

Private law and public regulation for investor protection in the asset management industry: aims and practices of transposing the UK model in China

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Abstract

The paper discusses how asset managers are regulated in the UK in order to provide investor protection and market confidence. Fiduciary duties and the duty of care in the English common law, statutory laws, the rules of the FCA, and other industry codes are examined to provide an explanation of the UK regulatory approach to the asset management industry. The paper then discusses the extent to which a legal transplant of the UK model to China may be feasible as the asset management industry is currently being reformed in China. Recommendations are made for China to develop an independent asset management industry, to provide more investment outlets for investors, and to have effective enforcement mechanisms of laws and rules to deliver market confidence and investor protection.

Keywords

Asset management, fiduciary duty, investor protection, shadow-banking, China

1. Introduction

The asset management industry has contributed significantly to the economy of the United Kingdom, for example through the management of large pension funds and other corporate activities such as takeovers.¹ The UK asset management industry is currently ranked the second largest in the

1. R. Meade et al., *Asset Management in the UK 2017–2018: The Investment Association Annual Survey* (The Investment Association, 2018).

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world after that of the United States, and overseas clients represent 40% of their business.² The success of this industry can be attributed to a number of factors: the tax regime, legal and financial expertise, and the legal and regulatory framework.³ These frameworks are part of the essential infrastructure in the development of asset management, and they aim to provide both investor confidence and legal certainty in order that the industry can manage its legal risk.⁴

The asset management industry in China has developed rapidly since 2012. The total financial value of assets under management increased from 27 trillion RMB in 2012 to 115 trillion RMB in 2016, and the average annual growth rate was 44%.⁵ However, the large size of the asset management market and its high growth rate does not mean that China's asset management industry is solid and consistent. Before the introduction of the regulations on shadow banking in 2017, many asset management institutions in China were tools (platform providers) through which commercial banks evaded regulatory requirements to expand their scale of credit loans.⁶ Many asset management institutions were involved in risky shadow banking businesses. Asset managers promised investors guaranteed returns, for example through rigid payment, which discouraged investors from insisting on their right to know and influence investment decisions.⁷ In other words, investors were protected by rigid payment, yet such an arrangement increased the systemic risk of the financial market and made financial institutions inherently fragile.⁸

A strict regulatory regime on asset management industry was implemented in China from 2017 onwards, and rigid payment has been banned there in order to protect investors. Investor protection has become increasingly important for the growth and stability of the industry. However, because the financial markets in China are supervised sector by sector, there are regulatory overlaps and gaps between the asset management vehicles governed by different Chinese authorities. There is room for regulatory arbitrage. In addition, there is no single set of duties that apply to asset managers, in the way that fiduciary duty is regulated in the UK. Instead, asset managers' duties are set out in different laws and legislation which are not always consistent. There is a need for China's asset management industry to unify its governing rules on asset management vehicles in order to enhance asset managers' accountability and investor protection.

In a global competitive market, the legal and regulatory framework is one consideration for asset managers and clients when they decide where the legal seat and management seat for the funds should be sited.⁹ The legal and regulatory framework comprises several legal sources: private law, public regulation and other industry standards (soft law). This paper investigates the UK legal and regulatory model through an examination of how private law (fiduciary duties and duty of care in English common law) interacts with public regulations (the Financial Services and Markets Act 2000 and the rules of the UK Financial Services Authority) to protect investors and provide legal certainty to the asset management industry. As China develops its asset

2. A. Bailey (Chief Executive at the FCA), 'Asset Management: A Regulatory Perspective', (2018), www.fca.org.uk/news/speeches/asset-management-regulatory-perspective.

3. H. Van Steenis, *Future of Finance: Review on the Outlook for the UK Financial System*, Bank of England.

4. P. Dickson, *The Asset Management Review* (4th edition, Law Business Research Ltd, 2015), p. 476.

5. Z. Zheng et al., *Annual Report on the Development of China's Assets Management Industry* (June 2018).

6. S. Wei, 'Wealth Management Products in the Context of China's Shadow Banking: Systemic Risks, Consumer Protection and Regulatory Instruments', 23 *Asia Pacific Law Review* (2015), p. 102.

7. *Ibid.*

8. *Ibid.*

9. P. Dickson, *The Asset Management Review* (6th edition, Law Business Research, 2017), p. 476.

management industry, its legal and regulatory frameworks are critical in promoting investor trust and market confidence.¹⁰ This paper, based on a comparative law analysis, first examines the UK model and assesses whether China can transplant the UK model, or some aspects of it, to provide investor protection and legal certainty and thereby develop a trustworthy and independent asset management industry.¹¹ Thus, the paper will first discuss how UK private law, particularly fiduciary duties and duty of care in English common law, deliver the two regulatory goals of investor protection and legal certainty. It will identify some of the difficulties that arise from the UK legal system in which there is judge-made law – common law. Further, it will show how regulatory rules can supplement the common law duty to protect retail and consumer investors and reduce transaction costs by providing legal certainty.¹² Specifically, we will investigate how these laws and rules are enforced through public or private actions to show how investors can best obtain redress, and how the authorities can maintain market confidence.

2. UK mixed model: global champion, adjusted common law, outcome-based regulation

In English common law, asset managers owe a set of fiduciary duties and a duty of care to their clients, whether institutional¹³ or retail. Fiduciary duties include the duty of loyalty, the duty to avoid conflict of interest and the duty to act in good faith. These fiduciary duties arise out of relationships ‘where one person acts on behalf of or for the benefit of another with a discretion or power that affects the interests of the other’.¹⁴ The effect of fiduciary duty in equity in English common law is to impose more stringent duties on financial services providers than contract law would.¹⁵ Asset managers owe fiduciary duties to clients who entrust to them property or information, and rely on their expertise to manage their investment.¹⁶ Such fiduciary duties do not depend on the form of the investment vehicle, whether company, partnership or trust, but arise out of the relationship. An asset manager can simply be considered an agent who searches for and offers products in which clients can invest. They therefore owe fiduciary duties to their clients and are covered by a range of regulations. These include: Undertakings for the Collective Investment in Transferable Securities¹⁷ (UCITS, which facilitates the removal of restrictions on the free

10. W. Shen and S. Li, ‘Unified Supervision of New Asset Management Regulations in China: The Logic, Tools and Boundary’, 5 *Law of Finance and Economics* (2019), p. 81, 108.

11. *Ibid.*; also see Y. Miao, ‘The Legal Characterisation of the Internal Asset Management Relationship: Looking Back and Looking Forward’, 3 *The Jurist* (2018), p. 98, 112; Y. Liu and J. Lou, ‘The Asset Management Plans in Corporate Takeovers’, 6 *Tsinghua Law Review* (2016), p. 71, 75; R. Huang, ‘The Legal Basis and Operational Models of Asset Management: the US Experiences and Implications for China’, 5 *Global Law Review* (2019), p. 1, 15.

12. Law Commission, *Fiduciary Duties of Investment Intermediaries*, Law Com No. 350, June 2014.

13. The main corporate clients of asset management firms are pension funds, insurance companies and retail banks, who entrust large pools of individual savings to them.

14. M. Conaglen, ‘Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties’, 5 *Edinburgh Law Review* (2011), p. 320, 321.

15. ‘Discussion Paper on a Duty of Care and Potential Alternative Approaches’, FCA Discussion Paper DP18/5, July 2018, p. 3; also see ‘A Duty of Care and Potential Alternative Approaches: Summary of Responses and Next Steps’, FCA Feedback Statement FS19/2, April 2019.

16. *Reading v. R* [1949] 2 K.B. 232 at 236.

17. Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the Coordination of Laws, Regulations and Administrative Provisions relating to Undertakings for Collective Investment in Transferable Securities.

movement of cross-Europe mutual funds); Alternative Investment Fund Managers Directive¹⁸ (AIFMD, which works to establish common requirements that govern the authorization and supervision of alternative investment funds); and Markets in Financial Instruments Directives¹⁹ (MIFID II or EU laws that govern the provision of investment services in financial instruments by banks and investment firms and the operation of traditional stock exchanges and alternative trading venues and offer investors a high level of protection).²⁰

An array of investment vehicles is used by asset management businesses in the UK, including limited companies, trusts and limited partnerships. The choice of investment vehicle is influenced by several factors, such as tax treatment and regulatory implications for the funds and the fund managers.²¹ Investment vehicles are divided into three major groups: open-ended investment vehicles, closed-ended investment vehicles and alternative investment funds. The investment strategy of a closed-ended fund is determined by the fund's constitutional documents or by regulatory requirements. The most common structure that closed-ended funds use is partnership. Unlike open-ended funds, closed-ended funds do not usually undergo constant expansion and reduction of the number of securities in issue throughout their life.²² Alternative investment funds (AIMs), such as hedge funds and private equity funds, are designed for smaller companies and, because of their higher risks, are aimed at investors with an appropriate degree of knowledge and experience.²³ Open-ended funds offer lower costs, and are an easy way to pool investors' capital and to invest in a diversified portfolio.²⁴ Because of this, they are the commonest investment vehicle in the UK. Since closed-ended and alternative investment funds are designed and aimed at specific categories of investors and are less accessible than open-ended investment funds, this paper will mainly discuss open-ended investment funds.

A. Structure of asset management vehicles and fiduciary relations under collective investment schemes (CIS)

1. The structure of asset management vehicles in the UK

In the UK, unit trusts and open-ended investment companies (OEIC) are the most common types of open-ended investment funds.²⁵ Both are mutual funds and have no restriction on the number of

18. Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and Amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

19. Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

20. European Commission, 'Investment services and regulated markets – Markets in financial instruments directive (MiFID)', https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/securities-markets/investment-services-and-regulated-markets-markets-financial-instruments-directive-mifid_en.

21. P. Dickson, *The Asset Management Review*, p. 386.

22. *Ibid.*, p. 393.

23. 'Alternative Investment Market: What Is It and How Does It Work?', *Daily Telegraph* (2016), www.telegraph.co.uk/investing/online-investments/alternative-investment-market-defined/.

24. London Stock Exchange, 'Open-End Funds', www.lseg.com/markets-products-and-services/our-markets/borsa-italiana/etps/open-end-funds.

25. Unit Trusts and Open-Ended Investment Companies (OEICs), (2020), www.moneyadvice.service.org.uk/en/articles/unit-trusts-and-open-ended-investment-companies-oeics.

shares they can issue. Open-ended investment funds were developed from unit trusts²⁶ and although the trustees of unit trusts are normally financial institutions, in practice there are also separate fund managers delegated to establish and execute the trusts' investment strategies.²⁷ Under English law, trusts are set up under trust deeds and cannot contract in their own name because they do not have separate legal personality.²⁸ Hence, trustees hold the legal titles to the investors' assets or property,²⁹ rather than the unit trusts themselves holding investment assets. At common law, trustees owe fiduciary duty directly to their beneficiaries, that is, the investors.

In contrast, OEICs are established under company law and have separate legal personality³⁰ so they are able to contract with investors directly, and the investors are therefore their shareholders. As normal corporations, OEICs can raise capital and pool them to construct investment portfolios under their own name. In terms of organization structure, OEICs are governed by the OEIC Regulation 2001 which requires that there should be at least one FCA-approved director in an OEIC. Approved directors are known as Authorised Corporate Directors (ACDs), and take responsibility for the operation of the funds. As company directors, ACDs owe fiduciary duty to the funds, that is, the OEICs.

In practice, although it is not obligatory, ACDs usually delegate the management of OEICs to external investment managers.³¹ This is because, in a purely technical sense, OEICs are initially set up by asset managers such as investment management companies, and at this stage the asset managers are the sole shareholder and can appoint ACDs to deal with day-to-day operations. Once all the shares of the OEIC have been sold to investors, the asset manager becomes an external party to the company and therefore needs to appoint an ACD who delegates investment management back to the asset managers who in turn manage the funds and make investment strategies through contractual agreements on behalf of OEICs. In this way, fund managers can concentrate on investment and hand over the daily operation of the OEIC to an ACD. Because of the separate legal entity of OEICs, although asset management companies manage the investment assets, the OEICs are the owners of the assets.

The significant point is that fund management and asset ownership are kept separate by this structure and there is no direct relationship between fund managers and investors (shareholders). As a result, the investment properties managed by OEICs are isolated from the creditors of the asset managers. This structure also restricts the right of investors to control the managers of their assets, thus enabling asset managers to hold multiple funds simultaneously and thereby to benefit from the economy of scale.³² However, operating multiple funds inevitably results in conflicts of interest because resources such as the allocation of investment opportunities and administrative capacity are inevitably limited³³ and if investors had a controlling hand, it would be difficult for

26. P. Dickson, *The Asset Management Review* p. 388, 392.

27. *Ibid.*

28. *Ibid.*

29. *The Asset Management Review*, p. 387.

30. Unit Trusts and Open-Ended Investment Companies (OEICs), (2020), www.moneyadviceservice.org.uk/en/articles/unit-trusts-and-open-ended-investment-companies-oeics.

31. P. Dickson, *The Asset Management Review*, p. 388, 392; Article 30 of UCITS.

32. J. Morley, 'The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation', 123 *The Yale Law Journal* (2014): 1228, 1287.

33. *Ibid.*

asset managers to hold multiple funds simultaneously. The separation of the management and ownership of managed assets is an effective solution to this problem.

In addition, the English Law Commission clarified that the general law on fiduciary duties had only limited application in the financial sector (a modified form of fiduciary duty).³⁴ Financial institutions could contractually determine the scope of their fiduciary duties subject to the regulatory principles,³⁵ which means that conflicts of interest are allowed in the asset management industry, subject to mandatory regulations, such as the FCA Conduct Rules in the UK and MiFID II in the EU. As a result, some scholars have argued that general fiduciary law is not sufficient to provide the public good of client protection through regulating conflicts of interest.³⁶ Although investors' right to control their asset managers has been restricted by this structure by comparison with shareholders' right to influence management decisions in ordinary companies, their right of control was compensated for by exit rights and could be traded off against the additional profits resulting from economies of scale.³⁷ As a type of mutual fund, the majority of OEICs allow shareholders to redeem their shares freely at the net asset value every working day.³⁸ To exit from ordinary companies, on the other hand, shareholders would need to transfer their shares on the market, rather than requesting companies to buy back their shares. In this way, allowing asset managers to hold multiple funds can enable investment portfolios to achieve economies of scale.³⁹ To safeguard the investment assets, an independent FCA-approved entity should be appointed by ACDs as a custodian who holds the legal title to the OEIC's investment property.⁴⁰ In addition to the function of safe-keeping managed assets, custodians also provide a number of ancillary services which enhance the protection of investments on behalf of investors.⁴¹ For instance, custodians may be responsible for asset valuation, compliance monitoring and performance measurement of the investment, as well as securities lending and cash management.⁴²

2. Fiduciary relations under the collective investment scheme (CIS)

There are two kinds of fiduciary duty related to OEICs: fund managers owe fiduciary duty to their clients (the OEICs), and ACDs owe fiduciary duty to the OEICs. There is a contractual relationship between OEICs and their appointed asset managers which gives rise to a fiduciary duty. The Law Commission held the view that 'expressed contract terms would be central to the court's assessment of the existence and scope of any fiduciary duties'.⁴³ In the case *Kelly v. Cooper*⁴⁴, Lord Browne-Wilkinson held that it is necessary to have regard to the express or implied terms of contract when deciding whether there are fiduciary relations. The court will look at the contract

34. Law Commission, 'Fiduciary Duties and Regulatory Rules', Law Com Consultation Paper No. 124, 1995.

35. *Ibid.*

36. P. Hanrahan, 'Fiduciary Duty and the Market: Private Law and the Public Good', *University of Melbourne Legal Studies Research Paper No. 347* (2013).

37. J. Morley, 'The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation', *123 The Yale Law Journal* (2014), p. 1228, 1287.

38. *Ibid.*

39. *Ibid.*

40. Regulation 5, OEIC Regulations.

41. Oxford Economic Research Associates, *The Role of Custody in European Asset Management*, European Asset Management Association.

42. *Ibid.*

43. Law Commission, *Fiduciary Duties of Investment Intermediaries*, Law Com No. 350, June 2014.

44. [1993] AC 205 at 214.

documents and FCA rules when considering fiduciary obligations.⁴⁵ In English company law, ACDs do not owe fiduciary duties to client shareholders, that is, the investors. To lift the veil of incorporation and hold the ACDs liable to shareholders for a breach of fiduciary duty, shareholders would need to entrust property or information to the directors⁴⁶ since directors may owe fiduciary duties if they act as an agent of shareholders when negotiating a deal on their behalf.⁴⁷

3. *Fiduciary relations in intermediated asset management businesses*

In practice, the investment chain of asset management is normally intermediated, and although retail investors can buy shares of funds directly from the fund management, they normally buy shares through an agent who has ties to the manager, through online fund platforms, stockbrokers or independent financial advisors/planners.⁴⁸ Many banks and specialist brokers provide clients with a range of options and leave it up to investors to decide which fund to invest in. Brokerage fees are charged for the service⁴⁹ and clients' investment decisions are based on the information provided by brokers who are responsible for providing options, rather than for assessing them and advising whether a specific fund is suitable for their clients.⁵⁰ In this situation, investors are less likely to claim compensation if the investment turns out to be unsuitable.⁵¹ In order to enhance investor protection, MiFID II introduced 'appropriateness assessments', which require financial services providers, such as brokers and online fund platforms, to consider suitability when providing clients with direct-offer or non-advised business options.⁵² Complex products should be assessed on a case-by-case basis under such an assessment.⁵³ However, MiFID II also identifies certain categories of assets, such as non-structured shares or units in UCITS, as automatically non-complex, which means that financial services providers are exempt from the requirement of having to undertake an appropriateness assessment⁵⁴ (although this exemption is not applicable to advised or discretionary business).⁵⁵ If a client makes an unsuitable investment on the advice or recommendation of a broker, this may amount to financial mis-selling and the client may be eligible for compensation. If the broker's response to a complaint proves unsatisfactory, the Financial Ombudsman Services may take up the client's case for investigation.⁵⁶ At English Common Law,

45. Law Commission, *Fiduciary Duties of Investment Intermediaries*, Law Com No. 350, June 2014.

46. Such as in the case *Dawson International Plc v. Coats Patons Plc* (1988) 4 BCC 305, the directors played the role of the agents of shareholders to see whether the takeover bid is beneficial to the company, and therefore the court held that directors are under a fiduciary duty to shareholders in general and in particular current shareholders with respect to the disposal of their shares in the most advantageous way.

47. P. Dalley, 'Shareholder (and Director) Fiduciary Duties and Shareholder Activision', 8 *Houston Business and Tax Journal* (2008), p. 301, 326.

48. The Money Advice Service, *Unit Trusts and Open-Ended Investment Companies (OEICs)*, (2020), www.moneyadvice.org.uk/en/articles/unit-trusts-and-open-ended-investment-companies-oeics.

49. The Money Advice Service, *Do You Need a Financial Adviser?*, (2020), www.moneyadvice.org.uk/en/articles/do-you-need-a-financial-adviser.

50. *Ibid.*

51. *Ibid.*

52. Article 25(4)(a), MiFID II.

53. Under MiFID II, investment product manufacturers and distributors have responsibility to ensure that complex investment products are suitable for customers investing without any advice. For detailed instructions, see ESMA, *Guidelines on MiFID II Product Governance Requirements* (ESMA, 2018).

54. *Ibid.*

55. *Ibid.*

56. European Parliament, *Marketing, Sale and Distribution: Mis-Selling of Financial Products*, IP/A/ECON/2016-17.

financial advisors owe a fiduciary duty to their clients which means that in an advisory business, a financial advisor owes a fiduciary duty to investors. As Evans Lombe LJ held in the case *Investors Compensation Scheme Ltd v. West Bromwich Building Society*, ‘Where an adviser undertakes, whether pursuant to a contract and for consideration or otherwise, to advise another as to its financial affairs it is commonplace for the courts to find that the adviser has placed himself under fiduciary obligations to that other’.⁵⁷

These fiduciary duties, which arise out of the law of equity, do not include a duty of care, which is regarded as a duty in the law of torts.⁵⁸ The duty of care in tort law requires asset managers to exercise reasonable care, skills, and diligence for their clients.⁵⁹ Fiduciary duty under English common law differs from the fiduciary duties in the US, another common law jurisdiction, where fiduciary duties include a duty to exercise ‘professional care, skills, and diligence’.⁶⁰ This difference affects not only the remedies available to claimant clients⁶¹ (tort remedies and equitable remedies) but also how liabilities can be limited. In English common law, parties can exclude tortious liabilities by agreement.⁶² This enables asset managers and clients to negotiate how risks will be apportioned, which is a useful risk management mechanism for asset managers and for institutional and professional investors.⁶³ In the UK, the primary institutional clients of asset management firms are pension funds and insurance companies. Pension funds represent 35% of the asset management market, and insurance companies, which include in-house insurance and third-party insurance, represent 25% of the asset management market as of 2018/19.⁶⁴ The apportionment of risk can affect the fees that asset managers charge and the investment strategies they deploy for portfolios. Managers will charge higher fees if they have to take on more liability risk, as they would need to take out insurance cover.⁶⁵ They are less likely to undertake riskier investment strategies if there is a higher chance that they will be sued by institutional investors for negligent investment.⁶⁶ Because asset managers will exercise independent judgment subject to certain contractual mandates given by the clients, it is important to allocate risks through a definition of the scope of the fiduciary duties and duty of care in the contract or relevant documents, for example the contractual agreement between the asset managers and investment funds, and partnership agreements or constitutions of hedge funds. Asset managers control and manage

57. *Investors Compensation Scheme Ltd v. West Bromwich Building Society* [1999] Lloyds Rep. PN 496, 509.

58. Law Commission, *Fiduciary Duties of Investment Intermediaries*, Law Com No. 350, June 2014.

59. FCA, ‘Discussion Paper on a Duty of Care and Potential Alternative Approaches’, Discussion Paper 18/5, July 2018.

60. *Thing v. La Chusa* (1989) 48 Cal. 3rd, 644, 667.

61. Under the UK model, the nature of duty of care is tortious one and the corresponding remedies include two legal remedies: compensation and consequential damages. If the duty of care is a part of fiduciary duty, then breach of such duty will result in equitable remedies. Equitable remedies emphasize fairness with wider scope of remedies, including specific performance, account of profits, equitable compensation, declaratory relief, rescission, rectification, subrogation and marshalling.

62. *Armitage v. Nurse* [1998] Ch 241; also see Aaron Taylor, ‘Concurrent Duties’, 82 *The Modern Law Review* 2019, p. 17, 45.

63. B. Cheffins and J. Armour, ‘The Past, Present and Future of Shareholder Activism by Hedge Funds’, 38/2011 *Legal Studies Research Paper Series* (2011).

64. The Investment Association, *Asset Management in the UK 2017–2018: The Investment Association Annual Survey*, The Investment Association, September 2018.

65. A. Bailey, ‘Asset Management: A Regulatory Perspective’, (2018), www.fca.org.uk/news/speeches/asset-management-regulatory-perspective.

66. Such as *Rubenstein v. HSBC Bank Plc* [2012] EWCA Civ 1184; *Lenderink-Woods v. Zurich Assurance Ltd and Others* [2016] EWHC 3287 (Ch); *Zaki and Others v. Credit Suisse Ltd* [2013] EWCA Civ 14.

assets, and their clients are not involved with investment decisions. Had the clients controlled their asset funds and been able to make direct investment decisions or even dispose of assets, they may have not been entitled to benefits such as reduction of or exemption from tax. This means that fiduciary duties and duty of care are important tools that enable clients to hold their asset managers accountable. It also means that clients are able to select an asset manager according to their tolerance of risk.

The duty of loyalty may operate in a way that creates an obstacle to the development of the asset management industry. This duty requires the fiduciary to serve only one master who is entitled to the single-minded loyalty of their fiduciary.⁶⁷ However, asset managers may need to serve multiple clients/beneficiaries in one or multiple funds simultaneously.⁶⁸ Consequently, conflicts of interest can arise, unintentionally or incidentally, even though they are not committed by the asset managers in bad faith.⁶⁹ The English court in *Armitage v. Nurse* did not allow the trustee's duty to act in good faith to be excluded, as 'the duty of trustees to perform the trust honestly and in good faith for the benefit of the beneficiaries (the irreducible core of a trust) is the minimum necessary to give substance to the trust'.⁷⁰ In other words, asset managers should not act dishonestly and recklessly towards their clients.⁷¹ However, the court in this case allowed professional trustees to exclude liability for gross negligence through exoneration clauses. Although there has been a great deal of criticism for such a lenient approach,⁷² wide exoneration clauses are still permitted under English law⁷³ and liabilities that arise out of duty of care in tort can be excluded by agreement.

B. Public regulation and industry guidelines

Although the allocation of risk permitted in this bargaining model at common law can deliver benefits to both asset managers and their clients,⁷⁴ it can also have a prejudicial effect on investors such as retail investors and consumers who have substantially less bargaining power. Therefore, such exclusionary rules or the risk allocation model should be subject to other mandatory rules to ensure fairness, such as best execution rules and client suitability rules of the Financial Conduct Authority (FCA).⁷⁵ The EU MIFID II also imposes a duty on investment firms to act 'honestly, fairly, and professionally in accordance with the best interests of its clients'.⁷⁶ In terms of regulating conflicts of interest, the EU and UK regulators have adopted a meta-regulatory approach in which affairs are regulated by a single law and a single regulator so that financial institutions can

67. *Bristol & West Building Society v. Mothew* [1998] Ch 1 at 18, per Millett LJ.

68. J. Hawley and J. Lukomnik, 'The Purpose of Asset Management', Pension Insurance Corporation, March 2018.

69. A. Crockett et al., 'Conflicts of Interest in the Financial Services Industry: What Should We Do about Them?', *Geneva Reports on the World Economy* 5 (2003).

70. [1998] Ch. 241.

71. A. Hudson, *Equity and Trusts* (9th edition, Routledge, 2017), p. 750.

72. For instance, in accordance with Jersey and Guernsey law, trustees are not allowed to restrict liability for gross negligence; also see *Walbrook Trustee (Jersey) Ltd and others v. Fattal and others* [2009] EWCA Civ 297.

73. Dechert LLP, 'Recent Developments in the Law Relating to Trustee Exoneration Clauses', (2011), www.mondaq.com/uk/Wealth-Management/151674/Recent-Developments-In-The-Law-Relating-To-Trustee-Exoneration-Clauses.

74. B. Cheffins, 'Company Law and the Hypothetical Bargaining Model', in *Company Law – Theory, Structure and Operation* (Clarendon Press, 1997), p. 264.

75. 9.2 & 11.2 of the COBS.

76. Article 24(1), MiFID II; Article 24(2) and 19(2), MiFID II.

easily identify, manage and disclose conflicts of interest.⁷⁷ In transposing this EU law requirement, the FCA rules also require asset managers to undertake these duties with both fiduciary and tortious nature, and they cannot be excluded by agreement in a contract or a trust document.⁷⁸ There is an array of regulations that govern the relationships between both managers and investors and their funds in addition to the common law fiduciary duty. For instance, MiFID and UCITS regulate the relations between funds and investors, while AIFMD and some FCA rules, such as the best execution rule and the client suitability rule, regulate the relationships between fund managers and investment funds.

This risk allocation model sometimes fails to protect the ultimate beneficiaries. For instance, asset managers also manage assets on behalf of pension funds, and in this case their direct clients are the trustees of the pension funds, while the ultimate beneficiaries are the pension policyholders. To close this governance gap, the UK Stewardship Code was introduced as an addition to the mandatory rules to ensure that asset managers take a long-term view of investment when they exercise their duties towards pension fund clients.⁷⁹ Stewardship activities were defined by the Law Commission as ‘the activities of monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, corporate governance, culture and remuneration’.⁸⁰ The duty of pension fund trustees when acting as asset managers should include stewardship of the companies in their portfolio, and this implies exertion of influence over them.⁸¹ In other words, trustees should devote a higher level of corporate governance to monitoring the performance of their portfolio companies in order to benefit the pension beneficiaries in the long term.⁸² We can argue that the risk allocation model created by private law should also be subject to mandatory rules, and to the voluntary code that sets out the industry standards.

Private law can create a bargaining model in which parties can allocate risks and this model is useful for the development of the asset management industry. Mandatory laws can be introduced with a specific scope to protect weaker parties and raise the overall professional standards of the sector. Voluntary codes can introduce industry standards that detail best practice. Examples are the UK Stewardship Code, which aims to enhance the quality of engagement between investors and companies to help improve long-term risk-adjusted returns to shareholders,⁸³ and the Association of Investment Companies’ Code of Corporate Governance (AIC Code), which sets out a framework of best practice for the governance of investment companies.⁸⁴ How these multiple legal and regulatory tools can be coordinated to deliver the intended outcomes will depend on their enforcement mechanisms which include litigation, arbitration, alternative dispute resolution (such as the UK Financial Ombudsman Services), regulatory sanctions and market reputation.

77. Article 18, MiFID II; Articles 24, 25 & 26, MiFID Commission Directive; also see Mads Andenas and Iris Chiu, *The Foundations of Future of Financial Regulation: Governance for Responsibility* (1st edition, Routledge, 2014), p. 289.

78. 2.1 of the COBS.

79. Article 1, The UK Stewardship Code.

80. Law Commission, *Fiduciary Duties of Investment Intermediaries 2014*, Law Com No. 350, June 2014.

81. A. Tilba and A. Reisberg, ‘Fiduciary Duty under the Microscope: Stewardship and the Spectrum of Pension Fund Engagement’, 82 *The Modern Law Review* 2019, p. 456, 487.

82. *Ibid.*

83. Financial Reporting Council, ‘2012 UK Stewardship Code’, (2012), [www.frc.org.uk/investors/uk-stewardship-code/2020-uk-stewardship-code-\(1\)](http://www.frc.org.uk/investors/uk-stewardship-code/2020-uk-stewardship-code-(1)).

84. The Association of Investment Companies, ‘AIC Code of Corporate Governance’, (2019), www.theaic.co.uk/aic-code-of-corporate-governance-0.

There are overlaps between the concept of stewardship and fiduciary duty of trustees. The court in *Cowan v. Scargill* held that the discretion of trustees to make investments for the benefit of their members and trustees is not allowed to ignore the financial interests of beneficiaries.⁸⁵ On the other hand, the Freshfields report commissioned by UNCP stated that ‘the economic power wielded by institutional investors ought to be harnessed to meet social and environmental needs through the wider integration of ESG considerations into investment decision-making’.⁸⁶ As a result, in practice various asset managers might each have a different understanding of their fiduciary duty.⁸⁷ For instance, there is evidence that some pension fund trustees believe their fiduciary duty is to secure the best financial interests of members, while others hold the view that their fiduciary duty should also include non-financial interests, such as encouraging investor stewardship.⁸⁸ Hence, the law ought to clarify that the scope of fiduciary duty should not be limited to the financial interests of fund members – beneficiaries and clients.⁸⁹ Soft law initiatives can supplement private law and provide industry guidance, while enforcement will rely on the market mechanism in ‘comply or explain’ mode.⁹⁰

3. China – the growth, shadow banking, and sectoral supervision

China’s asset management industry is very diverse and includes many shadow banking businesses such as channel-type businesses and asset management businesses with implicit payment guarantees that use the asset management name in order to avoid regulations.⁹¹ Before 2017, bank lending was also disguised as asset management in order to evade regulatory restrictions against shadow banking. The result has been that in China, the majority of asset management businesses were in reality shadow banking businesses rather than traditional asset management businesses that aimed to diversify investment and provide investment outlets.⁹² In addition, the various asset management instruments, although identical in essence, were subject to different supervisory regimes (sectoral supervision) which, although very similar, gave room for regulatory arbitrage and contracting parties could select the organizing structure that suited them best. In order to make profits through regulatory arbitrage, an increasing number of shadow banking or off-balance sheet businesses were conducted by financial intermediaries to evade regulatory requirements.⁹³ China’s asset management industry had become merely a tool for commercial banks to evade regulatory restrictions before the authorities clamped down on it with a round of strict supervisions in 2018. For example, in channel-type businesses, non-bank financial institutions, such as securities

85. [1985] Ch 270.

86. Freshfields Bruckhaus Deringer, *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment: Produced for the Asset Management Working Group of the UNCP Finance Initiative*.

87. *Ibid.*

88. J. Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making*, Department for Business, Innovation and Skills, 2012.

89. *Ibid.*

90. Baker McKenzie, ‘The Stewardship Code 2020: Is This an Opportunity for Listed Companies to Increase Meaningful Stakeholder Engagement?’, (2020), www.bakermckenzie.com/en/insight/publications/2019/11/stewardship-code-2020.

91. S. Wei, 23 *Asia Pacific Law Review* (2015), p. 102.

92. S. Wei and L. Shuping, 5 *Law of Finance and Economics* (2019), p. 81, 108.

93. *Ibid.*

companies and trust companies, lost their independent decision-making power to construct investment portfolios and make investment strategies. These institutions played the role of platform providers for commercial banks, by conducting off-balance sheet bank lending.⁹⁴ As platform providers, non-bank financial intermediaries provided assistance to commercial banks and followed their orders by, for example, executing orders and recording transactions, rather than actively conducting investment activities using their own decision-making power.⁹⁵

Because supervision of the financial market in China is sectoral, it is difficult to supervise off-balance sheet businesses that are conducted by more than one financial intermediary when the intermediaries are governed by different authorities.⁹⁶ In addition, because of the nature of off-balance sheet businesses, information about their transactions is often obscure. Before the introduction of the strict supervision, most financial intermediaries conducted any shadow banking business under the name of asset management⁹⁷ which enormously increased the systemic risk of the entire financial market. The effect of the new regulations made in 2018 was to reduce the amount of shadow banking significantly.⁹⁸ However, a side effect of cracking down on shadow banking has been the shortage of social financing⁹⁹ because, over the past decade, the shadow banking system had provided loans to small and micro enterprises that were classified as non-qualified borrowers for bank loans.¹⁰⁰ As a result, there has been a sharp decrease in the year-on-year growth rate of aggregate financing in the real economy from 12.8% in 2016 to 9.8% in 2018.¹⁰¹

Because of the drawbacks associated with sectoral supervision, China changed its supervisory system for financial markets. In 2018, the banking authorities (the China Banking Regulatory Commission, CBRC) and insurance authorities (the China Insurance Regulatory Commission, CIRC) were merged and replaced by the China Banking and Insurance Regulatory Commission (CBIRC). The China Securities Regulatory Commission (CSRC) is, however, still responsible for supervision of the securities market. In addition, the Financial Stability and Development Committee was set up under the state council to coordinate sectoral supervision of the various authorities. Despite all this, sectoral supervision of the financial market has not been eliminated¹⁰² and there is still the possibility of regulatory overlaps or gaps between different authorities. Sectoral supervision is unlikely to be replaced by integrated regulation in the near future.

94. S. Guofeng, 'China's Shadow Banking: Bank's Shadow and Traditional Shadow Banking', *BIS Working Papers* 822 (2019).

95. *Ibid.*

96. S. Wei and L. Shuping, *5 Law of Finance and Economics* (2019), p. 81, 108.

97. *Ibid.*

98. *Ibid.*

99. 'Total social financing refers to the aggregate volume of funds provided by China's domestic financial system to the private sector of the real economy within a given timeframe.' For detailed explanations of the definition of total social financing, see China Banking News, 'Total Social Financing', www.chinabankingnews.com/total-social-financing/. Also see S. Guofeng, 'China's Shadow Banking: Bank's Shadow and Traditional Shadow Banking', *Bank of International Settlement Working Papers* 822 (2019).

100. China Banking News, 'Total Social Financing Shrinks in May as Shadow Banking Crack-Down Takes Effect', (2018), www.chinabankingnews.com/2018/06/13/total-social-financing-shrinks-may-shadow-banking-crackdown-takes-effect/.

101. People's Bank of China, Report on Aggregate Financing to the Real Economy People's Bank of China (October 2019).

102. H. Hui, 'The Logics and Path of China's Financial Regulatory Structure Reform: International Experiences and Local Choice', 3 *The Jurist* (2019), p. 124, 137.

One possible solution to sectoral supervision is to introduce fiduciary duties into China's asset management industry in order to unify asset managers' duties and thereby enhance investor protection and develop an active asset management industry. The Guiding Opinions on Regulating the Asset Management Business of Financial Institution (the 'Guiding Opinions')¹⁰³ was introduced to bring a wide range of asset management vehicles into its supervisory scope, regardless of the supervising authority of the investment vehicle. These Guiding Opinions established the definition and scope of asset management in an attempt to promote uniform regulatory standards in the industry.¹⁰⁴ Financial institutions are obliged to perform their activities with good faith, diligence, and dutifulness for the interest of the principals¹⁰⁵ and duties are imposed on asset managers to protect investors and provide legal certainty.¹⁰⁶ However, the primary aim of these rules is to clamp down on shadow banking by restricting the use of 'channel type businesses' for de facto bank lending. The measures include requirements for a decreased leverage ratio for structured finance, restrictions on the use of implicit guarantee payment, and requirements for the active management of asset funds.¹⁰⁷ General principles have been provided for the regulation of the asset management industry and they grant the power to introduce specific regulations to the People's Bank of China and other financial regulatory departments (CSRC and CBIRC). The CSRC has introduced mandatory rules to prevent asset management institutions from conducting shadow banking and to limit them to conducting genuine asset management business. As an example, the CSRC established a duty of asset managers of privately offered funds to maximize their clients' interest.¹⁰⁸ In addition, the revised Securities Law 2020 states that securities companies, supervised by the CSRC, that provide securities asset management services must comply with the provision of the Securities Investment Fund Law¹⁰⁹ in which trust law principles apply. This means that there is now a definite statutory fiduciary duty on asset managers governed by the CSRC.¹¹⁰ However, asset management institutions that are governed by CBIRC rather than the CSRC (that is, conducted by insurance companies or subsidiaries of commercial banks) are not under the governance of Securities Investment Fund law and therefore the trust law principles introduced into the Securities Investment Fund Law, such as defined fiduciary duty, do not apply to them. There is still a gap in the supervision of asset management businesses between the CSRC and CBIRC.

103. The Guiding Opinions of the People's Bank of China, the China Banking and Insurance Regulatory Commission, the Securities Regulatory Commission, and the State Administration of Foreign Exchange on Regulating the Asset Management Business of Financial Institutions, No. 106 (2018) of the People's Bank of China.

104. *Ibid.*, Article 2.

105. *Ibid.*

106. *Such as ibid.*, Articles 5 and 22.

107. S. Wei, 23 *Asia Pacific Law Review* (2015), p. 102.

108. Article 3, 'Measures for the Administration of the Privately Offered Asset Management Business of Securities and Futures Business Institutions', Order No. 151 of the CSRC, October 2018. Securities and futures business institutions that carry out privately offered asset management business shall, under the principles of free will, fairness, honesty and credibility, and maximizing the interests of clients, scrupulously perform their duties, be prudential and diligent, protect the lawful rights and interests of investors.

109. Article 120, Securities Law 2020.

110. Article 3, 'Securities Investment Fund Law'.

A. Applying fiduciary duties to China's asset management industry

At common law, fiduciary duty addresses the asymmetry of information between the fiduciary and the beneficiary.¹¹¹ It is both relational and proprietary.¹¹² Relationships that can give rise to fiduciary duty include those between lawyers and clients, doctors and patients, teachers and students, and professional advisers and advisees.¹¹³ Company directors owe a fiduciary duty to the company (a legal person) as the company entrusts its property, information, and affairs to them. When directors negotiate a deal on behalf of shareholders and provide them with advice and recommendations, they owe a fiduciary duty to the shareholders.¹¹⁴ When asset managers act on behalf of their clients, they may manage the investment for clients but do not hold the legal titles to these assets because the law may require them to be held by custodian banks.¹¹⁵ Some asset management companies only provide investment advice and access to the funds for their clients.¹¹⁶ Yet in all these cases, the advisers still have fiduciary duties to their clients, because fiduciary duties in English law do not arise solely from trust, partnership, or the body corporate. As the asset management industry develops more financial products to serve client needs,¹¹⁷ fiduciary duties need to cover any situation where clients entrust their investment affairs to asset managers, regardless of the investment vehicle used. Fiduciary duties should be incurred whenever asset managers engage in 'investment activities' for and on behalf of their clients.¹¹⁸

There is a debate about the legal nature of asset management products in China. Some scholars argue that the asset management business is essentially a trust relationship between the financial services provider and clients.¹¹⁹ In that case, trust law should not only be applied to the asset management business of trust companies but also to that of other financial institutions such as banks, securities, and insurance companies.¹²⁰ Some essential principles in the asset management business, such as the prohibition of payment guarantee and the fiduciary duties of the asset manager, are typically principles of trust law.¹²¹ However, trust law explicitly stipulated that engaging in a trust business requires a franchise licence from the China Banking and Insurance Regulatory Commission (CBIRC).¹²² In practice, the asset management plans of securities companies are based on agency relationships and governed by civil law principles. However, those asset management plans mimicked all the essential characters of their counterparts which have

111. A. Hudson, *The Law of Finance* (2nd edition, Sweet & Maxwell), p. 94.

112. L. Rotman, 'Understanding Fiduciary Duties and Relationship Fiduciary', 62 *McGill Law Journal* (2017), p. 4.

113. Stimmel Law, 'The Fiduciary Duty: What is It and What Does It Impose Upon You', www.stimmel-law.com/en/articles/fiduciary-duty-what-it-and-what-does-it-impose-upon-you.

114. C. Gerner-Beuerle and M. Schilling, *Comparative Company Law* (Oxford University Press, 2019), p. 469.

115. FCA, CASS6.3: Depositing Assets and Arranging for Assets to be Deposited with Third Parties, in *FCA Handbook* (FCA).

116. FCA, 'Asset Management Market Study', Interim Report, MS 15/2, November 2016.

117. PWC, 'Asset and Wealth Management Revolution: Embracing Exponential Change', www.pwc.com/gx/en/asset-management/asset-management-insights/assets/awm-revolution-full-report-final.pdf.

118. Law Commission, *Fiduciary Duties of Investment Intermediaries*, Consultation Paper No. 215, January 2014.

119. W. Yong, 'Restructuring Underlying Legal Relationships in Asset Management Industry to Trust Relations', 1 *Tsinghua Financial Review* (2018), p. 82, 84.

120. *Ibid.*

121. *Ibid.*; Article 25 of Trust Law.

122. Article 2 of the 'Notice of the General Office of the State Council on Relevant Issues Concerning the Implementation of the Trust Law of the People's Republic of China', No. 101 (2001) of General Office of the State Council.

been established on trust models, such as inviting a third party's custodianships to obtain the risk-isolation function of trust structures.¹²³ As discussed, asset managers only provide investment advice and access to funds for their clients to whom they then owe fiduciary duty, even if the asset managers and their clients are not in a trust relationship.¹²⁴ There is no jurisdiction in which the asset management industry relies entirely on trust law to solve problems.¹²⁵ The UK model shows that common law, the Financial Services and Market Act 2000 and FCA rules together comprise the regulations of asset management industries in addition to the contractual agreements between parties.

In order to strike a fair balance between the development of an active asset management industry and the need to control the systemic risks inherent in it, the scope of asset management and its supervision needs to be relatively broad, rather than limited solely to trusts, in order to govern the increasing number of asset management products that emerge during rapid financial innovation.¹²⁶ This means that it is unlikely for trust law to be sufficient as the sole governing law of the asset management industry. Alternatively, the introduction of fiduciary duty into the asset management industry could be a possible way to regulate asset managers' behaviour and to protect the interests of investors since fiduciary duty is not only applicable to relationships within the asset management industry but also has the flexibility to cope with active financial innovation.

B. Transplant of English fiduciary duty law to China

Compared to that of China, the UK's asset management industry plays an independent gatekeeping role for corporate governance of the industry's portfolio companies.¹²⁷ It also promotes price discovery, especially by larger institutional investors, through researching and conducting due diligence on potential investment opportunities and diversifying their clients' portfolios.¹²⁸ In terms of investor protection, financial services providers in the UK typically owe fiduciary duty to their clients, and this provides solid protection to the interests of investors, together with additional public regulations.¹²⁹

The civil law-based legal system in China does not provide an equivalent concept to the common law fiduciary duty applicable to asset managers. Asset managers' obligations are set out in various laws and administrative rules and, in some areas, appear to be inconsistent.¹³⁰ For instance, only the asset managers of trusts and securities investment funds owe a defined fiduciary duty to their clients.¹³¹ The Guiding Opinions listed the obligations of asset managers in a general manner, rather than outlining a clear fiduciary duty of asset managers.¹³² The General Rules of the

123. L. Yan, 'The Structure, Function and Legal Characters of Asset Management Plans', 3 *Investors* (2018), p. 4.

124. *Ibid.*

125. *Ibid.*

126. C. Gian, 'The Contribution of the Asset Management Industry to Long-Term Growth', 1 *OECD Journal: Financial Market Trends* (2011), p. 69–78.

127. J. Hawley and J. Lukomnik, 'The Purpose of Asset Management', Pension Insurance Corporation.

128. *Ibid.*

129. A. Hudson, *The Law of Finance* (2nd edition, Sweet & Maxwell), p. 113.

130. Article 8(2) of the Guiding Opinions; Article 6 of Measures for the Supervision and Administration of the Wealth Management Business of Commercial Banks; Article 147 of Company Law and Articles 25 and 33 of Trust Law; and Article 21, Securities Investment Fund Law.

131. Articles 25 and 33 of Trust Law; Article 21, Securities Investment Fund Law.

132. Article 8(2) of the Guiding Opinions.

Civil Law also stipulate the principles of honesty, fairness and trustworthiness.¹³³ For these reasons, a wholesale transplant of the UK system to China would produce several conflicts.

In China, scholars debate whether fiduciary duties should arise solely out of trust or whether the investment service agreement between asset managers and clients should expressly stipulate fiduciary duties. The former is deemed to be a statutory duty as there is a specific law of trust in China, while the latter is a contractual duty based on Chinese contract law.¹³⁴ If the duty is statutory, it is mandatory and cannot be contracted out; if it is contractual, parties have the freedom to contract it out subject to other mandatory rules, such as the principle of good faith.¹³⁵ As China is a civil law jurisdiction, fiduciary duty is not a general duty in civil law¹³⁶ so it is difficult to identify the equivalent of fiduciary duties in Chinese civil law.

This means that relationships between managers and their clients would be regulated according to the instruments created, such as trust and contract. Trust law is a specific type of law that can impose a set of fiduciary duties on the trustee. For instance, under Article 25 of the Chinese Trust Law, trustees should abide by the provision of the trust documents, and handle the trust in the utmost interest of beneficiaries. In addition, they should fulfil their duties by carrying out their obligation to be honest and trustworthy and by managing assets effectively. Under this article, a trustee owes not only a set of fiduciary duties but also a duty of care. These duties cannot be excluded, and liabilities cannot be exempted. Contractual provisions or provisions in any document that run contrary to this would be invalid under Article 52 of the Chinese contract laws, which stipulates that a contract clause that violates laws and administrative regulations, is invalid.

In civil law, an agent owes duties to the principal to act with honesty, trustworthiness and fairness.¹³⁷ Transplanting English fiduciary duties to Chinese law would impose an additional duty on agents to act in the best interest of their clients. According to English law, in a partnership, each partner owes fiduciary duties to the other partners. However, in Chinese law, partners do not owe such duties to each other¹³⁸ so the transplantation of fiduciary duty would also affect Chinese partnership law.

As discussed, the English fiduciary duty entails several duties but does not include a duty of care. Numerous details, such as the equitable doctrines and the relevant remedies for breach of fiduciary duties, would be lost in the legal transplant from England to China. The introduction of special laws through statutes or CSRC rules would be a better way of mitigating the risk of confusion. Additionally, specific laws can clarify: (1) that the specific fiduciary duties and duty of care apply to asset management regardless of the types of investment vehicle used; (2) which duties and liabilities that arise from these duties can be excluded and the methods of exclusion; (3) the mandatory rules and aims of parties that cannot be excluded by their agreement; (4) the enforcement mechanisms that can best deliver access to justice; and (5) which bodies should develop industry standards.

133. Articles 6 and 7 of General Rules of the Civil Law.

134. W. Yong, 1 *Tsinghua Financial Review* (2018), p. 82, 84; also see Liu Yan, 'An Analysis of the Underlying Legal Relationships of Asset Management Industry', 4 *Tsinghua Financial Review* (2018), p. 25, 28.

135. Z. Lianhui, 'Fiduciary Duties in Channel-Type Business', (2017), www.financialnews.com.cn/trust/zjgd/201707/t20170710_120667.html.

136. Z. Ruidong, 'Property Right, Trust Law and Civil Code', 3 *Journal of Gansu Institute of Political Science and Law* (2007), p. 71, 75.

137. Articles 5, 6 and 7 of the General Rules of Civil Law.

138. Article 28 of Partnership Law.

C. A special law: a potential solution

One solution to the problem described above is to introduce a special law that both defines the asset management industry and also lists investment activities that are considered to be asset management activities, regardless of whether it is a trust or other asset management plan. This special law should outline both general and specific duties without the need to specify the nature of the duty – fiduciary duty or duty of care.

1. Fiduciary duty

The aim of fiduciary duty is to address the problem of asymmetric information. In asset management, clients may not have all the information that asset managers have access to. Fiduciary duty prohibits managers, by virtue of their fiduciary position, from making personal gains from the use of this additional information. Fiduciary duties, therefore, require asset managers to disclose all information to their clients, and if they wish to use that information for the benefit of someone other than the client, they must obtain authorization from the client. This raises a number of questions: what information should be disclosed; when can the asset managers use the information to make personal gains; and how can the clients authorize conflict of interest activities conducted by the asset managers?¹³⁹ Mandatory law and regulation can provide legal certainty if they stipulate what information must be disclosed and how clients can give authorization.¹⁴⁰ When clients are sophisticated investors, the information to be disclosed can be on a voluntary basis. A set of industry standards or a voluntary code could provide the necessary guidance about what information should be disclosed. For many retail investors, however, the disclosure of information may not be sufficient to remove the risk of conflict of interest. The law should require either stricter control on products and activities, such as banning risky products from being offered to investors and investment funds (client suitability rules), or require that asset managers abide by a certain set of professional behaviours. For example, the principle of ‘best interest of clients’ requires asset managers to ‘establish and implement clear, effective and appropriate policies and procedures to identify and protect vulnerable customers and not to engage in high pressure selling or carry out a cold call in person’.¹⁴¹ The ‘best execution’ rule requires investment firms to ‘summarise and make public, on an annual basis, for each class of financial instruments, the top five investment firms in terms of trading volumes where it transmitted or placed client orders for execution in the preceding year, and information on the quality of execution obtained when the investment firm selects other firms to provide order execution services’.¹⁴² Under the duty to act honestly, fairly, and professionally, a firm must act in the best interests of its clients.¹⁴³

This special law regime must specify how enforcement actions can be taken to obtain redress. In the UK, owners of investment funds, such as unit trusts and OEICs, may make a claim against asset managers based on a breach of statutory law. Under FSMA 2000, a contravention by an authorized person of an FCA rule is actionable at the suit of a private person who suffers loss as a result of the

139. Law Commission, *Fiduciary Duties of Investment Intermediaries*, Consultation Paper No. 215, January 2014.

140. PWC, ‘Markets in Financial Instruments Directive II – Level 2: ESMA’s Technical Advice to the Commission on MiFID II and MiFIR’, www.pwc.lu/en/mifid/docs/pwc-markets-in-financial-instruments-directive-2-mifid-2-level-2.pdf.

141. 2.1.2, 2.1.2, 2.1.4 and 2.1.5 of the CMCOB.

142. 11.2 A of the COBS.

143. 2.1.1 of the COBS.

contravention, although there are some exceptions.¹⁴⁴ This has proved to be a burdensome route for retail investors, as the legal costs can be enormous. According to the Lord Chief Justice's annual report to parliament, civil justice is unaffordable to most people in the UK¹⁴⁵ and the expense of high court (tribunal) fees and legal advice have prevented individuals from pursuing litigation.¹⁴⁶ The UK's Financial Services Ombudsman provides access to an alternative mechanism for dispute resolution for retail investors or customers to obtain redress through, for example, compensation. China could set up a similar body to help retail investors gain access to justice and protection. The special law should specify whether breaches of these rules would give rise to private action.

2. Duty of care

Duty of care requires asset managers to exercise due care, diligence, and skills in managing investment affairs.¹⁴⁷ However, the way in which asset managers ought to behave depends on what can reasonably be expected of an asset manager.¹⁴⁸ In the UK, the standard is not defined as the way in which the majority of managers would have behaved, but instead whether 'any reasonable manager would have acted in such a way'.¹⁴⁹ Hence, the common law standard is rather low and financial regulators have recognized the inadequacy of common law principles to provide protection for investors.¹⁵⁰ Hence, the FCA Handbook provides more detailed rules that set out the business conduct standards with which asset managers should comply, such as duty to act in the best interests of clients, duty to act with integrity, and the best execution rule.¹⁵¹ Breaches of these standard rules do not, per se, amount to a breach of duty of care¹⁵² but retail investors may be able to obtain redress for mis-selling investment products by financial services providers through the Financial Services Ombudsman. In addition, investment funds, such as OEICs, are able to receive compensation for asset managers' breach of FCA rules. To obtain court redress, these conduct rules may provide some guidance to the courts, but they are not definitive statements of the standard of care required by asset managers.¹⁵³ The lesson we must draw from the UK's model is that a rigid standard of care increases the likelihood of litigation in the courts. The FCA sets out industry standards for the good conduct of business in its handbook, and falling short of these standards would result in regulatory sanctions as well giving clients cause for complaint to the

144. In accordance with 138D (2) of the FSMA 2000. 'A contravention by an authorised person of a rule made by the FCA is actionable at the suit of a private person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty.' However, this clause is not applicable to authorized person's breach of rules of conduct under section 64A of FSMA 2000.

145. Judiciary of England and Wales, *The Lord Chief Justice's Report 2015* (Judicial Office, 2015).

146. The Bach Commission on Access to Justice, *The Crisis in the Justice System in England and Wales*, Interim Report, November 2016.

147. FCA, *A Duty of Care and Potential Alternative Approaches: Summary of Responses and Next Steps*, FCA Feedback Statement FS19/2, April 2019.

148. FCA, *Asset Management Market Study Remedies and Changes to the Handbook – Feedback and Final Rules to CP 17/18*, Policy Statement PS 18/8, April 2018.

149. *Speight v. Gaunt* (1833) UKHL 1; *Re Waterman's Will Trusts* [1952] 2 All ER 1054; *Barlett v. Barclay Bank Trust Ltd (No. 1)* [1980] Ch. 515.

150. Law Commission, *Fiduciary Duties of Investment Intermediaries*, Law Com No 350, June 2014.

151. Chapter 2 of the COBS.

152. FCA, *A Duty of Care and Potential Alternative Approaches: Summary of Responses and Next Steps*, FCA Feedback Statement FS19/2, April 2019.

153. PERG 8.1 of the FCA Handbook.

FOS. The decisions of the FOS are not published, and it decides cases with high efficiency and quality,¹⁵⁴ so the FOS is able to resolve most complaints within three months of the case handler getting in touch with clients. In 2018/19, 63% of people in the UK were satisfied with FOS services, 76% of the public trust FOS and 79% of business respondents had confidence in FOS.¹⁵⁵ FOS also has a cost advantage compared with litigation fees: clients do not need to pay a case fee for their first 25 complaints. From the 26th complaint onwards, FOS charges a case fee of GBP 550.¹⁵⁶ If clients accept the ombudsman's decision, the business must comply with that decision. However, if clients do not want to accept the ombudsman's decision, they may still be able to take legal action against the business although the FOS would not be involved in the court proceedings. As mentioned previously, breaches of the industry standards set out in the FCA's handbook would not necessarily be a breach of the standard of care that would result in the courts awarding damages to the claimant. In this way, the US style of class action can be avoided, especially when the fiduciary duty in the US also includes the duty of care.

The translation and interpretation of the common law duty of care into Chinese civil law is a task which is far from straightforward, but European standards for asset management could provide a blueprint for how these standards of care for asset management can be embraced by both common law and civil law jurisdictions. Any special law created for asset management should include specific duties with which asset managers should comply. To avoid conflicts between this special law and the general principle of civil law, the specific duties could be created in such a way that the law would only provide regulatory sanctions or enable investors to claim compensation through an alternative dispute resolution mechanism. This would remove the risk of class action lawsuits against funds or host institutions, which could be detrimental to the development of the industry.

3. Raising industry standards

The UK's FCA introduced a Senior Managers and Certification Regime (SMCR) to hold individuals accountable for breaching the rules intended to raise the standards of the asset management industry.¹⁵⁷ Asset managers need to comply with a number of prescribed duties and will also be responsible for any breach of these rules by their employees if they fail to take reasonable steps to prevent the risks.¹⁵⁸ The SMCR increases the individual costs for senior managers in the asset management industry¹⁵⁹ but it also sets standards for financial services providers that are higher than the common law rules.¹⁶⁰ It not only aims to encourage asset managers to take personal responsibility for their actions, but also to ensure that financial firms and their staff clearly understand and live up to their responsibilities.¹⁶¹ If there is a breach of SMCR rules, FCA

154. E. Kempson, S. Collard and N. Moore, 'Fair and Reasonable: An Assessment of the Financial Ombudsman Service', Personal Finance Research Centre, University of Bristol.

155. Financial Ombudsman, Financial Ombudsman Services Annual Review 2018/2019, Financial Ombudsman.

156. *Ibid.*

157. FCA, Extending the Senior Manager & Certification Regime to FCA Firms – Feedback to CP 17/25 and CP 17/40, and Near-Final Rules, Policy Statement PS 18/14, July 2018.

158. FCA, The Senior Managers and Certification Regime: Guide for FCA Solo-Regulated Firms, July 2019.

159. FCA, Individual Accountability: Extending the Senior Managers and Certification Regime: Cost-Benefit Analysis, Consultation Papers CP 17/25 and CP 17/26, July 2017.

160. FCA, 'Senior Managers and Certification Regime', www.fca.org.uk/firms/senior-managers-certification-regime.

161. *Ibid.*

investigations and disciplinary action will follow. For instance, Tullett Prebon (Europe) Limited was fined £15.4m by the FCA because of its inadequate risk management systems, its failure to be open and cooperative with the FCA, and its failure to conduct its businesses with due skill, care and diligence between 2008 and 2010.¹⁶²

While private law may be an effective way to raise professional standards (such as the US style of class action), private enforcement can be costly and clients may not have the means or incentive to bring suits against financial institutions that are better able to defend themselves against claims. Under the UK model, the FCA has the direct power to monitor firms' activities and require them to submit a statement to demonstrate how they are living up to their responsibilities. Firms need to set up rigorous internal compliance systems to cover issues such as training, and to ensure that their employees at all levels comply with the standard.

Because SMCR is merely the FCA's set of rules of conduct for employees of relevant authorized persons,¹⁶³ created in order to advance the operational objectives of the FCA, and is not a statutory law,¹⁶⁴ a breach of SMCR rules does not give rise to client action for damages in accordance with FSMA 2000.¹⁶⁵ There has been intensive discussion about the consequence of breaching these rules.¹⁶⁶ Intensive lobbying from the industry may be one reason for the lack of private enforcement power; another practical reason is that the conduct rules are subject to change.¹⁶⁷ Regulators need to take time to write the rules, the industry requires time to implement them, and then the regulators need to learn from experience in the application of the rules before making improvements. Allowing breaches of the rules to trigger private actions in the courts makes reform of the rules more difficult. Because some of the conduct rules are designed not only to protect investors but also to reinforce market integrity and market competition, it is not possible to stipulate the objective of each rule.

4. Recommendation

China is in the process of developing its capital market under its open reform programme and should gradually open this sector to more competition. Asset management is an important sector that can help distribute investment power that was previously more centralized. It can provide additional investment outlets and financial products to consumers, and thereby create an independent asset management sector that can act as a corporate monitoring mechanism. However, asset management is and has been used in China for shadow-banking, which creates financial instability.¹⁶⁸ The current asset management industry in China does not exist to help institutional investors diversify investment risks;¹⁶⁹ providing investment outlets and additional products to retail

162. Dentons, 'FCA Disciplinary Action Puts Senior Managers in the Spotlight', (2019), www.dentons.com/en/insights/articles/2019/november/25/fca-disciplinary-action-puts-senior-managers-in-the-spotlight.

163. 64A(b) and 71A, FSMA 2000.

164. 64A, FSMA 2000.

165. 64A, 138D of FSMA 2000.

166. FCA, Individual Accountability: Extending the Senior Managers and Certification Regime: Cost-Benefit Analysis, Consultation Papers CP 17/25 and CP 17/26, July 2017.

167. S. Leslie, 'SMCR Practical Steps: Conduct Rules, Employment Contracts, Policies', www.xperthr.co.uk/legal-guidance/smcr-practical-steps-conduct-rules-employment-contracts-policies/164729/.

168. S. Wei, 23 *Asia Pacific Law Review* (2015), p. 102.

169. UBS, 'UBS Asset Management Launches Debut China Onshore Multi Asset Private Fund', (2019), www.ubs.com/global/en/media/display-page-ndp/en-20191024-multi-asset-private-fund.html.

investors and consumers has not been its core business.¹⁷⁰ We have argued that reliance on private law alone does not provide investor confidence and in China, fiduciary duty is only imposed on those asset managers who use trust as the legal vehicle to manage client assets. Investors do not benefit from the protection of fiduciary duty when other types of asset management vehicles such as agency relationships are used. Since the provision of trust services in China is limited to trust companies, many investors use agency as a mechanism to circumvent this restriction for investment firms to manage their assets. This creates a protection gap for investors because there is no fiduciary duty under the law of agency.

In China, the protection given to investors by fiduciary duty is especially important when asset managers are prohibited from promising an expected (fixed and guaranteed) return to investors, that is, rigid payment. Before the introduction of the Guiding Opinions, the asset management industry often provided rigid payment to their clients, and investors were unlikely to insist on their right to know or to influence the investment strategy applied by asset managers. Even if the investment was unsuccessful, when guaranteed payments were allowed investors still received the agreed investment return which meant that fiduciary duty was of little importance. However, asset management businesses have normally been off-balance sheet activities with no capital reserve requirement for possible losses and no 'lender of last resort' protection from the Central Bank. When payment is guaranteed to investors, financial institutions make their profit through the difference between the guaranteed payments to investors and the actual investment returns, rather than through commission fees or carried interests (performance fees). In reality, asset management businesses which guaranteed payment were lending, but it was disguised under another name. These shadow banking businesses created systemic risk for financial institutions because any shadow banking system is inherently fragile¹⁷¹ since it lacks the protective measures that are applied to normal bank lending. As a result, the expansion of asset management businesses meant that there was an increasing systemic risk until eventually rigid payment was banned by the Guiding Opinions. Without the protection provided by guaranteed payments, fiduciary duty becomes increasingly important to investors because of the information asymmetry and the difference in bargaining power between financial services providers and investors.

In recent years, China has been active in the introduction of the EU style of regulation to provide protection to investors. The duty of avoiding conflict of interest, the suitability rules, due care and diligence, and best execution rules have all been introduced in order to provide more protection to investors.¹⁷² For instance, the revised Securities Law 2020, which came into force on 1 March 2020, introduced 'the suitability rule' and transplanted Chinese-style class actions from the investor protection model of Taiwan.¹⁷³ Investors are able to bring a legal action to the court to claim compensation on the basis of asset managers' breach of the suitability rule, and the basic principles as set out in various laws. The main basis for claims is provided by, for example, the Contract Law, the Securities Law, the Securities Investment Fund Law, the Trust Law and the normative

170. European Commission, *Distribution Systems of Retail Investment Products Across the European Union* (European Commission, 2018).

171. K. Hachem, 'Shadow Banking in China', *10 Annual Review of Financial Economics* (2018), p. 287.

172. Such as Article 21, Securities Investment Fund Law; Articles 25 and 33, Trust Law; Articles 6, 8 and 22, New Asset Management Rules.

173. Articles 88 and 95 of Securities Law (2019 revision); also see Tang Xin, 'Alternative Mechanism of Securities Class Action from a Comparative Perspective' *4 Securities Law Review* (2011), p. 174, 200.

document issued by the State Council.¹⁷⁴ In addition, the Supreme People's Court has clarified that departmental rules, such as the Guiding Opinions, or the CSRC and CBIRC rules, can also be applied by the court to decide whether or not asset managers have breached the suitability rule. UK law provides for private action against breaches of public regulations such as the FCA public rules¹⁷⁵ but reliance on the courts to provide redress is slow and costly¹⁷⁶ so, as in the UK, China should establish a Financial Services Ombudsman to provide expedient dispute resolution mechanisms for investors.

It is not, however, necessary for China to revise its civil law to provide protection to investors in asset management. In English law, as noted above, fiduciary duty has a very broad scope of application that can conflict with civil law jurisdiction. Lawmakers in China therefore need to introduce specific rules that close the asymmetric information gap when asset managers exercise their duties. These specific duties can be outlined in public regulations. In English law, some of the fiduciary duties can be contracted out or limited by way of approval or authorization; these can also be specifically stated in public regulations. One difference between English law and the US common law approach to fiduciary duty lies in the duty of care: whether asset managers must exercise due care and diligence in exercising fiduciary duty. In English law, such a tortious duty can be limited by agreement but in the US, it is part of the fiduciary duty and some states, such as Delaware, allow parties to contract out fiduciary duties in the operating agreement,¹⁷⁷ while in others, such as Arkansas, the duty of loyalty may not be eliminated and duty of care may not be unreasonably reduced.¹⁷⁸ It is possible for public regulations to state clearly whether the duty to exercise due care and skill can be contracted out and what remedies are available for any breach. In the UK, the standards of care are set by public regulations such as the FCA conduct rules. Chinese policy makers can decide how to set the standards of conduct in the asset management industry and state clearly whether a breach of these industry standards will result in a breach of duty of care.¹⁷⁹ Some flexibility is needed in the way they set and address industry standards. Since the market is developing rapidly, the codification of standards into civil law would make the rules rigid and inflexible. Furthermore, as the courts may not be familiar with the operations and expectations of the industry, their rulings can have an adverse impact on market development.¹⁸⁰ For the protection of institutional investors, there can also be soft law, such as the UK Stewardship Code,¹⁸¹ to

174. Article 73, Notice by the Supreme People's Court of Issuing the Minutes of the National Courts' Civil and Commercial Trial Work Conference, No. 254 of the Supreme People's Court, November 2019.

175. The breach of FCA conduct rules is not civilly actionable.

176. FCA, Review of Retained Provisions of the Consumer Credit Act: Final Report, Presented to Parliament Pursuant to Paragraph 20 (8) of Part 5 of the Financial Services and Market Act 2000 (Regulated Activities), Order SI 2014/366, March 2019.

177. J. Pace, 'Contracting Out of Fiduciary Duties in LLCs: Delaware will Lead, but will Anyone Follow?', 16 *Nevada Law Journal* (2016), p. 1085, 1143.

178. Arkansas Code Annotated S. 4-47-110 (b) (5) & (6).

179. FCA, Discussion Paper on a Duty of Care and Potential Alternative Approaches, FCA Discussion Paper DP18/5, July 2018, p. 3; also see FCA, A Duty of Care and Potential Alternative Approaches: Summary of Responses and Next Steps, FCA Feedback Statement FS19/2, April 2019.

180. A. Street, *Judicial Review and the Rule of Law: Who Is In Control?* (1st edition, The Constitution Society, 2013), p. 20, 49.

181. The 2012 UK Stewardship Code aims to enhance the quality of engagement between investors and companies to help improve long-term risk-adjusted returns to shareholders.

provide voluntary industry standards for asset managers to exercise their governance rights in the invested companies for the benefits of their clients.

The collective investment vehicles, such as securities investment funds, collective trust plans and collective asset management plans that are widely applied in China, do not have separate legal personality¹⁸² which means that under such vehicles, there is a direct relationship between investors and asset managers. As a result, under China's model the advantages of the separated model mentioned in 2.1, such as benefits from economies of scale cannot benefit investors. The separate legal personality of certain collective investment vehicles should be admitted by law in order to develop an active asset management industry and to enhance investor protection.¹⁸³

5. Conclusion

The UK legal and regulatory model for investor protection in asset management consists of private law, public regulation and industry guidelines. Private law can create a bargaining model in which parties can allocate risks through contractual negotiation. This model is useful for the development of the asset management industry. Public regulation can be introduced with a specific scope to protect weaker parties and to raise the overall professional standards of the sector. Voluntary codes can improve industry standards and detail best practice. Under the UK model, private law sets out the minimum standards of asset managers' duties, and public regulation establishes higher industry standards and provide different modes of enforcement mechanisms for redress, such as the Financial Services Ombudsman. There is also soft law in the form of industry standards such as the Stewardship Code and the AIC code that emphasize good industry practice.

In addition to private law, public regulation also governs the asset management industry under the UK model. EU laws, such as MIFID II, UCITS and AIFMD have been transposed and integrated into the UK model, and these impose higher standards of duty for asset managers to protect weaker parties and maintain market integrity. For example, FSMA 2000 introduced the non-exclusive fiduciary obligations for scheme managers of UCITS funds. The FCA's Conduct of Business Rules, which it enforces, also set higher standards including the best execution rule, the principle of best interests of clients, the duty to act with integrity and fairly towards the clients, and the duty to cooperate with the FCA. However, a breach of FCA rules by fund managers does not automatically trigger private action. Alternatively, the FOS, established by parliament, decides cases by official experts with high efficiency and resolves disputes in the financial service sector without lengthy and expensive court litigation. To hold individuals accountable for breaching rules, the FCA introduced SMCR, which aims to raise the standards of the asset management industry.

China's asset management industry has been criticized for its lack of independence, insufficient investor protection, and potentially higher systemic risks. This paper has shown that the English model of investor protection in the asset management industry can offer lessons to China. First, the duties of asset managers in China are set out in various laws and administrative regulations, which are inconsistent in some areas. In the UK, the specific fiduciary duty and duty of care apply to asset management regardless of the type of investment vehicle used. Hence, the introduction of a UK-style fiduciary duty scheme into the asset management industry can unify the duties of asset


182. R. Huang, 5 *Global Law Review* (2019), p. 1, 14.

183. *Ibid.*

managers to provide identical protections to investors. Secondly, the UK model identifies circumstances in which duties of asset managers can be excluded by contractual agreements, along with the methods of exclusion, in order to promote the development of the asset management industry, but it also offers protections to the party with a weaker bargaining position through non-excludable duties in mandatory rules. China can also learn from this model how to strike a fair balance between the development of the asset management industry and the protection of investors through the introduction of a special law. Thirdly, collective investment vehicles do not have separate legal personalities under China's current model and as a result, the UK-style separated structure of investment vehicles cannot be applied. Hence, we suggest that the separate legal personality of certain investment vehicles should be admitted by laws. Fourthly, the enforcement mechanisms under the UK model can give access to justice, while soft law (industry guidelines) can help establish industry standards. Because of the unequal bargaining position between investors and asset managers brought about by information asymmetry, the principles of fairness, trustworthiness, and equality in China's contract law are not adequate to protect investors and alternative mechanisms for dispute resolution, such as the UK's FOS, may provide an efficient resolution to address the imbalance.

A wholesale legal transplant of the UK model into China is not likely to provide legal stability because it would affect a number of relationships under the civil law system. It would also be difficult to reconcile with some existing civil law principles in China, such as the principles of fairness, trustworthiness and equality. Instead, the introduction of a special law for the asset management industry that details general and specific duties is a more realistic approach. Current regulations, such as trust law and the Guiding Opinions, have already provided a list of duties for asset managers but they are set out in several regulations and are not consistent. The introduction of a fiduciary duty regime into the asset management industry in China through a special law could unify the duties of financial services providers in different sectors of the asset management industry, and also avoid difficulties of reconciliation with existing civil law principles.

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