KEY STEP TOWARDS A FAIR, MARKET-BASED CAPITAL MARKET: THE UNPRECEDENTED PRIVATE INVESTMENT FUND REGULATION

Xu Changle

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Abstract

After the 2008 financial crisis, the regulatory ideology of private funds has experienced a paradigm shift in the global context. The recent regulatory framework focuses on the collection of industrial information and adopts a differentiated approach to regulate different types of private funds. In China, in response to the enormous expansion and associated risks in the private fund market, the Private Investment Funds Regulation was introduced to protect investors and provide guidance for the industry. The Regulation aligns with the global trend and addresses deficiencies in the private fund market. This article explains the development of the regulatory framework of private funds and analyzes the current framework under the Private Fund Regulation. This article highlights the special section for the regulation of venture capital funds, which implies the differentiated approach adopted by the Chinese government to achieve a fair, market-based capital market. Furthermore, the author comments on the Regulation from a comparative law perspective by introducing the U.S. framework under the Dodd-Frank Act. This commentary advocates for the differentiated approach and stringent information disclosure as means to promote a fair market.

Keywords: Private Investment Funds Regulation; private funds; venture capital funds; differentiated regulation; investor protection; Dodd-Frank Act

I. INTRODUCTION

The People's Republic of China ("PRC" or "China") has been hailed as the investment opportunity of the century given its staggering size and rapid economic growth.[1] Seeing the potential for continuous increases in the future, it has garnered a tremendous amount of interest from foreign and domestic investors, establishing a sophisticated capital market. As an important type of financial intermediary, investment funds play a critical role in the development of a market-based financial market. It provides investors with the possibility to diversify and distribute their investments with a flexible and systemic approach.

Beginning in the late 1970's and accelerating in the 1980's, the Chinese government began to allow the establishment of private enterprises in greater and greater numbers.[2] During this period, the authority made initial efforts to establish a venture capital system aimed at enhancing economic performance

[1] *See* Joseph Chan (陈永坚), Zhongguo Fengxian Touzi yu Simu Guquan (中国风险投资与私募股权) [Venture Capital & Private Equity in China] 415 (2008).

[2] *Id.* at 418.

and efficiency, particularly in promoting the high-tech industry.[3] Following the lead of venture capital companies (the most common types are corporate types funds during the early age), foreign private equity firms also started to expand their activities in China.[4] For example, TPG acquired a minority stake in Lenovo in 2004 as part of Lenovo's acquisition of IMB's PC business.

In recent years, the private investment fund industry has grown rapidly with an enormous expansion in scale. The recent figures from the market are illustrative. According to the Asset Management Association of China (the "AMAC"), as of September 30, 2023, there were 21,730 private fund managers registered with AMAC, with approximately 153,000 fund products under their management.[5] The scale of private investment funds exceeded RMB 20.81 trillion, which is approximately one-fourth of the China stock market.[6]

The development of the industry is associated with the emergence of certain material risks and issues. In market practice, misbehaviors such as illegal fundraising, fraudulent disclosure, and the sale of product to unqualified investors, are not uncommon. These disorders not only took tolls on investors, but also poses significant risks to the entire industry.[7] However, the industry has been lacking top-level design, which means that relevant regulations are absent under the regulatory framework, lacking a sufficient legal basis for supervision and administration. Therefore, the industry has been anticipating strong, high-level regulation to protect investors and mitigate industrial risks.

Indeed, there has been a paradigm shift in the regulatory ideology concerning the private fund industry.[8] Traditionally, the idea reflected by the securities laws was that private investors could fend for themselves, leading to loose regulation over all types of private funds.[9] Nevertheless, since the 2008 financial crisis, the Dodd-Frank Act has significantly altered the regulatory paradigm. This shift is characterized by differentiated regulation as a means to prevent systemic risks.[10] This global trend also influences China's regulatory design.

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[3] The first venture capital fund is the China New Technology Start-Up Investment Company, founded in 1985 by the State Science and Technology Commission and the Ministry of Finance.

[4] *Supra* note 1 at 420.

[5] *Monthly Report on Registration of Private Equity Fund Managers and Product Filing*, Asset Management Association of China Official Website (Sep. 2023), https://www.amac.org.cn/sjtj/tjbg/smjj/202311/P020231126403861429686.pdf.

[6] *China Market Capitalization*, CEIC Data Official Website, https://www.ceicdata.com/en/indicator/china/market-capitalization.

[7] Ba Shusong (巴曙松), *Jianguan yu Fazhan Bingzhong de Simu Xinpianzhang—"Simu Touzi Jijin Jiandu Guanli Tiaoli" Jiedu* (监管与发展并重的私募新篇章—《私募投资基金监督管理条例》解读) [*A New Chapter of Private Equity with Emphasis on Regulation and Development—Interpretation of the Regulations on Supervision and Administration of Private Investment Funds*], MOJ Official Website (Jul. 11, 2023), https://www.moj.gov.cn/pub/sfbgw/zcjd/202307/t20230711_482425.html.

[8] *See* Guoli (郭雳), *Meiguo Simu Jijin Guifan de Fazhan Jiqi Qishi* (美国私募基金规范的发展及其启示) [*The Development of Private Fund Regulation in the United States and Its Implications*], 4 Huanqiu Falü Pinglun (环球法律评论) [Global Law Review] 90, 90–92 (2009).

[9] *Id.*

[10] *See* Guoli (郭雳), *Jinrong Weiji Hou Meiguo Simu Jijin Jianguan de Zhidu Gengxin yu GuannianDiedai* (金融危机后美国私募基金监管的制度更新与观念迭代) [*Institutional Updates and Conceptual Iterations*

In the recent decade, in response to the enormous expansion in scale, risk exposure and 'retailization' tendency, on September 1, 2023, the State Council issued the Regulation on the Supervision and Administration of Private Investment Funds (the "Private Investment Funds Regulation" or "Regulation").[11] To a large extend, this Regulation aligns with the global regulatory trend and addresses deficiencies in the private investment funds regulatory system. The primary objective of the Regulation is to protect investors and prevent systemic risks.[12] The entire regulatory framework aims to regulate the internal relationship between the funds and their investors, and simultaneously, to govern the external influence of funds on the market, which eventually fosters a market-based capital market.

Excluding the Introduction and the Conclusion, this article is divided into the following three sections: Part I introduces the new investor protection mechanism under the Regulation, which clarifies the registration requirements for fund managers and the disclosure requirements to the authority; Part II discusses the differentiated regulation approach, which outlines special regulatory requirements for venture capital funds; Part III compares the Regulation with the U.S. framework under the Dodd-Frank Act, further analyzing the differentiated regulation approach, providing comments and suggestions on the new updates.

II. Investor Protection: Registration and Information Disclosure

Historically, private investment funds were characterized by their ability to be free from regulatory requirements. Regulators believed that investors were capable of protecting themselves, thus leaving a blank space in regulation. The private fund industry fell outside the scope of supervision before 2013.[13] This attempt gave managers substantial freedom in their investment activities, resulting in a fragile and risky capital market. The investors have no protection backed by the authority.

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in the Regulation of Private Equity Funds in the United States after the Financial Crisis], 6 Bijiaofa Yanjiu (比较法研究) [Comparative Law Study] 125, 125, 137–41 (2021).

[11] Simu Touzi Jijin Jiandu Guanli Tiaoli (私募投资基金监督管理条例) [Regulation on the Supervision and Administration of Private Investment Funds] (promulgated by State Council Jul. 3, 2023, effective Sep. 1, 2023) (Chinalawinfo) [hereinafter *Regulation*].

[12] *See* Guoli (郭雳), *Simu Jijin Jianguan de Xinguize, Xinjieduan, Xinlinian—Ping "Simu Touzi Jijin Jiandu Guanli Tiaoli"* (私募基金监管的新规则、新阶段、新理念—评《私募投资基金监督管理条例》) [*New Rules, New Stages and New Concepts of Private Fund Supervision and Administration—Comment on the Private Investment Funds Regulations*], MOJ Official Website (Jul. 11, 2023), https://www.moj.gov.cn/pub/sfbgw/zcjd/202307/t20230711_482426.html.

[13] Chen Chen, Zhu Shunnan (陈琛，朱舜楠), *Zhongguo Simu Guquan Touzi* (中国私募股权投资基金监管问题探讨) [*Discussion on the Regulation of Private Equity Funds in China*], 5 Yunnan Shehui Kexue (云南社会科学) [Yunnan Social Science] 101, 104 (2017).

The turning point came in 2013. With the amendment of the *Securities Investment Fund Law* (the "Investment Fund Law" or "Law"),[14] private funds were brought to the scope of supervision. The Investment Fund Law made four major attempts: (i) "qualified investors" definition;[15] (ii) private fund managers registration with AMAC;[16] (iii) information disclosure to investors;[17] (iv) recordation requirement with AMAC after offering.[18] Though being criticized for being vague, ambiguous and reducing the flexibility in such investments,[19] the Law marked the first step which laid the foundation for the future regulatory framework. Conspicuously, "investor protection" was at the core of this legislation.

While the legislators relied on information disclosure to protect investors, the Law did not provide any specific guidelines regarding such registration. They authorized the corresponding regulatory authorities under the State Council to promulgate rules mandating registration and disclosure from private fund managers, as stipulated in Article 32 of the Investment Fund Law.[20]

A. Registration Requirements of Private Investment Fund Managers

In response to the legislative requirements, from 2013 to 2020, the China Securities Regulatory Commission ("CSRC") made repeated efforts to register private fund managers. Nevertheless, the regulators have provided limited and sometimes contradictory guidance.

First, in 2014, the CSRC adopted the "basic registration requirements" under article 7 of the *Measures for the Supervision and Administration of Private Investment Funds* (the "Measures").[21] According to the Measures, fund managers are only required to submit basic information, including (i) business license; (ii) company bylaws or partnership agreements; (iii) list of shareholders or partners; (iv) information about senior officials.[22] Following the completion of Registration, AMAC will disclose their information on official websites. Certain scholars cast doubt on the effectiveness of this initiative to protect investors, since private fund investors can access the above information with basically no effort. They do not get any additional information to assess the risk in their investments. Also, without explicit legal consequences, some unregistered private fund managers conducted investment

[14] Zhengquan Touzi Jijinfa (2012 Xiuding) (证券投资基金法(2012修订)) [Securities Investment Fund Law] (promulgated by Standing Committee of the National People's Congress Feb. 28, 2012, Effective Jun. 1 2013) (Chinalawinfo) [hereinafter *Investment Fund Law*].

[15] *Investment Fund Law,* art 18.

[16] *Investment Fund Law,* art 10.

[17] *Investment Fund Law,* art 31.

[18] *Investment Fund Law,* art 22.

[19] *Supra* note 6.

[20] *Investment Fund Law,* art 32.

[21] Simu Touzi Jijin Jiandu Guanli Zanxing Banfa (私募投资基金监督管理暂行办法) [Measures for the Supervision and Administration of Private Investment Funds] (promulgated by China Securities Regulatory Commission Aug. 21, 2014, effective Aug. 21, 2014) (Chinalawinfo) [hereinafter *Measures*].

[22] *Measures,* art. 7.

activities, resulting in illegal fundraising and securities scams that jeopardized the interests of investors.

In 2020, the CSRC introduced the *Provisions on Strengthening the Regulation of Private Investment Funds* (the "Provisions") to elevate the level of supervision. The Provisions aimed to clarify the legal consequences for any misrepresentation, misleading statement or material omission of registration information, with the goal of ensuring accurate, complete and timely reporting of relevant information.[23] The Provisions also prohibited unregistered fund managers from using the terms "fund" or "fund management" in their titles when conducting private investment activities.[24] However, legal consequences for the violation of the above provisions were still vague, as such kinds of breach would only result in "market entry prohibition", "administrative punishments" or "the entry of dishonest list".[25] In other words, these requirements lacked sufficient deterrent effects.

As a brief summary, over the past decade, while initiatives had indeed played an active role in protecting private fund investors, certain aspects had still been unsatisfactory. For instance, the regulatory framework lacked top-level design to establish a sufficient legal basis for supervision; the disclosed information was not effective in protecting investors; the punishments and consequences for the violation of registration requirements were rather unclear and lacked deterrent effects.[26]

To strengthen investor protection, in 2023, ten years after the amendment of the Investment Fund Law, the State Council issued the Regulation on the Supervision and Administration of Private Investment Funds (the "Private Investment Fund Regulation" or "Regulation"). The Regulation placed a strong emphasis on investor protection and systemic risk prevention, adopting an "all-rounded regulatory approach", from both *ex-ante* and *post-ante* perspectives.

The Private Investment Fund Regulation highlighted the supervision of "key performers" as part of the *ex-ante* measures and introduced a "look-in and look-through approach" to fund managers registration. Pursuant to the Regulation, fund managers are required to register with the regulatory agency of the State Council. On top of the submission of basic information, fund managers shall provide the information of key performers, such as the shareholders, actual controllers, managing officials, LP and GP.[27] To enhance investor protection and mitigate various risks associated with private fund investments, such as money laundering and terrorist financing, the Regulation requires the submission of the beneficial owners of the shareholders and

[23] Guanyu Jiaqiang Simu Touzi Jijin Jianguan de Ruogan Guiding (关于加强私募投资基金监管的若干规定) [Provisions on Strengthening the Regulation of Private Investment Funds] (promulgated by China Securities Regulatory Commission Dec. 30, 2020, effective Dec. 30, 2020) (Chinalawinfo) [hereinafter *Provisions*].

[24] *Provisions*, art. 3.

[25] *Provisions*, art. 13.

[26] Chen Jie (陈洁), *Simu Jijin Hangye Fazhan de Fazhihua Tujing* (私募基金行业发展的法治化图景) [*A Rule of Law Picture for the Development of the Private Equity Industry*], MOJ Official Website (Jul. 11, 2023), https://www.moj.gov.cn/pub/sfbgw/zcjd/202307/t20230711_482424.html.

[27] *Regulation*, art 10.

partners.[28] This approach can increase the transparency of fund operation, helping the authority to identify the potential risks of fund managers, enabling investors to conduct thorough due diligence.

The Private Investment Fund Regulation also introduced the "consistent monitoring mechanism" during the fund operation. To ensure sustainable and consistent supervision, the *Regulation* mandates fund managers to register with the authority in the event of any material changes in controlling shareholder, actual controller, GP or LP.[29] This requirement aimed at addressing information asymmetries between managers and investors by promoting transparency and timely disclosure of significant changes within the fund structure.

To provide *ex-ante* measure for victims, the Private Investment Fund Regulation finally clarifies the legal consequences for the violation of registration by introducing the "double accountability mechanism". Under the current regime, both the fund and the "directly liable members" will be fined for the violation of legal obligation. According to article 44 of the Regulation, unregistered fund managers could be fined one to five times their illegal income, and at the same time, the fines for "directly liable members" fall within the range of RMB 30,000 to RMB 300,000 on a discretionary basis.[30] This provides a clear guideline and strengthen the *ex-post* regulation.

B. Information Disclosure to Regulatory Authority

In addition to mandating the registration of private investment fund advisers, the regulatory landscape requires fund managers to maintain records and provide additional information that the regulator requires to evaluate the private fund industry, maintain appropriate oversight and avoid systemic risk.

Prior to the enactment of the Private Investment Fund Regulation, the 2014 Measures also relied on mandatory information disclosure to evaluate the private fund market. Any registered fund manager was required to report to AMAC any information regarding the private funds they manage. The required disclosures include information related to investment strategy, fund contact, fund structure, risk disclosure statements, etc. In the early stage, regulators focused on assessing fund managers and their management practices.

After the repercussions of 'Shanghai Fuxing Group securities crime cases,' the private fund market revealed underlying risks associated with the development of private fund industry. One significant concern was illegal operation, by which certain private funds conducted "debt investment in the name of equity investment (disguised debt)" and engaged in shadow banking, exposing themselves to high liquidity and credit risks. Some managers conducted illegal fundraising, selling private fund products to non-qualified

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[28] *Id.*
[29] *Id.*
[30] *Regulation*, art. 44.

investors by constructing multiple layers of investors, posing serious societal problems.[31]

To address these issues, under article 22 of the Regulation, the State Council requires fund managers to submit (i) the fund contract; (ii) the custody agreement or measures to ensure the security of private fund assets; (iii) supporting documents for private fund assets; (iv) basic information of investors, subscription amount, number of shares held, and information of their beneficial owners.[32] AMAC should classify the information in accordance with the size of fund raised and disclose it to the public. Notably, the regulatory focus has shifted to the legality of fund assets and the qualification of the actual beneficial owners of private fund investors.

This approach aims to prevent systemic risks associated with the private fund market. However, the disclosure requirements have long been the center of controversies. Some scholars believe that government intervention should be reduced to promote market development;[33] while others assert that the authority should strengthen the supervision to enhance investor protection.[34]

Mandatory information disclosure is a common regulatory mechanism for private investment funds regulation worldwide. For instance, SEC requires fund advisors to file Form ADV and Form PF to report relevant information regarding fund management.[35] SEC believes that the public reporting requirements will provide a level of transparency that will help them identify practices that may harm investors, will aid investors in conducting their own due diligence, and will deter advisers' fraud and facilitate earlier discovery of potential misconduct.[36] In fact, these required disclosures are highly sensitive in nature, involving the reporting of risk metrics, investment strategies, financial information, credit exposure, performance and change in performance etc. Despite these apparent challenges, surveys suggest that the impact of such disclosure has been adsorbed quickly by the market.[37] This article believes that information disclosure is an effective mechanism to mitigate market risks and

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[31] Long Junpeng (龙俊鹏), *Wanshan Woguo Simu Jijin Jianguan Tizhi: Daoxiang, Kuangjia yu Duice* (完善我国私募基金监管体制：导向、框架与对策) [*Improving China's Private Equity Fund Regulatory System: Orientation, Framework and Countermeasures*], 5 Nanfang Jinrong (南方金融) Southern Finance 82, 84–85 (2019).

[32] *Regulation*, art. 22.

[33] *See* Huang Yaling, Lai Jianping, Zhao Zhongyi (黄亚玲、赖建平、赵忠义), *Woguo Simu Guquan Jijin Jianguan Chuyi* (我国私募股权基金监管刍议) [*Ruminations on the Regulation of Private Equity Funds in China*], 4 Zhengquan Shichang Daobao (证券市场导报) [Securities Market Herald] 67, 69–71 (2010).

[34] *See* Liang Qinghua (梁清华), *Lun Woguo Simu Xinxi Pilu Zhidu de Wanshan* (论我国私募信息披露制度的完善) [*Improvement of China's Private Funds Disclosure System*], 5 Zhongguo Faxue (中国法学) [China Legal Science] 149, 152–55 (2015).

[35] Liu Yuheng (刘瑜恒), *Woguo Simu Jijin Fengxian ji Jianguan DuiceYanjiu—Jiyu Meiguo de Bijiao Fenxi* (我国私募基金风险及监管对策研究—基于美国的比较分析) [*Study on the Risks and Regulatory Countermeasures of Private Funds in China—Comparative Analysis Based on the U.S.*], 8 Jinrong Jianguan Yanjiu (金融监管研究) [Financial Regulation Research] 42, 55 (2018).

[36] Investment Advisers Act, Rules Implementing Amendments to the Investment Advisers Act of 1940, Release No. IA-3110, 49-50.

[37] Wulf A. Kaal, *Private Fund Disclosures Under the Dodd-Frank Act*, 9 BROOK. J. CORP. FIN. & COM. L. 428, 428 (2015).

protect investors. The central issue in regard to information disclosure of private fund, is to strike a balance between investor protection and financing efficiency.

III. Differentiated Regulation Approach: Special Regulations for Venture Capital Funds

There are various types of private investment funds, categorized by the funds' investment strategies. For instance, the SEC characterized private funds into seven types—hedge funds, liquidity funds, private equity funds, real estate funds, securitized asset funds, venture capital funds and other funds.[38] Under the Chinese legislative landscape, legislators do not provide official characterizations to distinguish different types of private funds. However, in real-life commercial practice, the industry has developed different types of private funds. AMAC characterized private funds into four major types: private securities funds, private equity funds, venture capital funds and private asset allocation funds.[39] Each type of fund has specific features and poses different risks to investors and the industry, but other than VC funds, the regulatory requirements are genuinely the same. Therefore, certain scholars advocate for "differentiated regulation regime,"[40] which means that the authority should pose different regulatory requirements on each type of fund based on their specific features, to strike a balance between risk mitigation and investor flexibility.

The Regulation reflects the concept of "differentiated regulation" and implements special regulatory requirements for venture capital funds ("VC funds"). VC funds typically invest in companies that are relatively new and risky. The Chinese government has recognized venture capital investments as "an important component" of China's economy, serving as an essential role in promoting technological innovation.[41] Therefore, the authority has introduced preferential policies to provide incentives for VC investments, including tax incentives, governmental investment guidance and investment exit protection etc.

The Regulation has a specific chapter to regulate VC funds, providing preferential policies and exemptions. The author believes that these initiatives aim to foster the development of the VC fund industry as a whole and prevent systemic risks, instead of investor protection.

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[38] *Infra* note 64.

[39] *Youguan Simu Touzi Jijin "Jijin Leixing" he "Chanpin Leixing" de Shuoming* (有关私募投资基金"基金类型"和"产品类型"的说明) [*Description of "Fund Type" and "Product Type" of Private Investment Funds*], AMAC Official Website, https://ambers.amac.org.cn/web/app/static/template/org Type.pdf.

[40] *See supra* note 7; *see also supra* note 8.

[41] *Sifabu, Zhengjianhui Fuzeren jiu "Simu Touzi Jijin Jiandu Guanli Tiaoli" Da Jizhe Wen* (司法部、证监会负责人就《私募投资基金监督管理条例》答记者问) [*Press Conference Conducted by the Officials of the Ministry of Justice and the CSRC Regarding the Private Investment Funds Regulation*], MOJ Official Website (Jul. 9, 2023), https://www.moj.gov.cn/pub/sfbgw/zcjd/202307/t20230707_482213.html.

A. Simplification of Registration and Recordation Requirements

According to article 37 of the Regulation, the regulatory authority shall simplify the registration and recordation formality of venture capital funds in order to optimize their business environment.[42] This implies that VC funds are subject to lower compliance requirements compared to other private funds. This approach is designated to facilitate financing efficiency and streamline risk management associated with VC investments.

The Regulation imposes restrictions on VC funds. It prohibits VC funds from utilizing leverage financing in their investments.[43] Additionally, the Regulation mandates a 'minimum duration' for the investor redemptions,[44] restricting the short-term exits of VC investors. Consequently, it is unlikely for a run on the fund to occur, in which a VC fund faces a surge in redemption requests from investors. On top of these restrictions, VC fund investments are genuinely isolated from the banking industry since commercial banks are not allowed to engage in VC fund investments,[45] further reducing the 'contagious' issue of the non-performance of VC funds. These initiatives create the foundation for adopting the differentiated regulatory approach with lower compliance standards, enabling VC fund managers to conduct flexible investments.

Seemingly, the above reform under the Regulation may follow the traditional regulatory theory and focus on investor protection. Yet, under closer inspections, the new regulatory landscape aims to prevent systemic risks. For VC funds, by nature, target private companies, making it difficult, if not impossible, for investors to obtain sufficient information. Moreover, while having substantial capital demands, private companies generally lack comprehensive corporate governance structure, thus requiring more information to protect investors. The simplified registration and disclosure requirements as introduced by the Regulation seems to go the opposite way.

In contrast, from the systemic risk prevention perspective, the special regulations of venture capital funds are more easily understood. As mentioned above, the prohibition on leverage financing and early redemption classifies them as exempt from the registration requirement, placing them on the "white list" for systemic risk prevention. The Regulation focuses on the externalities of VC investments instead of the internal relationship between fund managers and the investors. This indicates a deliberate effort to tailor regulations for VC funds in a manner that aligns with the broader goal of averting systemic risks in the financial system.

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42 *Regulation,* art. 37.

43 *Regulation,* art. 35.

44 *Regulation,* art. 37.

45 Shangye Yinhang Fa (商业银行法) [Law of Commercial Banks] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 29, 2015, effective Oct. 1, 2015), art. 43 (Chinalawinfo).

B. Risks Related to the Conflicts of Interest

Private fund investments, especially venture capital investments, are characterized by flexibility, invisibility and broad involvement. However, the market for financing unlisted companies lacks the safeguards provided by governance and periodic information disclosure requirements for listed companies. While supporting venture capital funds, attention should also be directed to the inherent risks of conflicts of interest between private fund investors and private fund managers, as well as the potential threats to investor interests and market fairness. In this context, this article proposes the following regimes to further enhance the investor protection aspect on VC fund investments.

Without excessively intervening in fund investment and financing activities, information disclosure remains the most effective means of protecting investors and constraining fund managers. Within information disclosure, the disclosure of conflicts of interest risks is particularly crucial. The International Organization of Securities Commissions ("IOSCO") examined the conflicts of interest risks at the stages of fundraising, investment, management, and exit in private fund investment and financing practices, proposing principles to mitigate these risks.46

At the fundraising stage, private funds regularly employ the services of third-party advisors. For instance, it is common for private funds to engage an external placement agent to market the fund to a wider range of institutional buyers. Private fund managers may attribute costs associated with the appointment of a placement agent to the fund on an undisclosed basis, creating material conflict of interests with investors. Also, potential conflict of interest remains between the private equity firm's desire to maintain its market position by raising funds of an increasingly larger size, set against the investors' need to ensure that the raised capital can be effectively deployed towards suitably attractive investment opportunities within the fund's proposed investment period.

At the investment stage, it is common for multi-strategy firms to have overlapping or fundamentally competing investment strategies. This problem can arise when a firm operates a private fund alongside a credit fund or debt fund. Alignment of interests may be undermined when the investee company experiences financial distress, leading to divergent interests among investors in different parts of the capital structure.

At the exit stage, fund manager may arrange to sell the majority of a fund's investment in an investee company to a third party, but given its perceived growth potential, will seek to retain a minority stake in the investee company for investment by one of its other funds. This is more likely to occur in VC investments where the fund may not be of sufficient size to finance the portfolio company's follow-on investment needs. For example, such situations can occur

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[46] IOSCO Consultation Report, *Private Equity Conflicts of Interest* (Nov. 2009), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD309.pdf.

in down rounds where the portfolio company is in financial trouble and in up rounds where further capital is required for continued growth and expansion. Given that the fund manager is, in effect, on both sides of the transaction (representing the interests of two sets of fund investors), this creates the potential for conflicts of interest to arise in respect of the pricing of the transaction.

IV. OUTLOOK: IMPLICATION UNDER THE DODD-FRANK ACT

The differentiate regulation approach was introduced by the U.S. through the enactment of the Dodd–Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or "Dodd-Frank"). This regulatory regime altered the traditional regulatory focus from investor protection to systemic prevention. This section provides deeper analysis of the differentiated regulation approach embodied in the Dodd-Frank Act, advocating for the adoption of similar approach in China's future regulatory landscape.

The purpose of differentiated regulation is to reduce systemic risks in the financial market, aligning with the general purpose of the Dodd-Frank Act. Globally, financial regulators are confronting the problem of systemic risk–namely, the risk that a localized economic shock can have worldwide repercussions because of the interconnections between financial institutions.47 In 2008. The United States essentially witnessed a localized economic shock in its subprime mortgage market, which nearly caused the meltdown of worldwide capital markets as that shock was transmitted through the global market with the speed of a tsunami. In the United States, reacting to public anger at bailouts, the Dodd-Frank Act invests heavily in preventive regulation and supervision to prevent a future crisis. Although lacking evidence indicating the direct relationship between private fund investments and the crisis, financial regulators observed the underlying risks in the U.S. private fund markets and altered the regulatory paradigm, which strengthen the collection of industry information, and is characterized by differentiated regulation to prevent systemic risks.

Despite industry concerns about the effects of the Dodd-Frank Act,48 surveys demonstrate that the private fund industry adjusted well to the post-Dodd-Frank regulatory landscape.49 They suggested that private fund advisers successfully addressed the compliance demands associated with the Dodd-Frank Act and absorbed the increased compliance costs of the registration and

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[47] Steven L. Schwarcz, *Systemic Risk*, 97 Geo. L. J. 204 (2008).

[48] *See* Hedge Fund Operations: Hearing Before the H. Comm. on Banking & Fin. Servs., 105th Cong. 26 (1998); *see also* U.S. Sec. & Exch. Comm'n, *Staff Report: Implications of the Growth of Hedge Funds* 90 (2003), http://www.sec.gov/ news/studies/hedgefunds0903.pdf; *See also* Golod, Gal, *Private Equity Regulation in The Aftermath of The 2008 Financial Crisis: Is Title IV of The Dodd-Frank Act The Right Answer? The Political Economy of Dodd-Frank and The Case Against the Regulation of Private Equity Funds Under Title IV*, SJD Dissertations (2016) 18, https://ir.lawnet.fordham.edu/sjd/18.

[49] *Supra* note 23.

disclosure rules relatively quickly after registration.50 Commentators also recognize that Dodd-Frank has reduced systemic risk in the financial system.51 Therefore, it is critical to understand the regulatory ideology behind the regulation and use it as a reference for the implication of our local regulatory landscape.

After the enactment of the Dodd-Frank Act, the SEC amended its Form ADV for better investor protection and introduced Form PF to acquire information so as to evaluate the private fund industry, maintain appropriate oversight, and avoid systemic risk.

A. Amended Form ADV to Enhance Investor Protection

Form ADV is a disclosure document,[52] that any investment advisers registering with the SEC is required to file. The SEC maintains the information submitted on this form and makes it publicly available. The major purpose of Form ADV is to foster investor protection by information disclosure to address the relationship between fund advisers and investors. This ensures the transparency of operation and serves as the anti-fraud mechanism. The required disclosures include information regarding investment strategy, fund structure, ownership, gross asset value, the fund's use of consultants, etc.[53]

The SEC intends to ensure the availability of sufficient data, which is required to understand an adviser's business and prepare for on-site examinations. Accordingly, revised Form ADV requires advisers to disclose their clients, employees, compensation arrangements, and advisory activities.[54] Required disclosures include total number of employees as well as the number of nonemployees who solicit advisory clients on the adviser's behalf.[55] Those nonemployees are further categorized by those who perform advisory functions, who act as registered representatives of broker-dealers, who are registered with state authorities as investment adviser representatives, and who are insurance agents.[56]

Witnessed by the SEC, the authority recognized the conflict of interest between fund managers and fund investors during the fund operation. Amended Form ADV allows the SEC to address conflict of interest in various ways. Advisers are required to disclose transactions involving a conflict of interest that may arise in direct transactions between advisers or related persons and

[50] Wulf A. Kaal, *Hedge Fund Manager Registration Under the Dodd-Frank Act*, 50 San Diego L. Rev. 243 (2013).

[51] *See* Aaron M. Levine & Joshua C. Macey, *Dodd-Frank is a Pigouvian Regulation*, 1336 Yale L. Rev. 1340 (2018); *See also* Doris Toyou, *Protection of Private Equity Investors under the Dodd-Frank Act*, 37 J.L. & Com. 115 (2019).

[52] U.S. Sec. & Exch. Comm'n, OMB NO. 3235-0049, Form ADV, Uniform Application for Investment Adviser Registration and Report by Exempt Reporting Advisers (2011) [hereinafter *Form ADV*], http://www.sec.gov/about/forms/formadv.pdf.

[53] Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. at 42965–66

[54] *Form ADV*, part 1A (Item 5); *see also supra* note 52.

[55] *Form ADV*, part 1A (Item 5.A); see also Form ADV, part 1A, at 8–10 (Items 5.C, 5.H).

[56] *Form ADV*, part 1A (Item 5.B).

clients.[57] Form ADV requires advisers to identify their type of business activities,[58] whether one of those businesses is the adviser's primary business,[59] and whether the adviser provides any service other than investment advice to their clients.[60] Such disclosures are intended to avoid potential conflicts of interest between the different types of businesses and services the adviser may engage in.[61] Other disclosures in this context include related-person status of brokers and dealers;[62] soft dollar benefits;[63] and compensation for client referrals.[64]

B. Introduction of Form PF to Prevent Systemic Risks

Form PF is the creation after Dodd-Frank with an aim to enhance regulatory oversight over the private fund industry by gathering more industry-related information.[65] Reporting obligations on Form PF increase the regulatory oversight of private funds to unprecedented levels. Form PF requires investment managers to disclose information about themselves, their managed funds, and their investors. These required disclosures are highly sensitive in nature. The SEC intended Form PF to improve its understanding of reporting funds' liquidity, exposure and assets, to collect industry information and to evaluate the risks associated with the private fund industry. Therefore, this information would not be disclosed publicly or to investors.

To help the SEC understand reporting funds' liquidity, exposure, and assets, Form PF requires investment advisers to disclose the time increments it would take to liquidate a certain percentage of the reporting funds' portfolio,[66] the dollar value of long and short positions in each asset class,[67] the value of turnover by asset class,[68] the market value of each of the advised funds' borrowings, the types of their creditors,[69] and the aggregate value of all derivative positions for each advised fund.[70] Finally, Form PF requires disclosure, if applicable, of the reporting funds' restrictions on investor withdrawals and redemptions,[71] and other information pertinent to investor liquidity, such as the percentage of NAV.[72]

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[57] *Supra* note 52; *Form ADV*, part 1A (Item 8.A).
[58] *Form ADV*, part 1A (Item 6.A).
[59] *Form ADV*, part 1A (Item 6.B).
[60] *Id.*
[61] *Supra* note 51.
[62] *Form ADV*, part 1A (Items 8.D, 8.F).
[63] *Form ADV*, part 1A (Item 8.G).
[64] *Form ADV*, part 1A (Items 8.H–I).
[65] U.S. Sec. & Exch. Comm'n, OMB NO. 3235-0679, Form PF, Reporting Form for Investment Advisers to Private Funds and Certain Commodity Pool Operations and Commodity Trading Advisors (2014) [hereinafter "Form PF"], http://www.sec.gov/about/forms/formpf.pdf.
[66] *Form PF*, section 2b (Item B.32).
[67] *Form PF*, section 2a (Item B.26); *Form PF*, section 2b (Item B.30).
[68] *Form PF*, section 2a (Item B.27).
[69] *Form PF*, section 2d (Item D.43).
[70] *Form PF*, section 2d (Item D.44).
[71] *Form PF*, section 2d (Item D.49).
[72] *Form PF*, section 2d (Item D.50).

Form PF demonstrates a differentiated regulatory mechanism by posing different reporting requirements based on the features of different types of private funds. Form PF has four sections: section 1 requires basic information about private funds and all Form PF filers are obligated to fill in; section 2 requires aggregate information about hedge funds and only large hedge fund advisers are obligated to fill in; sections 3 require aggregate information about liquidity funds; and section 4 requires aggregate information about private equity funds.

The SEC adopted a tiered approach intended to reflect the relative risks of each type of fund.[73] Large hedge fund advisers must update their Form PF filings quarterly.[74] In contrast, private fund advisers with less than $1.5 billion RAUM attributable to private funds file Form PF on an annual basis.[75] Larger hedge fund advisers, that must file quarterly, face substantially higher compliance costs—both for their initial data reporting and for subsequent quarterly filings. This reflects SEC's concerns over the risks associated with hedge funds. Hedge funds and liquidity funds receive extra scrutiny from regulatory authorities based on the characteristics of their assets and investment strategies. In contrast, the managers of venture capital funds are exempt from reporting, reflecting the overall concept of the Form PF reporting system, which distinguishes between different types of private funds based on the overarching goal of preventing systemic risks.

As a brief summary, with the adoption of stringent information disclosure requirements, SEC gained a better understanding of private fund industry practices and noticed some major problems in fund operation, particularly conflicts of interest, which required regulatory intervention. This observation underscores the challenge faced by even qualified investors in adequately safeguarding their interests within the intricacies of private fund investments. The post-financial crisis regulation under Dodd-Frank has become differentiated to prevent systemic risk, but the purposes of differentiation go beyond. Classification and categorization allow for a more efficient and refined regulatory regime based on the identification of asset types and investment strategies of different types of private funds. Instead of setting general rules for all private funds, regulators can differentiate and impose stricter regulatory requirements on certain types of private funds, while providing preferential policies for others based on their features.

C. Legislative Implication with Reference to the U.S. Legislative Framework

According to the above analysis, the primary focus of the U.S. framework is to mitigate systemic risk. This purpose is met by imposing differentiated

[73] Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Release No. 3308, 76 Fed. Reg. 71128, 71136 (Nov. 16, 2011).

[74] *Form PF* (Instruction 9) (You [large hedge fund advisers] must file a quarterly update that updates the answers to all Items in this Form PF relating to the hedge funds that you advise.)

[75] *Id.*

regulation on different types of investment funds, both to the investors and the authorities, based on their corresponding risks and features. Granted, the market practice in China is different from that of the U.S. This means that China should not adopt such approach without modification. Consequently, China should not adopt the U.S. approach wholesale but modify it to align with its unique circumstances. Nevertheless, the Chinese government could draw upon the regulatory ideology from the U.S. and develop a framework that is most suitable for the Chinese market.

Investigating the private fund industry in China, as of April 30, 2023, there were more than 22,270 registered private fund managers, managing approximately 154,000 fund products, with a scale exceeding RMB 20.75 trillion.[76] Turing to the U.S. market, according to the SEC, in the first quarter of 2023, there were 3,791 registered private fund advisers, managing 47,431 fund products, with a total gross asset value of approximately USD 20.48 trillion.[77] Despite the potential differences in statistical methodology, it is evident that the number of private equity funds and managers in China far exceeds that of the United States. However, the total asset value is significantly lower, indicating that China has a larger number of private equity funds that are not as formidable, with generally smaller average sizes.

In light of this, the primary focus of the current regulatory landscape is to promote a fair market. Systemic risk prevention is not the main target of regulators under the current framework. This approach aligns with the development of China's private funds market, which is not fully standardized, and is smaller and more fragmented compared to that of the U.S. Also, the private fund industry is basically isolated from the banking industry, preventing commercial banks from engaging in direct private fund investments. This means that the regulators should consider the current market development in China, instead of merely replicating the U.S. approach. Frankly, systemic risk prevention is not the foremost priority in China's private fund market. Nonetheless, the "differentiated regulation" and the "stringent information disclosure" under the U.S. framework provide valuable insights and can be used as reference to enhance investor protection and promote a fair, market-based capital market. For instance, as embodied in the Regulation, the enhanced registration and disclosure requirements can bolster investor protection and prohibit illegal operations, such as misrepresentation and insider trading.

To further improve the current regulatory framework, this article supports the differentiated approach to strike a better balance between investor protection and the flexibility of fund management. As mentioned above, there is no explicit classification of private equity funds at the regulatory level. In practice, the classification does not involve any differences in regulatory measures. While investor suitability and private fundraising do apply uniformly to all types of private funds, the risks associated with different investment

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76 *Supra* note 6.

77 U.S. Sec. & Exch. Comm'n, *Private Funds Statistics: First Calendar Quarter 2023*, 4 (Oct. 16, 2023), https://www.sec.gov/files/investment/private-funds-statistics-2023-q1.pdf.

strategies and targets vary from one another. For instance, the fund managers of private securities funds have higher potential to engage in insider-trading; the fund managers of private equity funds encounter significant conflicts of interest during valuation and the fund exit process. Imposing a uniform standard for all kinds of private funds would decrease investor protection efficiency and increase the compliance costs of private funds. Regulators should consider the differentiated approach, tailoring the compliance requirements based on the risks and features of different types of private funds to avoid excessive supervision.

Furthermore, this article advocates the protection of VC investors while implementing preferential policies for VC funds. The U.S. framework suggests the difficulties for qualified investors to protect themselves in certain investment activities. For VC funds, due to significant information asymmetries, the conflict of interests between fund managers and investors becomes severe, thus demanding regulatory intervention through registration and information disclosure. Despite VC fund's positive impact to promote the development of new industry, authorities should recognize and be aware of the inherent conflicts of interest, along with the potential threats to investors' interests and market fairness. This involves refining and implementing information disclosure requirements for fund managers, improving fund governance to enhance alignment of interest, and safeguarding the legitimate rights and interests of fund investors.

V. CONCLUSION

The implementation of Private Investment Funds Regulation marks a significant stride toward establishing a fair and market-based capital market. This regulation encompasses comprehensive protection throughout the fundraising, investment, management, and exit stages, embodying an "all-round protection" framework. Notably, the Regulation strengthens the registration and disclosure requirements for fund managers, and also, clarifies the consequences for the violation of their legal obligations, protecting investors from both *ex-ante* and *post-ante* perspectives. On top of this, the inclusion of a special chapter for VC funds demonstrates the efforts of the authority to explore a differentiated approach to private fund regulatory framework.

However, excluding VC funds, the Regulation maintains uniform regulatory requirements to other types of private funds. Indeed, there are common characteristics among private funds. Most of these funds target high-risk investments, emphasizing the qualified investor requirements and non-public offerings during capital raising, striking a balance between investment risk and information disclosure. However, as the market continue to evolve and economic potential is further unfolded, distinctions between different types of private equity funds will become more and more apparent. Certain private funds employ investment strategies with negative externalities, risking market disruption while yielding high returns. Conversely, some contribute to optimizing social resource allocation and job creation but are susceptible to unique conflicts of interest and moral hazards. Thus, recognizing different private fund types and implementing differentiated regulation holds long-term and critical policy value. Private funds could be positioned as the driving force behind the economic, capital, and innovative development of our market.