

The Practical Analysis on Participators of Current Chinese POF

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Abstract

Current Chinese POF industry is still short of comprehensive legislation. Thus, the cooperative relationship between participants involved in account management model POF and trust plan model POF is quite unsteady and risky before the promulgation of new PBL. Furthermore, the conflict between Chinese Company Law and the new PBL had restrained the scope of development of limited partnership POF. A more systematic legal platform is to be established urgently.

Keywords: Privately offered fund, POF, Analysis, Custodians, Partnership

At present, privately offered fund (POF) industry in PRC is still short of comprehensive statute law, even if the industry has experienced a phenomenal growth in recent years. Due to the deficiency of legislation, fund manager's administrative behaviors and investment plans can't get appropriate supervised. Consequently, the private offered fund industry may face an imbalanced development under certain circumstance. On the one hand, a number of investors will benefit from investing on the well-organized and responsible POF. On the other hand, a number of amateurish and irresponsible POF will harm both their investors' interests and Chinese financial framework. Nonetheless, a series of effective law and rules which aimed at establishing a transparent and comprehensive system of regulation to support the sustained development of POF can't be legislated in a fairly short time, especially in PRC. Therefore, the establishment of a steady, efficient and restricted cooperative foundation between POF managers, custodians and investors is a duly acceptable solution to sustain a continuous growth of current Chinese POF industry. Nowadays, domestic supervisory institutions should enhance the mutual dependence and restriction between POF managers, custodians and investors in order to control the risk and protect investors' interests while the whole legal platform has not been perfectly constituted.

1. Legal background of Chinese POF

There is no comprehensive statute that governs the regulation of investment funds in Japan, but there are a wide array of laws and rules for various aspects of the funds industry including organization, fund raising and management (Makoto Igarashi, 2006). The same situation is currently happening in China, whereas the difference is that a variety of aspects of Chinese funds industry are short of corresponding laws and rules. Presently, there are only a few enacted law and rules dealing with POF industry more or less in PRC. The Securities Investment Funds Law (SIFL) was promulgated by the National People's Congress (NPC) on 28 October 2003. And the SIFL has commenced operation from 1 June 2004. The law has specifically paved the way for the introduction of further regulations that will facilitate the introduction of new and innovative investment products, as well as the offer of funds by way of private placement (Effie Vasilopoulos and Felicity Wong, 2004). However, the supervision of POF is not involved in the SIFL as in which article 2 declares that this law is only applicable to the public offering funds. The scope of SIFL is restricted to the regulation of funds investing in listed stocks or bonds and other securities specified by the China Securities Regulatory Commission (Effie Vasilopoulos, Felicity Wong, 2004). Nonetheless, we can not conclude that current diversiform domestic POF is illegal in PRC in respect that the SIFL has not provided any official systematic and institutional regulation (Huang Tao, 2007). Such an investment instrument can still be operated in PRC legally at present because it is not prohibited by any statute law. Notwithstanding, we could no doubt confirm that the deficiency of specific legal regulation especially in the aspect of funds administration and management in POF industry is incontestable. Besides, the new Partnership Business Law enacted on 1st June 2007 has made strong impact on domestic POF industry and will be discussed below.

2. General information of domestic POF industry

As estimated, the gross amount of POF invested on Chinese stock market is over a thousand billion CNY in the year 2007. Additionally, it is around 8% of the whole domestic capital market value (Huang Tao, 2007). Besides, it is still in the process of highly rapid developing. The so-called POF in PRC used to be classified into 2 categories when POF was introduced to domestic capital market as an investment instrument. The first category is consisted of security broker collective asset management plan, trust and investment companies' trust business and investment companies' own capital management. Almost all these sorts of funds are operating with governmental background.

The other category is mostly made up of the small-scale private placements. These POF always provide collective financial services to other investors by signing authorized financial property management contract in the name of consultation or advisory company, financing service studio and even individuals. Obviously, such funds have hardly any affiliation with governmental capital or background. In the year 2005 and 2006, the great mass of investors invested on either the two sorts of POF had gained enormous profits under the phenomenal domestic stock market circumstance. The huge risk has been hiding out behind the rapidly expanding market background, and has emerged inch by inch since 2007 which is the year of security market adjustment. For the moment, credit is still the foundation of the existence of Chinese POF (He Lu, 2007), especially the second sort of POF. From the fund placement to the management, there are clearly no adequate legal regulation and rules to monitor or restrict the funds managers, custodians, and investors, as well as their behaviors. Additionally, more and more dissimilar financial institutions and experienced financial practitioners have been engaged in POF business to provide the collective investment services as the performance of domestic security market is predicted to be upgrade in the future. The qualification, capability, credit and morality of both these new and existing participants are extremely difficult to regulate appropriately through legal instruments presently. Under certain circumstance, some particular techniques can be introduced to the current Chinese POF industry for the sake of protecting investor interests. Firstly, only qualified investors can be permitted to invest their money on POF financial products. It is actually an extraordinary elementary requirement for private placement investment globally. Literally, it was born to serve the specific investors with nice financial condition. Take United States for example: according to the US Investment Company Legislation of 1940, individual investors can invest on private placement financial products only when holding security assets more than 5 million US dollars, and the latest 2 years' annual income exceeding 200,000 US dollars. In PRC, over 80% of POF assets are from individual investors (Qin Rui, 2007). Most of the individuals are lack of financial knowledge, and even less educated. Furthermore, a majority of Chinese investors can not endure too much loss because the low-level of domestic average personal and household income. The remarkable mismatches between risk preference of investors and substantial risk of the current POF in the market always bring about instabilities to the entire industry. The present annual personal GDP of medium-sized Chinese cities is approximately 4000 US dollars. Besides that, the domestic general public offering funds require the minimum investment limit of 1000 Chinese Yuan. Consequently, with referring to the American standardization and current Chinese economic situation, a minimum investment limit of 1,000,000 Chinese Yuan while investing on POF is a reasonable hypothesis.

Another unintelligible practice among the current Chinese POF industry is that plenty of so-called "POF" are advertising through the media for raising funds. Obviously, only public offering funds can raise funds from public with advertisement since these funds have the obligation of information disclosure. Without the consideration of information disclosure, POF should not be allowed to attract investors with mass media, especially in Chinese capital market which is full of irrational investors. Therefore, certain POF only issuing to finite investors and partners with special capital asset requirement ought to be prohibited from advertising while the corresponding supervision system for both POF and Public offering funds have not been perfectly built in PRC yet.

Take the US and UK for example, the investment targets of the POF in the two countries include listed and non-listed stocks, bond, futures, option, warrant, foreign exchange, gold & silver, real estate, IT software industry and venture capital investments for Small and Medium-sized Enterprises, etc (Ba Shusong, 2007). By the reason of Chinese derivative financial market is quite immature and undeveloped, nowadays, domestic POF primarily spend their money on purchasing the stock of listed companies from A-share market. A few of other POF are focusing on real estate, energy, metal and other rapidly developing industry engaging in equity business. Apparently, duration of POF investment is usually longer than the one of other financial products. Investors' funds can not be redeemed anytime when investing on POF because the POF is not functioned the same way as public offering funds with highly broad capital source. However, a majority of Chinese investors simply concentrate on the capital gains when investing on domestic stock market. Moreover, a great deal of investors always eager for quick success and instant benefit. Thus, these investors often bring pressure to bear on the funds managers to make profit in a fairly short period after they have invested in the certain POF if the stock market or domestic financial market has performed well during that period. Some of them even claim their funds back if the performance of the POF on which they have invested is not as perfect as they desire within an extraordinary short period. Moreover, the definition of POF investors and funds managers is not explicit enough in PRC. The difference between them is generally difficult to be identified because the investment strategy of funds managers or custodians may usually be modified under the pressure of some significant investors in order to meet these investors' interests. Occasionally, some investors may even require the managers to invest in their favorable ways. For instance, domestic POF managers had to select a couple of blue chips and put them in their investment portfolios during the year 2005 and 2006 when most of the blue chips in A-share market performed extremely well and drove up the whole domestic stock market much rapidly.

Not surprisingly, investors from private enterprises but not state-owned enterprises are the most favorable collaborator for POF funds managers in PRC. What are funds managers and custodians concerned with is that the power rent-seeking which is a specific phenomenon existed widely in Chinese capital market for long may follow the cooperation with state-owned enterprises and intervene in their market manipulation. To solve these problems, a formal contract included a series of essential clauses to grant funds managers or custodians their necessary rights can be signed before the deal of investment is done. First of all, the investment time limit specified above should be contained in the contract to prevent the investors from redeeming their funds excessively soon. Furthermore, the exact way how investors can increase their capital and redeem their funds also must be contained in the contract or investment agreement. Besides that, the right and obligation of both funds investors and managers or custodians should be listed explicitly in the contract. These problems mentioned above also exist in relation to the dominating form of domestic POF. Because limited partnership POF is the leading model of POF in America, general partner and limited partner are primarily taking part in American POF industry at present. General partners are basically in charge of business activity and daily management affairs. On the contrary, limited partners are merely providing the funds but not participating in the funds management. A precise definition of dissimilar participants' authorities would restrict their behaviors and benefit the funds managers or custodians' market manipulation. The details of Chinese POF models will be discussed later.

3. the relationship between participators of different Chinese POF

Based on US Investment Company Act, the main funds established in America are the venture capital, hedge funds, investor clubs, private equity investment and some structural investment tools. The most significant forms of all these are venture capital and hedge funds (Ba Shusong, 2007). Different from US, Chinese POF used to operate primarily in two different models which are account management model and trust plan model before the promulgation of the new Chinese Partnership Business Law. In the account management model, investors usually open an account with a stock broker in the name of themselves firstly. Then the funds managers will act on behalf of the investors to manage their accounts. If the net value of investment has lost more than a certain percentage, say 10%, investors is permitted to end the clientage unilaterally. Oppositely, the profit exceeding 10% will be distributed at a promissory ratio. Most of petty POF are operating in this model, and main investors are from funds custodians' relative or friends. Because such type of POF is short of legal safeguard, both investors and custodians could not appeal to court if their benefits had been infringed. On the contrary, a great number of POF with huge amount of capital may raise funds and invest collectively in the way of trust plan. Hence, it is a fairly regular POF model at present. These two sorts of POF exist widely in the current domestic financial market. The present supervision of these POF should focus on the qualification and marketing channels to cut down the social influence of the investment risk by establishing a qualification management system of POF managers or custodians. However, the popular limited partnership POF in other countries is not quite prevailing in PRC because the risk of institutional investors investing on POF is extremely too high. Before the new Partnership Business Law (PBL) was promulgated, institutional investors interested in POF could only invest their money on POF as general partners shouldering unlimited joint and several liabilities. Nevertheless, after 1st June 2007 when new PBL was enacted, fund, commercial bank, and other financial institutions can legally participate in POF as limited partners shouldering limited liabilities. Additionally, funds managers or custodians can inject only a few capitals into the POF acting as general partners in charge of daily management of the funds and earn management fee according to the partnership agreement.

After the promulgation of new PBL, a number of new limited partnership POF have emerged in China. The first real limited partnership POF named South China Sea development and business start-up Limited Joint Enterprise was established on 28th June 2007 in Shenzhen. Later, the first Shanghai limited partnership POF named Rosefinch Investment was established on 2nd July 2007. After this, the first Beijing limited partnership POF called Redstone international venture capital fund primarily engaging in equity investment business was registered with Beijing administration for industry and commerce Caoyang branch officially on 16th January 2008. Compared with other sorts of POF in Chinese financial market, limited partnership POF performed much more actively and flexibly. They can not only investing in secondary market, but also involved in private placement, strategic allotment, private equity investment, etc.

Some of illogical phenomena in the capital market had improved quite a lot indeed after legislation of the new PBL. For instance, the chaotic personnel flow of funds managers in fund industry has been decreased since the foundation of cooperative relationship of the limited partnership POF is much more stable. The limited partnership is also a significant solution to the capital insufficiency of domestic real estate industry. Before the new PBL has been enacted, domestic POF could only cooperate with Chinese real estate enterprises as a general partner. Those real estate developer enterprises could take charge of the whole project in which investing the land and merely a few

capital. POF involved in real estate businesses have to bear a much too high risk because the great amount of invested capitals are not marching the right and profit gained from the businesses. Thus, a lot of POF used to sign complementary agreements with real estate developers to ensure the profit previously. Nonetheless, Ministry of commerce of PRC had emphasized that both domestic and foreign investors in real estate industry could not sign any forms of agreement to guarantee a fixed monetary return to any participators. Accordingly, the agreement mentioned hereinbefore is definitely greatly risky. However, for domestic POF, these sorts of risk can be eliminated through running business in the way of limited partnership POF after the promulgation of new PBL.

Nevertheless, a few issues still existed in terms of funds participators after the legislation of new PBL. Article 3 of the new PBL declares that solely state-owned companies, state-owned enterprises, listed companies, public institutions and social groups are not permitted to act as the general partner. Obviously, such an article was intended to protect these state-owned assets and listed companies from the joint and several liabilities to lower the risk. In the meanwhile, this specific restriction also had limited the capability of leverage financing of these state-owned assets and listed companies. Furthermore, the new PBL is conflict with the Company Law of PRC in terms of the identity of legal person participating in POF business. According to the new PBL, the legal person and other organizations are allowed to behave as a general partner investing in partnership enterprises. On the contrary, companies are not permitted to invest in partnership enterprises as a general partner referring to the Company Law. Consequently, the rules of the qualification of other funds management companies, security companies and venture capital companies participating in limited partnership POF as a general partner is to be legislated as early as possible. Under current legal circumstance when a conflict between the new PBL and the Company Law is occurring, the government could make a difference between different companies and industries by promulgating a provisional or transitional law to lead the capital in some underdeveloped regions or specific industries with insufficient funds. For instance, funds management companies, security companies and venture capital companies mentioned above could be permitted to deal with certain limited partnership POF primarily investing in city basal facilities construction, biomedical industry, and domestic aviation industry as general partners. By issue such a policy, underdeveloped areas could gain much more funds to solve the problem of backward infrastructure construction. The imbalance development between cities of different areas could be improved. Additionally, less risky industries supported by domestic government such as aviation also could attempt a new capital resource. Furthermore, such a policy could be an experiment for the future reform of the general partner qualification of limited partnership POF.

In conclusion, present Chinese domestic POF industry is still short of corresponding legislation. The supervision of the fund set up, marketing and sales, and fund management is lack of legitimate support. All the participants in present domestic POF desiring legal safeguard and monitor might not be able to appeal to court if their rights had been infringed due to the insufficiency of relevant supervisory legislation. The cooperative relationship between these participants involved in account management model and trust plan model is quite unsteady and risky before the new PBL was enacted since the identity of these POF had not been acknowledged officially by domestic statute law. Nonetheless, the limited partnership POF prevalent recently after the promulgation of new PBL is much more beneficial to both the custodians to be master of relevant funds and investors to control their investment risks. Notwithstanding, the conflict between Chinese Company Law and the new PBL restrain solely state-owned companies, state-owned enterprises, listed companies, public institutions and social groups from participating in limited partnership POF as general partners in order to protect them from the risk of unlimited joint and several liabilities. Therefore, a complementary rules or regulations much be enacted as early as possible. To sum up, the investors, fund partners and custodians involved in current Chinese POF business are cooperating without any tremendous disasters in spite of lots of shortcomings existing in the industry. Nevertheless, a systematic and comprehensive legal platform for Chinese POF industry is to be established urgently.

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