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BUSINESS TRUSTS IN CHINA: A REALITY CHECK

*Lusina Ho**

I. INTRODUCTION

In 2001, China took the bold step of enacting the Trust Law.¹ It is remarkable for a communist country to adopt a legal institution that was originally created to preserve wealth for the landed gentry in England.² It is even more extraordinary that the business trust was promoted by the Chinese government long before the (relatively simpler) family trust took root. These facts make China's enactment of the Trust Law provides an interesting case study for how a socialist, civil-law jurisdiction with a rudimentary private law system may put in place a sophisticated legal concept that has taken the West centuries to develop.

Indeed, China had a lot of ground to cover in a short period of time. The development of private law was not a high priority during the early decades after the establishment of communist China.³ Accordingly, soon after China adopted the Open Door Policy in 1979, it began enacting specialist statutes on private law areas like contract,⁴ property,⁵ and company law,⁶ to name but a few, in order to fill gaps in its private law

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1. Trust Law (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 28, 2001, effective Oct. 1, 2001) (China) [hereinafter "Chinese Trust Law"], <http://www.usig.org/countryinfo/laws/China/Trust%20Law%20of%20People%27s%20Republic%20of%20China.pdf> [<https://perma.cc/9WRR-RLDE>].

2. Stephen Tensmeyer, *Modernizing Chinese Trust Law*, 90 N.Y.U.L. REV. 710, 712 (2015).

3. The General Principles of the Civil Law, which contained rudimentary provisions on personhood, obligations and property, were only enacted in 1986. General Principles of the Civil Law (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 12, 1986, effective Jan. 1, 1987), http://www.fdi.gov.cn/1800000121_39_3343_0_7.html [<https://perma.cc/T252-VCN8>]; Albert Chen, AN INTRODUCTION TO THE LEGAL SYSTEM OF THE PEOPLE'S REPUBLIC OF CHINA 29-30 (2019, 5th ed); J Quigley, *Socialist Law and the Civil Law Tradition*, 37 AM. J. COMP. LAW 781, 782 (1989). It was only in 2017 that China promulgated the General Provisions of Civil Law as the first step towards the enactment of a comprehensive Civil Code: General Provisions of the Civil Law (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 15, 2017, effective Oct. 1, 2017), CLI.1.291593(EN), <http://www.npc.gov.cn/npc/c12435/201703/7944f166a8194d788c63cc6610aebb4a.shtml> (last visited Mar. 19, 2020), unofficial trans. <http://en.pkulaw.cn/Display.aspx?lib=law&Cgid=291593> [<https://perma.cc/5EF6-ESVC>].

4. Contract Law (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 15, 1999, effective Oct. 1, 1999) (China), http://www.fdi.gov.cn/1800000121_39_2741_0_7.html [<https://perma.cc/UJ7M-JZV3>].

5. Property Law (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007) (China), http://english.www.gov.cn/services/investment/2014/08/23/content_281474982978047.htm [<https://perma.cc/WMB2-VAY7>].

6. Company Law (Revised 2013) (promulgated by the Standing Comm. Nat'l People's Cong.,

system. As China interacted more with common law jurisdictions in trade, finance, and investment, the influence of those common law jurisdictions impacted Chinese law. The Chinese government's adoption of Trust Law is one example of this trend.

Soon after the enactment of the Trust Law, the Chinese enacted two main administrative regulations to govern the licensing and operation of trust companies and the collective-investor trusts ('CIT')—a form of business trust that can only be operated by trust companies.⁷ The business trust is championed as an instrument for funnelling private capital to desirable investment targets that are crucial to the rapidly growing economy.⁸ These legislative initiatives in trust law fuelled explosive growth in the trust industry. The total assets managed by trust companies skyrocketed from USD 39 million in 2003 to USD 3.27 trillion by March 2019, over 83,000 times its value in 2003.⁹ However, trust businesses in China bears little resemblance to those in Western countries. Private wealth management took up only 16% of the revenue of the Chinese trust industry. The balance is split equally between single-investor trusts ('SIT') and CITs, both of which are trusts in name only.¹⁰

SITs involve a single settlor and are typically used by commercial banks in collaboration with trust companies to provide unofficial lending in the shadow of the state credit system. CITs pool funds from investors but promise them fixed rates of return over a set period of time, irrespective of the value of the underlying assets. Many CIT products are sold by state-owned banks, giving customers the appearance that they are backed by a governmental guarantee. Therefore, CITs are trusts in name, but in substance they are fixed income products often used to sidestep regulatory constraints. This rendered the trillions of dollars invested in

Dec. 28, 2013, effective Mar. 1, 2014), http://www.fdi.gov.cn/1800000121_39_4814_0_7.html [<https://perma.cc/2Q3Z-C5HR>].

7. Measures for the Administration of Trust Companies (promulgated by the China Banking Reg. Comm'n ("CBRC"), Dec. 28, 2006, effective Mar. 1, 2007), http://www.gov.cn/flfg/2007-03/28/content_563583.htm (last visited Mar. 19, 2020), unofficial trans., <http://en.pkulaw.cn/display.aspx?cgid=83c9e8177e31ca76bdfb&lib=law> [<https://perma.cc/657N-P24X>]; Measures for the Administration of Trust Companies' Collective Trust Plans (promulgated by the CBRC, Dec. 17, 2008, effective Feb. 4, 2009) (repealing the 2007 Measures by the same name) [hereinafter "CIT Measures"], http://www.gov.cn/gongbao/content/2009/content_1456086.htm (last visited Mar. 19, 2020), unofficial trans., <http://en.pkulaw.cn/Display.aspx?lib=law&Cgid=122991> [<https://perma.cc/MTB5-VNXP>].

8. Eric Linge, *Trust as Institutions in China's Financial Markets*, 3 TSINGHUA CHINA L. REV. 283 (2011).

9. *Main Business Data of Trust Companies at the End of the First Quarter of 2019*, CHINA TR. ASS'N [hereinafter *Main Business Data*], <http://www.xtxh.net/xtxh/statistics/45321.htm> [<https://perma.cc/9L7Z-DR9L>].

10. Torstein Ehlers, Steven Kong, & Feng Zhu, *Mapping Shadow Banking in China: Structure and Dynamics* 16-17 (Bank for Int'l Settlements Working Paper No. 701, 2018), <https://www.bis.org/publ/work701.pdf> [<https://perma.cc/62G4-NH66>].

them extremely vulnerable to regulatory corrections.

Compounding the regulatory risks are the inadequacy of private law remedies for breach of trust and the failure to utilise the judicial process to enforce these remedies. The Trust Law was enacted in broad strokes that leave many conceptual issues about the rights and remedies of the beneficiaries unanswered.¹¹ For example, the degree to which China replicates the proprietary remedies that have made the trust such an attractive institution in the common law world is unclear. These uncertainties could have been resolved by the courts through the adjudication of trust disputes, but unfortunately the regulators have been too fast to intervene by administrative means.

In light of these challenges, this Article examines the unique phenomenon of the Chinese business trust. It argues that a major reason why proper business trusts have not yet taken root in China is her systemic failure to appreciate and adhere to the core principles of trust law. This systemic distortion is shared across private investors, trust companies, and regulators. Regulatory tightening is only partially effective in guiding the industry to legitimate trust business. The key to accomplishing this goal lies in implementing the core principles of trust law in judicial practice.

In what follows, Part 2 will outline the business trust as it was originally conceived by the law drafters. Part 3 will compare this vision with the reality of Chinese business trusts to show how the trust concept has been systematically distorted and abused. It will also examine the partial success of regulatory efforts to rein in such trusts. Part 4 will argue that only when the core features of the trust have taken root in Chinese private law would the trust industry be able to truly break away from its currently problematic business model. To this end, the Article will identify what these core problematic features are and then propose specific amendments to the Trust Law to resolve these problems.

II. BUSINESS TRUSTS: THE VISION

The Chinese Trust Law was introduced in 2001 to tighten up the supervision of trust and investment companies. These were non-bank financial institutions that the Chinese government revived at national and provincial levels after the adoption of the Open Door Policy. Their main purpose was to obtain extra-budgetary investments to fund infrastructure and development projects that burgeoned in China.¹² However, their

11. See generally LUSINA HO, TRUST LAW IN CHINA (2003); Lusina Ho, Rebecca Lee, & Jin JinPing, *Trust Law in China: A Critical Evaluation of its Conceptual Foundation*, in TRUST LAW IN ASIAN CIVIL LAW JURISDICTIONS: A COMPARATIVE ANALYSIS 80, 85-91 (Lusina Ho & Rebecca Lee eds., 2013).

12. See Vincent Pace, *Comment: The Bankruptcy of the Zhu Kuan Group: A Case Study of Cross-*

business model was limited, and was comprised primarily of so-called “trust deposits.” Trust deposits were fixed deposits, or “trust loans,” whereby these companies acted as agents between companies lending to each other. There was no ring-fencing of funds that was fundamental to a trust, nor was the investor’s investment returns, which were interests paid on the deposits, linked to the performance of the underlying assets. It was thought that the Trust Law could set forth the legal requirements of a trust, and help guide these companies to develop proper trust businesses.¹³

The drafters thus laid down a framework of “one law, two regulations”¹⁴ for trust activities, whereby the Trust Law introduces the essential features of the common law trust into China and the regulations provide a legal footing for the operation of trust business. Crucially, the Law affirms the axiom of the segregation of trust property from the personal property of the trustee, and the principle that the trust property includes all properties derived from the initial trust property, whether lawfully or not.¹⁵ None of these notions were previously embraced in China in relation to the trust.

The two core regulations aim at steering the trust industry towards proper trust business and giving them a core competitiveness against other financial institutions. They are: (1) the Measures for the Administration of Trust Companies (“Trust Companies Measures”),¹⁶ which govern the

Border Insolvency Litigation against a Chinese State-Owned Enterprise, 27 U. PA. J. INT’L ECON. L. 517, 520-21 (2006).

13. Lusina Ho, *Trust Law in China: History, Ambiguity and Beneficiary’s Rights*, in RE-IMAGINING THE TRUST: *TRUSTS IN CIVIL LAW* 183, 188-89 (Lionel Smith ed., 2012).

14. This was reinforced in 2010 by the Measures for the Administration of Net Capital of Trust Companies (promulgated by the China Banking Regulatory Commission, July 12, 2010, effective Aug. 24, 2010), http://www.gov.cn/flfg/2010-09/10/content_1699764.htm [<https://perma.cc/8CLD-DPMK>], unofficial trans., <http://en.pkulaw.cn/display.aspx?id=8343&lib=law> [<https://perma.cc/WQD5-VBJV>]. The Measures mandate internal risk control mechanisms in trust companies and a minimum ratio of 40 per cent net capital to net assets.

15. Chinese Trust Law, *supra* note 1, arts. 14 & 15.

16. *See supra* note 7 and accompanying text. There are other laws, regulations and guidelines that pertain to the trust, such as Securities Investment Fund Law (promulgated by the Standing Comm. Nat’l People’s Cong., Oct. 28, 2003, rev’d Dec. 28, 2012, effective Apr. 24, 2015), http://www.npc.gov.cn/wxzl/gongbao/2015-07/03/content_1942864.htm [<https://perma.cc/S7U6-ZZAF>], unofficial trans., <http://en.pkulaw.cn/display.aspx?cgid=cd8acac44fc18cabdbfb&lib=law> [<https://perma.cc/M33G-YQ6T>]; Measures for the Administration of Financial Asset Investment Companies (for Trial Implementation) (promulgated by the China Banking and Ins. Reg. Comm’n (“CBIRC”), June 29, 2018, effective, June 29, 2018), <http://www.cbrc.gov.cn/chinese/newShouDoc/2F17C2C95E724066818561C7D2F622D8.html> (last visited Mar. 19, 2020), unofficial trans., <http://en.pkulaw.cn/display.aspx?cgid=8f3f09dee23fc64bdfb&lib=law> [<https://perma.cc/337W-E33A>]; Measures for the Administration of Wealth Management Subsidiary Companies of Commercial Banks (promulgated by the China Banking and Ins. Reg. Comm’n, Dec. 2, 2018, effective Dec. 2, 2018), <http://www.cbrc.gov.cn/chinese/newShouDoc/C441E44624394A76B25051CA7F4AFE5C.html> (last visited Mar. 19, 2020), unofficial trans.,

licensing and operation of trust companies and place them under the supervision of the former China Banking Regulatory Commission (“CBRC”); and (2) the Measures for the Administration of Trust Companies’ Collective Trust Plans (“CIT Measures”), which set out the rules for operating CITs and give trust companies an exclusive licence to operate them.¹⁷ They were regulated by the CBRC, which was merged in April 2018 with the China Insurance Regulatory Commission to form the China Banking and Insurance Regulatory Commission (“CBIRC”).¹⁸

This regulatory framework puts in place three important measures to carve out a special role for business trusts. First, CITs may invest across an unrestricted range of markets in debt, equity, property and any other means,¹⁹ a privilege not enjoyed by other financial instruments such as securities investment funds or real estate investment trusts. Second, trust companies have an exclusive licence to operate CITs. In granting trust companies the privilege to operate the only cross-market investment product in the financial market, the regulators have given them a core competitiveness over other financial institutions. Third, to counteract the higher investment risks that stem from this unique flexibility, CITs are subject to strict conditions on the number of individual investors and the threshold investment amount of each investor. For example, the minimum investment by any investor in a CIT is CNY 1 million (about USD 150,000). Individual investors in a CIT must pass an asset- or income-based test.²⁰ In any trust plan, there can only be at most 50 individual investors that invest less than CNY 3 million each. These restrictions aim at confining CITs to high net-worth individuals and institutional investors, who have a higher risk tolerance and are more

<http://en.pkulaw.cn/display.aspx?cgid=17f5d34771cda0f4bdfb&lib=law> [https://perma.cc/MP5Z-Z9VV]; Measures for the Supervision and Administration of the Wealth Management Business of Commercial Banks (promulgated by the China Banking and Ins. Reg. Comm’n, Sept. 26, 2018, effective Sept. 26, 2018), http://www.gov.cn/gongbao/content/2018/content_5350052.htm (last visited Mar. 19, 2020), unofficial trans., <http://en.pkulaw.cn/display.aspx?cgid=4a42780a616a0fe3bdfb&lib=law> [https://perma.cc/EK43-RYY8]; and Guidelines on Due Diligence of Trust Companies in Fiduciary Duties (promulgated by the China Trustee Ass’n, Sept. 1, 2018, effective Dec. 31, 2018, <http://www.txh.net/txh/u/cms/www/201809/19095441wnkx.pdf> (last visited Mar. 19, 2020), unofficial trans., <http://en.pkulaw.cn/display.aspx?cgid=aba940dce2d97fa1bdfb&lib=law> [https://perma.cc/UL8A-FASV].

17. See *supra* note 7 and accompanying text.

18. *Zhongguo Yinhang Baoxian Jiandu Guanli Weiyuanhui Zhengshi Guapai* [The China Banking and Insurance Regulatory Commission Officially Begins Operation], CHINA BANKING REGULATORY COMM’N (Apr. 9, 2018), <http://www.cbrc.gov.cn/chinese/newShouDoc/EB7840D7EA7344CEBFAD044E5CDE33DA.html> (last visited Mar. 19, 2020).

19. CIT Measures, *supra* note 7, art. 26.

20. Individual investors must either have at least CNY 1 million assets by themselves or with family members, or an annual income of over CNY 200,000 by themselves or CNY 300,000 with their spouses in the three years prior to the investment.

sophisticated investors.²¹ While CITs are privately placed investment trusts that pool funds from two or more investors, SITs serve single, large-scale investors who are typically financial institutions.

The light regulation of CITs and trust companies are designed to encourage the development of innovative and tailor-made investment structures for sophisticated investors. In the years following the enactment of the regulations, the CBRC through continuous notices provided guidance to trust companies on the operational models of innovative investment trusts.²² It sought to assign trust companies the *de facto* role of domestic private investment banks, which have yet to appear in China. This is due, in one part, to the heavy regulatory constraints placed on state commercial banks to provide such financial services, and, in another part, to the underdevelopment of debt equity markets in China. High hopes are thus placed on trust companies to channel capital to those segments of the economy that are cut off by this market vacuum, and the business trust is a key instrument in this design.

III. THE REALITY: SYSTEMIC DISTORTION OF THE TRUST

The CIT has proven to be extremely popular. The percentage share of industry assets held under such trusts rose from 13% in 2010 to 42% in the first quarter of 2019, at a value of CNY 9.5 trillion (USD 1.3 trillion).²³ But a closer examination reveals a reality that is in sharp contrast to their intended function. Trust companies manage CITs no differently as banks would with fixed deposit instruments, pocketing profits they made from the underlying investment after paying the promised rate of return to

21. The CBRC has indicated its intention to issue the Measures for the Management of Capital Trusts before the end of 2019. *Yinjianbaohui: Zhengqu Niandiqian Tuichu Jijin Xintuo Guanli Banfa* [China Banking and Insurance Commission: Seeking to Promulgate the Measures for the Management of Capital Trusts Before the End of the Year], SEC. DAILY (China) (Mar. 1, 2019), http://epaper.zqrb.cn/html/2019-03/01/content_413640.htm?div=-1 [https://perma.cc/W64R-SNNB]. The Measures will provide for public placement capital trusts with a significantly lower threshold requirement of CNY 10,000 (about USD 1,500), which will be subject to the same, more stringent regulatory requirements of other investment products such as securities investment funds.

22. Notice on Issuing the Guidelines for Trust Companies to Operate the Trust Private Equity Investment Business (promulgated by the CBRC, June 25, 2008, effective June 25, 2008) <http://fgcx.bjcourt.gov.cn:4601/law?fn=chl474s509.txt> (last visited Mar. 19, 2020), unofficial trans. <http://en.pkulaw.cn/display.aspx?cgid=21222b478d90acc1bdfb&lib=law&EncodingName=big5> [https://perma.cc/3ZPT-EPV9]; Notice on the Relevant Issues Concerning Supporting the Innovation and Development of Trust Companies (promulgated by the CBRC, Mar. 25, 2009, effective Mar. 25, 2009), CLI.4.142650(EN) (Lawinfochina), unofficial trans. <http://www.lawinfochina.com/display.aspx?lib=law&id=8682&CGid=> [https://perma.cc/BY7S-Q7HL], article 10 of the 2009 Notice was revoked by paragraph 3 of the Notice on Strengthening the Supervision of the Structured Trust Business of Trust Companies (promulgated by the CBRC, Feb. 5, 2010, effective Feb. 10, 2010), unofficial trans. <http://en.pkulaw.cn/display.aspx?cgid=2e35ce36e7d8efdfbdfb&lib=law> [https://perma.cc/X6Y3-JMEF].

23. See *Main Business Data*, *supra* note 9.

investors. Investors also treat trust products as high-yield bonds, and expect trust companies or local authorities to bail out these trusts should they default. The regulators, all too eager to avert any social instability that may stem from trust defaults, intervene to tackle transgressions by administrative intervention, thus suppressing the development of private law remedies for breaches of trust. A closer look at each of these problematic aspects is now in order.

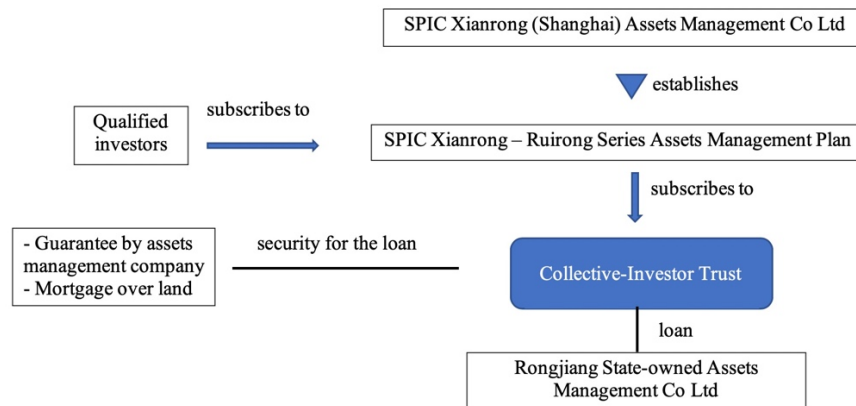
A. Fixed Income Products

In actual practice, CITs are fixed income products and a far cry from their ideal form as private placement trusts meant to be tailor-made for sophisticated investors. A significant proportion of them are initiated by state-owned enterprises (“SOEs”) and local government financing vehicles as a financing platform. Trust companies, mostly controlled by local governments, do not actively manage a diversified portfolio of fluctuating assets under the trusts. Rather, fund investments take the form of extending loans to the initiators in return for interest and serve the purpose of financing the latter’s business projects or real estate and infrastructure projects. The trust plans are for a set period of time, usually one to two years, at a fixed return rate of some eight to nine percent, which is much higher than the capped interest rates of bank deposits that do not apply to trusts.

The structure of a typical CIT can be illustrated by a trust plan initiated by SPIC Xianrong (Shanghai) Assets Management Co Ltd, an ultimate subsidiary of one of the top five electricity generation companies in China.²⁴ In this plan, SPIC Xianrong issued a wealth management product to provide financing for Rongjiang State-owned Assets Management Co Ltd, the investment arm of the Rongjiang county in Guizhou. Qualified investors subscribed to the wealth management product at a minimum threshold of CNY 1 million. The pooled funds were then used to subscribe to a CIT, which loaned the funds to Rongjiang Assets Management to finance the county’s government projects to relocate the poor for urbanization. The subscription was for a fixed period of 2 years at 7.5% interest rate (or 7.9% for investors of a higher amount), with interest payable bi-annually. The loans to the county’s asset management company were secured, *inter alia*, by six plots of lands owned by the county government in prime location in the city center. The offering of government land as security was designed to instill investor

24. Diagram adapted from 2019 *Chengtou Weiyuechao Laishi Xiongxiang* [The Tidal Wave of Defaults by City Investment Corporations], SINA FIN. (Jan. 19, 2019) (China), <https://finance.sina.cn/china/gncj/2019-01-19/detail-ihrfqziz9000688.d.html?vt=4&pos=17> [<https://perma.cc/2HP6-XUWS>].

confidence. The plan can be seen in the following diagram.



In this arrangement, even though the borrower of the loan was an asset management company, it was obvious that the main driver and architect of the CIT was the government of the Rongjiang County. The trust company's role as trustee was purely passive. In this regard, it is very telling that the sales information of the trust specifically mentioned, as a point of attraction, the availability of "support of government documents." Since local governments are under strict prohibition from running deficits to fund government projects, CITs allow them to obtain non-standard financing for these purposes. In reality, they are high yield government bonds that conceal the true extent of the fiscal deficit and run a high risk of default because of the lack of a diversified investment portfolio.²⁵

B. Illusory Investor Protection

Apart from not operating CITs as genuine investment trusts, trust companies also pay lip service to investor protection measures that are applicable to such trusts. Article 6 of the CIT Measures imposes a threshold investment amount of CNY 1 million from individual investors and requires them to satisfy an asset- or income-based test. Articles 7 and 8 stipulate prudence measures such as mandatory risk disclosure, disclosure of the professional qualification of trust company personnel, and prohibition on misleading statements. Yet, Article 8(3) also allows trust companies to delegate the distribution of trust plans to other financial institutions, but unfortunately does not stipulate any duty of supervision on the part of the trust companies or liability for the distributor's

25. *Id.*

wrongdoing.

As trust companies do not yet have any established client base of their own, they typically delegate the distribution of trust plans to commercial banks owned by local governments. In fact, a majority of the plans are sold by third-party intermediaries that are not financial institutions. This is problematic for several reasons. First, these institutions are loosely regulated and ill-equipped to distribute high-risk investment products to their client base of small investors. Second, since Articles 7 and 8 only apply to trust companies, these provisions are easily bypassed once distribution is delegated to another institution. Third, trust companies also delegate the screening of qualified investors to intermediaries without monitoring compliance with the regulation. Worse still, to boost their business volume, it is not uncommon for the intermediaries to split the minimum subscription of CNY 1 million into smaller units, thus defeating the original design of confining CITs to sophisticated investors who are better placed to absorb investment losses than small investors.²⁶ Fourth, since the intermediaries charge fees, it is not in their interest to make full disclosure of the risk rating of the products; in fact, they often encourage investors' assumption that the local governments will bail out the plans at default. There is thus very little investor awareness of the risky nature of the trust plans, let alone the fact that the high interest rates are precisely because the underlying borrowers cannot obtain credit from state banks.

Regulatory response is slow and piecemeal. It was not until 2014 that the matter was addressed in the sub-provisions of the Notice on Improving the Organizational Management System of Banks' Wealth Management Business²⁷ and the Guiding Opinions on the Risk Supervision of Trust Companies of 2014.²⁸ Article 4 of the Notice prescribes prudential measures on the sale of wealth management products by banks, including making clear statements in sales brochures that "wealth management products are not deposits, and are subject to investment risks." Article 2 of the Guiding Opinions affirms the need for strict adherence with the CIT Measures, namely the requirements on private placement, qualified

26. *Hsu Mou yu Wang Mou Hezuo Hetong Jiu fen An* (许某与王某合作合同纠纷案)[*A Case Concerning the Dispute over the Cooperation Contract between Hsu and Wang*], Beijing Yizhong Min Zhong Civil Case No. 7332, (July 12, 2012) (China).

27. Notice on Issues Concerning Improving the Organizational Management System of Banks' Wealth Management Business (promulgated by the CBRC, July 10, 2014, effective July 10, 2014), art. 4, para. 1, http://www.gov.cn/gongbao/content/2014/content_2781483.htm (last visited Mar. 19, 2020), unofficial trans., <http://en.pkulaw.cn/display.aspx?cgid=229217&lib=law> [<https://perma.cc/T9SU-9XEU>].

28. Guiding Opinions on Regulation of Risk Supervision of Trust Companies (promulgated by the CBRC, Apr. 8, 2014, effective Apr. 8, 2014), art. 2, para. 2, unofficial trans., <http://www.lawinfochina.com/display.aspx?id=22196&lib=law> [<https://perma.cc/4VGB-L99W>].

investors, as well as risk and information disclosure, so as to prevent intermediaries from transferring sales risks to trust companies. But just as the original CIT Measures were largely ignored, there is little evidence that the subsequent instruments have been heeded.

A further attempt to improve investor protection was made in the Administrative Measures for Trust Registration of 2017,²⁹ which sought to launch the long-awaited system for trust registration mentioned in Article 10 of the Trust Law of 2001. The Measures provide for registration of trust products and the beneficial rights held under them. This involves pre-registration of a trust product five working days prior to its issuance, and initial registration within ten working days of establishment.³⁰ Apart from basic information about the trust product, the trust company must also disclose the source of trust property, trust property management plan, transaction structure, risk warning statements, risk-control measures, and information on off-site promotion.³¹ It is noteworthy that beneficiaries are allowed to open a trust beneficial right account to record their beneficial rights and changes to these rights with the trust registration corporation.³² Beneficial right registration is by the real name of the beneficiary, such that the rights, if any, of sub-owners of investment units in CITs will not be registered. To track changes to beneficial rights, the Measures mandate further registration of trust variation and termination, as well as correction of inaccurate information in the registry.³³

Most recently, in September 2018, the China Trustee Association issued Guidelines on the Due Performance of Trustee Duties by Trust Companies, which provide that in marketing trust products, trust companies shall conduct knowing-your-client procedures to match clients' risk assumption capabilities with their investments, and prepare marketing information themselves for distribution by sale intermediaries.³⁴

These guidelines affirm the regulator's commitment to steering trust business to its originally intended scope, but still fall short of providing concrete directions to achieve this goal. For example, the Measures for Trust Registration does not guarantee compliance of trust products with the regulations, nor the continuous validity of registered information

29. Notice on Printing and Distributing Administrative Measures for Trust Registration (promulgated by the CBRC, Aug. 25, 2017, effective Sept. 9, 2017) http://www.gov.cn/gongbao/content/2018/content_5254334.htm [<https://perma.cc/5TJY-PHFV>].

30. *Id.* at arts. 10-11.

31. *Id.* at art. 10(1).

32. *Id.* at arts. 22-29.

33. *Id.* at arts. 12-15.

34. Guidelines on Due Performance of Trustee Duties by Trust Companies, *supra* note 16, arts. 13 & 17.

about the investment value and risks of trust products.³⁵ Besides, registration of beneficial ownership is voluntary.³⁶ Moreover, the Measures provide for registration of trust products but not trust property itself, and leave open the question as to whether the former is deemed to include registration of trust property. In a civil law jurisdiction such as China, registration of trust property is crucial to the enforceability of the beneficiary's right against third parties. Before these questions are resolved, the utility of the Measures lies only in providing a public repository of information on trust products. They have achieved very little in enhancing the protection of investors' beneficiary rights.

Second, it is ironic that when detailed provisions on investor protection were finally issued, they were promulgated in much weaker form as industry guidelines issued by the China Trustee Association. In any event, the tightening of investor protection rules will only achieve partial success in developing proper trust practice in China. In so far as CITs continue to provide fixed return rates not based on the periodic performance of the underlying asset, investors will treat them no differently from high-yield bonds. In fact, a more serious problem is that Chinese investors assume that there will be implicit guarantees of such returns.

C. Implicit Guarantee

1. The emergence and prevalence of implicit guarantee

A fundamental principle of trust law is that profits and losses arising from the use of trust property are attributable to the beneficiary. Specifically, in the absence of any breach of duty by the trustee, investment losses are borne by the beneficiary. This principle stems from the notion of trust property as a segregated and fluctuating fund held by the trustee on behalf of the beneficiary. Yet the Trust Law does not expressly provide for this principle, and stops short at merely stipulating the segregation of the trust fund.³⁷ Furthermore, Article 34 of the Trust Companies Measures and Article 8(1) of the CIT Measures only focus on prohibiting trust companies from guaranteeing any minimum return or promising the absence of investment loss. The principle is indirectly dealt with in the provisions of the CIT Measures pertaining to disclosure of risks to investors. Articles 11(3) and 14 of the CIT Measures respectively provide that statements of subscription risks and trust contracts should

35. Administrative Measures for Trust Registration, *supra* note 29, art. 19.

36. *Id.* at art. 22.

37. *Id.* at art. 16.

declare that risks arising from authorised trust activities shall be borne by the trust property.

In reality, however, CIT contracts stipulate fixed rates of return irrespective of the performance of the underlying asset. Furthermore, investors expect eventual government rescue of the trust plan by way of so called ‘rigid payment’ (*gangxing duifu*). This phrase was coined to mean that when a plan defaults on maturity, the trust company or even the local government—who is technically not the borrower—will make partial or full payment from their own assets or other sources of funding. While trust companies avoid making any express guarantee of repayment or minimum return in the trust contract, the structure of CIT transactions and past precedents of bailouts strongly suggest otherwise.

As to the structure of CIT transactions, the trust company and even the borrower in a typical CIT are controlled by or related to the SOE or local government that ultimately benefits from the loan. For example, in a government-initiated CIT, the borrower is the financing vehicle of the local government. The underlying loan is guaranteed by its associated company or secured by government land, and the purpose of the loan is to fund its real estate or infrastructure projects. Furthermore, the trust plan may be sold by a state-owned commercial bank controlled by the same government. All these features give the appearance that the trust is backed by the local government, who provides an implicit guarantee, even though they have no legal obligation to do so.

The prevalent practice of bailouts has also contributed to investors’ assumption of an implicit guarantee.³⁸ Ironically, the first few instances of out-of-court compensation were ordered by the regulators. Around 2005, a number of high-profile trusts defaulted on maturity. The regulators intervened and ordered a repayment arrangement based on expediency rather than principles of trust law. This was, essentially, an executive-ordered settlement. For example, in the widely publicized case of the Jinxin Trust,³⁹ the trust plan collected over CNY 80 million from

38. For media and academic discussion of implicit guarantee, see David Keohane & Josh Noble, *For the “2010 China Credit / Credit Equals Gold #1 Collective Trust Product” Bugs Out There*, FIN. TIMES (London) (Jan. 17, 2014), <https://ftalphaville.ft.com/2014/01/17/1744832/for-the-2010-china-credit-credit-equals-gold-1-collective-trust-product-bugs-out-there/> [<https://perma.cc/QB52-69BW>]; Deng Gang, *Gangxing Duifu de Falv Zhili [Legal Control of Implicit Guarantee]* 97(2) JINRONG FAYUAN [FINANCIAL LAW FORUM] 205, 211 (2018), https://www.finlaw.pku.edu.cn/jrfy/gk/2018_jrfy/jrfnzd97j/270913.htm, [<https://perma.cc/76QH-RJ2M>].

39. See *Jinxin Yupin Xintuo Yinbao Xintuo Duifu Weiji [The Incident of Jinxin Trust Set Off Trust Default Risks]*, SINA FIN. (China) (July 12, 2004), <http://news.sina.com.cn/c/2004-07-12/10373679952.shtml> [<https://perma.cc/V4J5-UNS2>]. This involves a CIT that had collected over CNY 80 million from investors for the purported merger and acquisition of two dairy companies, in return for a fixed return of 5% at the end of the trust period upon the exercise of a repurchase option of the shares of the target companies. Six months after the issuance of the trust, the companies went into financial difficulties, and it transpired that the trust had not acquired any share ownership in these companies.

investors for the purported merger and acquisition of two dairy companies. In return, investors received a fixed return of five percent at the end of the trust period upon the exercise of a repurchase option of the shares of the target companies. Six months after the issuance of the trust, when the dairy companies encountered financial difficulties, the trust funds were unlawfully transferred to the dairy companies without any allocation of shares in favor of the trust. The trust company was ordered to repay small investors CNY 100,000 or less the full amount of their principal, and to repay those who invested more than CNY 100,000 90% of their principal. Senior employees of the trust company were convicted of the crime of illegal absorption of public savings. Over time, with repeated instances of bailouts, these aberrations have become the norm.⁴⁰ Trust companies even formalize this practice by so-called “drawer agreements,” in which they enter into shadow contracts—outside of the trust contract—to pay liquidated damages very much at the level of a guarantee of return.⁴¹

2. Causes and Implications

Several factors contributed to this peculiar phenomenon.⁴² First, ignorance of trust law and the economic reality of such trusts as fixed-term loans to government-related entities encouraged investors’ assumption that the authorities would eventually come to their rescue. The investors of the Jinxin Trust, for example, organized demonstrations in front of the branch office of Shanghai Communications Bank, through which they bought the trust product, to put pressure on the government to provide a bailout.

Second, concerns about political stability motivated regulators and local governments to exert political pressure on trust companies to do so. In a 2004 circular to trust companies, the CBRC stated that defaults of

40. A few examples of high profile bailouts are: Zhengzhi Jinkai No. 1 Trust Plan of Zhongcheng Xintuo Co Ltd in 2014 (CNY 3 billion plan with promised return at 9.5%-11% to acquire shares of coal mining enterprises; on default, investors were given the option to have the principal restored without interest, or obtain shares in the underlying enterprise); Jixin-Songhuajiang No. 77 Trust Plan of Jilin Trust Co Ltd in 2014 (CNY 970 million invested in coal mining); Xinhua Xintuo-Shanghai Lvren Trust Plan of Xinhua Trust Co Ltd in 2014 (CNY 850 million at 9.8%-12% return rate, invested in real estate corporation), discussed in *Zhongguo Xintuo Ye Xianru Duifu Weiji* [Chinese Trust Industry in Default Crisis], JRJ.COM, <http://trust.jrj.com.cn/focus/trustcri/> [<https://perma.cc/JQ4X-2QT3>].

41. See, e.g., *Wangmou Su Shanghai Mou Zichan Guanli Youxian Gongsu Weituo Licai Hetong Jiufen An* (王某诉上海某资产管理有限公司委托理财合同纠纷案) [A Case Concerning Entrusted Wealth Management Contract between Wang and A Shanghai Asset Management Ltd Co] (2012) Shanghai Minhang Min Si (Shang) Chu Civil Case No. 4, Mar. 15, 2012 (China).

42. See Li Jiang Jun & Fan Wen Xiang, *Jinrong Licai Chanpin Gangxing Duifu Kunju de Chengyin Jiqi Huajie* [Problems and Resolutions of the Rigid Payment Dilemma of Wealth Management Products] 11 XIANDAI JINGJI TANTAO [MODERN ECON. RESEARCH] 44-48 (2014).

CITs must be reported to their local branch, which would immediately suspend the trust company from issuing new collective trusts.⁴³ To avert such a drastic sanction and the disruption of business, trust companies were left with no feasible alternative but to bail out such plans.

Third, trust companies were also eager to protect their commercial reputation and maintain the client base that they had expended tremendous efforts to build. As investor expectation of compensatory payment built up, they bailed plans out even in the absence of orders from the CBRC.

Fourth, and ironically, trust companies often fund the bailouts by infringing beneficiaries' rights. For example, the lack of enforcement and proper trust accounting standards allow them to retain any balance of profits that may remain after meeting the fixed rate of return promised to the investors. Yet this amounts to a clear breach of the no-profit rule that is set out in the Trust Law and the CIT Measures.⁴⁴ Trust companies also, through rolling the issuance of funds and aggregating fund management, mix the funds of trusts with different maturity periods into a commingled pool without separate accounting, and pay bailouts from pooled assets.⁴⁵ This, in effect, misappropriates funds from other trust plans and diverts them to unprofitable plans. Alternatively, the trust companies roll over investors' rights from unprofitable plans to new one, and in doing so blur the line between CITs and Ponzi schemes.⁴⁶

The implications of implicit guarantee for the financial market are far-reaching.⁴⁷ The perception of guaranteed profitability disincentivizes

43. Notice on Further Regulating Collective Trust Schemes (promulgated by the CBRC, Dec. 7, 2004, effective Dec. 7, 2004), art. 18, http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/1077.html (last visited Mar. 19, 2020).

44. Article 26 of the Chinese Trust Law provides that except obtaining remuneration according to the provisions of this Law, the trustee may not seek interests for himself by using the trust property; Article 26 of the CIT Measures also provides that: application of the trust funds by the trust company shall be consistent with the investment direction and strategies agreed upon in the documents of the Trust Scheme.

45. Zhongguo Renmin Yinhang Jinrong Wending Fenxi Xiaozhu [FIN. STABILITY ANALYSIS GROUP, PEOPLE'S BANK OF CHINA], CHINA FINANCIAL STABILITY REPORT 120 (2017), <https://www.gov.cn/xinwen/2017-07/06/5208092/files/572fec1a7b41440295c62fe548ad56fd.pdf> [<https://perma.cc/K48F-FHLU>].

46. Zhang Minjie, *Woguo Jihe Zijin Xintuo Jihua Touzizhe Quanyi Baohu zhi Guankui* [Protection of Investors in Chinese Collective Capital Trust Schemes] 27(5) YANJIUSHENG FAXUE [GRADUATE LAW REVIEW] 78, 79 (2018), <http://new.big5.oversea.cnki.net/KCMS/detail/detail.aspx?dbcode=CJFQ&dbname=CJFD2012&filename=CUPL201205008&v=MjYzMTkxRnJDVV13cWZaT2RtRnl6a1VyeKpKampiWXJHNEg5UE1xbzIGYkISOGVYMUx1eFITN0RoMVQzcVRyV00=> [<https://perma.cc/NZN4-LYXG>].

47. Dan Awrey, *Law and Finance in the Chinese Shadow Banking System*, 48(1) CORNELL INT'L L.J. 1, 42-43 (2015); see also Guo Wei, *Jinrong Jigou Baodi Licai de Hefaxing Miju uu Kunjing* [The Legality and Dilemma of Implicit Guarantee by Financial Institutions] 43(5) BEIJING DAXUE XUEBAO [JOURNAL OF PEKING UNIVERSITY] 111 (2006), <http://new.big5.oversea.cnki.net/KCMS/detail/detail.aspx?dbcode=CJFQ&dbname=CJFD2006&filename=BDZK200605015&v=MTk5NzJGeXprVUx6S6p5blJaYkc0SHRmTXFvOUVZWV14ZVgxTHV4W>

investors from rigorous risk assessment and encourages underlying borrowers to compete purely by offering higher, often unrealistic interest rates. Trust companies also have little incentive to scrutinize aggressive borrowers, as a higher interest rate gives them a wider margin for personal profits. As a result, the practice shields low-grade debts and disrupts the flow of capital to truly competitive economic activities. It also transfers the risks of unprofitable investments to financial institutions and creates a time bomb that ticks in the shadow of the financial market.⁴⁸

3. Regulatory control

In 2014, CBRC issued the Notice on Issues Concerning Improving the Organizational Management System of Banks' Wealth Management Business to urge banks not to undertake guaranteed payment, which had limited effect on prevalent practice.⁴⁹ Regulatory intervention finally came in April 2018, when the central bank and three regulatory bodies jointly issued the Guiding Opinions on Regulating the Asset Management Business of Financial Institutions ("Asset Management Opinions").⁵⁰ The Opinions adopt two strategies. First, they provide a non-exhaustive list of situations that are deemed to provide implicit guarantee and are hence prohibited under Article 2(2). These include: (1) direct guarantees of the principal or returns for a product; (2) transfers of the rights of different investor groups by means such as a rollover in order to provide such guarantee; and (3) direct payments by the issuer or manager of an investment product on default, whether through raising funds on its own or commissioning another institution to do so.⁵¹ This inclusive definition closes the loophole left by the Trust Companies Measures and Trust Plans Measures, which only proscribes the express undertaking of guaranteed returns in trust contracts.

Second, a series of prudential measures aimed at preventing out-of-

VM3RGgxVDNxVHJXTTFGckNVUjdxZlpPZG0= [https://perma.cc/W4Y7-G6CN].

48. See Ning Zhu, CHINA'S GUARANTEED BUBBLE: HOW IMPLICIT GOVERNMENT SUPPORT HAS PROPELLED CHINA'S ECONOMY WHILE CREATING SYSTEMIC RISK, Ch. 11 (McGraw-Hill Education, 2016).

49. See *supra* note 27. For a thorough critique, see Pu Zhengxing, *Ziguan Xingui de Yaodian Fenxi yu Yingxiang Qianzhan* [Analysis of the Key Points and Effects of the New Asset Management Rules] 502 NANFANG JINRONG [SOUTH CHINA FINANCE] 66 (2018), <http://new.big5.oversea.cnki.net/KCMS/detail/detail.aspx?dbcode=CJFQ&dbname=CJFDLAST2018&fileaname=GDJR201806010&v=MjI4MjIxTHV4WVM3RGgxVDNxVHJXTTFGckNVUjdxZlpPZG1GeXprVnIvQklpbkjmTEc0SDluTXFZOUVaSVI4ZVg=> [https://perma.cc/DZ7R-KLTL].

50. Guiding Opinions on Regulating the Asset Management Business of Financial Institutions (promulgated by the People's Bank of China, China Sec. Reg. Comm'n, & the State Admin. of Foreign Exchange, Apr. 27, 2018, effective Apr. 27, 2018) [hereafter Asset Management Opinions], unofficial trans., <http://en.pkulaw.cn/display.aspx?cgid=ff2037951095d290bdfb&lib=law> [https://perma.cc/J9XF-8DAD].

51. *Id.* at art. 19.

court payments are reiterated. For example, the assets of a trust product must be held by a custodian separately from the trustee.⁵² There must be separate accounting and segregation of funds, and the pooling of cash for rolling issuance and aggregate operation is prohibited.⁵³ To reduce leverage levels, investors' risk tolerance level and the risk rating of the invested assets must be matched.⁵⁴ Additionally, financial institutions are required to create a risk reserve from ten percent of the management fees to meet legal liability arising from its own breaches of duties.⁵⁵ Importantly, Article 18 of the Opinions mandates the management of trust assets on the basis of their net value, so that the value of the trust product directly reflects the value of its underlying assets. To facilitate the calculation of the net value of trust assets, the article requires proper accounting and auditing of accounts in accordance with national standards, and submission of audit reports to the regulatory authority. While this is standard practice in Western markets, and should have been adopted along with the reception of the trust in 2001, it has yet to take root in China.

The Asset Management Opinions were supplemented by a series of Measures and Notices.⁵⁶ The impact of these drastic measures is palpable. Since mid-2018, there have been media reports of defaults of over 100 trust plans, some of which even involve trust products backed by the provincial governments of Tianjin and Guizhou.⁵⁷ Even though this latest

52. *Id.* at art. 14.

53. *Id.* at art. 15.

54. *Id.* at art. 16.

55. *Id.* at art. 17.

56. Notice on Commencing the Work on "Consolidating Achievements in Irregularity Rectification and Promoting Compliance Building" (promulgated by the China Banking and Insur. Regulatory Comm'n, May 8, 2019, effective May 8, 2019), art. 11, sec. IV, Annex 1, http://www.gov.cn/xinwen/2019-05/17/content_5392623.htm (last visited March 19, 2020), unofficial trans., <http://en.pkulaw.cn/display.aspx?cgid=660b9d9a1b0a235abdfb&lib=law>. See also, in relation to other financial institutions, Measures for the Supervision and Administration of the Wealth Management Business of Commercial Banks, *supra* note 15; Measures for the Administration of Wealth Management Subsidiary Companies of Commercial Banks, *supra* note 15, arts. 31 & 55; Provisions on the Administration of Operation of Privately Offered Asset Management Plans of Securities and Futures Business Institutions (promulgated by the China Sec. Regulatory Comm'n, Oct. 22, 2018, effective Oct. 22, 2018), art. 31, <http://www.csrc.gov.cn/pub/zjhpublic/zjh/201810/P020181022809298932631.pdf> (last visited Mar. 19, 2020), unofficial trans., <http://www.lawinfochina.com/display.aspx?id=29332&lib=law> [<https://perma.cc/F58A-624W>]; Measures for the Administration of the Privately Offered Asset Management Business of Securities and Futures Business Institutions (promulgated by the China Sec. Regulatory Comm'n, Oct. 22, 2018, effective Oct. 22, 2018), art. 4, <http://www.csrc.gov.cn/pub/zjhpublic/zjh/201810/P020181022804792210933.pdf> (last visited Mar. 19, 2020), unofficial trans., <http://www.lawinfochina.com/display.aspx?id=3d62931e3f373daabdfb&lib=law> [<https://perma.cc/68CZ-3QD8>].

57. Don Weinland and Sherry Fei Ju, *Public Default at Chinese Trust Company Highlights Cracks in Market*, FIN. TIMES (London) (June 25, 2019), <https://www.ft.com/content/11a89df6-9720-11e9-8cfb-30c211dcd229> (last visited Mar. 19, 2020); Liang Hong & Denise Jia, *Anxin Trust Delays \$405 Million Payment to 1,000 Investors*, CAIXIN GLOBAL (China) (May 22, 2019),

round of regulatory crackdown appears effective, regulation cannot, and should not, replace the long overdue development of private law remedies which have thus far been side-lined.⁵⁸ This is because the regulatory approach is liable to the influences of political and commercial considerations, as is borne out in the development of shadow banking in China.

D. Shadow Banking

1. The abuse of the trust

Contrary to CITs, SITs are established by single investors. They are typically used in a similar way as special purpose vehicles found in Western jurisdictions. Because of China's unique regulatory environment, only the trust license can invest in different financial markets. This allows trust companies to leverage on the regulatory privilege to provide "channelling service" for other institutions that are restricted from making such investments. Ironically, the channelling business that the Chinese government now seeks to curb grew out of China's CNY 4 trillion (USD 56.7 billion) stimulus package in 2009 to counteract the global financial crisis. Through a number of notices, CBRC allowed banks to issue wealth management products that pooled funds from customers for investment in trusts managed by trust companies.⁵⁹ It did urge trust companies to actively manage the

<https://www.caixinglobal.com/2019-05-22/anxin-trust-delays-405-million-payment-to-1000-investors-101418350.html> [https://perma.cc/7UDH-LWRA]; Xie Yu, *Tianjin Government-backed Property Firm May Default as China's Deleveraging Campaign Reaches State-owned Sector*, SOUTH CHINA MORNING POST (May 14, 2018) (Hong Kong), <https://www.scmp.com/business/companies/article/2146070/tianjin-government-backed-property-firm-may-default-chinas> (last visited Mar. 19, 2020).

58. Liu Yan, *Daziguan Shangweifa Zhi Jiuwen [Study on the Asset Management Opinions as Higher-Level Law]* 4 QINGHUA JINRONG PINGLUN [QINGHUA FINANCIAL REVIEW] 25 (2018), <http://new.big5.oversea.cnki.net/KCMS/detail/detail.aspx?dbcode=CJFQ&dbname=CJFDLAST2018&filename=JRQH201804010&v=MTI3ODF6L2Fackc0SDluTXE0OUVaSVI4ZVgxTHV4WVM3RGgxVDNxVHJXTTFGckNVUjdxZlpPZG1GeXptVTc3T0w=> [https://perma.cc/5RZT-ZBQV].

59. Notice on Issuing the Guidelines on the Business Cooperation between Banks and Trust Companies (promulgated by the China Banking Regulatory Comm'n, Dec. 4, 2008, effective Dec. 4, 2008),

http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/20081222D75C0AA1792B5FBBFFC19BF9CCDB9000.html (last visited Mar. 19, 2020), unofficial trans., <http://www.lawinfochina.com/display.aspx?lib=law&id=7263&CGid=> [https://perma.cc/PPG6-CH85]; Notice on the Relevant Matters concerning the Cooperation between Banks and Trust Companies (promulgated by the China Banking Regulatory Comm'n, Dec. 14, 2004, effective Dec. 14, 2004), unofficial trans., <http://www.lawinfochina.com/display.aspx?lib=law&id=8109&CGid=> [https://perma.cc/29W8-TVF7]; Notice on Regulating Relevant Matters on Wealth Management Cooperation between Banks and Trust Companies (promulgated by the China Banking Regulatory Comm'n, Aug. 5, 2010, effective Aug. 5, 2010), unofficial trans., <http://en.pkulaw.cn/display.aspx?cgid=136288&lib=law> [https://perma.cc/DNR4-3B2R].

investments in these trusts, and not merely serve as a channel for the banks,⁶⁰ albeit very few paid credence to the request. At its height in mid-2010, 84% of business trusts in China were SITs; their percentage share of the trust market declined gradually, along with the tightening of regulation, to 42% in the first quarter of 2019.⁶¹

Channelling business has become the heart of shadow banking in China, where the trust is not so much misunderstood but rather is misused for the purposes of regulatory arbitrage. It is beyond the scope of the present Article to explore this vast subject, which also affects other financial institutions.⁶² Instead, this Article focuses on the use of the business trust in shadow banking, the most prominent example of which is the bank-trust cooperation. Banks use the SIT to conceal risky corporate loans off their balance sheets in order to bypass their loan-to-deposit ratio and to invest in prohibited industries fenced out of the state credit system. This is achieved by nesting the SIT in multiple layers of coordinated loans. For example, instead of lending directly to the target corporate borrower, the bank lends to an intermediate bank which has capacity under its loan-to-deposit ratio to make corporate loans. The intermediate bank loans the same amount to an intermediate company,⁶³ which then subscribes to an SIT that makes the loan to the target borrower. The intermediate company, which is the beneficiary of the SIT, then assigns its beneficial right back through the chain of transactions to the original lending bank. This nesting of layers allows the debt to be booked as an interbank loan, for which less capital needs to be set aside because they are considered less risky. The original bank also books the trust beneficial interest on its balance sheet. Bank-trust cooperation may also take a simpler, alternative structure, which is neatly illustrated by a recent decision publicized by the Chinese Supreme Court. In *Shenzhen City Xili Baoen Fudi Graveyard Co. Ltd. v. Everbright Xinglong Trust Co. Ltd.* and in *Beijing Peking University Hi-Tech Industrial Investment Co. Ltd. v. Everbright Xinglong Trust Co. Ltd.*,⁶⁴ Baoshang Bank

60. Notice on Regulating Relevant Matters on Wealth Management Cooperation between Banks and Trust Companies (promulgated by the China Banking Regulatory Comm'n, Jan. 13, 2011, effective Jan. 13, 2011), art. 2, http://www.gov.cn/gzdt/2011-01/20/content_1789471.htm (last visited Mar. 19, 2020), unofficial trans., <http://www.lawinfochina.com/display.aspx?lib=law&id=11524> [https://perma.cc/4TPB-LF33].

61. See *Main Business Data*, *supra* note 9.

62. See generally SHEN WEI, SHADOW BANKING IN CHINA: RISKS, REGULATIONS AND POLICY (2016); Steven L. Schwarcz, *Shadow Banking and Regulation in China and Other Developing Countries*, DUKE LAW SCH. (Nov. 16, 2016), https://scholarship.law.duke.edu/faculty_scholarship/3694 (last visited Mar. 19, 2020).

63. Banks are not allowed to lend directly to trust companies, hence the interposition of an intermediate corporate borrower.

64. *Ziguan Xingui Shenzhenshi Xili Baoen Fudi Muyuan Youxiang Gongs, Guangda Xinglong Xintuo Youxian Zeren Gongs, Jiekuan Hetong Jiufen*

established an SIT with the defendant trust company to extend a loan to the appellants to bypass the bank lending rate of 6%.⁶⁵ The interest rate for the loan was 11.8%, and the interest payable on default was as high as 17.7%, giving Baoshang Bank close to double the profit margin it obtains from the official lending rate.

Furthermore, insurance companies that are eager to boost profits also use the trust to skirt regulatory restriction on investment in the stock market and on permitted types of investments. In fact, they have emerged as a major lender for cash-strapped property developers and local governments, as the long maturity period of loans for construction and infrastructure projects matches the long-term liabilities of insurance companies. Often the loans are arranged directly with the borrower and the trust company only provides channelling service with no active duty in managing the underlying trust assets, let alone controlling their risks. These opaque and multi-layered loan structures make it difficult for the regulators to assess the actual risks borne by the chain of companies involved. The spread of shadow banking from banks to other institutions also means that hidden credit risks in China are much larger than current financial data suggest, and a small vulnerability may cause a systemic shock.

2. Paradigm shift in regulatory policy

In 2013, the Chinese government began its efforts to regulate shadow banking. In the first four years, it took a measured approach that did not prohibit channelling business *per se*, but only its (mis)use to circumvent regulation. As these efforts proved ineffective, there was a paradigm shift in regulatory policy in 2017 to: (1) prohibit such business outright; (2) assume centralized, cross-market oversight of financial institutions; and (3) adopt standardized regulation based on products rather than the institutions that operate them. The latter two measures aim at closing loopholes that make regulatory arbitrage possible.

These regulatory efforts can be traced back to 2013, when the State Council issued an internal document, the Notice on Issues Concerning

(资管新规深圳市西丽报恩福地墓园有限公司、光大兴陇信托有限责任公司借款合同纠纷) [A Loan Contract Dispute between Shenzhen City Xili Baoen Fudi Graveyard Co Ltd and Everbright Xinglong Trust Co Ltd] (2015) Min Er Civil Case No. 393, June 29, 2018 (China); *Ziguan Xingui Beijing Beida Gaokeji Chanye Touzi Gongsi, Guangda Xinglong Xintuo Youxian Zeren Gongsi Jiekuan Hetong Jiufen* (资管新规北京北大高科技产业投资有限公司、光大兴陇信托有限责任公司借款合同纠纷) [A Loan Contract Dispute between Beijing Peking University Hi-Tech Industrial Investment Co Ltd and Everbright Xinglong Trust Co Ltd] (2015) Min Er Civil Case No. 401, June 29, 2018 (China) ('Everbright Xinglong Trust Cases'). The two cases were heard together.

65. The figures are based on the facts of *Beijing Peking University Hi-Tech Industrial Investment Co Ltd v. Everbright Xinglong Trust Co Ltd*, *id.*

Strengthening the Supervision of Shadow Banking (the “Notice”).⁶⁶ The Notice sought to strike a balance between risk prevention and financial innovation, and paved the way for a spate of concrete regulatory measures. In 2014, the CBRC issued the Guiding Opinions on the Risk Supervision of Trust Companies,⁶⁷ and the Guidelines for the Consolidated Management and Supervision of Commercial Banks (2014 Revision),⁶⁸ the latter of which was the first time the regulator defined channelling business.⁶⁹ These instruments do not prohibit bank-trust cooperation *per se*, but urge trust companies not to help other institutions bypass regulation. The purposes of these Guidelines are threefold: (1) to stipulate unequivocally that the risks of channelled investments are borne by the originating banks; (2) to require banks to disclose the risk allocation in written contracts; and (3) to bring these investments on to the balance sheets and capital adequacy requirements of these banks. The China Insurance Regulatory Commission also issued a similar notice for insurance companies, albeit it prescribed more stringent requirements on the type and credit rating of the underlying assets.⁷⁰

Yet the overheating of the economy continued unabated, prompting the latest tide of regulation that involves a paradigm shift in policy. This began with the CBRC announcement in March 2017 to rectify the so called “three infringements, three self-profiteering, four incorrectness, and ten chaos,” which was followed up by a spate of on-sight inspections and instructions for financial institutions to investigate and report their own infringing activities. This was followed by a surge in the number and amount of administrative penalties at over 10 times that of the amount ordered in the previous year. The high-handed approach continues to date, and was affirmed by the CBRC as effective in curbing shadow-banking, which has, according to official data, fallen by 21% in 2018 as compared to the previous year.⁷¹ The percentage share of SITs in the trust

66. Notice on Issues Concerning Strengthening the Supervision of Shadow Banking (promulgated by the Gen. Office of the St. Council, Dec. 31, 2013, effective Dec. 31, 2013), unofficial trans., <http://en.pkulaw.cn/display.aspx?cgid=013f924f0d4a849abdfb&lib=law> [https://perma.cc/L6YA-9GCQ].

67. *See supra* note 28.

68. (promulgated by the China Banking Reg. Comm’n, Dec. 30, 2014, effective Jul. 1, 2015), unofficial trans., <http://en.pkulaw.cn/display.aspx?cgid=241371&lib=law> [https://perma.cc/D2YC-N3MP].

69. *Id.* at art. 87.

70. Notice on Matters Concerning the Investments in Collective Fund Trust Plans with Insurance Funds (promulgated by the China Ins. Reg. Comm’n, May 5, 2014, effective May 5, 2014), <http://bxjg.circ.gov.cn/web/site0/tab5225/info3914862.htm> (last visited Mar. 19, 2020), unofficial trans., https://www.pkulaw.com/en_law/7fe77ab909d869fabdfb.html (last visited Mar. 19, 2020).

71. Statistics available from CBRC, <http://www.cbrc.gov.cn/chinese/newShouDoc/8940ED1F6F7B4A4DB569D46764C9CBD8.html> (last visited Mar. 19, 2020).

market also dropped from 50% in the last quarter of 2016 to 42% in the first quarter of 2019.⁷²

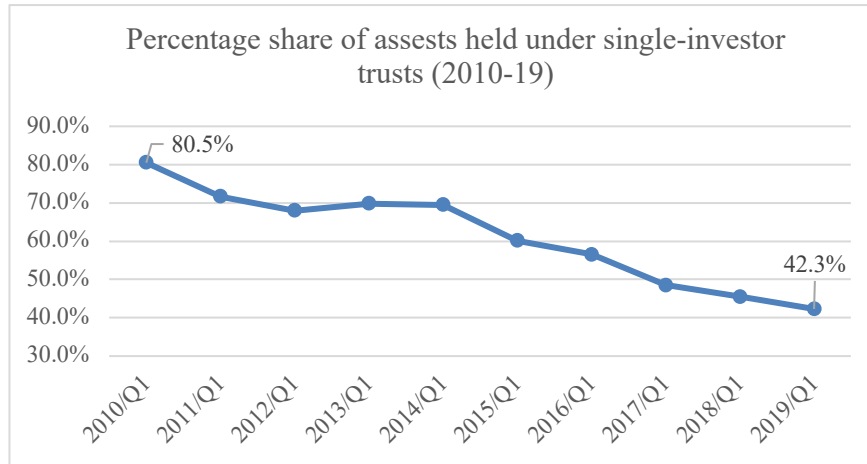


Figure 1: Percentage share of assets held under SITs (2010-19)

These strong policy messages led to a series of regulatory instruments. In December 2017, CBRC issued the Circular on Regulating Bank-Trust Business (“Document 55”),⁷³ which stipulated two new requirements whilst reiterating previous regulatory themes: (1) commercial banks should rigorously assess, select and monitor the quality of their counterparties in bank-trust cooperation through a name-list system; and (2) trust companies are strictly prohibited from accepting guarantees from originating banks, entering into under-the-table agreements with banks, providing channelling services to other institutions, and investing trust funds in prohibited asset class such as real estate, local governments, the stock market, or sectors with excess production capacity.

72. See *supra* note 9.

73. Notice on Regulating the Bank-Trust Business (promulgated by the China Banking Reg. Comm’n, Nov. 22, 2017, effective Nov. 22, 2017), http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/656ED8C75FA44F0387EF393B842A8A11.html (last visited Mar. 19, 2020), unofficial trans., <http://www.lawinfochina.com/display.aspx?id=27146&lib=law> [https://perma.cc/DAJ9-4HSB]. Prior to this Notice, there were: Notice on Special Inspection of Regulatory Arbitrage, Idle Arbitrage and Related Arbitrage in the Banking Industry (promulgated by the China Banking Reg. Comm’n, Mar. 28, 2017, effective Mar. 28, 2017, <http://www.waizi.org.cn/law/18867.html> [https://perma.cc/QB7F-ATWW]); Notice on Carrying out the Special Campaign against “Inappropriate Innovations, Inappropriate Transactions, Inappropriate Incentives, and Inappropriate Collections of Fees” in the Banking Industry (promulgated by the China Banking Reg. Comm’n, Apr. 6, 2017, effective Apr. 6, 2017), https://www.ndrc.gov.cn/xwdt/ztl/gbmjcbzc/yjh/201807/t20180704_1209906.html (last visited Mar. 19, 2020), unofficial trans., <http://www.lawinfochina.com/display.aspx?id=23914&lib=law> [https://perma.cc/M6Q7-CWX4].

Document 55 foreshadowed further concrete measures to combat market irregularities. After a flurry of such measures⁷⁴ came the Asset Management Opinions of April 2018 (the “Opinions”),⁷⁵ which overhauled the previous approach to combating channelling business in several ways. First, the Opinions centralized, cross-market regulation through the establishment of the Financial Stability and Development Committee under the State Council. Second, the Opinions involved the standardization of regulation based on products rather than institutions to minimize any room for channelling business to achieve regulatory arbitrage. Third, the Opinions standardized the leverage ratio of all asset management products and prohibited the launching of asset management products (including trusts) to bypass regulation. Finally, the Opinions limited such products to just one level of delegation to ensure transparency of regulation.

The Opinions, originally set to take effect on June 30, 2019, have now been postponed to December 31, 2020 to allow a longer transition period. To guide trust companies to proper trust business, the CBRC has further plans to issue Measures for the Management of Capital Trusts before the end of 2019 to allow trust companies to operate public placement capital trusts with a significantly lowered threshold of CNY 10,000, but subject to more rigorous regulatory standards comparable to securities investment funds.⁷⁶ It is too early to tell whether these new measures are but another cycle of the cat and mouse regulatory game, or the transformation of the trust industry in keeping with its Western counterparts. However, as Figure 1 shows, the percentage share of SITs managed by the trust industry have indeed been on a steady decline, and will likely continue to do so as existing SITs phase out upon maturity.

3. Judicial activism

This hard-line approach has also found expression in recent judicial practice. In *Everbright Xinglong Trust Cases*,⁷⁷ the borrower argued that

74. Notice on Further Rectifying the Market Chaos in the Banking Industry (promulgated by the China Banking Reg. Comm’n, Jan. 12, 2018, effective Jan. 12, 2018), http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/84BF855655F54ECDA63CBB0048F6C15.html (last visited Mar. 19, 2020), unofficial trans., <http://en.pkulaw.cn/display.aspx?cgid=0dfab0ebc9f53a7abdfb&lib=law> [<https://perma.cc/RPG6-MFUH>]; see also Notice on Issues Concerning Strengthening the Supervision of Shadow Banking, *supra* note 66, Annex.

75. See Asset Management Opinions, *supra* note 50.

76. See SEC. DAILY, *supra* note 21.

77. *Ziguan Xingui Shenzhenshi Xili Baoen Fudi Muyuan Youxiang Gongsi, Guangda Xinglong Xintuo Youxian Zeren Gongsi Jiekuan Hetong Jiufen* (资管新规深圳市西丽报恩福地墓园有限公司、光大兴陇信托有限责任公司借款合同纠纷) [*A Loan Contract Dispute between Shenzhen City Xili Baoen Fudi Graveyard Co Ltd and Everbright Xinglong*]

the loan contract which allowed Baoshang Bank to bypass the bank lending rate was an attempt to ‘conceal illegal goals under the disguise of legitimate form and hence void under Article 52(3) of the Chinese Contract Law. It understandably did not rely on the Asset Management Opinions or any of the recent regulations because the 2011 loan contract pre-dated them. However, in assessing this argument, the Chinese Supreme Court cited the Opinions on its own initiative, and summarized the regulatory prohibitions before rejecting the argument on the narrow ground that the Opinions had not come into effect when the contract was made.

These exhortations are remarkable because they signify the readiness of the Court to invoke the Opinions beyond the calls of necessity, and to pronounce its view about the effect of the Opinions on such contracts in the future. In doing so, the Court blurred the line between judicial adjudication of private law disputes and regulation, and extended the reach of the latter into the private law realm. This is because another paragraph, namely Article 52(5) of the Contract Law, provides that a contract that violates the compulsory provisions of laws or administrative regulations is invalid.⁷⁸ The Opinions, being issued as a notice to the financial institutions, do not fall into either of these two categories. However, by invoking them to meet the broad criterion of concealment of illegal goals under Article 52(3), the Court has elevated the legal status of the Opinions through the backdoor.

4. Summary

To recapitulate the discussion so far, there has been rampant abuse of the business trust in China by banks, provincial governments and state-owned enterprises to sidestep regulatory constraints on lending and borrowing. This is possible because in reality, business trusts provide the legal façade for operating fixed-income products backed by implicit guarantee and masquerading off-balance sheet loans in the shadow economy. At the micro-level, investors’ private law rights under a trust are put in abeyance; at the macro-level, the business trust contributes to the overheating economy and the time bomb of a financial crisis is ticking away. Regulatory clampdown with tougher rules and enforcement came in 2018, with the Supreme Court joining in the concerted efforts to bolster

Trust Co Ltd] (2015) Min Er Civil Case No. 393, June 29, 2018 (China); *Ziguan Xingui Beijing Beida Gaokeji Chanye Touzi Gongsi, Guangda Xinglong Xintuo Youxian Zeren Gongsi Jiekuan Hetong Jiufen* (资管新规北京北大高科技产业投资有限公司、光大兴陇信托有限责任公司借款合同纠纷) [4 *Loan Contract Dispute between Beijing Peking University Hi-Tech Industrial Investment Co Ltd and Everbright Xinglong Trust Co Ltd* (2015) Min Er Civil Case No. 401, June 29, 2018 (China).

78. Chinese Contract Law, *supra* note 4, art. 52(5).

the regulatory decrees. However, a key answer to the current problems has thus far been overlooked: it is to go back to the basics of the trust and reinforce the private law rights protected by this institution, for only then would the concept be immune from abuse and distortion.

IV. RETURNING THE TRUST TO ITS ORIGINAL ROOTS

A. *Inherent Limitations of Regulation*

After almost two decades since the promulgation of the Trust Law, aberrations in trust practice have been tackled almost exclusively by tightening regulation. However, proper trust practice has yet to take root in China as trusts continue to be misused to provide financing outside of state credit limits. There have been cycles of boom and bust that coincided with the loosening and tightening of regulation. While the abuse of trust for regulatory arbitrage can indeed be tackled by closing regulatory loopholes, the source of the other problems mentioned in this Article lies in the systemic distortion of the trust concept in China which cannot be solved by regulation alone.

The use of trusts to operate high-yield loan services, the improper selling of trust products to investors, and the practice of implicit guarantee are all due, in great part, to the failure to adhere to the proper trust concept, with the result that the original allocation of rights and risks in a trust that has made it so successful has become dysfunctional. The proper solution is to bring the Chinese trust in line with the core private law principles of the trust.⁷⁹ Regulation can only facilitate this process through administrative or criminal sanctions. As the regulatory cycles in the past two decades have shown, regulatory policy may be influenced by fiscal and political considerations. Nor does regulation achieve the supposed allocation of risks in a trust relationship, which is a matter for the courts through allocating legal liability *inter partes*. Unfortunately, the regulators' administrative intervention in the Jinxin trust scandal has robbed the courts of the golden opportunity to develop trust jurisprudence.

79. See also Liu Yan, *supra* note 58; Li Chen, *Ziguan Chanpin Gangxing Duifu de Jianguan Jinlu yu Sikao* [Prospects and Thoughts on the Regulation of Implicit Guarantees on Asset Management Products] JINRONG FAYUAN [FINANCIAL LAW FORUM] 194, 203 (2018), <http://new.big5.oversea.cnki.net/KCMS/detail/detail.aspx?dbcode=CJFQ&dbname=CJFDLASN2019&filename=JRFY201802038&v=MjE4MjU3cWZaT2RtRnI6a1Y3cktMei9OZDdHNEg5bk1yWTIHYklSOGVYMUx1eFITN0RoMVQzeVRyV00xRnJDVVI=> [<https://perma.cc/C76G-SHCB>]; Zhou Minjia, *Lun Xintuo Gangxing Duifu Falv Guizhi de Wanshan* [Thoughts on Improving the Legal Regulations of Implicit Guarantee in Trusts] 3 HEZUO JINGJI YU KEJI [COOPERATIVE ECONOMY AND SCIENCE] 188, 190 (2018), <http://new.big5.oversea.cnki.net/KCMS/detail/detail.aspx?dbcode=CJFQ&dbname=CJFDLAST2018&filename=HZJJ201806081&v=MDM1ODZxZlpPZG1GeXprVkwzSUxUZkJaTEc0SDluTXFZOU5aWV14ZVgxTHV4WVM3RgGxVDNxBHJXTTFGckNVUjc=> [<https://perma.cc/ZAF5-EE3Q>].

By compelling the trust company to make out-of-court compensatory payments, the regulators set a dangerous precedent. Worse still, as the amount of these payments is set by considerations of expediency rather than the legal entitlements of the investors (that is, a higher level of compensation for smaller investors who are larger in number), private law redress for breach of trust is further side-lined.

B. The Essential Core of the Trust

It is time the core features of the trust took root in Chinese private law. The past two decades have exposed the inadequacy of the Trust Law, and the need for its broad provisions to be rendered into concrete operating principles for a jurisdiction that does not previously have the concept of a trust. This can be achieved by amendment of the Law itself, or as often happens in China, the promulgation of a Judicial Interpretation of the Trust Law by the Supreme Court. Between the two methods, there is more scope for the Judicial Interpretation to flesh out the operating principles for direct application by the courts.

Aberrations of the business trust practice that could have been avoided by observing the core features of the trust abound. The payment of bailouts from pooled assets was a direct infringement of the ring-fencing of the trust property and the trustee's duty to provide accounts on demand. Similarly, in retaining profits from the investment of trust funds and giving investors fixed interest payments, trust companies breached the no-profit rule and ignored the important principle that profits and losses arising from the trust property were attributed to the beneficiaries. Finally, the prevalence of bailouts shows that private law reliefs for breaches of trust were simply cast to the wayside. A closer examination of these features is in order.

Three of these core features, namely the ring-fencing of trust property, the attribution of profits and losses to the beneficiary, and the trustee's duty to provide accounts, can be considered together because they pertain to the proprietary effect of the trust relationship, which has been under-appreciated in China. For example, a vast amount of official literature and commentaries depict the trust in a saying that does not clearly distinguish a trust from an agency. The saying describes the trust as a legal relationship whereby, "having received a mandate, one manages property for another" (*shouren zhituo, dairen licai*).⁸⁰ It captures the

80. See, for example, *Jianchi Shouren Zhituo Dairen Licai de Fazhan Fangxiang* [Insisting on the Development Direction of Receiving a Mandate and Managing Property for Another], ZHENG QUAN SHI BAO [SECURITIES TIMES], <http://trust.jrj.com.cn/2008/11/0708442632450.shtml> [<https://perma.cc/7XXH-X2A4>]; Ji Hong, *Shouren Zhituo Dairen Licai Xintuo Ye Jianjie* [Receiving a Mandate and Managing Property for Another – A Brief Survey of the Trust Industry] 3 SHIJIE ZHISHI

representative nature of the trust relationship, but fails to accentuate two important aspects. First, the trustee's mandate is granted in virtue of his power to administer the property as if he were the owner. Second, the trust relationship is not merely about the trustee's managerial service, rather it creates a segregated and fluctuating fund in relation to which the beneficiary has enforceable rights.

It is precisely the failure of the trust companies to observe this latter feature that renders CITs trusts in name only. With the benefit of hindsight, although the Trust Law lays down the principle of segregation of trust property in Article 16,⁸¹ it does not set forth concrete operating rules to give real teeth to this principle. For example, Articles 20, 33 and 49 give the beneficiaries the right to inspect trust accounts, but limit this right to the receipt of an annual report. For trust products that involve a short maturity period, some as short as one year, this right is illusory. It is disappointing that despite the recent tightening of regulation, this important issue is dealt with by industry guidelines issued by the China Trustee Association, which only provides that a trust company shall provide an account on a regular basis *as agreed in the trust document*.⁸² Given the unequal bargaining power between trust companies and investors, the stipulation is unlikely to have any real impact. A better approach is to recognize the right of the beneficiary to demand an account on reasonable notice. Equally, the Trust Law does not stipulate the principle that losses arising from authorized dealings of trust property are attributable to the beneficiary. Instead, this principle only forms part of the mandatory statement on the disclosure of subscription, is only part of the mandatory content of the statement, and only finds itself in the disclosure provisions of the CIT Measures.⁸³ It is hoped that these gaps can be plugged in a future amendment of the Trust Law or Judicial Interpretation of the Supreme Court.

Turning to the no-profit rule, the Trust Law is unclear as to its nature and scope, thus allowing trust companies (and trustees generally) to ignore the prohibition with impunity.⁸⁴ Article 26 of the Law states that

[WORLD AFFAIRS] 14 (1997), <http://new.big5.oversea.cnki.net/KCMS/detail/detail.aspx?dbcode=CJFQ&dbname=CJFD9697&filename=SJZS199703009&v=MDEwMTN5em1WTHZNTmlmUmZiS3hGOWJNckk5RmJZUjhlWDFMdXhZUzdEaDFUM3FUcldNMUZyQ1VSN3FmWk9kbUY=> [https://perma.cc/32X2-2F26].

81. See Chinese Trust Law, *supra* note 1, art. 16 (the trust property shall be segregated from the trustee's own property); article 18: claims and liabilities arising from different trust properties should not be offset against each other; article 29: the trustee shall separate trust property from its own property and the properties of different trusts for management and account-keeping purposes. Articles 16 and 29 are reiterated in articles 3 and 29 of the Trust Companies Measures, *supra* note 7.

82. *Guidelines on Due Performance of Trustee Duties by Trust Companies*, *supra* note 16, art. 52.

83. CIT Measures, *supra* note 7, art. 11(3).

84. For a study of the basis of the fiduciary duty in China, see Jianbo Lou and Xuelian Jiang, *Xinyi Yiwu de Fali Yanjiu – Jianlun Dalu Faxi Guojia Xintuofa yu Qita Falv Xinyi Yiwu Guize de Hudong* [A

except when a trustee receives authorized remuneration, it shall not obtain personal profits from the use of trust property.⁸⁵ Under Article 35, remuneration for the trustee may be authorized by express stipulation in the trust contract or upon subsequent agreement. This invites the argument that when a CIT contract stipulates a fixed rate of return for the investors, it is authorizing the trust company to retain as remuneration any profits it makes from the trust fund over and beyond the fixed rate of return. On this view, the trust company owes no duty to account for these profits.

The scope of Article 26 is also limited. It states the no-profit rule, but not the no-conflict rule, which has a distinct scope of its own. Besides, the article prohibits the making of profits from the use of trust property, but leaves open profits arising from the use of the trustee's position. These gaps are now expressly addressed in the Trust Companies Measures, where breaches are remedied by administrative sanctions such as confiscation of unlawful profits or administrative fines.⁸⁶ Such awards, if indeed ordered, may provide greater deterrence than remedies. However, their availability is subject to the initiative and discretion of the regulators, who may be influenced by political considerations and state policies.

Finally, the most underdeveloped aspect of the Chinese trust is its remedial system. Remedies for breach of the no-profit rule provide an immediate example, for there are significant gaps both in black-letter law and judicial practice. In terms of black-letter law, Article 26 only stipulates that personal profits obtained from the use of trust property will accrue to the trust property.⁸⁷ This limited provision leaves the beneficiaries without remedy in two common scenarios: (1) where such profits are dissipated without the fault of the trustee and hence no such property for the beneficiaries to claim; and (2) where the trustee makes profits from the use of his *position* as opposed to trust *property*. To claim these profits, the beneficiaries will have to try their luck with arguments based on general principles in Chinese private law.

Study on the Theory of Fiduciary Duty – with Commentary on the Interaction between the Fiduciary Principles in Civil Law and Other Jurisdictions] 1 SHEHUI KEXUE [JOURNAL OF SOCIAL SCIENCES] 102 (2017).

85. Remuneration can be authorized in advance in the trust contract or subsequently, and the level of remuneration can be adjusted by the parties' agreement: Chinese Trust Law, Article 34.

86. *Trust Companies Measures*, *supra* note 16, arts. 25, 34(1), 59. Article 31(7) of the *Guidelines on the Due Performance of Trustee Duties by Trust Companies*, *supra* note 16, also prohibits the trust company from 'seeking illicit gains or conducting commercial bribes for itself', but as industry guidelines, they do not have the force of law or administrative regulation.

87. *Cf.* Trust Act, Law No. 108, of 2006, sec. 3, art. 40(3) (Japan), http://www.japaneselawtranslation.go.jp/law/detail_main?re=02&vm=02&id=2476#en_ch3sc3at2 [<https://perma.cc/EDN2-P7KH>] (providing generally for restitution of profits obtained from a breach of fiduciary duty).

First, the beneficiary will have to characterise the gains as a loss of the chance to make profits on the part of the trust property, and then bring a compensatory claim under Article 22 of the Trust Law. But some gains of the trustee cannot be treated as loss of trust property by any stretch of imagination. For example, unauthorized profits made from investments that are prohibited by the trust contract cannot be recast as profits that the trust could have made. Second, the beneficiary may invoke Article 404 of the Chinese Contract Law, which stipulates that a mandatary agent shall “hand over to the principal any property acquired in handling the entrusted affairs.”⁸⁸ Mandate is a type of agency in civil law jurisdictions whereby the agent can act in its own name without having ownership of the managed property. The beneficiary will have to contend that Article 404 is applicable because the trust contract is a species of contract. However, this article is crafted with mandataries rather than trustees in mind. In any event, the scope of the article is limited to the first scenario, where the unauthorized profits are deemed as trust property and hence the trustee is handling “entrusted affairs.” It does not offer any solution to the second scenario. Before any amendment of the law takes place, one can only count on judges to resolve these issues. Yet this is where the least progress has been made in China.

In terms of judicial practice, administrative intervention and preference for criminal sanction have thus far deprived the courts of the opportunity to flesh out the implications of Articles 22 and 26.⁸⁹ In the Jixin Trust, for example, the trust company released the trust fund to the target company without acquiring any shares; it also transpired that the trust company was associated to the target company. This clearly amounted to an unauthorised disposition of trust property and a breach of fiduciary duty, which would entitle the beneficiary to rescind the disposition and seek a court’s order for restitution of the invested amount or compensation for loss from the trustee under Article 22.⁹⁰ As compared to the regulator’s order for bailout based on expediency (full recovery for small investors—because they made up the majority of the protectors—and 90% recovery for large investors), judicial remedy would have been more principled and would have provided the basis for developing a rational

88. See Contract Law, *supra* note 4, and see generally Ying Chieh Wu, *Constructive Trusts in the Civil Law Tradition*, 12 J. OF EQUITY 320, 327 (2018).

89. Chief officers of Jixin Trust were convicted for illegally taking in deposits from the public under article 176 of the Chinese Criminal Law in *Jinxin Xintuo Touzi Gufen Gongsi ji Heguipin Dengren Feifa Xishou Gongzhong Cunkuan An* (金新信托投资股份有限公司及何贵品等人非法吸收公众存款案) [*The Case of Illegally Taking in Deposits from the Public by Jinxin Trust Ltd and He Guiping & Ors*] (2006) Xinjiang Xing Er Criminal Case No. 55, July 18, 2006 (China).

90. Assuming that knowledge of the breach of trust was imputed to the target company, it would also be liable for restitution of the trust amount and compensation for the loss, albeit it had become unworthy to sue.

system of trust principles in China.

V. CONCLUSION

In 2018, the regulatory clampdown following the Asset Management Opinions caused convulsion in the trust industry. Cash assets under management at these companies fell, but the decline was reversed marginally in the first quarter of 2019.⁹¹ There are even suggestions that regulation may loosen in response to the severe credit crunch that is happening at a challenging time of the Chinese economy, because China has become too dependent on shadow banking to shoulder the shock of a drastic clean up.⁹² Furthermore, regulatory approaches are liable to the influences of politics and fiscal policies. These remarks highlight the dangers of relying solely on regulation to promote proper trust practice and show the importance of developing the core principles of trust law.

It is only when a rational system of rights and remedies is developed in the private law realm that the trust will be immune from distortion. This Article has proposed a few clarifications or amendments of the Trust Law that would assist this process. They include stipulations that: (1) both the losses and gains made from the use of trust property are borne by the beneficiary; (2) the beneficiary has the right to demand the trustee to provide an account upon giving reasonable notice; (3) the trustee is also prohibited from making unauthorized profits from the use of its position; and (4) it is liable to account for any unauthorized profits made from the use of trust property or its position as trustee. These propositions are rudimentary to any common law jurisdictions, but precisely because they have not been adhered to in China, the Chinese business trust has yet to reap the full benefits of this legal tool.

91. See *Main Business Data*, *supra* note 9.

92. Anjani Trivedi, *For China, Kicking a \$9 Trillion Habit is Tough Work*, BLOOMBERG (N.Y.) (June 26, 2019), <https://www.bloomberg.com/opinion/articles/2019-06-25/china-s-reliance-on-shadow-banking-is-growing-not-shrinking> [<https://perma.cc/676S-XUCA>].