

Research on Problems of Private Equity Fund in China——Take the Fuxing Incident as an example

Muqian Gao^{1, *, †}, Xinzhe Peng^{2, †}, Yingxi Zhang^{3, †}

¹Mudanjiang No.1 Senior Heigh School

²Shenzhen Foreign Languages School

³Beijing 21st Century International School

*Corresponding author: gmq0413@outlook.com

†These authors contributed equally.

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Abstract: With continuous development and progression of multi-level capital market in China, private equity fund, as a new investment method, is becoming increasingly important for supporting the development and innovation of Chinese industry. Despite that private equity fund has been a vital role to the Chinese economy, Fuxing cashing crisis revealed the flaws existed in Chinese private equity fund. With the description and analyzation of Fuxing cashing crisis, this article presents the problem that lies in Chinese private equity fund and potential improvement in private equity fund policies.

1. Introduction

The concept of private equity fund originates in United States in mid-20th century. After decades of development, private equity fund had been transformed from a severely unregulated investing method to a popular and regulated form of investment. Although the global market of private equity fund had been relatively mature for years in 20th century, Chinese private equity fund was not set up until late 1980s. Due to the incomplete reform of ownership, overregulation of government, inefficient funding management and ineffective policies, investment fund in China suffered from disordered regulation and almost ceased developing [1].

Even though in 2012, the amendment of Securities Investment Fund Law, which initially aimed to regulate public equity fund, began to include private equity funding as a separate chapter, Chinese government still failed to draw a clear regulation boundary between private equity fund and other investment methods. The problem of identifying responsibility and ineffective regulation still existed.

For the long-term development of private equity fund, it is crucial for Chinese government to set the boundary and issue a matched regulation to private equity fund. In China, private security investment fund mainly invests in negotiable securities within the scope permitted by policies, while private equity investment funds mainly invest in unlisted companies or non-publicly raised shares of listed companies. Enterprises have various financing needs in all stages of their growth. Enterprises can directly enter the public market to issue securities. On the other hand, enterprises can also obtain the required financial support from the private market. Venture capital funds for venture enterprises and M&A investment funds suitable for the mature stage of development can be classified into private equity investment funds in a broad sense. One of the most important characteristics of private equity funds is that they do not invest directly in any publicly issued equities; at the same time, private equity investment is not the same as industrial equity investment, it seeks to achieve financial capital appreciation through equity management within a limited period of equity investment and ultimately profit through exit investment. Therefore, private equity

investment fund and private equity securities investment fund have the same non-public nature, but also have their own uniqueness. The use of the same set of legal norms will easily lead to unclear rights and responsibilities as well as disordered regulation [2].

With domestic investors and investment institutions' increasing attention to private equity fund, Chinese private equity funds are also increasingly engaged in venture investment activities of emerging new fields [3]. It is not until 2015 that the Department of Private Equity Fund introduced departmental regulations and self-regulatory measures in the private investment industry, which opened a new page for the standardized development of private equity investment market. Problems, however, are generated due to the sheer development private equity fund. This article, based on the analyzation of Fuxing payment crisis, discusses about the problems exist in Chinese private equity fund and proposes advice to the formulation of regulation policies [4].

2. Overview of "Fuxing system" event

Shanghai Fuxing Industrial Group Co., Ltd. (hereinafter referred to as "Fuxing Group") is a private company. The group's business covers a wide range of fields, including finance, real estate, metals, medical treatment, culture and so on. Zhu Yidong, chairman and actual controller of Shanghai Fuxing Industrial Group Co., Ltd., was born in 1981 and inherited the family business Dalian electric porcelain from his father Zhu Guancheng. However, Zhu Yidong unintentional industry has long been committed to establishing the "Fuxing system" capital empire. According to the statistics of the "tianyancha" enterprise credit query platform, the layout of "Fuxing Group" is complex, and its affiliated companies are mainly investment companies and asset management companies, including real estate, education technology, medical equipment and other companies, as the primary subsidiaries of important connection points. There are often about 10 limited partnerships under it, and the relationship layout is nested layer by layer. In June 2018, Zhu Yidong lost contact and fled overseas, and the cashing crisis of "Fuxing series" related private placement products began to occur frequently; In September 2018, Zhu Yidong was arrested overseas, and the "Fuxing Department" executives were arrested successively. The details of the case behind the "mine explosion incident" began to surface gradually [5].

3. Analysis On the risk of private equity funds in China from the "Fuxing system" incident

(1) Advertisement of public equity funds and low risk-tolerance of investors

From the perspective of legislation and public perception, private equity funds have the investment characteristics of "high barriers to entry." In recent years, the regulation of private equity fund has been difficult for the government, which leads to the chaos in the private fund investing environment. Some private equity fund managers are doing "illegal fundraising" under the banner of "private equity." Taking the "Fuxing System" as an example, some private equity fund sales personnel promote personal equity products to unspecified targets without a qualified investor confirmation procedure. The "appointment evaluation" and "online consultation" columns on the websites of some of its private equity fund companies do not have the necessary preliminary confirmation procedures, such as questionnaires for qualified investors. Those who do not need to go through the preliminary review procedures, such as the qualified investor questionnaire, can obtain access rights of the product promotion materials that some private equity fund companies published on the official website or WeChat public account

The behavior of the "Fuxing System" private equity institutions to promote private equity products to unspecified targets indirectly led to the "Fuxing System" incident. After the actual controller of the "Fuxing System", Zhu Yidong, fled overseas, more than 8,000 investors were expected to be involved in the incident. The principal and interest of the investment are as high as 18 billion RMB. Most of the investors are from middle-class families and do not have the risk-bearing ability that matches with their investment amount.

The relevant laws of private equity funds stipulate that private equity fund sales agencies and managers shall not use public media or telephone, SMS, WeChat, or other communication methods to promote private equity products to unspecified targets without confirming qualified investors. The significance of the regulations is to reduce a series of problems caused by investors' inadequate risk-bearing ability during the fundraising stage. However, it is because of the "non-public offering" nature of private equity funds that the difficulty of supervision of private equity funds during the fundraising stage has dramatically increased.[6]

(2) Commitment to guaranteed capital gains and inducing investors to invest blindly

Private equity funds cannot promise investors to preserve capital and return. Many private equity funds in China have alluring propaganda behaviors that guarantee capital and return at the fundraising stage. In "Fuxing incident", design phase of the private equity fund product and most of the product promotion documents contained a large number of guarantee letters, liquidity support letters, share repurchases, and other disguised promises to guarantee capital and income.

The main guarantee promises were "Fuxing Group" and its affiliated companies.[7] The carrier forms of guarantee include independent documents, contract attachments, clauses, and even issuing customized guarantee letters to individual investors directly according to their particular requirements.

In the product promotion link, most of the products under the "Fuxing System" have inductive publicity behaviors, for example:

① Institutional sales staff promise investors not to lose the investment principal and promise the lowest return through WeChat and verbal promises

② On the official website and WeChat public account, publicly publish inductive propaganda texts about fund products pay in full on schedule.

The private equity fund's capital-guaranteed behavior reflected in the "Fuxing System" incident is the epitome of private fund industries' fraudulent advertisement which means the promise of capital-guaranteed revenue at the publicity level and the use of affiliated companies to guarantee revenue. Although there were previous cases where investors resorted to court after a particular private equity fund similar to "Fuxing System", the court ruled that the private equity fund manager's commitment to guarantee capital gains was practical and protected the rights and interests of investors. In recent years, with the improvement of regulatory regulations methods and strengths, it can see that the violation of the capital preservation and income commitment will inevitably follow the principle of "buyer conceit" and better safeguard the development of the capital market in the long term.

(3) fundraising fraud, illegal embezzlement, and misappropriation of fund property

According to the judicial appraisal verification issued by Lixin Certified Public Accountants, 160 fund products under the "Fuxing System" raised a total of 36.845 billion RMB. Lixin Certified Public Accountants verified and analyzed the capital flow of 36.797 billion yuan: the amount of the capital flow that is used for payment of principal and interest reached 15.670 billion RMB, the amount occupied by related companies and individuals reached 4.42 billion RMB, and the amount used for asset or equity purchases reached 3.644 billion RMB. The assets and equity purchased were not the investment targets agreed upon when "Fuxing system" fundraises. Only small amount of funds remains in the account [Data source: Wind.].

Except for the surplus remaining in the fundraising account and the company's account of the investment target, the remaining raised funds are not used according to the agreed purpose, which constitutes embezzlement and misappropriation of fund property, accounting for more than 95% of the total raised funds. Among them, most of the funds are transferred to the fund pool account controlled by the "Fuxing System" through multiple routes after being transferred to the investment account, which seriously violates the "Interim Measures for the Supervision and Management of Private Investment Funds" and belongs to illegal industry operations.[8]

After the "Fuxing System" incident occurred in 2018, with the continuous in-depth investigations by the China Securities Regulatory Commission and other relevant departments, the fund pool account controlled by the "Fuxing System" was exposed; long-term, massive capital misappropriation and embezzlement behavior also reflects a more serious violation and embezzlement problem.

Although "deception" behavior of fund managers may restrict the effectiveness of supervision by the China Securities Investment Fund Association or other regulatory authorities to a certain extent, the slack supervision of regulatory agencies is partially responsible for the "Fuxing" incident.

The "Fund Law" and the "Securities Law" stipulate that the China Foundation Association, the China Securities Regulatory Commission, and other regulatory agencies are responsible for overseeing the authenticity of the management and operation of fund companies. Nevertheless, the regulatory authorities are far from verifying the authenticity of investment projects. The more prominent phenomena include:

- ① Multi-layer nesting of investment products;
- ② Major related transactions;
- ③ Constraints on the risk of capital flow after being transferred to the account Inability to wait.

Regarding the core investment management link of private equity funds, none of the four private equity institutions under the "Fuxing System" have corresponding department settings. Furthermore, they do not hire professionals responsible for project selection, due diligence, flow tracking, return, and other specific tasks in the investment process.

The actual investment management functions wholly concentrate on Zhu Yidong, Zhao Zhuoquan, and other core personnel of the "Fuxing System," which seriously violated the "Interim Measures for the Supervision and Management of Private Investment Funds" on the professional management requirements of private equity fund managers. The serious virtualization of the investment management functions of private equity fund managers makes it difficult to guarantee the exclusive use of the funds raised. To a certain extent, it also provides convenience for the actual controller of the "Fuxing System" to control the fund pool account.[9]

- (4) Custody responsibilities are not clear, and investors' rights and interests are not protected

At present, our country's private equity funds lack exceptional legal support. They only use the self-regulatory management rules "Fund Law" and the departmental regulatory document "Interim Measures for the Supervision of Private Equity Funds" as the guiding documents. There are also other severe defects, which directly led to disputes over the trusteeship responsibilities of the "Fuxing System": After "Fuxing System" incident, the Asset Management Association of China believes that under the circumstances that fund managers cannot typically perform their duties, the custodian bank is required to perform the joint fiduciary duties effectively, convene a meeting of fund unit holders, and preserve the fund's property. However, the China Banking Association refused to establish an emergency response mechanism using "the 'Fund Law' only applies to public funds and private equity funds" as an excuse, failing to protect investors' rights and interests promptly [10].

4. Conclusion

With the gradual development of domestic private equity, the share of private equity funds in the capital market in China is getting higher and higher. Still, the problems exposed are also gradually increasing. This paper takes the "Fuxing system" private equity fund as the research object, analyzes the development scale and current situation of private equity funds in China, further examines the problems of private equity funds in the development process in China, and conducts a preliminary exploration of the path for the existing issues, and draws the following conclusions.

First, private equity products advertise publicly and widely, yet investors do not have the corresponding risk-bearing ability.

Second, contrary to the rules of the promise of capital preservation income, to induce investors to invest in protecting the capital and income blindly

Third, China's private equity funds suspected of capital-raising fraud, illegal appropriation, and misappropriation of fund assets

Fourth, the trusteeship responsibilities of private equity fund managers in China are unclear, making it impossible to protect investors' rights and interests on time.

Because of the positive role of private equity funds in promoting economic development, it is of great practical significance to analyze the problems of private equity funds in combination with financial theories and the actual situation in China. Even though the primary conditions for developing private equity funds in China are already in place, further promoting the product, form, and improvement into a complete system is still an issue to be discussed. The external environment and its senior constraints; the capital market system is imperfect; the relevant departments are not in place to regulate it. The imperfection of the financing structure and other factors have restricted the development process of private equity funds in China.

This paper analyzes the risks of private equity funds with practical examples, but there are still shortcomings; the development of private equity funds in China is not mature and perfect. There is a lack of data support, so there is no evidence for further research and discussion. The detailed management plan of the relevant departments for this emerging system is not perfect, which leads to the author's regulatory evaluation study of the relevant events.

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