169]

---

[162] Article 60 of PEL provides that the PRC LP is regulated under the Chapter III of the PEL which contains 25 provisions. Where Chapter III does not specifically provide for the relevant situation, there is a fall-back clause which states that the provisions on general partnership and its partners shall be used.

[163] BROMBERG & RIBSTEIN, *supra* note 188, at 6.71; *Bassan v. Investment Exch. Corp*., 83 Wash. 2d, 524 P.2d 233 (1974).

[164] See J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARNTERSHIP, § 12:4 (2016).

[165] PRC PEL, Art. 5.

[166] PRC Contract Law, Order of the President of the People's Republic of China No. 15 (1999),Art 6.

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

[168] CIVIL LAW 23 (Zhengying Wei ed., 2000). For principle of good faith in PRC law, see also Ping Jiang et al, *Freedom of Contract and Principle of Good Faith under the New Contract Law*, 1 J. CHINA U. POL. SCI. & L. (1999).

[169] *Supra* n 138.

provides several statutory duties and obligations governing fund managers in private equity funds.[170]

- 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.[171]
- 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"; "not to engage in insider trading, market manipulation or other improper trading activities"*.
- Fund managers have to disclose fund information to investors.[172]
- 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*).[173]

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 judgements.[174]

---

[170] Pursuant to the Private Equity 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 offering and target qualified investors during fundraising.

[171] Article 22 of CSRC Interim Measures.

[172] Article 24 & 25 of CSRC Interim Measures.

[173] Article 4 of CSRC Interim Measures.

[174] According to Article 4 of Provisions of the Supreme People's Court on Citation of Such Normative Legal Documents as

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.[175] 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.[176]

c. Other Remedies Available to LPs under the PEL

One may argue that duties owed by GPs are just one of many possible constraints on misbehavior by GPs. LPs can invoke other provisions in the PEL to protect their interests. Nevertheless, evidence shows that these remedies are not always effective.[177]

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, or causes losses to the partnership as a result of intentional or gross negligence, or conducts himself improperly while carrying out partnership business. However, as discussed in my another paper,[178] it is not easy to remove a partner in practice, as it needs unanimous approval of all partners.[179] In the case of a large-size private equity fund which involves a large number of partners, it is even more difficult to obtain the unanimous consent from all partners to expel a GP. Also, removing a GP will have a significant impact on the private equity fund as the GP is the manager that designs and executes long-term investments. Furthermore, the existing cases show that Chinese courts are reluctant to order the removal of partners.[180]

Laws and Regulations in the Judgments, "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 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."

[175] Notably, CSRC itself has stated that the rationale as to why fund managers of all private funds must report to AMAC on the use of leverage is due to systemic risks posed by leveraged buyout funds and hedge funds. Instead of carving out an exception, an "one size fits all" approach is taken. CSRC, *Explanations to the Drafting of Private Investment Fund Guidance Maagement Interim Measures (For Consultation),* SINA FINANCE (Jul. 11, 2014, 6:16PM), http://finance.sina.com.cn/money/smjj/20140711/181619680780.shtml.

[176] This same criticism has been made with regards to the AIFMD. 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).

[177] For further discussion on the enforcement issues in the context of private equity limited partnerships in China, see Lin, *supra* note 40.

[178] Lin Lin, *Limited Partners' Derivative Action: Problem and Prospects in the Private Equity Market of China*, 41(2) H. K. L. J. 517 (2011).

[179] Partnership Enterprise Law, Art. 49(1).

[180] In the case of *Zhang Liming and others v Shijiazhuang Long Run Investment Management Centre (2016 Ji 01Minzhong*

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.[181] However, as discussed in my other paper,[182] this article is very general and functions as a provision of principle. There are no supporting provisions of this article as to 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. As the law is silent on the procedural matter, some courts have adopted a conservative approach and required consensus by all the LPs before a derivative action will be granted.[183] However, due to the high costs and the lack of trust amongst the dispersed investors, approval by all the LPs is difficult to achieve.[184] It is also unclear as to how litigation costs are to be calculated and apportioned. Are the litigation costs calculated based on the entire fund's assets under management or based on the investment amount committed by the LPs that are initiating the lawsuit? If it is the former calculation method, 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 disincentivizing LPs from pursuing litigation.

Furthermore, even though 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*)", LPs can rarely obtain the evidence needed to prove such misbehavior. Such evidence is often retained by the GP and since LPs have no right to participate in the actual management and operation of the partnership, it is difficult for LPs to collect relevant evidence through legitimate channels.[185] In addition, the fund manager is often

---

No. 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 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.

It was held in the case of *Cao Ruofu v Guo Hua and others* (2014) 1 Tamin (Final) 185, which concerned an application to remove a partner from a partnership enterprise, that because the removal of a partner is deemed to be a form of termination, it is used typically as a last resort in place of settlement and should thus be effected 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 RMB100m to the partnership enterprise. 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.

[181] Lin, *supra* n 178.

[182] *Id.*

[183] Interview, Mr Zhong, Partner, Deheng Law Firm (Shenzhen office) in Singapore (Nov. 24, 2016); Mr Deng, Senior Associate, Deheng Law Firm (Shenzhen office) in Singapore (Nov 24, 2016).

[184] Telephone Interview with Mr Chen, Vice President, Shanghai Linyi Capital (Mar. 6, 2017).

[185] Interview, Mr Zhong, Partner, Deheng Law Firm (Shenzhen office) in Singapore (Nov. 24, 2016); Mr Deng, Senior Associate, Deheng Law Firm (Shenzhen office) in Singapore (Nov 24, 2016).

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, where the Supreme Court ruled in favor of the LPs in *Anhui Ruizhi Real Estate Development Co. Ltd v Jiao Jian and others.*[186] 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.[187]

V. Moving Forward

In common law jurisdictions, partners have long been regarded in equity as fiduciaries among themselves.[188] Fiduciary duties play an essential role in governing the internal relations among partners.[189] Fiduciary duties have a prophylactic function. Imposing fiduciary duties on a specific party also "[encourages] good behavior in persons other than the parties in the instant case" .[190] Fiduciary duties also serve an exemplary function, for the purpose of the "safety of mankind".[191] Thus, anyone who breaches his fiduciary duties must bear the consequential legal liability. Fiduciary duties protect vulnerable parties by restraining opportunistic behavior.[192]

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,

---

[186](2016) Supreme People's Court (Final) 756.

[187] Lin, *supra* note 181, at 538-542.

[188] ALAN BROMBERG & LARRY RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP 6:67 (1991). The very early description of a fiduciary duty in partnerships can be found in *Helmore v Smith (*(1885) 35 Ch D 436*)* and *Aas V. Benham (*(1891) 2 Ch 244 at 256*)* The leading cases in this area include *Corley v. Ott* (485 S.E.2d 97 (S.C. 1997).) (duty of loyalty during formation of partnership); and *Latta v Kilbourn (*150 U.S. 524, 541 (1893).*)* (the partners must refrain from self-dealing).
Meinhard v. Salmon, 249 N.Y. 458, 463, 164 N.E. 545, 546 (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 Larry Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms* 54 Wash. & Lee L. Rev. 537 1997. He characterizes fiduciary duties as a "hypothetical bargain", arguing that fiduciary duties are a form of implied term in the contract between partners.

[189] See STEPHEN I. GLOVER & CRAIG M. WASSERMAN, PARTNERSHIPS, JOINT VENTURES AND STRATEGIC ALLIANCES 5.02 (2003).

[190] See GARY WATT, TRUSTS AND EQUITY 338 (2008).

[191] *Id*. See also *Parker v. McKenna* (1894) LR 10 Ch App 96.

[192] See 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 (2002).

fiduciary duties are imposed on the GP for the purpose of protecting the non-controlling LPs.[193] In the US and the United Kingdom (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.[194]

The discussed legislative gap in Part IV of this article suggests that duties owed amongst 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.[195] This may cause LPs to be less willing to entrust their investments to a GP and be less interested in making investments in the private equity market.

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 of all, the theory of incompleteness of law proposes that "the more incomplete the law, the less effective the transplant will be."[196] An open-ended concept "cannot provide clear guidance for actual behaviour or (act) as an effective deterrent against violations."[197] The doctrine of fiduciary duties is deemed as one of the most elusive concepts in Anglo-American law.[198] Since it has not been fully defined even in common law jurisdictions, it would be even more difficult to adopt it in China. Moreover, the considerable different legal traditions and judicial cultures between common law and Chinese law will make the transplantation 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 do not have lawmaking powers. This serves as a strong barrier to successful transplant.

---

[193] Kenneth Jacobson, *Fiduciary Duty Considerations in Choosing between Limited Partnerships and Limited Liability Companies*, 36(1) Real Prop. Prob. Trust J. 1, 6 (2001); Larry E Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 Suffolk U. L. Rev. 927, 939 (2004).

[194] See Yeo, *supra* note 98, at 187. The Uniform Partnership Act (1997) §103 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."

[195] Lin, *supra* note 40.

[196] Katharina Pistor & Chenggang Xu, *Fiduciary Duty in Transitional Civil Law Jurisdictions: Lessons from the Incomplete Law Theory IN* GLOBAL MARKETS, DOMESTIC INSTITUTIONS: CORPORATE LAW AND GOVERNANCE IN A NEW ERA OF CROSS-BORDER DEALS 95 (Curtis J. Milhaupt ed., 2003).

[197] *Id*.

[198] Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 37 Duke L. J. 879 (1988).

On the other hand, codification increases certainty, predictability and accessibility of the law.[199] Statutory duties play an *ex ante* informative and preventive role by specifying what parties may or may not do. This may bolster investor confidence as they can be sure 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,[200] 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.[201] The codification of the duty of good faith and the duty of disclosure owed by partners has also been proposed in the UK.[202]

Third, setting out partners' basic duties in statutory form would minimize transaction costs.[203] As discussed in Part III of this article, small Chinese firms are unable to have tailor-made agreements due to the lack of experience and sophistication. Individual investors are unlikely to pay attention to the language of the partnership agreement due to information asymmetry.[204] With a set of clear statutory duties, GPs would be able to carry out their business with confidence instead of having to navigate through multiple laws, regulations, and directives. In particular, in the Chinese market where LPs are relatively active in the management of the firm,[205] 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.[206]

However, over-policing through the imposition of excessive duties would not only scare off GPs but may also cause the law to become out of tune with commercial realities. Hence, aside from the most basic general duties, it would be neither possible nor practical to prescribe any further duties. Instead, it would be much 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

---

[199] HART, *supra* note 101, at 126.

[200] Codification exercises in China can be traced back to 536 BCE in Chinese history, see 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).

[201] For example, Revised Uniform Partnership Act §404 (1997); Partnership Act 1890 (UK), ss. 29 and 30. It must be noted that the connotation of fiduciary duties differ in the US and the UK.

[202] See THE LAW COMMISSION (LAW COM NO 283) AND THE SCOTTISH LAW COMMISSION (SCOT LAW COM NO 192), PARTNERSHIP LAW, 189-192 (2003), *available at* http://www.lawcom.gov.uk/wp-content/uploads/2015/03/lc283_Partnership_Law.pdf.

[203] See similar discussion of the function of fiduciary duty. Costs of fiduciary duties may even outweigh the benefits. See Larry E. Ribstein, *Are Partners Fiduciaries?*, U. Ill. L. Rev. 209, 213 (2005).

[204] Empirical studies show that for partnership agreements where LPs are natural persons, the part on 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.

[205] Lin, *supra* note 40.

[206] Christopher Gulinello, *Venture Capital Funds, Organizational Law, and Passive Investors*, 70 Alb. L. Rev. 267 (2006).

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.

A. 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,[207] and the Uniform Limited Partnership Act (ULPA 2001), [208] the duty of loyalty imputes liability when the partner misuses or misappropriates partnership property, abuses his position or competes with the partnership.[209] Under the Delaware Code, the partner has to account to the partnership and hold as trustee for it any property, profit or benefit derived in his position as partner.[210] The partner must also refrain from competing or dealing with the partnership.[211]

The position in English Law is found in section 29 (duty to avoid conflicts)[212] and section 30 (duty not to compete)[213] of the Partnership Act 1890.[214] Section 29, contains the no-conflict rule and the no-profit rule.[215] This section forces a 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".[216] This is a wide provision which would work to prevent almost all cases of unduly profiting from one's position as a partner.[217]

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 than the

---

[207] In the US, apart from common law, partnership agreements and states law, there are acts (model laws) proposed by National Conference of Commissioners of Uniform State Laws for the governance of business partnerships by US states. Although these model laws are not binding, they remain persuasive as most of the states adopted the model laws in their state laws.

[208] Uniform Limited Partnership Act § 408 (b) (2001).

[209] Uniform Partnership Act § 409 (b) (1997). See also Uniform Limited Partnership Act § 409(b) (2001).

[210] Delaware Code tit. 6, at §15-404(b).

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

[212] *"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."*

[213] *"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."*

[214] Liability arises once it is shown that the business is in actual competition with the firm. *Rochwerg v Truster* (2002) 212 DLR (4th) 498.

[215] See MORSE, *supra* note 188, 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).

[216] *Chan v Zacharia* (1984) 154 CLR 178.

[217] See MORSE, *supra* note 188, at 171.

duty of loyalty in the US and the UK and is also too general. Although the CSRC Interim Measures supplements the PEL with a list of scenarios which are similar to the duty of loyalty, those are interim rules and are too vague to be of use.

It is argued 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 that this would bring, 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.

B. Duty of Care

The concept of a duty of care helps to ensure that GPs take proper care in the course of management. The US position on this generally requires partners to refrain from engaging in "grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law."[218] The duty of care is taken from the development of the tort of negligence in common law.[219] Unlike the duty of loyalty which requires the fiduciary to act in the best interest of the beneficiary, the duty of care is a management duty.[220]

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".[221] 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".[222] These general statements have created difficulties in judicial practice. As a result, the Chinese judicial case

[218] Ribstein, *supra* note 193, at 962.
[219] See *Donoghue v Stevenson* (1932) AC 562.
[220] 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 US and the UK.
[221] PEL, Article 35.
[222] While PEL does not directly stipulate 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.

database[223] reports very few cases relating to breach of duty by partners (e.g. Article 32 and Article 35 of the PEL).[224]

A similar duty of care is found in Article 3 of the CSRC Interim Measures which states that parties shall 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 states a duty to act with "diligence".[225]

The question here is the appropriate standard of care that should be applied in determining whether there has been a breach of this duty. The standard of care has been evolving and varies from jurisdiction to jurisdiction.[226] Lord Hamilton in the case of *Ross Harper and Murphy v Banks* stated that the test under the UK tort of negligence should be objective and depends on the context of the partnership.[227] Generally, the court considers if the partner can show that he has acted to the standards of a reasonable businessman in the same situation.[228] However, the court will also take into account the special skill or experience that the partner claims to possess.[229] To promote clarity and certainty, the UK Law Commission provisionally proposed a 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*".[230]

Turning to the US, the standard of duty of care prescribed by the UPA[231] and the Delaware Code[232] considers if 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

[223] Peking University Legal Case Database.

[224] See e.g. cases of *Cheng and others v He Jinming and Li Chongying* (2016) Zhejiang 11 (Final) 41; *Tin Li v Yu Guanghai* (2014) Zibo (Final) 143; *Cheng Shixuan v China No 4. Metallurgical Construction LLC and others* (2014) Suzhou People's Intermediate Court (Final) 01002. But there are some other related cases in the context of a general partnership.

[225] This is also mentioned in Article 4 of the CSRC Interim Measures.

[226] Initially, American courts tend to use "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 a "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 in using the business judgment rule in defining gross negligence in partnerships.

[227] *Ross Harper and Murphy v Banks* (2000) SLT 699 CS (OH).

[228] *Id.*

[229] *Winsor v Schroeder* (1979) 129 NLJ 1266.

[230] THE LAW COMMISSION (LAW COM NO 283) AND THE SCOTTISH LAW COMMISSION (SCOT LAW COM NO 192), *supra* note 202 at 186.

[231] Uniform Partnership Act § 409 (c) (1997). See also Uniform Limited Partnership Act § 409(c) (2001). 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."

[232] Uniform Partnership Act § 409 (c) (1997). Delaware Code tit. 6, §15-404(c).

business judgment rule to determine general partner's liability for duty of care breaches.[233] A GP will be entitled to the protection of the business judgment rule. To defeat this, 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.[234] Notably, in the context of corporate directors, the local Chinese courts have established different standards of care, with one adopting the business judgment rule while the other preferring the objective standard of care under the English law.[235]

It is submitted that the "gross negligence" standard set by the UPA and the Delaware Code should be preferred in the context of China. The aim of this duty, as highlighted above, is only to protect against bad behavior and not to found liability for business mistakes. The higher threshold would also be consistent with business realities and a test that is too strict may only have an undesirable cooling effect by causing partners to be overly cautious with their business decisions, resulting in a cooling effect and further market failure. At the same time, the duty defined by the UPA and the Delaware Code is much clearer as a statutory provision and would probably be more suitable for transplant into a civil law jurisdiction as compared to the common law test found in the UK.[236]

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

Given that China does not have 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 judgement rule may end up with judges absolving wrongdoing partners from liability due to uncertainty in the law. If and when the business judgement rule is adopted, a possible way around this is to impose statutory presumptions of a breach when

---

[233] *Jackson v Marshall* 140 N.C. App. 504, 537 S.E.2d 232 (2000). *Rosenthal v Rosenthal* 543 A.2d 348 (Me. 1988).

[234] *Id.*

[235] Tianshu Zhou, *Standard of care required for directors' duty of diligence*, 10 LEGAL MAG. 93 (2014). (in Chinese)

[236] The fact that Chinese judges do not have rich experience and sophisticated techniques in applying precedents should not be an excuse for not adopting the business judgment rule in the PRC 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, Chinese legislature and judiciary may take a steady manner in introducing the concept of business judgment rule in the context of the PRC limited partnership.

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 judgement rule.

C. Mandatory Statutory Duties

In Delaware, the main consideration is to "give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements".[237] 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.[238]

In this aspect, it is submitted that 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 the 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 the basic duties are enforced in all partnerships, the regulator would not only be able to maintain 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.

D. Duties Alone Are Insufficient

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

China currently only has a rudimentary legislative framework to govern GP's behavior and 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.[239] Even in the relatively mature field of corporate law, aggrieved parties rarely assert

[237] Delaware Code tit.6, § 17-1101(c).
[238] Uniform Partnership Act § 103 (1997).
[239] Peking University Legal Case Database.

their rights by initiating claims against directors for breach of duties.[240] 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 judges' decisions.[241] 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 statute.[242] As a result of their limited competence, restricted power of legal interpretation and bureaucratic-like 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".[243] 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.[244] Evidently, 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, there needs to be drastic improvements in both investor awareness and the 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.[245] 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.[246] In light of the talent shortage,[247] development of private equity professionals should be another priority for the industry. Training should also be conducted to allow present practitioners to fully understand the regulatory history, status quo and any regulatory changes.

VI. Conclusion

[240] Guangdong Xu et al, *Directors' Duties in China*, 14 Eur. Bus. Org. L. Rev. 57, 64 (2013). For the discussion on judicial enforcement of duties in China, see further in Xiaoyu & Xuke, Studies of the Fiduciary Duties of Private Equity Fund Managers, Vol 37 No. 6 (2015) Modern Law Science 86 (Simu Guquan Jijin Guanliren Xinyi Yiwu Yanjiu); and Luo Peixin, Commercial Judgement Experience- Empirical Studies of the Cases relating to Fiduciary Duties, 2014 (5) Academic Monthly [Xueshu Yuekan] 46-49. (Zimaoqu Shangshi Caipan Jingyan Kefuzhi, Ketuiguang Zhi Kunjing Bianxi- Yi Xinyi Yiwu Anjian de Shizheng Fenxi wei Shijiao)

[241] *Id.* at 66.

[242] Xu, supra note 240, at 68.

[243] *Id.*

[244] Xu, supra note 240, at 69.

[245] Telephone Interview with Ms Lu, Legal Counsel, Shenzhen Chinalin Securities (Mar. 29, 2017).

[246] Telephone Interview with Mr Chen, Vice President, Shanghai Linyi Capital (Dec. 20, 2016 & Mar. 6, 2017).

[247] For the lack of experienced GPs in Chinese private equity sector, see Lin, *supra* note 40. 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, Vice President, Shanghai Linyi Capital (Dec. 20, 2016 & Mar. 6, 2017).

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,[248] it is not a suitable option in the China context 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. There are also legal and institutional barriers preventing investors from legally safeguarding their interests.

Although regulators have taken proactive steps to strengthen regulation on China's private equity industry, the intrusive approach has substantively increased operational costs while failing to protect investors. It is argued that the current regulatory approach is misguided and the regulatory 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 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. Therefore, the proposed form of regulation should be able to address these unique problems while striking a balance between investor protection and market efficiency.

Moreover, when developing further regulatory measures, regulation, private law norms, industry self-discipline, market governance and party autonomy should work hand-in-hand to form a common regulatory system for the private equity industry. Policy makers should also be cognizant of China's evolving industry and implement the right mix of soft law and hard law to correct market failure and address evolving risks.

[248] Thomsen, *supra* note 35. Thomsen argues that the market force is working well in PE context. Banks and labour unions appear to have both the ability and the incentives to safeguard against managerial conflicts of interest, excessive debt and other maladies.