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Money Under Sunshine: An Empirical Study Of Trust Contracts Of Chinese Hedge Funds

Cover Page Footnote

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MONEY UNDER SUNSHINE: AN EMPIRICAL STUDY OF TRUST CONTRACTS OF CHINESE HEDGE FUNDS

Jing Li

MONEY UNDER SUNSHINE: AN EMPIRICAL STUDY OF TRUST CONTRACTS OF CHINESE HEDGE FUNDS

Jing Li[*]

ABSTRACT

This article conducts the very first empirical study exploring the contractual arrangements of Chinese hedge funds, which are organized not as limited partnerships but as trusts. Using 139 trust contracts collected by hand, this article sheds light on the structure, covenants, and compensation mechanisms used by "sunshine funds," the local name for hedge funds in China. It shows that, while sunshine funds do have similar contractual arrangements as typical LP-organized hedge funds, they also possess many undeniable differences due to the jurisdiction-specific characteristics of China. In particular, because of the direct involvement of trust companies, sunshine funds include certain covenants and terms that could both narrow the decision-making power and dampen the incentives of investment advisers. New, but rapidly developing, sunshine funds have been frequently targeted by regulatory efforts, which, however, come at a low level of consistency and sometimes lack in-depth consideration. Growing out of gray regulatory areas, Chinese sunshine fund managers have demonstrated remarkable competence in positioning themselves by taking advantage of favorable regulations and mitigating the impact of unfavorable ones. Looking ahead, it is of key importance that a proper balance is reached in terms of what role regulators should play in dealing with the Chinese hedge fund industry.

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INTRODUCTION

Although lacking a legal or regulatory definition, the term "hedge fund" usually describes a type of alternative investment vehicle that possesses four general characteristics: (1) it is a pooled, privately organized fund; (2) it is administered by professional investment managers; (3) it is not widely available to the public; and (4) it operates outside of securities regulation and registration requirements.[1] Although many private equity or venture capital ("VC") funds also share these characteristics, those funds are distinguishable because they invest in unlisted portfolio companies for relatively long-term periods for the purpose of securing lucrative exits afterwards. As a class, however, hedge funds can embark upon a broad range of investments including equities, debt and commodities. They are often associated with using active trading strategies and employing sophisticated instruments (most notably short-selling and derivatives) to hedge investment risks and increase returns. Most of the time, hedge funds tend to focus on trading publicly-listed securities; in recent years, however, they also have invested through side pockets into those assets that are comparatively illiquid or hard-to-value,[2] thus indirectly broadening their coverage further to private markets. Therefore, it is important to bear in mind that there is a wide range of variations among hedge funds, and while some hedge funds do share some or all of these characteristics, others do not. Every hedge fund has its own investment strategy that determines the type and method of investment it undertakes. As a result, it is easier to recognize hedge funds than it is to define them.[3]

Due to strong economic growth while major developed countries suffered from the global recession, China recently surpassed Japan to

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1. Frank Partnoy & Randall S. Thomas, *Gap Filling, Hedge Funds, and Financial Innovation*, *in* BROOKINGS-NOMURA PAPERS ON FINANCIAL SERVICES, 23 (Yasuki Fuchita & Robert E. Litan eds., 2007), *available at* http://ssrn.com/paper=931254.

2. Houman B. Shadab, *Coming Together After the Crisis: Global Convergence of Private Equity and Hedge Funds*, 29 NW. J. INT'L L. & BUS. 603, 608 (2009).

3. Hedge Fund Standards Board, *The Hedge Fund Sector: History and Present Context*, HFSB.ORG, http://www.hfsb.org/sites/10109/files/what_is_a_hedge_fund.pdf (last visited Nov. 4, 2010).

become the world's second-largest economy.[4] The value of the Chinese stock market has boomed. From a marketplace with only twelve stocks trading when its first two stock exchanges opened in 1990 in Shanghai and Shenzhen,[5] the combined value of companies with stocks traded on China's equities markets is now comparable to that of Japan's, surpassing the latter periodically during the past two or three years.[6] Furthermore, the long-anticipated margin trading[7] and stock index

4. David Barboza, *China Passes Japan as Second-Largest Economy*, N.Y. TIMES, Aug. 15, 2010, at B1.

5. Bai Haiyan, *Ziben shichang fazhan dui gongsi zhili de zuoyong* [*The Impact of the Development of Capital Markets over Corporate Governance*], 22 ZHONGGUO JINGMAO [CHINESE BUS. UPDATE] 83, 83 (2008).

6. The combined value of companies trading on China's equities markets reached US$3.09 trillion as of August 16, 2010, compared with US$3.51 trillion for Japan, according to data compiled by Bloomberg News. *See China to Surpass Japan as No. 2 Stock Market*, BLOOMBERG NEWS, Aug. 17, 2010, *available at* http://business.financial post.com/2010/08/17/china-to-surpass-japan-as-no-2-stock-market/#ixzz0xRYgQnER. China briefly surpassed Japan by capitalization in January 2008, shortly after PetroChina Co. debuted in Shanghai, and again in July 2009 as a consequence of the government's 4 trillion-yuan (US$587 billion) economic stimulus program directed at infrastructure projects and shares.

7. Margin trading was officially legalized in June 2006 by Zhengquan gongsi rongzi rongquan yewu shidian guanli banfa [Measures for the Administration of Pilot Securities Lending and Borrowing Business of Securities Companies] (promulgated by China Securities Regulatory Commission [hereinafter CSRC], June 30, 2006), LAWINFOCHINA, *available at* http://www.lawinfochina.com, but only materialized on Mar. 19, 2010 when the CSRC designated six securities brokerage firms as the first batch of "trial firms" to begin the business of margin trading and securities lending. *Mainland China Securities Survey 2010* (KPMG China, Hong Kong), Sep. 2010, at 6, *available at* http://www.kpmg.com/cn/en/IssuesAndInsights/ArticlesPublications/Page s/China-securities-survey-201010.aspx. The day before the official launch of the trial program, CITIC Securities signed an agreement with Jiangsu Winfast Investment and Development Co. Ltd., offering the latter credit limits of RMB 28 million for margin trading and RMB 10 million for short selling. This is considered to be the very first of such transactions in China. *See* Hu Yang, *China Begins Margin Trading Trial*, CHINA DAILY, Mar. 31, 2010, *available at* http://www.chinadaily.com.cn/business/2010-03/31/content_9668589.htm. Jiangsu Winfast is a securities asset management company, and has several sunshine funds (one type of Chinese hedge funds) under its management. *See* Jiangsu Winfast Investment Holding Grp., *Company Profile*, http://www.jiangsuruihua.com/en/article.asp?c_id=42 (last visited Nov. 8, 2011); Jiangsu Winfast Investment Holding Grp., *Securities Trust Schemes Issued by Winfast*, http://www.jiangsuruihua.com/en/article.asp?c_id=56 (last visited Nov. 8, 2011).

futures[8] finally materialized in the spring of 2010, so it is now possible to get credit quotas for margin trading and short-selling from approved securities brokerage firms, and to trade Shanghai-Shenzhen 300 stock index futures contracts. These technical developments, combined with considerable market capitalization and strong economic growth, demonstrate China's great potential to become an important hedge fund market.

Nonetheless, a "hedge fund" is still a very novel concept in China. Given that Chinese people's familiarity with hedge funds is somewhat limited to anecdotal knowledge,[9] the apparent existence of the Chinese hedge fund industry is ambiguous. Among other things, this ambiguity partially results from the general aversion in China towards the phrase "hedge funds," due to the negative impression they left on South-eastern Asian countries in the 1997 Asian financial crisis,[10] and more recently,

8. Financial derivatives (specifically, futures) were officially legalized in March 2007 by Qihuo jiaoyi guanli tiaoli [Regulation on the Administration of Futures Trading] (promulgated by the State Council, Mar. 16, 2007), LAWINFOCHINA, *available at* http://www.lawinfochina.com, but only materialized in April 2010 when the Shanghai-Shenzhen 300 stock index futures contracts, the very first of such in China, were listed on the China Financial Futures Exchange. *See Mainland China Securities Survey 2010*, *supra* note 7, at 8.

9. For a collection of anecdotal articles on hedge funds in China, *see generally* Richard Wilson, *China – Hedge Funds: Guide to Hedge Funds in China*, HEDGEFUNDBLOGGER.COM, http://richard-wilson.blogspot.com/2008/05/china-hedge-funds-hedge-funds-in-china.html (last visited Nov. 2, 2011).

10. Hedge funds have been charged with playing a pivotal role in the 1997-98 Asian financial crisis due to their involvement in large transactions they have done in various Asian currency markets, such as Thailand, Malaysia, the Philippines, and then Hong Kong, South Korea, etc. In particular, the then Prime Minister of Malaysia blamed hedge fund manager George Soros for "attacks in the marketplace on the Malaysian ringgit and other currencies in order to generate profits for themselves without regard to the livelihood of the Malaysian or other local people." *See* DICK K. NANTO, CONG. RESEARCH SERV., THE 1997-98 ASIAN FINANCIAL CRISIS (1998), *available at* http://www.fas.org/man/crs/crs-asia2.htm; *see also* Barry Eichengreen & Donald Mathieson, *Hedge Funds, What Do We Really Know?*, ECON ISSUES No. 19, International Monetary Fund (1999), *available at* http://www.imf.org/external/pubs /ft/issues/issues19/index.htm#5. However, it is also submitted that despite these allegations, there is no empirical evidence that George Soros, or any other hedge fund managers, were responsible for the crisis. *See* Stephen J. Brown et al., *Hedge Funds and the Asian Currency Crisis*, 26 J. PORTFOLIO MGMT. 95 (2000).

accusations against them in the 2008 global financial crisis.[11] As such, it would be unwise and difficult for private investment managers to raise a fund in China under a name that the public generally associates with a negative image. Rather, the hedge-fund-like investment vehicles are referred to as "sunshine privately offered funds,"[12] which can sound quite odd to outsiders. For the sake of simplicity, I refer to these funds as "sunshine funds" in this article.

Another important factor contributing to the dearth of information on Chinese hedge funds is their unique organizational structure. In the United States, which has the world's most developed hedge fund industry,[13] the limited partnership ("LP") prevails as the prevalent business form for a hedge fund.[14] On the one hand, fund managers act as general partners, actively managing the fund and bearing unlimited liability.[15] On the other hand, investors are passive limited partners who

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11. The financial crisis of 2008 has led to renewed debate about the impact of hedge funds on the functioning of financial markets. Although it is largely recognized that hedge funds should not be blamed for causing the crisis, there seems to be a consensus among regulators in the world that they should be more regulated, which is arguably stems more from a political fear for being criticized if no scapegoat can be spotted rather than from a real need. *See* Anne C. Rivière, *The Future of Hedge Fund Regulation: A Comparative Approach: United States, United Kingdom, France, Italy, and Germany,* 10 RICH. J. GLOBAL L. & BUS. 263, 291 (2011).

12. The term "sunshine privately offered funds" is a literal translation of the corresponding Chinese. For a brief introduction of sunshine funds, *see* http://www.asimu.com/knowledge/infocontent/1238/41297.html. Because this type of fund uses a trust to raise capital from investors and then manages the raised capital for them, they are legal and thus "under the sunshine." In contrast, those funds that do not use the trust form may face various challenges such as ambiguous legal status, thus they operate "in the shadow." Therefore, this name is actually a vivid depiction of those privately offered funds, using the trust as their business form, and primarily focusing on investing in publicly listed securities. Sunshine funds, particularly the unstructured ones (further discussion in Part II.B), are considered comparable to hedge funds, in that that they both aim to pursue absolute returns and have similar fee structures. *See* http://www.crctrust.com/cgi-bin/web/TemplateAction?catalogNo=ywgl,smzs.

13. As of the end of 2009, the US was the largest management center for hedge funds and also the leading location for management of hedge fund assets with over two-thirds of the total. *See* International Financial Services London, *IFSL Research Hedge Funds 2010*, THECITYUK.com, (Apr. 2010), *available at* http://www.thecityuk.com /assets/Uploads/Hedge-funds-2010.pdf.

14. DOUGLAS L. HAMMER ET AL., U.S. REGULATION OF HEDGE FUNDS 88 (2008).

15. Jacob Preiserowicz, *The New Regulatory Regime for Hedge Funds: Has the SEC Gone Down the Wrong Path?*, 11 FORDHAM J. CORP. & FIN. L. 807, 812 (2005). In practice, however, the "actual" general partner of a fund is often not the fund manager

are shielded with limited liability protection but have to leave investment decisions to general partners.[16] One important feature common to virtually all LP-type hedge funds is their fee structure, typically consisting of a management fee of 2% and a performance fee of 20%.[17] This structure heavily incentivizes managers to generate good performance for investors. In contrast, no Chinese hedge fund was formed as a LP until March 2010, when the first LP-type private securities investment fund was created in Beijing.[18] Although limited partnerships have been legally authorized in China since 2007,[19] only 31 private securities investment funds were identified as LPs as of the end of 2011.[20] Arguably, the low usage of LPs among Chinese hedge funds may be a result of the fact that there are virtually no precedents available to regulators, practitioners, and taxation authorities on how to deal with this new business form.[21]

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itself, but a management company set up by it. By doing this, fund managers are shielded by the limited liability protection of the management company, thus leaving the unlimited liability at the entity level. *See infra* notes 15, 28 and accompanying text.

16. Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1735 (2008).

17. *Id*.

18. Zhao Juan & Hu Zhongbin, *Shouge hehuozhi zhengquan simu jijin tanmi* [*Exploring the First Privately Offered Partnership Securities Fund*], JINGJI GUANCHA BAO [THE ECONOMIC OBSERVER], Mar. 13, 2010, *available at* http://www.eeo.com.cn/finance/securities/2010/03/13/165159.shtml. This first partnership fund is named Yinhe Purun, and is registered in Beijing.

19. Limited partnership was first legally permitted in 2006, when China amended its Partnership Enterprise Law. *See* Zhonghua renmin gongheguo hehuo qiye fa [Partnership Enterprise Law (P.R.C.)] (promulgated by the Nat'l People's Cong., Feb. 23, 1997) (amended Aug. 27, 2006) (took effect June 1, 2007), LAWINFOCHINA, *available at* http://www.lawinfochina.com.

20. According to the database provided by Simuwang.com, a total of 11 funds were set up as limited partnerships for the entire year of 2010, and 20 funds for the entire year of 2011. *See* http://data.simuwang.com/product.php (follow "product type"; then select limited partnership; next choose 2010 and 2011 from under "year established").

21. It is submitted that in order to enhance the popularity of limited partnership among privately offered securities investment funds, four difficult questions need to be tackled first. Among other things, it remains to be seen (1) whether these LP-organized funds will be equally attractive to investors when there is no trust company involved; (2) how LP-organized funds are going to properly entertain frequent subscription and redemption needs, given the statutory requirement for unanimous approval from all partners and changing official registration with the regulatory authorities when an

Instead of the LP form, the vast majority of Chinese hedge funds are created as securities investment trust plans based on a "four party cooperation platform" provided by various trust companies.[22] This might explain the impression that China seems to lack a hedge fund industry – after all, these trust-like funds look quite different from the much better known LP-type funds. The very first trust-organized sunshine fund in China was created in 2004,[23] yet the industry has been developing at a remarkable pace ever since. According to the *Go-Goal Database for High-End Investors*, there are altogether 703 trust sunshine funds in operation as of August 9, 2010, and the number increases to 838 when including those that had been terminated.[24] Although it is undisputed that China's hedge fund industry still has a long way to go, it seems equally unwarranted to simply deny its existence when a large number of funds are already in the business. Given the limited understanding of these trust sunshine funds, timely research into them is both worthwhile and practicable.

Just as LP agreements provide insight into the creation and governance of American hedge funds, the best way to understand how Chinese sunshine funds are established and operated is to look at their "trust agreements for collective securities investment funds." Fortunately, while hedge funds in developed markets are generally

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existing partner exits or a new partner is brought into the partnership; (3) how they are going to safely keep and use the money from investors when the Partnership Enterprise Law does not make mandatory a custodian bank to be designated for that purpose; and (4) which governmental authority should be supervising LP-organized sunshine funds. Moreover, many questions also remain unanswered as to the taxation of limited partnerships and their investors and managers. *See* Xiao Yongjie, *Yangguang simu youxian hehuo zhi sida nanti* [*Four Difficulties for Sunshine Funds Organized as Limited Partnerships*], ZHENGQUAN SHIBAO [SECURITIES TIMES], Mar. 15, 2010, *available at* http://simu.howbuy.com/xinwen/178846.html.

22. *See infra* Part II.B.

23. This fund was called SZITIC PureHeart, created on Feb. 20, 2004 in Shenzhen and terminated on Jan. 15, 2008. The fund is reported to have realized an accumulated return of 370.86% as of its liquidation. *See* Zhang Bin, *Zhao Danyang: Shangwu huigui A gu shichang de jihua* [*Zhao Danyang: Currently No Plan to Return to a Stock Market*], CAIJING, Feb. 18, 2009, *available at* http://www.caijing.com.cn/2009-02-18/110071131.html.

24. *See* GO-GOAL DATABASE FOR HIGH-END INVESTORS, http://www.go-goal.com/inv_trust/basic/default.aspx. *See infra* Part III for further discussion of empirical data. Sunshine funds were filtered out manually by the author on the website provided.

considered quite secretive due to the much lighter regulation and disclosure requirements imposed on them, the trust-like sunshine funds are somewhat more transparent because trust companies in China are subject to certain disclosure requirements as supervised and regulated financial institutions.[25] In addition, some fund managers also voluntarily publish information on their websites about the funds they manage. As a result, it is possible to obtain the trust contracts of some Chinese hedge funds. Using a sample of 139 trust agreements and explanations of trust plans,[26] this article investigates the contractual arrangements of Chinese sunshine funds and aims to demonstrate how the salient terms of these trust plans govern the operation of sunshine funds. Particular attention will be given to those terms that control the roles of investment advisers and trust companies, who cooperate and interact with each other in a manner analogous to fund managers in American hedge funds contracts.

Part I of this article provides a brief summary of the contractual and governance structure of American LP-type hedge funds, together with an overview of previous research papers written on the contractual arrangements of alternative private investment vehicles. Part II describes the current regulatory environment surrounding hedge funds in China. Finally, Part III discusses and analyzes empirical data regarding the structure, covenants, and compensation mechanisms of sunshine funds.

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25. Generally, trust companies must disclose to their clients and the relevant interested parties the key information about their business. For a collective capital trust plan, they must, at least for every quarter of a year, create a "trust capital management report" to disclose the major issues in managing the trust. They must also disclose weekly on their websites the unit net asset value of each of their securities investment trusts (such as sunshine funds). *See* art. 34-38 of Xintuo gongsi jihe zijin xintuo jihua guanli banfa [Administrative Measures for Collective Capital Trusts Established by Trust Companies] (promulgated by the CBRC, Jan. 23, 2007), LAWINFOCHINA, *available at* http://www.lawinfochina.com; *see also* art. 15-17 of Xintuo gongsi zhengquan touzi xintuo yewu caozuo zhiyin [Guidelines on Running the Business of Securities Investment Trusts by Trust Companies], (promulgated by the CBRC on Jan. 23, 2009), LAWINFOCHINA, *available at* http://www.lawinfochina.com.

26. *See infra* Part III.A.

I. CONTRACTUAL AND GOVERNANCE STRUCTURE OF HEDGE FUNDS

A. LIMITED PARTNERSHIP AS THE PREVALENT BUSINESS FORM IN PRIVATE INVESTMENT FUND INDUSTRY

LPs are widely used to contain the business of both hedge funds and private equity funds. The popularity of the LP in the private investment fund industry can be attributed to two primary incentives: flexible contractual structure and favorable tax benefits. Limited partners are those persons contributing substantially all of the partnership's capital, such as institutional investors, wealthy individuals,[27] and sometimes other hedge funds (giving rise to the fund of funds).[28] The general partner is a management company set up by professional investment managers, who are effectively shielded from the risk of unlimited personal liability arising as a result of actively managing the partnership and making investment decisions on the pooled capital.[29] Unlike a corporation, LPs are not separately taxed as an entity, so that the fund's profits and losses are passed through to its partners without any entity level tax.[30] Compared to limited partners, the general partner only contributes a nominal portion of the total assets/committed capital of the partnership, normally 1%,[31] but has the right of compensation much greater than its original contribution if the fund runs well. Such compensation is often referred to as the "2-20" mechanism, consisting of a fixed management fee, usually 2% of the total assets/committed capital of the fund, and a performance-based right to share 20% of the fund's net profits.[32] Such an arrangement serves to incentivize the general partner to work hard and manage investments diligently, providing an effective solution to the principal-agent problem.

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27. JOSEPH G. NICHOLAS, INVESTING IN HEDGE FUNDS, REVISED AND UPDATED EDITION 16-17 (2005).

28. *Id.* at 39. *See also* Jacob Preiserowicz, *supra* note 15, at 811.

29. *Id*. at 40.

30. NAVENDU P. VASAVADA, TAXATION OF U.S. INVESTMENT PARTNERSHIPS AND HEDGE FUNDS: ACCOUNTING POLICIES, TAX ALLOCATIONS, AND PERFORMANCE PRESENTATION 5 (2010).

31. Simon Friedman, *Partnership Capital Accounts and Their Discontents*, 2 N.Y.U. J.L. & BUS. 791, 798 (2006).

32. *See* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008); *see also* Friedman, *supra* note 31.

The governance structures of a typical private equity fund and hedge fund are shown in Figure 1 and Figure 2 below.

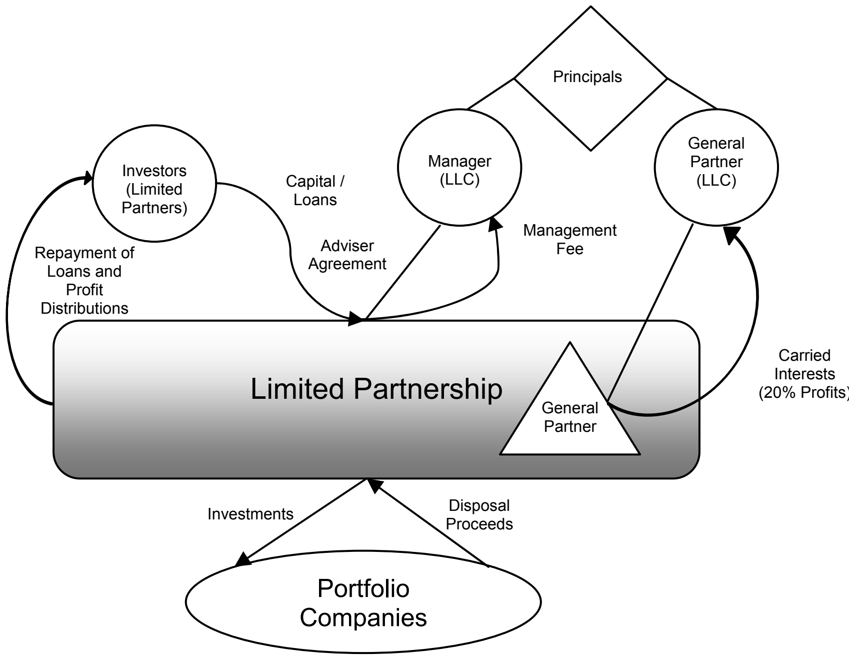
Particularly, the compensation scheme in hedge fund partnership agreements is usually identified by one important feature: high-water marks. By definition, a high-water mark is the highest peak in value that an investment fund has reached.[33] As already mentioned above, such performance-based compensation normally amounts to 20% of the net new profits if the previous high water mark is exceeded. The prevalence of high-water marks among hedge funds might be partially explained by the high level of reliance on fund manager expertise. Since investor payoff is presumably based more upon the expectation of superior managerial skill and less upon the expected returns to an undifferentiated or passively managed portfolio of assets, a mechanism is needed to incentivize fund managers to demonstrate their skills in order to justify their fees.[34]

33. William N. Goetzmann et al., *High-Water Marks and Hedge Fund Management Contracts*, 58 J. FIN. 1685, 1685 (2003).

34. *Id*. at 1686.

Governance Structures of Private Equity Funds and Hedge Funds

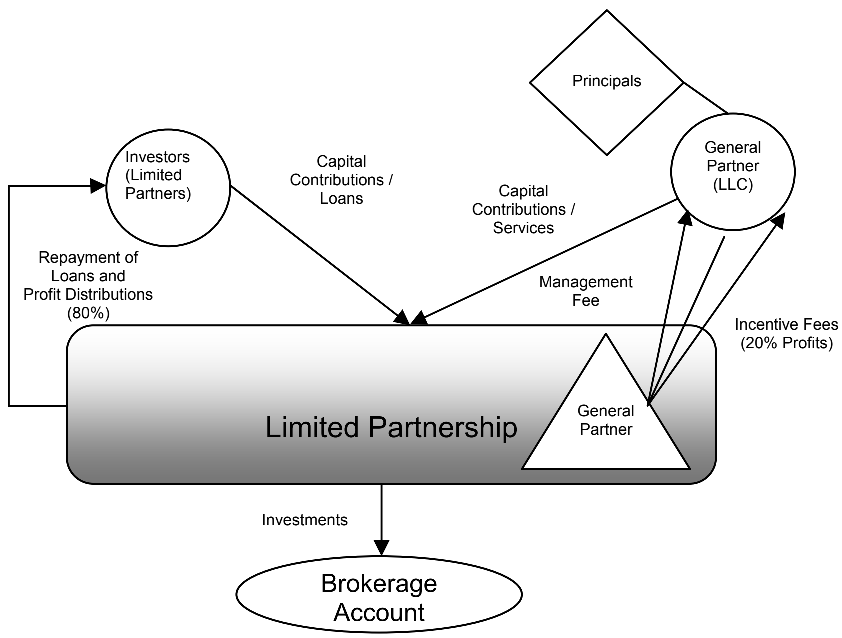
Figure 1
Private Equity Fund



Adapted from McCahery & Vermeulen (2008).[35]

35. JOSEPH A. MCCAHERY & ERIK P. M. VERMEULEN, CORPORATE GOVERNANCE OF NON-LISTED COMPANIES 187 (2008).

Figure 2
Hedge Fund



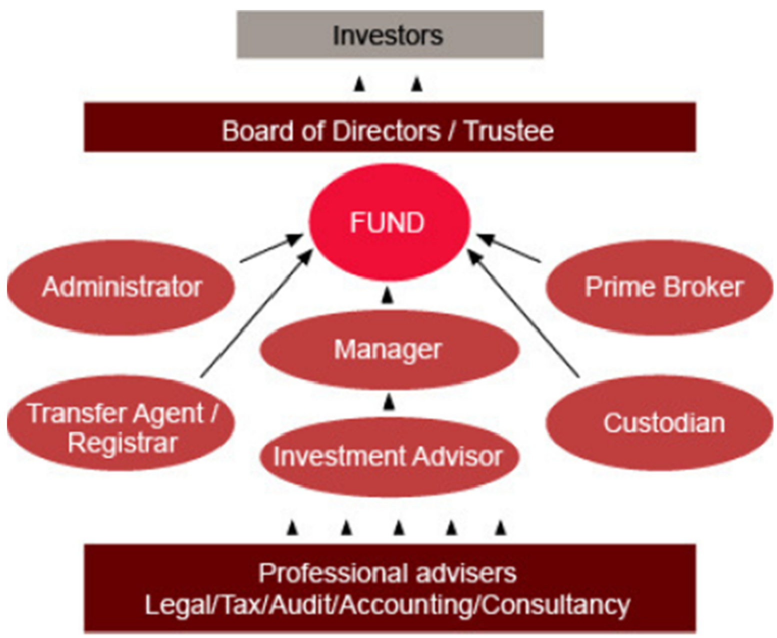
Adapted from McCahery & Vermeulen (2008).[36]

Despite a certain level of similarity between the two diagrams above, hedge funds differ from private equity funds in that hedge funds generally invest in public liquid assets via a brokerage account, whereas private equity funds typically purchase stock directly in non-listed portfolio companies. As such, hedge funds need an array of service providers working around them in order to maintain their operations. Figure 3, below, lists the typical parties involved in the operation of hedge funds. Specifically, an administrator is appointed to maintain records, as well as to independently verify the asset value of the fund. A registrar/transfer agent is responsible for processing subscriptions and redemptions and maintaining the registry of shareholders. A prime broker provides access to stock and loan financing and serves as a host

36. *Id.* at 186.

of value-added services.[37] A custodian ensures the safe-keeping of assets. At the top level, the board of directors or trustee of the fund bears a fiduciary duty to the investors to ensure that all parties involved in the fund properly carry out their respective tasks.[38] It is submitted that outsourcing a hedge fund's functions can help to minimize the risk of collusion among hedge fund participants to perpetuate fraud, and may also mitigate liability in the event that hedge fund participants are accused of improperly performing their management duties.[39]

Figure 3
Typical Service Providers for a Hedge Fund



Source: Cumming & Dai (2010)[40]

37. Douglas J. Cumming & Na Dai, *A Law and Finance Analysis of Hedge Funds*, 39 FIN. MGMT. 997, 1001 (2010).
38. *Id*. at 1001–1003.
39. *See* Cumming & Dai, *supra* note 37.
40. *Id.*

B. COVENANTS IN HEDGE FUND PARTNERSHIP AGREEMENTS – HOW CAN THE CORRESPONDING LITERATURE ON PRIVATE EQUITY FUNDS BE HELPFUL?

Although both private equity and hedge funds employ the same legal structure and "2-20" compensation mechanism from the outset, there are also pronounced differences between them in terms of their operations. Such differences result from the contractual flexibility of limited partnerships, which allows investors and fund managers to enter into covenants and schemes to suit their respective investment mandates.[41] A straightforward example in this regard is differing fund terms. Since investments by private equity funds are generally highly illiquid[42]—private equity funds focus on buying shares in unlisted firms and only hope to harvest from there after three to seven years.[43] There is a need to agree on a limited fund term at the expiration of which the general partner is obliged to return to limited partners the capital together with distributed profits. Correspondingly, general partners cannot access the full amount of the committed capital from the beginning of the fund, but they have the right to call in capital contributions once they have located proper investment projects.[44] Once the capital is invested, limited partners then need to remain patient and are prohibited from redeeming their partnership units until the end of the fund. In contrast, because hedge funds primarily invest in publicly listed securities, their assets are comparatively more liquid and investors can get back their contributed capital through periodically-opened redemptions. This explains why many hedge funds are perpetual in life rather than having a fixed fund term, and why limited partners have to make contributions up front.

While an in-depth comparison of the difference between the two types of funds is beyond the scope of this article, it is nevertheless necessary and inspiring to bring up the topic here. As mentioned in the

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41. *See* MCCAHERY & VERMEULEN, *supra* note 35, at 172.

42. Josh Lerner & Antoinette Schoar, *The Illiquidity Puzzle: Theory and Evidence from Private Equity*, 72 J. FIN. ECON. 3, 7 (2004).

43. Douglas Cumming & Uwe Walz, *Private Equity Returns and Disclosure Around the World*, 41 J. INT'L BUS. STUD. 727, 728 (2010).

44. Ludovic Phalippou & Oliver Gottschalg, *The Performance of Private Equity Funds*, 22 REV. FINANC. STUD. 1747, 1750 (2009).

Introduction, a good way to understand how hedge funds are set up and operated is to look at their contracts, either LP agreements for typical American-style hedge funds or trust agreements for Chinese sunshine funds. Given the many similarities between private equity and hedge funds in terms of organizational structure and compensation mechanisms, a look into the contractual arrangements (covenants in particular) of private equity LP agreements will provide helpful guidance in understanding the contractual arrangements of hedge funds, which, however, have received scant attention in literature. The lack of literature on hedge fund contractual arrangements might result from the difficulty of obtaining access to the organizational documents of hedge funds; but it is more likely explained by the fact that hedge funds tend to rely much less on self-regulatory means like covenants due to shorter lock-up periods and the fund's liquidity. Furthermore, those hedge fund activities that fall within the public domain, particularly in the market for corporate control, can also help to limit the principal-agent problems that may otherwise emerge.[45] The following paragraphs summarize important research on contractual covenants in the agreements of private investment funds, including both private equity funds, as well as venture capital funds, one of the most important subtypes of private equity. Although this information might not be directly useful in terms of drawing conclusions for this paper given the different topics and jurisdictions covered in this area, exploring methods of classifying covenants may be a good starting point for classifying the covenant arrangements in Chinese hedge funds.

In their 1996 paper, Professors Gompers and Lerner studied covenants in a sample of 140 U.S. VC partnership agreements.[46] They focused on 14 classes of covenants, which were divided into three broad families: (a) covenants relating to overall fund management; (b) covenants relating to activities of general partners; and (c) covenants restricting the types of investment.[47] According to them, contractual restrictiveness in VC funds, measured by the number and kind of covenants in the partnership agreement, is determined by two important factors, namely, the supply and demand conditions in the VC market, as

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45. *See* MCCAHERY & VERMEULEN, *supra* note 35, at 190.

46. *See* Paul A. Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J.L. & ECON. 463 (1996).

47. *Id*. at 480.

well as the variations of the cost of contracting.[48] When the supply of capital is large and the demand for the services of experienced, professional VC managers is great, fewer covenants are observed, and general partners' compensation under the partnership agreement is higher.[49] Such supply and demand theory is generally supported by all types of covenants.[50] In terms of variations in the cost of contracting, the rationale is that because negotiating and monitoring specific covenants can be costly, and the ease of monitoring and the potential of engaging in opportunistic behavior may vary across funds, more restrictive contracts will be employed when monitoring is easier and the potential for opportunistic behavior is greater.[51] Such theory is supported particularly by those covenants restricting the fund management and investment activities.[52]

In Europe, Daniel Schmidt and Mark Wahrenburg explored factors that influence the design of financing contracts in terms of covenant restrictions and compensation schemes between VC investors and European VC funds.[53] Their analyses focused on the impact of VC funds' reputations and changes in the overall demand for VC services.[54] While conventional wisdom would assume established market participants care more about their reputation and have less incentive to behave opportunistically, thus requiring fewer covenant restrictions, their findings show that established funds are actually more severely restricted by contractual covenants.[55] Moreover, empirical results also show that established fund managers with stronger reputations are more often obligated to make a capital contribution than first-time fund managers.[56] Such results indicate that when established funds care less

48. *See id*. at 470.

49. *See id*. at 488.

50. *Id*. at 496.

51. *Id*. at 464.

52. *Id*. at 493.

53. *See* Daniel Schmidt & Mark Wahrenburg, *Contractual Relations Between European VC Funds and Investors: The Impact of Bargaining Power and Reputation on Contractual Design* (Risk Capital and the Financing of European Initiative Firms, Working Paper No. 8, 2004), *available at* http://www2.lse.ac.uk/fmg/research/RICAFE/pdf/RICAFE-WP08-Schmidt.pdf.

54. *Id*.

55. *Id*. at 3-4.

56. *Id*. at 4.

about their reputation, stronger performance-related incentives may be concurrently used with more restrictive covenants in order to prevent opportunism.[57] With respect to the effects of VC supply on contract design, Schmidt and Wahrenburg's conclusion is opposite to that in Gompers and Lerner's 1996 paper, in that Schmidt and Wahrenburg find that VC funds receive less base compensation and higher performance-related compensation in years with strong capital flows into the VC industry.[58] They interpreted such finding as a signal of overconfidence: strong investor demand seems to coincide with overoptimistic expectations by fund managers, which makes them willing to accept higher powered incentive schemes.[59]

A later paper by Douglas Cumming and Sofia Johan in 2006, broadened the study by introducing an international dataset on covenants in contracts of private equity and VC funds outside the US.[60] They divided the covenants into five groups on the basis of Gompers and Lerner (1996), but incorporated, among other things, necessary changes to reflect the structure of non-U.S. funds that may be organized in various legal forms other than the LP. The five groups were: (a) authority of the fund manager regarding investment decisions; (b) restrictions on the fund manager's investment powers; (c) types of investment; (d) fund operation; and (e) limitation of liability of the fund manager.[61] Their central hypothesis is that the frequency of covenants is influenced by the quality of law of the country in which the fund is legally registered. Related to this central hypothesis, they also proposed that the frequency of covenants is influenced by the presence of legally trained fund managers.[62] They observed a statistically significant positive relation between the quality of a country's laws and the number of covenants pertaining to fund operation (such as the sale of fund interests, restrictions on fund raising, and matters pertaining to public disclosure).[63] Compared with the same amount of improvement in the

57. *Id*. at 26.
58. *Id*. at 4.
59. *See* Schmidt & Warenburg, *supra* note 53.
60. Douglas J. Cumming & Sofia A. Johan, *Is it the Law or the Lawyers? Investment Covenants Around the World*, 12 EUR. FIN. MGMT. 535 (2006).
61. *Id*. 539-41.
62. *Id*. at 537.
63. *Id*.

Legality index[64] among developed countries, such improvement in the Legality index among developing countries leads to a greater probability of including an extra covenant pertaining to fund operation.[65] With respect to legally-trained fund managers, a 20% increase of fund managers with legal training increases the probability of additional covenants pertaining both to investment decisions (such as the size of any single investment and co-investment) and types of investment (for different asset classes) by approximately 10%.[66] Taken together, Cumming and Johan concluded that while law and lawyers are both important, the presence of lawyers has a more economically significant impact on the use of covenants than the legal environment itself.[67]

II. OVERVIEW OF CURRENT REGULATORY FRAMEWORK FOR CHINESE HEDGE FUNDS

A. ALTERNATIVE FORMS FOR HEDGE FUNDS IN CHINA OTHER THAN SUNSHINE FUNDS

Before proceeding further, it is worthwhile to point out that the so-called "sunshine privately offered funds" are not the only way to structure hedge funds under the relevant Chinese laws and regulations. The name "sunshine funds" typically refer to those funds organized as trusts and managed by private investment advisory/management firms. In addition to them, there are several other possible alternatives.

First, securities brokerage firms[68] and public fund management companies[69] can, upon approval from the China Securities Regulatory

64. For the definition and derivation of the Legality index, *see* Daniel Berkowitz et al., *Economic Development, Legality, and the Transplant Effect*, 47 EUROPEAN ECON. REV. 165 (2003).

65. *Id*. at 567.

66. *Id*. at 568-69.

67. *Id*. at 571.

68. Zhengquan gongsi kehu zichan guanli yewu shixing banfa [Trial Implementation Measures for Client Asset Management Business of Securities Companies] (promulgated by the CSRC, Dec. 18, 2003), LAWINFOCHINA, *available at* http://www.lawinfochina.com; Zhengquan gongsi jihe zichan guanli yewu shishi xize (shixing) [Detailed Rules for Implementation of Collective Asset Management Business of Securities Companies (for Trial Implementation)] (promulgated by the CSRC, May 31, 2008), ST. COUNCIL GAZ. (P.R.C.).

Commission ("CSRC"), China's securities market watchdog, engage in the asset management business by pooling capital from high-end investors, and creating and managing their own investment funds.[70] This being said, nothing in the law prevents them from resorting to the four party cooperation model[71] provided by trust companies to form trust-like funds.[72] In such a case, they will act as the third-party investment adviser to the trust fund.

Second, trust companies are also allowed to pool capital by creating "collective capital trust plans" and attracting qualified investors to invest therein.[73] If a private investment advisory/management firm asks a trust company to set up such a collective trust plan and to appoint the firm as the investment adviser for the capital pooled thereunder, a sunshine hedge fund can be so created. Of course, a trust company can also choose not to retain any third-party investment adviser and manage the fund relying wholly on its own expertise and skills. The three major

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69. Jijin guanli gongsi teding kehu zichan guanli yewu shidian banfa [Trial Measures for Public Fund Management Companies to Engage in Asset Management Services for Specific Clients] (promulgated by the CSRC, Aug. 25, 2011), LAWINFOCHINA, *available at* http://www.lawinfochina.com/display.aspx?lib=law&id =8909; Jijin gongsi teding duoge kehu zichan guanli hetong neirong yu geshi zhunze [Guidelines on Content and Format of Contracts for Public Fund Management Companies to Engage in Asset Management Services for Specific Clients] (promulgated by the CSRC, Aug. 25, 2011), *available at* http://www.csrc.gov.cn/pub /zjhpublic/G00306201/201109/t20110902_199420.htm.

70. *See* Trial Implementation Measures for Client Asset Management Business of Securities Companies, *supra* note 68, art. 11; Trial Measures for Public Fund Management Companies to Engage in Asset Management Services for Specific Clients, *supra* note 69, arts. 7-8.

71. *See infra* Part II.B for further discussion.

72. Actually, because these funds are also organized as trusts, the Go-Goal database covers them. The primary difference between these funds and sunshine funds is that the latter are managed by a private, independent investment advisory/management firm, rather than a securities brokerage firm or a public fund management company. However, because such difference is not captured in the Go-Goal database, the sample of sunshine funds used in this paper was hand-collected from the original data in Go-Goal.com.

73. This was first allowed under Chinese law in 2002 by Xintuo touzi gongsi zijin xintuo guanli zanxing banfa [Interim Measures for Administration of Capital Trust Established by Trust and Investment Companies] (promulgated by the CBRC, June 13, 2002) LAWINFOCHINA, *available at* http://www.lawinfochina.com, which were amended and replaced by Administrative Measures for Collective Capital Trusts Established by Trust Companies, *supra* note 25.

business models of trust-organized hedge funds are discussed in more detail in Part II.B, below.

Similarly, commercial banks can design various asset management plans and sell them to various groups of their clients to pool funds.[74] The pooled capital will then be managed and invested as described in the asset management plan. For those plans that target high-risk assets, and/or those that do not guarantee any fixed returns, banks may only pool funds from investors with previous investing experience.[75] A common way for commercial banks to conduct such business is through collaboration with trust companies:[76] a bank entrusts the funds pooled from its asset management plan to a trust company, which will manage and invest the entrusted assets either on its own or by retaining third-party investment advisers. It must be noted that such a trust is prohibited from investing in non-listed firms, should not be designed as an open-end fund, and must have a term of at least one year.[77]

To be sure, a number of differences exist among the aforementioned types of "privately offered funds" because of the nature of the financial institutions that raise and/or manage them. For example, the minimum capital contribution required by law to participate in a privately offered fund pooled and managed by a securities brokerage

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74. Shangye yinhang geren licai yewu guanli zanxing banfa [Temporary Rules for Administration of Asset Management Business for Individual Clients of Commercial Banks] (promulgated by the CBRC, Sep. 24, 2005) LAWINFOCHINA, art. 10, *available at* http://www.lawinfochina.com.

75. The minimum subscription price for those asset management plans targeting investors with previous investing experience should be RMB100,000. *See* Guanyu jinyibu guifan shangye yinhang geren licai yewu touzi guanli de tongzhi [Notice on Regulating Investments Made Under the Asset Management Business for Individual Clients of Commercial Banks] (promulgated by the CBRC, July 6, 2009), LAWINFOCHINA, art. 5, *available at* http://www.lawinfochina.com.

76. Shangye yinhang yu xintuo gongsi yewu hezuo zhiyin [Guidelines for Business Cooperation between Commercial Banks and Trust Companies] (promulgated by the CBRC, Dec. 4, 2008), LAWINFOCHINA, *available at* http://www.lawinfochina.com.

77. *See* arts. 3-5, Guanyu guifan yinxin licai hezuo yewu youguan shixiang de tongzhi [Notice on Regulating Several Issues Concerning Business Cooperation between Commercial Banks and Trust Companies] (promulgated by the CBRC, Aug. 10, 2010), *available at* http://www.cbrc.gov.cn/chinese/home/jsp/docView.jsp?docID=201008120BD60A6611EE72C2FF98E47C97F36A00.

firm is RMB 50,000.[78] In comparison, an investor must contribute at least RMB 1 million to participate in a fund pooled by a trust company[79] or by a public fund management company.[80] However, securities brokerage firms are not prohibited from raising their entry threshold to a higher level such as RMB 1 million,[81] thus reducing the number of investors in the fund. Moreover, there are certain investment restrictions on the collective investment funds pooled and managed by established financial institutions, like securities brokerage firms and commercial banks, due to the need for risk management and diversification. For instance, a securities-company-created-collective-fund is subject to the so-called "double 10%" restrictions, namely, that the fund shall not invest more than 10% of its assets in any single security, and shall not hold more than 10% of the stock of any company.[82] Such investment restrictions are not required by law for trust funds, while trust companies can surely apply them in managing their funds if they wish. Thus, the differences among various types of "privately offered funds" become nominal in light of their inherent similarities. Essentially, they all can satisfy the four key characteristics of hedge funds as set forth at the beginning of this article: they are pooled, privately organized funds administered by professional investment managers; they are targeted at only a limited number of investors,[83] and thus operate outside the

78. Trial Implementation Measures for Client Asset Management Business of Securities Companies, *supra* note 68, art. 30.

79. Administrative Measures for Collective Capital Trusts Established by Trust Companies, *supra* note 25, art. 6.

80. Trial Measures for Public Fund Management Companies to Engage in Asset Management Services for Specific Clients, *supra* note 69, art. 9.

81. In practice, securities brokerage firms actually do ask for a higher minimum capital contribution from the investors in the funds they pool. For example, Baoding No. 1 Collective Asset Management Plan (raised and managed by Shenyin Wanguo Securities) asks for a minimum capital contribution of RMB 1 million, as does Zijin Strategic Picks Collective Asset Management Plan (raised and managed by Huatai Securities).

82. Trial Implementation Measures for Client Asset Management Business of Securities Companies, *supra* note 68, art. 37.

83. To set up a collective asset management fund, a securities brokerage firm can only pool and manage the capital from a specific group of people, i.e., its own clients, or clients from its promotion agencies. *See* Detailed Rules for Implementation of Collective Asset Management Business of Securities Companies (for Trial Implementation), *supra* note 68, art. 6. As for collective asset management funds created by public fund management firms, there cannot be more than 200 investors in a single fund. *See* Trial Measures for Public Fund Management Companies to Engage in

onerous securities regulation and disclosure requirements[84] applicable to public offered funds.[85]

This article only focuses on one particular type of hedge fund in China, the sunshine fund, because among all of the types mentioned above, only sunshine funds are initiated and managed by private, independent investment management firms whose sole or primary business is to run collective securities investment funds. Trust companies have been involved because private fund managers could not otherwise legally raise hedge funds from investors in China before the LP form was officially allowed, and thus they needed a platform to legalize this process. This offers an explanation of the origin of the name "sunshine funds," as hedge funds in China, which are otherwise illegitimate, are put under sunshine because of the possibility that a trust form can be utilized.

As already mentioned in the introduction, the first LP-organized private securities investment fund in China was created in March 2010. Although it is immediately obvious that the LP form grants investors pass-through taxation benefits, its significance to China's alternative asset management industry goes far beyond that. In simple words, the LP form provides a legally recognized vehicle that delivers the much

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Asset Management Services for Specific Clients, *supra* note 69, art. 11. A collective capital trust established by a trust company cannot have more than 50 natural person investors, but there is no limit for institutional investors. *See* Administrative Measures for Collective Capital Trusts Established by Trust Companies, *supra* note 25, art. 5.

84. Note that, this is so only to a relative extent, i.e., when compared to publicly offered funds. The aforementioned collective funds do not totally escape regulation capture. For example, collective asset management funds established by securities brokerage firms need to be registered with the CSRC (prior registration). *See* Trial Implementation Measures for Client Asset Management Business of Securities Companies, *supra* note 68, art. 21. Collective asset management funds established by public asset management firms also need to be registered with the CSRC (post-registration). *See* Trial Measures for Public Fund Management Companies to Engage in Asset Management Services for Specific Clients, *supra* note 69, art. 18. Collective securities investment trust funds established by trust companies need to be filed with the CBRC (post registration). *See* Guidelines on Running the Business of Securities Investment Trusts by Trust Companies, *supra* note 25, art. 11. Comparatively, setting up a publicly offered fund needs prior approval from the CSRC, and the disclosure obligation is much broader and more onerous.

85. *See* Partnoy & Thomas, *supra* note 1.

needed contractual flexibility to contain the compensation, distribution and exit mechanisms necessary to incentivize talented fund managers to work hard for their investors. Comparatively, such high level of contractual flexibility is not directly and fully offered by normal closed companies. Although the LP form was made available in June 2007, when China's amended Partnership Enterprise Law took effect,[86] Chinese hedge funds industry only began to use this business form in 2010 because Chinese law did not allow partnerships to open securities accounts until the end of 2009.[87] Before that, even if a Chinese hedge fund was willing to adopt the LP form, it could still not do business without a securities account. In comparison, because private equity funds only invest in non-listed companies and do not need such accounts, China's PE industry enthusiastically welcomed the LP form and started to reap its benefits by using it to set up new funds immediately after its birth,[88] despite the fact that PE funds could also be organized as companies[89] or as trusts,[90] similar to sunshine funds.

Theoretically, the emergence of the LP form in China is undoubtedly good news for private, independent fund managers, in that

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86. *See* Partnership Enterprise Law, *supra* note 19.

87. *See* Zhengquan dengji jiesuan guanli banfa [Measures for Administration of Securities Registration and Clearing] (promulgated by the CSRC, Apr. 7, 2006) (amended Nov. 20, 2009), art. 19, *available at* http://www.csrc.gov.cn/pub/zjhpublic/G00306201/200911/t20091127_173555.htm.

88. The first limited partnership VC fund in China was Cowin Capital, which was set up on June 26, 2007 in Shenzhen. Cowin was reported to have already successfully exited from two of its investments in 2009. *See* Jiang Fei, *Quanguo shoujia youxian hehuozhi chuangtou jijin quxian tuichu* [*China's First Limited Partnership VC Managed Exits Despite Detour*], DIYI CAIJING RIBAO [FIRST FINANCIAL DAILY], Mar. 17, 2009, *available at* http://finance.ifeng.com/money/fund/jjdt/20090317/450613.shtml.

89. Chuangye touzi qiye zanxing guanli banfa [Interim Measures for the Administration of Startup Investment Enterprises] (jointly promulgated by National Development and Reform Commission, Ministry of Science and Technology, Ministry of Finance, Ministry of Commerce, People's Bank of China, State Administration of Taxation, State Administration of Industry and Commerce, the CBRC, the CSRC, and State Administration of Foreign Exchange, Nov. 15, 2005), LAWINFOCHINA, art. 6, *available at* http://www.lawinfochina.com.

90. Xintuo gongsi siren guquan touzi xintuo yewu caozuo zhiyin [Guidelines for Trust Companies to Operate the Trust Private Equity Investment Business] (promulgated by the CBRC, June 25, 2008), LAWINFOCHINA, *available at* http://www.lawinfochina.com. Other than trusts, private equity funds in China can also take two other forms, namely, a company and limited partnership.

they can now set up on their own a private equity or hedge fund as a limited partnership without having to resort to the trust platform offered by trust companies. In practice, however, it is far too early to predict that the Chinese hedge fund industry will soon shift toward this new business form. The governance structure of the very first LP-organized private securities investment fund, named Yinhe Purun and managed by a firm called Yinhe Fortune (Beijing) Asset Management Co., Ltd. ("Yinhe Fortune"),[91] is still substantially different from what is prevalent in the U.S. hedge fund business. According to an anecdotal report, the partnership was formed by no more than 49 limited partners,[92] each of whom had to contribute at least RMB 300,000. Rather than a mere nominal portion of total capital contribution, general partners were responsible for financing as much as half of the partnership interests.[93] Given the reported fund size of approximately RMB 300 million at its inception, general partners should have contributed RMB 150 million into the fund.[94] As reported, such a large amount was paid not only by Yinhe Fortune, but also by institutions with deeper pockets and acting as additional general partners.[95] The fund has a term of only one year and expects a fixed target return of around 7-8% for limited partners.[96] It will be forced into termination if its unit net asset value ("NAV") is lower than 70% of the original purchase price of its partnership units.[97] Except for the fact that a partnership is used as its business form, such a set of contractual arrangements is distinct in almost every way from that of a U.S. hedge fund. The typical 2-20 compensation mechanism was abandoned because the game here is no longer about betting on a fund manager's personal superior skills. This is understandable considering that the fund is the very first one raised in China using a LP as the business form, and the fund manager does not have an established record for raising and managing other hedge funds, nor a very deep

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91. *See* Yinhe Fortune's official website, *available at* http://www.yhzc.com.cn/html/.

92. *See* Zhao & Hu, *supra* note 18. In China, a limited partnership can have no more than 50 partners. Partnership Enterprise Law, *supra* note 19, art. 61.

93. *See* Zhao & Hu, *supra* note 18.

94. *Id*.

95. *Id*.

96. *Id*.

97. *Id*.

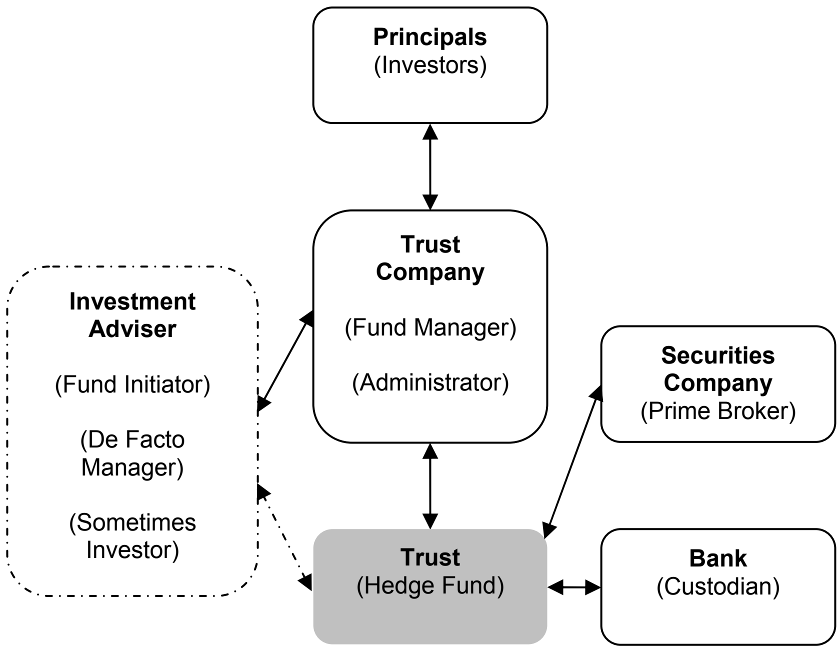
pocket.[98] As an asset management firm with almost zero accumulated reputational capital and willing to set up its first and also China's first LP-type hedge fund, it might be necessary for Yinhe Fortune to take out substantial capital contributions and secure fixed returns for limited partners in order to sufficiently impress them and make the fundraising easier to accomplish. It thus remains to be seen what kind of contractual arrangements will be used in subsequent LP funds, especially for those with more established managers.

A. Hedge Funds Organized as Trusts: Structure and Business Models

As shown in Figure 4, below, although taking the form of a trust, a typical Chinese hedge fund trust engages a similar group of primary service providers as those included in Figure 3. Because besides the investors, there are four parties (trust company, investment adviser, securities company and custodian bank) that are also involved in setting up and running a trust-organized hedge fund in China, such structure is also often called "four party cooperation" model. The major notable difference between the two figures rests with the multi-identities of the investment adviser, and its interaction with the trust company resulting therefrom. Such interaction can be classified into three models in which hedge fund trusts can choose to operate their business. Interestingly, the three models are named after the place where they were invented and primarily implemented, namely, the Yunnan model, the Shenzhen model, and the Shanghai model.

98. Yinhe Fortune was incorporated in 2008 and has a registered capital of RMB 10 million. *See* http://www.yhzc.com.cn/html/index.asp. Both Yinhe Fortune and its key managers were considered "not well known" within China's asset management business until the establishment of Yinhe Purun. *See* Zhao & Hu, *supra* note 18.

Figure 4
Typical Structure for a Chinese Hedge Fund Organized as a Trust



In the Yunnan model, the trust company does not engage a third-party investment adviser, but rather uses its own professional team and acts as the *de facto* manager and adviser to operate the fund.[99] The most pronounced example of this model is a series of funds called "China Dragon," which were created and are managed by Yunnan Trust Corporation.[100] At present, there are altogether 22 trust funds under the name of China Dragon,[101] the first of which was established in August 2003,[102] even earlier than the first sunshine fund that was created in

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99. *See* Zhu Xiaomin & Ding Ding, *216%! Yunguotou zaichuang shenhua* [*216%! Another Legend of Yunnan Trust Corporation*], HEXUN, Mar. 12, 2008, *available at* http://funds.hexun.com/2008-03-12/104392658.html.

100. *Id; see also* http://www.chinadragonfunds.com/team.aspx. All four major fund managers for the China Dragon series are from Yunnan Trust.

101. *See* http://www.chinadragonfunds.com/product.aspx.

102. The first China Dragon fund, also the very first hedge fund trust in China, was called "China Dragon Capital Market Collective Money Trust Plan," and was set up by

2004.[103] It is worth noting that although Yunnan is an inner province located in the southwest of China, China Dragon's performance is recognized even when compared to the highest-profile sunshine funds located Shanghai and Shenzhen.[104] Note that because the manager of the Yunnan model fund is the trust company itself, it is not classified, based on the definitions in this article, as a sunshine fund, which only refers to those funds managed by private investment advisory/management firms.

The Shenzhen model is at present the most prevalent business model employed by sunshine funds. The reason it is so named is that the two most representative trust companies promoting such a model are Shenzhen International Trust and Investment Corporation ("SZITIC"), and Ping An Trust Co., Ltd. ("Ping An"), which are both headquartered in Shenzhen.[105] As mentioned in the introduction, the very first sunshine fund in China was created in Shenzhen by SZITIC.[106] The most distinctive feature of the Shenzhen model is that the trust company retains a third-party investment adviser to act as the *de facto* manager of the fund. The adviser will be responsible for establishing the investment strategy and creating a desirable portfolio to invest in, while the trust company only carries out the investment order from the adviser upon formally checking it. Thus, the trust company only serves as an asset management platform and a financial service provider.[107] Compensation to the investment adviser consists of two parts: a fixed fee based on total assets managed, plus a performance-based flexible fee referred to as

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Yunnan Trust on Aug. 1, 2003. *See* China Dragon Milestones, http://www.chinadragonfunds.com/Resume.aspx?Page=8.

103. *See* Zhang, *supra* note 23.

104. For example, the 2007 annual return of China Dragon Capital Market Collective Money Trust Plan was 216.44%, ranking No. 2 among all publicly and privately offered funds in China during that year. *See* Zhu & Ding, *supra* note 99.

105. *See* Shen Xing, *Shenzhen niangzao simu fuhuaqi: Shenguotou moshi fengsheng shuiqi* [*Shenzhen Creates Incubator for Privately-Offered Funds: SZITIC Model Thrives*], JINGJI GUANCHA BAO [THE ECONOMIC OBSERVER], Apr. 1, 2007, *available at* http://finance.sina.com.cn/stock/y/20070401/10473461412.shtml.

106. *See* Zhang, *supra* note 23.

107. Though a controversial issue, this was confirmed by Mr. Lu Qiang, SZITIC's Vice General Manager during a recent interview with him. *See* Zhang Xiaozhou, *Yangguang simu yewu jintui zhidao* [*Future Strategies of Sunshine Funds' Business*], ERSHIYI SHIJI JINGJI BAODAO [21ST CENTURY BUSINESS HERALD], June 11, 2010, *available at* http://finance.sina.com.cn/money/fund/20100610/23358099889.shtml. For more detailed discussions of the roles of the trust company and investment adviser. *See infra* Part III, where empirical data are analyzed.

"special trust interests," in the contracts, as distinguished from the "ordinary trust interests" – i.e. the returns enjoyed by the fund's investors upon the trust units they hold.[108]

The Shanghai model, represented by those funds created by Huabao Trust Co., Ltd. ("Huabao") and Shanghai International Trust and Investment Corporation ("SITICO"), is a third business model employed by sunshine funds. Unlike the Shenzhen model, where all investors bear the same level of risk, investors in the Shanghai model funds are classified into a preferred class and a subordinated class (may also be called "ordinary class").[109] Subordinated investors are almost always the investment advisers of the fund (and/or its related or designated parties).[110] Subordinated investors are required to contribute a significant portion of the total capital in a fund.[111] Preferred investors/beneficiaries will enjoy a pre-determined fixed rate of return, usually 5% – 10%, which may be topped with some extra flexible

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108. The two terms used here (i.e., special trust interests and ordinary trust interests) are direct translation of the corresponding Chinese (*i.e., teshu xintuo liyi and yiban xintuo liyi*, respectively). They are used as the standard terms in the trust contracts of sunshine funds.

109. *See* Zhongguo yinhangye jiandu guanli weiyuanhui guanyu jiaqiang xintuo gongsi jiegouhua xintuo yewu jianguan youguan wenti de tongzhi [Notice of China Banking Regulatory Commission on Strengthening the Supervision of the Structured Trust Business of Trust Companies], (promulgated by the CBRC, Feb. 5, 2010), LAWINFOCHINA, *available at* http://www.lawinfochina.com, art. 1.

110. *See* Kong Peng, *Shichanghua xintuo chanpin yeji gengjia* [*Market-Oriented Trust Products Show Better Performance*], XIN CAIFU [NEW FORTUNE], Oct. 17, 2008, *available at* http://www.p5w.net/newfortune/qianyan/200810/t1952084.htm. It is worth noting that trust companies are explicitly prohibited from acting as the subordinated class investors. *See* Notice of China Banking Regulatory Commission on Strengthening the Supervision of the Structured Trust Business of Trust Companies, *supra* note 109, art. 7.

111. *See* Notice of China Banking Regulatory Commission on Strengthening the Supervision of the Structured Trust Business of Trust Companies, *supra* note 109, art. 6 (requiring that "the proportion of investment from subordinated class investors should not be set too low"). In practice, subordinated investors can contribute between 40% - 60% of the total capital. *See* Wang Chao, *Qianxi zhengquan touzixing jiegouhua xintuo simu chanpin de shouyi fencheng moshi jiqi fengxian kongzhi* [*A Brief Analysis of the Return Distribution and Risk Control of Structured Securities Investment Trust Funds*], 8 ZHONGGUO SHANGJIE [BUSINESS CHINA] 3, 3 (2008), *available at* http://wenku.baidu.com/view/8d32bf3b87c24028915fc3bc.html.

returns payable if the NAV as of termination is greater than a certain pre-determined threshold.[112] Once preferred investors are satisfied, subordinated investors share what remains.[113] If the fund loses money, it is only the investments from the subordinated investors/beneficiaries that will suffer from the loss, so as to make sure that the preferred investors/beneficiaries are still able to get the promised fixed return. To that end, subordinated investors/beneficiaries bear the obligation to contribute new capital into the fund, which is usually triggered by the NAV thereof falling under a certain precaution threshold.[114] Since the Shanghai model funds have two classes of investors/beneficiaries, which are very different from each other in terms of risk and returns, they are also more often referred to as "structured funds,"[115] whereas Shenzhen model funds are more often referred to as "unstructured funds."[116] Looking back again at the contractual arrangements of Yinhe Purun, one may have the feeling that the fund actually operates much like a structured trust under the Shanghai model – the distinction between general and limited partners reflects the structural difference between preferred and subordinated investors.

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112. *See* Wang, *supra* note 111; *see also* Zhang Yue, *Woguo xintuo xing simu jijin sanzhong moshi de bijiao fenxi* [*A Comparative Analysis of the Three Models of Organizing Privately-Offered Trust Funds in China*], 23 XIANDAI SHANGYE [MODERN BUSINESS] 8, 8 (2010), *available at* http://www.cqvip.com/Read/Read.aspx?id=3494 9103 for its published form [hereinafter Zhang, *A Comparative Analysis*].

113. *See* Zhang, *A Comparative Analysis*, *supra* note 112.

114. *See* Notice of China Banking Regulatory Commission on Strengthening the Supervision of the Structured Trust Business of Trust Companies, *supra* note 109, art. 6. To give examples from the sample of contracts I collected, in the contract of a structured fund named "SITICO Sapphire – Hengda Tonghui," subordinated class investors need to put money into the fund as soon as the unit NAV falls under 95% of the starting value. The trigger for another structured fund, namely, "SZITIC He Ying Structured," is 90%.

115. For a complete definition of "structured trust business," *see* Notice of China Banking Regulatory Commission on Strengthening the Supervision of the Structured Trust Business of Trust Companies, *supra* note 109, art. 1; *see also* Kong, *supra* note 110.

116. *See* Qin Liping, *Shenzhen moshi vs. Shanghai moshi: Yangguang simu liang panghuang* [*Shenzhen Model vs. Shanghai Model: Sunshine Funds' Dilemma*], DIYI CAIJING RIBAO [CHINA BUSINESS NEWS], July 4, 2009, *available at* http://money.163.com/09/0704/03/5DBMCO1Q00253B0H.html.

III. EMPIRICAL ANALYSIS OF TRUST CONTRACTS OF SUNSHINE FUNDS

A. SAMPLE AND DATA COLLECTION

The sample used in this article consists of hand-collected contracts and explanations of the trust plans of 139 sunshine fund trusts. Data collection began with Go-Goal's Investment Trusts Database.[117] Within this database, one can find basic information about the name, inception date, trust term, trust company, prime broker, custodian, investment adviser, and manager(s) of a trust fund, as well as more advanced information of these items, such as the registered place of business of the investment adviser, curriculum vitae of the fund managers, fees, targeted return (for structured funds), and even the volatility and Sharpe ratio of the fund.[118] Such more advanced information may not be updated or complete for every fund and thus may require supplementation through further research. Go-Goal also provides real time data on the latest unit net asset value and annualized return of the current year for all of the funds in the database, as long as they are available.[119] As of August 9, 2010, there were 1,230 private-offered securities investment funds organized as trusts on file in Go-Goal's investment trusts database.

To be sure, Go-Goal is not the only provider of data on Chinese private securities investment trust funds. There are also some other websites, such as www.simuwang.com and www.asimu.com. Compared to Go-Goal, the databases provided by these websites are generally less comprehensive and complete, particularly with respect to the non-basic, advanced information. That said, the most important reason that this study utilized Go-Goal over these other websites is that Go-Goal also collects information for those funds that are already terminated,[120] while

117. *See* http://www.go-goal.com/inv_trust/basic/.

118. *See* http://www.go-goal.com/inv_trust/Achievement/.

119. *See* http://www.go-goal.com/inv_trust/basic/.

120. Go-Goal database offers four basic filters: structured funds, unstructured funds, terminated funds, and existing funds. One can tick one or more of them to set the desired search.

such is not directly available from the other two websites.[121] Including terminated funds expands the time range of my sample, thus permitting the consideration of certain changes that happened during different times and the extrapolation of interesting conclusions therefrom. However, the major disadvantage of Go-Goal is that it lacks effective filters to distinguish sunshine funds from those trust funds managed by established financial institutions, like trust companies, securities brokerage firms, and public fund management companies. As a result, one must manually count the sunshine funds to determine their number and detailed breakdown thereof.

The total number of sunshine funds with clearly indentified investment adviser(s) in Go-Goal's database from February 20, 2004 to August 9, 2010 is 838. The 838 funds cover privately-offered securities investment funds organized as trusts and managed by private investment advisory/management firms. As said before, this number excludes the trust funds managed solely by trust companies, securities brokerage firms, public fund management companies, commercial banks, or subsidiaries thereof, and (to the extent I am aware of) those funds pooled by banks and entrusted to trust companies via the "commercial bank – trust company cooperation" business model. This number includes those funds where both private investment adviser firms and established financial institutions (or subsidiaries thereof) are involved in co-management, and those funds managed by private investment advisers that are (whether separate or not) subsidiaries of industrial institutions and PE/VC firms but not established financial institutions.

Several legal documents are required to set up a hedge fund trust. Beyond those entered into between the trust company and various service providers of the fund, the law requires a trust company to execute at least the following three documents with its fund investors: (a) the trust contract; (b) explanations of trust plan; and (c) the risk statement for investors subscribing into the fund.[122] I went through the

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121. The database offered by Simuwang.com does not allow users to directly search for terminated funds. As such, it is not a very good choice to begin my research with, as I would not be able to know whether the database covers both existing and terminated funds (which would be ideal), without first knowing which ones are already terminated. With respect to Asimu.com, it offers a ranking system for existing funds based on their NAV and annual performance, and users can choose funds they wish to invest in by reading the rank.

122. *See* Administrative Measures for Collective Capital Trusts Established by Trust Companies, *supra* note 25, arts. 10 and 15.

list of 838 funds one by one and attempted to obtain the trust contract and/or explanations of trust plan for each fund. Since there is no legal requirement to disclose these contracts/explanations, they are not public unless the relevant parties to a trust fund voluntarily disclose them for various reasons. The contracts I was able to obtain primarily come from websites of investment advisers and trust companies, and certain online document collection websites (similar to www.onecle.com) that allow free online reading but charge a download fee. These websites are particularly valuable in terms of collecting those old contracts dated from 2004 to 2007.

In deciding whether to include a certain document in the sample, I focused on whether it expresses the major important terms of the trust fund, rather than whether it is literally named "trust contract." There are a number of funds, for example some from Ping An, whose contracts are merely standard documents with general terms, while all the deal-specific terms and conditions are actually contained in the explanations of trust plans that are ancillary agreements to the trust contracts. Furthermore, the fact that the sample contains trust documents for 139 funds does not mean that every one of these documents contains all important contractual terms. This is particularly true for those explanations of trust plans, some of which do not provide, *e.g.*, fee information or covenants. Nevertheless, they are included because they contain information useful in other respects, and the study uses smaller samples within the 139 funds when discussing certain contractual terms. Finally, it is necessary to point out that the contracts in my sample are unexecuted documents. This makes sense because, while it might be smart to publish unexecuted sample documents absent mandatory disclosure requirements so that potential clients may access them and consider investing, it is unwise to disclose confidential information, such as the identities of investors, to people not affiliated with the fund. As such, I cannot fully exclude the possibility that sample documents may have been amended when they are executed, especially when such amendments are demanded by those investors contributing a large amount of capital.

B. SAMPLE COVERAGE

Table 1
*Comparison of Go-Goal Database with My Sample**

	My Sample	**Go-Goal**	**Coverage**
Total Number of Sunshine Funds	139	838	16.6%
Terminated	7	135	5.2%
In operation	132	703	18.8%
Structured (Shanghai Model)	17	263	6.5%
Unstructured (Shenzhen Model)	122	575	21.2%
Fund of funds (including trust of trusts)	2	Not known**	Not known**
Number of Trust Companies	20	40	50.0%
Number of Investment Advisers***	74	347	21.3%

* All numbers referring to funds are for sunshine funds.
** These numbers are not known for the whole Go-Goal database, as the information in such respects can only be obtained if the trust contracts/explanations of trust plans of these funds can be obtained.
*** Among the 74 investment advisers, four are corporate investment arms belonging to industrial parent companies, four also run overseas hedge funds in addition to onshore sunshine funds, and three advisers are organized as limited partnerships.

As shown in Table 1, above, the sample includes approximately 16.6% of the sunshine funds in Go-Goal's database. In particular, the coverage for funds in operation is 18.8%, and for unstructured (Shenzhen model) funds is 21.2%. The coverage of my sample is particularly low with respect to terminated funds, as well as structured (Shanghai model) funds. It is reasonable that contracts for terminated funds are harder to find, because there is no reason that investment advisers/trust companies should still keep them online after termination.[123] In fact, all of the legal documents for the seven terminated funds were found through several online document collection websites instead of the official websites of trust companies and investment adviser firms. Structured funds are easier to raise because

123. A trust company or an investment adviser may want to upload to its website a sample of a sunshine fund trust contract, with the hope that a potential investor may want to invest in the fund upon opening the webpage and reading the contract. However, it will not make much sense to keep the contract online once the fund is already terminated. As such, it is much more difficult to find trust contracts for terminated funds than for funds in operation.

they generally are of a short term (normally one to two years)[124] and secure a fixed target return to investors;[125] therefore, the need to publicize the legal documents to attract potential investors might not be as high as compared with unstructured funds.

One may question the potential selection bias of my sample, even though it is collected from publically available data to the most extent possible. One may criticize that my sample has included disproportionally more funds initiated and managed by those less-experienced investment advisers with potentially thin client bases. Such investment advisers may be located outside those big and/or rich cities, or young in terms of inception year, and thus are particularly keen on publicizing their fund documents to enhance their reputation to better compete with the well-located or more-experienced investment advisers and even attract investors from such advisers. This is indeed a valid point; yet a comparison of my sample with Go-Goal in terms of the location of investment advisers does not seem to lend much support to such criticism. As shown in Figure 5, below, the overwhelming majority of investment advisers captured in my sample also come from big, rich municipalities and coastal areas, while only some 5% of them are from inner provinces, which are generally considered as comparatively less developed. With respect to investment advisers' inception years, my sample also shows wide coverage from 2000 to 2009. Figure 6, below, shows the distribution of the inception years of the investment advisers included in my sample (based on a sample of 68 out of 74 advisers). Comparing Figure 6 with Figure 7 (fund inception years), below, both charts demonstrate a spike from 2006 to 2007, meaning that the bulk of funds started to come into existence in that year. As such, it is reasonable that advisers formed in recent years are more often covered in my sample, given that hedge funds are an emerging business in China.

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124. For the 17 structured funds in my sample, four funds have a term of five years, one fund has a term of three years, two funds have a term of two years, five funds have a term of 1.5 years, and also five funds have a term of one year.

125. *See supra* note 112 and accompanying text.

Figure 5
Comparison of Go-Goal Database with my Sample in Terms of Adviser Location

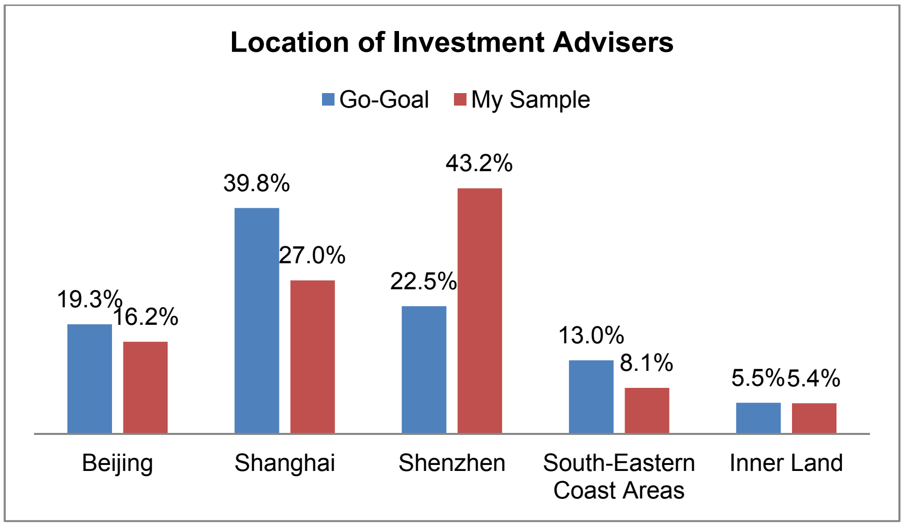
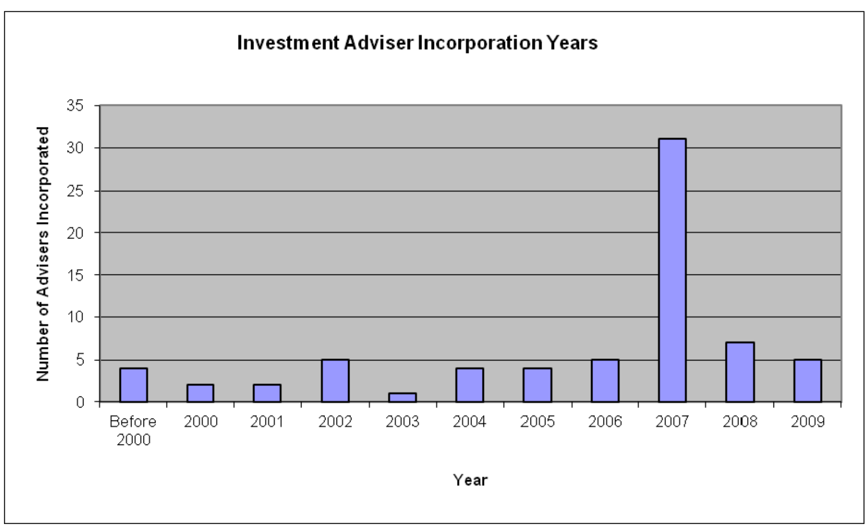


Figure 6
Investment Advisers' Year of Inception



C. DESCRIPTIVE STATISTICS

An interesting point arises if one looks at Figure 7 together with Table 1. As shown in Table 1, my sample only covers two funds of sunshine funds. Since I collected my data from public resources, it is difficult to control the types of funds when the data depends on availability. However, the actual number of funds of sunshine funds should be much bigger because in July 2009, China Securities Depository and Clearing Corporation Limited, the holder and manager of all securities brokerage accounts in China, suspended the approval of all new account opening applications by trust companies for securities investment trusts, based on the "concerns that the imprudent behavior of some trust companies may harm the reform of the system for new shares offering."[126] Presently, this suspension is still in place.[127] Since a

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126. *See* Guanyun xintuo gongsi xintuo chanpin zhuanyong zhengquan zhanghu youguan shixiang fengxian tishi de tongzhi [Notice on the Risks Related to Certain Issues of Securities Accounts for the Trust Products of Trust Companies] (promulgated by the CBRC, Aug. 18, 2009), *available at* http://www.yanglee.com/flfg/2010/4/19/13524.html. To be more precise, because every trust product can open a securities account, and a trust company can have many trust products under its name, some trust companies are abusing this by opening a lot of securities accounts to participate in IPO allotments. This is done to enhance the success rate of subscribing for new shares. *See* Ma Yufeng et al., *Zhengjianhui yaoqiu xintuo zanting kaihu: fangfan duokai zhanghu daxin* [*CSRC Suspends New Account Opening by Trusts: To Guard Against Participating in IPO Allotments with Multi-Accounts*], MEIRI JINGJI XINWEN [NATIONAL BUSINESS DAILY], July 14, 2009, http://bank.jrj.com.cn/2009/07/1407055498665.shtml.

127. The suspension of opening securities accounts for trust funds came out of "an oral notice from the CSRC to China Securities Depository and Clearing Corporation Limited" in July 2009; however, more than a year later, there is now no indication of when it will resume. *See* Liu Zhaoqiong & Zhao Juan, *Simu de "diren"* [*"Enemies" of Sunshine Funds*], JINGJI GUANCHA BAO [THE ECONOMIC OBSERVER], Nov 1, 2010, *available at* http://www.eeo.com.cn/finance/funds/2010/10/31/184399.shtml. There have been rumors that the suspension would be lifted upon checking and cleaning up the current securities investment trust accounts, as well as upon the promulgation of a new regulation by the CBRC targeted at the issue of trust companies opening securities accounts. This new regulation would prohibit trust companies from splitting one fund for the purposes of opening multiple accounts and from re-using accounts left by liquidated funds for new funds. *See* Cheng Zhiyun & Zhao Juan, *Zhengquan touzi xintuo chongqi kaihu; yangguang simu canzao wushang* [*Opening of Securities Investment Trust Accounts May Be Soon Resumed; Sunshine Funds However Remain*

sunshine fund can only run its business with a securities account, it is reasonable to predict that, given such suspension, the number of funds established during the past year should be significantly reduced. However, this is not supported by empirical data, whereas according to the statistics of Simuwang.com, a total of 481 sunshine funds were created for the whole year of 2010, exceeding the number of funds created in 2009. This poses an interesting question - how did these new funds come into being despite the regulatory obstacle?

According to anecdotal reports, newly created sunshine funds in the year of 2010 either managed to buy and use those old accounts previously opened by trust companies hoping that they would be lucky enough to not be detected by regulatory authorities,[128] or, more cleverly, started to organize as trusts of trusts ("ToT", or trust of funds, "ToF"), investing in other securities investment trust funds. Organizing as a ToT does not require a securities brokerage account, as the trust units of other trust funds are not publicly listed securities.[129] SZITIC was the first trust company to start the ToT business.[130] According to the database provided by Simuwang.com, 16 sunshine funds were set up as

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Hurt], JINGJI GUANCHA BAO [THE ECONOMIC OBSERVER], Sept. 13, 2009, *available at* http://www.eeo.com.cn/finance/banking/2009/09/13/151234.shtml.

128. *See* Zhang Huiyu, *Yangguang simu xintuo zhanghu qiyue gaoji: mailuqian qibu 150 wan* [*Shortage of Sunshine Fund Trusts (Securities) Accounts in July: At Least 1.5 Million to Buy One*], LICAI ZHOUBAO [MONEY WEEK], July 4, 2011, http://finance.ifeng.com/fund/smjj/20110704/4221735.shtml. There runs a regulatory risk for investment advisers to buy old securities accounts from trust companies, in that trust companies must cancel and clean up the opened but un-used accounts, and are, in fact, prohibited from re-using the liquidated but not yet canceled accounts. *See* Notice on the Risks Related to Certain Issues of Securities Accounts for the Trust Products of Trust Companies, *supra* note 126.

129. Huang Ting, *Simu ToT chanpin shichang chuju chuxing: xinxi pilu butouming cheng yinhuan* [*ToTs Emerging as a Scaled Business: Lack of Disclosure Could Be a Possible Concern*], DIYI CAIJING RIBAO [FIRST FINANCIAL DAILY], July 17, 2009, http://news.hexun.com/2010-07-17/124279881.html.

130. Note that, although SZITIC was the first trust company to start a ToT business within the sense of sunshine funds, the idea was created and implemented earlier by Donghai Securities, a securities brokerage firm, in its collective asset management business. *See* Dong Xing, *Huarun xintuo jijiang tuichu zhongguo shouzhi "tuofubao" ToF* [*SZITIC to Launch the Very First ToF*], HEXUN, Sept. 15, 2009, http://funds.hexun.com/2009-09-16/121112374.html.

ToTs for the entire year 2010.[131] Alternatively, some newly incepted sunshine funds are identified as having a "double layer" structure: they first use a trust platform to raise capital from investors, and then the trust will invest as a limited partner in a limited partnership, which is created and managed by a sunshine fund management company as the general partner thereof. It is the limited partnership that will be directly engaged in the securities investment business. Because limited partnerships are now able to open securities accounts, such trust-in-LP structure then solves the account opening suspension problem which would trouble the traditional trust-based sunshine funds. Moreover, since a trust can contain a larger number of investors (maximum 50 natural persons, no limitation for institutions)[132] than a limited partnership (maximum 49 investors),[133] having a trust as a limited partner can also help to broaden the investor base of a classic LP-based fund.[134] Apparently, ToTs and trust-in-LPs are notable new trends of development for Chinese hedge funds, and it would be interesting to observe their sustainability in China relative to the classic LP-organized funds in future research.

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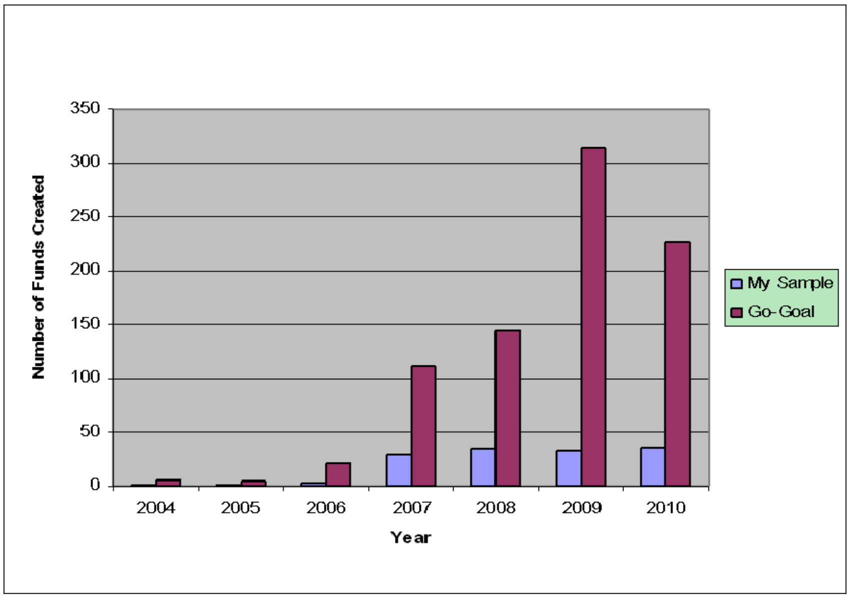
131. This number would increase to 36, if including those private securities investment trust funds managed by established financial institutions, such as trust companies and securities brokerage firms, etc.

132. *See* Administrative Measures for Collective Capital Trusts Established by Trust Companies, *supra* note 25, art. 5.

133. Ye Defeng, *Yangguang simu nengfou jiedao "xintuo hehuo zhi" baituo faxing kunju?* [*Can sunshine funds get over the new fund creation difficulty by making use of the trust-in-LP structure?*], YICAI, Mar. 18, 2011, http://www.yicai.com/news/2011/03/710888.html.

134. *Id*.

Figure 7
Sunshine Fund Inception Years



* *For the year 2010, data ended as of August 9, 2010.*

Table 2
Distribution of Trust Companies in my Sample

City (Province) / Location	Number of Trust Companies	Number of Funds
Beijing	4	13
Shanghai	2	3
Shenzhen	2	53
Chongqing / Southwest	1	2
Guangdong Province / Southeast	1	3
Fujian Province / Southeast	1	5
Heilongjiang Province / Northeast	1	8
Henan Province / Middle	1	1
Inner Mongolia / North	1	1
Shandong Province / Northeast	1	9
Shaanxi Province / Northwest	3	35
Sichuan Province / Southwest	1	2
Zhejiang Province / East	1	4
Total	**20**	**139**

<u>*Table 3*</u>

Trust Companies in Terms of Number of Funds Created (As of August 9, 2010)

	Number of Funds in My Sample	Number of Funds in Go-Goal	Number of Structured Funds in Go-Goal	Percentage of Structured Funds	Number of Terminated Funds in Go-Goal
SZITIC (Shenzhen)	45	168	19	11.3%	18
ZRITC (Heilongjiang)	7	128	12	9.4%	37
CITIC (Beijing)	9	118	38	32.2%	1
SITICO (Shanghai)	1	101	97	96.0%	75
SITIC (Shandong)	9	85	47	55.3%	14
FOTIC (Beijing)	2	84	42	50.0%	16
Ping An (Shenzhen)	9	79	2	2.5%	4
Huabao (Shanghai)	2	51	38	74.5%	20
SITI (Shaanxi)	32	39	9	23.1%	1
XMITC (Fujian)	5	31	3	9.7%	2
CCITIC (Beijing)	1	31	18	58.1%	22
XITIC (Shaanxi)	1	25	16	64.0%	6
CRTrust (Sichuan)	2	15	6	40.0%	7
BJITIC (Beijing)	1	18	1	5.6%	0
Guangdong Finance Trust (Guangdong)	3	11	1	9.1%	1
Western Trust (Shaanxi)	2	9	2	22.2%	1
New Times Trust (Inner Mongolia)	1	8	3	37.5%	4
ZTTrust (Zhejiang)	4	7	0	0.0%	3
CQITIC (Chongqing)	2	7	1	14.3%	3
BRITC (Henan)	1	3	2	66.7%	0

Looking at Table 2 and Table 3 together may generate some interesting findings. First, it can be easily identified from Table 3 that there are obvious concentrations of unstructured funds in Shenzhen (SZITIC and Ping An) and structured funds in Shanghai (SITICO and Huabao), respectively, despite the fact that all trust companies maintain a mixture of both business models to different extents.[135] Only 11.3% of SZITIC's funds and 2.5% of Ping An's funds are structured, while 4% of SITICO's funds and 25.5% of Huabao's funds are unstructured. The underrepresentation of structured funds in the sample is most pronounced for SITICO, where only one out of its 101 funds is covered in the sample. Again, this is not surprising, given that the legal documents for structured funds are harder to find due to the reasons discussed above, especially when the funds are already terminated.

Second, the funds located in Shenzhen and Shaanxi Province are highly concentrated. Out of the 54 funds from Shenzhen, 45 are contributed by SZITIC, and out of the 35 funds from Shaanxi Province, 32 are contributed by Shaanxi International Trust and Investment Corporation ("SITI"). The concentration found in the Shenzhen market is relatively straightforward, as SZITIC was the inventor and very first implementer of trust-organized hedge funds in China and has been known as the "base of the Shenzhen business model" ever since. As a matter of fact, SZITIC is the undisputed leader in China's hedge funds industry because it has the largest number of sunshine trust funds under its name. Although smaller than Shanghai and Beijing in geographical and population size, Shenzhen is fourth largest economy among all of China's big and medium sized cities, with a GDP that is comparable to a middle-sized Chinese province.[136] Shenzhen is also known for its spirit

135. ZTTrust (Zhejiang Province) is exceptional. All of its seven funds were created in October and November 2007, and it does not have any other sunshine funds according to Go-Goal's record. As such, the fact that it does not have any structured funds under its name is more likely due to the fact that the trust company does not actively engage in the sunshine funds business any longer after 2007, rather than an intentional focus on promoting unstructured funds.

136. *See* Information Office of Shenzhen People's Government, *Shenzhen Overview,* SZ.GOV.CN, http://www.sz.gov.cn/cn/zjsz/szgl/201107/t20110712_167568 7.htm (briefly summarizing the comprehensive competitiveness of Shenzhen's economy).

of innovation,[137] especially for economic and financial development. Therefore, it is not surprising that it has managed to develop a cluster of hedge funds, which is also well represented in my sample. SITI's dominance is also relatively straightforward. My sample contains 32 of all 39 funds created by SITI, representing a very high rate of coverage. SITI funds have such a high rate of coverage because SITI is the only listed trust company among all trust companies that engages in the business of creating and managing securities investment trust funds. As a public company, SITI discloses a set of legal documents of the trusts it created on its website, where I accessed the explanations of trust plans for the 32 funds.

A very important reason for Chinese hedge funds to base themselves upon trusts is that trust companies, which are almost always state-owned financial institution and enjoy established reputations, can advertise and sell hedge funds trust units to investors[138] much more easily and effectively than private investment advisory firms. That said, a trust company can only advertise and sell trust products within the province where it is registered, and must report and file with the local China Banking Regulatory Commission ("CBRC") if it wants to advertise and sell trust products in other provinces.[139] Therefore, investment advisers prefer to set up hedge funds with those trust companies located in richer and more developed provinces, since the likelihood of quickly attracting high-quality investors is higher in these places. It is thus interesting to find that, compared with the location distribution of investment advisers, as shown in Figure 6, above, trust companies do not appear to exhibit a similar level of heavy concentration in developed and rich areas as investment adviser firms.

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137. Shenzhen was No. 1 on Forbes's 2010 Rank of Most Innovative Cities in China. S*ee* http://www.forbeschina.com/list/776.

138. A trust company can surely advertise the trust plans created under its name, provided that it does not do so by directing its advertisement toward the general public or through public means. For example, it can place introductory brochures at its place of business, but advertising through public media such as newspapers, radio, or television is not allowed. *See* Administrative Measures for Collective Capital Trusts Established by Trust Companies, *supra* note 25, art. 8. However, it can be difficult in practice to decide if a particular behavior should be allowed or not, e.g., sending group messages to potential clients.

139. Administrative Measures for Collective Capital Trusts Established by Trust Companies, *supra* note 25, art. 7. More precisely, the report and filing procedures must be done at the local CBRC authorities both in its own province *and* the province where it plans to advertise and sell trust products.

Certain trust companies, like ZRITIC (Heilongjiang), SITI (Shaanxi), CRTrust (Sichuan), and New Times Trust (Inner Mongolia), have surprisingly more funds under their names than one would presume based on their location. After all, these places are all located in China's inland and are by no means outstanding either in terms of economic development or financial innovation. It cannot be the case that the investment advisers serving on these funds are predominantly from the same province where the trust company runs its business, as there are simply not so many advisers located in these provinces (the total number of inland registered investment advisers in the whole Go-Goal database is only 20). Instead, they must have created most of the funds by attracting investment advisers from outside their own provinces.

The question then is how did such trust companies attract investment advisers. One may argue that it is because these trust companies provide good services. However, their services are not likely to be so good as to compensate for the disadvantages associated with locating in less developed areas. Given that a hedge fund is purely a money-play business, it needs a cluster of either good brains (experienced and skilled fund managers) or good money (wealthy, risk-tolerate investors) to develop in the first place. For a service provider located in a city or province that does not possess the inherent advantage to attract either good brains or good money, it may outperform its counterparts located in those places with such inherent advantage only if it can exhibit the innovation desired by the hedge fund managers. Thus, it can grow into a good service provider as a result of improving its service quality while accumulating more and more experience by serving a lot of funds. This is exactly the route followed by SZITIC and SITICO as the first movers of the Shenzhen and Shanghai models of business, respectively.[140] It is hardly convincing that a not-so-well-located and less-established trust company can manage to attract a good number of funds purely by providing them with even-better services than those trust companies already with better location and more experience.

140. It was SITICO that first created and applied the "structured model" (i.e., the Shanghai model) in setting up trusts. *See* http://www.sitico.com.cn/Sitico/all_info.jsp?id=13, which provides a brief introduction of SITICO.

A more credible explanation to this question is actually quite straightforward and practical. As mentioned before, a brokerage account is needed in order to trade in China's securities market. Before the lift of the ban on partnerships' opening securities accounts in China, there was no better platform on which to base a hedge fund than a trust. As such, the most fundamental attractiveness of a trust company to an investment adviser is that it can open securities brokerage accounts based on the trust product contracts in its hands.[141] While new investment advisers are always being incorporated, the number of trust companies is relatively fixed,[142] therefore there is only limited opportunity to work with well-known trust companies like SZITIC. Moreover, the potential dark side of those high-profile trust companies is that they are more prone to being targeted by potential regulatory intervention. In comparison, regulatory authorities arguably have less incentive to interfere with trust companies in less developed inner lands, as the number of sunshine funds created within their jurisdiction is still too small to trigger serious worries. In this sense, the likelihood of a sunshine fund being targeted by regulatory authorities[143] is lower in less developed areas, meaning

141. Guanyu xintuo touzi gongsi kaishe xintuo zhuanyong zhengquan zhanghu he xintuo zhuanyong zijin zhanghu youguan wenti de tongzhi [Notice on the Relevant Issues Concerning Trust and Investment Companies Opening Trust Exclusive Securities Accounts and Capital Accounts] (jointly promulgated by the CSRC and CBRC, Sept. 10, 2004), *available at* http://www.cbrc.gov.cn/chinese/home/jsp/docView.jsp?doc ID=1085.

142. As financial institutions, trust companies are subject to the supervision of the CBRC. A trust company can only be incorporated upon the approval of the CBRC and must obtain a "Financial License." The same approval is needed when a trust company wants to change its business scope or open branch offices. *See* arts. 7, 11, and 12, Xintuo gongsi guanli banfa [Measures for Administration of Trust Companies] (promulgated by the CBRC on Jan. 23, 2007), LAWINFOCHINA, *available at* http://www.lawinfochina.com.

143. Note that, a trust company does not have to obtain prior regulatory approval in order to set up a new sunshine trust fund. It is, however, required to report to and file with the local CBRC the necessary trust fund documents within 10 working days after the fund's inception. *See* Guidelines on Running the Business of Securities Investment Trusts by Trust Companies, *supra* note 25, art. 11. This said, prior review and approval is needed if a trust company wants to open a securities brokerage account to hold securities and engage secondary market trading. *See* Measures for Administration of Securities Registration and Clearing, *supra* note 87. In this sense, regulatory authorities can easily kill a fund by refusing to give it an account. However, given the suspension on new securities accounts opening after July 2009, it is now impossible to open new accounts for trust funds anyway. As such, many investment advisers ended up buying

that it can be somehow easier and safer to establish a fund with the trust companies there. As such, and because the trust platform and securities trading accounts are needed regardless, investment advisers, particularly those newly-formed, less-experienced ones, may have to turn to non-first-class trust companies even if they are located in less developed parts of China.

Another important type of descriptive data is fund size. Such information, however, is very hard to find, as most of the investment advisers avoid disclosing to the public any information about the amount of money under management, while others only say a vague number aggregating all of their funds. Therefore, the data is mostly the expected size as stated in the trust contracts/explanations of trust plans, instead of the actual size as of fund inception. Similarly, funds are equally (if not more) unwilling to publicize information regarding the number of investors contributing capital. Therefore, it is impossible to know the proportion of institutional investors versus individual investors in each of the funds. Nevertheless, Figure 8, below, presents the distribution of sizes of the funds in my sample, as a reference. It can be said that, at least according to this chart, sunshine funds in China are still quite small in size.

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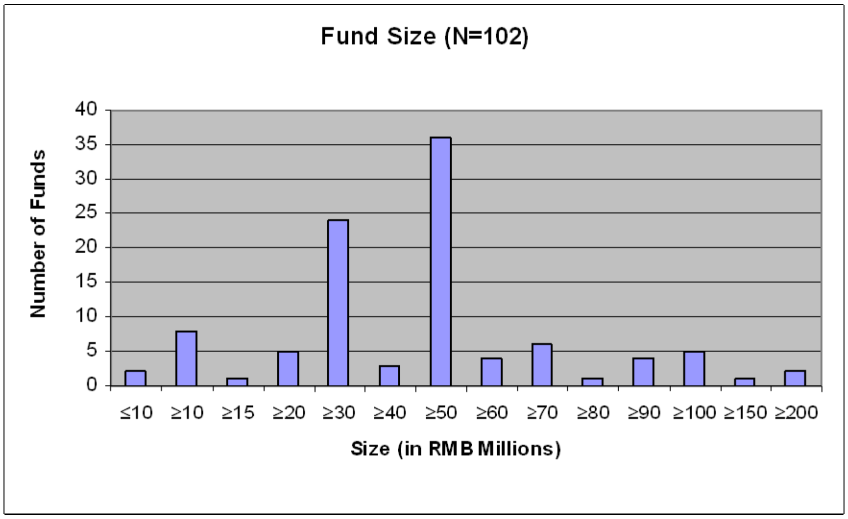
the previously-opened securities accounts from trust companies to set up new sunshine funds. As already mentioned earlier in this Part, such practice is not lawful. As one might imagine, if someday the relevant Chinese regulatory authorities decide to investigate into such irregular practice, the likelihood for them to target those high-profile trust companies in richer provinces would be much higher, because these trust companies tend to have a larger number of sunshine funds under their names, meaning that the probability of discovering wrong doing will be higher.

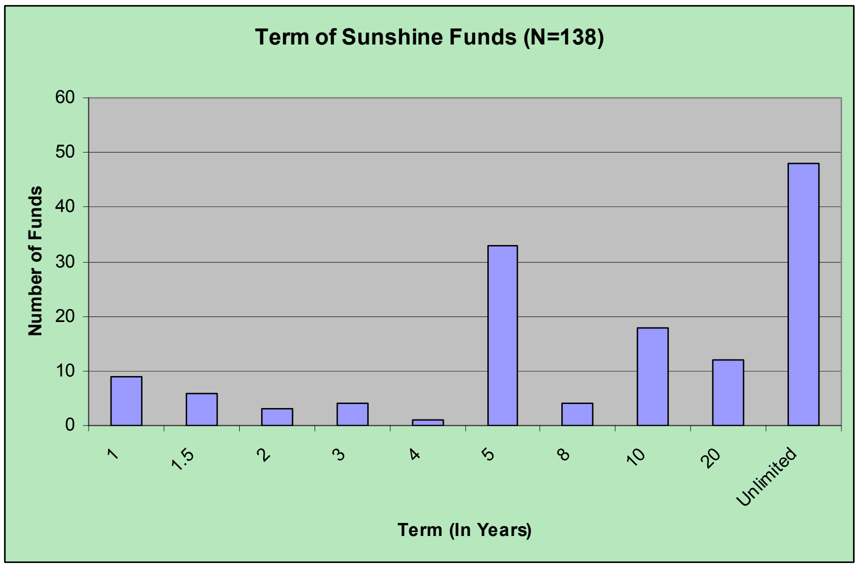
Figure 8
Size of Funds Included in my Sample



Compared to private equity funds, hedge funds can have a perpetual term,[144] and investors can get in and out of the fund periodically on those days the funds are open for redemption.[145] That said, most sunshine funds (90 out of 138) in China chose to have a fixed term, and the funds having unlimited term are mostly from SZITIC. Though not a big issue, adopting a fixed fund term is perhaps a safer strategy for new market players testing the water of the hedge fund business, so that potential risks will be contained in one fund for a relatively short period of time. If the fund runs well, parties can always choose to renew the term or transfer the fund into a perpetual one.

144. Jonathan Bevilacqua, *Convergence and Divergence: Blurring the Lines between Hedge Funds and Private Equity Funds*, 54 BUFF. L. REV. 251, 260 (2006).
145. *See* George O. Aragon, *Share Restrictions and Asset Pricing: Evidence from the Hedge Fund Industry*, 83 J. FIN. ECON. 33, 36 (2007).

Figure 9
Term of Funds Included in my Sample



D. COVENANTS

Having examined general features such as fund inception years, distribution of hosting trust companies, and fund sizes, I structured this article to focus on contractual terms of sunshine funds, beginning with the covenants. Before proceeding, I must make two points. First, the covenants discussed in this section do not refer only to those written explicitly under the "covenants section" of the contracts. Due to their higher level of liquidity, hedge funds tend to present a less complex set of issues regarding covenants and entitlement of compensation in comparison to private equity funds.[146] Therefore, it is likely that the covenants' section of a contract would consist of only a few explicit investment restrictions, while other more subtle, implicit covenants would be scattered throughout the contract and interwoven with other

146. *See* Stephanie Breslow, Address at the New York City Bar Association Conference: Issues in Structuring Ownership and Compensation Arrangements for Private Investment Fund Managers – Hedge Funds (May 2006) (on file with author).

relevant terms. As a result, a limited approach might leave important covenants out of consideration. Instead, I take a broader approach to examine restrictive covenants by reviewing each of the contracts as a whole. Second, in grouping the covenants that appeared in sunshine funds, I primarily follow the classification in Cumming and Johan's 2006 paper because their sample included contracts from non-common law countries.[147] Presumably, their classification should be more suitable for the purposes of this article, which deals with Chinese hedge fund contracts, than that of Gompers and Lerner (1996), which was based solely on U.S. contracts.[148] Needless to say, I made necessary modifications and adaptations to the five categories to make them more suitable for the Chinese hedge fund context.

1. Covenants on the Authority of Fund Managers Regarding Investment Decisions

While the hedge fund business is essentially a bet on fund managers' personal skills and expertise in making good investment decisions, such a game should not be left totally unchecked for the purposes of preventing fund manager opportunism. In terms of investment decisions, this means that sometimes fund managers might have to honor certain percentage limitations on investment size. They may also be obligated to pay dividends to investors periodically, rather than letting the capital gains be automatically included into NAV for reinvestments, at the expense of risking investors' profits.

a. Restrictions on Investment Size

Although Chinese law does not specify mandatory limitations on the size of investments by trust funds created by trust companies,[149] investment size is the most frequently used type of restriction among all covenant categories. Out of the contracts of 60 sunshine funds that explicitly provide information on restrictive covenants (usually in a

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147. Cumming & Johan, *supra* note 60, at 539.

148. Gompers & Lerner, *supra* note 46, at 477.

149. Chinese law only requires that a structured trust fund not invest more than 20% of the fund's total assets into the shares of one company. Other than that, it does not set forth any other explicit restrictions on investment size by trust funds. *See* Notice of China Banking Regulatory Commission on Strengthening the Supervision of the Structured Trust Business of Trust Companies, *supra* note 109, art. 9.

separate section named "Investment Restrictions"), there is no single contract granting 100% freedom to its investment adviser in this respect, although some variations do exist in terms of the approaches used to that end, as shown in Table 4, below.

Table 4
Restrictions on Investment Size (N=60)

Restrictions on size of investments in any single security (*e.g.*, stock, fund, convertible notes, etc.)	**Number of Funds**
Prescribed percentage restriction to be set aside if the consent of trust company is obtained	24
Not more than certain percentage of the capital (total or outstanding) of the invested company	51
Not more than certain percentage of the capital (total or outstanding) of the invested company. To this end, the other investments by the funds under the management of the same investment adviser shall also be counted	2
Not more than certain percentage of the capital (total or outstanding) of the invested company. To this end, the other investments by the trust funds under the management of the same trust company shall also be counted	10
Not more than certain percentage of the total trust assets	60
Not more than certain percentage of the portfolio containing the security	7

b. Covenants on Dividend Payouts

While restrictions on reinvestments are very important to private equity funds, this issue is not so crucial in the hedge fund context. Note that, hedge funds open periodically for subscription and redemption, *e.g.*, once a month, once a quarter, or once a year, unlike PE funds that restrict capital withdrawals for several years once invested. If a hedge fund makes money while the fund manager does not want to pay dividends, investors can simply ask to redeem their investments on an open day at the then-higher NAV and leave the fund. The only difference is that, in most cases, the leaving investor bears a redemption fee, while dividends are received without a fee. Table 5, below, summarizes the various solutions to the dividend payout issue as found in 84 sunshine funds.

Table 5:
Covenants on Dividend Payout

How should a decision on dividend payout be made? (N=84)	Number of Funds
Dividends must be paid at pre-determined frequency and amount	3
Dividends must be paid at pre-determined frequency and amount, but only subordinated investors can get dividends (for structured funds)	3
Sole decision of the investment adviser on whether to pay dividends or not	2
Joint decision of investment adviser and trust company on whether to pay dividends or not	55
Sole decision of the trust company on whether to pay dividends or not	9
No dividend	12

Forms of dividend (N=74)	
More trust units	42
More trust units, unless investors ask for cash dividends in advance	19
Cash or more trust units	12
Cash only	1

It can be seen from the Table above that in 66 of the 84 contracts, the decision on whether to pay out a dividend is at the discretion of the investment adviser and/or the trust company. Investors are far more likely to get more trust units instead of getting paid cash. The Table thus confirms the perception that a dividend payout is not a big deal in the hedge fund context. That said, one should also recognize that dividend payments can serve as a good signaling mechanism for investment advisers and/or trust companies to show their confidence in maintaining the funds' profitability, thus effectively enhancing their reputation among investors. Decisions to pay out dividends from time to time despite the absence of contractual obligation to do so can help keep the investor base at a reasonably stable size, because, otherwise, investors may soon seek to have their trust units redeemed due to impatience or disappointment. Relative to the practice of the past years, more sunshine funds paid dividends in 2009, recognizing the importance of keeping their investors after experiencing the dramatic plummet of Chinese stock market in 2008.[150] For practical reasons, a dividend payout also serves as

150. Zhang Ning, *Biaogong huikui xinqie: yangguang simu fenhong [Reward for Reputation: Many Sunshine Funds Pay Out Dividends*], ZHENGQUAN SHIBAO [SECURITIES TIMES], Jan. 18, 2010, *available at* http://news.stockstar.com/info/darticle.aspx?id=JL,20100118,00001378 [hereinafter, Zhang, *Reward for Reputation*].

a tool to adjust funds' NAV at times when investment advisers and/or trust companies consider appropriate, *e.g.*, to restore the trust unit price to its starting value at the beginning of every year for the ease of calculation.

2. Covenants on Fund Managers' Capital Contributions

Under this category, I will discuss one very important and unique feature of Chinese hedge funds contracts: a capital contribution by the investment adviser, the *de facto* manager of a sunshine fund. To be sure, a general partner contribution is not a novel idea *per se*. In order to demonstrate that its interests are aligned with those of the limited partners, a general partner normally needs to contribute into the fund and thereby share in the good and bad times with limited partners. Without this covenant in place, the general partner will be less disciplined by the possible negative returns and risk, and may carelessly squander other people's money because the general partner has nothing to lose. The amount of contribution is usually 1-5% in private equity industry, depending on fund sizes and business focuses,[151] and practitioners have submitted that the level for hedge funds is usually 1% or even less.[152] The general partner's contribution is generally no more than a slight percentage of the total fund assets because running a hedge fund is a risky business. An excessive share of capital by the general partner will backfire because fund managers may behave in a risk-averse manner and make overly conservative investment decisions. Rather, the combination of nominal capital contribution (1%) and substantial profit sharing (20%) encourages fund managers to take necessary risks in exchange for higher returns than other conservative investment vehicles, such as mutual funds.

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151. DAVID TOLL, PRIVATE EQUITY PARTNERSHIP TERMS AND CONDITIONS 31 (2d ed. 2001).

152. *See* Friedman, *supra* note 31; *see also* Breslow, *supra* note 146.

Table 6
Capital Contributions and Holding by Investment Adviser (N=70)[153]

Capital Contribution by the investment adviser as of fund inception (N=34)	Number of Funds
Minimum contribution required for qualified investors in the fund[154]	18
Greater than the minimum contribution required for qualified investors, but less than 10% of total fund assets[155]	2
10% of total fund assets	12
Greater than 10% of total fund assets	2
Minimum holding by the investment adviser during the fund term (N=55)	
Less than 10% of total fund assets	7
10% of total fund assets	45
10% of total fund assets for the first few years of the fund	2
Greater than 10% of total fund assets	1
Percentage of incentive fees (if any) to be transferred into trust units upon each NAV day if the investment adviser holds less than the minimum holding (N=48)	
10% of incentive fees	12
20% of incentive fees	7
30% of incentive fees	1

153. All numbers in Table 6 are for unstructured funds. Structured funds are left out of consideration because, although they always require investment advisers (as subordinated class investors) to contribute and keep on holding a significant portion of the total assets of the fund, *see supra* note 111 and accompanying text. The purpose of doing so is to secure the fixed target return for their preferred investors. Therefore, they are not really comparable to the typical U.S.-style hedge funds.

154. The minimum investment legally required to participate in a fund pooled by a trust company is RMB 1 million, unless the trust contract prescribes for a higher amount. *See* Administrative Measures for Collective Capital Trusts Established by Trust Companies, *supra* note 25. An initial contribution clause requiring investment advisers to pay the minimum capital contribution required for other qualified investors in the fund is generally reasonable. It would normally result in the percentage of investment adviser's capital contribution being less than 10% (in most cases 2%), if the calculation is determined by taking the minimum total capital required to set up the fund as the total fund assets.

155. For those funds that require the investment adviser to pay/hold a fixed, upfront contribution which is more than the minimum capital contribution required for qualified investors in the fund, I calculated the percentage of investment adviser's capital contribution/holding versus the total fund assets by treating the minimum total capital required to set up the fund as the total fund assets.

50% of incentive fees	25
No limitation, until the minimum holding is reached	3
Percentage of incentive fees (if any) to be transferred into trust units, regardless if the investment adviser holds less or more than the minimum holding (N=10)	
50% of incentive fees, but only applicable for the first year of the fund's inception	8
15% of incentive fees, but investment adviser has full discretion over how and when to dispose of the trust units transferred from incentive fees	1
100% of incentive fees, but investment adviser can, at discretion, ask the fund to redeem such trust units transferred from incentive fees	1

Table 6, above, presents a picture of the contractual arrangements in Chinese sunshine funds contracts dealing with the issues of investment adviser capital contribution and holding. The difference is straightforward. Instead of a nominal contribution and holding of around 1%, the prevailing industry practice in China seems to be 10%, at least according to the Table above. Investment advisers can make their capital contributions in two ways. They can contribute upon the inception of a fund, or by transferring their incentive fees gradually until the required minimum holding is reached. A 10% capital contribution requirement would seem too excessive relative to the 20% profit sharing mechanism, which would dampen investment advisers' incentives to take risks and over-perform. Note that, in order to satisfy such high capital contribution threshold, investment advisers may need to put a very significant portion of their personal wealth into the fund. If they manage to make good investments and bring in profits for the fund, they can only increase their personal wealth to a rather limited extent (10% capital contribution for 20% profit, compared with 1% capital contribution for 20% profit). However, if the fund underperforms, the fund managers get severely penalized as they lose a lot of their assets and will also find it difficult to raise follow-on funds.[156] Unfortunately, the number of funds requiring such excessive capital contribution is not small.

Although the second method of capital contribution does not require the investment adviser to contribute all of the required capital

156. THOMAS MEYER & PIERRE-YVES MATHONET, BEYOND THE J-CURVE: MANAGING A PORTFOLIO OF VENTURE CAPITAL AND PRIVATE EQUITY FUNDS 34 (2005).

upfront, it is still unfavorable because the requirement cuts into their incentive fees. After all, it might take some time before the investment adviser achieves the 10% threshold. This said, investment advisers arguably would prefer the second method to the first one, as they do not have to pay the whole capital contribution entirely from their own pockets. In other words, they are not made unduly risk-averse from the very beginning, and can still pursue an aggressive investment strategy to impress their investors at relatively low cost. In this sense, the second alternative better aligns the incentives of the investors and investment advisers. Among the contracts/explanations of trust plans of all the 70 unstructured funds that provide information on the issue of investment adviser capital contribution and holding, 26 contracts are from SZITIC, and it is worth noting that all 26 contracts have followed the second method. Arguably, this perhaps explains SZITIC's success in China's hedge fund industry: investment advisers are willing to choose SZITIC because their terms appear more reasonable from the adviser's point of view, and such reasonableness is delivered with certainty.

A more important question under this topic is why a much higher level of capital contribution from investment advisers emerged in China in the first place. This mechanism was not in the trust contract of PureHeart, the very first Chinese hedge fund created by Mr. Zhao Danyang on the trust platform provided by SZITIC in 2004. Instead, the contract of PureHeart looked quite like a typical U.S. hedge fund in important respects, such as the 20% flexible performance fee. So if the whole industry in China was started by transplanting an already well-tested business model, why do we now observe such a crucial difference in practice with respect to capital contribution and holding by investment advisers (general partners)? Three important reasons, in my opinion, provide possible answers to this question.

a. Concerns of Chinese Investors

One has to bear in mind that China has a civil law history. In such a country, statutes tend to be considered more serious than contractual terms in the sense that people believe that default legal provisions are more reliable than contractual arrangements, even when the former are often too rigid, formal and sometimes outdated, while the latter are carefully tailored to suit the specific business needs of the parties. A typical example to illustrate this point is the minimum capital requirement for setting up a company. Though a long abandoned idea in common law countries like the U.S. and United Kingdom, Chinese people still seem to attach a lot of importance to the requirement and the amount of registered capital is often directly associated with the quality of a company.[157] A high capital contribution number on a company's registry documents gives its investors and creditors some "sense of security" about the money they are going to inject into company;[158] while a company with only nominal registered capital is very likely to be perceived as a paper sham.[159] As a matter of fact, minimum capital requirement is also very often referred to by lawmakers in setting out qualifications for the relevant market players.[160] For example, in order to be retained by a trust company as a third-party adviser for its trust funds, an investment management company or partnership must have at least

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157. Liu Yongguang, *Riben gongsi ziben zhidu gaige de lifa shijian jiqi dui woguo de qishi* [*Reform of Company Capital System Legislation in Japan and What Can We Learn From It*], (1) FASHANG YANJIU [STUDIES IN LAW AND BUSINESS] 30, 31-32 (2004).

158. Zhou Yu, *Ziben xinyong shenhua de zhongjie* [*The End of the Capital Credit Legend*], (2) DONGSHIHUI [DIRECTORS & BOARDS] 88, 88 (2006), *available at* http://finance.sina.com.cn/g/20060207/18252323393.shtml.

159. *Id*. Around the end of the 1980s, China witnessed a wave of new company establishments. Because there lacked legal authority to regulate corporations (Chinese company law first came into being only in 1993), many sham companies were set up without capital in them, and many abusive and fraudulent business activities were found to be associated with these companies. It was against this background that Chinese company law was enacted, with relatively high registered capital requirements. *See* Jin Jianfeng, *Gongsi renge fouren lilun jiqi zai woguo de shijian* [*The Theory of Disregard of Corporate Personality and its Implementation in China*], (2) ZHONGGUO FAXUE [CHINA LEGAL SCIENCE] 118, 122-123 (2005). As such, it is quite likely that a company with only nominal registered capital may leave people with the impression that it is a paper sham.

160. Many laws and regulations in China, as long as they involve setting out the qualifications for certain market players (e.g., what qualifications must be met in order to be able to engage in certain business), include requirements for the minimum capital in a company. In these cases, the default minimum capital requirements as set out in Chinese Company Law are no longer applicable. *See* Zhonghua renmin gongheguo gongsi fa [Company Law of the People's Republic of China] (promulgated by the Nat'l People's Cong., Dec. 29, 1993) (amended Dec. 25, 1999, Aug. 28, 2004, and Oct. 27, 2005), LAWINFOCHINA, *available at* http://www.lawinfochina.com, arts. 26 and 81. For a tip-of-the-iceberg picture of the different minimum capital requirements for companies in various lines of business, *see* http://www.investsjs.gov.cn/a/service/touziliucheng/1355.html.

RMB 10 million paid up capital;[161] as for a trust company, the law requires for at least RMB 300 million registered capital, which must be already fully paid up.[162]

By the same token, investors in China may find it hard to accept when a fund manager is going to use their money at his discretion and share one-fifth of what they are going to earn, while the manager only contributes a nominal amount relative to what investors have invested. In some sense, this could also sound like a sham. Comparatively, a 10% capital contribution will better bind the adviser, and the business will look more serious in the eyes of investors. Given that the idea of hedge funds is still so novel, and that the whole scheme is based on contracts, the requirement that investment adviser contributes at least 10% of the fund's total assets serves as a quasi-legal mechanism to provide the needed sense of security to investors. This argument echoes the thesis of a paper by Professors Lerner and Schoar in 2005.[163] They found that, in a private equity investment context, transactions in low enforcement and civil law nations tend to use common stock and debt, and rely on more rigid yet straightforward mechanisms such as equity and board control to monitor portfolio companies, instead of convertible preferred stock, which is more flexible yet more contractual in nature, as seen in common law countries.[164] Similarly, the higher investment adviser contribution requirement used in the Chinese hedge fund contract context serves as a more rigid and straightforward mechanism to make up for the general unfamiliarity and uncertainty of Chinese investors towards the new business, reflecting of the civil law culture in China.

b. Liability Concerns of Trust Companies

If an investment adviser underperforms and the sunshine fund under its management loses money, the reputation of the trust company will also be negatively affected because the fund is created and operated under its name. From a formal point of view, a trust company is the one signing the trust contract directly with the investors, while the investment adviser is standing one step back being the third-party

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161. *See* Guidelines on Running the Business of Securities Investment Trusts by Trust Companies, *supra* note 25, art. 22.

162. *See* Measures for Administration of Trust Companies, *supra* note 142, art. 10.

163. Josh Lerner & Antoinette Schoar, *Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity*, 120 Q.J. ECON. 223 (2005).

164. *Id*. at 223.

service provider retained by the trust company through an advisory service agreement. As such, a trust company would have the incentive to preserve its reputation as a reliable market player. It need to have some reliable mechanisms to ensure that if the investment adviser fails to bring in good returns for a sunshine fund, disgruntled investors of that fund will not make its life too difficult. With a high investment adviser capital contribution at the outset, the investors may feel that their losses are at least partially shared by the person who caused the losses. Otherwise, annoyed investors will first blame the trust company for not installing a mechanism to hold the investment adviser accountable, and liability on the part of trust company may even be triggered. In this sense, it is understandable that most trust companies have included this requirement in their contracts, despite the incentive-dampening effect it is likely to have on investment advisers.

c. Legal Restrictions

A recent regulation, namely, Guidelines on Running the Business of Securities Investment Trusts by Trust Companies, which took effect in February 2009,[165] permitted trust companies to charge management fees and performance-based compensation by virtue of running securities investment trusts business. However, performance-based compensation can only be paid as of the termination of a trust, provided that the trust has been profitable.[166] Furthermore, the fees incurred as a result of retaining third-party investment advisers should only be paid out of the management fees and performance-based compensation charged by the trust company from investors.[167] This means that the investment adviser will have problems getting its incentive fees on a regular basis, as the trust company cannot get its performance-based compensation until the fund's termination in the first place. However, if the investment adviser contributes a higher level of capital into a fund and thus gets more trust units in return, such regulatory restriction can be circumvented by paying dividends or "special trust interests" from

165. Guidelines on Running the Business of Securities Investment Trusts by Trust Companies, *supra* note 25.

166. *Id*. art. 18.

167. *Id*. art. 21.

time to time to the investment adviser based on its holding of trust units. In this respect, a higher level of capital contribution by the adviser as seen in many sunshine funds contracts is even necessary under the current Chinese regulatory framework. This issue will be discussed in more detail in Part III.E.

3. Covenants on Types of Investment

This category of covenants serves to limit investment advisers specifically with respect to certain risky securities. Within the sunshine funds context, I identify two important types of covenants under this category, namely, restriction on types of investment and the decision power on expanding investment scope of a fund. Findings on the two types of covenants are summarized and presented in the two Tables, below.

Table 7

Covenants on Types of Investment (N=60)

Covenants	**Number of Funds**
Restrictions on investing in stocks that forecast future loss	
Not allowed at all	4
Not allowed until the company's performance is officially published	5
Certain percentage restriction applies until the company's performance is officially published	18
Allowed, if jointly agreed by the trust company and investment adviser	1
Restrictions on investing in special treatment ("ST") stocks and/or other securities issued by ST companies	
Not allowed at all	30
Allowed but with certain percentage restrictions	11
Allowed, if agreed by the trust company	24
Default percentage restrictions to be forfeited if approved by the investors of the trust	2
Restriction on investing in derivatives (*e.g.*, warrants)	
Not allowed at all	5
Not allowed to actively buy in derivatives on secondary markets	2
Allowed but with certain percentage restrictions	19
Allowed plus certain percentage restrictions if approved by the investors of the trust	1
Restrictions on engaging in short selling/margin trading	
Not allowed at all	22
Allowed, if approved by the investors of the trust	3
Allowed, if agreed by the trust company	23
Restrictions on investing in ChiNext[168] stocks	
Allowed but with certain percentage restrictions	2

168. ChiNext is specially tailored to list those enterprises engaged in independent innovation and other growing venture enterprises. It was only officially launched on Oct. 23, 2009. *See* Samuel Shen & Fion Li, *China launches second board for start-ups*, REUTERS, Oct. 23, 2009, *available at* http://www.reuters.comarticle/2009/10/23/chinext-launch-idUSSHA27095520091023.

Restrictions on investing in the securities of related parties[169]	
Not allowed to invest in securities of the trust company as well as the related parties thereof	18
Not allowed to invest in securities of the companies that are related parties of the investment adviser	6
Not allowed to engage in non-arms length transactions among other funds as managed by the same trust company and/or the investment adviser	1
Not allowed to invest in those securities that may involve personal interests of the trust company and the investment adviser, and the managers thereof	1
Restrictions on investing in an exchange-traded fund ("ETF")	
Only trade ETF within an exchange	3
Obligation to invest certain percent of trust assets in securities with at least "neutral" or "hold" rating	5

169. Note that the law does not generally prohibit related party transactions by trust companies, provided that they are carried out with fair market price and reported to the CBRC in advance on a transaction-by-transaction basis. *See* Measures for Administration of Trust Companies, *supra* note 142, art. 35.

<u>*Table 8*</u>

Decisions Needed to Broaden Investment Scope (N=110)

How can a decision of investment scope expansion be made?	**Number of Funds**
Investment scope not changeable	1
All of the principals' consent must be sought	2
Half of the principals need to approve	13
Sole decision by trust company but consent of investment adviser should be sought	11
Sole decision by trust company provided that advance notice is made on its website	2
Joint consultation and decision by the trust company and investment adviser	75
Sole decision by investment adviser, once the trust company permits it to do so	4
Sole decision by investment adviser	2

In particular, Cumming and Johan's 2006 paper finds that private equity funds in civil law countries are more likely to have covenants pertaining to the types of investment than private equity funds in common law countries.[170] Since no research was presented regarding covenants in hedge fund partnership contracts, I cannot say whether their conclusion is also true within the hedge fund context by comparing the covenants from the two systems. However, one may have the impression from looking at the covenants summarized in the above two Tables that investment advisers have limited freedom in terms of the types of investments they can make. Hedge funds in developed countries usually advertise themselves as being able to make use of a wide range of sophisticated financial instruments and transactions for the purposes of delivering absolute returns. Apparently, Chinese hedge funds are far more limited in that regard. In essence, they are still at the stage of being "stock trading funds" rather than real "hedge funds." This being said, the current cautious approach of allowing only limited types of investment is however understandable and even worthwhile, given that the Chinese capital market is a huge laboratory itself where many new things are still to be tested.

It is important to note one particular point about the data presented above. Despite some variations, it is apparent that the trust company

170. Cumming & Johan, *supra* note 60, at 571.

plays quite a role in terms of deciding what kind of investments are to be made or not, as well as whether to allow the investment scope expansion. As already mentioned above, a trust company is more like a service provider than a *de facto* fund manager for the sunshine funds created under its name.[171] Decisions regarding which securities to invest in, at what price to buy in or sell out, and the number to be bought in or sold out, are all made by the investment adviser and contained in a document called the "investment plan." A trust company normally is there only to conduct a formality check upon the investment plan before executing it. It is a "formality check" in that the trust company will only refuse to carry out the investment plan if the recommendations contained in the investment plan involve investments violating the relevant legal requirements or contractual stipulations in the trust contract, or when exogenous reasons make it impossible to trade a stock as of the time of the investment plan, *e.g.*, when that stock is suspended from trading during preparations for periodic reporting. Thus, the trust company is not there to judge whether the specific investment decisions made by the adviser in the investment plan, i.e., those regarding how, when and at what price to dispose of certain securities, are good or bad.[172] That said, a trust company does retain an important right allowing it to have a say over issues on a more general level, such as what kind of securities can a fund invest in and what kind of transactions can a fund engage in. As can be seen from the two Tables above, if an investment adviser wants to invest in risky assets, such as special treatment stocks or warrants, or deploy risky trading strategies, such as short selling, or want to have a more liberal investment scope, it is most likely that the adviser has to ask for the trust company's permission. Therefore, compared with a manager in a classic hedge fund partnership, an investment adviser to a Chinese sunshine fund enjoys most but not full discretion in making investment decisions, and there are times that the trust company may interfere, mostly on formal and general issues. Again, the reason here relates to the liability concern of trust companies. Since their reputation and interests are on the line if the investments in risky assets lead to investors' losses, they have the incentive to retain the power of deciding whether to allow their advisers to do so in the first place.

171. *See supra* note 107 and the accompanying text.
172. Summarized based on contracts in my sample. *See also id*.

4. *Covenants on Fund Operation*

This category of covenants covers those issues regarding the general management and operation of a sunshine fund. Some covenants shown in the Table below can also fall under the previous sub-category of investment types. Table 9, below, provides a summary of the usage of this kind of covenants in 60 sunshine funds contracts that explicitly provide information on restrictive covenants (usually in a separate section named "Investment Restrictions"). To avoid misunderstanding, I excluded covenants that deal with those restrictions already expressly stipulated in the relevant statutes.[173]

Table 9

*Covenants on Fund Operation Issues (N=60)**

Covenants	**Number of Funds**
Not to invest the trust assets in a way that unlimited liability might be incurred	7
Not to invest the trust assets in companies that might be convicted of violating laws and regulations	2
Not to invest all trust assets in order to keep certain liquidity	8
Not to buy any securities within certain days[174] before the expiration of fund term	4
Not to buy any securities whose applicable lock-in period falls after the expiration of the fund term	4
Not to operate the fund with borrowed debt	5

* Sample size is 60 because there are 60 sunshine funds contracts that explicitly provide information on restrictive covenants (usually in a separate section named "Investment Restrictions"). The numbers do not add up to 60 because some contracts simply do not touch upon certain covenants under this type in their "Investment Restrictions" section.

173. For example, there are eight funds in my sample prohibiting using the trust assets to extend loans or attach any encumbrance thereon. Such a covenant, however, is not included in Table 9 because there is an explicit statutory provision saying that trust companies shall refrain from using the trust assets for purposes other than ones stipulated in the trust contract, nor should they use trust assets to provide collateral for others. *See* Measures for Administration of Trust Companies, *supra* note 142, art. 34.

174. Such time limits are: Western Trust Cheng Nuo No.1: 14 trading days; Western Trust Mingyuan Bakelai; 14 trading days; BJITIC Tong Wei Value Increase: 15 trading days; and FOTIC Ying Rong Da No. 1: 5 trading days.

5. *Limitation of Investment Adviser's Power*

The last category of covenants is also unique to Chinese hedge funds. Essentially, these covenants deal with a situation where an investment adviser will lose all of its power and the trust company will take over. This could happen both in the case of a particular security in a fund's portfolio, and in the case of the fund as a whole. The happening of the latter will directly lead to the termination of the sunshine fund. The right of a trust company to dispose securities in a fund without consulting the investment adviser is called the "special transaction right." To be sure, this section does not lend itself to talking about the general circumstances in which a trust company has the right to terminate a sunshine fund. After all, technically it is the trust company and not the investment adviser who creates a sunshine fund; it follows that the trust company will also have a termination right. There can be a set of such circumstances where the termination will simply be a natural and logical outcome thereof. For example, the trust company can terminate a fund when all the beneficiaries (*i.e.*, investors) decide so; when the core managers of the investment adviser leave and there is no one else to replace them; when the investment adviser cooperates with other trust companies to launch similar trust funds without obtaining prior consent of the current trust company; or when the fund is so under-subscribed that its NAV is lower than a defined minimum amount for a certain period of time.

Table 10

Trust Companies' Special Transaction Right (N=112)

Triggers of the Special Transaction Right	**Number of Funds**
Trust company has reason to believe that certain securities should not be held and thus sells them	75
If the unit value of trust assets falls under certain threshold,[175] then trust company has the right to sell all trust assets to cash out. The trust will be terminated as a result.	66
50%	28
60%	3
70%	21
80%	2
>80%	9[176]
Percentage not specified	3
For the purpose of keeping enough cash for redemption and liquidity needs of the fund, and to the extent that cash needs are satisfied	8
Value of any stock in the portfolio falls under certain threshold, then sell that stock	5
60%	1
70%	4

The situations listed Table 10, above, however, are of a different nature. In these cases, the decision of the trust company to sell a security or even to terminate a fund by selling all of the securities therein is a substantive one. The first category of triggers allows a trust company to sell certain securities if it has reason to believe that they should not be held. It encompasses, for example, the right of a trust company to sell a

175. Note that although a trust company should impose certain appropriate "alert thresholds" depending on the nature of a trust fund and the market trends, and also diligently keep track of the market on a daily basis, it is not a mandatory statutory requirement to also have a "loss-stopping threshold." A "loss-stopping threshold" entitles the trust company to sell trust assets and stop losses for a trust fund. Whether to include a "loss-stopping threshold" clause is left to the discretion of the business parties, and if they do agree on the clause in the trust contract, the trust company should take action accordingly. *See* Guidelines on Running the Business of Securities Investment Trusts by Trust Companies, *supra* note 25, art. 14. That said, Chinese law makes it mandatory that trust companies impose "loss-stopping thresholds" for structured trust funds, so as to limit losses for preferred class investors. *See* Notice of China Banking Regulatory Commission on Strengthening the Supervision of the Structured Trust Business of Trust Companies, *supra* note 109, art. 9.

176. This includes eight structured funds.

security when the investment adviser (or together with its related parties) holds more than 5% of that stock. However, this is not the real point of the special transaction right embodied in this trigger, as selling the stock to make its holding fall back under 5% is merely for legal compliance purposes, otherwise a disclosure will have to be made.[177] Rather, it deals more with the situation when, for example, the market falls 3% in one day or 8% accumulatively for two consecutive days, or the value of the any stock falls under 90% of its initial cost, or trading volume of any stock doubles for two consecutive days.[178] Upon the occurrence of any of these listed scenarios, the trust company will be alerted and ready take further actions, if necessary. It is no longer bound by the decisions of the investment adviser any more, even if it chooses to consult with the investment adviser first about the possible solutions. It can directly decide to sell the concerned security to stop further losses, even if the adviser wants to keep it for a longer period.

As to the second category of triggers, selling thresholds (i.e., loss-stopping thresholds) higher than 80% of the original NAV are mostly found within structured, as opposed to unstructured, fund contracts. The selling threshold for structured fund contracts is generally higher because investment advisers need to meet the fixed target return for their preferred class of investors, thus leading to a more acute need to limit loss than for unstructured fund contracts. Moreover, there is normally also a "capital add-in threshold" to serve as the first-step buffer before the selling threshold is reached. Therefore, a structured fund will only be terminated if the subordinated investors are not willing to contribute new capital into the fund to make up for the loss, and the fund's NAV keeps falling toward the selling threshold. In any case, cashing out all securities and terminating a fund is a substantive right of the trust company leading to a serious outcome, as it deprives the investment adviser of the chance to reverse the losses by changing its strategy and trying again.

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177. If an investor's holdings reach 5% of the issued shares of a listed company, a disclosure must be made within three days. *See* art. 13, Shangshi gongsi shougou guanli banfa [Regulations on the Takeover of Listed Companies] (promulgated by the CSRC, July 31, 2006) (amended Aug. 27, 2008), LAWINFOCHINA, *available at* http://www.lawinfochina.com.

178. These circumstances are expressly stipulated in SZITIC trust contracts, and the trust company may, upon the occurrence of such circumstances, exercise its special transaction right to sell a stock without consulting the investment adviser. Trust contracts from other trust companies have similar stipulations of such circumstances.

It is not hard to understand why so many trust companies choose to retain the special transaction rights. As the party signing the trust contract with investors directly, a trust company bears more risk than the investment adviser of becoming the target of a lawsuit if the fund's losses make investors unhappy. In this sense, the existence of a special transaction rights can serve as a liability exemption or reduction disclaimer against the accusation that "the trust company has failed to fulfill its duty to monitor the investment adviser and stop losses."[179] Such disclaimer, although effectively limiting the potential liabilities that may be charged upon trust companies, comes at the cost of sacrificing investment advisers' decision power in very important circumstances. In this sense, trust companies are not merely playing the role of transaction executors, but also the role of substantive decision makers in Chinese hedge funds. As long as trust companies are providing investment advisers with the trust platform on which to base sunshine funds, it is not likely for them to give up their special transaction rights. Industry practitioners thus would be curiously anticipating the prospective development of limited-partnership-organized hedge funds, especially in terms of their potential to overcome the inherent shortcomings (such as special transaction rights) of trust-organized ones.

E. COMPENSATION

Since sunshine funds are based on trusts, the compensation mechanisms in their contracts also have some unique aspects that reflect this fact. In simple words, the fixed and flexible fees paid by investors of a fund are shared between the investment adviser and the trust company, with the former taking a larger portion. The following two Tables summarize some important features of compensation

179. Such an accusation was raised by investors in a lawsuit against SZITIC, as a result of the huge losses (more than 60%) of Xinpeng No. 1, a sunshine fund created under its name. *See* Dan Youwei, *Huarun xintuo yu kehu duibu gongtang: cheng Xinpeng 1 qi bucunzai qizha [SZITIC Responded on the Lawsuit Brought by Its Clients: We Did Not Defraud on Xinpeng Trust Contract*], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES NEWS], Dec. 22, 2009, *available at* http://news.hexun.com/2009-12-22/122110286.html.

mechanisms of 82 sunshine funds in my sample that provided information on fees and compensation.

<u>*Table 11*</u>
*Fee Levels of Sunshine Funds (N=82)**

Flexible Fees: Investment Adviser / Trust Company	Number of Funds	**Fixed Fees:** Investment*** Adviser	Number of Funds	**Fixed Fees:** Trust Company***	Number of Funds
Combination = 20%	*67*	0%	11	0.50%	4
12% / 8%	1	0.25%	24	0.75%	1
15% / 5%	3	0.30%	1	0.90%	1
16% / 4%	1	0.40%	2	1.00%	32
				Fixed amount + extra 1% if NAV is greater than 100% of its original value	1
17% / 3%	37	0.50%	12	1.15%	1
17.5% / 1.5%	1	0.75%	5	1.25%	6
18% / 2%	3	1%	2	1.30%	7
18.5% / 1.5%	4	1.50%	2	1.30% if fund size as of inception is not greater than 100 million + 1% for the portion exceeding 100 million if the fund size as of inception is over 100 million	1
20% / 0%	17			1.50%	12
Combination > 20%	*5*			1.70%	1
19% / 3%**	1			1.75%	1
20% / 2%	2			2%	1
30% / 0%	1				
35% / 0%	1				

* The numbers in the Table might not add up to 82 because in some cases, the specific proportion of split is not given.
** This proportion is only applicable during the first year of the fund. Afterwards, the proportion is changed into 17%/3%. *See* the contract of SZITIC Hengda Tonghui No.1.
*** The two columns of fixed fees should be read separately from each other. They are sorted from low to high under each column, but the numbers in the same row are not related to each other, *e.g.*, the 0% and 0.5% in the first row does not mean a 0%/5% split of fixed fees between adviser and trust company.

Table 12
Usage of High Water Mark (N=78)

Usage of High Water Mark	Number of Funds
Typical high water mark, with hurdle rate	2
Typical high water mark, no hurdle rate	65
Hurdle rate, no high water mark	3
Revised or no high water mark, no hurdle rate	8
Difference between the NAV of the compensation payment day and the purchase price of trust units	2
Flexible fees paid yearly, based on the difference of the NAV of year end between the NAV of year beginning	1
Difference between the NAV of the current compensation payment day and the NAV of the last payment day	1
Highest historical NAV during the past 12 months	4

Similar to the typical hedge fund industry practice, the performance-based flexible fees in Chinese sunshine funds also largely cluster at 20%. However, what is different is that the 20% needs to be split between the investment adviser and the trust company, and the most frequently seen proportion of such a split is 17% to the investment adviser and 3% to the trust company. Fixed management fees are also split; however, if adding the investment adviser's portion with the trust company's portion, the sum does not cluster at 2%. As shown in Table 11, above, the level of fixed management fees charged by trust companies is generally at a higher level than that charged by investment advisers. The usage of a high water mark is also identified as a prevalent practice among sunshine funds. A high water mark is defined in most contracts as the highest historical NAV; it has been used in a few contracts with twists to this meaning to make the conditions of compensation payouts less stringent, as shown in Table 12, above.

As already mentioned in Part III.D.2, a regulation that took effect in February 2009 introduced into the industry some very strange legal requirements. According to that regulation, performance-based compensation can only be paid as of the termination of a trust provided that the trust remains profitable.[180] Furthermore, the fees incurred as a result of retaining third-party investment advisers should only be paid

180. *See supra* note 166 and the accompanying text.

out of the management fees and performance-based compensation charged by the trust company from investors.[181] Such requirements might be well-meant. For example, it may be that the regulatory authorities do not want investors to bear the obligation of paying sunshine funds managers (trust company and investment adviser) on a periodic basis, when the NAV of these funds can be so volatile[182] that, in the end, investors will only earn nominal returns compared to the accumulated amount of fees they have paid out. They may also have gotten the inspiration from the compensation mechanism of private equity funds, which normally require general partners to return part or all of the capital committed or invested by limited partners before they can share the 20% carried interests.[183]

Moreover, it is interesting to note that certain changes have been evolving among hedge funds as a result of the shock to the industry brought about by the 2008 financial crisis. According to Job Search Digest's *2010 Hedge Fund Compensation Report*, many funds are contemplating a new form of partnership with their LPs in exchange for money being locked in for a longer period of time.[184] For this purpose, they will, among other things, charge the incentive fee in two or three-year rolling cycles as opposed to the current norm of annual or semi-annual payment. In this respect, the hedge fund industry's compensation structure is also partially converging toward that of the private equity industry.[185]

Although making perfect sense within a private equity context where long-horizon investments and lack of liquidity are the norm, the arrangement that carried interest is only payable upon the investors' recoupment of their contributed capital might not be an ideal solution to incentivizing hedge funds managers. Hedge fund incentive fees are often viewed as having option-like characteristics.[186] Incentive fees are earned

181. *See supra* note 167 and the accompanying text.

182. Indeed, it has been submitted that Chinese hedge funds in general still lack the ability to maintain a relatively stable level of high returns. Rather, their NAV curves are quite volatile, which is also a result of the high volatility of the Chinese stock market. *See* Zhang, *Reward for Reputation*, *supra* note 150.

183. TOLL, *supra* note 151, at 51.

184. Job Search Digest, *The 2010 Hedge Fund Compensation Report* 11 (2010) (on file with author).

185. *Id*.

186. *See,* e.g., Carl Ackermann et al., *The Performance of Hedge Funds: Risk, Return and Incentives*, 54 J. OF FIN. 833, 840 (1999); *see also* William N. Goetzmann et

when the fund's performance exceeds a high-water mark, which is analogous to a call option with the high-water mark as the strike price. Managers are incentivized to work hard and keep the fund value above the high-water mark in order to assure that their incentive options will finish in the money.[187] However, if they can only exercise their options at the end of the game, but not periodically throughout the life of the fund, their incentives are dampened. Opportunistic fund managers may fail to manage their funds diligently until they approach the end of their terms. For example, if they lose money during a certain period, they may feel a less urgent need to adjust their trading strategy to stop the losses and recoup some of their losses as soon as possible, as they will not be rewarded even if they indeed manage to make money for the next period and there is enough time to try out before the end of fund term anyway. Alternatively, they could choose to comfortably maintain a conservative trading strategy so that they can secure a modest compensation at the termination. Either way, it is unlikely that fund managers will constantly exert their best efforts to maximize the net asset value when running the fund. This is apparently not in the best interest of the investors. Different from private equity, the primary focus of hedge funds on active short term trading of public securities requires fund managers to actively monitor the market and work consistently to trade in and out; otherwise many money-making or loss-stopping opportunities may be missed in the blink of an eye. In this respect, the one-time-at-termination compensation system may work poorly despite its well-meant intention.

Regardless of the real motive for regulators to impose such apparently strange requirements, the rules are already promulgated and industry players should comply. It would thus be natural to predict that funds created as of February 2009, the effectuation date of the Guidelines on Running the Business of Securities Investment Trusts by Trust Companies, should have complied by changing the language of their compensation clauses to allow payment of flexible fees only upon termination. This is because performance-based compensation can only

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al., *supra* note 33, at 1687; James E. Hodder & Jens Carsten Jackwerth, *Incentive Contracts and Hedge Fund Management*, 42 J. FIN. & QUANTITATIVE ANALYSIS 811, 812 (2007).

187. Hodder & Jackwerth, *supra* note 186.

be paid at the termination of a profitable trust pursuant to the regulation.[188] However, a look at the contracts in my sample—recognizing the limited nature of the sample[189]—does not seem to support such a prediction. Only one unstructured fund[190] out of the 55 fund contracts that (a) were dated prior to or in February 2009 and (b) contained information on trust company and/or investment adviser compensation stipulated for compensation payment upon termination. After this cut-off point, only two unstructured funds[191] out of 27 fund contracts that were (a) dated after February 2009 and (b) contained information on trust company and/or investment adviser compensation stipulated for compensation payment upon termination.[192] Given such an apparently low rate of compliance with the February 2009 regulations, one may wonder what strategies trust companies and investment advisers might have crafted to adapt to the unfavorable legal requirements. As far as my sample shows, four strategies can be identified.

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1. Temporarily No Performance-Based Compensation; to be Resumed if Allowed by Law in the Future

The point of this strategy is that once the ban is lifted by a new law and the fund managers (trust company and investment adviser) are

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188. *See supra* notes 165-67.

189. *See supra* Parts III.A, III.B for a discussion of the limitations of the sample. The reader is reminded that the sample consists of unexecuted documents obtained from online sources, and that the sample covers approximately one-sixth of the sunshine funds listed in the Go-Goal database as of August 9, 2010.

190. I only refer to unstructured funds here because structured fund fees are normally paid at termination with or without the 2009 regulation in place, given that these funds normally only have less than five years of life by their design anyway, *see supra* note 124. The name of this unstructured fund is Western Trust Cheng Nuo No. 1.

191. The two funds are: CRTrust Xin Lan Rui No. 2 and XMITIC Puer Qilin.

192. Among the 27 funds, there is one fund, namely, SZITIC Tong Wei No. 1, that did not seem to adopt any particular strategy to mitigate against unfavorable regulations. Arguably, I would not consider this a case of non-compliance, because the fund was officially set up in March 2009. Normally, it would take some time before fund managers could raise enough capital from investors and then officially set up a fund. Therefore, the March establishment of SZITIC Tong Wei No. 1 very likely shows that the trust documents were already executed by investors earlier than February 2009, thus making the regulation not applicable to the fund.

allowed to charge fees periodically again, the new fees to be charged then will be substantially raised to make up for the previous loss of fees. This strategy has been adopted by one fund.[193]

2. Trust Companies' Fixed Fees and Flexible Compensation Combined Together and Called "Trust Management Fee"; Investment Advisers' Flexible Incentive Fees Received as "Special Trust Interests"

Although this strategy sounds like a "words game," it has been employed by seven funds.[194] The rationale behind this strategy is quite straightforward. Previously, trust companies' compensation was usually expressed as consisting of two portions, namely, a fixed fee (in most cases 1%) and a performance-based compensation (in most cases 3%, as shown in Table 11, above). Since the requirement in the 2009 regulation only limits the payment of performance-based compensation and not the fixed part,[195] the limitations can be circumvented if the trust company is only going to receive a fixed fee and not flexible one. As such, what these seven funds did was to increase the level of the fixed management fee, effectively covering the flexible fee. The investment adviser will share with the trust company the fixed fee, without charging a performance-based "fee" in exchange for its "investment advisory services." What it will receive is the so-called "special trust interest" as a result of its identity as the "special beneficiary" of the sunshine fund. There is usually one clause at the very beginning of fund contracts that requires fund investors to agree to appoint the investment adviser as the "special beneficiary." This appointment, coupled with the fact that an investment adviser is usually required to contribute and hold at least 10% of the fund's capital, will fortify its right to receive "special trust interests." These trust interests are special in that they are paid more frequently, such as monthly or quarterly, are paid based on high water mark, and are paid prior to the receipt by normal investors of their "ordinary trust interests." Essentially, this arrangement resembles the

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193. This fund is called Ping An Fortune Tong Wei No. 1.

194. These seven funds are: SZITIC He Ying Fine Selection No.1, SZITIC Zhi Cheng No. 2, No. 3, No.4 and No. 5, SZITIC Hengda Tonghui No. 1, and FOTIC Steady Value Increase (Yongsheng Huiyuan).

195. *See supra* note 166 and accompanying text.

old incentive-based fees, but adapts to the regulatory change by using a different structure.

It is worth pointing out that, although the "special trust interests" arrangement looks more sophisticated than the idea of an "encompassing management fee," it is actually not new to Chinese hedge funds. As far as I can see in my sample, the earliest contract adopting a "special trust interests" arrangement is PureHeart China Growth I Fund, established in May 2006 by Ping An Trust. The earlier two funds managed by the same investment adviser, including China's very first hedge fund, PureHeart Fund, established in February 2004 by SZITIC, used the direct wording of "performance-based compensation." It is not clear at this point why the third fund managed by the same adviser used different treatment on this issue than its previous two counterparts. A reasonable deduction may be that the name "special trust interest" sounds milder to investors and fits better into the "trust" context. After all, the hedge fund business was and still is novel in China, and Chinese investors might find it difficult to accept that someone can share as much as almost 20% of their profits simply by providing "investment advice" to their trustee. Regardless, such an arrangement apparently worked to mitigate the impact of the 2009 new regulation on China's hedge fund industry; otherwise the consequences might have been much more severe. A related interesting finding is how this arrangement has been made more sophisticated alongside the development of sunshine funds. A typical variation to the original "special beneficiary" treatment would give an investment adviser the status of a "principal" of the trust, where it is appointed as the "representative of all principals" by all the other investors by entering into the contract. As such, the trust company has the obligation to consult and listen to the "principals' representative" in managing the fund, and the investment adviser thus receives its "special trust interest" based on such status and work.

3. *Trust Company Designated Together with Investment Adviser as Special Beneficiary to Share Special Trust Interests*

The third alternative is based on a similar rationale as the second one but the twist is elsewhere. Under this strategy, investors designate both the investment adviser and the trust company as the special beneficiaries of the sunshine trust fund. Since special trust interests can be paid much more frequently as long as the fund's new profits exceeds its high water mark, this solves the problem posed by the 2009 new regulation that a trust company is only able to receive its flexible compensation as of fund termination. Two funds have adopted this strategy.[196]

4. Flexible Fees Payable Upon Investors' Redemption

This is a partial compliance strategy, but nonetheless based on reasonable grounds. After all, the trust company and investment adviser will not be able to get their fees if their investors have already left the fund by redemption. This strategy has been adopted by two funds.[197]

With these strategies adopted by Chinese sunshine funds, as discussed above, it is no longer a mystery why the compliance rate for the "flexible compensation payment upon fund termination" requirement, as stipulated in the regulation promulgated in 2009[198] is so low at first sight. Chinese hedge funds emerged by borrowing from foreign experience, but they grew with their own characteristics from the very first day. They have shown remarkable competence to overcome unfavorable regulatory limitations and find new ways for further development of the business. Of course, it remains to be seen how the regulatory authorities will react to these apparent circumvention strategies of sunshine funds, and, more generally, how Chinese regulatory authorities are going to define their role in the regulation of hedge funds. New and interesting findings may be generated by further research when the industry is more mature structurally and when the regulatory framework is more developed.

CONCLUSION

While the hedge funds industry is already a trillion dollar business in the developed world, it is still in its infancy stage in China. Organized as trusts, Chinese hedge funds take drastically different business forms than LPs, making it more difficult for researchers to understand them. This is a very interesting area that has not been researched thoroughly,

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196. These two funds are: CITIC He Ju No. 1, and CITIC He Ying No. 1.
197. These two funds are CQITIC Chuan Shi No. 1, and ZRTrust Hun Dun No. 2.
198. *See supra* notes 165-67.

and this article is, to my knowledge, the first research exploring the contractual arrangements of Chinese hedge fund agreements.

Using 139 contracts and explanations of trust plans of sunshine funds collected by hand based on the list of securities investment trusts provided by Go-Goal database, this article analyzed the structure, covenants, and compensation mechanisms of sunshine funds. They have been organized as trusts primarily because private fund managers cannot legally pool capital from investors, and a trust was thus far the most appropriate platform offered under the Chinese regulatory framework for that purpose. As the article demonstrates, on the one hand, sunshine funds do have similar contractual arrangements as typical LP-organized hedge funds, such as charging, on top of a fixed management fee, a performance-based compensation, which also largely cluster at 20%. On the other hand, they are also undeniably different from LP-organized hedge funds, due to jurisdiction-specific characteristics of China. The most crucial difference is the involvement of the trust company in the fund. Normally, it is merely a transaction executor responsible for carrying out investment orders from the investment adviser. The trust company also shares with the investment adviser a small portion of performance-based compensation in exchange for such services to the fund. However, because relying on trust companies has been the only practical way for Chinese hedge fund managers to conduct the business, and trust companies are the real contractual parties signing the trust contracts with investors, investment advisers also need to accept certain conditions that are much more stringent than mere profit sharing, such as a higher level of fund manager capital contribution and narrowed decision making power. Typically, an investment adviser (*de facto* manager) to a sunshine fund in China is required to contribute or hold at least 10% of the fund's total assets. If a fund fails to perform well, the trust company retains the power to sell all of the fund's assets and terminate the fund without consulting with the investment adviser.

Although harsh and even incentive dampening, these China-specific covenants and arrangements in sunshine funds contracts are unlikely to be eliminated as long as trust companies remain involved. This is because trust companies require some measures to protect their pecuniary interests and reputational capital from being hurt as a result of acting as a direct contractual party with investors. Moreover, given the deep-rooted influence of civil law tradition and that hedge funds are still mostly unheard of, Chinese investors may find it difficult to accept certain highly contractual arrangements. Rather, they would prefer something more straightforward and consistent with their past experience, even if the former is more incentive-aligning and the latter is incentive-twisting on the part of the investment adviser. A typical example is that Chinese sunshine funds abandon in their contracts the arrangement of nominal general partner capital contribution and big performance-based compensation. It is the regulatory and institutional settings that shaped the contractual covenants in sunshine fund agreements.

It remains to be seen how the Chinese hedge funds industry will develop in the future. At present, many new things are being attempted, and new regulations are frequently being promulgated, yet at a low level of consistency and, apparently, lacking in-depth consideration. Emerging as an alternative investment vehicle and originated from the gray regulatory areas, Chinese sunshine funds have demonstrated remarkable competence by taking advantage of favorable legal provisions and apparently adapting to unfavorable ones. Currently, the industry is expecting to see how the newly materialized limited partnership would shape the future development of hedge funds in China. It is critical that regulators achieve a proper balance in regulating China's hedge fund industry.