The Dominance of Regulatory Oversight in Chinese Investment Trusts

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I Introduction

A fundamental tenet in the relationship between regulations and private law is their functional dichotomy. Private law deals with the adjudication of bilateral rights and duties between individuals. Its main purpose is to protect the rights of individuals from infringement by others. In contrast, regulations primarily serve public interests, and are typically enforced by regulatory agencies through administrative sanctions or criminal liability. In this chapter, we argue that the Chinese legal regime for investment trusts departs from this paradigmatic dichotomy. Regulatory supervision not only addresses public interest concerns, but also frequently displaces private law in resolving disputes amongst trust parties, blurring the boundary between private law and regulations. We examine the unique circumstances in China that account for this regulatory dominance and argue that it can be justified only as a temporary measure.

Following this introduction, Part II discusses the main reason for regulatory dominance in China. We examine how the widespread use of investment trusts for shadow banking raises public interest concerns when private law rights are enforced in such trusts. In Part III, we explore the use and limitations of regulatory supervision to address both the public interest and private law concerns raised by trust (mal)practice. Part IV contends that whilst regulations can be an effective interim measure for addressing private law disputes, legislators should in the long term adopt a proactive approach and enact trust laws that clearly define the rights and responsibilities of the trust parties. Part V concludes.

II Promised Returns, Shadow Banking, and Social Stability

In Western capitalist countries, which reject centralised economic planning, regulations are used primarily to address such market failures as information asymmetry, the inequality of bargaining power, and the externalities of private transactions.[1] However, in state capitalist countries such as China, regulations play an additional role in implementing state fiscal policies.[2] In this part of the chapter, we outline the intended fiscal role of investment trusts within China's regulatory framework based on state capitalism and demonstrate that, in reality, such trusts have ironically become a major source of disruption to state fiscal policy. We also demonstrate that because most trust companies are either state-owned enterprises or heavily backed by the state, disputes between trust companies and investor-beneficiaries are seldom purely private law matters.

The Chinese trust industry is unique both within China's financial regulatory framework and amongst trust industries worldwide. Within China, trust companies are the only financial institutions allowed to engage in investment business across an unrestricted range of financial

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[1] J Armour et al, *Principles of Financial Regulations* (Oxford: Oxford University Press, 2016) 52-61; TT Arvind and Joanna Gray, 'The Limits of Technocracy: Private Law's Future in the Regulatory State' in K Barker, Karen Fairweather, and Ross Grantham (eds) *Private Law in the 21st Century* (Oxford: Hart Publishing, 2016) 238.

[2] State capitalism is an economic system whereby the state undertakes commercial economic activities typically through state-owned-enterprises. See M Wright et al (eds), *The Oxford Handbook of State Capitalism and the Firm* (Oxford: Oxford University Press, 2022).

markets, including debt, equity, real estate, and other unallocated assets.[3] All other financial institutions must abide by the requirement to segregate financial business. This requirement means that commercial banks are prohibited from engaging in securities, trust investment, or real estate investment business and that securities and insurance companies are barred from banking or trust business. Such segregation is intended to prevent financial risks from rapidly spreading across financial sectors. In exempting trust companies from the segregation policy, the Chinese government has sought to entrust them with the *de facto* role of private investment banks, which are lacking in China. Trust companies are intended to develop bespoke, private placement collective investment trusts[4] for high net-worth individuals and institutional investors. At the time of their establishment, it was hoped that such trusts would help to mobilise capital from niche investors to drive new segments of the economy and foster growth and innovation.[5] Retail investors are therefore barred from participating in investment trusts owing to means-tested minimum investment thresholds,[6] and trust companies have paid little attention to developing the private wealth management business typical of their counterparts in most jurisdictions.

In this distinct framework, Chinese trust regulations perform a dual function. First, they construct the regulatory infrastructure for a state-driven financial market and ensure that trust companies adhere to their designated role. Second, they function similarly to regulations in capitalist jurisdictions by tracking and replicating private law obligations within trusts, occasionally reinforcing them with supplementary obligations to address market failures such as unequal bargaining power.

However, China's high hopes for collective investment trusts were quickly dashed. Despite their rapid growth – with the total assets managed by trust companies increasing from US$39 million in 2003 to US$2.93 trillion in March 2023[7] – many of these trusts became vehicles of regulatory arbitrage and shadow banking, as well as sources of social unrest when they failed. Nearly half of the assets under management (AUM) by trust companies are held in so-called 'channelling businesses' for the purpose of regulatory arbitrage.[8] In such businesses, commercial banks and insurance companies settle assets in a single-investor trust for investment business that goes beyond their permitted financial markets. Instead of actively managing investment portfolios, trust companies serve merely as conduits for other financial institutions, charging a fee to facilitate and avoid regulatory scrutiny by concealing the identities of beneficiaries through multilayered trust structures. The other half of trust companies' AUM are held in collective investment trusts, which are marketed to retail investors as high-yield savings products,[9] with the pooled savings then typically lent to state-owned enterprises or the incorporated investment arms of local governments. These trust arrangements have become a tool for shadow banking, allowing local governments to

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[3] See generally K Liu, 'Chinese Shadow Banking: The Case of Trust Funds' (2019) 53 *Journal of Economic Issues*, 1070; W Shen, *Shadow Banking in China: Risk, Regulation, Policy* (Cheltenham: Edward Elgar Publishing 2016); L Ho, 'Business Trusts in China: A Reality Check' (2020) 88 *Cincinnati University Law Review* 767 (hereafter 'A Reality Check'); L Ho, 'Protecting Investors of Collective-Investor Trusts in China' in A Laby (ed) *Cambridge Handbook of Investor Protection* (2022) 153.

[4] The regulatory framework for collective investment trusts is set out in Trust Law of the People's Republic of China (hereafter 'Trust Law') (People's Republic of China), National People's Congress, 28 April 2001 and Measures for the Administration of Trust Companies' Collective Trust Plans (hereafter 'Collective Trusts Measures') (People's Republic of China), China Banking Regulatory Commission, 4 February 2009.

[5] Liu (n 3) 1071; Ho, 'A Reality Check' (n 3) 772.

[6] According to article 5(3) of the Collective Trusts Measures, an individual investor must pass an asset- or income-test and invest a minimum of RMB1 million (about US$150,000). There can only be at most 50 individual investors who invest less than RMB3 million (about US$410,700) each.

[7] Main Business Data of Trust Companies at the End of the First Quarter of 2023, China Trust Association, http://www.xtxh.net/xtxh/statistics/48527.htm.

[8] According to the China Trust Association (n 7), 47.21% of the trust assets were held in those businesses.

[9] Interest rates for collective investment trusts are approximately 8-9%, as compared to the 2-3% for regular bank deposits.

circumvent the state's fiscal scrutiny by financing projects that might not obtain state credit from central and commercial banks.

If the regulations were strictly adhered to, trust companies would not be able to operate collective investment trusts in the manner described. For one thing, the regulations prohibit trust instruments from including any promises of a guaranteed level of investment return, and trust companies have indeed taken care not to include any such promises.[10] However, owing to the heavy involvement of local governments and past instances of government bailouts, investors have come to assume that there is an implicit guarantee of returns (*gangxing duifu* 刚性兑付).[11] This situation is exacerbated by the fact that the commercial banks responsible for selling these products often ignore the eligibility requirements for individual investors in collective investment trusts.[12] They arrange for retail investors to pool their investments together to meet the minimum investment threshold, thus affording unsophisticated investors access to high-risk products. Finally, to finance payments upon fund maturity, trust companies often combine the assets of the collective investment trusts they manage, and sometimes issue new products to obtain funding to pay for trusts with earlier maturity dates.[13]

These trust practices have significant consequences in both the private law and public domains. In private law, they clearly involve breaches of several core duties of trustees, although the legal effect of and remedies for such breaches are unclear. First, the failure to keep separate accounts for assets pooled from different trusts breaches trustees' fundamental duty to segregate the trust funds they hold.[14] If a trust company uses funds from one trust product to meet its liability with respect to another, it is misappropriating the trust funds and becomes liable for restoring them to their former state or offering compensation.[15] Whilst the Trust Law of the People's Republic of China (Trust Law)[16] provides for the remedy of requiring trustees in such situations to 'restore the [trust] property to its former state or make compensation', and of treating profits unlawfully made from the use of trust assets as belonging to the trust, it offers no elaboration on how to measure liability.[17]

Second, the sale of trust products to retail investors likely involves mis-selling and regulatory breaches by commercial banks, which sell trust products on behalf of trust companies. This situation raises difficult questions about the assignment of liabilities between commercial banks and trust companies. It is also unclear whether investors whose names are used to purchase a trust product on another's behalf are considered to have met the eligibility requirements for investors, and, if they have not, whether the relevant trust contract is invalid. The same concern applies to agreements amongst retail investors who pool their funds together to circumvent the threshold requirement[18] and to implicit guarantees of return, which infringe article 2 of the Guiding

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[10] Article 34(3) of the Collective Trusts Measures (n 4).

[11] Ho, 'A Reality Check' (n 3) 774; Yuan Xiaojun and Chen Zhifeng, 《信托业刚性兑付模式之法律分析》 [Legal Analysis of Promised Return in Trust Industry] (2017) 20 *Securities Law Review* 341, 343. For an account of the legal effect of implicit guarantee of returns under Japanese trust law, see Liu Yan and Zou Xingguang, 《信托与大资管的关系 -- 日本实践的启示》 [The Relationship between Trusts and the Asset Management Opinion - Insights from Japanese Practice] (2021) 33 Securities Law Review 1, 8-10.

[12] Song Yitong, 《信托"拼单"难禁, 谁在踩红线》[Hard to Ban 'Group-Buying' in Trusts, Who is Crossing the Red Line?], Beijing Business Daily, available at https://www.bbtnews.com.cn/2021/0909/411742.shtml.

[13] Lin Shi, 《影子银行的庞氏骗局》 [The Ponzi Scheme of Shadow Banking] (2012) 12 *New Finance and Economics* 39, 41; Chen Jia and Wang Xiaotian, Banking Section in Good Health, Top Officials Say, China Daily, 12 November 2012, available at http://www.chinadaily.com.cn/cndy/2012-11/12/content_15915122.htm

[14] Trust Law (n 4), arts. 16, 29 and 49.

[15] Trust Law (n 4), arts. 16, 27 and 49.

[16] Trust Law (n 4).

[17] Trust Law (n 4), arts. 22 and 26.

[18] Civil Code of the People's Republic of China (hereafter 'Chinese Civil Code'), National People's Congress, 1 January 2021, art. 153.

Opinions on Regulating the Asset Management Business of Financial Institutions issued in 2018 (Asset Management Opinions).[19] However, as we discuss below, the private law effects of breaches of these regulatory requirements, which are stipulated in departmental rules (*bumen guizhang* 部门规章), remain to be worked out by the courts.[20]

In the public domain, these investment trusts exert a negative impact on fiscal and social stability. With respect to fiscal stability, they have become a vehicle for shadow banking. They enable local governments to secure financing beyond the central bank's purview, promote industries or economic sectors not sanctioned by the state, and bypass the state's fiscal and economic policies. This practice cripples the state's ability to manage economic cycles and hinders the flow of capital to genuinely competitive economic activities,[21] contributing to overheating of the economy. Investment trusts have also been used for regulatory arbitrage, with commercial banks and insurance companies establishing single-investor investment trusts with trust companies to invest across different financial markets. With respect to social stability, such trusts breed discontent with the government. Because the majority are ultimately backed by the government, investor dissatisfaction with defaults, trustee mismanagement, and a lack of compensation can easily lead to discontent with the government and social instability.

In sum, the substantial involvement of local governments in Chinese investment trusts and their misuse of such trusts to bypass fiscal policies have had problematic consequences. Not only do investment trusts undermine fiscal stability, but they also create unrealistic expectations amongst unsophisticated retail investors about the security of their legal rights and the profitability of such trusts. These expectations, in turn, lead to dissatisfaction with the government when trust companies fail to make payments, ultimately heightening the risks of social instability.

III The Dominance of Regulations

As we have shown, defaults in the Chinese investment trust industry invite questions about how regulation and private law interact to address improper trust practices. How can we delineate the boundaries between these two branches of law? Which branch should be employed to remedy breaches of private law obligations that are also encompassed by regulations? After examining the approaches of the courts and government to these questions, and the predominance of regulation in addressing private law breaches, this part of the chapter evaluates the use and limits of regulations.

A Regulatory Intervention

The initial framework of the Chinese trust law system is often described as 'one law, two rules' (*yifa lianggui* 一法两规). The Trust Law serves as the foundational law (*falyu* 法律) for trust relationships, whilst the two departmental rules are the Measures for the Administration of Trust Companies (Trust Companies Measures)[22] and the Measures for the Administration of Trust Companies' Collective Trust Plans (Collective Trusts Measures).[23] The Trust Law establishes the fundamental principles of Chinese trusts and defines the rights and duties of trust parties in private law. The two departmental rules provide supplementary provisions based on public interest

[19] Guiding Opinions on Regulating the Asset Management Business of Financial Institutions (hereafter 'Asset Management Opinions') (People's Republic of China), People's Bank of China, China Banking and Insurance Regulatory Commission, China Securities Regulatory Commission, and the State Administration of Foreign Exchange, 27 April 2018, art. 2. According to article 153 of the Chinese Civil Code (previously article 52 of the Chinese Contract Law), contracts that infringe a provision of law or administrative regulation are void.

[20] See Part III.B.

[21] Xiaodong Zhu, 'The Varying Shadow of China's Banking System' (2021) 49 *Journal of Comparative Economics* 135.

[22] Measures for the Administration of Trust Companies (hereafter 'Trust Companies Measures') (People's Republic of China) China Banking Regulatory Commission, 23 January 2007.

[23] Collective Trusts Measures (n 4).

concerns regarding investor eligibility, the custody and management of trust funds, and information disclosure to investors. Both the Trust Law and the two departmental rules are instrumental in delineating the practical boundaries of Chinese trust law.

In the past two decades, trust companies have adopted new business structures that cannot be adequately regulated by either the Trust Law or the two departmental rules. As the legislative process is complex and time-consuming, regulators have taken the initiative to issue numerous regulations, primarily through departmental rules[24] or normative files (*guifanxing wenjian* 规范性文件),[25] to specifically regulate those structures. As explained below,[26] these regulations not only realign trust companies with the public policy goals of fiscal control and investor protection, but they also refine and supplement trust principles in private law.

Notable examples of the issuance of departmental rules to restore financial stability following widespread irregularities within the trust industry include the expedited enactment of Measures for the Administration of Trust and Investment Companies (2002)[27] and Interim Measures for the Administration of Trust Companies' Collective Capital Trust Plans (2002)[28] after the collapse of the Guangdong International Trust Investment Company in 1999. Additionally, the Guidance Note on Risk Management of Trust Companies (2014)[29] was introduced in response to a series of high-profile defaults of trust plans and bailouts, whereas the Asset Management Opinions were issued to address the overheating of the economy – particularly in the property market – by clamping down on implicit guarantees of returns, amongst other things. Whether by reinforcing the permissible parameters of trust business, stipulating minimum paid-up capital requirements, or tightening the requirements for risk disclosure and qualified investor scrutiny, these departmental rules serve to address public interest concerns about financial stability, the internal risk management of trust companies, and investor protection. To give these rules real teeth, severe consequences are imposed for breaches, including criminal liability, administrative sanction, or even the revocation of the trust companies' licenses. These measures provide powerful deterrence against breaches, making departmental rules more effective and efficient than private law in enforcing compliance and restoring financial order during times of crisis.[30]

In addition, departmental rules replicate and supplement the private law obligations stipulated in the Trust Law. A prominent example is article 34(1) of the Trust Companies Measures, which prohibits trustees from obtaining unauthorised gains through the use of their *position*. This provision expands the narrow ban in article 26 of the Trust Law with respect to obtaining gains through the use of *trust property*, and thus rightly includes bribes and secret commissions, which are omitted from the Trust Law.[31] This 'twin-track' approach of duplicating or supplementing private

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[24] Departmental rules refer to regulations issued by ministries and commissions of the State Council in accordance with the law and the State Council's administrative regulations, decisions, and orders: Ordinance on the Archivist Filing of Regulations and Government Rules, Order No. 337 of 2001, State Council, art. 2.

[25] Normative documents are documents formulated by administrative organs and authorised organisations, within their powers of public affairs management. They possess general binding force in the administrative region or its management scope and are repeatedly applicable for a certain period of time. See Nicholas Calcina Howson, 'Enforcement without Foundation? — Insider Trading and China's Administrative Law Crisis' (2012) 60(4) *American Journal of Comparative Law* 955, 979.

[26] See Part IV.B.

[27] Measures for Administration of Trust and Investment Companies (People's Republic of China), People's Bank of China, 9 May 2002, repealed by Trust Companies Measures in 2007.

[28] Interim Measures for Administration of Trust Companies' Collective Trust Plans (People's Republic of China), China Banking Regulatory Commission, 18 July 2002, repealed by Collective Trusts Measures in 2009.

[29] Guiding Opinions on Regulation of Risk Supervision of Trust Companies (People's Republic of China), China Banking Regulatory Commission, 8 April 2014.

[30] Lu Li, 《论金融司法与金融监管协同治理机制》On the Collaborative Governance Mechanism of Financial Judiciary and Financial Regulation (2021) 2 *China Legal Science* 189, 201; Huang Tao, Judicial Expression of Financial Security (2020) 4 *The Jurists* 68, 73-74.

[31] For detailed discussion, see Part IV.B

law obligations (stipulated in the Trust Law) with public regulations (such as the Trust Companies Measures) is well established in jurisdictions with extensive experience in financial regulation.[32] In the European Union, for example, the Markets in Financial Instruments Directive establishes a foundational duty for an investment firm to 'act honestly, fairly, and professionally in accordance with the best interests of its clients'.[33] This duty overlaps with fiduciary or similar duties present in the private laws of EU member states. Similarly, in the United States, the courts have interpreted the Investment Advisers Act to impose a fiduciary duty on investment advisers, requiring them to act in the best interest of the fund and its investors.[34]

B Two Judicial Tactics

The Trust Law has remained unchanged since its enactment over two decades ago, and nor has the Chinese Supreme People's Court issued any judicial interpretation of this Law, as per its usual practice. Nonetheless, judges have taken proactive steps to declare trust contracts that breached the abovementioned departmental rules to be invalid by adopting a broad interpretation of the relevant rules in private law, thereby blurring the boundary between private law and regulations. Specifically, article 153 of the Civil Code of the People's Republic of China (Chinese Civil Code)[35] identifies two scenarios in which contracts are deemed invalid. The first is contracts that contravene mandatory provisions of laws (*falyu* 法律) and administrative regulations (*xingzheng fagui* 行政法规).[36] Significantly, departmental rules and normative documents, the types of instruments in which trust regulations are issued, do not fall into the category of laws and administrative regulations. The second is legal actions that violate public order and morals (*gongxu liangsu* 公序良俗).

Judicial practice shows that the courts have adopted an expansive interpretation of article 153 of the Civil Code to embrace departmental rules or normative documents. First, where these instruments are authorised by laws or administrative regulations, the courts have assumed, without explanation, that the article is applicable.[37] In *Shenzhen Wanqi Clothing Co Ltd and China Minsheng Trust Co Ltd*, for example, the Beijing Financial Court declared a trust contract that included an implicit guarantee of return to be invalid without delving into the issue of the legal categorisation of the invalidating rule. Second, when courts do acknowledge that departmental rules are neither laws nor administrative regulations, they seize upon the open-ended ideas of public order and morals to treat violations of department rules or normative documents as violations of public order and morals. *Liu Moubin and Zhongrong Trust Company*, a decision of the Beijing No 2 Intermediate People's Court, provides a neat illustration of this approach. In this case, the court held that although a departmental rule prohibiting so-called 'umbrella trust' schemes[38] was not a law or administrative regulation, its aim is to 'control the risks of the financial market'. As a result, trusts

[32] J Armour et al, *Principles of Financial Regulations* (Oxford: Oxford University Press, 2016) 231-233.

[33] MIFID II, art. 24(1)

[34] Investment Advisers Act of 1940, Section 206(2); *Santa Fe Industries v Green*, 430 US 462, 472 (1977).

[35] Chinese Civil Code (n 18).

[36] Administrative regulations are formulated by the State Council and promulgated by the Premier through decrees of the State Council: Legislation Law of the People's Republic of China, National People's Congress, 13 March 2023, arts. 72 and 77.

[37] Trust Dispute between Shenzhen Wanqi Clothing Co Ltd and China Minsheng Trust Co Ltd, Beijing Financial Court, 2022, Civil Division, Appeal Ruling, Case No 415.

[38] Umbrella trusts were previously popular trust structures that allowed retail investors to participate as junior tranche beneficiaries, granting them the ability to invest at multiple times leverage in the stock market. However, owing to their opacity, retail investors often had limited understanding of the leverage involved in these schemes and the associated risks.

contravening that rule are considered to be in violation of the 'public, social, and economic order' under article 153.[39]

C The Use and Limits of Regulations

Having considered regulatory and judicial attempts to rein in improper trust practices, we now assess the use and limits of regulations. There is no doubt that the use of investment trusts for regulatory arbitrage and shadow banking falls within the purview of regulators rather than private law. These trust activities give rise to significant public interest concerns, as they hinder the allocation of capital to sectors prioritised by the state and disrupt the stable progression of economic cycles. Whilst the use of regulations to steer capital allocation might be viewed as excessive government interference in capitalist economies, it is a justifiable approach for a country that embraces state capitalism. Furthermore, the history of Chinese trust companies has demonstrated that regulations have proven to be the most efficient and effective means of restoring financial stability following widespread irregularities within the trust industry.[40] As we explain above, multiple instances of economic overheating caused by excessive credit availability through trusts have been addressed by regulatory tightening measures.

It is also a legitimate goal of regulation to achieve investor protection through the imposition of mandatory disclosure requirements, and Chinese regulation is no exception. In an ideal scenario, when parties with similar bargaining power negotiate at arm's length and have symmetrical access to information, the private law duties they agree upon might provide adequate protection for both parties. However, this is rarely the case when consumer-investors purchase trust investment products from large financial institutions, and even less so when the contracts are presented in standard forms containing exemption clauses that safeguard the financial institutions.

Finally, the use of regulations to replicate and supplement private law obligations is justifiable on pragmatic grounds. Consumers face numerous practical hurdles in enforcing their rights in court. The legal process is lengthy, costly, and often difficult for beneficiaries with limited access to information about a trust's management. In addition, private law remedies such as compensation for loss or disgorgement of profits provide insufficient deterrence compared to public law remedies such as penalties, licence revocation, or criminal liability. The enactment of private law statutes may also take years to materialise, if at all, and the development of private law through judicial rulings is subject to the haphazard nature of litigation.

In China, the constraints of private law are further exacerbated by the nascent state of the country's financial market. For example, the inequality of bargaining power is more pronounced than elsewhere owing to the limited financial literacy amongst retail investors and the ubiquity of government-related defendants with political power. Further, the broad-brush nature of stipulations in, and absence of amendments to, the Trust Law means that existing laws are

[39] Trust Dispute Case between Liu Moubin and Zhongrong Trust Company, Beijing No 2 Intermediate People's Court, 2019, Civil Division, Appeal Ruling, Case No 10655. See also Appeal Case of the Dispute over the Entrusted Investment Contract between Xie Weicong and Huang Junhui, Intermediate People's Court of Dongguan City, Guangdong Province, 2008, Civil Division, Appeal Ruling, Case No 709, explanatory notes by Dai Junyong.

[40] Li Yong,《信托业监管法律问题研究》*Study on Legal Issues of Trust Industry Regulation* (China Financial & Economic Publishing House, 2008) 118-123; Liu Guangxiang,《大资管与信托实战之法》*Practical Principles of Management Asset and Trust* (China Legal Publishing House, 2018); Song Hui, 《金融司法的金融监管功能及其权力界限》The Regulatory Function and Power Boundaries of Financial Justice in Financial Regulation (2022) 2 *Dalian University of Technology Journal (Social Sciences Edition)* 98, 102; Mei Xiaying, 《民法权利思维的局限与社会公共维度的解释展开》The Limitations of Civil Law Rights Thinking and the Interpretation and Development of Social Public Dimensions (2019) 1 *The Jurist* 15, 22; Liu Zhiwei, The Response of Private Law Norms to Financial Innovation] (2021) 5 *Economic and Trade Law Review* 95, 101-103.

inadequate to address the full range of legal issues raised by complicated trust structures.[41] These limitations of private law highlight the useful role that regulations can play in China, even within the realm of private law. Regulations can comprehensively supplement the content of private law duties. Regulators are better funded and equipped than private litigants to enforce those duties, and regulatory changes can be implemented efficiently, professionally, and systematically.

Nevertheless, whilst regulations play a useful role in supplementing private law, it is an entirely different proposition to replace the judicial adjudication of private law obligations with administrative enforcement. Unless corrective justice through private law is completely replaced by an insurance-based compensation system, two vital aspects of private law decisions cannot be achieved through regulations: the vindication of rights and the competitive selection of thriving enterprises. A determination of breach is significant not merely for court-ordered remedies but also for the vindication of the plaintiff's rights and the establishment of the defendant's culpability.[42] Whilst a successful plaintiff may not always receive the full remedy awarded by the court due to the defendant's insufficient funds to satisfy the judgment, at least the plaintiff's rights are acknowledged by both the defendant and the state. Furthermore, if the defendant cannot fulfil the judgment, the plaintiff may initiate the defendant's bankruptcy. The enterprise bankruptcy regime helps to eliminate underperforming enterprises and supports the economic process of natural selection, whereby only the most robust entities survive.

In addition, regulators often make decisions based on their conceptions of the 'economic market order' and 'public order'. However, the meaning of these concepts remains unclear, making it difficult to anticipate and question the regulators' decisions.[43] The interpretation and enforcement of regulations by regulators are often influenced by politics and policies considerations, resulting in a lack of transparency and consistency typically associated with judicial decisions.[44] For instance, the practice of implicit guarantees and government bailouts of failed trust plans was tolerated by regulators for over a decade before a decisive change in approach was effected in the Asset Management Opinions.[45] This change in approach resulted in multiple failures of trust plans after the grace period for compliance with the Opinions expired. A notable example is the recent failure of Zhongrong International Trust, which holds approximately US$100 billion on trust, to repay the proceeds of two trust products. News of the failure sparked the dumping of trust products by the companies invested in them and a sharp fall in the stock market owing to

[41] Zhang Yang, 《金融司法监管化的边界约束》Boundary Constraints on the Judicial Supervision of Finance (2023) 2 *Tsinghua University Law Journal* 125, 131; Xu Yingjun,《金融风险生成的契约群逻辑及其法律规制》Contractual Group Logic and Legal Regulation of Financial Risk Generation (2020) 6 *Law Review* 64, 65; Zhang Jianwei and Li Yan, 《复杂性、 法律适应性与金融法之艺术》Complexity, Legal Adaptability, and the Art of Financial Law (2016) 1 *Financial Law Forum* 3, 3.

[42] See also the literature on therapeutic jurisdiction by Tom Tyler, 'The Psychological Consequences of Judicial Procedures: Implications for Civil Commitment Hearings', in David Wexler and Bruce Winick (eds), *Law in a Therapeutic Key: Developments in Therapeutic Jurisprudence* (Caroline Academic Press, 1996) 3. We thank Ian Murray for this point.

[43] Zhang (n 41) 126; Song (n 40) 102.

[44] Chen Qiuzhu, 《金融监管规则介入司法裁判的合理性及其限度 — 基于穿透式监管对商事合同效力认定的影响》The Rationality and Limits of Financial Regulatory Rules' Intervention in Judicial Adjudication: The Impact of Penetrating Regulation on the Recognition of the Effectiveness of Commercial Contracts (2021) 3 *Southern Finance* 76, 82-83; Zhao Yao,《金融司法监管化的逻辑审视》 [Logical Examination of the Judicial Financial Regulatory Process] (2020) 5 *Journal of Huazhong University of Science and Technology (Social Science Edition)* 72, 78; Zhang Yan, 《大资管时代的行业监管困境与出路》[The Industry Regulatory Dilemma and Solution in the Era of Large Asset Management] (2019) 2 *Chinese Legal Review* 194, 194.

[45] Engen Tham et al, 'Waning Trust: China Shadow Banks Pivot Away from Property to Survive', Reuters, 12 December 2022, available at https://www.reuters.com/business/finance/waning-trust-china-shadow-banks-pivot-away-property-survive-2022-12-12/.

concerns over those companies' risk exposure.[46] Therefore, given the limitations of regulations and the indispensable role of private law in vindicating rights and eliminating non-competitive enterprises, a better approach would be to employ regulations to support rather than replace private law litigation.

Unfortunately, in China, there is a tendency to replace private law litigation with regulatory-based solutions. When the trustees of a collective investment trust default on payment upon maturity, courts often suspend the judicial process owing to the public interest concerns raised.[47] Regulators or governments typically intervene to propose a compromise settlement for investors. Whilst these strategies may be driven by a well-intentioned desire to resolve disputes and address the risks of social unrest efficiently, they reinforce lay investors' perception that the judiciary and executive branch are protecting trust companies from assuming their full responsibilities. As a result, there is a real risk of investors' dissatisfaction with these companies transforming into broader discontent with the justice system and government involvement in the violation of their rights. Ignoring such sentiments can sow the seeds of social unrest. Additionally, excessive government intervention risks impeding the market's ability to improve itself. Non-competitive trust companies may evade insolvency, which undermines the quality and reputation of the trust industry. Investors may rely on the government to protect them from unwise investment choices rather than learning from their mistakes and actively scrutinising trust products. It is ironic that relying solely on regulation to protect investors and promote social and financial stability may actually undermine these objectives in the long run.

IV The Way Forward

Having clarified the unique context of Chinese investment trusts and the use and limitations of regulations, this part outlines the future development direction for such trusts. First, regulation is the most appropriate tool for addressing public interest concerns associated with Chinese investment trusts. Second, giving the uncertain prospects of any Trust Law amendment in the short term, regulations can be utilised to refine trustees' duties in private law and strengthen compliance with those duties. Third, in the long term, the development of a coherent trust law system in China necessitates proactive Trust Law amendments and active judicial engagement in interpretating and rationalising trust rules. We analyse these three aspects of the way forward in detail below.

A The Dominant Role of Regulations in Achieving Public Policy Objectives

As explained in Part I, private law and public law have distinct boundaries and functions: private law aims to protect the rights of individuals, whilst public law serves to protect the public interest. Regulations, which are typically enforced by regulatory agencies through administrative sanctions or criminal liability, fall under the purview of public law. Consequently, regulations can play a predominant role in implementing a state's public policy objectives. In China, regulators have enacted numerous regulations to achieve three primary policy objectives of investment trusts: fostering financial stability, implementing effective capital control measures, and safeguarding investor interests.

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[46] Thomas Hale, 'Chinese Investors Alarmed over Trust Company's Missed Payments', Financial Times, 14 August 2023, available at https://www.ft.com/content/19270d30-a781-4f39-9c30-9b384fcbe5c4; Chen Hongjie, 《中融信托现兑付逾期, 三家信托公司回应停兑风波》Zhongrong Trust's Current Redemption is Overdue, Three Trust Companies Respond to the Suspension of Redemption Controversy, 12 August 2023, available at http://m.caijing.com.cn/article/308159?target=blank.

[47] Liu Hui, 《72 亿纠纷案达成执行和解 万余名投资者合法权益得到维护》7.2 Billion-dollar Dispute Settled, Over Ten Thousand Investors' Rights Protected, 25 Aug 2022, Jingfa WangShi, available at https://mp.weixin.qq.com/s/IktCt7KHdf2bOVpz82oJBQ.

1 Financial Stability

Regulators have adopted two approaches to foster financial stability. The first approach is macro and involves establishing principles that guide the conduct of trust businesses in a broad sense. These principles include 'directing [trust] funds towards the real economy to better support economic structural adjustment, transformation and upgrading',[48] encouraging trust companies to 'conduct a detailed analysis of each trust product's design, fund allocation, information disclosure and risk status',[49] and ensuring that trust activities do not 'harm the national interests and public interests of the society'.[50] The second approach is micro and involves clearly defining the prohibited activities for trust companies. An instance of this approach is the Trust Companies Measures, which prohibit trust companies from using their assets for industrial investment and from engaging in any liability business other than interbank borrowing.[51]

In practice, trust companies use tactics like nesting trusts in opaque, multilayered legal structures[52] to bypass the regulatory requirements mentioned above. In response, regulators have implemented two interrelated principles to ensure compliance by trust companies. The first is the principle of penetrating regulation, which necessitates identifying each management product's underlying assets and ultimate investors.[53] The Opinions on Further Strengthening Risk Supervision of Trust Companies state that '[regulators] should supervise trust companies to identify the ultimate investors of trust products based on the penetrating principle'.[54] The second principle is the principle of substance over form, whereby regulators apply regulatory rules based on the actual effects of the transaction rather than its superficial form.[55] For instance, article 1(5) of the Notice on Standardising the Categorisation of Trust Business of Trust Companies[56] specifies that trust business should be classified according to the substance, rather than form, of that business.

2 Capital Control

The second policy objective concerns capital control, which is achieved by defining how trust companies conduct trust business and operate. Regulators have implemented two measures to achieve this objective: (a) setting limits on the ratio of trust funds invested in a specific asset and (b) clarifying capital requirements for trust companies.

Measure (a) pertains to managing trust assets, such as article 4 of the Asset Management Opinions, which requires fixed income products to invest at least 80% in debt assets and equity products to invest at least 80% in equity assets. By contrast, measure (b) focuses on trust companies' capital requirements to ensure their business development aligns with their risk management capabilities and internal control levels.[57] The Net Capital Management Measures for

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[48] Asset Management Opinions (n 19), Introduction.

[49] Notice on Further Strengthening Risk Management of Wealth Management Business in Bank-Trust Cooperation by Trust Companies (People's Republic of China), China Banking Regulatory Commission, 19 December 2008, art. 2.

[50] Trust Companies Measures (n 22), art 4.

[51] Trust Companies Measures (n 22), arts. 20 and 21.

[52] Maoxian Jiang, Discussions of 'Nested Layers' after the Implementation of the Asset Management Regulation, 18 May 2018, available at https://www.jingtian.com/Content/2018/09-12/1842360015.html.

[53] Asset Management Opinions (n 19), art. 27(2).

[54] Opinions of the General Office of the China Banking Regulatory Commission on Further Strengthening the Work of Supervising the Risks of Trust Companies, China Banking Regulatory Commission, 18 March 2016, art. 2(5).

[55] Wenming Xu and Zhicheng Wu, 'Regulation-Driven Legal Doctrines of Investment Trusts in China' (2022) 23 *European Business Organization Law Review* 391, 413.

[56] Notice on Standardising the Categorisation of Trust Business of Trust Companies (People's Republic of China), China Banking and Insurance Regulatory Commission, 20 March 2023.

[57] Notice on Issuing Relevant Matters on Calculation Standards for Trust Companies' Net Capital (People's Republic of China), China Banking Regulatory Commission, 27 January 2011, art. 1.

Trust Companies (Net Capital Measures)[58] were enacted specifically to address measure (b). Article 13 of the Net Capital Measures defines two risk control indictors that trust companies must adhere to: net capital shall not be less than 100% of the sum of risk capital, and net capital shall not be less than 40% of net assets.

3 Investor Protection

The third policy objective focuses on safeguarding investor interests, which is essential for enabling investors to make well-informed decisions about their private law rights and duties. As Chinese collective investment trusts involve numerous small retail investors with limited resources, any mismanagement of funds by trust companies can severely erode public confidence in investing in trusts.[59] The media coverage highlighting the maladministration of investment trusts has attracted significant attention from regulators, motivating them to include investor protection as a policy objectives in their regulatory rules.

Regulators have adopted two measures to protect investors: (a) investor suitability management and (b) sufficient information disclosure to investors. Article 6 of the Asset Management Opinions provides a clear explanation of how measure (a) works: 'Financial institutions issuing and selling asset management products should … strengthen investor suitability management and sell asset management products that are appropriate for investors' risk identification and risk-taking abilities.' Accordingly, the central concern of this measure is to match investors' risk-taking abilities with the risk level of the trust products they invest in. Measure (b) focuses on the disclosure of trust product information to investors, enabling them to make informed decisions about whether or not to invest in trust products when presented with such opportunities by trust companies. Article 12 of the Asset Management Opinions exemplifies this measure by requiring trust companies to provide accurate and timely information to investors about fund allocation, income distribution, custody arrangements, and investment risks.

B Short-Term Use of Regulations to Resolve Private Law Disputes

The use of regulations as an interim measure to resolve private law disputes is justified on three grounds. First, the Trust Law's provisions are ambiguous and do not cover all legal issues related to Chinese investment trusts. Second, the power imbalance between trustee companies and investors has enabled the former to limit investor rights through contractual arrangements. Investors often face difficulties in accessing trust management information and enforcing their rights in court.[60] Third, the enactment of private law statutes is a time-consuming process that may take years to materialise.[61] These factors have created an opportunity for regulations to play a role in resolving private law disputes between trust parties. Regulatory practices have reflected this trend, with regulators enacting regulations to clarify ambiguous trust law rules. We now examine the regulatory rules concerning three specific aspects of private trust law: the proper accounting of gains and losses in trust business, trustee duties, and remedies for breaches of trustee duties. Unlike the regulations mentioned in Part IV.A, the regulations discussed here are based on rules and principles derived from private law. Their interpretation and enforcement are not primarily governed by the politics and policies of the state.

1 The Proper Accounting of Gains and Losses in Trust Business

The first rule is the proper accounting of gains and losses in trust business. Presently, article 22 of the Trust Law regulates compensation for the loss of trust assets. It states that trustees are liable

[58] Measures for the Administration of Net Capital of Trust Companies (People's Republic of China), China Banking Regulatory Commission, 24 August 2010.

[59] F Allen et al, 'Implicit Guarantees and the Rise of Shadow Banking: The Case of Trust Products' (2023) 149(2) *Journal of Financial Economics* 115, 116.

[60] Ibid.

[61] Ibid.

for compensation of losses resulting from their departure from administrative duties or improper handling of trust affairs. However, the article does not clarify whether trustees are obliged to replenish trust assets for losses arising from the proper management of trusts. In the absence of legislative clarification, many trust companies have adopted the practice of implicitly guaranteeing profits to attract investors,[62] a practice that has contributed to the 'overall risks and fragility of the entire financial system'.[63]

To strike a balance between affording flexibility to trustees in managing trust assets and protecting beneficiaries' interests, a reasonable principle is that profits and losses resulting from the proper management of trust assets are attributable to beneficiaries.[64] Accordingly, implicit guarantees of return should not be permitted. To protect all parties involved in trust business,[65] regulators have adopted various measures to prohibit such guarantees. For example, article 11 of the Collective Trusts Measures lists the mandatory content of risk disclosure statements for subscription, including the requirement that risks arising from proper trust asset management be borne by the trust assets themselves. Another example is article 2 of the Asset Management Opinions, which states that clients assume investment risks during the proper management of asset management products by financial institutions.

2 Trustee Duties

The second rule pertains to trustee duties. To ensure the proper administration of trust assets, trustees must adhere to an exacting range of duties and standards of conduct. Whilst the Trust Law introduced a variety of duties for trustees, many lack a clear definition. As a result, regulators have taken steps to clarify the meaning and performance of these duties. One example is the duty of loyalty, which requires trustees to act in the best interest of beneficiaries and refrain from being influenced by personal interest.[66]

The duty of loyalty includes the no-profit rule and no-conflict rule. Article 26 of the Trust Law stipulates the no-profit rule, which prohibits trustees from pursuing personal interests using trust assets unless authorised by the trust instrument. However, its narrow scope excludes scenarios in which trustees receive bribes or commissions by exploiting their position as trustees. To enhance the effectiveness of the no-profit rule in preventing such scenarios, regulators have revised the rule in their regulations. For instance, article 34(1) of the Trust Companies Measures prescribes that trustees should not pursue illegitimate gains by exploiting their trustee position. This wording is similar to that of the no-profit rule under English law,[67] and its scope extends to bribery and commission scenarios.

The scope of the no-conflict rule under the Trust Law is also narrow, as outlined in article 28. This article forbids trustees from engaging in two specific acts: conducting transactions between their own assets and trust assets, and conducting transactions between the trust assets of different settlors. Although article 28 effectively prevents trustees from benefiting personally by purchasing trust assets at undervalued prices or favouring one beneficiary over another, it falls short in regulating situations where trustees use trust assets to transact with affiliated parties, a common occurrence in trust practice. This limitation hinders the effective fulfilment of the no-

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[62] See Part II.

[63] Allen et al (n 59) 116.

[64] Ho, 'A Reality Check' (n 3) 792

[65] Collective Trusts Measures (n 4), art. 1.

[66] H Jing, 'The Duty of Loyalty in Chinese Trust Laws' (2020) 13 Journal of Equity 347, 357; Zhao Lianhui, 《信托法解释论》 [Interpretative Theory of Trust Law] (China Legal Publishing House, 2015) 311; Zhou Xiaoming, 《信托制度: 法理与实务》 [Trust System: Theory and Practice] (China Legal Publishing House, 2012) 276.

[67] English law refers to the law of England and Wales. English law imposes a duty on trustees to account for any benefits or gains acquired as a result of their position, including information or opportunities arising from that position. See *Regal (Hastings) Ltd v Gulliver* (1967) 2 AC 134, 154; *Williams v Barton* (1927) 2 Ch 9, 10–11; *Bristol and West Building Society v Mothew* [1998] Ch 1, 18.

conflict rule's prophylactic function. To address this problem, regulators have revised the no-conflict rule in their regulations. Article 24 of the Asset Management Opinions, for instance, establishes an overarching prohibitive rule and specific enumerations of prohibited conduct. The first part of article 24 prohibits trust companies from engaging in improper transactions, the transfer of benefits, insider trading, or market manipulation with affiliated parties using trust assets. The second part provides various examples of prohibited activities, including investing in fraudulent projects of affiliated parties and participating in joint acquisitions of listed companies with affiliated parties.

3 The Remedial System

The third rule concerns the remedial system in trust law. One example is the administrative remedy available for breaches of the no-profit rule. Article 26 of the Trust Law specifies that any personal benefits gained by trustees *through the use of trust assets* must be treated as part of the trust assets. However, as noted above, the no-profit rule under the Trust Law does not cover scenarios where trustees make profits by exploiting their trustee position, such as accepting bribes or commissions. In such cases, article 26 does not provide guidance on how to address the situation.

Regulators have reformed the remedial regime for breaches of the no-profit rule to address the abovementioned deficiency. Article 59 of the Trust Companies Measures allows regulators to confiscate any illegitimate gains obtained by trustees. Additionally, regulators may impose administrative penalties on trustees, such as fines or trustee licence suspensions, based on the amount of these gains. A similar provision is included in article 49 of the Collective Trusts Measures. Under the revised regime, if the profits made by trustees are considered 'illegitimate gains', whether acquired through the use of trust assets or through the exploitation of their position, the remedial regime under article 59 and article 49 can be employed to strip trustees of those gains. Regulators may also use their discretion to impose administrative penalties on defaulting trustees, which have a potent deterrent effect as they become public knowledge quickly and cause significant reputational damage to the trustees concerned.

C Legislative Updates Based on Regulations in the Long Run

Whilst regulations can address private law disputes in the short term, we propose that legislators should in the long term play a proactive role in enacting trust laws to guide the role of each party involved. This proposal is based on two considerations: the essential role of private law decisions and the benefits of legislation.

As analysed in Part III, private law decisions play an essential role in two interrelated aspects: the vindication of rights and the competitive selection of thriving enterprises. The 'vindication' role aligns with private law's commitment to protecting individual rights. By awarding court remedies to successful plaintiffs, the state and the defendant acknowledge the plaintiff's rights. In cases where the defendant lacks sufficient funds to satisfy the court-imposed remedies, the plaintiff can initiate bankruptcy proceedings against the defendant to enforce their rights. Such proceedings have the effect of eliminating underperforming enterprises, in accordance with market economy principles. Allowing defendants to go bankrupt also motivates plaintiffs to learn from past investment experiences and make more careful decisions in the future.

The second consideration pertains to the benefits of legislation in two areas: the development of coherent legal rules and the clarity provided to the public regarding the use of legal tools. Compared to regulations, which are influenced by political and policy considerations, legislation focuses on establishing coherent legal rules. To achieve this objective in the context of investment trusts, legislators should consider two key factors when enacting trust laws: the substance of each party's rights and responsibilities, as well as the appropriate remedies for any failure to fulfil those responsibilities. Moreover, owing to the complexity of investment trust structures, enacted trust laws may be insufficient to address all disputes. In such cases, courts should issue judicial interpretations to supplement the operation of trust laws. The second area of

benefit is the clarity provided to the public regarding the use of legal tools. Legislation that clarifies the rights and responsibilities of each party enables investors and trustee companies to understand their roles in the trust structure and make informed decision about participation. If a dispute arises during the administration of a trust, the clarity provided by legislation can aid both parties in identifying ways to enforce their rights and assessing the extent to which their rights can be enforced. This, in turn, facilitates private law's role in vindicating parties' rights.

Based on previous regulatory experiences with investment trusts, the enactment of investment trust laws should not pose a significant challenge. As analysed in Part IV.B, regulators have implemented numerous regulations to clarify the ambiguities associated with the Trust Law. These regulations cover various aspects of trust administration, including trustees' duties and the remedial system for trusts, and have proved helpful in guiding trust administration and resolving trust law disputes. Rather than starting from scratch, legislators can use these regulations as a valuable reference point when drafting investment trust laws.

There may be doubts about the proper enforcement of newly enacted laws, given similar challenges faced by existing regulations. However, this issue is not unique to China, and it would be self-defeating to avoid enacting legislation due to concerns about its enforcement. As explained in Parts IV.A and B, China has implemented two types of regulations regarding collective investment trusts. The first type of regulation focuses on implementing the state's policy objectives, whilst the second type deals with resolving private law disputes. The reform of trust laws we advocate involves incorporating the second type of regulations, which replicate and substantiate private law rights and remedies in collective investment trusts. These regulations have been primarily interpreted and implemented independently from political and policy considerations. Whilst legislative updates based on these regulations do not guarantee law enforcement, compared to the vague and incomplete provisions in the current Trust Law, the reformed law is more likely to provide concrete guidance to judges and individuals, thus increasing the likelihood of its proper enforcement.

V Conclusion

In China, the boundaries between private law and regulations are blurred in the context of investment trusts due to its specific political, social, and economic circumstances. Regulations have a higher priority in regulating Chinese investment trust businesses and addressing related disputes compared to private law. This chapter has identified two crucial findings. First, the function of regulatory oversight in the Chinese investment trust setting is twofold: (a) to address public interest concerns raised by trust malpractice and (b) to displace private law in resolving disputes amongst trust parties. Second, due to the limits of regulations, they can be used only as an interim measure in resolving private law disputes. To develop coherent trust jurisprudence in the long run, legislators must play a proactive role in amending or enacting trust laws to define the rights and responsibilities of trust parties. The enactment of trust laws can benefit from referencing regulations that have been specifically implemented to resolve private law disputes.

This chapter represents an initial step in analysing regulations in the context of Chinese trusts. Owing to space limitations, certain questions remain unaddressed, such as the applicability of the findings on investment trust regulation to other types of commercial trusts. Additionally, the increasing use of private trusts, like family trusts,[68] by the public raises the need to consider how the experience of investment trust regulation can inform the regulation of private trusts. Although the Trust Law was enacted in response to widespread malpractice by trust companies,

[68] Global Family Business Research Centre at Tsinghua University's PBC School of Finance and HSBC Bank (China) Limited, 《2023 中国家族财富管理 — 穿越不确定性: 传承浪潮与家族信托调查研究》 [2023 China Family Wealth Management — Navigating Uncertainty: Trends in Succession and Family Trusts], available at https://www.pbcsf.tsinghua.edu.cn/chuanchenglangchaoyujiazuxintuodiaochayanjiu.pdf.

the background against which it was enacted has significantly changed over the past two decades. Despite this, no meaningful reforms to the Trust Law have been undertaken. However, there is a growing call for trust law reform in both academia and practice,[69] suggesting that the State Council may include trust law reform in its legislative agenda in the near future. Future studies should address the aforementioned issues to achieve two objectives: first, to provide a comprehensive understanding of the interaction between regulations and private law in different types of Chinese trusts, and, second, to offer critical insight into the reform of trust rules with unique Chinese characteristics.

[69] Wang Jing, 《代表建议修改信托法促进信托业长期健康发展》 [Representatives Suggested Amending the Trust Law to Promote the Long-term and Healthy Development of the Trust Industry], Rule of Law Daily, 8 March 2022, available at http://www.legaldaily.com.cn/government/content/2022-03/08/content_8683992.html; Ji Kuiming, 《历史、议题与展望: 中国信托业、信托法四十年》[History, Issues, and Prospects: 40 Years of China's Trust Industry and Trust Law] 2019 (26) *Securities Law Review* 156, 178-182.