

Research on the Risk Causes of Private Equity Fund in China -- Take the Fuxing Incident as an Example

Xinye Wei*

The University of California Davis

*Corresponding author: xywei@ucdavis.edu

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Abstract: Since the emergence of private equity funds in China, they have had a very positive impact on China's social and economic development. The advantage of this financial model is that the investment objectives of private equity funds are more targeted, the investment is more flexible, and the returns are high, which can meet the investment requirements of more people. Therefore, private equity funds can promote the future development of the national economy. In recent years, high-net-worth individuals have become more and more interested in investment and financial management, which has also brought unprecedented attention to investment and financial management with professionalism and flexibility. This article first introduces the development status of private equity funds and analyzes the causes of risks and future improvement directions of private equity funds in China through the "Fuxing" incident.

1. Introduction

Standing on the intersection of "two" one hundred goal of history, along with The 14th Five-Year Plan, China's top priority is innovation drive private equity funds as an important tool of direct financing, innovation as the main carrier of capital formation, in carry out the new development concept, to speed up the building the new development pattern, At the same time, it is still a long way to go to promote the industry to further practice the concept of responsible investment and value investment to achieve high-quality development [2].

At resent, the development status of Private equity funds in China is as follows:

1.1 The overall scale is presenting an upward trend.

Although the growth rate of private equity fund in China is still very slow, it still shows an upward trend on the whole. Despite the epidemic, the overall management scale of the industry still keeps growing. By the end of 2020, the number of private equity fund managers registered with the association reached 14,986, up 0.7% year on year. 39,800 private equity investment funds have been recorded, with a scale of 11.562043 billion yuan, up 9.18% and 14.7% respectively. The number of private equity fund managers with a management scale of more than 100 million yuan continues to increase.

1.2 The regulatory self-discipline environment is improving day by day, promoting the development of industry standards

Currently, China adopts the "7+2" self-discipline system to promote the development of Chinese private equity industry. Among them, "7" represents seven self-discipline management measures, which regulate the seven aspects such as: fundraising, registration and filing, information disclosure, investment advisory business, custody business, outsourcing service management, and qualification management. "2" represents two guidelines, including guidelines on internal control and fund contracts. In addition, the private equity industry continues to face new challenges in the development process, and relevant government departments continue to introduce new policies to deal with this situation, making Chinese private equity industry more standardized. For example, starting from February 7, 2020, the China Securities Investment Fund Industry Association will try to adopt the "channel

separation system + spot check system" method for private equity fund product filings for private equity fund managers with continuous compliance operations and good credit status; the 13th session The 15th meeting of the Standing Committee of the National People's Congress deliberated and passed the revised "Securities Law of the People's Republic of China", which will come into force on March 1, 2020; on January 8, 2021, the China Securities Regulatory Commission issued the "Regarding Strengthening the Supervision of Private Investment Funds" "Some Provisions of the People's Republic of China" etc.

1.3 Industry concentration has further improved

By the end of 2020, among the private equity fund managers with funds under management, the top 10 managers with the largest management scale account for 8.47% of the total fund size under management, which is equivalent to the sum of 8.61% of the total fund size under the management of 12,175 managers with the overall fund size under the management of 500 million. The number of managers with a management scale of more than 1 billion yuan accounts for 14.07% of the total industry scale, and the scale of funds under management accounts for 85.22% of the total industry scale, that is, the top 15% of managers under management scale are in charge of more than 85% of the fund scale., the industry began to split from the 20% with 80% to the 10% with 90% [3].

1.4 Diversified investment target, the strategic emerging industry investment increase obviously

The distribution of investment objects of private equity fund in China is relatively various, including secondary market products of securities, unlisted enterprises, entrepreneurial enterprises, cultural industry, etc. According to the classification of investment objects, China's private equity funds can be divided into private securities, private equity, entrepreneurship, investment in other direction of private equity funds and other four categories. Affected by the epidemic domestic and abroad and the national need for high-tech industries, "new infrastructure" and online related industries have broad investment opportunities. The trend of early investment, small investment and technology investment continues, and investment in strategic new industries has significantly increased. By the end of 2020, among the top 10 industries in terms of investment capital, The semiconductor, pharmaceutical and biological industries and medical device and service industries saw the highest year-on-year growth, with 39.32%, 27.85% and 21.69%, respectively.

2. Overview of "Fuxing" incident

Shanghai Fuxing Industrial Group Co., LTD. (hereinafter referred to as Fuxing Group) was established in 2011 with a registered capital of 2.3 billion yuan. Zhu Yidong holds 70% of the shares and is the actual controller. It is a large private group integrating commercial real estate, asset management, finance, rare metals, health care, trade and culture, and media, with nearly 100 subsidiaries and 3,800 employees. The group focuses on the development strategy of the city circle, with its business scope covering Beijing, Shanghai, Shenzhen, Nanjing, Ningbo, Hangzhou, Qingdao, and Changchun as the core, radiating to north China, East China, South China, northeast China, and Shenzhen-Hong Kong region. In 2017, the group's total assets under management exceeded 35 billion yuan and its total trade exceeded 30 billion yuan.

Fuxing Group is mainly associated with Shanghai Xishang Investment Management Co., LTD., Shanghai Yilong Wealth Investment Management Co., LTD., Shanghai Yutai Investment Management Co., Ltd., and other three companies with private fund licenses. By July 2018, the website of the Asset Management Association of China disclosed that the three companies had issued a total of hundreds of private fund products, involving about 50 projects. The involved custodians include nearly 10 financial institutions, including Ping An Bank, China Everbright Bank, Bank of Shanghai, Guosen Securities, China Merchants Bank, HSBC, Pudong Development Bank, and Zheshang Bank. On January 29, 2018, CCTV exposed That Zhu Yidong manipulated the share price of Dalian Electric Porcelain controlled by his father Zhu Guancheng, making illegal profits of more than 600 million yuan, which was punished by the CSRC. At the same time, in July 2018, Fuxing Group failed to pay

several private equity fund products due, which triggered the "Fuxing system" runaway explosion event, more than 8,000 investors in private equity funds suffered deeply.

Since 2012, Fuxing Group, without profitability, has promised fixed income through related enterprise guarantee and liquidity support, packaged and issued limited partnership and creditor's rights financial products and private fund products, and raised funds from the unspecified public [5]. Most of the money raised was used to repay the principal and interest of maturing products, pay sales commissions, personal spendthrift, and commit securities market manipulation crimes. Fu Xing's private equity fund is a "Ponzi scheme + self-financing" capital operation tricks. The core of the Ponzi scheme is "promise high interest, borrow new to repay old"; However, self-financing means "raising funds by oneself and using them by oneself".

3. The Cause of Risk of Private Equity Fund in China from "Fuxing" Event

3.1 Information disclosure supervision is insufficient to adapt to the development situation

From the regulatory body, "interim measures for the supervision and administration of private equity fund" for the priority for private equity fund supervision laws and regulations without clear instructions, combined with the existing regulatory approach is not abolished, caused multiple regulators on the same funds to have regulatory responsibilities, constraints between different laws and regulations of the direction and scope makes private equity fund managers have to repeat, Reduce information disclosure efficiency. In addition, multi supervision is also easy to cause regulatory gaps, different regulatory bodies shirk, leaving opportunities for private fund managers to exploit loopholes [1].

In addition, the practice of information disclosure lacks effectiveness. CSRC's supervision of information disclosure is a mere formality, and the authenticity of information disclosure cannot be guaranteed. Different private equity's official website of qualified investors, for example, questionnaire content format is almost uniform, no particular in terms of risk evaluation to the risk rating of investment by private equity, investment deadline set different questionnaire and variety characteristics, a full set of procedures are performed by the web application, the lack of artificial information check, giving the results of the reliability of doubt. In addition, the Management Measures for Information Disclosure of Private Investment Funds (Draft for Comments) stipulates that "best" and "largest" shall not appear in the performance disclosure of private funds, but there are still many private funds to induce investors through performance forecasts and payment promises on their websites.

Therefore, how to improve the information disclosure system and make private fund managers complete and faithfully implement the information disclosure system is a problem that the regulatory authorities need to think deeply, and also an obstacle to the far-reaching and healthy development of private funds in China [6].

3.2 Investor risk management consciousness is weak, lack investor education

Private equity investment has the characteristics of high return and high risk, so it requires higher risk identification ability and risks tolerance ability of investors. Early "Fuxing Group" actual controller "directed" Dalian porcelain stock price manipulation event exposure, market investors did not learn from the "lessons of the past", and finally suffered "Fuxing" loss. At the current stage, when investors choose to invest in private funds, due to their lack of basic investment knowledge, in most cases they will choose the subjective evaluation and recommendation of private fund managers as the decision-making reference standard. However, to pursue the maximization of their interests, The subjective recommendations made by private fund managers may not match the risk tolerance of investors themselves. However, due to the weakness of investors' risk management consciousness, it is often difficult to make rational judgments and timely stop losses, and it is easy to be blinded by the gimmicks of some products and fall into the trap of illegal private placement [4].

In addition to investors' initiative to learn and understand investment-related knowledge, investor education activities are also a shot in the arm to protect investors' legitimate rights and interests.

Education activities are carried out to further help investors correctly understand the essence of investment activities, to more intuitively guide investors to strengthen personal risk awareness, improve self-protection ability, and invest prudently under a more rational premise. However, among the public information disclosed by some functional institutions such as The Bank of China Association, there is little content about "investor education activities". There is no description of investor education content in the information announcement documents of some investment products, so it is urgent to promote "investor education activities".

3.3 There are defects in trusteeship law and the scope of application of the subject is vague

There are serious loopholes in the custody of private equity funds in China. On the one hand, China's Fund Law arranges that fund managers and fund trustees perform the fiduciary duties, but the fiduciary duties here are not joint fiduciary duties. As a fund trustee, the bank and the fund manager jointly accept the entrustment of investors, but perform their respective duties. In other words, there are only two cases where the custodian bank needs to assume the fiduciary responsibility, one is when the custodian bank itself has problems in the custody of funds, and the other is when the custodian bank and the fund manager jointly have improper behaviors. As a result, the custodian bank can easily be absolved of responsibility for any problems that arise in the private equity fund's investments, rather than in the custodian bank. On the other hand, the scope of application of different normative documents and self-regulatory management rules varies [11]. Fund law and the interim measures for the inconsistent definition of host range, although the "interim measures" based on the fund law, expand the use of main body, clear private equity funds, but the majority of private equity fund managers, the trustee, and investors in still set based on the fund, the fund contract. In addition, the Interim Measures is a lower law of the Fund Law, so the interim measures are not effective for private equity funds.

3.4 Laws and regulations mechanism is not completely , the fund management lack of transmission chain for verification

At present, financial supervision cannot keep up with financial innovation, and relevant laws and regulations are not sound. Under the background of the wild growth of private equity funds, the supervision scope and intensity of the relevant regulatory departments and industry self-regulatory organizations are difficult to form a normative restraint mechanism for new financial institutions. The definition of private equity fund is not clear in the regulatory regulations, especially private equity funds are not included in the scope of application of fund subjects in the Fund Law. The lack of regulatory regulations directly allows the BANK of China Association and China Basic Research Association to shirk their responsibilities [16].

From the perspective of capital chain supervision, custodian banks lack the right of follow-up fund management verification for funds transferred to investment project accounts. Although responsibility supervision and fund custodian bank closed loop management, however, once the funds drawn from the escrow account, and loss of control of the fund's assets custodian bank, which funds by multi-layer nested products and associated accounts flow to the mound hing group of the actual control of process, is not within the scope of the escrow bank supervision and check of power. In particular, if the fund manager intends to conceal the authenticity of the investment project, the custodian bank can be easily deceived even if it has the relevant documents submitted by the private equity fund company. Therefore, it remains to be discussed whether the custodian bank directly undertakes the responsibility of refinancing investors. In addition, although China Securities Regulatory Commission (CSRC) and Asset Management Association of China is a self-regulatory association require fund companies and custodian banks to disclose true fund operations, they do not explicitly require disclosure of long-term fund management and the ultimate flow of funds [7]. The supervision department's verification of the authenticity of investment projects is far from being in place, especially the supervision of multiple nested investment products and related investment is far from being enough [9][10].

4. The future improvement direction of China's private equity fund from the "Fuxing" event

4.1 Strengthen the information disclosure regulation, reduce the risk of asymmetric

Formulating a comprehensive information disclosure system for private equity funds, strengthening the contents and ways of disclosure by private equity fund managers to investors, and protecting investors' right to know can protect investors' legitimate rights and interests to a certain extent. One is, we should clear the content of the disclosure of information, such as frequency, mode, and channel matters, including fund investors investment, assets, and liabilities, income distribution, the potential of conflicts of interest, affect the interests of the investors and other major matters, such as disclosure way mainly adopts closed-door way or by private equity funds to disclose backup system is disclosed. The second is to clarify the prohibited behavior of information disclosure, including non-public disclosure or disguised public disclosure, no false records, misleading statements or material omissions, no prediction of investment performance, no illegal promise of earnings, etc. Third, the management of documents and materials related to information disclosure should be specified. The manager shall properly keep relevant information and materials disclosed to investors during the whole life cycle of the private equity fund. Fourth, information disclosure management departments, processes, emergency plans, and accountability mechanisms should be clarified. Once there is a problem with the fund, the emergency mechanism, and accountability mechanism will be immediately activated. The risk control compliance department will immediately investigate the relevant responsible persons and punish them according to the corresponding violations [15].

4.2 Consolidate risk prevention and control publicity and education, standardize investors' investment behavior

The industry supervision department and private fund investors should jointly bear the supervision responsibility for the illegal behaviors of private fund managers promoting private products to unspecified investors in public or disguised form. As an industry supervision department, it is difficult to conduct comprehensive supervision in the face of large and complicated private equity institutions and enterprises, but supervision is the necessary basis for the normative operation of the industry. Therefore, before making investment decisions, investors should carefully consider the legality and compliance of relevant private equity products if they encounter sales staff of private equity institutions promoting private equity products in public or disguised public ways, and report the situation to CSRC and other industry regulatory authorities when necessary [8]. The CSRC and other industry regulators also need to strengthen the risk education of private fund investors. As to avoid some investors falling into the scam without knowing it from the beginning because they are not familiar with private fund management regulations [13].

4.3 Clarify the regulations for the main body, clear elaboration custodian Banks

To solve the fundamental problem of private equity fund trusteeship, first of all, the Fund Law needs to bring private equity funds into the scope of application. The subjects of application of the Fund Law and the Interim Measures need to be unified. The Law of the Securities Investment Fund only applies to pooled investment activities facing the securities market, directly excluding private equity funds, resulting in the private equity fund contracts based on the Law of the Securities Investment Fund becoming meaningless. In the future, the Securities Investment Fund Law shall be renamed as The Investor Fund Law when the private equity fund reaches a certain scale, to include the private equity fund in the scope of application and unify it with the subject of the application of the Interim Measures, to truly become the basic law of the fund industry.

Secondly, from the custodian Banks, custodian Banks full guarantee of private equity funds and indeed without reason, but according to the supervision and fund custodian bank operation situation report content and format guidelines (trial) ", the fund custody department has the responsibility to supervise the fund investment operation, once the fund operation problems, if not promptly reported or not clear in time fund managers real capital operation situation, Joe Tube bank also should depend on the circumstance to bear a certain proportion to investor compensation liability. Therefore, on the

one hand, when the custodian bank signs the contract with the private equity fund company, it should classify the default situations of different degrees and clarify the custodian bank's custodian responsibilities to avoid shirking the responsibility afterward. On the other hand, CSRC should determine the compensation proportion that custodian banks should bear according to the actual responsibilities borne by private equity funds.

4.4 Improve the mechanism of laws and regulations, implement capital chain transmission regulation

On the whole, the most important thing for the healthy development of private equity funds is to improve the legal and regulatory mechanisms. Based on the international experience, the UK realizes the supervision of private equity funds through the Association of Private Equity Funds. Among them, the Association mainly formulates the Guidelines on Private Equity Investment Information Disclosure and Transparency to strictly require fund managers to disclose information, so as to regulate private equity funds. While Hong Kong, China, implements a strict access system for private equity funds, focusing more on risk prevention and control at the source. China can learn from the experience of Britain and Hong Kong, improve the access system of private equity funds, put forward requirements on the management experience and ability of private equity fund managers, strengthen the supervision rules of information disclosure, improve the legal and regulatory mechanism, and reduce the risk of private equity funds from the source [12][14].

In addition, from the perspective of regulators, we should improve the penetrating supervision of private equity fund capital chain management, and realize the real supervision of the source and destination of funds up and down. It is necessary not only to carry out penetrating verification on the intermediate nested links of underlying assets and capital, but also to consider the risks that the final risk-return bearers can bear, and judge whether there is an asset class mismatch, especially to prevent the public offering of private equity products.

5. Conclusion and Future Expectation

As an emerging professional financial product, private equity fund is not only an important investment target for professional investors but also an important industry for the government to develop the financial market, as well as an increasingly important financing source for the development of enterprises, which is conducive to promoting the continuous innovation and development of enterprises. Under the current policy environment where innovation is the primary task, private equity funds can effectively drive enterprises through difficult times and help them develop rapidly. Meanwhile, they are also the concentrated embodiment of improving the allocation efficiency of social advantage resources, thus indirectly promoting the high-quality development of the national economy [18]. As a powerful financial tool to directly promote the development of corporate financing and an important driver to indirectly promote economic development, the healthy development of private equity funds is extremely important. Promoting the rapid development of the industry is the focus of current attention, and risk management still needs to be improved with great efforts.

Based on the current situation of private equity funds, this paper focuses on the cause of its risk through the "Fuxing" event and puts forward the improvement direction of private equity funds in the future. Private equity funds need to establish a comprehensive and effective risk control system including policy risk control mechanism, the institution itself internal control risk control mechanism, and the process of investment risk control mechanism, regulators also need to form a complete set of policies, improve the overall risk control system, minimize the investment risk, safeguard private equity fund long-term, stable, healthy and orderly development.

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