THE BURGEONING SECURITIES INVESTMENT FUND INDUSTRY IN CHINA: ITS DEVELOPMENT AND REGULATION

TINGTING TAO*

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* S.J.D. Candidate, University of New South Wales (UNSW); LL.B. 1994, Hangzhou University, the PRC; qualified as a lawyer in the PRC in 1995. The author deeply appreciates the financial assistance of the Overseas Postgraduate Research Scholarship provided by the Law Faculty of UNSW. The author would also like to express her gratitude to Ian Cameron, Kam Fan Sin, and Kerrie Daley of the Law Faculty of UNSW for their constant support, and Sumi Sakata and other editors for their great editorial assistance. The responsibility for any errors in the article is solely the author's.

I. INTRODUCTION

The first investment fund in China was born in 1991. Despite this late start, China's investment funds have grown rapidly, and their number and size are expected to expand greatly in the coming years. The funds have developed in two stages demarcated by the national regulation promulgated in 1997. Before that time, funds were at the stage of self-development. A total of 75 funds and 47 fund-like certificates had been launched with the accumulated capital of more than Renminbi ("RMB") 7 billion yuan (approximately US $1 = RMB 8.3 yuan as of September 1999).[1] These funds are often referred to as "old funds," as opposed to the new funds established after the national regulation. The old funds introduced the concept of the investment fund into China and led the Chinese to realize their potential as instruments for investment.

The small size of the old funds, however, made them unable to play a significant role in China's securities market. Their erratic management and poor risk control also highlighted the necessity of official regulation. The Provisional Measures for the Administration of Securities Investment Funds ("Provisional Measures"), promulgated in November 1997, are the first national regulation governing the domestic fund industry. Under the Provisional Measures, China's funds began a new era of development, and 14 new funds had been set up with a total capital of RMB 32 billion yuan by the end of July 1999.[2]

The government's regulatory strategies towards fund development are distinctively Chinese. In realizing the important role of institutional investors to China's securities market, the government is committed to developing funds through cautious guidance, and current development of new funds is regarded as experimental. The regulatory authority has issued a set of rules and notices to implement the Provisional Measures, provided favorable policies for funds to support their development, and been strict in approving their establishment and supervising their operation. Such a regulatory framework, while beneficial for the healthy development of the fund industry in its infant stage, has also raised concerns about over-regulation. The sustainable development of this promising industry in China depends on the adoption of more market-oriented approaches.

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1. *See Funds Can Curb Market Volatility*, CHINA DAILY BUS. WKLY., Sept. 7, 1997, at 3; *Zhongguo Jijin Shichang 1998 Nian Huigu Yu 1999 Nian Zhanwang [An Overview of China's Investment Fund Market of 1998 and Prospects for 1999]*, ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES], Mar. 30, 1999, *available in* <http:// www.cs.com.cn>.

2. *See infra* Appendix A, p. 243.

This article explores the regulatory framework under the Provisional Measures and implementing rules, and examines their impact on the development of securities investment funds in China. Part II begins with the significance of investment funds to China's securities market, followed by an overview of the old funds and their problems. Part III then introduces the regulatory regime governing securities investment funds. Part IV sets out the main provisions of the Provisional Measures and implementing rules, and some issues left unsolved by the Provisional Measures. Part V then analyzes the unique role of investment funds in China's economic reform, the authority's implementing strategies, the development of funds after the Provisional Measures, and finally, provides some suggestions for the future development of funds.

II. THE EMERGENCE OF INVESTMENT FUNDS

A. *Background: Investment Funds and China's Securities Market*

Since the early 1980s,[3] the size of the securities market in China has expanded quickly. By the end of September 1999, the number of listed companies in the securities market had surged to 926, while the total value of stocks hit RMB 2979.7 billion yuan.[4] Meanwhile, the structure of the market has gradually been built up. The securities trading structure has evolved into "two exchanges and two systems" — a nation-wide system centered around the Shanghai and Shenzhen securities exchanges[5] and the two national electronic trading systems.[6] Trading centers have been set up in major cities around the country, and the number of securities institutions and other securities-related intermediaries such as accounting firms, law firms, and credit rating agencies has also been increasing quickly.[7] With the

3. For details of the early development of China's securities market, see Yichen Zhang & Da Yu, *China's Emerging Securities Market*, 29 (2) COLUM. J. WORLD BUS. 112, 113 (1994).

4. *See Tongji Baobiao [Statistical Reports]*, ZHENGQUAN SHIBAO [SECURITIES TIMES], Sept. 30, 1999, *available in* <http://www.securitiestimes.com.cn>. There are 474 companies listed on the Shanghai Securities Exchange for a total stock value of RMB 1622.2 billion yuan, and 452 companies listed on the Shenzhen Securities Exchange for a total stock value of RMB 1357.5 billion yuan. *See id.*

5. The Shanghai and Shenzhen securities exchanges were established in December 1990 and July 1991 respectively. *See* Zhang & Yu, *supra* note 3, at 113.

6. The two electronic trading networks are the Securities Trading Automatic Quotations System ("STAQ") and the National Electronic Trading System ("NETS"). *See* Jayzhe Zhang, *Securities Markets and Securities Regulation in China*, 22 N. C. J. INT'L L. & COM. REG. 557, 563 (1997).

7. *See* Zhang & Yu, *supra* note 3, at 113.

flourish of China's securities market, the market environment for developing investment funds, therefore, has matured.

Yet, just as the fast expansion of the securities market has laid the foundation for the growth of investment funds, the development of the funds is also crucial to fostering a stable and mature securities market in China.

First, investment funds can attract more capital to the securities market. In China, individual savings had grown to RMB 5.92 trillion yuan by the end of June 1999.[8] People are eager to find new investment tools due to the low deposit interest rate,[9] but approximately only 3% of the overall population had participated in the securities market by February 1998.[10] Most people do not have enough knowledge or time to trade securities themselves, and are fearful of the high risks in the market. Also, certain groups in China, such as Party cadres and personnel of securities institutions, are not permitted to trade securities.[11] Investment funds can answer these problems. Because funds are managed by experts who are expected to achieve optimal returns and minimize risks, they can attract more people, including Party cadres and securities personnel, to participate in the securities market.

Second, investment funds can improve investor structure and rationalize securities investment activities. Retail investors have dominated China's securities market. Most of the retail investors lack specialized investment knowledge and are interested only in short-term speculation. Non-economic information and rumors, therefore, heavily influence the market, which often results in unusually sharp fluctuations of prices.[12] Investment funds, as managed by institutional investors with long-term rational investment strategies, can provide a counterweight to speculative investment and foster the stable development of the securities market.

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8. *See Taxation on Savings Requested*, CHINA DAILY BUS. WKLY., Aug. 29, 1999, at 3.

9. On June 10, 1999, the People's Bank of China ("PBOC") announced a cut on borrowing and lending rates of financial institutions. It was the seventh interest rate cut on both deposits and loans since May 1996, and was aimed to help squeeze part of the huge amount of savings from banks. *See Interest Rates Cut Benefits Enterprises*, CHINA DAILY, July 14, 1999.

10. By February 1998, individual investors registered in the Shanghai and Shenzhen securities markets numbered more than 30 million, which accounted for about 3% of the overall population. *See Securities Companies Win Approval for Trial Funds*, CHINA DAILY, Feb. 24, 1998.

11. *See* Andrew Xuefeng Qian, *Riding Two Horses: Corporatizing Enterprises and the Emerging Securities Regulatory Regime in China*, 12 UCLA PAC. BASIN. L. J. 62, 87 (1993).

12. *See Stock Market Changes Face of Finance*, CHINA DAILY BUS. WKLY., Dec. 14, 1998, at 2.

B. *Historical Development Before the Provisional Measures*

Investment funds were formally established in China in 1991.[13] The first two funds, the Shenzhen Nanshan Venture Investment Fund and the Wuhan Securities Investment Fund, were launched in October in Shenzhen and Wuhan respectively.[14] The development of investment funds surged in the next two years. By the end of 1993, there were more than forty-five funds set up in China.[15]

The approval of investment funds, however, was not unified. Most were approved by the provincial and municipal branches of the People's Bank of China ("PBOC"), and only a few funds were approved by the headquarters of the PBOC.[16] Many problems arose with these funds due to the absence of uniform regulation. Consequently the PBOC issued an Emergency Notice on May 19, 1993, announcing that approval to set up

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13. The origin of investment funds can be traced to the fund activities conducted by the Bank of China and China International Trust and Investment Co. In 1987, together with some overseas institutions, they have initiated an investment fund targeting overseas investors. *See Woguo Laojijin De Fazhan Licheng Yu Shichang Guimo [Historical Development of China's Old Funds and Their Market Scale]*, ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES], *available in* <http://www.cs.com.cn>; *see also* HONGQIN CHEN, GONGTONG JIJIN YUNZUO SHIWU [PRACTICING MUTUAL FUNDS] 28, 282 (1995).

14. *See* WORLD BANK DISCUSSION PAPER 358, CHINA'S NON-BANK FINANCIAL INSTITUTIONS: TRUST AND INVESTMENT COMPANIES 47 (Anjali Kumar ed., 1997) (stating that the first fund was the Wuhan Securities Investment Fund); *Touzi Jijin Zhoujin Niwota [Investment Funds Are Approaching Us]*, RENMIN RIBAO [PEOPLE'S DAILY], Dec. 4, 1997, at 10 (stating that the first fund was the Shenzhen Nanshan Venture Investment Fund); *Zhongguo Jijinye Lishi Huigu Yu Fazhan Sikao [History of China's Fund Industry and a Discussion of its Development]*, ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES], *available in* <http://www.cs.com.cn> (stating that both were the earliest funds); *but see Historical Development of China's Old Funds and Their Market Scale, supra* note 13 (stating that the Zhuxin Fund, launched in Zhuhai municipality in July 1991, was the first fund in China).

15. Official statistics about the old funds are not easily available. For example, the Yearbook of China's Securities Market of 1994 provides only the total issuance of fund units in 1992 as RMB 0.98 billion yuan. The total issuances in 1991 and 1993 are absent and no other statistics about investment funds are provided. *See* CHINA SECURITIES REGULATORY COMMISSION, ZHONGGUO ZHENGQUAN SHICHANG NIANJIAN (1994) [THE YEARBOOK OF CHINA'S SECURITIES MARKET (1994)]. Therefore the figures about the old funds, as stated in various newspaper articles, are sometimes conflicting. *See* ZHONGGUO ZHENGQUAN SHICHANG YU ZHENGQUAN TOUZI [CHINA'S SECURITIES MARKET AND SECURITIES INVESTMENT] 138 (Haiyun Liu, Renfeng Li & Fangquan Huang eds., 1997) (stating there were 45 funds by the end of 1993); ZHONGGUO ZHENGQUAN SHICHANG ZHOUSHI [THE TREND OF CHINA'S SECURITIES MARKET] 77 (Fengqi Chao & Changhui Yao eds., 1994) (stating there were about 50 funds by the end of 1993); ZHENGQUANFA LIJIE SHIYONG YU ANLIE PINGXI [UNDERSTANDING AND PRACTICE OF SECURITIES LAW AND CASE STUDIES] 276 (Yan Gao & Pingjun Yi eds., 1997) (hereinafter UNDERSTANDING AND PRACTICE) (stating there were 56 funds by November 1993); World Bank Discussion Paper 358, *supra* note 14 (stating there were 73 funds by the end of 1993).

16. *See* UNDERSTANDING AND PRACTICE, *supra* note 15; *see also Guifan Xianyou Jijin de Shexiang [A Vision for Standardizing Current Funds]*, ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES], Nov. 17, 1997, at 7.

funds and fund management companies would only be given by the headquarters of the PBOC.[17]

Since the Emergency Notice, the development of China's funds has slowed down. The headquarters of the PBOC has not formally approved the establishment of any domestic funds since then.[18] The number of funds, however, still increased slowly in subsequent years, reflecting the irregularities of the old funds. By the time the Provisional Measures were promulgated in November 1997, China had set up 75 funds and 47 fund-like certificates,[19] with a total capital of more than RMB 7 billion yuan.[20]

Most of the old funds are closed-end contractual funds, with a few established as closed-end corporate funds.[21] The Shandong Zibo Town and Township Enterprise Investment Fund, approved by the headquarters of the PBOC in November 1992, was the first corporate investment fund in China.[22] Most of the old funds were small. The largest fund launched was Tianji, a RMB 581 million yuan fund launched in Shenzhen.[23] The smallest fund had a capital of RMB 10 million yuan.[24]

These funds have investment policies involving a combination of direct investment and indirect portfolio investment.[25] Funds began their listing in 1993 and the trading was active in that year.[26] The listing of Shandong Zibo Town and Township Enterprise Investment Fund in August

17. *See* WORLD BANK DISCUSSION PAPER 358, *supra* note 14, at 47; *see also Historical Development of China's Old Funds and Their Market Scale, supra* note 13.

18. *See* WORLD BANK DISCUSSION PAPER 358, *supra* note 14, at 47; *see also Historical Development of China's Old Funds and Their Market Scale, supra* note 13.

19. *See Funds Can Curb Market Volatility, supra* note 1; *Historical Development of China's Old Funds and Their Market Scale, supra* note 13; *History of China's Fund Industry and a Discussion of its Development, supra* note 14.

20. *See An Overview of China's Investment Fund Market of 1998 and a Prospect for 1999, supra* note 1 (stating there is a total capital of RMB 7.6 billion yuan); *Historical Development of China's Old Funds and Their Market Scale, supra* note 13 (a total of RMB 7.196 billion yuan); *Investment Funds Are Approaching Us, supra* note 14 (a total of about RMB 8 billion yuan).

21. *See* UNDERSTANDING AND PRACTICE, *supra* note 15, at 276. It also mentions that two of the old funds are open-ended. Article 55 of the Provisional Measures defines closed-end and open-end funds. A closed-end fund refers to a fund whose total issuance has been determined before its establishment, whose number of units is fixed for its duration, and whose investors can trade fund units through the securities market after listing. An open-end fund refers to a fund whose total issuance and unit number are not fixed, and whose investors can subscribe to and redeem units according to unit prices in the operating places stipulated by the state. For a discussion on contractual and corporate funds, see *infra* notes 171-76 and accompanying text.

22. *See* World Bank Discussion Paper 358, *supra* note 14, at 47.

23. *See id.*; *see also Funds Can Curb Market Volatility, supra* note 1.

24. *See* World Bank Discussion Paper 358, *supra* note 14; *Funds Can Curb Market Volatility, supra* note 1.

25. They primarily invest in securities and real estate. *See* World Bank Discussion Paper 358, *supra* note 14.

26. *See* CHEN, *supra* note 13, at 31.

1993 on the Shanghai Securities Exchange was one of China's top ten securities news in that year.[27] By the end of 1997, 25 of the 75 funds had been traded in the Shanghai and Shenzhen securities exchanges.[28] The rest were traded in regional trading centers or over-the-counter markets.[29]

C. *The Call for Standardization*

Although progress had been made, these funds ran into many problems due to a lack of uniformity. First, not only was the standard for approval of new funds lax, but different agencies had the power to approve. Thus, the headquarters of the PBOC, the local branches of PBOC, and local governments each separately approved different investment funds.[30] Meanwhile, supervision over funds was inadequate and scattered. There was no department directly overseeing the operation of funds, allowing the local branches of the PBOC to assume such supervisory roles.[31] Nor was there a self-disciplinary body inside the industry.[32]

Second, the structure of funds was not standardized. The principle of independence is stressed in contractual funds in order to reduce investment risks. Therefore funds should have fund managers, to manage funds, and fund custodians, to take custody of fund assets, who are mutually independent. The positions of fund managers and fund custodians should be assumed by organizations with legal person status who can independently engage in activities and assume legal liabilities.[33]

The structure of the old funds, however, was far from standard. Some fund managers or fund custodians did not have legal person status and

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27. *Id.* at 31-32; *see also* World Bank Discussion Paper 358, *supra* note 14, at 47.

28. *See Investment Funds Are Approaching Us*, *supra* note 14; *Funds Can Curb Market Volatility*, *supra* note 1 (stating there are 25 old funds listed); *but see Historical Development of China's Old Funds and Their Market Scale*, *supra* note 13 (stating there are 24 old funds listed); *Regulation Targets Funds: New Rules to Favor Stability*, CHINA DAILY BUS. WKLY., Oct. 19, 1997, at 3 (stating there are 27 old funds listed). This number includes those funds listed in the two securities exchanges and those, although not listed in the securities exchanges, that are nevertheless traded there because of the electronic link of some trading centers to the securities exchanges. *See* World Bank Discussion Paper 358, *supra* note 14, at 47.

29. *See Funds Can Curb Market Volatility*, *supra* note 1.

30. *See* UNDERSTANDING AND PRACTICE, *supra* note 15; *see also A Vision for Standardizing Current Funds*, *supra* note 16.

31. *See* World Bank Discussion Paper 358, *supra* note 14, at 49; *see also Funds Can Curb Market Volatility*, *supra* note 1.

32. *See Funds Can Curb Market Volatility*, *supra* note 1.

33. A legal person in China is defined as "an organisation which possesses civil legal capacity and capacity for civil acts and which, according to the law, independently enjoys civil rights and assumes civil obligations." *See* General Principles of Civil Law, art. 36, *translated and available in* CHINA LAWS FOR FOREIGN BUSINESS - BUSINESS REGULATION 19-150 (CCH loose-leaf service) (adopted on April 12, 1986, by the Fourth Session of the Sixth National People's Congress ("NPC").

were merely departments of banks or securities institutions, with no independent legal capacities.[34] Some may have had legal person status but inadequate management structures.[35] It was not unusual for an old fund to have one company or department to act both as the fund manager and fund custodian. In some cases the roles of the fund promoter, fund manager and fund custodian were all assumed by one company.[36]

Third, risk control and investor protection were inadequate. These funds invested widely without careful research or restrictions on their investment apportionment.[37] Some funds invested heavily in real estate resulting in a low liquidity,[38] some lent fund capital at high interests,[39] and some fund managers invested in the name of the investment funds with capital from other sources.[40] Also, fund profit distribution was discretionary, and some funds suspended distribution for several years, which seriously damaged the interests of investors.[41] Furthermore, information disclosure was also inadequate. The information about investment portfolios and fund profits disclosed by these funds every half-year was often too simple and too vague; thus, investors were not informed about the operation of funds.[42] Yet, at the time, investors had only limited knowledge of funds, and were unable to tell the difference between funds and stock shares.[43]

The need to improve the operation of the old funds was self-evident. Investment funds were becoming an imperative part of China's securities market, but their operation needed to be standardized. The fund industry

34. *See* WORLD BANK DISCUSSION PAPER 358, *supra* note 14, at 46.

35. *See id.* Only the fund manager of the Zibo Fund has been approved by the headquarters of PBOC. *See Xianyou Touzi Jijin De Guifanhua Lujing* [*The Way for Standardizing Current Investment Funds*], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES], Nov. 27, 1997, at 9.

36. *See* UNDERSTANDING AND PRACTICE, *supra* note 15, at 281.

37. *See Laojijin De Sige Buguifan* [*Four Non-Standard Aspects of Old Funds*], ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES] *available in* <http://www.cs.com.cn>

38. *See Funds Can Curb Market Volatility, supra* note 1.

39. *See Cong Touzi Yunzuo Kan Xianyou Jijin De Chulu* [*Looking at the Future of Current Funds from the Perspective of Investment Operation*], ZHENGQUAN SHIBAO [SECURITIES TIMES], Nov. 24, 1997, at 11.

40. Some listed companies entrusted fund managers to invest their capital in the securities market, which has seriously infringed upon the interests of investors of these companies. *See id.*

41. *See The Way for Standardizing Current Investment Funds, supra* note 35. From 1994 to 1996, Jun'an Shouyi and Hainan Yingtong did not distribute profits for three years; Tianji Fund and Lantian Fund did not distribute profits for two years; and Shenyang Gongzhong, Shenyang Wanli, and Guangzheng Shouyi did not distribute profits in 1996. *See id.*

42. *See Four Non-Standard Aspects of Old Funds, supra* note 37.

43. According to a market survey in the end of 1997, 62% of individual investors regarded funds and stocks as almost the same. *See "Sanhu Yu Touzi Jijin" Wenjuan Diaocha Fengxi Baogao* [*A Report Based on the Survey of "Individual Investors and Investment Funds"*], ZHENGQUAN SHIBAO [SECURITIES TIMES], Nov. 19, 1997, at 11.

consequently slid to a halt and waited for guidance from the national regulation.

III. THE REGULATORY REGIME

A. *Regulations Before the Provisional Measures*

Prior to 1993, the main focus in debates about investment funds was whether they should be developed in China. With the development of funds, their advantages and significance were gradually realized and the focus turned to how to standardize them. The media hotly engaged in the discussion concerning investment funds, and state authorities began to consider their regulation.[44]

The Provisional Regulations on the Administration of the Issuing and Trading of Stocks, promulgated by the State Council on April 22, 1993,[45] was an early legal, although indirect, acknowledgment of investment funds in China.[46] When stipulating that certain persons, such as the employees and management personnel in the securities trading industry, could not hold or trade securities either directly or indirectly, Article 39 explicitly states that these people are still permitted to trade units of investment funds.

There was no official national legislation or regulation directly regulating investment funds before 1997.[47] Indirectly applicable regulations were contained in the Administrative Regulations Governing Financial Institutions of 1994,[48] and the Administrative Measures for Overseas Investment Funds of 1995.[49] The former regulates the establishment, management and termination of financial institutions, which include fund management companies.[50] The latter applies to investment funds which are

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44. *See* CHEN, *supra* note 13, at 283-84. As early as July 1994, the CSRC had pronounced four measures to foster the securities market, two of which are relevant to investment funds. Specifically, they pertain to the development of domestic investment funds and the allowance of foreign funds into China's A shares market. *See id*, at 28.

45. *Translated and available in* CHINA LAWS FOR FOREIGN BUSINESS - BUSINESS REGULATION 13-574 (CCH loose-leaf service). This was the core securities regulatory statute before the promulgation of the Securities Law in December 1998.

46. *See* CHEN, *supra* note 13, at 283.

47. *See* World Bank Discussion Paper 358, *supra* note 14, at 48.

48. *Translated and available in* CHINA LAWS FOR FOREIGN BUSINESS - BUSINESS REGULATION 8-400 (CCH loose-leaf service) (promulgated on August 9, 1994, by the PBOC).

49. *Available in* <http://www.cs.com.cn> (approved by the State Council on Aug. 11, 1995, and enacted by the PBOC on Sept. 6, 1995).

50. Administrative Regulations Governing Financial Institutions, supra note 48, art. 3.

registered and raise capital outside China, but which mainly invest in industrial projects within China.[51] In addition, corporate investment funds are also subject to the Company Law of 1993.[52]

In the absence of national legislation, local regulations were formulated to cover investment funds. The first and most important local regulation, the Shenzhen Interim Provisions for the Administration of Investment Trust Funds, were promulgated in Shenzhen in June 1992.[53] Shanghai also promulgated local regulation in 1993, the Shanghai Provisional Measures for the Administration of Renminbi Securities Investment Trust Funds.[54] Additionally, the Shanghai and Shenzhen securities exchanges also issued rules regarding investment funds.[55] However, these local regulations are not uniform and are far from adequate. National legislation, therefore, was urgently needed to regulate all aspects of investment funds.

B. *Current Regulatory Regime*

1. The Enactment of the Provisional Measures

The current national legislation is said to have been revised more than ten times.[56] The long-awaited Provisional Measures for the Administration of Securities Investment Funds were finally promulgated in November 1997.[57] They contain 57 articles,[58] and regulate securities investment funds, which invest in stocks, bonds, and other financial instruments.[59] Individuals, legal persons or other institutions who engage in

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51. Administrative Measures for Overseas Investment Funds, *supra* note 49, art. 2.

52. *Translated and available in* CHINA LAWS FOR FOREIGN BUSINESS - BUSINESS REGULATION 13-518 (CCH loose-leaf service) (adopted on December 29, 1993, by the Eighth NPC)

53. *See* WORLD BANK DISCUSSION PAPER 358, *supra* note 14, at 48; *The Way for Standardizing Current Investment Funds*, *supra* note 35; *Historical Development of China's Old Funds and Their Market Scale*, *supra* note 13.

54. *See* WORLD BANK DISCUSSION PAPER 358, *supra* note 14; *The Way for Standardizing Current Investment Funds*, *supra* note 35; *Historical Development of China's Old Funds and Their Market Scale*, *supra* note 13.

55. *See* WORLD BANK DISCUSSION PAPER 358, *supra* note 14, at 48; *see also* UNDERSTANDING AND PRACTICE, *supra* note 15, at 282.

56. *See* WORLD BANK DISCUSSION PAPER 358, *supra* note 14, at 49.

57. *Available in* <http://www.cs.com.cn> (approved by the State Council on Nov. 5, 1997) (promulgated by the State Council Securities Commission ("SCSC") on Nov. 14, 1997)

58. These articles are divided into the following seven chapters: (1) general principles; (2) establishment, issuing and trading; (3) fund custodians and fund managers; (4) rights and duties of fund holders; (5) investment operation, and supervision and management of funds; (6) punishment; and (7) supplementary provisions.

59. Provisional Measures, art. 2.

fund and related activities within the territory of the People's Republic of China ("PRC") fall under the domain of the Provisional Measures.[60]

2. Subsequent Rules and Notices

To ensure standard and healthy development of securities investment funds and to protect the legal rights and interests of fund participants, the China Securities Regulatory Commission ("CSRC") issued four trial implementing rules in December 1997 in accordance with the Provisional Measures.[61] These implementing rules are (1) Contents and Format of Fund Contracts of Securities Investment Funds; (2) Contents and Format of Custodian Contracts of Securities Investment Funds; (3) Contents and Format of Prospectuses of Securities Investment Funds; and (4) Guidance to the Essential Clauses in Articles of Association of Fund Management Companies. In March 1998, the CSRC further promulgated the fifth implementing rule, Guidance to the Information Disclosure of Securities Investment Funds.[62]

In addition, the CSRC has also issued a number of notices to regulate investment funds. These notices include guidelines on the application for the establishment of fund management companies,[63] application for the establishment of investment funds,[64] and favorable policies for the subscription of new issues by investment funds.[65] The Notice on Some Issues for Strengthening the Supervision of Securities Investment Funds, issued on August 21, 1998, is regarded as the most important among these notices.[66]

60. *Id.*, art. 4.

61. Notice on Promulgating the Implementing Rules of the Provisional Measures for the Administration of Securities Investment Funds, CSRC Investment Fund File [1997] No. 3, *available in* <http://www.cs.com.cn>.

62. *Available in* <http://www.cs.com.cn>.

63. CSRC Investment Fund File [1997] No. 1 *available in* <http://www.cs.com.cn>.

64. CSRC Investment Fund File [1997] No. 2 (issued Dec. 12, 1997), *available in* <http://www.cs.com.cn>.

65. Notice Regarding the Subscription for New Issues by Securities Investment Funds (issued Aug, 11, 1998), *available in* <http://www.cs.com.cn>.

66. *Available in* <http://www.cs.com.cn>.

IV. THE REGULATORY FRAMEWORK

A. The Regulatory Authorities

1. Gradually Centralized Authority of the CSRC in Fund Regulation

Historically, China had a decentralized regulatory structure governing the securities industry. Although the PBOC retained control over the securities industry as a whole,[67] local municipal governments and the local PBOC branches came to assume more important supervisory roles by formulating their own rules.[68] This regulatory structure was inadequate to regulate the securities market properly.

In order to centralize regulation, a two-tier structure — the State Council Securities Commission ("SCSC") and the China Securities Regulatory Commission ("CSRC") — was established in October 1992.[69] The SCSC consists of representatives of various government ministries,[70] and is primarily responsible for drafting securities regulations and formulating guidelines for the market development.[71] The CSRC is the management arm of the SCSC, and exercises supervision and control over the issuing and trading of securities.[72] As the SCSC played a limited role in regulating the securities market,[73] it was eventually merged into the CSRC in October 1998.[74]

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67. It was responsible for promulgating and implementing regulations for the securities market, licensing securities institutions, and approving new listings. *See* Zhang, *supra* note 6, at 561-62.

68. *See* Qian, *supra* note 11, at 69.

69. In China, the SCSC is referred to as "*Zheng Quan Wei*" and the CSRC is referred to as "*Zheng Jian Hui*". They were established pursuant to the State Council Circular to Further Strengthen the Overall Administration of the Securities Market, *available in* ZHENGQUAN FALU SHIYONG SHOUCHE [SECURITIES LAW PRACTISING HANDBOOK] (Handbook Series Editing Committee ed., 1997) (hereinafter State Council Circular) (issued Dec. 17, 1992) (translation available in Qian, *supra* note 11, at 69 n. 30)

70. *See* Zhang, *supra* note 6, at 562.

71. State Council Circular, *supra* note 69, art. 1 sec. 1; Provisional Regulations on the Administration of the Issuing and Trading of Stocks, *supra* note 45, art. 5.

72. State Council Circular, *supra* note 69, art. 1 sec 2; Provisional Regulations on the Administration of the Issuing and Trading of Stocks, *supra* note 45, art. 5.

73. *See* Xiqing Gao, *Developments in Securities and Investment Law in China* 6 AUST. J. CORP. LAW 228, 232 (1996).

74. In April 1998, Zhou Zhengqing, chairman of the CSRC, said that as a result of current institutional reform, the SCSC would be merged with the CSRC; securities regulating functions of the PBOC would be transferred to the CSRC; and local securities regulatory institutions would be controlled by the CSRC instead of by local governments. *See China's Securities Legislation Pressing Ahead,* CHINA DAILY, Apr. 21, 1998; *see also Guowuyuan Pizhun Zhongguo Zhengjianhui Shanding Fang'an [The State Council Approved the Plan of the CSRC Concerning its Functions, Structure and*

Initially, the PBOC was responsible for regulating investment funds and was drafting regulations for funds.[75] After the establishment of the CSRC, however, the division of responsibilities between the PBOC and the CSRC was not known. It was preferred that a single competent regulatory authority should be responsible for investment funds.[76] Therefore, the Provisional Measures were released in the name of the SCSC, and the CSRC was recognized as the sole authority for regulating funds. The PBOC retains only the powers to regulate fund custodians in conjunction with the CSRC, because the positions of fund custodians are assumed by commercial banks.

2. The Regulatory Powers of the CSRC

Generally speaking, the Provisional Measures provide the CSRC with four categories of regulatory powers. First, the CSRC has the power to formulate rules and requirements to implement the Provisional Measures. The CSRC can specify the contents and format of fund contracts, custodian contracts and prospectuses,[77] which it has already done in a series of subsequent implementing rules. The CSRC is also authorized by the Provisional Measures to set other requirements in addition to what have already been provided. Accordingly, the CSRC can stipulate further conditions regarding the establishment of an investment fund and a fund management company,[78] further investment restrictions in portfolio management,[79] and other activities which funds are forbidden to conduct.[80]

Second, the CSRC has the power of approval. The establishment of funds is subject to the examination and approval by the CSRC,[81] as is the establishment of fund management companies.[82] Also, the CSRC is authorized to approve the enlargement or extension of closed-end funds,[83] the removal of fund managers,[84] the resolutions made in fund holders' meeting concerning certain matters,[85] and the results of liquidation.[86]

Personnel], RENMIN RIBAO [PEOPLE'S DAILY], Oct. 19, 1998, at 4.

75. *See* World Bank Discussion Paper 358, *supra* note 14, at 49.

76. *Id.* at 50.

77. Provisional Measures, art. 8.

78. *Id.* art. 7 sec. 5, art. 24 sec. 7.

79. *Id.* art. 33 sec. 5.

80. *Id.* art. 34 sec. 13.

81. *Id.* art. 5.

82. *Id.* art. 23.

83. *Id.* art. 11.

84. *Id.* art. 27.

85. *Id.* art. 30. These matters are modification of fund contracts, termination of funds in advance, and change of fund custodians or fund managers. *See id.*

86. *Id.* art. 41.

Third, the CSRC has the power to supervise and examine the operation of funds. Article 39 of the Provisional Measures states that the CSRC and the PBOC can, under their respective authorities, at any time examine the issuing, trading, and operating of investment funds and other related activities. As a result, the CSRC can require the termination of a fund because of a serious violation of laws or regulations.[87] Additionally, if the CSRC has sufficient grounds to believe that a fund manager can no longer carry out his functions, it can require the fund manager to resign.[88]

Last, the CSRC has the power to impose legal sanctions. Violations of the Provisional Measures would result in sanctions imposed by the CSRC according to Articles 43-54.

3. The Regulatory Powers of the PBOC

As to matters relating to fund custodians, the regulatory powers are shared between the CSRC and the PBOC. Both the CSRC and the PBOC must approve appointment of fund custodians.[89] Fund custodians must prepare reports for submission to the CSRC and the PBOC.[90] Moreover, an old fund custodian can resign only after a new custodian has received approval from the CSRC and the PBOC.[91] The CSRC and the PBOC can at any time examine matters relating to fund custodians under their respective authorities.[92]

The reference to "respective authorities," however, is vague. Because the CSRC and the PBOC share regulatory powers over fund custodians, the division of powers between the two authorities is not clear. Fortunately, the Provisional Measures do take notice of the potential for conflicts of power. Article 52 stipulates that the CSRC and the PBOC can impose legal sanctions under their respective authorities, but that two or more sanctions may not be applied to one illegal action.[93] This provision is aimed at avoiding the possible overlap of legal sanctions imposed by the CSRC and the PBOC.

87. *Id.* art. 40 sec. 3.
88. *Id.* art. 27 sec. 4.
89. *Id.* art. 16.
90. *Id.* art. 19 sec. 6.
91. *Id.* art. 22.
92. *Id.* art. 39.
93. *Id.* art. 52.

4. Securities Exchanges

Besides the CSRC and the PBOC, the securities exchanges in Shanghai and Shenzhen are also responsible for securities market administration.[94] The Provisional Measures authorize the securities exchanges to approve and supervise the listing of closed-end investment funds,[95] and to formulate listing rules concerning closed-end funds with approval from the CSRC.[96]

B. Establishment, Issuing and Trading

1. Qualifications for Establishment

Fund promoters can apply to the CSRC to establish either closed- or open-end funds.[97] Certain requirements, as provided in Article 7, must be satisfied to establish funds. The Provisional Measures require that main promoters be securities firms, trust and investment companies ("TICs"),[98] or fund management companies.[99] The criterion for differentiating main promoters and promoters, however, is not provided. The capital of each promoter can be no less than RMB 300 million yuan, and main promoters are further required to have at least three years of experience in securities investment, and must have earned profits during this period consecutively. Fund management companies are exempted from this requirement when acting as promoters.[100]

Moreover, fund promoters, fund custodians, and fund managers must be in good financial condition, and have sound management systems, organizations, and standard operating activities.[101] Fund custodians and fund managers are further required to have qualified management premises,

94. For details of the functions of securities exchanges in China, see Zhang, *supra* note 6, at 563-66.

95. Provisional Measures, art. 14.

96. *Id.*

97. *Id.* arts. 5, 6.

98. In China, securities institutions include securities firms and TICs. The former are referred to as "specialized securities institutions" and the latter as "institutions which engage in securities business concurrently with other business." *See* Administrative Measures on Own-account Securities Business Conducted by Securities Institutions, art. 4, *translated and available in* CHINA LAWS FOR FOREIGN BUSINESS - BUSINESS REGULATION 13-590 (CCH loose-leaf service) (promulgated Oct. 24, 1996, by the CSRC)

99. Provisional Measures, art. 7 sec. 1.

100. *Id.* art. 7 sec. 2.

101. *Id.* art. 7 sec. 3.

facilities for safety, and other facilities relevant to fund operation.[102] In addition, open-end funds must be able to disclose to investors at least weekly the fund's net asset value and the prices for subscription and redemption.[103]

The Provisional Measures also specify in Article 8 a list of documents to be submitted in the application. These documents include the following: an application form; a promoters' agreement; a fund contract; a custodian contract; a prospectus; an issuance plan; a legal opinion provided by a law firm; and, if the promoters are securities firms or TICs, financial reports for the last three years audited by accounting firms.[104] The contents and format of fund contracts, custodian contracts and prospectuses have been detailed in the subsequent implementing rules.

Interestingly, there are some differences between the above two articles concerning the financial requirements of promoters. Article 7 requires only that the main promoters to be profitable. Accordingly, if securities firms or TICs do not act as main promoters, they need not meet this requirement. In contrast, Article 8 stipulates that when securities firms or TICs act as promoters, they must provide financial reports to prove their profitable financial condition. Furthermore, while Article 7 does not stipulate that the three years of securities investment experience required of main promoters be over the last three years, Article 8 specifically requires the promoters to provide financial reports for the last three years.

2. Procedures for Issuing and Trading

Prospectuses must be published by promoters in newspapers specified by the CSRC three days before the issuance of funds.[105] The duration of closed-end funds may not be less than five years, and the minimum capital raised should not be less than RMB 200 million yuan.[106] To protect investors' interests, promoters are required to purchase and hold certain proportions of total fund units when issuing and maintaining funds, as stipulated by the CSRC at a later date.[107]

The period for funds to raise capital is three months from the date of approval. Closed-end funds can only be established if they have raised more than 80% of the approved capital projections at the end of this period.

102. *Id.* art. 7 sec. 4.
103. *Id.* art. 7.
104. Provisional Measures, art. 8 sec. 1-7.
105. *Id.* art. 12.
106. *Id.* art. 10.
107. *Id.* art. 9. The CSRC has not stipulated such proportions yet.

For open-end funds to be established, their net sale volumes are required to be more than RMB 200 million yuan within this period.[108] If funds fail to meet the requirement, fund promoters must bear all fund-promoting fees, and the money raised plus short-term bank deposit interests must be given back to investors within 30 days.[109]

After their establishment, closed-end funds can be listed in the securities market upon approval from the CSRC and the securities exchanges.[110] The subscription and redemption of open-end funds, on the other hand, can only take place where stipulated by the state,[111] an issue not specified in the Provisional Measures.

C. *Investment Fund Participants*

1. Fund Custodians

The Provisional Measures require each investment fund to have a fund custodian, a role that only a commercial bank can assume.[112] Fund custodians and fund managers must be mutually independent in their administration and finances, and their high-level managing staff may not assume positions within each other.[113] To qualify as fund custodians, commercial banks must have at least RMB 8 billion yuan capital, specialized fund custodian departments, and sufficient professionals who are familiar with custodian operation.[114] They should also have facilities for the safekeeping of fund assets and efficient capacities for clearing and settlement.[115]

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108. *Id.* art. 13.

109. *Id.*

110. *Id.* art. 14.

111. *Id.*

112. *Id.* art. 15. Under the Commercial Banking Law, commercial banks must separate their banking business from non-bank financial activities such as trust and investment funds and securities. *See* Commercial Banking Law, art. 43, *translated and available in* CHINA LAWS FOR FOREIGN BUSINESS - BUSINESS REGULATION 8-350 (CCH loose-leaf service) (adopted by the Thirteenth Session of the Eighth NPC on May 10, 1995) (effective July 1, 1995). The Provisional Measures provide commercial banks with the opportunity to get a slice of the booming securities industry through fund custody. In practice, all major commercial banks in China have acted as fund custodians. *See* Appendix A, *infra* at 242.

113. Provisional Measures, art. 17. Furthermore, personnel in fund management companies and fund custodian departments should not hold positions concurrently in other business institutions. *See* Notice on Some Issues for Strengthening the Supervision of Securities Investment Funds, *supra* note 66, art. 2 sec. 1.

114. Provisional Measures, art. 18 sec 1-3.

115. *Id.* art. 18 sec. 4-5.

Fund custodians must strictly separate fund assets from their own assets and establish different fund accounts for different funds' assets.[116] The duties of fund custodians include the following: keeping fund assets safe; carrying out investment directions of fund managers; responsibility for capital flow in the name of the funds; checking and examining the funds' asset net value and fund prices as provided by fund managers; keeping fund accounting books and records for more than 15 years; preparing reports about fund custody to the CSRC and the PBOC; and fulfilling obligations as stipulated in fund contracts.[117]

In addition, fund custodians are responsible for monitoring the investment operation of fund managers. If it is found that an investment operation of a fund manager has contravened laws or regulations, fund custodians must refuse to carry out the direction and report it to the CSRC.[118] An implementing rule further requires that fund custodians must fulfil their duties in accordance with the principles of honesty and good faith (*chengshi xinyong*), and the principle of due diligence (*qinmian jinze*).[119] Except as provided under law or the relevant fund contracts, they may not seek profits for themselves or for any third party.[120]

2. Fund Managers

In order to establish a fund management company, the capital of each promoter can be no less than RMB 300 million yuan. The main promoters, if either a securities firm or TIC, must have been profitable for the last three consecutive years.[121] In addition, the proposed fund management company must have a minimum capital of RMB 10 million yuan, a practical fund management plan, and qualified fund management personnel.[122] Upon approval from the CSRC, fund management companies can manage funds and initiate new funds.[123]

The obligations of fund managers as set out in Article 26 include the following: operation and management of fund assets according to fund contracts; distribution of profits to fund holders in a timely and sufficient

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116. *Id.* art. 20.

117. *Id.* art. 19 sec. 1-2, 4-7.

118. *Id.* art. 19 sec. 3.

119. *See* Contents and Format of Fund Contracts of Securities Investment Funds, *supra* note 62, art. 10 sec. 2 para. a.

120. *Id.* art. 10 sec. 2 para d. They are also prohibited from entrusting a third party with fund assets. *See id.*

121. Provisional Measures, art. 24 sec. 1-3.

122. *Id.* art. 24 sec. 4-6.

123. *Id.* art. 25.

manner; keeping fund accounting books and records for more than 15 years; preparation of fund financial reports that are timely and publicly disclosed and submitted to the CSRC; calculation and disclosure of the net asset value of funds and per unit; and performance of other duties as stipulated in fund contracts.[124] They should, like fund custodians, perform their duties in accordance with the principles of honesty and good faith, and the principle of due diligence.[125]

3. Fund Holders

Investors are referred to as fund holders in the Provisional Measures. While the Provisional Measures stipulate only the obligations of fund custodians and fund managers, they provide both the rights and obligations of fund holders. Article 29 sets out various rights enjoyed by fund holders: the right to purchase, redeem and transfer fund units; the right to receive fund dividends; and the right to the residual assets after liquidating funds.[126] Fund holders can also monitor the management of funds and gain access to materials about their operation and financial situation.[127]

Moreover, they can attend fund holders' meetings by themselves or through representatives.[128] The Provisional Measures require that a fund holders' meeting must be convened when modifying fund contracts, terminating a fund before it is due, changing fund custodians or fund managers, or in other situations stipulated by the CSRC.[129] Also, they may remove fund custodians or managers with the agreement of more than 50% of the fund holders,[130] and enjoy other rights as provided in fund contracts.[131] However, the Provisional Measures do not provide the procedures to exercise these rights and therefore it may still be hard for investors to put their rights into practice.

Meanwhile, fund holders bear certain obligations. They must observe fund contracts, pay subscription and other required fees, bear limited liabilities when funds suffer losses or are terminated, and may not

124. *Id.* art. 26 sec. 1-6.
125. *See* Contents and Format of Fund Contracts of Securities Investment Funds, *supra* note 62, art. 9 sec. 1 para a.
126. Provisional Measures, art. 29 sec. 2, 4-5.
127. *Id.* art. 29 sec. 3.
128. *Id.* art. 29 sec. 1.
129. *Id.* art. 30 sec. 1-5.
130. *Id.* art. 21 sec. 3; art. 27 sec. 3.
131. *Id.* art. 29 sec. 6.

conduct any activity which may damage the interests of funds or other fund holders.[132]

D. The Regulation of Fund Operation

Before the fund is established, the investors' money must be deposited in commercial banks and cannot be used by others.[133] A cash distribution of more than 90% of the fund net income to the investors at least once a year is required.[134] In order to reduce investment risks, the Provisional Measures mandate certain requirements for investment portfolio management. More than 80% of the fund assets must be invested in stocks and bonds, and more than 20% of the fund net assets invested in treasury bonds.[135] To ensure the diversity of investment, the Provisional Measures set two other main limits. First, funds are prohibited from investing more than 10% of their net asset value in the shares of any one listed company. Second, funds managed by the same fund manager can hold no more than 10% of a company's stake.[136]

In addition to investment restrictions, the Provisional Measures further enumerate a series of prohibited activities. Mutual investments between funds are prohibited.[137] Fund custodians and commercial banks are forbidden from conducting fund investment activities,[138] and state-owned enterprises are banned from speculating in funds.[139]

Most prohibited activities pertain to fund managers. They are forbidden from engaging in underwriting or other own-account business activities in securities other than treasury bonds,[140] and may not trade securities on credit.[141] They may not invest in the name of a fund with borrowed money, with money loaned from banks, or with any money not owned by the fund.[142] They are also prohibited from investing in real estate

132. *Id.* art. 31 sec. 1-4.

133. *Id.* art. 32.

134. *Id.* art. 38.

135. *Id.* art. 3 sec 1, 4.

136. *Id.* art. 33 sec. 2-3.

137. *Id.* art. 34 sec. 1.

138. *Id.* art. 34 sec. 2.

139. *Id.* art. 34 sec. 7. Consequently, state-owned enterprises can still trade in funds, but are prohibited from speculating in them. However, distinguishing between "trade" and "speculation" is difficult.

140. Own-account securities business refers to activities of a securities institution "by which it trades, for itself, in listed securities or other securities as recognized by the CSRC." *See* Administrative Measures on Own-account Securities Business Conducted by Securities Institutions, *supra* note 98, art. 5.

141. Provisional Measures, art. 34 sec. 4, 9.

142. *Id.* art. 34 sec. 3, 5-6.

or using fund assets for mortgages, asset lending or loans.[143] Any investment that may cause funds to bear unlimited liability is forbidden, and fund assets may not be invested in the shares of a company that is related to the fund custodian or fund manager.[144]

Further requirements concerning the operation of fund managers and fund custodians are provided in the implementing rules and notices. First, fund managers must strictly adhere to the investment policies disclosed in prospectuses.[145] The capital of the fund managers can only be used to initiate funds, manage funds, and trade treasury bonds.[146] A fund manager is prohibited from trading in a fund regulated by himself, as are promoters of the fund and promoters of the fund manager.[147]

Related party transactions are prohibited; thus, a fund manager may not use fund assets to coordinate the securities business conducted by promoters of the fund manager, promoters of the funds regulated by the fund manager, or any other securities institution.[148] The annual trading amount of each fund through one securities institution should not exceed 30% of the fund's total annual securities trading amount.[149]

Second, fund managers and fund custodian departments must establish supervising departments for internal control.[150] Fund managers are further required to have monitors whose appointment and removal are subject to approval by the CSRC.[151] They are responsible for overseeing the operation of fund managers and must prepare monthly supervision reports for the CSRC and chairmen of the board of fund managers.[152]

Third, except for administrative staff, personnel in fund management companies and fund custodian departments must have fund practitioner qualifications.[153] They may not trade in the shares and funds, directly or indirectly, for themselves or for others.[154]

143. *Id.* art. 34 sec. 8, 10.

144. *Id.* art. 34 sec. 11-12.

145. *See* Notice on Some Issues for Strengthening the Supervision of Securities Investment Funds, *supra* note 66, art. 4 sec. 2.

146. *Id.* art. 2 sec. 3. Fund management companies are required to submit materials concerning the operation of their own assets and financial situation to the CSRC at the beginning of every month to be put on record. *See id.* art. 4 sec. 4.

147. *Id.* art. 2 sec. 3.

148. *Id.* art. 4 sec. 2.

149. *Id.* art. 1 sec. 2.

150. *Id.* art. 2 sec. 4.

151. *Id.*

152. *Id.*

153. *Id.* art. 2 sec. 1. The Interim Provisions for the Administration of Fund Personnel Qualifications were issued by the CSRC on November 12, 1999, *available in* <http://www.cs.com.cn>.

154. *See* Notice on Some Issues for Strengthening the Supervision of Securities Investment Funds, *supra* note 66, art. 2 sec. 1.

Fourth, standard and adequate information disclosure is required in order to control risks. Those responsible for information disclosure[155] should ensure that the information disclosed is without false or serious misleading statements, and without any significant omission.[156] Information required to be made public by funds includes prospectuses, listing announcements, annual reports, semi-annual reports, portfolio announcements, fund net asset value announcements, and others.[157] Funds must disclose their portfolios every three months, and closed-end funds must make public their net asset value every week.[158] Information in fund management companies and fund custodian departments, on the other hand, must be kept secret and under strict control.[159]

E. Legal Liabilities

The Provisional Measures provide mainly two categories of illegal activities to be punished. The first category concerns unauthorized operation. When investment funds, fund managers or fund custodians operate without the authorities' approval, or funds are listed without official approval, sanctions should be imposed.[160]

The other category concerns unlawful operation. Sanctions may be imposed in any of the following circumstances: if investors' subscription money is used by fund managers before the establishment of funds;[161] if an investment operation does not conform to investment portfolio requirements;[162] if prohibited investment activities are conducted;[163] if fund managers or fund custodians refuse to coordinate the examination of the CSRC and the PBOC;[164] and if fund custodians do not keep fund assets

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155. These include fund promoters, fund managers, fund custodians, issue coordinators and persons who recommend the listing of funds. *See* Guidance to the Information Disclosure of Securities Investment Funds, *supra* note 62, art. 3.

156. *Id.*

157. *Id.* arts. 4, 11 sec. 1.

158. *Id.* art. 11 sec. 4-5.

159. *See* Notice on Some Issues for Strengthening the Supervision of Securities Investment Funds, *supra* note 66, art. 4 sec. 5. All telephone calls in fund management companies and fund custodian departments should be recorded and all mobile phones of the personnel engaging in investment operation should be collected during work time. Without approval from the CSRC, a fund custodian department should not provide to other departments and personnel any fund information which has not been made public. *See id.*

160. Provisional Measures, arts. 43-46.

161. *Id.* art. 47.

162. *Id.* art. 48.

163. *Id.* art. 49.

164. *Id.* art. 51.

separate.[165] In addition, the CSRC will impose legal liabilities on market fraud, such as insider trading, manipulation, false and misleading statements, and other fraudulent activities.[166]

Sanctions imposed by the CSRC and the PBOC include cancellation of unauthorized operation, forfeiture of unlawful gains, and fines. The authorities can also suspend or revoke the qualifications of fund managers or fund custodians,[167] as well as the qualifications of the personnel who are in charge or directly responsible for the violations.[168]

Apart from administrative sanctions, the Provisional Measures also briefly mention civil liabilities and criminal liabilities. Those who cause damages to others through the violation of the Provisional Measures should bear civil compensation liability according to law.[169] If the violation constitutes a crime, criminal liability will be imposed.[170]

F. The Provisional Measures Leave Some Important Issues Open

Although the Provisional Measures have provided a basic framework for fund regulation, they are silent in some crucial issues concerning the legal nature of funds. First, they fail to specify whether the legal form of investment funds in China is the contractual fund or the corporate fund. Corporate funds, such as mutual funds, are popular in the United States,[171] while contractual funds, such as unit trusts, are the most common type of collective investment schemes in the United Kingdom and Australia.[172]

In China, the definitions of securities investment funds[173] and fund units,[174] as well as the tripartite structure of fund custodian, fund manager

165. *Id.* art. 46.
166. *Id.* art. 53.
167. *Id.* art. 50.
168. *Id.* art. 54.
169. *Id.*
170. *Id.*
171. *See Collective Investment Schemes in the United States, in* A REVIEW OF COLLECTIVE INVESTMENT SCHEMES IN OVERSEAS JURISDICTIONS: COLLECTIVE INVESTMENT RESEARCH PAPER 2 (Law Reform Commission (ALRC) ed., 1993) (hereinafter A REVIEW OF COLLECTIVE INVESTMENT SCHEMES). Corporate funds in the USA are called investment companies, and open-end investment companies are commonly known as mutual funds. *See id.*
172. *See Collective Investment Schemes in the United Kingdom, in* A REVIEW OF COLLECTIVE INVESTMENT SCHEMES, *supra* note 171; *An Overview of Collective Investment Schemes in Australia, in* A REVIEW OF COLLECTIVE INVESTMENT SCHEMES, *id.* Investment funds in the European Community and Australia are referred to as collective investment schemes. *See id.*
173. A securities investment fund in the Provisional Measures refers to a collective securities investment vehicle in which all investors share profits and risks. Fund units are issued to investors

and fund holders, imply that the Provisional Measures contemplate investment funds as contractual funds. The Provisional Measures do not provide for a board of directors, which is essential to corporate funds. Furthermore, the Contents and Format of Fund Contracts of Securities Investment Funds require fund contracts to specify what type of funds will be established; the only examples given are the closed-end or open-end contractual funds.[175] The rule contains no mention of corporate funds.

Contractual and corporate funds have different advantages,[176] and the former is regarded as easier to initiate and operate; thus, they are favored in China at the present. Although a few corporate funds were established in China before the Provisional Measures, all subsequent securities investment funds were contractual funds. Yet, despite its preference for contractual funds, the Provisional Measures deliberately avoid specifying the legal form of investment funds, most likely to preserve the future possible development of corporate funds in China.

Second, the Provisional Measures are silent about the governing principles of contractual investment funds. Contractual investment funds in the Anglo-Saxon common law systems, such as unit trusts in the United Kingdom, were originally established under trust principles. Yet, it has been argued that unit trusts were governed by both trust and contract principles, as private trust principles alone cannot cover all legal aspects of unit trusts.[177] In contrast, contractual investment funds in the Continental civil law systems, such as Germany, are governed by only contract principles because traditionally these countries did not have the trust institution.

Historically, China's legal system was more influenced by the civil law system, and by German law in particular. Nevertheless, China is also considering introducing trust principles into its legal system and is currently drafting a Trust Law.[178] It is not clear whether both trust and contract

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to collect capital, while fund assets are kept by a fund custodian, managed and operated by a fund manager, and invested in shares, bonds and other financial instruments. This definition reflects the investment nature of shared profits and risks, as well as the operating process of the fund. *See* Provisional Measures, art. 2.

174. Fund units refer to the certificates issued by fund promoters to unspecified investors, which entitle the holders to the ownership rights, rights to benefit, and other relevant property rights over the fund assets, and to bear corresponding obligations. *Id.* art. 55 sec. 1.

175. *See* Contents and Format of Fund Contracts of Securities Investment Funds, *supra* note 62, art. 3 sec. 2.

176. For a detailed discussion of the respective advantages of contractual funds and corporate funds, *see* Wallace Wen Yeu Wang, *Corporate Versus Contractual Mutual Funds: An Evaluation of Structure and Governance*, 69 WASH. L. REV. 927 (1994).

177. *See* KAM FAN SIN, THE LEGAL NATURE OF THE UNIT TRUST 129 (1997).

178. *Quanguo Renmin Daibiao Dahui Changwu Weiyuanhui Gongzuo Baogao* [*The Work Report*

principles would apply to China's investment funds, or whether contract principles alone are sufficient to govern the legal relationships of funds. The Provisional Measures leave this issue open and avoid any mention of trusts.[179]

Last, the Provisional Measures also fail to specify whether investment funds in China are legal persons or not. Under the Company Law, corporate investment funds would be legal persons.[180] The issue is less clear for contractual investment funds, especially as they do not enjoy legal person status in many countries such as Germany.[181] If contractual investment funds are legal persons, then they can enjoy the following characteristics of a legal person: the ability to possess necessary property or funds; the ability to possess its own name, organizational structure and premises; and the capacity for independent civil liability.[182] This issue relates to the legal capacity of contractual investment funds and needs to be clarified in the future legislation.

V. ANALYSIS AND FUTURE PROSPECTS

A. *The Role of Funds in the Economic Reform of Socialism: Unique to China*

1. Investment Funds Can Help Circulation of Public Shares

After years of debates about securitization (*gufenhua*) of state-owned enterprises ("SOE"),[183] the joint-stock system was finally recognized

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of the Standing Committee of the NPC], RENMIN RIBAO [PEOPLE'S DAILY], Mar. 20, 1999, at 2.

179. The term "trust" does not appear anywhere in the Provisional Measures or the Implementing Rules.

180. Company Law, *supra* note 52, art. 3. This provision states that limited liability companies and companies limited by shares — the only two categories of companies which can be established under the Company Law — are enterprises with legal person status.

181. *See* Wang, *supra* note 176, at 951-53.

182. General Principles of Civil Law, *supra* note 33, art. 37. This article provides four requirements of a legal person. The first requires proper form — a legal person must be set up in accordance with the law. The other three, as indicated, have often been referred to by scholars as containing the characteristics of a legal person in China. *See* JIANFU CHEN, FROM ADMINISTRATIVE AUTHORISATION TO PRIVATE LAW: A COMPARATIVE PERSPECTIVE OF THE DEVELOPING CIVIL LAW IN THE PEOPLE'S REPUBLIC OF CHINA 95 (1994).

183. Securitization of SOEs is one of the greatest controversial economic reform measures introduced in China since 1979. For details of the debates, *see* Jianfu Chen, *Securitisation of State-owned Enterprises and the Ownership Controversy in the PRC*, 15 SYDNEY L. REV. 59 (1993); *see also* Qian, *supra* note 11.

as a form of public ownership by the 15th National Congress of the Communist Party of China in September 1997.[184] In order to maintain the dominant position of public ownership, shares in China have been divided into three different types: state shares, legal person shares (C Shares), and individual shares (A shares).[185] State shares refer to those shares purchased with state assets by government departments or organs that have been authorized to represent the state concerning investment matters.[186] Legal person shares refer to those shares purchased by legal persons with their legal funds, and individual shares are the shares purchased by individuals.[187]

State shares are of a public nature, as are legal person shares if the shareholders are state-owned or state-controlled companies.[188] Currently state shares and legal person shares account for 60% - 70% of the total shares.[189] Conversion of both is restricted, and neither is transferable to the securities market.[190] Individual shares, which can be traded in the securities market, account for only a small fraction of the total shares.[191]

The circulation of state shares has become a difficult issue in China. The quality of non-transferability discounts their value, and state shares need to be traded.[192] Yet the state worries that the transfer of state shares might result in private control. Moreover, the huge amount of state shares might flood the secondary market, which would have limited ability to absorb them.[193]

184. The joint-stock system was listed as "a form of public ownership favorable to expanding the areas controlled by public capital and enhancing the dominant role of public ownership." *See China's Top 10 Economic News in '97 Editor's Note*, CHINA DAILY BUS. WKLY., Jan. 11, 1998, at 8.

185. *See Gufenzhi Qiye Shidian Banfa [Trial Measures on Share-Formulated Enterprises]*, art. 4, *translated and available in* CHINA LAWS FOR FOREIGN BUSINESS - BUSINESS REGULATION 13-570 (CCH loose-leaf service) (issued on May 15, 1992, by the State Commission for Restructuring the Economic System).

186. *See id.*

187. *See id.*

188. *See* Zhang, *supra* note 6, at 571. Public shares are shares that constitute the investment of state-owned or collectively owned assets. *See id.*

189. *Wanshan Jijin Shichang Huanjing [Improve the Market Environment of Funds]*, RENMIN RIBAO [PEOPLE'S DAILY], Dec. 4, 1997, at 10.

190. For the transfer of state shares, approval from the state department concerned is required and the specific measures shall be formulated separately. *See* Provisional Regulations on the Administration of the Issuing and Trading of Stocks, *supra* note 45, art. 36. However, there is no such specific rule formulated. *See* Zhang, *supra* note 6, at 570. While the Provisional Regulations on the Administration of the Issuing and Trading of Stocks limit the transfer of state shares, they are silent on the transfer of legal person shares. In practice, a transfer is often done through negotiated agreements between legal person shareholders. *See* Zhang, *id.* at 571. They are also traded in the two electronic trading networks — the Securities Trading Automatic Quotations System (STAQ) and the National Electronic Trading System (NETS).

191. *See* Qian, *supra* note 11, at 87.

192. *See* Liufang Fang, *Comments: China*, 28 (3) LAW & POL'Y INT'L BUS. 897, 898 (1997).

193. *See* UNDERSTANDING AND PRACTICE, *supra* note 15, at 278.

Suggestions have been made to resolve this issue through investment funds. If the main concern is the tolerance of the secondary market, the government could sell state shares to the public gradually, using the money raised to establish index funds.[194] Because index funds invest in shares in line with their index weightings, investing in the securities market through index funds will cause no serious price fluctuation in the securities market.[195] This way state shares, and eventually legal person shares, can be circulated.

Another school of thought tackles the issue of how to maintain public ownership when transferring state shares.[196] Fund management companies in China are of a public nature because the mostly state-owned securities firms and TICs promote them.[197] If state shares are transferred to investment funds by certain means, then state shares can be circulated and the dominant position of public ownership will not be affected. Consequently, a series of funds that particularly related to SOE reform and development should be established. However, these suggestions are still not complete; the practicalities are vague, such as how the state shares will be transferred to investment funds, how many state shares should be transferred and, after the transfer, how the funds should trade the state shares.

2. Investment Funds Can Improve Corporate Governance of SOEs

An important reason to securitize SOEs in China is the need to create a system of corporate governance that is independent of bureaucrats.[198] In the past, SOEs could only take on a single ownership form — the "whole-people" owned system.[199] The state represented the whole people in running SOEs, resulting in direct government intervention. With

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194. *See Yong Zhishu Jijin Jiejue Guojiagu Liutong Wenti [Use Index Funds To Solve the Problem of State Shares Circulation]*, ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES], Aug. 25, 1999.

195. *Id.*

196. *See, e.g.*, ZHENGQUAN TOUZIXUE [THEORIES OF SECURITIES INVESTMENT] 219-20 (Yizhi Shao ed., 1995); UNDERSTANDING AND PRACTICE, *supra* note 15, at 278-79; *Zhongxifang Touzi Jijin De Bijiao [A Comparison of Investment Funds Between China and the West]*, ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES], Nov. 10, 1997, at 7; *Jijin Rushi Qierukou Daodi Zai Nali [What Is the Appropriate Way for Funds to Enter the Securities Market]*, ZHENGQUAN SHIBAO [SECURITIES TIMES], Nov. 26, 1997, at 12.

197. Because no individual is allowed to establish financial institutions, most securities firms and TICS in China are SOEs, although a few are shareholding companies in which the state holds the controlling stake. *See* THEORIES OF SECURITIES INVESTMENT, *supra* note 196.

198. *See* Michael Spencer, *Securities Markets in China*, 32(2) FIN. & DEV. 28, 31 (1995).

199. *See* Qian, *supra* note 11, at 93-4.

SOEs transformed to shareholding companies, a multi-ownership system has emerged through which diversified shareholders can monitor the management of companies and government intervention can be reduced. However, because the shares that the public holds are widely dispersed, individual investors have too small a stake to justify monitoring costs; thus, they cannot exert enough discipline for companies to improve their operation.[200] Small investors are far more likely to sell their shares if they are not satisfied with a company's performance.[201]

Investment funds can act as an important force in the shareholder structure of companies transformed from SOEs. Fund managers can represent investment funds in shareholders' meetings of the companies in which the funds invested.[202] As long-term shareholders, they have incentives to monitor the management of companies and give suggestions concerning their operation. Consequently, the participation of funds as institutional shareholders can exert more discipline on companies and improve their management.

B. *The Government's Regulatory Strategies*

1. The Government is Determined to Develop Investment Funds

Awareness of the importance of investment funds has prompted China's government to give serious attention to their development. Due to the limited practical experience of funds, the current stage of fund development is experimental,[203] and cautiously guided.

The cautious attitude is reflected in the legislation. The Provisional Measures set out only a basic temporary framework. They are supplemented by subsequent implementing rules and notices, which are formulated according to the new problems encountered. This is a pragmatic method that provides for continuing adjustment. As experience is gained, the legislation will gradually mature.

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200. *See* Spencer, *supra* note 198.

201. *See id.*

202. *See* Notice on Some Issues for Strengthening the Supervision of Securities Investment Funds, *supra* note 66, art. 1 sec. 3.

203. The Notice on Some Issues for Strengthening the Supervision of Securities Investment Funds and the Notice Regarding the Subscription for New Issues by Securities Investment Funds explicitly state that these notices are formulated, among other purposes, to ensure the smooth progress of the investment fund experiment.

The CSRC emphasizes forceful supervision of funds. A subsequent notice requires fund managers to be subject to regular examination by the CSRC every three months,[204] and that the CSRC should annually review fund managers and fund custodians.[205] Furthermore, the CSRC has provided severe penalties for violators from the very beginning. It punished 33 institutions on April 14, 1998, for illegally subscribing to two funds that were targeted at retail investors,[206] and imposed sanctions on institutions and individuals on June 10, 1998, for illegally subscribing to a third fund.[207]

Apart from strict regulation, the authority has also provided favorable policies for new funds to subscribe to initial public share offerings ("IPOs").[208] For IPOs between 50 million shares and 100 million shares, all investment funds can collectively buy up to 10% of the offerings. For IPOs between 100 million shares and 200 million shares, the ratio is 15%. For IPOs of 200 million shares and more, the ratio climbs to 20%.[209] In China, the prices of nearly all new issues rise sharply after listing; thus such policies are very supportive to funds. They can even expect high profitability by subscribing to IPOs without participating in the risky secondary market.

To avoid the risks of that situation, the authorities also carefully guide funds' entrance into the secondary market. No fund can subscribe to more than 5% of any IPO and has to keep its total annual investment in IPOs to less than 15% of its capital.[210] Funds are also prohibited from selling their IPO shares until two months after they are listed, during which time the shares should be placed in the custody of the securities exchanges.[211]

On November 22, 1999, the CSRC issued a supplementary notice whereby the policies for investment funds in IPOs became even more

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204. *See* Notice on Some Issues for Strengthening the Supervision of Securities Investment Funds, *supra* note 66, art. 3.

205. *Id.*

206. *See Guifan Jijin Shichang, Baohu Touzizhe Liyi, Zhengjianhui Chufa Weigui Shengou Jijinzhe [Standardize Fund Market and Protect Investors' Interests: the CSRC Punishes Violators Who Illegally Subscribe to Funds]*, RENMIN RIBAO [PEOPLE'S DAILY], Apr. 14, 1998, at 2; *see also CSRC Initiatives*, CHINA DAILY BUS. WKLY., June 15, 1998, at 1. The first two funds could only be subscribed by individuals. Legal persons, except promoters, were prohibited from subscription. *See Zhengjianhui Xinwen Fajanren Jiu Zhengquan Touzi Jijin Faxing Da Jizhe Wen, [The Spokesman of the CSRC Answers Questions from Journalists Concerning the Issuance of Securities Investment Funds]*, RENMIN RIBAO [PEOPLE'S DAILY], Mar. 17, 1998, at 4.

207. *CSRC Initiatives*, *supra* note 206.

208. *See* Notice Regarding the Subscription for New Issues by Securities Investment Funds, *supra* note 65; *see also Briefs*, CHINA DAILY BUS. WKLY., Aug. 23, 1998, at 3.

209. *See* Notice Regarding the Subscription for New Issues by Securities Investment Funds, *supra* note 65, art. 2 sec. 1.

210. *Id.* art. 2 sec. 3-4.

211. *Id.* art. 4.

favorable.[212] The former notice set limits restricting collective purchases in IPOs by investment funds, ranging from 10% to 20% of the total IPO issuance. The supplementary notice, however, abandons these limits and stipulates that for IPOs of 50 million shares or more, all investment funds can collectively buy at least 20% of the offerings.[213] It is up to the main underwriters and issuing companies to decide the exact proportion of the shares placed in investment funds. Furthermore, instead of the former limit of 15%, an investment fund can annually invest up to 30% of its capital in IPOs.[214] 50% of the IPOs shares subscribed by an investment fund cannot be sold within six months from the date of subscription, which should be monitored by custodial banks; another 50% can be sold the day they are listed.[215]

2. Concerns About Over-Regulation

The development of investment funds in China has been an administrative scheme, raising concerns about excessive government interference. First, at present, the approval of new funds is under tight control and more applications have been submitted than approved. Because all of the applications have met the establishment requirements, it is not known by what criteria the CSRC approves some while refusing others. This may result in unfairness to those that have been refused.

It is further argued that the qualifications set for promoters might be too high. Except for fund management companies acting as promoters, promoters are required to have at least RMB 300 million yuan of capital each. Few securities institutions can meet the capital requirement. Because investment funds require more investment skill than capital, the capital requirement could be reduced. Otherwise small securities institutions will not get opportunities to initiate funds, resulting in low competition in the fund industry.

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212. *See* Supplementary Notice for Further Advancing the Subscription for New Issues by Securities Investment Funds, *available in* <http://www.cs.com.cn>.

213. *Id.* art. 1.

214. *Id.* art 2. Furthermore, the capital used by the fund to invest in IPOs of 400 million shares or more is not calculated in the 30% limit. According to the recent reform of the issuance system in China, companies with capital of more than 400 million yuan can conduct IPOs through a combination of public offerings and share placements to institutional investors. The rules require that shares placed with institutional investors should be between 25% and 75% of the total issuance of an IPO, and no single firm may buy more than 5% of the total. *See New Rules to Benefit Market*, CHINA DAILY BUS. WKLY., August 1, 1999, at 4.

215. *Id.* art. 3.

Second, the regulatory and disciplinary power of the CSRC might be too extensive. For example, if the CSRC has sufficient grounds to believe that a fund manager cannot carry out his functions, it can order his removal.[216] Because the Provisional Measures fail to provide what constitutes sufficient grounds for removal, there is danger for abuse.

Third, the government's favorable policies to develop funds are also a matter for debate. The policies are under criticism because they reduce the chances of the public to participate individually in IPOs,[217] and they increase the speculation in these new funds when they are listed.[218] The profitability of funds should be based on their performance, rather than government support policies.

Last, investment funds in China are not only tools for investment, but also possible tools for the state to coordinate the stable development of the securities market.[219] Because publicly-owned fund management companies manage the funds, the state will be able to influence the securities market through the funds.[220] However, the healthy development of funds depends on their profit-orientation. Although objectively funds can help to stabilize the market through their large size and specialized operations, they bear no obligation to do so and should not be intentionally manipulated by the government for this purpose.[221]

C. *Recent Developments and Future Prospects*

1. Recent Performance

Since the promulgation of the Provisional Measures, fourteen funds managed by ten fund managers have been established as of July 30, 1999. All of these funds are closed-end funds with fifteen-year terms. The first ten each have a registered capital of RMB 2 billion yuan, and the more recent four each have RMB 3 billion yuan. These funds have a face value of RMB 1 yuan and an issue price of RMB 1.01 yuan per unit. Eight are listed in the

216. Provisional Measures, art. 27 sec. 4.

217. *See Zhongguo Touzi Jijinye Shida Guanjian Wenti [Ten Crucial Issues in the Development of China's Investment Fund Industry]*, ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES] *available in* <http://www.cs.com.cn>.

218. *See infra* note 230 and accompanying text.

219. *See An Overview of China's Investment Fund Market of 1998 and Prospects for 1999*, *supra* note 1.

220. *See* THEORIES OF SECURITIES INVESTMENT, *supra* note 196, at 220.

221. *See, e.g., Jijin Zhouguo Chunxia Qiudong [Funds Have Walked Through Four Seasons]*, ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES], Oct. 24, 1998, *available in* <http://www.cs.com.cn>.

Shanghai Securities Exchange and six are listed in the Shenzhen Securities Exchange.[222]

When the Kaiyuan Fund and the Jintai Fund, China's first two new funds, made their debut in March 1998, investors warmly welcomed them. People swarmed to open special investment fund accounts or securities accounts for fund trading,[223] and the funds were oversubscribed by over 40 times.[224] The two funds rose more than 30% on their first day of listing,[225] and the Jintai Fund reached a high of 2.21 on April 27.[226] The Xinghua Fund, China's third fund, opened at a high of RMB 2.01 yuan when listed on May 8.[227]

The high prices were partly triggered by the authority's favorable policies for funds' subscription to IPOs.[228] Investors commonly believed that because these were experimental funds, the government would not allow them to fail.[229] Some investors regarded the funds mainly as vehicles for speculation; thus, there was a high level of speculation when these funds opened.[230] To prevent the speculation of funds, in August 1998, the CSRC prohibited investors, other than fund promoters or other stipulated exceptions, from holding directly or indirectly more than 3% of any fund's units.[231]

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222. *See infra* Appendix A at pp. 243-245.

223. *See Investors Expect Good Return*, CHINA DAILY BUS. WKLY., Mar. 22, 1998, at 3. Investment funds can be subscribed to through investment fund accounts, or through securities trading accounts that enable investors to trade both funds and stocks. *See id.*

224. *Funds To Make Exchange Debut*, CHINA DAILY, Apr. 7, 1998. The first five funds were oversubscribed by 42.6 times, 40.7 times, 54.8 times, 52.6 times and 85.9 times, respectively. *See Xinjijin Xiaodang'an [A Simple Record of New Funds]*, RENMIN RIBAO [PEOPLE'S DAILY], Aug. 24, 1998, at 10.

225. When listed on April 7, the Jintan Fund rose from the issue price of RMB 1.01 yuan to RMB 1.45 yuan and the Kaiyuan Fund rose to RMB 1.37 yuan. *See Jijin Shangshi Diyitian [The First Day of Fund Listing]*, RENMIN RIBAO [PEOPLE'S DAILY], Apr. 8, 1998, at 2.

226. *See Ruhe Kandai Xinjijin [How to View New Funds]*, ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES], May 1998, *available in* <http://www.cs.com.cn>.

227. *See Market Movements Make Few Waves*, CHINA DAILY BUS. WKLY., May 10, 1998, at 3.

228. Although the Notice Regarding the Subscription for New Issues by Securities Investment Funds was not promulgated until August 1998, the favorable policies were put into practice at the beginning of the development of the new funds. According to the prospectuses of four new listed companies on April 23, 1998, investment funds could subscribe to up to 5% of the shares of each company. Consequently the prices of funds have risen dramatically. *See How to View New Funds*, *supra* note 226.

229. *See Investors Expect Good Return*, *supra* note 223.

230. Fund managers of the first two funds made a public announcement in China's three main securities newspapers on April 27, 1998, warning that there were signs of over-speculation and that investors should be cautious about the unusual rise of prices. *See How to View New Funds*, *supra* note 226.

231. *See* Notice on Some Issues for Strengthening the Supervision of Securities Investment Funds, *supra* note 66, art. 1(1). If investors already held more than 3%, they should report to their fund managers within 10 days from the promulgation of the Notice and sell the excessive units within 6

The performance of the new funds, however, has not lived up to investors' expectations. After the first disclosure of the funds' net asset values in June 1998, the prices of funds began to drop.[232] Due to the dramatic fall of the indices in both Shanghai and Shenzhen securities markets, the net asset value of four of the five existing funds fell below their face value in August 1998.[233] Against a backdrop of the continuing bearish securities market in the first half of 1999, six of the eight funds fell below their per unit net asset value according to the market report on May 5, 1999.[234] The Jinghong Fund and the Hansheng Fund, China's ninth and tenth new funds, fell below their issue prices on their first trading day of May 18, 1999.[235] Since the rise of China's securities market on May 19, 1999,[236] the net asset value of funds began to increase.[237] By June 1999, however, the prices of most funds were still below their net asset value.[238]

Meanwhile, the variety of funds has increased. The establishment of the Xinghe Fund and the Pufeng Fund, China's first two index-weighted investment funds, on July 14, 1999, marks a significant step forward in the fund history.[239] Index-weighted funds are attractive to China's investors because they mainly invest in listed companies according to their weight in the composite indices of the securities exchanges;[240] thus, they can lower investment risks and ensure stable yields.

2. An Assessment

It is necessary to have a rational look at the recent development of funds. On the one hand, due to strict regulations, these new funds start off

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months. *See id.*

232. *See Yeji Qiwang Bubi Taigao [Expectation of Fund Performance Should Not Be Too High]*, ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES], Nov. 5, 1998, *available in* <http://www.cs.com.cn>.

233. *See Funds Have Walked Through Four Seasons, supra* note 221.

234. *See Poor Performance Dogs Funds*, CHINA DAILY BUS. WKLY., May 23, 1999, at 4.

235. *Id.*

236. Indices in both Shanghai and Shenzhen soared between May 19 and June 27, 1999. *See Securities Law to Guard Market*, CHINA DAILY BUS. WKLY., June 27, 1999, at 1.

237. *See Xinjijin Jingzhi Jiashu Zengzhang [The Growth of the Net Asset Value of New Funds is Accelerating]*, ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES], June 21, 1999, *available in* <http://www.cs.com.cn>.

238. Except for the Taihe Fund, the prices of the other nine funds are still lower than their net asset value per unit. *See id.*

239. *See Analysts Welcome Index-Weighted Funds*, CHINA DAILY BUS. WKLY., July 11, 1999, at 4; *see also infra* Appendix A.

240. According to their prospectuses, the two funds will invest 50% of their net assets in listed firms according to their weight in the exchanges' composite indices. Another 30% will be invested in shares and the remaining 20% will be invested in bonds. *See id.*

with good qualities and their performance is much more standardized than that of the old funds. Fund managers are expected to shun short-term speculative activities and focus on the long-term investment prospects.[241] Their investment strategies have already had positive effects on small investors' investment activities. Currently the rational investment strategies of funds, rather than their market size, play a positive role in China's securities market.

In addition, funds have shown better ability in warding off market risks than average investors,[242] and their net asset value has shown much narrower fluctuations than the composite indices of the securities market.[243] This performance is valuable, because new financial instruments such as index futures, options and other derivatives commonly used by foreign fund managers to control risks are not available in China.[244] Furthermore, the requirement that funds invest more than 80% of their assets in shares and bonds adds to the difficulties of fund managers because they cannot liquidate their shares when the securities market is down.[245] The funds did not reap large earnings in 1998, but their average income rate per unit is still a little higher than the one-year fixed deposit interest rate,[246] and China Securities Co. analysts expect their performance to be strong enough to maintain investors' confidence in their long-term prospects.[247]

On the other hand, the experience of fund managers is limited and their operation needs to be improved. In 1998, a large proportion of the funds' profits came from the state's favorable policies governing funds' subscriptions to IPOs.[248] Also, these funds have similar investment philosophies and strategies, preventing investors from distinguishing between them.[249] Therefore the operation of fund managers need to be gradually matured over time.

241 *See Securities Funds Eye Long Term*, CHINA DAILY BUS. WKLY., Oct. 11, 1998, at 3.

242. The securities markets in Shanghai and Shenzhen dropped 12% or so in August 1998, while the net asset value of funds only dropped 3%. *See Xinjijin: "Titanic"* [*New Funds: "Titanic"*], RENMIN RIBAO [PEOPLE'S DAILY], Sept. 28, 1998, at 10.

243. *See Securities Funds Eye Long Term*, *supra* note 241.

244. *See New Funds: "Titanic," supra* note 242.

245. *Id.*

246. According to the annual reports of the five new funds in 1998, their average income rate per unit is 3.935%, while the one-year fixed deposit interest rate is 3.78%. *See Zhengquan Touzi Jijin Nianbao Jiedu* [*Analysis of the Annual Reports of Securities Investment Funds*], ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES], Apr. 13, 1999, *available in* <http://www.cs.com.cn>.

247. *See Securities Funds Eye Long Term*, *supra* note 241.

248. *See An Overview of China's Investment Fund Market of 1998 and a Prospect for 1999*, *supra* note 1.

249. *See Poor Performance Dogs Funds*, *supra* note 234.

3. A Vision for the Future

As of July 1999, the total issue value of funds was RMB 32 billion yuan, which accounts for less than 4% of the roughly RMB 900 billion yuan transaction volume of the securities market in 1999.[250] Thus there is great space for funds to expand and the regulatory authorities are aiming to accelerate their growth.

The development, however, is a trial and error process, and many issues will probably be resolved as various participants — the regulatory authorities, fund managers, fund custodians and investors — develop more experience. Yet, there are many things that can be done to ease this development.

First, China must build up an investment fund legal system to facilitate the development of funds. Apart from the regulation governing securities investment funds, China is also drafting regulations on joint venture investment funds and industrial investment funds. Developing joint venture funds in China is important because they can provide access for overseas institutional investors in the domestic A share market and introduce foreign fund management experience into China.[251] It is also imperative to develop industrial funds because, as those funds put money directly into industrial projects rather than into securities, they can provide the necessary capital to companies which, despite great market potential, cannot enter the securities market because of the limited scope for it to expand.[252]

In November 1998, the Chairman of the CSRC announced the impending promulgation of the Administrative Measures for Joint Venture Funds.[253] In addition, the Administrative Measures for the Experiment of Industrial Investment Funds, drafted by the PBOC, the CSRC and other relevant departments, were also submitted to the State Council for approval

250. *See Statistical Reports, supra* note 4.

251. Shares in China are divided into A shares and B shares. A shares are denominated in RMB, and are subscribed to and traded in RMB by Chinese citizens. B shares, in contrast, are denominated in RMB and traded in foreign currency by legal and natural persons outside China. *See* Qian, *supra* note 11, at 89-90; Zhang & Yu, *supra* note 3, at 119.

252. *See Investment Funds Good for State-Owned Enterprises,* CHINA DAILY BUS. WKLY., Jan. 31, 1999, at 3.

253. After several revisions, the draft is nearly finished. *See An Overview of China's Investment Fund Market of 1998 and a Prospect for 1999, supra* note 1; *see also Time to Let Foreign Funds Enter Home Stock Market?* CHINA DAILY, Mar. 3, 1998. The draft measures would require that one-third of joint venture fund assets be invested in industries, and two-thirds invested in the securities market, including A shares, B shares and bonds. *See An Overview of China's Investment Fund Market of 1998 and a Prospect for 1999, id.*

in November 1998.[254] However, to date neither of them has been approved for promulgation.

Instead, China is currently drafting a new statute called the Investment Fund Law and the draft committee was established on March 30, 1999.[255] If possible, the law is expected to be finalized within the term of the Ninth National People's Congress ("NPC") (March 1998 to March 2003).[256] It is not clear whether the Investment Fund Law will cover all categories of funds, including joint venture and industrial funds. The legislation will be more mature and complete than the Provisional Measures through the experience gained from the current experimental development of funds.

In the meantime, other legislation will be relevant to the regulation of funds. The long-awaited Securities Law was promulgated on December 29, 1998, and became effective on July 1, 1999.[257] The Securities Law and the Investment Fund Law are related but different. Article 2 of the Securities Law states that the statute governs the issuing and trading of shares, corporate bonds, and other securities approved by the State Council, and that where the statute provides no regulation, the provisions of the Company Law and other laws and regulations should apply.[258] The Securities Law therefore regulates the issuing and trading of investment funds, but has no particular stipulation concerning them. Thus, it will be necessary to have a separate Investment Fund Law to regulate funds specifically.

The Contract Law, promulgated on March 15, 1999, is also an important law governing the legal relationship of funds.[259] Formerly, the Economic Contract Law of 1981 did not apply to contracts made between individuals and institutions;[260] thus the contractual relationships between investors and fund promoters, fund managers, or fund custodians were not

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254 *Id.*

255. *Touzi Jijinfa Lifa Gongzuo Qihang [The Drafting of Investment Fund Law Has Begun]*, ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES], Mar. 31, 1999, *available in* <http://www.cs.com.cn>.

256. *See id.*

257. *Translated and available in* CHINA LAWS FOR FOREIGN BUSINESS - BUSINESS REGULATION 8-699 (CCH loose-leaf service) (adopted by the Sixth Session of the Standing Committee of the Ninth NPC)

258. Securities Law, art. 2.

259. *Translated and available in* CHINA LAWS FOR FOREIGN BUSINESS - BUSINESS REGULATION 5-650 (CCH loose-leaf service) (adopted by the Second Session of the Ninth NPC).

260. *Translated and available in* CHINA LAWS FOR FOREIGN BUSINESS - BUSINESS REGULATION 5-500 (CCH loose-leaf service) (adopted on December 13, 1981, by the Fourth Session of the Fifth NPC). Article 2 states that the law applies to "contracts concluded between legal persons of equal civil standing, other economic organizations, individual industrial and commercial households and rural contracting households in order to define mutual rights and duties and conclude contracts so as to achieve certain economic goals."

covered.[261] Instead, these contractual relationships were governed by the General Principles of Civil Law of 1986,[262] which alone were insufficient to settle cases and required supplemental support.[263] As the new Contract Law applies to contracts made between individuals and legal persons, the protection for investors' contract rights has been improved.

Furthermore, the Company Law of 1993 would also govern corporate funds, should they be established. The Company Law, however, did not take corporate funds into consideration when drafted; thus, it may be inadequate to regulate them. Moreover, if funds are governed by trust principles, the Trust Law will also play a significant role in regulating the legal relationship of funds. The Investment Fund Law should coordinate its relationship with the Company Law and the Trust Law, and clarify the unsolved issues in the Provisional Measures.

Second, the development of funds should exploit more market-based approaches. A self-regulating fund industry organization in China is necessary. The CSRC has its shortcomings because as a governmental institution, it does not participate in fund operations itself; thus, its regulation can not cover all aspects of the fund business. A self-regulating organization, in contrast, could provide more timely and flexible regulation, and many problems could be solved by the organization without resorting to the regulatory authority.[264] Self-regulation, therefore, would supplement the official regulation and reduce governmental intervention.

Investment funds in China should also move from closed-end to open-end funds. Closed-end funds have higher risks than open-end funds because units of closed-end funds can only be transferred, not redeemed. The prices of closed-end funds are easily affected by market demand, are less likely to reflect their real value, and are more amenable to speculation when the funds are listed in the secondary market. In addition, fund managers receive management fees that are fixed at a certain proportion of

261. Investment funds are established according to fund contracts. The original parties to fund contracts are fund promoters, fund managers and fund custodians. *See* Contents and Format of Fund Contracts of Securities Investment Funds, *supra* note 62, art. 2. The rules state that when investors acquire fund units issued according to fund contracts, they became fund holders; the action of holding fund units itself indicates their acknowledgment and acceptance of fund contracts. Thus investors enjoy the rights and bear the obligations as provided in the Provisional Measures, fund contracts and other relevant stipulations. *See id.* art. 1 sec. 4.

262. *See* General Principles of Civil Law, *supra* note 33.

263. The supplementation is normally by statutes and, where there are no statutes, by doctrines from the writings of scholars. *See* William C. Jones, *Some Questions Regarding the Significance of the General Provisions of Civil Law of the People's Republic of China*, 28 HARV. INT'L L. J. 309, 325 (1987).

264. *See* THEORIES OF SECURITIES INVESTMENT, *supra* note 196, at 221.

the fund asset value regardless of their performance; thus, there is not enough pressure on fund managers to improve their operation.

Open-end funds can exert more pressure on fund managers because if investors are not satisfied with the operation of the funds, they can redeem their units. Currently all China's new funds are closed-end funds, but open-end funds will be launched when the time is ripe.[265] The requirement that funds disclose the per unit net asset value every week is in preparation for this development. Since the performance of open-end funds depends more on market forces than closed-end funds, the future development of China's funds are expected to be more market-driven.

VI. CONCLUSION

The experiment currently underway in developing investment funds in China has met with initial success, although the funds' performance needs to be improved over time. The Provisional Measures are a critical step in the right direction for the rational development of China's fledgling fund industry. The legal framework, however, is still evolving as the industry gains more experience. The authorities' regulatory strategies towards funds are both supportive and strict. This framework has facilitated the development of funds in the current stage, but the extent of government involvement is an issue of concern and excessive control should be avoided. With appropriate regulation, investment funds have high potential for growth, and will play an increasingly important role in China's securities market and economic reform.[266]

265. The vice-chairman of the CSRC has pronounced this intention. *See China To Issue More Investment Funds*, XINHUA NEWS AGENCY, May 13, 1998.

266. The main websites to which this article refers are the following: CHINA DAILY and CHINA DAILY BUSINESS WEEKLY, <http://www.chinadaily.com.cn>; PEOPLE'S DAILY, <http://www.peopledaily.com.cn>; CHINA SECURITIES, <http://www.cs.com.cn>; SECURITIES TIMES, <http://www.securitiestimes.com.cn>; and SHANGHAI SECURITIES, <http://www.ssnews.online.sh.cn>. China Securities has a topic called "Securities Investment Funds" in its website, where the regulations of investment funds and most articles about their development in China Securities can be found.

APPENDIX A:

A TABLE OF NEW INVESTMENT FUNDS IN CHINA (AS OF JULY 1999)

Details are in Securities Investment Funds, *available at* <http://www.cs.com.cn>

Name	Fund Manager	Fund Custodian	Date of Establishment	Date of Listing	Securities Exchange	Term in Years	Size in RMB
Kaiyuan Fund	Southern Fund Management Co., Ltd.	Industrial and Commercial Bank of China (ICBC)	March 27, 1998	April 7	Shenzhen	15	2 billion
Jintai Fund	Guotai Fund Management Co., Ltd.	ICBC	March 27, 1998	April 7	Shanghai	15	2 billion
Xinghua Fund	Huaxia Fund Management Co., Ltd.	China Construction Bank	April 23, 1998	May 8	Shanghai	15	2 billion
Anxin Fund	Hua'an Fund Management Co., Ltd.	ICBC	June 22, 1998	June 26	Shanghai	15	2 billion
Yuyang Fund	Boshi Fund Management Co., Ltd.	China Agricultural Bank	July 25, 1998	July 30	Shanghai	15	2 billion

Puhui Fund	Penghua Fund Management Co., Ltd.	China Transportation Bank	January 6, 1999	January 27	Shenzhen	15	2 billion
Taihe Fund	Jiashi Fund Management Co., Ltd.	China Construction Bank	April 8, 1999	April 20	Shanghai	15	2 billion
Tongyi Fund	Changsheng Fund Management Co., Ltd.	ICBC	April 8, 1999	April 21	Shenzhen	15	2 billion
Jinghong Fund	Dacheng Fund Management Co., Ltd.	Bank of China	May 5, 1999	May18	Shenzhen	15	2 billion
Hansheng Fund	Fuguo Fund Management Co., Ltd.	China Agricultural Bank	May 10, 1999	May18	Shanghai	15	2 billion
Anshun Fund	Hua'an Fund Management Co., Ltd.	China Transportation Bank	June 15, 1999	June 22	Shanghai	15	3 billion
Yulong Fund	Boshi Fund Management Co., Ltd.	China Agricultural Bank	June 15, 1999	June 24	Shenzhen	15	3 billion

Xinghe Fund	Huaxia Fund Management Co., Ltd.	China Construction Bank	July 14, 1999	July 30	Shanghai	15	3 billion
Pufeng Fund	Penghua Fund Management Co., Ltd.	ICBC	July 14, 1999	July 30	Shenzhen	15	3 billion

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