ONLINE LENDING PLATFORMS IN CHINA:
PURE INFORMATIONAL INTERMEDIARY OR
FINANCIAL INTERMEDIARY?

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Abstract

This dissertation examines the current status, future development, and legal regulations of Peer-to-Peer online lending platforms in China. Chinese P2P online lending platforms not only provide an alternative source of funding for small and medium enterprises, but also bring investors more diversified investment opportunities. Until recently, most P2P platforms operated as financial intermediaries that pooled money from the public and then lent that money to individuals and small businesses. In recent years, however, the Chinese government decided that the financial intermediary model imposed too many risks on the country's financial and social stability. Because of the growing number of P2P collapses, in 2015 the government prohibited this model and forced the platforms to adopt the information intermediary model instead.

This dissertation argues that the Chinese government should allow P2P lenders to play a financial intermediary role. Properly regulated, this model would bring more benefits than costs to the Chinese financial market. It would provide investment diversification and reduce investors' screening and monitoring costs, and as financial intermediaries, P2Ps would fill an important need by providing retail investors with the advantages that result from the pooling of large numbers of short-term loans.

After legalizing the P2P lenders' financial intermediary role, the government should regulate these lenders rather than turn a blind eye to them, in order to mitigate the risks about which it is concerned. China should follow the U.S.'s example and expand the scope of its securities law to cover the financing methods of China's P2P lenders. Securities regulation with information disclosure and anti-fraud rules would protect investors from being misled and defrauded. Imposing capital requirements, which are not currently in place, would prevent intermediaries from making risky investment decisions, absorbing operating losses due to borrower default. Effective mutual fund regulation, like the system in the U.S., can keep investors informed and deter platforms from making risky investments, so it is a good model for the Chinese government to consider as it evaluates the regulation of P2P online platforms. Together, these laws would mitigate the risks of these platforms' collapse and allow the government to retain overall control of the operation of China's financial institutions.

To my wife, Wenwen, who accompanied me to find the goodness of the world.

To my son, Henry, who brought happiness to me, who is the apple of my eye, and I love his breath, smiles, and tears.

To my parents, Zhi Li and Bo Ning, who taught me to dream and to never give up.

To my mother-in-law, Dongmei Sun, who lived with us through the years in Charlottesville.

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Introduction

China's economy has enjoyed 30 years of explosive growth, making it the second largest in the world.[1] The driving force behind this growth has largely been small and medium-sized enterprises (SMEs). By the end of 2017, SMEs and micro-enterprises were contributing over 60% of the country's economic output and were providing over 80% of nationwide employment.[2] However, this segment has little access to capital from traditional financial intermediaries. Banks, which are mainly under government control, only support large and state-owned enterprises.[3] In addition, the lack of a reliable credit system has created an information asymmetry that deters banks from granting loans to SMEs, which generally lack dependable financial histories. SMEs also cannot enter into the stock market, as the Chinese government strictly controls this market and limits it to large and financially competitive enterprises.[4]

As a result, since the 1990s, SMEs have turned to the non-bank lending sector (including the P2P lending industry) for funds. In the meantime, these non-bank lenders

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[1] *See* World Bank, The World Bank in China: Overview, (Apr. 23, 2020, 04:14 PM), https://www.worldbank.org/en/country/china/overview.

[2] SME's Account for over 60% of China's GDP, Beijing Mulls Inclusion of Loans as MLF Collateral, Chinabankingnews.com (May.4, 2019), http://www.chinabankingnews.com/2018/06/22/smes-account-60-chinas-gdp-beijing-mulls-inclusion-loans-mlf-collateral/.

[3] *See* infra Chapter I Part II.A.3.

[4] Prince Christian Cruz, Gao Yuning & Song Lei Lei, *The People's Republic of China's Financial Markets: Are They Deep and Liquid Enough for Renminbi Internationalization?* 26 (May 1, 2014). ADBI Working Paper 477. Available at SSRN: https://ssrn.com/abstract=2431616 or http://dx.doi.org/10.2139/ssrn.2431616.

have provided additional investment channels to public investors who have sufficient funds but whose investment needs cannot be satisfied by the Chinese financial market. Due to both the supply needs of retail investors who have limited choice of investment channels and the demand needs of SMEs for funding, non-bank lenders started appearing in the 1990s and have been growing in numbers and gaining in popularity since the 2000s.

Non-bank lenders pool money from the public and then lend it to households and small businesses. In other words, they fill the role that financial intermediaries would play in the United States. However, the Chinese government is wary of non-bank lenders and has prohibited them from raising money from the public, fearing that their fundraising activities will cause financial instability, as in fact, often happens.

In many countries, P2P lenders collect and disseminate information and provide a platform through which to connect borrowers and lenders with each other; they do not become actively involved in investing the money. When it first allowed the development of P2Ps, the Chinese government assumed that P2P lenders would follow this example and serve only as informational intermediaries. In this role, these lenders do not assume the risk of default, they carry lower risks, and would not threaten or have much effect on China's financial system. In order to encourage the development of P2P lending in the early development period, the government deliberately kept its regulatory policies loose.

After China established the first P2P lending platform in 2008 and because of the loose regulations, the P2P industry grew rapidly.[5] By September, 2019, China had developed the largest P2P market in the world, with a total transaction value of US $266 billion.[6] The P2P industry's rapid and expansive growth in China was possible mainly because P2P lenders filled a gap in the financial system. The platforms came to play not only a financial intermediary role, but also to provide investment channels for retail investors, as the Chinese financial market cannot satisfy all of their investment needs. Until the development of non-bank lenders (most recently, P2P lenders), financial intermediaries in China served only large entities and investors with large investments. P2P lenders have also become one of the most important financing methods for households and SMEs, which lack access to formal bank lenders.

Therefore, the business model of China's P2P lending market departs from the P2P business model in other countries, in which the online lending platform acts primarily or even exclusively as an information intermediary. In China, the vast majority of P2P lenders play roles that are similar to those of financial intermediaries elsewhere in the world. Until the recent regulatory changes, they not only raised money from the public but

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[5] Gan Deyin, Comparative Analysis of Peer-to-Peer Lending in China and the United Kingdom: an Assessment of the Lending Plaza's Market Entry Prospects (Jan.17, 2018) (unpublished thesis of Master of Arts, University of Southern California) (on file with author).

[6] Data from Statista, *available at* https://www.statista.com/outlook/399/117/alternative-lending/china#market-globalRevenue. In comparison, the transaction value was $33,513 million in the U.S. and $ 4,493 million in the U.K.

also lent the raised funds to households and SMEs. The most frequently used fund-raising vehicles have been wealth management products (WMPs). WMPs are investment vehicles that offer fixed or non-fixed rates of return, which are usually above the regulated interest rates of deposits (some can reach an annual rate of 30%). WMPs are usually of short maturity, with terms of less than a year (generally between one and three months). Retail investors can invest as little as 100RMB ($16) in a non-bank lender's WMP. When they offer a guaranteed fixed return, these lenders act like banks; without one, they act like mutual funds, and in particular, money market funds. This dissertation will not examine the problems on the lending side (the ways that P2P lenders offer funds to households and SMEs).

The financial intermediary model was popular among P2P lenders from the beginning, even though this was contrary to the form that the government wanted them to take. However, as the Chinese government intended to help SMEs get funds through these platforms, it turned a blind eye towards those P2P lenders. Nonetheless, in late 2015, when the P2P lenders started to collapse and couldn't repay investors, the government realized that the risks of allowing P2Ps to play a financial intermediary role might be greater than the benefits that they brought by doing so. Therefore, the government started to enforce the initial regulations about which it had formerly been lax, and also issued new, more specific regulations, in an attempt to limit the role that P2Ps could play. However, currently the government only enforces these laws when P2P defaults lead to crises that threaten financial and social stability. It was not until 2018, when the collapse of online lending platforms became so severe that it threatened social and financial stability, that the government started to crack down on any P2P that takes on more than an informational role.

This dissertation argues that making the financial intermediary model legal for P2Ps would actually bring more benefits than costs to the Chinese financial market. As financial intermediaries, the online lending platforms would provide investment diversification to investors. Further, online platforms that serve as intermediaries would reduce screening and monitoring costs for investors. Under the financial intermediary model, platforms would share the risks of borrowers' default, which would motivate them to be more careful in screening borrowers and more aggressive in collecting unpaid loans. Additionally, the financial intermediary model is attractive to platform owners, while only very few platforms ever chose to adopt the informational intermediary model.

Despite these public benefits, the Chinese government is still prohibiting P2Ps from taking the role of financial intermediary. It is concerned that allowing P2P lenders to act as financial intermediaries would cause instability to the financial system. Further, in the government's view, these intermediaries would draw money away from state-controlled banks; they would make the low interest subsidies more obvious, and they would weaken the government's claim to be Communist. I argue that appropriate regulation would mitigate or remove these concerns and risks.

Nonetheless, the frequent and massive collapses of P2P lenders since late 2015 prove that the current regulations are not working. Currently, the Chinese government requires P2P lenders to comply with regulations that apply to every other non-bank lender, as well as with regulations that specifically designed to limit the activities of P2P lenders.

As non-bank lenders not only interfere with the government controlled financial market but also threaten its financial stability, the Chinese government has been wary of their development. The regulations have focused on restricting the business scope of non-bank lenders and on forbidding them from carrying out public fundraising activities. Under the current regulations, if non-bank lenders raise money from the public, their activities are illegal and they face administrative sanctions, including fines and the closure of their business. Further, the Chinese government has taken the step of criminalizing non-bank lenders' illegal fundraising activities when they involve a large number of investors and/or a vast amount of money. Two crimes — the crime of illegally taking public deposits and the crime of fraudulent fundraising, both falling under the umbrella term "illegal fundraising" within the Chinese criminal law system – are pertinent to this paper. Criminal sanctions aim to punish and deter these illegal fundraising activities.

Although the Chinese government does not allow fundraising activities, it is inconsistent in its enforcement of this prohibition. Sometimes, the government allows informal finance to exist with little regulation, sometimes it completely prohibits it, and at other times, it has taken a middle ground. The Chinese government initially promoted the development of the P2P industry, so it did not enforce these regulations. It hoped that this innovative technology would enhance the efficiency of financial intermediation and reduce the costs for related parties. The government only started to enforce these sanctions against the P2P lending industry seriously in late 2015, when platforms started to collapse and could not repay investors. But the imposition of strict regulations does not seem to have deterred the rapid growth of P2P lenders' fundraising activities or to have prevented the subsequent collapse of many P2P lenders. As its resources are limited, it is difficult for the government to monitor and prosecute every case.

Since the end of 2015, the government has also increased its control over the industry by issuing several specific regulations. Its main approach follows the logic of the previous prohibition measures. It allows P2P lenders to serve only as information intermediaries and bans them from acting as financial intermediaries. They may not raise money from the public or provide guaranteed returns to investors. The government has issued specific rules protecting investors in the P2P lending industry. It now requires each online lending platform to disclose to investors certain types of information that are important for investors as they make their investment decisions. Another regulation imposes special registration requirements. Further, to limit the risk to investors, the regulations cap the size of the loan that an individual or business may borrow from one platform and all platforms. According to the regulations, platforms must separate their own funds from those of lenders and borrowers and select a qualified bank as the custodian of lenders' and borrowers' funds. Although there are national regulations regarding P2P lending, these tend to focus on forcing online lending platforms to serve solely as information intermediaries and forbidding them to play a financial intermediary role. All of these rules are broad and lack enforcement mechanisms. The frequent collapse of P2P lenders proves that current regulations are ineffective.

The Chinese government is reluctant to allow non-bank lenders, including online platforms, to play a financial intermediary role, mainly because these institutions have a higher risk of collapse, and it is concerned about the potential financial instability that could accompany the failure. The government also fears that once it opens this door, it will lose control of the financial system. However, this dissertation argues that the government should allow P2P lenders to act as financial intermediaries, and that carefully designed regulation would alleviate the risks and the government's concerns. These regulations should draw on principles behind U.S. securities, mutual fund, and banking regulation. China should follow the U.S.'s example more closely and expand the scope of its securities law to cover the financing methods of China's P2P lenders. Securities regulation with information disclosure and anti-fraud rules would protect investors from being misled and defrauded. However, China should also adopt less demanding disclosure requirements in order to reduce the platforms' financing costs.

Mutual fund regulation can keep investors informed and prevent the platforms from making risky investments, so it is a good model for the Chinese government to consider as it evaluates the regulation of P2P online platforms. Further, capital requirements can prevent intermediaries from making risky investment decisions, absorbing operating losses due to borrower default, and ensuring that investors get at least some funds back from the capital on hold. Together, these pieces of law would help to mitigate the risks of these platforms' collapse and allow the government to control the operation of the financial institutions. We should also consider which regulator would best enforce these rules. As most of my suggestions have focused on the relevance of securities regulation — whether for ordinary public corporations or for investment companies – it would be logical for the China Securities Regulatory Commission (CSRC) to regulate P2Ps and any other non-bank lenders that raise funds from the general public through the sale of WMPs.

This dissertation focuses on P2P online lending platforms, which not only provide SMEs with greater access to funding, but also offer retail investors additional investment channels. It proceeds in four chapters. Chapter I discusses the Chinese P2P lending market and its two types of business models — informational and financial intermediaries. It states that most P2P lenders have adopted the financial intermediary model and explains why this has more advantages than the informational intermediary model. It also examines the Chinese government's concerns about the rise of these intermediaries. Chapter II provides an overview of current the regulations of the P2P industry and their shortcomings. Chapter III analyzes how China might draw on the example of U.S. regulations through securities, mutual fund, and banking regulations to solve the problems in the P2P industry. Chapter IV presents my conclusion.

Chapter I. The Historic and Economic Background of Peer to Peer Lending Platforms in China

This chapter focuses on the historic and economic background of the Chinese peer-to-peer ("P2P") lending market. P2P lending, as one of the most important types of non-bank lending, belongs to the informal sector of China's financial system. Non-bank lending accounts for a more significant proportion of China's lending market than it does in the markets of developed countries like the United States. While weak legal institutions and China's policies of financial repression partly explain this phenomenon,[7] there are other, particularly Chinese characteristics that account for the prevalence of non-bank lending, including P2P lending, in China.

Over the past decade, two main business models for P2Ps — financial intermediary and information intermediary — have evolved in China. The conventional informational intermediary model, under which the P2P lending platform provides information to investors and borrowers and matches lenders with borrowers, is not popular among P2P lenders, but this is the one that the Chinese government promotes. Most P2P platforms operate as financial intermediaries; they pool money from the public in various

[7] WEI SHEN, SHADOW BANKING IN CHINA: RISK, REGULATION AND POLICY 226-74 (2016).

ways, especially through selling wealth management products, and then lend the pooled money to individuals and small businesses.

China's current regulation allows only the information intermediary model to exist and forbids the platforms from playing a financial intermediary role. However, this chapter argues that the financial intermediary model offers some important advantages and that China should legalize it. It recognizes that the Chinese government has reasons for resisting the rise of these intermediaries, but as Chapter III will discuss, appropriate regulation would allay the government's concerns.

This chapter opens with an overview of the Chinese financial system. It then introduces different types of non-bank lenders, including the P2P lenders. Following that, the chapter presents the concept and historical development of P2P lending, and the two business models of P2P lenders. Finally, it analyzes the advantages of the financial intermediary model and the Chinese government's concerns about legalizing this model in the P2P lending industry.

I. Overview of the Chinese Financial System

China's financial system has played a critical role in fueling its economic expansion in the past thirty-five years. A review of this system is important in order to understand the role of P2P lending.

Overall, China's financial system includes both formal and informal sectors. The formal sector is comprised of a large banking sector and a fast-growing stock market.[8] Almost all Chinese banks are state-owned or state-controlled, and the state strictly regulates the banking industry. Although SMEs contribute 60% of the value of China's economic growth, they can only obtain 30% of the loans from official/government financial institutions.[9] A survey that the All-China Federation of Industry and Commerce conducted in 2013 showed that 62.1% of SMEs lacked access to bank loans.[10] This survey also revealed that most SMEs don't expect to get loans from big banks and they don't have bank loans. I will discuss the reasons for SMEs' lack of access to bank loans in the next section.

In China, the stock market currently plays a more limited role than do banks in allocating financial resources.[11] By the end of 2016, the total assets from the stock market accounted for around 27% of the total assets of China's financial market, while the assets

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[8] Franklin Allen & Jun "QJ" Qian, *China's Financial System and the Law*, 47 CORNELL INT'L L. J. 499, 500-01 (2014).

[9] Ying Yiyuan, Private Sector Contributes over 60% to GDP, CCTV (Feb. 6, 2013, 15:52 BJT), http://english.cntv.cn/program/bizasia/20130206/105751.shtml.

[10] All-China Federation of Industry and Commerce, Report on Small and Micro Business Financing Development, 2013. Zheng Yangpeng, SMEs Hungry for Long-Term Loans, CHINA DAILY (Apr. 7, 2013, 08:22PM), http://www.chinadaily.com.cn/business/2013-04/07/content_16379440.htm.

[11] Allen & Qian, *supra* note 8, at 499.

from banks accounted for 70%.[12] The Chinese government strictly controls this market and only permits large and financially competitive enterprises to enter it.[13]

Because the formal sectors have not served the needs of non-state firms, SMEs and households, an informal sector — mostly made up of non-bank lenders — that provides alternative-financing channels has emerged.[14] This sector operates largely outside the stock market and the banking system.

China's regulatory institutions are divided primarily by the broad types of activity they oversee, although there are some overlaps. Banks are regulated primarily by the China Banking and Insurance Regulatory Commission (CBRC)[15] and securities by the China Securities Regulatory Commission (CSRC).[16] The Chinese central bank, the People's Bank of China (PBC), is in charge of regulating systemic risks and maintaining managing financial stability.[17] The PBC also sets limits on deposit interest rates and lending interest rates.

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[12] Experts Suggests Developing Multi-Level Capital Market, baijianhao.baidu.com (Dec.12, 2018, 12:22PM), http://baijiahao.baidu.com/s?id=1586720722158101402&wfr=spider&for=pc. I would include statistics for other countries as a reference. However, these statistics are unavailable.

[13] Cruz, Gao & Song, *supra* note 4, at 26.

[14] Allen & Qian, *supra* note 8, at 543.

[15] The China Banking and Insurance Regulatory Commission (CBRC), http://www.cbirc.gov.cn/web2019/english/index.html.

[16] The China Securities Regulatory Commission (CSRC), csrc.gov.cn , http://www.csrc.gov.cn/pub/csrc_en//about/intro/200811/t20081130_67718.html.

[17] The People's Bank of China (PBC), pbc.gov.cn, http://www.pbc.gov.cn/en/3688066/3688080/index.html.

II. Introduction to P2P Lending in China

As the most important part of the non-bank lending industry, P2P lending has grown rapidly since China established its first P2P lending platform in 2007. This section introduces the concept of non-bank lending, reviews the development of the P2P lending industry, and describes the two main business models of P2P lending.

A. P2P Lending as a Type of Non-Bank Lending

P2P lending is currently the most crucial part of China's non-bank lending industry. Regulation that applies to the non-bank lending industry also applies to the P2P lending industry. Thus, it is essential to understand the concept of non-bank lending before we analyze China's P2P lending market.

1. The Concept of Non-Bank Lending

"Non-bank lending" covers the financing method that exists outside of but parallel to the conventional banking system. Scholars have used several terms, such as private lending, informal finance, informal lending, shadow banking, and underground lending to discuss the lending market outside of the formal banking system.[18] These terms are overlapping, but none of them encompasses the entirety of the non-bank lending market. Moreover, researchers rarely offer a clear definition of whichever term they are using.

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[18] SHEN, *supra* note 7; JIANJUN LI, SARA HSU, INFORMAL FINANCE IN CHINA: AMERICAN & CHINESE PERSPECTIVES 3 (2009).

This reality complicates any analysis of this market. For example, scholars using the term "private lending" might find that they are applying it to different aspects of the market.[19] Similarly, scholars utilizing different terms might in fact be referring to exactly the same lending market. In order to avoid these kinds of problems, this section first attempts to define the scope of the relevant terms.

"Non-bank lending" covers the financing method that exists outside of but parallel to the regular banking system. In the broadest perspective, non-bank lending refers to a widely-employed financing method through which Chinese entrepreneurs, individuals, or households borrow money from relatives, friends, enterprises, professional money lenders, or other "shadow banks" to fund their business ventures or their living expenses.[20]

To understand the definition and scope of non-bank lending better, we need to compare it to related concepts that often cause confusion, such as "informal finance," and "shadow banking." Informal finance consists of non-bank financing activities, whether conducted through family and friends, local money houses, or other types of financial association.[21] The term "non-bank lending" is interchangeable with "informal finance." From the comparison of the formal and informal financial systems, we can better

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[19] Susan Finder, Private Lending in China: Out of the Shadows?, The Diplomat (Oct.28, 2017, 10:44 AM), https://thediplomat.com/2015/08/private-lending-in-china-out-of-the-shadows/.

[20] Lerong Lu, 'Runaway Bosses' in China: Private Lending, Credit Crunches and the Regulatory Response, Financial Regulation International (2015), Vol 18 (9), pp.1-13, 4.

[21] LI & HSU*, supra* note 18. at 3.

understand the characteristics of informal finance or non-bank lending. While the Chinese government regulates banks quite heavily, informal finance firms face little regulation or sometimes none at all. Government agencies monitor some informal financial institutions, but leave most of them alone. Unlike banks, informal finance firms may not take deposits and thus are unable to mobilize savings deposits from the public.[22]

Shadow banking is another difficult concept with many definitions. The Chinese Financial Stability Board defines "shadow banking" as, "credit intermediation involving entities and activities outside the regular banking system."[23] Similarly, the United Sates defines shadow banking as, "financial intermediaries that conduct maturity, credit, and liquidity transformation without access to central bank liquidity or public sector credit guarantees."[24] In other words, in the United States, the term "shadow banking" only covers lending that involves intermediaries;[25] it does not include lending by friends, relatives, or enterprises. Thus, while it is an important component of the non-bank lending industry, shadow banking is different from non-bank lending.[26] Nevertheless, the two

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[22] In practice, a large number of informal lending firms illegally take deposits from the public in China.

[23] FINANCIAL STABILITY BOARD, SHADOW BANKING: SCOPING THE ISSUES 1 (2011).

[24] Zoltan Pozsar, Tobias Adrian, Adam Ashcraft, Hayley Boesky, Shadow Banking, Federal Reserve Bank of New York Staff Report No. 458, 1 (2010).

[25] Jun Luo, Shadow Banking, Bloomberg (Oct.26, 2018, 4:47 PM), https://www.bloomberg.com/quicktake/shadow-banking.

[26] FINANCIAL STABILITY BOARD, SHADOW BANKING: SCOPING THE ISSUES 1 (2011).

share many characteristics, including the reasons that attract entities to turn to them and the risks that they pose to the financial market.[27]

2. Types of Non-Bank Lending

There are two types of non-bank lending. The first generally involves two parties – individuals and enterprises. Within this category, two forms exist: (1) individual or household (consumer) borrowing, which accounts for a small proportion of the non-bank lending market;[28] (2) business borrowing (mainly SMEs) from other enterprises or from individuals or households. The borrowing and lending between enterprises comprises a large proportion of non-bank lending activities,[29] although it was not legal until 2015.[30] Individuals and households borrow money from or lend money to enterprises based on the parties' relationship and reputation. When enterprises borrow money from individuals or

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[27] I did not explore the relationship between shadow banking and private lending in the United States further, since its shadow banking system is completely different from that of China in terms of composition, players, and drivers. The United States' shadow banking system consists of securitized loans and obligations, asset-backed commercial paper, repurchase agreements, and money market funds. In contrast, China's shadow banking system includes the extension of direct credit by non-bank financial institutions (especially trust companies and brokerage firms) and informal securitization through the pooling of proceeds from wealth management products that banks provide. China's shadow banking system is by no means simple in structure but is not dominated by complex derivatives. Tong Li, Shadow Banking in China: Expanding Scale, Evolving Structure, Emerald Insight (Jun. 26, 2015 04:55 PM) 2, available at https://www.emerald.com/insight/content/doi/10.1108/JFEP-11-2013-0061/full/html.

[28] *Id.*

[29] Xi Yuemin, *The Characteristics, Problems and Legal Solutions to Private Lending,* 6 POL'Y & LEGAL REV. 62. 2012.

[30] Enterprises were not allowed to lend money to or borrow money from other enterprises prior to the 2015 Supreme People's Court Interpretations of the Application of Laws in the Trial of Private Lending Cases. However, these borrowing and lending activities are common and have not been regulated in practice. The 2015 Interpretation allows enterprises to lend to and borrow from each other as long as the exchange is for business purposes.

households, they usually turn to a large number of people. In this case, it involves raising money from the general public.

The government views this type of non-bank lending as a contract between the parties, subject to Article 211 of Chinese Contract Law, and contract law deals sufficiently with disputes among borrowers and lenders in this context.[31] The only financial regulation is that the lender may not set the annual interest rate beyond a usury level, which is currently 24%.[32] But when enterprises raise money from the general public, they risk triggering criminal sanctions and violating laws against illegal fundraising.[33] Certainly, when enterprises raise money from the public, there are potential threats to economic and social stability. However, lending without intermediaries' accounts for only a small proportion of the non-bank lending market. Moreover, unlike non-bank lending with intermediaries, it has little influence on the financial market. Thus, this paper will not address non-bank lending without intermediaries.

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[31] The Chinese legal system is similar to the Continental Legal System. China has a unified written Contract Law that applies nationally.

[32] The Supreme People's Court, Interpretations of the Application of Laws in the Trial of Private Lending Cases (2015). Article 26 states, "where the agreed yearly interest rate is under 24%, the lender is entitled to the full interest; where the agreed yearly interest rate is above 24% but under 36%, the interest exceeding 24% is void. However, if the borrower has already paid the interest to the lender, the borrower is not entitled to claim it back; where the agreed yearly interest rate is above 36%, the interest exceeding 36% is void. The borrower is entitled to request that the lender return the excess interest paid."

[33] For a clearer definition of criminal and illegal fundraising, *see* infra Chapter II. Part II.

The second type of non-bank lending involves a third-party intermediary. Third-party intermediaries — professional non-bank lenders, including both off-line and online P2P lenders – have much more influence in the non-bank lending market.[34] Both off-line and P2P lenders provide alternative funding sources for business and consumers, especially for those underserved segments.

Chinese off-line non-bank lenders usually are micro-loan companies, security companies, brokerage firms, small lenders and financial guarantors, pawnshops, credit guarantee agencies, and internet banks.[35] A number of credit guarantee agencies have moved beyond their intended purpose; they take deposits and provide loans.[36] Some of the lenders even use their own capital to provide business and individual loans, although this is illegal under the current law.[37]

A P2P lender is a type of non-bank lender that uses innovative financial technology and facilitates loans that originate outside of the traditional banking system by connecting consumer or business borrowers directly with lenders or investors, through an

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[34] Shu Zhang, China P2P Lender Dianrong Closing 60 Stores, Laying off 2, 000 Employees, Reuters (May. 25, 2019 12:00 AM), https://www.reuters.com/article/us-china-dianrong-layoffs/china-p2p-lender-dianrong-closing-60-stores-laying-off-2000-employees-source-idUSKCN1QI3IJ.

[35] SHEN, *supra* note 7.

[36] MICHAEL F. MARTIN, CONGRESSIONAL RESEARCH SERVICE, CHINA'S BANKING SYSTEM: ISSUES FOR CONGRESS, 6 (2012).

[37] *Id.*

internet platform.[38] Initially, Chinese P2P lenders served as financial intermediaries. However, I will discuss later in this Chapter, the Chinese government has forbidden P2P lending platforms from serving as financial intermediaries since 2016.[39]

Non-bank lenders differ from financial institutions whose approval and license for financial businesses comes from financial regulation departments of the central government.[40] They are registered like regular enterprises, except that they must meet certain regulatory standards (capital requirements, etc.). However, these standards are much easier to reach than those for official/central government financial institutions. In practice, although these professional lenders need the approval of the local government's financial office, it is easy for them to get the required authorization. Local governments prioritize economic growth. This leads them to encourage the establishment of professional lending enterprises, as these promote economic development.[41] However, there is little regulation of these professional lenders after they receive their approval.[42]

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[38] David W. Perkins, *Marketplace Lending: Fintech in Consumer and Small-Business Lending*, Congressional Research Service Report 1-2 (2018).

[39] Here Are Some of China's New Rules on P2P Lending, Fortune (Aug. 24, 2017, 09:30 AM), https://fortune.com/2016/08/24/china-p2p-lending-regulation/.

[40] Financial regulation departments include the People's Bank of China, China Banking Regulatory Commission, China Insurance Regulatory Commission and China Security Regulatory Commission.

[41] If the local financial office prevents the establishment of these professional lending enterprises, these lenders could get approved through giving bribes or relying on other connections with local governments. (This information comes from private conversation with the National Financial Regulation Department staff.)

[42] Jiang Xiaoyan, Research on Private Financial Institutions (2015) (Unpublished Ph.D. dissertation, Nanjing University).

Non-bank lenders finance their business through their personal assets, loans from family and friends, private equity, and/or raising money from the general public through direct lending or selling wealth management or other investment products.[43] There are fewer legal problems if the financing only involves personal assets, loans from family and friends, or private equity. It is raising money from the general public that causes problems because this fundraising activity is illegal and might trigger criminal sanctions.[44] However, savvy professional lenders manage to raise money from the public through direct fundraising, issuing different types of debt certificates (in the form of securities or bonds) without following legal procedures, and by selling wealth management products.[45]

Wealth management products (WMPs) are investment vehicles marketed to retail and corporate investors. They offer rates of return well beyond regulated interest rates of deposits (some can reach an annual interest rate of 30%).[46] Issuers use the pooled money to invest in individual and business loans, and in other types of assets.[47] WMPs were initially created and typically managed by Chinese banks.[48] But in recent years, various

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[43] Kellee Tsai, The Rise of Shadow Banking in China: The Political Economy of Modern Chinese State Capitalism, Iems.ust.hk (May.15, 2019 02:45 PM), https://iems.ust.hk/publications/thought-leadership-briefs/tsai-rise-of-shadow-banking-in-chin.

[44] *See* the regulation on fundraising activities in Chapter II Part II.

[45] BING PENG, THE LOGIC OF CROWDFUNDING LAW 178 (2017).

[46] Junhui Li, The Court Will Not Protect Loans That Charge an Annual Interest Rate Exceeding 24%, TECH.163 (Jun.24, 2016, 08:47AM), http://tech.163.com/15/0807/10/B0DL78RO000948V8.html.

[47] Tong Li, *supra* note 27. Wei Shen, *Wealth Management Products in the Context of China's Shadow Banking: Systemic Risks, Consumer Protection and Regulatory Instruments,* 23 ASIA PAC. L. REV. 55, 56, 59-60 (2015).

[48] Many of the WMPs that non-bank financial intermediaries create can still have bank involvement, as many of them

types of non-bank lenders have set up and managed a large and rapidly growing stock of WMPs.[49] WMPs are usually of short maturity, with terms of less than a year (mostly between one and three months). Retail investors can invest just 100RMB ($14.28) in the WMPs of non-bank lenders.[50] WMPs differ from conventional mutual funds in that the products have a set, if short, maturity. However, WMPs are also different from bank deposits because the funds raised are invested in individual and business loans and the returns of this investment are usually significantly higher than regulated deposit rates.

These professional lenders appeal to a large population, since the returns that they promise their public investors are very attractive compared to the interest rates that state-owned banks offer. However, I will discuss in greater detail in Chapter II, the current regulation of these lenders is inadequate, and there are few rules to protect investors. As a result, it happens all too often that professional lenders raise a huge amount of money from the public, then, unable to repay the loans with their high interest rates, vanish without giving the investors any notice.[51]

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are sold by banks. *See* Emily Perry & Florian Weltewitz, Wealth management products in China, RBA Bulletin 59-68 (2015).

[49] *Id*.

[50] Zhang Zhenzhen, P2P industry overview, NYTIMES (Nov. 15, 2015, 04:33 PM), https://cn.nytimes.com/business/20141201/cc01p2p/.

[51] Lu, *supra* note 20.

3. Why is Non-Bank Lending Prevalent in China?

Non-bank lending has increased in popularity over the past decade. It is essential to understand the reasons behind the explosion of non-bank lending in China. The two main reasons why private lending arose as an alternative structure to traditional bank financing include, first, that borrowers have difficulty getting loans through mainstream financial institutions, and second, that individual Chinese citizens have sufficient savings and have strong incentive to seek high returns from unregulated non-bank lending activities.[52]

a. High Financial Demands of SMEs

The adoption of reforms and opening-up policies in 1978 led to the revival of private enterprise in China.[53] Since then, China has witnessed the rapid expansion of the private sector.

As the state plan gave way to market discipline in the 1990s, Chinese private businesses began to grow even faster than state enterprises.[54] The Chinese economy is now largely been driven by private businesses, especially SMEs.[55] The economic value

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[52] Gil Lan, *Insights from China for the United States: Shadow Banking, Economic Development, and Financial Systems,* 12 BERKELEY BUS. L. J. 144, 157 (2015).
[53] Ralph W.Huenemann, Economic Reforms 1978-Present, Oxford Bibliographies (Aug.18, 2018, 04:50 PM), https://www.oxfordbibliographies.com/view/document/obo-9780199920082/obo-9780199920082-0008.xml.

[54] Lan, *supra* note 52, at 158.
[55] Yanzhong Wang, *Financing Difficulties and Structural Characteristics of SMEs in China*, CHINA & WORLD ECON VOL. 12, NO. 2, 34-49(2004).

that SMEs create accounts for 60% of the country's economic output.[56] Funding this rapid growth requires a great amount of capital.

According to the data from the Ministry of Industry and Information Technology, by the end of 2018, there were 30 million SMEs.[57] About 80% of these SMEs are under private ownership.[58] According to a recent World Bank report, there was a large gap between the financial demand and supply ($4.4 trillion and $2.5 trillion, respectively) in China for SMEs (including microenterprises).[59]

b. The Formal Financial Sector Cannot Provide Enough Loans to SMEs

As I mentioned earlier, although SMEs contribute to a large proportion of China's GDP, they cannot get enough loans from the formal financial sector. There are several reasons for this.

Since they were established, Chinese banks have been quite different from typical Western financial institutions. The Chinese government views banks as instruments by which to implement policies, rather than as commercially oriented financial

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[56] National SME Development Report Team, State Administration for Industry and Commerce, The Development of National SMEs in China (Abstract), www.gov.cn (Sep.26, 2016, 8:34AM), http://www.gov.cn/xinwen/2014-03/31/content_2650031.htm.

[57] Jun Li, The Ministry of Industry and Information Technology: More than 30 Million SMES Existed by the End of 2018, Chinanews (Jan. 24, 2020 9:34AM) http://www.chinanews.com/gn/2019/09-20/8961119.shtml. This number includes individual businesses.

[58] National SME Development Report Team, *supra* note 56.

[59] Miriam Bruhn, Martin Hommes, Mahima Khanna, Sandeep Singh, Aksinya Sorokina & Joshua Seth Wimpey, MSME FINANCE GAP: Assessment of the Shortfalls and Opportunities in Financing Micro, Small and Medium Enterprises in Emerging Markets, World Bank Report 30 (2018).

intermediaries. Since 1978, China has reformed its government-owned and -controlled banking system to make it more market oriented. Nonetheless, it still treats banks as extensions of the government, with overseers motivated by political concerns. The central bank — the People's Bank of China or "PBC" — oversees commercial banks, but in reality, banks are still financial arms of the government.[60]

While banks fail to provide SMEs with financial support, they give a disproportionate number of loans to state-owned enterprises (SOEs). SOEs can usually get loans from banks quite easily. Meghana Ayyagari states that banks loan overwhelmingly to SOEs and local government-backed investment units, and do so at very low cost.[61] The lending appears to be on a political rather than a commercial basis; the Chinese government maintains control of SOEs[62] via its control of loans to them. In addition, the central government gives a preference to SOEs with the aim of making them more competitive domestically or globally.[63]

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[60] MARK A. DEWEAVER, ANIMAL SPIRITS WITH CHINESE CHARACTERISTICS: INVESTMENT BOOMS AND BUSTS IN THE WORLD'S EMERGING ECONOMIC GIANT 106 (2012).

[61] Ayyagari, Meghana, Asli Demirgüç-Kunt, and Vojislav Maksimovic, *Formal versus Informal Finance: Evidence from China,* 23 REV. FIN. STUD. 3048, 3052 (2010) ("Historically, a large share of bank funding has gone to state-controlled companies, leaving companies in the private sector to rely more heavily on alternative financing channels.").

[62] China is a socialist/communist country. One important factor that determines the socialist/communist characteristic of China is the state ownership of most of the means of production. The control of SOEs is a way to maintain China's Socialist ideology.

[63] Michael F. Martin, *China's Banking system: Issues for Congress*, CONG. RES. SERV. 37 (2012).

Almost all Chinese banks are state-owned or state-controlled and the state strictly regulates the financial market. In 2013, only foreign banks, which account for a mere 1.7% of the total market, were completely private. According to World Bank statistics, "[t]he levels of state ownership in the banking sector [in China] and government intervention in the financial system are much higher than in other countries at a similar stage of economic development that later achieved high-income status."[64]

The government prevents the entry of newcomers, which helps to maintain the banking system's existing monopoly. In China, commercial banks are not freely established. Instead, they are "subject to the examination and approval of the banking regulatory organ of the State Council."[65] The China Banking and Insurance Regulatory Commission will not approve any private institution's request to enter the banking market unless that institution has the support of the Chinese government. The financial market started opening to private investment in 2014.[66] As of this writing, there are eighteen privately-owned banks.[67] However, the market share of these private-owned banks is still

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[64] The World Bank Dev. Research Ctr. of the State Council, The People's Republic of China, China 2030: Building A Modern, Harmonious, and Creative Society, 116 (2013), the World Bank, available at http://documents.worldbank.org/curated/en/781101468239669951/China-2030-building-a-modern-harmonious-and-creative-society.

[65] Law of the People's Republic of China on Commercial Banks (promulgated by the Standing Comm. Nat'l People's Cong., May 10, 1995, effective July 1, 1995) (Lawinfochina), Art.11.

[66] In 2014, the China Banking Regulatory Commission Released an Annual Report Regarding the First Batch of Five Private Banks, People Net (Feb.23, 2017 10:45AM), http://politics.people.com.cn/n/2015/0515/c70731-27005734.html.

[67] *See* A Description of All 19 Privately-Owned Banks, JRJ.com (Feb.23, 2020 11:33AM), http://trust.jrj.com.cn/2019/10/15073928247394.shtml.

much too small to have had any significant effect on the state-owned or state-controlled banks' monopoly.

What further strengthens the banks' monopoly status is the state-owned banks' close connection to the government. On the one hand, this monopoly power has brought the banks substantial profits,[68] since the banks control the price and entry requirements for enterprises seeking loans. As these banks regularly set the financing standards and costs (interest rates, fees, etc.) extremely high for SMEs, it is difficult for SMEs and start-ups to qualify for loans. On the other hand, this difficulty drives most SMEs and start-ups to turn instead to the private lenders for financial support.

For financial stability and risk reduction reasons, Chinese banks have created a centralized Credit Evaluation System ("CES") to evaluate each start-up's qualifications with regard to loans. However, the CES is set up to examine large enterprises.[69] The CES's requirements are extremely difficult for SMEs and start-ups to meet. These requirements are easier for SOEs because all existing SOEs are large and financially strong enterprises. There are currently three obstacles that prevent SMEs and start-ups from getting bank loans. First, according to the CES, the most important evaluation factors

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[68] The Four Largest National Banks Are All Listed in The Top 500 Fortune Global In 2019, Fortune (Feb.10, 2020, 5:33PM), See https://fortune.com/global500.

[69] City Finance Institut*e, Bank Loan Risk Evaluation for SMEs in the Background of the Big Data Era,* 49 BANKING INDUS. RES. 1 (2015).

are the applicant's profitability, its debt repayment ability, and its business conditions.[70] Chinese banks rely on financial reports when they evaluate these factors. However, SMEs and start-ups lack sufficient assets and the financial history to show that they are dependable. Second, where an applicant does not have a strong financial history, the banks require it to provide collateral for the loan. Again, it is generally difficult for SMEs to provide collateral. Many enterprises choose to pay guarantee companies to secure their loans (the standard is to offer a cash deposit of about 10% and fees of 3%-5% of the total loan). This increases the SME's total cost for getting loans. Thirdly, the required rate of return for SMEs and start-ups is higher than for large enterprises. As one survey shows, the average life of a Chinese SME is only three years,[71] which means that SMEs and start-ups default more frequently than large enterprises do. To protect against this risk, banks charge SMEs and start-ups a higher return rate. The total cost, including collateral and interest, can easily reach 15% or more per year.[72] The lack of a dependable financial history, the cost of collateral, and the higher interest rate all combine to keep SMEs from obtaining bank loans easily. It is true that investment on loans of SMEs are inherently

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[70] Lv Wendong, Xiao Yang & Zhao Yang, *Bank Credit Evaluation System for SMEs*, 23 SCI. Dec. 17, 35 (2012).

[71] Central Bank White Paper: The Average Lifespan of SMEs is only Three Years and the Non-performing Loan Ratio has Reached 5.9%, Caixin Net, http://finance.caixin.com/2019-06-25/101431232.html.

[72] City Finance Institute, *supra* note 69, at 2.

risky, but investors on these online lending platforms also receive much higher returns than the regulated interest rate of bank deposits.

China's credit reporting system is considerably less developed than that of other developed countries. This makes it more difficult for banks to confirm a company's financial status through a neutral third party; they can rely only on the financial reports that the firm applying for loans has provided.

When applying for a loan from a bank, firms must usually provide audited financial reports covering the previous three years, as well as the financial reports of the most recent three months.[73] Banks will evaluate and make decisions based on these reports. However, in practice, these reports cannot provide all of the information that the banks need. It is also the case that applicants tend to provide fake financial reports or to submit reports that do not reflect their actual debt status (for example, they might not show that the company has borrowed a large amount of money from private lenders). The lack of a reliable credit system creates an information asymmetry problem that deters banks from granting loans to SMEs or start-ups.

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[73] City Finance Institute, *supra* note 69, at 3.

c. High Money Supply from Private Wealth

The accumulation of private wealth has contributed substantially to the prosperity of the non-bank lending industry. Culturally, Chinese people prefer saving to borrowing money. With a saving to income ratio of 45%, China has one of the highest saving rates in the world.[74] However, because the Chinese capital market is underdeveloped, Chinese retail investors have only a very limited choice of investments. Also, as the central bank – the People's Bank[75] – controls the deposit and lending rates, the interest rate (the nominal rate minus the inflation rate) that Chinese depositors receive has remained negative for many years.[76] According to the International Monetary Fund, Chinese depositors' "financial income as share of total income remains one of the lowest in the world, " which means that the Chinese people are not fully compensated for depositors' savings.[77] For these two reasons, households with savings generally choose to invest with private lending firms, as doing so can generate considerably higher returns. According to a survey, in early days, the average annual interest rate in the city of Wenzhou was 23%, which was much higher than the bank interest rate of 2.75% (fixed deposit for the term of three years

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[74] China's Savings Rate is 45%, still the Highest in the World, xincainei.com (Jan.2, 2020 11:00 AM), http://www.xincainet.com/index.php/news/view?id=234646.

[75] Wei Qian & Li Tong, China's Financial Reform Should Focus on Interest Rate Liberalization, PEOPLE'S DAILY ONLINE (Apr. 5, 2012), http://english.people.com.cn/90778/7778507.html.

[76] Eating Bitterness in China's Financial System, Wall Street Journal (Jan.18, 2015, 09:45PM), https://blogs.wsj.com/chinarealtime/2011/03/18/eating-bitterness-in-china%E2%80%99s-financial-system/.

[77] Tarhan Feyzioğlu, Nathan Porter & Elől Takáts, Interest Rate Liberalization in China, IMF Working Paper No. 09/171, *available at* http://www.imf.org/external/pubs/ft/wp/2009/wp09171.pdf.

in 2019). At their highest, interest rates can reach 180% per year, although this is very rare.[78] In recent years, however, as the government strictly controlled the interest rates, the interest rates available to investors have become much lower (usually between 5% and 10% on P2P platforms)[79] although they are still higher than the bank interest rate.

In conclusion, the appeal of non-bank lending to both depositors and borrowers is easy to understand. Depositors turn to the system because state commercial banks cannot offer a reasonable rate of return, as the government maintains interest rates at an artificially low level;[80] seeking higher returns, depositors turn to non-bank lenders. Borrowers – private businesses (especially SMEs) and some households – also turn to non-bank lenders, because they are underserved by traditional banks that are mostly under state control. Non-bank lending helps borrowers get the money they need more easily. In short, the imbalance between an adequate supply of private capital and an insufficient supply of loans through the formal financial sector has led to significant non-bank lending throughout China.

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[78] Wenzhou Private Lending Annually Interest Rate Reaches 180%, Some Enterprises are Facing Bankruptcy, Sina Net (Feb.7, 2018 11:22PM), http://news.sina.com.cn/c/2011-09-26/161323219546.shtml.

[79] Jiefei Liu, The Dramatic Rise and Fall of Online P2P Lending in China, Techcrunch Net (sept.11, 2019, 06:07 PM), https://techcrunch.com/2018/08/01/the-dramatic-rise-and-fall-of-online-p2p-lending-in-china/.

[80] *See* Susan Feng Lu & Yang Yao, *The Effectiveness of Law, Financial Development, and Economic Growth in an Economy of Financial Repression: Evidence from China,* 37 WORLD DEV. 763, 764-65 (2009).

B. The Rise and Rapid Growth of the P2P Lending Industry

While various types of non-bank lenders have evolved since the 1990s, P2P online lending platforms have been developing rapidly over the past decade.

1. The Historical Development of P2P Lending in China

In 2007, China followed the example of the United Kingdom's zopa.com and established its first P2P lending platform, Paipaidai.[81] The P2P industry grew slowly at first, but expanded rapidly between 2011 and 2018.[82] By the end of 2011, 50 providers were in operation, and this number climbed to 2,595 platforms by the end of 2015.[83] Based on an industry report, P2P lenders originated around $556 billion of loans in 2017, an increase of 39% from the $401 billion in 2016, and an increase of 977% from the $13 billion in 2013.[84] Nonetheless, the industry has witnessed a decline in recent years, especially since 2018, when the Chinese government started to impose stringent regulations on it. In 2018, the number of platforms decreased to 1,021 by more than 50% compared with the previous year. This number continued to drop in 2019.[85]

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[81] Gan, *supra* note 5.

[82] Increasing Transparency to Drive the P2P Lending Market to Cross $370 Billion Mark by 2025: Industry ARC, Bloomberg (Jun.28, 2019, 10:44PM), https://www.bloomberg.com/press-releases/2019-06-28/increasing-transparency-to-drive-the-p2p-lending-market-to-cross-370-billion-mark-by-2025-industryarc.

[83] 2015 P2P Industry Annual Report, WDZJ (Oct.24, 2017 09:44 AM), https://www.wdzj.com/news/baogao/25555.html.

[84] LINGYI FINANCE, CHINA P2P LENDING SERVICE INDUSTRY DEVELOPMENT REPORT 35-40, (2018).

[85] Alfred Liu, China P2P Lending Crackdown May See 70% of Firms Close, Bloomberg (Oct.15, 2019 11:33PM), https://www.bloomberg.com/news/articles/2019-01-02/china-s-online-lending-crackdown-may-see-70-of-businesses-close.

Around the world, “P2P lending is small relative to the total personal and small-business credit outstanding” in most jurisdictions. For example, it “accounted for less than 1% of the total consumer and small-business loan market” in the United States at the end of 2017.[86] In China, market share is higher, at 13% of overall new lending (including both the formal and informal sector, and both consumer and business lending) in the first half of 2018, based on an estimate from WDZJ.com.[87]

2. Why is P2P lending so prevalent in China?

The abundant supply of funds from retail investors, and the high demand for access to funding from individuals and from the owners of SMEs are the two primary factors behind the rapid growth of P2P lending in China. China’s government’s strong support boosted this development. The government deliberately introduced moderately loose regulatory policies in the early period in order to encourage the continued growth of “internet finance,” including P2P lending.[88] It did so with the aim of fueling the economy through the supply of funds to SMEs. However, more recently, as thousands of platforms collapsed and investors who could not get repaid protested in large cities, the government

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[86] Perkins, *supra* note 38.

[87] China Online Lending Industry Annual Report, WDZJ Net, https://www.wdzj.com/zhuanti/2018report/.

[88] Institute of International Finance, China Spotlight: Internet Finance in Focus, IIF.com (Sept.23, 2017 5:55AM), https://www.iif.com/portals/0/Files/private/china_internet_finance_september2016.pdf.

gradually started to impose stringent regulations, which are causing the P2P market to shrink.

As the Chinese government forbade and cracked down on the fund-raising activities of these non-bank lenders, they turned to the P2P lending area, where it had previously imposed little regulation and which it even promoted. And it is usually the case that these P2P platforms also have off-line sales offices, which help to attract more investors.

We can attribute the rise and rapid growth of non-bank online lending in China to the above reasons, but there are some unique additional factors that contributed to its growth.

a. High Number of Internet Users

By the end of 2018, there were 829 million internet users in China.[89] This is greater than the number in the U.S. (275 million) or in Europe (719 million).[90] Although the online penetration rate is not as high as in the U.S. or Europe, the large number of internet users provides a good rationale for developing China's P2P online lending industry.

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[89] Yuying Liu, The Number of Chinese Netizens Reached 829 Million, Xinhua Net (May.24, 2019 6:44AM), http://www.xinhuanet.com/fortune/2019-02/28/c_1124175659.htm.

[90] Data from Statista, *available at* https://www.statista.com/outlook/399/117/alternative-lending/china#market-globalRevenue.

b. The Chinese Government's Lack of Regulation, and Even Strong Support of P2Ps' Development

Unlike the United States or the United Kingdom, China initially failed to regulate the P2P industry. This is mainly because in China, two different financial commissions are separately responsible for banking and insurance regulation, and securities regulation. It is difficult to determine into which category P2P lending falls and which commission should regulate this industry.

During the first few years after P2P lending was introduced in China, there were no specific barriers to entry and no regulatory authority was authorized to monitor the industry. The government did not apply criminal sanctions to this industry until later. This regulatory vacuum indirectly gave rise to the rapid, even distorted, development of the industry, because the Chinese government was unsure of the proper way to regulate it.

In the meantime, after 2013, the Chinese government explicitly turned to internet finance, including P2P lending, as a general policy tool by which to stimulate its economy.[91] From 2013 to 2017 (before online lending platforms started to collapse frequently), the Chinese Central Government had mentioned the development of internet finance in each of its annual Government Work Reports.[92] Many local governments also

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[91] The Big Bang of Internet Finance, Caixin Net (Jun.24, 2016 05:44PM), http://finance.caixin.com/2013/itfinance/.

[92] The Chinese Central Government's Government Work Report is one of the most important official documents that

implemented policies to promote the development of internet finance. For example, the city of Wenzhou built a professional service organization to facilitate its development.[93] It also established mandatory requirements for starting in the internet finance businesses. The Zhejiang and Jiangsu provinces facilitated the process by which internet finance companies register their businesses.[94] The Shijingshan district in Beijing built an internet finance industry base and the Haidian district in Beijing established an internet finance industry center.[95]

Although China has established a market economy, the government still controls the economy in many ways. For example, once the government indicates that it intends to develop a certain industry, it will devote a lot of resources and money to doing so. Because of the Central and local government's policies, P2P lending flourished in its first several years.

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shows the government's developmental plans and goals for the next year.

[93] China Legalizes Private Lending in Wenzhou, China Daily (Aug.1, 2016, 08:18 AM), https://www.chinadaily.com.cn/business/2014-02/28/content_17313886.htm.

[94] The World Economic Forum's Global Agenda Council, The Complex Regulatory Landscape for FinTech An Uncertain Future for Small and Medium-Sized Enterprise Lending, www3.weforum.org(Apr.2, 2017, 2:00AM), http://www3.weforum.org/docs/WEF_The_Complex_Regulatory_Landscape_for_FinTech_290816.pdf.

[95] Finance World & China Internet Association, China Internet Finance Report (Aug.24, 2017, 11:00AM), http://www.cac.gov.cn/files/pdf/zghlwjrbg2014.pdf.

3. The Collapse of P2P Lenders

Paipaidai established the first Chinese P2P online lending platform in 2007.[96] From 2011 to 2015, the Chinese government promoted the development of this industry and even loosened interest rate regulations in order to support its growth.[97] P2P online lending platforms developed gradually and smoothly in these years. From the very beginning, the platforms preferred the financial intermediary model. Although China prohibits raising money from the public, the government did not strictly apply the regulations against doing so until 2015. Scandals started to emerge in 2013 (see the table below). In 2015, when the number of platforms reached its highest level, correlatively, the number of failed platforms and the number of scandals started to surge.

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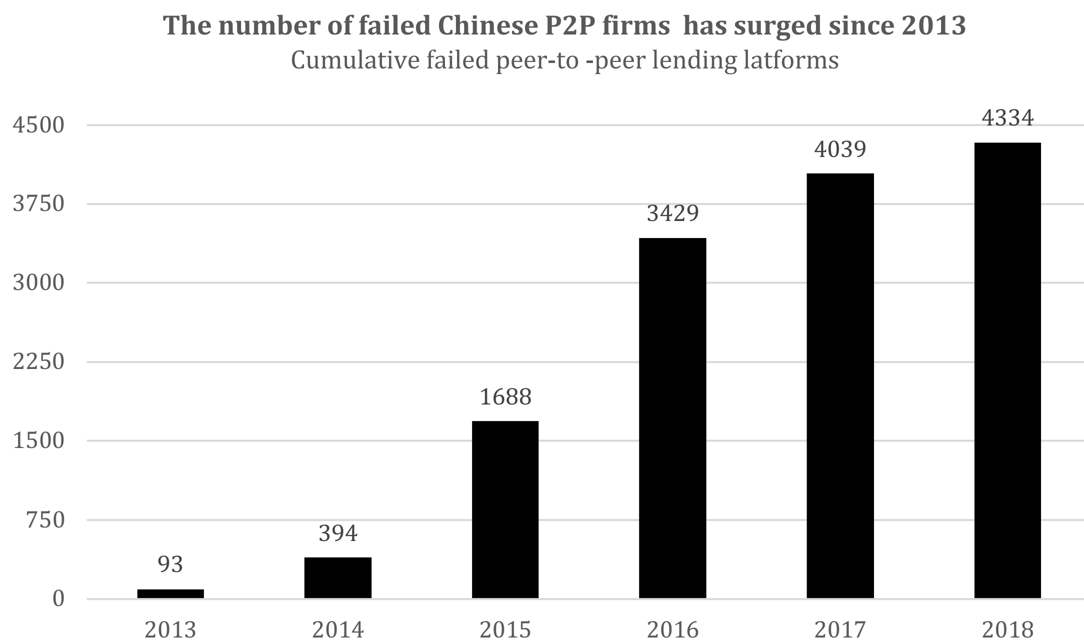
[96] Gan, *supra* note 5.

[97] 2013 China P2P Online Loan Big Data: Average Comprehensive Interest Rate 25.06%, China Economic Net(Jul.12, 2017, 04:56PM), http://finance.ce.cn/rolling/201401/14/t20140114_2117656.shtml.



Source: Yingcan Group
Note: Failed platforms include those that have been unable to repay investors, come under police investigation, halted operations, transformed into other businesses, or had operators flee with client funds. Data of June 2018

By the end of 2016, 3,234 (66.2%) out of a total of 4,885 platforms had failed. 30% of the failed platforms closed their businesses because of a change of policy or business strategy, or because they were unable to continue their operations.[98] The other 70% did so because of their difficulty in repaying investors.[99] Of these, 34% closed their websites or disappeared. 15% of the platform bosses maliciously ran away with the money that they had raised when they could not repay their investors. 11% of the platforms made it difficult for investors to withdraw their invested funds, while 7% turned out to have

[98] LINGYI FINANCE, THE DEVELOPMENT OF THE P2P LENDING INDUSTRY REPORT 45 (2017).
[99] *Id.*

been defrauding their investors from the very beginning.[100] Fewer than 30 platforms faced police investigations.[101]

The frequent and massive collapse of P2P online lending platforms threatens social and financial stability. When these institutions defaulted, the investors usually could not get their money back. According to the Deputy Director General of the Ministry of Public Safety, Wang Zhiguang, of all illegal fundraising cases, only an average of 10% returned some of their investors' money.[102] The current regulatory framework gives investors few ways to get their money back. Many investors turned to protests, because they had no other options. The institutions' offices, public places, and even the gates of governmental departments all became good locations for these protests.[103]

Take the example of Ms. Liao. She had invested her money in hundreds of platforms, and lost $1.5 million USD.[104] On August 7, 2018, she, and thousands of people like her, took to the streets in front of the China Banking Regulatory Commission's headquarters to show their distress at what they viewed as the government's lack of action

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[100] *Id.*

[101] *Id.*

[102] The Overall Situation of Illegal Fund-raising in China is Grim: the Number of Cases is Rising and They Are Difficult to Handle, News.cctv.com (Nov.11, 2019, 11:11PM), http://news.cctv.com/2018/04/23/ARTIno3Y974VNVfEpom5kSZS180423.shtml.

[103] Lu, *supra* note 20.

[104] Gu xiaohua, Luo Ya, Victims of P2P Lending Crash Hold Simultaneous Protests Across China**,** Theepochties.com (Dec.22, 2019, 10:40AM), https://www.theepochtimes.com/victims-of-chinas-p2p-lending-scams-hold-protests-police-arrest-protestors_2678751.html.

in regulating these online lending platforms.[105] Hundreds of police officers crushed in to clear the area.[106] The public security authorities arrested and detained an unknown number of people.[107]

In extremely large cases, the social effect of these protests has been tremendous. We see this in the Ezubao case. Ezubao was a platform that raised more than 50 billion RMB (7.6 billion USD), from more than 1.3 million investors across China.[108] When it failed, almost one million of them could not get all or part of their invested funds back.[109] When the police intervened in 2015, Ezubao had failed to repay 38 billion Chinese yuan (5.8billion).[110] After hundreds of thousands of investors had protested for years without success, investors from Beijing and 16 other cities[111] sprang into action. On October 1, 2018, almost 10, 000 demonstrators staged simultaneous protests across China. The P2P victims held signs and shouted slogans like, "give me my hard-earned money back."

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105 *Id.*
106 *Id.*
107 *Id.*
108 Zhou Xiaochuan, Holding the Bottom Line of No Systemic Financial Risks, The People's Bank of China (Jan.12, 2019, 10:30PM), http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/3410388/index.html.
109 *Id.*
110 Huileng Tan, Two Chinese Executives Get Life in Prison for $7.6 Billion Ponzi Scheme, CNBC (Dec.15, 2018, 08:18AM), https://www.cnbc.com/2017/09/12/ezubao-two-in-china-get-life-in-prison-for-7-point-6-billion-ponzi-scheme.html.
111 The cities of Beijing, Shanghai, Guangzhou, Hangzhou, Nanjing, Nanchang, Hefei, Chengdu, Chongqing, Wuhan, Changsha, Nanning, Fuzhou, Kunming, Zhengzhou, Jinan, and Shijiazhuang all participated.

In a country whose leaders, the Chinese Communist Party, believe that "stability trumps everything," public protests present a serious threat. Since the protests focused on P2Ps, the government came to consider the financing of P2P lenders to be the root of a major threat to its financial stability.

C. The Business Models of P2P Lending

P2P lending is usually defined as a lending platform that posts individual or business loan information, which helps lenders and borrowers find each other. In this view, the P2P lending platform serves as the information intermediary but not as a contractual party in the lending transactions. In China, over the past decade, however, this model exists alongside a second model, that of financial intermediary. China's current regulation only allows the information intermediary model to exist and forbids platforms from playing a financial intermediary role.

1. Information intermediary model

This model adheres to the traditional understanding of P2P lending, in which the platform mainly disseminates information and matches borrowers with lenders. P2P lending platforms profit as soon as they service the underlying loans. The platform is not a transacting party, and it does not share the risks of borrower default with investors. If borrowers fail to make payments on the underlying loans, investors won't receive payments. Information intermediary platforms conduct loan ratings, evaluate borrowers' creditworthiness and post their information online, offer investment advice, manage repayment, and provide collection services for delinquent loans.

Since these platforms do not bear any default risks and profit when they originate and service the transactions, they are motivated to stimulate high transaction volumes, often without taking enough precautions to filter borrowers.

This kind of P2P model was not popular among platform owners. However, the Chinese government has been promoting this model, as it believes that it carries lower risks than the financial intermediary model.

2. Financial Intermediary Model

Under this model, platforms pool money from investors by selling WMPs and then make investments using the pooled money. Until 2016, when the government issued the "Interim Measures on Online Lending" to forbid the operation of this model, it was the option that the vast majority of Chinese P2P lending platforms adopted. In fact, despite the prohibition, this model remained operative until 2018, when the government began more strict enforcement. Even after that, a number of platforms reformed their WMPs to comply with the new requirements by converting to the auto-selection model,[112] managing to

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[112] See detailed explanation below.

change the appearance of their WMPs without losing their ability to raise money from the public. Two types of financial intermediaries existed – investment pool with guaranteed return and investment pool without guaranteed return.

a. Investment pool with guaranteed return

In order to attract more investors, platforms used to guarantee the return of principal and fixed interests to investors, until the government forbad this model in the 2016 "Interim Measures on Online Lending."

Under the guaranteed return model, if the borrower defaults on the loan, a guarantee company is required to take joint and several liability. The credit risks transfer from the lenders to the platform or its associated entities. If a third party provides the guarantee, it evaluates the borrower's creditworthiness and charges certain amount per loan. If the borrower defaults on the loan for certain period, this third party will repay the investor. If the platform provides the guarantee, it may use its own funds or the risk guarantee funds to compensate for the defaulted loan. In this way, the platform plays a role that is similar to traditional banks.

The annual return rate that the platform guaranteed was very high (in 2013 it reached 40%, and the average annual return rate was 22.75%).[113] This enticed many

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[113] Yu Xiyan, P2P Return Rate is Less Than 10% in Two Years; It is Difficult to Reverse the Slowdown, Xinhua Net (Nov.11, 2018 , 10:56PM), http://www.xinhuanet.com/fortune/2017-03/11/c_129507092.htm. The average annual

investors to put all of their savings in these platforms, but the high return rate also made this business model unsustainable. Once a platform cannot attract enough investors or once enough borrowers' default, it usually collapses. Worse, with virtually no regulation of this industry in early years, some platforms even made up projects to defraud investors. The dramatic scale of the guarantees and the amount of money involved is why the collapse of platforms and the disappearance of platform owners with money frequently appeared on the news.

b. Investment pool without guaranteed return

Under this model, platforms do not bear the investment risks, and the investors' return on the investment depends on the performance of the underlying assets. Under this model, it is the platform or a third-party professional lender that originates loans to the borrowers. The third party is usually related to the platform. The platform then repackages the borrowers' loans into wealth management products and sells them to investors. Alternatively, the platform just raises funds from the public by selling wealth-management products and then lends the money to individual consumers and businesses.

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return rate has been declining since 2013 and is currently less than 10%.

After the Chinese government forbade P2P lending platforms to pool money from the public and required platforms to serve only as information intermediaries, many platforms created the auto-selection model.

In this model, the platform pools money from investors in the name of a certain wealth management product. The platform usually provides various types of products based on the term length and the amount of money it collects. The investors choose the type of product and the amount of money they would like to invest. It is usually the case that the longer the term, the higher the interest rate.

These platforms list all of the loans available under a certain type of product. For each listed loan, the platform provides information including the borrower's income, education, residence, the purpose for which he or she is borrowing, and credit information. Until recently, no platform provided such detailed information.

In order to meet the information intermediary requirement, the platform is supposed to state in the contract the specific loan that the investor has chosen. However, it seems that the nature of this model still allows platforms to raise money from the general public using the guise of matching the listed borrowers with investors. In practice, the platforms have various ways to evade the current regulation.[114] One popular trick is to

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[114] The regulation is intended to make these platforms behave like traditional P2P lending platforms that match borrowers and lenders.

split a single loan into several terms and repackage these into different products in continuous orders. Take, for example, a loan in the term of 12 months. The platform can split it into three four-month terms. Since the borrower won't repay the loan until the end of the 12 months, the platform can use new investors' money to repay the principal and interests of old investors. If the platform does this with hundreds of loans, the lists become so complicated that investors would really have to struggle to determine exactly how the platform invested the money. Thus, even if from reading the contract, the investor can guess which loan she/he has invested in, she/he remains uncertain about the truthfulness of the match. Complicating matters, the term in the contract is usually not exactly the same as that of the loan.

Regarding interest, platforms usually state that they do not guarantee that investors will receive the amount of interest listed for each product, and that interest payments depend on the performance of the underlying assets. They also warn that investors might not be able to get their principal or interest on time, and that there is always the risk of losing the entirety of the principal and the interest. The same holds true regarding bearing risks. The platforms do not guarantee that investors will receive the principal or interest on time, and state that they do not bear any risks.

Although most current operating platforms still retain this type of model, it might be prohibited in the near future as the government is tightening its regulation of the P2P lending industry.

III. Informational Intermediary vs. Financial Intermediary

Since the Chinese government believes that letting P2P lenders adopt the financial intermediary model is threat to its stability, it has, since 2016, forced these lenders to adhere to the informational intermediary model instead. Local governments' financial offices have been working to shut down platforms that do not operate under the informational intermediary model. However, this chapter argues that the Chinese government should allow P2P lenders to play a financial intermediary role. Platforms that serve as financial intermediaries bring more societal benefits through diversification and by reducing screening and monitoring costs than do pure P2P lending platforms, when they are appropriately regulated. Further, the rise of financial intermediaries in the P2P lending industry is inevitable and therefore the Chinese government would be wiser to work out a way to regulate them than to close its eyes to their existence. In other words, a pure informational intermediary model should not be the only option and China should allow online platforms to serve as financial intermediaries as well.

A. The Chinese Government Views the Informational Intermediary Model as Carrying Lower Risks

Although the informational intermediary model has never been a popular business model for online platforms, the Chinese government regards the format as offering lower risks than any other business model. It therefore promoted this model in early days and then in recent years, forced all online platforms to adopt it.

The informational intermediary model is actually also a form of illegal fundraising in China, because the borrower raises money from the public through the online platform, which is not permissible under Chinese law. Nonetheless, the Chinese government allows it because of its view that this is the lowest risk option.

First, the investor and the borrower are directly connected. In theory therefore, even if many borrowers default, there will be a large number of investors who can make claims against the borrowers on their own, although in practice, this might not be the case, as the investors might not be able to find the borrowers. These investors will have no complaints about a specific platform if it just provided an information intermediary service. This should diminish conflicts between investors and platforms, removing a link between disappointed investors and the source of their disappointment, which should accordingly reduce protests against platforms.

Second, under the informational intermediary model, the platforms do not share default risks, but rather the investors take the investment risk on their own, reducing the number of failed platforms. Third, although one borrower might attract more than one investor, the number of investors in a given loan is usually limited, which diminishes the fall-out should it default. In contrast, platforms that serve as financial intermediaries can attract millions of investors. Their collapse has far broader effects and carries many more risks. Besides, as the information intermediary model is unpopular, few investors invest their money and few loans are made on this type of platforms. As a result, few failures happened on this type of platforms.

B. The Advantages of Financial Intermediaries

A financial intermediary is an entity that acts as the middleman between two parties in a financial transaction.[115] Financial intermediaries can transfer funds from people who have surplus capital to those who require liquid funds in order to carry out a desired activity.[116] They have many ways to allocate uninvested money into enterprises, including through debt or equity.[117]

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[115] MICHAEL S. BARR, HOWELL E. JACKSON, MARGARET. THAYER, FINANCIAL REGULATION LAW AND POLICY 8-10, (2016).

[116] ARTHUR O'SULLIVAN, STEVEN M. SHEFFRIN, ECONOMICS: PRINCIPLES IN ACTION. 272 (2003).

[117] Tom C. W. Lin, *Infinite Financial Intermediation,* 50 WAKE FOREST L. REV. 643, 643-44 (2015).

In the U.S., there are various types of financial intermediaries in addition to banks. These include investment banks,[118] pension funds,[119] insurance companies,[120] finance companies, and mutual funds. Chinese P2P lenders operate like the final two of these. U.S. finance companies raise funds through the sale of commercial paper, bonds, and equities, rather than through the issue of deposits, and then make loans to individuals and SMEs. A mutual fund first pools money from many investors and then invests the pooled money in stocks, bonds, and short-term debt.[121] Like finance companies, mutual funds serve retail investors and SMEs. These two types of financial intermediaries generally operate smoothly and don't have as many scandals as Chinese P2P lenders.

There are various models of non-bank financial intermediaries in China, including insurance companies, financial asset management companies,[122] trust companies, finance

[118] An Investment company is, in basic concept, "any arrangement by which a number of persons invest funds in 'company' that is itself engaged in investing in securities." Richard S. Carnell, Geoffrey P. Miller, Jonathan R. Macey, The Law of Financial Institutions 643 (2013).

[119] Pension funds pool money from employers' contributions. They invest this pool of funds on the employee's behalf and the earnings on the investments generate income for the workers when they retire. Pension Plan, Investopedia (Jan.20, 2020, 08:20PM), https://www.investopedia.com/terms/p/pensionplan.asp.

[120] An insurance company is a financial institution that provides a range of insurance policies to protect individuals and businesses against the risk of financial loss in return for regular premium payments. An insurance company operates by pooling risk among a large number of policyholders.

[121] Mutual Funds, Investor.gov (Feb.14, 2020 4:39 AM), *See* https://www.investor.gov/introduction-investing/basics/investment-products/mutual-funds-and-exchange-traded-funds-etfs.

[122] "Financial asset management company" refers to the type of wholly state-owned, non-banking financial institution that the State Council established when it decided to purchase the non-performing loans of state-owned banks, as well as to manage and dispose of any assets resulting from purchase of the non-performing loans of state-owned banks. art.2.

companies,[123] financial leasing companies,[124] and micro-loan companies.[125] However, these financial intermediaries (other than the micro-loan companies) only serve large entities and investors with large investments. P2P lenders do not operate like any of these types of financial intermediary. The Chinese government resists new types of financial intermediary, which greatly constrains the ways that retail investors invest their money and SMEs get funds.

However, compared with an informational intermediary, financial intermediaries offer the following advantages:

1. Greater Investment Diversification

A financial intermediary pools and reallocates money from investors and then makes investments. Under the P2P model, individual investors can choose to invest in a few or many different peer-to-peer loans as a way to reduce their investment risks. However, as the vast majority of investors have limited investment funding, they are unable to diversify their investment as what financial intermediaries can do. Further, retail

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123 Here, a "finance company" means a non-bank financial institution that provides financial management services to the enterprise group member entities for the purposes of strengthening the concentrated management of the enterprise group funds and improving the efficiency of using the enterprise group funds. art. 2.

124 Financial leasing companies are non-bank financial institutions that the China Banking Regulatory Commission (CBRC) has approved. They mainly engage in financial leasing. art. 2.

125 Micro-loan companies are established with investments from natural persons, legal-person enterprises, or other social organizations. They do not absorb public deposits, and operate as micro-loan businesses. The Chinese government regards this type of company as a financial intermediary. See Guiding Opinions of China Banking Regulatory Commission and the People's Bank of China on the Pilot Operation of Micro-Loan Companies, art. 2. Micro-loan companies can solve some of the funding problems for SMEs but cannot provide additional investment channels for retail investors.

investors usually lack the resources and professional knowledge required to build a strong portfolio. A financial intermediary usually specializes in fund management and investing activities. This makes it better suited to providing a more diversified investment and greatly reduces the risks for individual investors.

2. Reducing Costs for Both Investors and Borrowers

A financial intermediary can reduce costs for both investors and borrowers.

First, the more diversified the portfolio that retail investors build, the greater the time and costs involved. Under the P2P model, investors have to evaluate borrowers' creditworthiness on their own. For the individual investor, this job is not only costly, but also extremely difficult because of China's poor credit reporting system. Financial institutions have better resources with which to screen borrowers and are able to provide professional evaluations of them, all at a much lower cost.

Second, a financial intermediary is motivated to be careful in its monitoring of the borrowers' behaviors because it shares the risks of the borrowers' default with investors. Its screening and monitoring of borrowers help to reduce the risks of default.

Third, a financial intermediary can accumulate and process information, thus helping both parties to overcome information asymmetries.[126]

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[126] Kathryn Judge, *Fee Effects*, 98 IOWA L. REV. 1517, 1525 (2013).

Fourth, "the pooling of funds provides administrative economies of scale since it is less costly to administer one $10 million loan than it is to administer 10,000 loans of $1,000 each."[127] Thus, financial intermediaries can reduce the total cost of each financial transaction that an individual investor would make if the financial intermediary did not exist.

C. The Inevitability of Financial Intermediaries in the P2P Industry

Despite the prohibition, P2P lenders' raising money from the public is an irreversible trend. The government has never been, and will never fully be able to enforce its harsh regulations.

The lack of investment and funding access to formal financial institutions drove the rapid growth of P2P and other types of non-bank lenders.[128] Although the government prohibited it from the start, the vast majority of platforms chose the financial intermediary model, and their fundraising was widespread until the government banned it. Even after the government issued regulations to encourage, and in 2015 began to enforce, the pure informational intermediary model, only 1% of platforms had adopted it by the end of 2016.[129]

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127 BENTON E. GUP, BANKING AND FINANCIAL INSTITUTIONS: A GUIDE FOR DIRECTORS, INVESTORS, AND COUNTERPARTIES 24 (2011).
128 LINGYI FINANCE, *supra* note 98, at 15.
129 *Id.*

P2P lenders that played the role of financial intermediary became a popular type of financial institution because more and more investors and borrowers chose them as the means through which to invest money and get funds. In 2013, only 0.51 million investors and 0.22 million borrowers participated in the industry. By 2017, 12.5 million investors and 13.5 million borrowers were actively involved,[130] and lending in the P2P industry ran to about 2.71 trillion RMB (or 0.39$ trillion).[131] WDZJ.com estimated that lending in the P2P industry accounted for about 13% of overall new lending in China (including both the formal and the informal sector) in the first half of 2018.[132]

It is true that financial intermediaries bring more risks than does the information intermediary model, because financial intermediaries usually involve a large number of investors, borrowers, and investments, and thus their failures are generally larger and have broader effects on society. But as Chapter III suggests, the Chinese government could establish specific rules to mitigate such risks. Even if every online platform were to adopt the informational intermediary model, doing so would not guarantee complete financial stability. As I will discussed in Chapter II, current regulations are not working and cannot provide investors with strong protections if they lose their invested money on a P2P online

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[130] *Id*, at 43.
[131] Lingyi Finance and Economic Research Institute, 2017 P2P Industry Semi-Annual Report, 01Caijing Net (Jan.2, 2018 09:44PM), http://www.01caijing.com/article/16196.htm.
[132] WDZJ Net, *supra* note 87.

lending platform. If these investors cannot find the borrower or get their invested money back, they might still choose to protest in front of the platform's offices or in public areas.

Therefore, China should change its regulatory style from prohibition to the legalization of P2P lenders and other types of non-bank lenders as financial intermediaries. With careful regulation, it will be able to mitigate the financial risks associated with financial intermediaries.

D. The Chinese Government Might still Prohibit the Financial Intermediary Model

Even if the Chinese government were to agree that P2P platforms using the financial intermediary model carry more societal benefits, are inevitable, and would remain stable if properly regulated (as I will discuss in Chapter III), it still has several reasons for prohibiting this model.

First, the government controls or owns the vast majority of the banks in the country and can enforce its policies as a way to achieve its economic or political goals. It is the central or local government that usually appoints the managers of those banks. Thus, the government has the power to instruct those managers to make loans to certain companies or projects.[133] In contrast, the government does not control non-bank lenders.

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[133] Bai Jiang, *Financial Repression, Rule of Law in Finance and Economic Growth,* ACADEMIC MONTHLY 71, 74 2014(7).

The development of the non-bank lending industry would decrease the financial resources that the government can utilize.[134]

Second, the government aims to control the increase of interest rates. The People's Bank of China determines the upper limit of the deposit rate and the lower limit of the loan interest rate. Governmental control of the interest rate lets it to provide lower cost funding to the industries or enterprises that it aims to develop. If it allows non-bank lenders to grow freely as financial intermediaries, the market is likely to determine the interest rate, which would compromise the government's ability to aid certain industries or enterprises. The government could continue lend at the chosen rate, but the subsidy would become more transparent.

Third, the government fears losing control of the financial sector if it allows the private sector to grow freely. State ownership of the means of production is an important feature of a communist country. Although China has abandoned the idea of complete ownership of all means of production, the Chinese Communist Party (CCP) still aims to maintain its communist identity through the control of the most crucial parts of the economy, including the financial sector. If it gives financial intermediaries free rein, it

[134] Lili Wang, Legal Regulation of the Informal Finance (May 2015) (Unpublished Doctoral Dissertation, East China University of Political Science and Law).

might have to give up its power over the financial market, which in turn would threaten that communist identity.

The Chinese government has long recognized the importance of expanding the private finance sector. It has allowed a fairly robust private sector to grow since the early 1990s and private finance since the 2000s. However, due to these three underlying factors, the government has been cautious about letting a large private finance sector to develop, preferring a slow, gradual expansion instead. It usually adopts the "development first and regulation later" approach.[135] To be specific, once a new type of financial activity or institution appears, the government usually gives it fairly free rein. If it promotes economic development and is not causing trouble, the government usually chooses to legalize and regulate it. For example, it legalized micro-loan companies in 2008[136] and this sector has been growing well. At the end of 2019, the government even suggested that P2P lenders transform themselves into micro-loan companies.[137] But if this new activity is causing trouble that threatens social and financial stability, the government will usually prohibit it. For example, several years before the rapid growth of P2P lenders, off-line

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[135] Robin Hui Huang, *Online P2P Lending and Regulatory Responses in China: Opportunities and Challenges*, 19 EUR. BUS. ORG. L. REV. 63, 83(2018).

[136] *See* Guiding Opinions of China Banking Regulatory Commission and the People's Bank of China on the Pilot Operation of Small-sum Loan Companies (2008).

[137] Chao Deng, Xie Yu, China's Once-Hot Peer-to-Peer Lending Business Is Withering, The Wall Street Journal (Mar.14, 2020, 09:55PM), https://www.wsj.com/articles/chinas-once-hot-peer-to-peer-lending-business-is-withering-11580644804.

non-bank lenders were prospering. When they started to collapse and cause instability, the government closed them. It is now applying this regulatory approach to the P2P lending industry.

Since it is inevitable that P2P lenders will play a financial intermediary role and since they are bringing more societal benefits than pure P2P lenders, the Chinese government should simply accept this fact and regulate to avoid risk.

Chapter II. National Regulation of P2P Online Lending Platforms and its Shortcomings

P2P lending brings societal benefits by providing funds to small and medium enterprises (SMEs). However, it also generates significant risks within the Chinese financial market. How to balance financial stability and innovation has now become the most important challenge in China's financial regulatory system. The Chinese government currently requires P2P lenders to comply with the regulations that apply to every other non-bank lender. However, the government only started to enforce these regulations against the P2P lending industry in late 2015, when platforms started to collapse and could not repay investors. These regulations have focused on restricting the business scope of non-bank lenders and on forbidding them from carrying out public fundraising activities. Further, the Chinese government has taken the step of criminalizing non-bank lenders' illegal fundraising activities when these involve large numbers of investors and/or a vast amount of money. Under these rules, P2P lenders' fundraising activities – selling wealth management products – would easily trigger criminal charges if the money it raised or the number of people it pooled exceeded the legal amount.

Since the end of 2015, the government has also increased its control over the industry by issuing several specific regulations, including requiring the informational intermediary model, prohibiting guaranteed returns, imposing information disclosure requirements and registration requirements, capping the size of the loan that an individual or business can borrower from online lending platforms, separating the funds of P2P lenders from those of lenders and borrowers, and selecting a qualified bank as the custodian of the funds of lenders and borrowers. All of these rules are broad and lack enforcement mechanisms. The imposition of strict regulations does not seem to have deterred the rapid growth of P2P lenders' fundraising activities or to have prevented the subsequent collapse of many P2P lenders. As its resources are limited, it is difficult for the government to monitor and prosecute every case.

This chapter first reviews the history of the regulation of the non-bank lending industry in China. Then it analyzes the general rules that apply to all non-bank lenders and the specific regulations imposed on the P2P industry. The chapter then describes the recent collapses of P2P online lending platforms. Finally, it discusses the shortcomings of current regulations.

I. The Regulation of the Non-Bank Lending Industry: A Short History

Through the history of the Chinese government's regulation of non-bank lending, we see the pendulum of the government's regulatory policies. It is clear that the government has hesitated to draw a clear line indicating which type of informal finance it will permit. Sometimes, the government allows it to exist with little regulation; sometimes, it completely prohibits it; at other times, it has taken a middle ground.

A. 1949-1953: Loose Policy Period

After the establishment of People's Republic of China in 1949, the Chinese government put all of its national financial resources into heavy industry construction.[138] The newly established national banking system was therefore unable to provide comprehensive financial services to individuals and households. During this period, the government gradually converted money houses into the private business arm of the People's Bank of China and merged them into the national banking system.[139] Simultaneously, the central government promoted the establishment of rural credit cooperatives, which provided funds to individuals and households.[140] At that point, the government did not impose restrictions on interest rates for non-bank lending activities.

B. 1953-1978: Strict Policy Period

The government established the People's Bank of China (PBC) in 1953, creating branches that reached all over China. It was the country's only national bank and held simple monopoly power over the national financial industry. The PBC also had sole

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138 Congressional Research Service, China's Economic Rise: History, Trends, Challenges, and Implications for the United States (Jun.25, 2019) 2, *available at* https://fas.org/sgp/crs/row/RL33534.pdf.
139 Shuxia Jiang, *The Evolution of Informal Finance in China and Its Prospects*. In LI &HSU ED., *supra* note 18, at 18.
140 Wang, *supra* note 134, at 75.

responsibility for all issues relating to national financial regulation, currency issuance, and any specifically financial businesses within China.[141] During this period, China did not yet have a financial market, let alone any independent financial regulatory institutions or financial regulation statutes.

In 1956, China completed its socialist transformation. State-owned enterprises (SOEs) obtained their dominant position and the government prohibited private enterprises. In order to guarantee that the national bank would have sufficient funds for SOEs, the government required individuals and enterprises to save their money in the bank and prohibited any type of non-bank lending, except lending between family and friends.[142] It treated almost every type of non-bank lending activity as usury, and outlawed it,[143] meaning that it could treat any type of financing activity as illegal.[144] Nevertheless, these regulations were mostly policies, which had not been written into any statute or regulation.

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141 LICHENG XU, HISTORY AND LOGIC OF CHINA'S BANKING INDUSTRY DEVELOPMENT AND SUPERVISION THEORY, NANJING UNIVERSITY PRESS 142(2015).
142 *Id.*
143 ZIHUI DENG, REPORT ON CONDITIONS AND PROHIBITIONS OF USURY 45 (1964).
144 Wang, *supra* note 134, at 75.

C. 1978-1995: Relative Loose Policy Period

After 1978, as China started to transform from a planned to a market economy, private enterprises began to emerge. Along with the country's rapid economic development, between 1986 and 1993 a large number of new financial institutions took shape.[145] For example, in 1992, the People's Central Government of Jilin Province issued "A Notice of Conference on Accelerating the Development of Township Enterprises" (No. (1992) 28). This legalized the existence of a "private bank" in Jilin province, and approved the establishment of the foundation of joint stock partnerships.

Due to the fact that these private enterprises could not get funds from the formal banking system, a huge number of them turned to the informal financing system in order to obtain financial support through non-bank lenders.[146] Correspondingly, many intermediaries began to appear. A variety of professional lenders also emerged and thrived. For example, the Wenzhou government approved establishment of the first private financial institution — Fangxing Money House – in 1984.[147] The southeastern coastal

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[145] XU, *Supra* not 141.
[146] *See* Kellee S. Tsai, *Beyond Banks: Informal Finance and Private Sector Development in Contemporary China*, Conference on Financial Sector Reform in China 4 (2001).
[147] Wang, *supra* note 134, at 78.

areas, which had the most rapidly developing private economy in China, established professional lenders like cooperative foundations or credit unions.[148]

In order to develop its private economy, the central government stepped back from its previous policy of total prohibition. The 1986 "General Principle of Labor Law" recognized the legality of lending activities between individuals and households for the purposes of living expenses and business operations, thus demonstrating the government's acceptance of the role of informal finance. However, a 1990 Supreme People's Court guideline stated that lending among enterprises was illegal.[149] In 1986, with the rapid development of various types of professional lenders, the State Council issued the "People's Republic of China Bank Management Temporary Regulation." This regulation prohibited individuals from establishing banks or other financial institutions[150] and prohibited non-financial institutions from operating financial businesses. As a result, many professional lenders were deemed illegal. The government encouraged rural cooperative foundations to provide funding to households and SMEs, but barred them from taking deposits from the general public. In 1993, the State Council issued several regulations that

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[148] Wang, *supra* note 134, at 77.

[149] Supreme Court of the People's Republic of China, Interpretation of Several Issues Concerning Trial of Joint Contract Disputes (1990).

[150] People's Republic of China Bank Management Temporary Regulation, art. 28 (1986).

prohibited the fundraising activities of enterprises.[151] Finally, through the Supreme People's Court's "Several Opinions on the Trial of Lending Disputes" in 1991, the government also imposed interest rates on lending activities.[152] The usury level was set at four times the formal banks' loan interest rate. This regulation remained unchanged until 2015.

D. 1995-2003: Strict Policy Period

In 1993 and 1994, several large fundraising cases, each of which involved tens of thousands of people, alarmed the government, which once again changed its policy. The 1995 "Commercial Bank Law" banned any illegally established banks and criminalized illegal fundraising activities.[153] In 1995, the PBC closed more than a hundred private money houses in the cities of Wenzhou and Hejin because they had no approval from any level of government.[154]

When the intermediaries involved in non-bank lending took deposits or loans without the approval of the central government,[155] the government considered these activities illegal and therefore punishable. In this period, only banks could take deposits or

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151 HONGMING CHENG, FINANCIAL CRIME IN CHINA: DEVELOPMENTS, SANCTIONS, AND THE SYSTEMIC SPREAD OF CORRUPTION 34 (2016).
152 *Id.*
153 Commercial Bank Law of the People's Republic of China, art. 79 (1995).
154 Wang, *supra* note 134, at 81.
155 Prior to 2003, PBC was the only regulator in the financial sector. The 2003 Amended People's Bank of China Law established the CBRC to oversee banks, financial institutions, trust companies and credit operations and their activities.

lend funds; the central government never approved these activities for non-bank financial institutions. To track down these now unlawful actions, the national government issued a series of regulations outlawing and criminalizing several kinds of fundraising activities.[156] It also forbad lending among enterprises during this period. However, few regulations discussed whether private lenders could lend funds to others.

E. 2004~2013: Relatively Loose Policy Period

In 2005, in yet another reversal of policy, the central government began once again to loosen the stringent regulations on non-bank lending, allowing some financial institutions to lend funds or engage in related activities. In 2005 for the first time, the PBC issued a report[157] that recognized the importance of informal finance in supplementing the formal financial system and promoting economic development. At that point, the national government started to promote the establishment of private professional lenders. For example, in October, 2005, the People's Bank of China set up "Micro-Loan Companies" in five provinces.[158] Four years later, in June, 2009, China's Banking Regulatory Commission issued the "Provisions on Restructuring Micro-Loan Companies into Village Banks" to regulate these companies. To promote non-bank lending, the government and

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[156] Criminal sanctions will be discussed in Part II of this chapter.

[157] PEOPLE'S BANK OF CHINA, 2004 REGIONAL FINANCIAL OPERATION REPORT 12 (2005).

[158] Microfinance in China: Growth and Struggle, knowledge.wharton.upenn.edu (Jun.14, 2015, 01:33PM), https://knowledge.wharton.upenn.edu/article/microfinance-in-china-growth-and-struggle/.

the central bank issued a series of other regulations during this period. These governmental campaigns promoted the emergence of varieties of professional lenders.

Then, in 2012, China's National Development Conference allowed "qualified private capital to set up small and medium-sized banks and other financial institutions." Since 2010, the Supreme People's Court has issued several Notices or Opinions that allow limited lending activities among enterprises. In other words, while it continued to prohibit fundraising activities, the government issued more refined rules regarding illegal fundraising.

F. 2014 to the Present: Strict Policy Period

In 2011, the private lending bubble has started to burst. Tens of thousands of what the Chinese call "private lending" crises developed across China. According to a report by the Chinese government, in 2014, 60% to 70% of SMEs in Wenzhou city in the province of Zhejiang risked insolvency because of business troubles.[159] In 2014, the phenomenon of runaway bosses[160] reached its highest level, as several high-profile entrepreneurs, including presidents and CEOs of listed companies, disappeared.[161] In responding to the crisis, in 2015, the Supreme People's Court issued its "Interpretations on the Application

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[159] Lu, *supra* note 20, at 5.

[160] To evade debt, many entrepreneurs across China took any assets left in their companies, deserted the companies, and hid somewhere else.

[161] Lu, *supra* note 20, at 6.

of Laws in the Trial of Private Lending Cases," which redefined the usury level for non-bank lending. Additionally, the central government issued several regulations and launched campaigns to crack down those non-bank lenders who raise money from the public.[162]

Starting in 2014, peer-to-peer (P2P) platforms began to sprout up across China. These P2P lenders not only provide a platform for borrowers and lenders, but also sell wealth management products and lend money to individuals, households, and enterprises. This new business model brings societal benefits and initially, the government and many scholars encouraged it. However, since late 2015, unexpected risks have arisen as well. Because thousands of these lenders disappeared after they couldn't repay their public investors,[163] most of the financial regulation since then has focused on P2P lenders.

In 2016, the government has issued a series of protocols to regulate these lenders. These regulations aim to prevent P2P platforms from engaging in illegal fundraising activities and other financial crimes. Additionally, the government has detained many entrepreneurs because of their illegal business practices. For example, in January 2015, the police detained more than 20 people associated with what they described as "a complete

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[162] I will discuss criminal sanctions in Part II of this chapter.

[163] Don Weinland, China P2P Lenders Braced for Regulatory Crackdown, Financial Times (Aug.29, 2018, 07:55PM), https://www.ft.com/content/41e706f4-d631-11e6-944b-e7eb37a6aa8e.

Ponzi scheme" after the founder of Ezubao allegedly absconded with more than 50 billion RMB ($7.14bn) from nearly one million investors.[164]

II. National Regulation of P2P Lending

Since the 1990s, the Chinese government's regulations have focused on restricting the business scope of non-bank lenders and on forbidding them to do any fundraising from the public. As long as non-bank lenders raise money from the public, their activities are illegal and they face administrative sanctions, including fines and the shutting down of their business. If the number of investors and/or the amount of money raised reaches a certain ceiling, non-bank lenders' activities might trigger criminal charges. However, the Chinese government initially promoted the development of the P2P industry and didn't enforce these regulations against it. It aimed to provide alternative channels through which to fund China's SMEs, which contribute greatly to the economy but are financially underserved. It hoped that this innovative technology would enhance the efficiency of financial intermediation and reduce the costs for related parties. However, P2P lending seriously affected financial and social stability in China when platforms collapsed and could repay investors, and as, in response, investors protested in major cities. It was then

[164] *Id.*

that the government started to enforce the regulations imposed on all non-bank lenders and also issued several specific rules to regulate P2P online lending platforms.

A. Regulation on All Non-Bank Lenders

1.National Regulations or Opinions on the Establishment of Non-Bank Lenders and Their Illegal Activities

Since the 1990s, the State Council of the national central government has issued several "regulations" or "opinions" concerning illegal financial institutions and illegal non-bank lending activities. The following three are the most important ones that are still in effect.

a. The 1998 "Measures on Banning Illegal Financial Institutions and Illegal Financial Business Activities"

This regulation aims to maintain financial order and to protect the public interest.[165] It is very general, stipulating the definitions of illegal financial institutions and illegal financial business activities; the agency in charge of the regulation; the banning procedures; the settlement of claims and debts; and penalties.

The regulation defines an illegal financial institution as any organization that failed to get the approval of either the People's Bank of China (PBC) before 2003, or the China

[165] State Council, Measures on Banning Illegal Financial Institutions and Illegal Financial Business Activities, art. 1 (1998).

Banking Regulatory Commission (CBRC), after 2003,[166] and that conducts financial business activities, including taking deposits, lending money, handling settlements, discounting notes, engaging in inter-institution borrowing and lending, or offering trust investments, financial leasing, financial guarantees, or foreign exchange trading.[167]

This regulation also states the definition of illegal financial activities, which includes any of the following financial business activities that do not have PBC approval – taking deposits illegally or in a disguised form; raising money from the public for any reason; and engaging in financial business activities such as money loans, trust investments, financial leasing, financial guarantees, and foreign exchange trading.[168]

In short, under the 1998 regulation, raising money from the public by any of these means is illegal without the PBC's approval. Since until recently only banks could take deposits and lend funds, the PBC never approved these activities for non-bank financial institutions; there is no instance in which the PBC has permitted any non-bank financial institution to raise money from the general public. However, after 2005, the Chinese government gradually began to loosen these stringent regulations and to allow some types

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[166] Prior to 2003, PBC was the only regulator in the financial sector.
[167] State Council, *supra* note 164, at art. 3.
[168] *Id.* art. 4.

of non-bank lenders (i.e. micro-loan companies) to operate businesses that lend money (but not to raise money from the public).

The PBC, before 2003, or the CBRC, after 2003, remains in charge of the clampdown on the illegal financial institutions and activities, and its regulations require local governments and the police to assist the PBC in their enforcement.[169] The clampdown procedure is as follows: After the PBC or CBRC discovers an illegal institution or activity, the local police are to intervene, after which the prosecutor imposes the standard criminal procedure.[170]

The regulation also stipulates the consequences of being deemed illegal. These consequences include the closing of the institution; a criminal charge against the owner; and the settlement of claims and debts.[171] Finally, it provides penalties, which mainly involve criminal charges and fines.[172]

b. The 2014 "Notice Regarding the Strengthening of Regulations Concerning Shadow Banking Activities"

This is a document that the State Council issued to the national government departments and provincial governments. Although it is unofficial, the "Notice" requires

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[169] *Id*. art. 6-15.
[170] *Id.*
[171] *Id*. art. 16-21.
[172] *Id*. art. 22-27.

the national government to make unified regulations and requires local governments to enforce them.

The "Notice" specifically mentions some of the intermediaries in the private lending market. For example, it clearly defines the business scope of trust companies' actions, saying that they "may not conduct non-standard wealth management fund pooling, " and that "small-loan companies should not take deposits." However, most sections of the "Notice" are general recommendations about how to improve the regulation of shadow banking.

The "Notice" has no legal effect. Nonetheless, the fact of its dissemination suggests that after the national government loosened the policy on non-bank lending activities in 2010,[173] it became aware of the risks and problems of the rapid development of the non-bank lending market and has been trying to find out an optimal approach toward regulating it.

c. The 2015 "Opinions on Further Preventing and Cracking Down on Illegal Fund Raising"

Most non-bank lending activities are legal as long as the lender has received government approval. However, non-bank lending often involves lenders' illegal

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[173] State Council, Opinions Regarding Encouraging and Guiding Private Investment in the Healthy Development Direction, 2010.

fundraising activities. Since the primary goal of this fundraising is to raise money from the general public, and since doing so involves large numbers of people, the non-bank lenders' collapse can cause social instability. Therefore, the Chinese central government has actively tried to prevent illegal fundraising. I will describe the relevant criminal sanctions in more detail below.

Since 1999, the State Council has issued several opinions on what precautions the national government departments and the local governments should take to inhibit illegal fund raising. Other opinions specify the actions that the government should take to protect investors' interests and to maintain social stability.

This Notice first emphasizes the importance of preventing illegal fundraising. It then grants each provincial government primary responsibility for preventing illegal fundraising in its area, and urges each one to set up regulation systems to enable this. It also provides suggestions for how to react to illegal fundraising, such as establishing a monitoring and warning system; improving the legal system; and educating citizens.

2. Criminal Regulation of Fund Raising by Non-Bank Lenders

Above and beyond the local governments' cracking down on illegal fundraising activities, another important measure that the Chinese government has taken is to criminalize these activities. Illegal fundraising usually involves a huge number of citizens and a vast amount of money. It damages public investors' interests and causes social instability. Criminal sanctions aim to punish and deter these illegal fundraising activities. However, the government only started to enforce these sanctions against the P2P lending industry seriously in 2015.

As early as 1995, the Standing Committee of the People's Congress[174] issued its "Decision on Punishing Activities of Damaging Financial Order, " which focused on three relevant crimes — the crime of illegally taking public deposits, the crime of establishing financial institutions without authorization, and the crime of fraudulent fundraising. Then, in 1997, the National People's Congress (NPC) added "Section 4. Crimes of Undermining the Order of Financial Market" to China's Criminal Code." The 1997 version of the Criminal Law Code incorporated the other three crimes as well.

Because the provisions of the Criminal Code relating to illegal fundraising are vague, it proved difficult to apply them to actual financial activities. This led to the Supreme People's Court's 2010 "Interpretation of Several Issues on the Specific Application of Law in the Handling of Criminal Cases about Illegal Fundraising" (the Interpretation). The Interpretation attempts to clarify the statute's definitions of illegal fundraising activities, the relevant provisions of the conviction and sentencing standards,

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[174] The People's Congress is the legislative branch in China.

and the unified law enforcement standards, in order to strengthen the effectiveness of their application to private transactions.

Two crimes are pertinent to this paper — the crime of illegally taking public deposits and the crime of fraudulent fundraising. These two crimes fall under the umbrella term "illegal fundraising" within the Chinese criminal law system. When non-bank lenders raise money from the public without following securities law or getting approval from the banking regulatory commission, they can easily trigger either of these two types of crimes.

a. The crime of taking public deposits illegally or in disguised form

This crime applies to both institutions and individuals. In order to charge an entity with this crime, the prosecutor must prove four elements: 1. That the entity has taken funds without official authorization from the government; 2. that the entity has advertised publicly via media, promotion conferences, leaflets, or text messages; 3. that the entity has promised to repay the capital with interest or to provide rewards of money, products, or company shares within a certain time frame; and 4. that the entity has taken funds from the general public (that is, a large but unspecified number of people).[175] The Interpretation also states that raising funds from family, friends, or coworkers without public promotion

[175] Supreme People's Court, Interpretation of Several Issues on the Specific Application of Law in the Handling of Criminal Cases about Illegal Fundraising, art. 1 (2010).

does not fall within the definition of the crime of taking public deposits illegally.[176] The Interpretation specifically enumerates the disguised ways in which individuals or institutions take public deposits.[177] These include using equity investment or financial management; repurchasing products under the name of selling products; repurchasing real estate under the guise of selling real estate; and transferring fabricated shares or issuing nonexistent bonds.[178]

The Interpretation stipulates that any entity that meets both the above elements and any of the following circumstances will be criminally liable:[179] 1. An individual who takes public savings of not less than 200,000 RMB ($28571.42) illegally or in disguised form, or an entity that takes public savings of not less than one million yuan illegally or in disguised form; 2. an individual who takes public savings from no fewer than 30 depositors illegally or in disguised form, or an entity that takes public savings from no fewer than 150 depositors illegally or in disguised form; 3. an individual who takes public savings illegally or in disguised form in a way that causes direct economic losses of not less than 100,000 yuan to depositors, or an entity that absorbs public savings illegally or in disguised form in a way that causes direct economic losses of not less than 500,000 yuan

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176 *Id.*
177 Supreme People's Court, *supra* note 175, at Art. 2.
178 *Id.*
179 *Id*. at art. 3.

to depositors; and 4. any other activities that have an excessively negative social impact or other extremely severe consequences.

The court imposes the lowest level of punishment — three or fewer years of imprisonment or detention and/or fines of between 20,000 RMB ($2857.14) and 200,000 RMB ($28571.42) —under any of the above four circumstances.[180] If the activities involve a huge amount of money or have other severe effects, the punishment is three or more years of imprisonment or detention and/or fines of between 50,000 RMB ($7142.85) to 500,000 RMB ($71428.57).[181]

The Interpretation explains that any of the following circumstances falls within the meaning of "a huge amount money or causing other severe consequences:"[182] 1. An individual who absorbs public savings of not less than one million yuan illegally or in disguised form, or an entity that absorbs public savings of not less than five million yuan illegally or in disguised form; 2. an individual who absorbs public savings from no fewer than 100 depositors illegally or in disguised form, or an entity that absorbs public savings from no fewer than 500 depositors illegally or in disguised form; 3. an individual who absorbs public savings illegally or in disguised form, in a way that causes direct economic

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[180] Criminal Code. art. 176 (2015).
[181] *Id.*
[182] Supreme People's Court, *supra* note 177, at Art. 3 (2010).

losses of not less than 500,000 yuan to depositors, or an entity that absorbs public savings illegally or in disguised form in a way that causes direct economic losses of not less than 2.5 million yuan to depositors; or 4. any other activities that cause extremely negative social impact or any other extremely severe consequences. From the above analysis, we find that the determinants of a crime and its punishment depend on the extent of the public deposits that individuals or institutions take and/or the number of public investors involved.

b. The crime of fraudulent fundraising

If an entity raises funds by fraudulent means for the purpose of illegal possession, the court can convict and punish it for the crime of fraudulent fundraising.[183] Any of the following circumstances, meet the condition of "for the purpose of illegal possession:" [184] 1. Failing to use the raised funds for production or business operations (lending the raised money does not count as business operations, which means that the fundraising activities of P2P lenders violate this rule and thus are "for the purpose of illegal possession"), or the amount of money used for production or business operations is obviously out of proportion to the amount of money raised, resulting in a failure to repay the relevant funds; 2. recklessly squandering the funds raised and failing to repay them; 3. running

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[183] Criminal Code. art. 192 (2015).

[184] Supreme People's Court, *supra* note 177, at Art. 4 (2010).

away with the funds raised; 4. using the funds raised to conduct illegal or criminal activities; 5. illegally withdrawing or transferring funds, or concealing property to evade repayment; 6. concealing or destroying accounts, or declaring false bankruptcy in order to avoid repayment; 7. refusing to confess to the spending of funds to avoid repayment; or 8. any other circumstance that may be deemed as "for the purpose of illegal possession." Thus, since enterprises are only allowed to raise money for their business operations, failing to use the raised funds for this purpose, using the fund for other purposes, refusing or being unable to repay the funds, etc., can easily trigger the crime of fraudulent fundraising. Ponzi schemes are therefore the target of this crime.

Whether or not the acts are committed "for the purpose of illegal possession, " the Interpretation makes it clear that any determination of the crime of fraudulent fundraising must be based on the actual circumstances. Where the offender raises some of the funds illegally for the purpose of illegal possession, the offender will be convicted of and punished for the crime of fraudulent fundraising to the extent of the amount of money involved. Where, in a joint offence of illegal fundraising, some offenders raise funds for the purpose of illegal possession, while other offenders demonstrate no intention or act of illegal possession of the funds raised, the offender with the intent of illegal possession will be convicted of and punished for the crime of fraudulent fundraising, but not those who do not have criminal intent.[185]

Unlike the crime of taking public deposits illegally, the determinant of the crime of fraudulent fundraising and its punishment is only on the amount of money involved. It is a "relatively large amount" if by fraudulent means, an individual raises an amount of 100,000 yuan or more; if the amount reaches 300,000 yuan or more, it is a "huge amount;" one million yuan or more, is "an extremely huge amount."[186] Regarding entities that raise funds by fraudulent means, an amount of 500,000 yuan or more is a "relatively large amount;" 1.5 million yuan or more is a "huge amount;" and 5 million yuan or more is "an extremely enormous amount."[187]

The two crimes that this section presents are the main way by which the Chinese government punishes and deters non-bank lenders who illegally take deposits from the public or engage in illegal fundraising activities. In 2015 alone, courts found that out of 1,420,000 non-bank lending cases, 58,000 of them violated China's criminal laws. In the same year, prosecutors charged 72,000 defendants, accounting for 4% of all non-bank lending cases, with the crime of illegal taking of public deposits or fundraising.

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[185] Supreme People's Court, *supra* note 177, at art. 4 (2010). This Interpretation stipulates how to calculate the total amount of money.
[186] Supreme People's Court, *supra* note 177, at Art. 5 (2010).
[187] Id.

The Wu Ying Case is the most dramatic instance of the application of criminal sanctions. Wu Ying raised 384 million RMB ($58 million) and then lent the money to individuals and enterprises at high interest rates. Prosecutors initially charged her with the crime of taking public deposits illegally or in disguised form. Eventually the charge became the crime of fraudulent fundraising. This is because Wu Ying didn't use the raised funds for business operations, but for repaying the raised funds and interests and for personal use, and because she made up projects to attract investment. In 2009, the Jinhua Intermediate People's Court in Zhejiang sentenced her to death for cheating investors.[188] However, the decision received enormous criticism from the general public and academics for being too harsh.[189] In 2012, the Supreme People's Court overturned the death penalty, sentencing her instead to death with a two-year reprieve.[190] Two years later, on 11 July, 2014, it commuted her death sentence to life in prison. Judges have been more careful not to sentence defendants to such severe punishments in recent years. But the fact that it happened demonstrates that the government takes the crime of illegal fundraising very seriously and views it as causing a severe problem to society.

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[188] Wu Ying Fraudulent Fundraising Crime Case. (2012) Zhe Criminal Erchongzi No.1.

[189] Chinese Court Overturns a Young Tycoon's Death Sentence. http://www.nytimes.com/2012/04/21/world/asia/china-court-overturns-death-penalty-for-tycoon-in-fraud-case.html.

[190] Wu Ying case, *supra* note 188.

The Interpretation demonstrates that the threshold of criminal responsibility for illegal fundraising is very low. It applies as soon as an entity illegally takes deposits from more than 150 persons, or when the total amount of the deposits that it has taken reaches 1,000,000 RMB ($142,857.14), or if the investor is damaged in the amount of 500,000RMB ($71,428.57).[191] For the crime of illegal fundraising, criminal sanctions apply as soon as an entity raises 500,000 RMB ($71428.57).

B. Regulatory Responses to the Development of P2P Lending

In the interest of developing internet finance to boost economic development, China first adopted a laissez faire approach toward the field. Before the "2016 Interim Measures on Online Lending, " China had a regulatory vacuum when it came to online lending.[192] Nonetheless, the frequent collapse of online lending platforms, the many stories of lost life savings, and the desperate requests for government assistance prompted the government to start taking action to regulate the P2P online lending industry.

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[191] Supreme People's Court. *supra* note 177, at art. 3 (2010). This Interpretation stipulates how to calculate the total amount of money.

[192] Joseph Luc Ngai, John Qu, Nicole Zhou, Xiao Liu, Joshua Lan, Xiyuan Fang, Feng Han & Vera Chen, Disruption and Connection: Cracking the Myths of China Internet Finance Innovation, mckinsey.com (Mar.22, 2017, 2:22 PM), https://www.mckinsey.com/~/media/mckinsey/industries/financial%20services/our%20insights/whats%20next%20for%20chinas%20booming%20fintech%20sector/disruption-and-connection-cracking-the-myths-of-china-internet-finance-innovation.ashx.

1. 2015 Guidelines for Promoting the Healthy Development of Internet Finance

On July 18, 2015, the PBC, China Banking Regulatory Commission, Ministry of Finance and seven other government departments, jointly issued the "Guidelines for Promoting the Healthy Development of Internet Finance."[193] This document defined the concepts of P2P lending, internet payment, online crowdfunding, internet insurance, and other internet finance categories. This was also the first time that the government recognized the legal status of P2P lending platforms. According to the guidelines, the platforms should mainly serve as an information intermediary and may not raise money from the public or provide guaranteed returns to investors. The document, however, had no legal effect. Instead, it mainly laid the framework for future regulation and provided some guidance for the development of P2P lending. It also confirmed that the CBRC, which has since merged with the insurance regulator to become the China Banking and Insurance Regulatory Commission, would be the main regulator of the online lending market.

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[193] The other seven departments include: Ministry of Industry and Information Technology, Ministry of Public Security, State Administration for Industry and Commerce, Legal Affairs Office of the State Council, China Securities Regulatory Commission, China Insurance Regulatory Commission, and National Internet Information Office.

2. 2016 Interim Measures on Online Lending

Starting in late 2015, the online lending market experienced an outbreak of scandals. For example, the Fanya Metal Exchange had illegally raised more than 40 billion RMB ($5.71bn) in December 2015, while Ezu Bao had reportedly pooled more than 50 billion RMB ($7.14 bn) from investors over the previous one and a half years. In April 2016, the Zhongjin group had illegally raised more than 30 billion RMB ($4.29 bn). By June 2016, a total of 1,778 online lending platforms, accounting for 43.14% of all lending platforms, were having or causing problems.[194]

On August 17, 2016, in response to the frequent reports of scandals in the P2P lending industry, the China Banking Regulatory Commission (CBRC), Ministry of Industry and Information Technology, Ministry of Public Security, National Internet Information Office, jointly promulgated the "Interim Measures for the Administration of the Business Activities of Online Lending Information Intermediary Institutions" (2016 Interim Measures on Online Lending). This marked the first time that the Chinese government had set up a relatively comprehensive and workable regulatory framework for the online lending industry. Violations of the 2016 Interim Measures on Online Lending can lead to administrative or even criminal penalties. Three rules followed the 2016

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194 LINGYI, *supra* note 98, at 45.

Interim Measures on Online Lending, specifying its implementation. These were the "2016 Guideline on Online Lending Registration, " the "2016 Standard on Information Disclosure, " and the "2017 Guideline on Custodian Business." These documents put an end to the previous unregulated online lending market and set up a relatively comprehensive regulatory system for it.

a. Restricting the Business Scope

The guidelines define online lending as direct lending between borrowers and lenders.[195] Chinese law restricts online platforms to being information intermediary institutions that provide information searches, information release, credit ratings, information exchange, and credit matching services.[196] By law, online platforms cannot act as financial intermediaries.[197] The regulations prohibit them from providing credit enhancement services and from raising funds from the public, either directly or indirectly.[198] Specifically, the law does not allow online platforms to carry out the following financial activities[199] – directly or indirectly raising funds for the platform itself; directly or indirectly accepting or pooling the lenders' funds; directly or indirectly

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[195] Interim Measures for the Administration of the Business Activities of Online Lending Information Intermediary Institutions, art. 2 (2016).
[196] *Id.*
[197] *Id.*
[198] *Supra* note 195, at art. 3.
[199] *Supra* note 195, at art. 10.

providing guarantees or promising guaranteed principal and interest to lenders; dividing the term of a invested project; raising funds by issuing and selling wealth management or other financial products by themselves; selling bank wealth management, brokerage fund management, funds, insurance or trust products and other financial products on a commission basis; conducting the asset securitization business or assigning claims in such forms as packaged assets, securitized assets, trust assets, and fund shares; and conducting equity crowd-funding or any other business. In sum, the new regulations prohibit all business models other than that of information intermediary.

Making guarantees to lenders was a common practice for P2P lenders before this regulation. Offering fixed returns helped the platforms attract large numbers of investors. But the guarantees introduced serious stability risks. It was often not the underlying loans that made the payouts to investors but rather the funds that new investors provided. This Ponzi-like structure risked collapse if the number of new investors fell, and it incentivized mass lending without regard for the credit risk. A guarantee also allowed P2P platforms to function like banks but without complying with the regulations imposed on banks.

b. Imposing Registration Requirement

The first step for setting up an online lending platform is to get a business license. The second step is to conduct recordation and registration with the local financial regulatory department, and the third – relevant only to the relevant businesses – is to apply for a telecommunications business permit from a competent communications agency. These are not difficult to get. The recordation and registration requirement are unique to the online lending business. But this requirement includes no substantive merit review and applicants do not need to meet any minimum registered capital requirements or any other special requirements. As long as the platform provides all of the relevant supporting materials, it can fulfill this requirement.[200]

Local governments issue their own rules for implementing this requirement. Most local governments seek to promote the online lending industry in order to develop the local economy.[201]

c. Lending Limits and Custodian Requirement

To limit the risk to investors of online lending, the law imposes lending limits on individual and business borrowers. It caps the size of the loan that an individual or business may borrow from one platform and all platforms at 200,000 RMB ($28, 571.43) for an individual or 1 million RMB ($0.14 million) for an entity from one platform; and 1 million RMB ($0.14 million) or 5 million RMB ($0.71 million), overall.[202] These specific

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200 CBRC, Ministry of Industry and Information Technology and State Administration of Industry and Commerce, Guideline on the Administration of Recordation and Registration of Online Lending Information Intermediary Institutions.

201 Huang, *supra* note 135, at 74.

202 Interim Measures, *supra* note 195, at art. 17.

numbers correspond to the threshold of the crime of illegal fundraising.[203] However, the law imposes no similar limit on investors, which is a drawback; in practice, many investors put all of their savings to these platforms and lost everything. The law does not include a mechanism by which to enforce this regulation.

The law requires platforms to separate their own funds from the funds of lenders and borrowers and to select a qualified bank as the custodian of the funds of lenders and borrowers.[204] This is to prevent fraudulent activities, especially the issue of runaways, which have occurred frequently in the past few years. For example, in 2015 and 2016, there were a total of 3,056 cases of problematic platforms, 32% of which (982 platforms) raised the runaway issue.[205]

d. Information Disclosure

The regulations require each online lending platform to disclose certain information to lenders, including their borrowers' basic information, information on the funded projects, the assessments of possible risks, and the utilization of funds in matched but unexpired projects.[206] The platform must also disclose information on the operation

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[203] Once the amounts that individuals or businesses raise exceed the limited amount, they can trigger the crime of illegal fundraising.
[204] Interim Measures, *supra* note 195, at art. 28.
[205] LINGYI FINANCE, *supra* note 98, at 45.
[206] Interim Measures, *supra* note 195, at art. 30.

and management of business activities, and periodically release annual reports on its official website.

The law established three mechanisms by which to ensure that the disclosed information is not fake, and is accurate and complete. First, an accounting firm must audit the information disclosure on a periodic basis; the platform must also hire a law firm or other third-party institution to assess its regulatory compliance and the soundness of its information systems.[207] Second, the platform must file information disclosure announcements and relevant documents with the local financial regulatory authority.[208] And third, the directors, supervisors, and senior executives of the platform must ensure the truthfulness, accuracy, completeness, timeliness, fairness of the information, and confirm that it does not contain false records, misleading statements, or material omissions.[209]

These requirements have forced many platforms to change their business models. The requirements of custodian, information disclosure, and registration have also driven out some smaller and weaker platforms with poor internal control mechanisms.

[207] Interim Measures, *supra* note 195, at art. 31.
[208] Interim Measures, *supra* note 195, at art. 31.
[209] Interim Measures, *supra* note 195, at art. 32.

3. Implementation Regulations

The “2017 Guideline on Custodian Business” gives detailed provisions regarding the role and responsibility of the custodian and confirms that the law will not hold custodians liable for lending defaults.

In terms of information disclosure, the CBRC issued the “Online Lending Information Intermediary Institutions Business Activity Information Disclosure Guideline,” (the Guideline) in October, 2017. The Guideline set up detailed provisions listing what kinds of information platforms must disclose, how to disclose that information, when platforms should fulfill this obligation, and so forth. The National Internet Finance Association of China issued the “Standard on Internet Finance Information Disclosure for Online Lending,” in December of the same year. This complemented the Guideline’s requirements regarding information disclosure.

In December 2017, the P2P Online Lending Risk Special Remediation Work Leading Group Office, a special office under the CBRC that is designed to monitor and clean up the P2P lending platforms, issued its “Implementation Plan for the Cleanup of Online Microloan Lenders.” This plan asked provincial government agencies to complete the evaluation and registration of qualified P2P platforms starting in April 2018 and finishing no later than June 2018. The government announced that it would close any platform that had not met the requirements of the “2016 Interim Measures on Online Lending” by that date. However, it did not implement this plan strictly. In August, 2018, the Office issued two more rules requiring local governments to confirm that all P2P online platforms had complied with the 2016 Interim Measures. Most provinces also issued their own, more detailed, rules about platform registration and rectification.

Overall, there is a lot of national regulation regarding P2P lending, focused primarily on forcing online lending platforms to serve solely as information intermediaries and forbidding them from playing a financial intermediary role. In recent years, the government has issued some rules specifically protecting investors in the P2P lending industry, but these are still broad, and there has not yet been enough time to evaluate their effectiveness at preventing scandals.

III. The Shortcomings of the Current Regulations

Although China prohibits companies from raising money from the public, it did not strictly apply this regulation to the P2P industry until 2015. Before that, there was little substantial regulation of platforms’ fund-raising activities.[210] Since 2015, the government

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[210] Cheng Leng & Engen Tham, China Gives P2P Lenders Two Years to Exit Industry: document, Reuters (Jan. 22, 2020 2:22PM), https://www.reuters.com/article/us-china-p2p/china-gives-p2p-lenders-two-years-to-exit-industry-document-idUSKBN1Y2039.

has regulated through prohibition, rather than by addressing the most pressing problems in this industry.

The government has under-enforced its current regulations because of its limited resources. It only imposes the rules when defaults lead to crises that threaten financial and social stability.[211] It is clear that these do not have a strong deterrent effect on non-bank lenders, who have continued to raise money from the public despite the prohibitions.

Each year, the press reports a large number of new illegal fundraising cases that encompass many people and huge amounts of money. From 2005 to 2010, there were 2,000 new illegal fundraising cases, involving 3 billion US dollars, each year.[212] Since 2014, the emergence and popularity of P2P platforms has driven illegal fundraising cases even higher. In 2014, the number of new cases reached 3,000.[213] In 2015, this doubled to around 6,000.[214] The cases involved 1.5 million investors and 27 billion US dollars.[215] 2017 brought fewer new cases, around 5,000, while the amount of money invested declined to 26 billion US dollars.[216] However, according to Yuzhu Yang, Director General, Office of the Inter-agency Anti-illegal Fund Raising Taskforce, the total number

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211 PENG, *supra* note 45, at 165.
212 Illegal Fundraising Reached New High, www.people.com.cn (May. 19, 2015, 09:59PM), http://legal.people.com.cn/GB/203936/13657130.html.
213 Pinqiu Zhang, The Number of Illegal Fundraising Cases in China and the Amount Involved in the Cases Started to Decline, bj.people.com.cn (Aug.14, 2018, 08:57PM), http://bj.people.com.cn/n2/2017/0426/c82839-30097980.html.
214 *Id.*
215 *Id.*
216 *Id.*

of illegal fundraising cases is still high, the number of people involved continues to rise, and inter-provincial cases continue to occur frequently.[217] This increase has been particularly marked in Beijing and Shanghai.[218]

A. The Effectiveness of the Current Regulations is Low

With the exception of criminal charges, all the rules that apply to non-bank lenders, and specifically to P2P lenders, are *interim* measures, notices, opinions, guidelines, which stand low in the legal hierarchy and lack enforcement mechanisms. These regulations are unofficial, have no legal effect, or are only suggestions. As I discussed earlier, the enforcement of these rules is inconsistent. Sometimes, the government enforces them strictly, but at other times the enforcement is loose. The weak and inconsistent enforcement of these rules has created ambiguity and and complicates any attempt to solve the collapse and repayment problem in this industry.

[217] *Id.*

[218] Yan Fei, Beijing Attorney's Office, Illegal Fund-raising Cases are on the Rise, xinhuanet.com (Feb.22, 2019, 09:59PM), http://www.xinhuanet.com/2018-07/05/c_1123080501.htm. *See* also Tonghuan Guo, Shanghai Attorney's Office, The Number of Illegal Fund-Raising Cases has Risen Markedly, dahe.com (Feb.24, 2019, 05:49PM), https://news.dahe.cn/2018/06-27/333003.html.; Yu Xiao, Shanghai Released a White Paper on Financial Crimes: The Number of People Involved and New Types of Crimes has Risen, chinanews.com (Sept.30 2018, 04:14 AM), http://www.chinanews.com/sh/2017/06-28/8263631.shtml.

B. The Current Regulations Fail to Address the Problems in P2P Lending that Caused Instability

The recent more specific regulations – including the information disclosure requirements, the limiting lending amounts requirement, and the requirement that funds separate platforms' accounts from clients'[219] – resolve some of the problems, but these rules are still unsound.

The credit reporting system is not well developed in China and online platforms have no strong motivation to evaluate borrowers carefully because the platforms do not share the borrowers' default risks. This means that the default rate of loans issued through online platforms is very likely to be higher than that of the banking industry. Accordingly, investors face a greater risk of losing their invested funds. Further, China has established no capital requirements for platforms when they first register. When borrowers default and the platform cannot help its investors to collect their funds (under current regulation, platforms have no strong motivation to help investors), there are virtually no measures to compensate the investors.

In response to the recent scandals stemming from the collapse of the P2P lending industry, the government has taken the regulatory approach of forbidding online lending

[219] Interim Measures, *supra* note 195.

platforms from playing a financial intermediary role and forcing them to serve as information intermediaries or to transfer funds to micro-loan companies.[220] In the government's view, the online lending platforms collapsed or failed to repay investors because they were acting as financial intermediaries. However, this was not the reason. The platforms collapsed because of the lack of appropriate regulation.

Recently, the Chinese government has been closing down platforms that fail to adopt the informational intermediary model. This has caused the rapid decline of online platforms and the transaction volume on them. By the end of November, 2019, there were only 456 platforms left in China (as opposed to 3,574 platforms in 2015),[221] and experts have estimated that this number will continue decline. The current regulation is very likely to put an end to the P2P industry. Doing so might achieve the government's goal of financial stability, but only at the price of depriving investors of alternative investment channels, and borrowers of funding. But history tells us that as long as investors and SMEs have financial needs, prohibitions will be insufficient and the industry will develop new types of non-bank lenders to meet those needs. It is important for the government to

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[220] Micro-loan companies are established with investments from natural persons, legal-person enterprises, or other social organizations. They do not absorb the public deposits and operate as micro-loan businesses. The Chinese government regards this type of company as a financial intermediary. *See* Guiding Opinions of China Banking Regulatory Commission and the People's Bank of China on the Pilot Operation of Micro-Loan Companies, art. 2.

[221] P2P Online Loan Industry Status, Transformation and Prospects, WDZJ Net (Jan.19, 2020, 11:33AM), https://www.wdzj.com/news/yc/5395798.html.

realize that when these platforms serve as financial intermediaries, they bring more societal benefits, including more investment diversification and lower screening and monitoring costs, than do pure P2P lending platforms. As I will discuss in Chapter III, appropriate regulation can mitigate or reduce the risks that financial intermediaries bring. Thus, P2P lenders should be allowed, and even encouraged, to act as financial intermediaries.

Another governmental action has been to forbid P2P lenders to guarantee rate of return. This has put investors in an even worse situation. The current credit reporting system in China is poorly developed, forcing investors to rely on lenders when they make their investment decisions. But P2P lenders are not taking responsibility for the default of borrowers. Without a guarantee, investors have almost no protection for their investment money.

Although the government has imposed special registration requirements on P2P platforms, these requirements are easy to meet, as they do not require substantive merit review. It is therefore possible for low quality P2P lenders to register their businesses, which increases the overall risks of failure.

Information disclosure is important to protect investors. However, what information is relevant is not yet clear. Further, there is no enforcement mechanism.

Current regulations fail to provide remedies for investors when P2P lenders violate the information disclosure requirements.

Additionally, the current regulations don't solve the problems of fraudulent statements and advertisements and the risk of P2P lenders making unsound investments.

C. Criminal Sanctions Lack Deterrence Effects

Although the government has set the threshold of criminal sanctions for illegal fundraising very low, there are still many P2P lenders evading the rule entirely. As I discussed earlier, the strict regulation does not seem to deter the rapid development of illegal fundraising activities. In fact, as some scholars have noted, raising money and taking deposits from the public have only increased since the government criminalized them in the 1997 Criminal Code.[222] This is also true in the P2P online lending industry. It was until 2018 that the Chinese imposed extremely strict crackdown regulation, the number of platforms dramatically decreased.

One reason for the weak deterrence effects of criminal sanctions is that it is not possible for the government to monitor and prosecute every case. Another reason is that the boundary between non-bank lenders' illegal fund raising and legal financing is vague. Many non-bank lenders are not sure whether they are violating the criminal law. Without a

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[222] Bing Peng, *Regulation of Illegal Fundraising,* CHINA LEGAL SCI. 43 (2008.2).

clear understanding of whether their actions are illegal, they continue to raise funds and take deposits. Some of them might suspect that they are violating the law, but they continue to assume the risk, as they know that the government's enforcement of the law is weak. Therefore, relying on criminal sanctions to regulate these fundraising or deposit-taking activities does not achieve the goals of alleviation or deterrence.

Chapter III Regulating China's P2P Online Lending Platforms

P2P online lending platforms serving as financial intermediaries not only provide an alternative source of funding for SMEs but also bring investors more diversified investment opportunities. From the start, Chinese P2P lenders have raised money from the public in various ways, mainly by selling wealth management products (WMPs) (especially after the government prohibited guaranteed return in 2015). The primary purchasers of WMPs are retail investors. P2P lenders pooled money from these investors and created funds that would purchase collections of loans. Before 2013, P2P lenders were able to invest in stocks and futures. But the Chinese regulations of 2015 prohibited P2P lenders from making such investments. When they were able to offer guaranteed and fixed returns, P2P lenders were like banks in operation. But the 2015 "Interim Measures for the Administration of the Business Activities of Online Lending Information Intermediary Institutions" prohibited P2P lenders from offering guaranteed returns.

WMPs usually have a set term (generally less than a year) and short maturity (also less than a year). They invest in individual and SME loans and pay higher rates of return than banks do.[223] After the strict governmental regulation began in 2018, many platforms appeared to reform their WMPs to comply with the new requirements (these regulations

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[223] See the definition in Chapter I and more details below. *See* PENG, *supra* note 45, at 178.

required P2P platforms to transition to the information intermediary model, under which all they are allowed to do is to match lenders with borrowers), but in fact, the platforms were able to change the appearance of their WMPs without losing the their ability to raise money from the public.

Although P2P lenders provide many societal benefits, the Chinese government continuously strengthens its regulation of the P2P industry. The government fears that P2P online lending platforms serving as financial intermediaries are not best suited to protect investors and have higher risks of collapse. The government also worries that once it opens the door to allowing private finance to grow freely, it will lose control of the financial system. However, these fears could be mitigated through carefully designed regulations. These regulations should draw on principles of securities, banking, and mutual fund regulation. China should follow the U.S. example and expand the scope of its securities law so that it covers the financing methods of China’s P2P lenders. However, China should also adopt less demanding disclosure requirements in order to reduce the financing costs of these firms. China should also consider capital requirements to prevent P2P lenders from making risky investments, and mutual fund regulation to end P2P lenders’ abusive activities and to protect investors. A hybrid of these regulations would allow China to maintain financial and social stability.

I. Securities Regulation Approach: Investor Protection and Financial Stability

P2P lenders have been raising money from the public since they first appeared in China. This has provided great investment opportunities for investors. However, as I have noted, with little regulation, many Chinese investors have taken great investment risks and platforms have collapsed.[224] In order to solve these problems and maintain financial stability, China should regulate P2P lenders through the principles of securities regulation as P2P lenders are acting like issuers when raising money from the public. China ought to follow the experience of the United States and expand the scope of its securities law to include the financing tactics of P2P lenders. However, as securities regulation is costly, China will do better if it adopts less demanding disclosure requirements.

A. How Investor Protection Rules Promote Financial Stability

From the regulatory experience of the United States, we see that investor protection rules in securities regulation can promote financial stability by addressing the problems of information asymmetry, and fraudulent statements and behavior, as well as the agency problem.[225]

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[224] Refer back to Chapter I. Part II. The Collapse of P2P Lenders.

[225] *See generally*, The Securities Act of 1933, The Securities Exchange Act of 1934.

1. Basic Definition of Securities and Investor Protection Rules in the United States

In the United States, the term "security" has a broad definition and covers "any note, stock… bond, debenture, evidence of indebtedness … investment contract …, or, in general, any interest or instrument commonly known as a "security."[226] There is no general standard of a security under the United States federal securities laws. The federal courts, particularly the Supreme Court, have used their discretion in shaping the meaning and scope of securities.

In 1946, the Supreme Court developed the Howey test in *SEC v. W. J. Howey Co.*[227] This created a four-part standard by which the SEC can determine when an "investment contract" is a security.[228] It requires an investment of money; in a common enterprise; with an expectation of profits; when those profits arise primarily from the efforts of other people.

However, there are three main types of exemptions to securities regulation. Section 4(a)(2) of the Securities Act of 1933[229] exempts transactions by an issuer if they

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[226] The Securities Act of 1933, § 77b (a)(1).
[227] *SEC v. W. J. Howey Co*., 328 U.S. 293 (1946).
[228] *Id, at* 293, 298-99 (1946).
[229] The Securities Act of 1933, 15 U.S.C § 77d (a) 2.

do not involve any "public offering;"[230] this is also referred to as the "private placement exemption." When issuers meet the private placement exemption, they don't need to follow the registration process.[231] In 1982, the SEC combined its exemptions for small and private offerings into one set of rules known as "Regulation D."[232] It designed Regulation D to provide an exemption to allow for the sale of securities to raise private capital without registering the securities. In 2012, the JOBS Act granted securities crowdfunding an exemption from registration when it meets certain criteria. The goal of the JOBS Act is "to help provide startups and small businesses with capital by making the relatively low dollar offerings of securities less costly."[233] I note that these three types of exemptions only apply to the registration process; issuers meeting the criteria are not exempted from mandatory disclosure and anti-fraud provisions.[234]

Regarding investor protection rules, the United States Congress enacted the Securities Act of 1933 to achieve two primary goals – to ensure investors are informed of financial and other significant information concerning securities being offered for public

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230 The private placement exemption has two forms: the §4(a)(2) statutory exemption, which completely exempts issuers from all Securities Act disclosure and registration requirements; and the safe harbor exemption — Rule 506 of Regulation D — which provides clear guidance for issuers, though mandates disclosure to certain investors, *see* 17 CFR § 230.506.

231 JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT. SECURITIES REGULATION: CASES AND MATERIALS 251 (2016).

232 Securities Act Rel. No. 6389 (1982).

233 SEC, Final Rule: Crowdfunding, Sec.gov (Jan.6, 2020, 10:40AM), https://www.sec.gov/rules/final/2015/33-9974.pdf.

234 The Securities Act of 1933, 15 U.S. Code § 77d (a) 2, the Jumpstart Our Business Startups Act, Pub. L. No. 112–106 § 201 (2012).

sale; prohibit misrepresentation and fraudulent activities in the sale of securities.[235] These both relate to the ultimate goal of investor protection.

The United States achieves its goal of investor protection through securities regulation with mandatory disclosure, anti-fraud, and related party liabilities rules.[236] First, the Securities Act of 1933 regulates initial public offering, mandating a registration process for any sale of securities to the public. Then, the Securities and Exchange Act of 1934 makes issuers subject to the periodic and current reporting requirements. Mandatory disclosure is established to inform investors of material financial and operational information of the issuer on a current and regular basis. The SEC generally requires sufficient information about the issuer and the terms of the offered securities to allow investors to form a reasoned opinion about the investment.[237]

Second, Section 17(a) of the Securities Act of 1933[238] and Rule 10(b)(5) in the Securities Exchange Act of 1934[239] list the different types of prohibited fraud activities in

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[235] The Securities Act of 1933, 15 U.S.C. § 77a. *See* also Zohar Goshen and Gideon Parchomovsky, *The Essential Role of Securities Regulation,* 55 DUKE L. J., 711 (2005), LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION ASPEN PUBLISHERS ONLINE 35 (1983), Frank H. Easterbrook and Daniel R. Fischel, *Mandatory Disclosure and The Protection of Investors,* 70 VA. L. REV. 669, 701 (1984).

[236] *Id.*

[237] *See* Registration Under the Securities Act of 1933, sec.gov (Feb.16, 2020, 09:44AM), available at https://www.sec.gov/fast-answers/answersregis33htm.html.

[238] It is unlawful to “employ any device, scheme, or artifice to defraud, ” “obtain money or property” by using material misstatements or omissions, or to “engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.”

[239] According to this rule, it is illegal for anyone to directly or indirectly, while conducting transactions involving securities, use any means to defraud, make false statements, eliminate relevant information or otherwise carry out operations of business that would mislead another person.

the offer or sale of securities. Third, the Securities Act of 1933 Section 11(a) states that "any person acquiring such security" may sue all or any of the following persons and "all or any one or more of them shall be jointly and severally liable: "(1) every person who signed the registration statement; (2) every person who was a director of … the issuer at the time of the filing of the part of the registration statement concerning which his liability is asserted; (3) every person who, with his consent, is named in the registration statement as being or about to become a director…; (4) every accountant, engineer, or appraiser, or any person ... who has with his consent been named as having prepared or certified any part of the registration statement…; (5) every underwriter with respect to such security."[240]

2. How Investor Protection Rules Promote Financial Stability

Securities regulations in the U.S. prioritize investor protection, and contain three types of rules — anti-fraud, mandatory disclosure, and related party liabilities — to achieve this goal. These rules not only guarantee the protection of investors' interests, but also help to promote financial stability.

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[240] The Securities Act of 1933, 15 U.S. C § 77k.

a. Investor protection rules correct the information asymmetry problem[241]

The market works best when investors are fully informed.[242] However, the entrepreneur or managerial team has better information about both the issuing firm and its securities than do the prospective investors. A system of mandatory disclosure and anti-fraud regulations aims to solve this information asymmetry. With sufficient information, investors are able to estimate the price for each security based on all available information. They are also more likely to make better investment decisions or at least to avoid making extremely bad ones.

b. Anti-fraud provisions and liabilities rules prevent or reduce fraudulent and inductive behavior or statements

Even without mandatory disclosure and anti-fraud provisions, issuers of high-quality securities have the incentive to take disclosure actions in order to distinguish themselves from low-quality ones.[243] However, low-quality can make fraudulent statements by mimicking the information that high-quality securities disclosed, while

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[241] John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System,* 70 VA. L. REV. VOL. 717, 730 (1984). Gregg A. Jarrell, *The Economic Effects of Federal Regulation of the Market for New Security Issues,* 24 J.L. & ECON. 613, 620 (1981); Ronald J. Gilson and Reinier H. Kraakman, *The Mechanisms of Market Efficiency,* 70 VA. L. REV. VOL. 549, 560 (May 1984); Nusret Cetin, *Investor Protection as the Objective of Securities Regulation: Goal v Instruments*, SSRN (Nov.21, 2017, 2:12PM), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2226778.

[242] U.S. Securities and Exchange Commission Chairman Mary L. Schapiro, Testimony Concerning Enhancing Investor Protection and Regulation of the Securities Markets, available at https://www.sec.gov/news/testimony/2009/ts032609mls.htm.

[243] Easterbrook and Fischel, *supra* note 235, at 680.

investors cannot verify the truthfulness of these statements. This ploy is especially attractive to infrequent players who find the gains from a single deception greater than any reputational loss.[244] As a result, investors, who usually do not have the time, ability, or resources, to verify the information that the issuers provide, will find it difficult to identify the fraudulent statements of these low-quality securities. Many investors might even find low-quality securities particularly attractive, due to their low costs or promised high returns.[245]

Anti-fraud and liabilities rules would potentially prohibit fraudulent behavior or statements. Moreover, these rules make it unnecessary or much less costly for individual investors to verify whether the issuers' information is true or false.[246] Accordingly, the laws decrease the likelihood that investors will make bad investment decisions based on fraudulent information.

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[244] *Id.*

[245] *Id.*

[246] Sanford J. Grossman, *The Informational Rule of Warranties and Private Disclosure About Product Quality,* 24 J. L. & ECON. 461, 470 (1981). Easterbrook and Fischel, *supra* note 235, at 680.

c. Reducing costs for high-quality firms will maintain the stability of the market

Anti-fraud rules and their penalties make it costly for low-quality firms making false disclosures through mimicking the disclosed information of high-quality firms.[247] But they impose fewer costs on honest, high-quality firms that have already taken expensive disclosure and verification actions to distinguish themselves.[248] In the long run, more high-quality companies survive, and more low-quality firms disappear.[249] Investors are better off because they have a higher-quality pool from which to choose. Additionally, the more well-qualified firms there are, the more stable they are likely to be, which ultimately strengthens the stability of the financial market as a whole.

d. Address specific agency problems between corporate promoters and investors

Some scholars also suggest that mandatory disclosure helps reduce monitoring costs caused by promoters' and managers' use of corporate assets for self-interested purposes.[250] The accounting statements that mandatory disclosure laws require explain

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[247] George J. Benston, *Security of Investors*, IN R. POOLE ED., INSTEAD OF REGULATION: ALTERNATIVES TO FEDERAL REGULATORY AGENCIES 169, 172 (1982); Linda Elizabeth DeAngelo, *Auditor Size and Audit Quality,* 3 J. ACCT. & ECON. 183, 185 (1981).
[248] Grossman, *supra* note 246, at 262.
[249] *Id.*
[250] Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems,* 62 THE UNIV. OF CHI. L. REV. 1075 (1995). HENRY HANSMANN AND REINIER KRAAKMAN, AGENCY PROBLEMS AND LEGAL STRATEGIES 89 (2004).

how a firm is using its money and assets, Which allows investors to catch breaches of management's duties to the shareholders. This helps investors protect their investment funds.

Furthermore, investor protection rules are critical to making sure that investors receive the returns they expect, and when they do, they are more likely to continue investing money.[251] Maintaining investors' confidence in the market will help businesses to grow, which is important for economic development.[252] Additionally, liabilities rules make sure that if a firm flees with the investment money, investors have a source to sue to try to get their money back. Being able to hold these related persons accountable also leads to a reduction in fraudulent behavior.

B. Expanding the Scope of Chinese Securities Law

Chinese Securities Act has the similar goal of investor protection to that of the United States. It also includes anti-fraud, mandatory disclosure, and related party liability rules to achieve this goal. However, the scope of Chinese securities is much narrower than the United States. As a result, non-bank lenders' fundraising activities fall outside of the

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[251] Luca Enriques and Sergio Gilotta, *Disclosure and Financial Market Regulation*, In JENNIFER PAYNE, EILÍS FERRAN ED. THE OXFORD HANDBOOK OF FINANCIAL REGULATION 513 (2015). JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE (1982).

[252] *Id.*

Chinese definition of securities, although they would be very likely to trigger securities regulations in the U.S.

1. The scope of securities law in China is narrower than that of the United States

a. "Securities" in the Chinese context

"Security" in the Chinese context has a much narrower meaning than it does in the United States. The Chinese law only lists very limited types of securities and does not provide any general standards with which to define securities. The Chinese Securities Act defines stocks, bonds, government bonds, shares of investment funds, depository receipts, asset-backed securities, and asset management products as securities.[253] The government just added these last three types of securities to the newly effective Securities Act Amendment. The Act also states that the State Council can decide whether to include other types of monetary tools in the definition.[254] But it fails to give the State Council any interpretation of what a security is. Nor does the Chinese court system offer any guidance. In practice, therefore, one identifies a security by its form (whether it is called a stock or bond), but not by its substance. As a result, many kinds of transactions or financing activities, such as P2P lenders' fundraising activities, that have the substance of securities

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[253] Securities Law of China, art. 2 (2020).
[254] *Id.*

currently fall outside the jurisdiction of securities regulation. Even worse, firms cannot legally use methods other than stocks and bonds to finance themselves, since most financing activities fall too easily into the realm of illegal fundraising.[255]

b. The Application of the United States' Rules to the Definition of Securities

If we apply the Howey test to Chinese P2P lenders' financing through taking deposits from the general public or selling wealth management products, we can see that their activities meet all four requirements – (1) investment: The general public is making an investment; (2) common enterprise: in the majority of federal courts, a common enterprise is defined as involving "horizontal commonality," meaning there is a pooling of assets from various investors and investors share the profits and risks based on their proportional contribution to the pool.[256]A common practice is that P2P lenders create a pool of money from multiple investors and the investors share in the profits and risks; (3) expected profits: The Chinese public investors' principal motivation behind the investment is its expected return; and (4) others' efforts: The small investors put their money in the entity, but they don't need to put any efforts into making profits. The United States courts have also developed a test that examines loans — the Family Resemblance

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[255] For the definition of illegal fundraising, refer back to Chapter II Part II.
[256] ALAN R. PALMITER. SECURITIES REGULATION (6TH EDITION) 52 (2015).

Test. In *Reves v. Ernst & Young,*[257] the Supreme Court adopted the "family resemblance" test to determine whether a note is a security. This test relied on Howey and further developed an analysis based on the risks of the loan.

The United States has a much broader definition of securities than China does. It not only includes all of the securities listed in Chinese Securities Act but also includes non-bank lenders' fundraising activities. Additionally, the federal courts enjoy the discretion to determine what qualifies as a security under the federal securities laws and thus can decide whether to append new instruments to the scope of securities in response to market development.

c. Why is the Definition of Securities Narrow in China?

Our earlier data shows that P2P lenders' fundraising activities are prevalent across China but fall outside any of China's financial regulations (which include only administrative crackdown and criminal regulation). China's securities law is outdated compared to the development of its securities market. The Chinese Securities Act gives the State Council the power to decide whether to include other types of securities.[258] However, the State Council has never exercised this authority.

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[257] 494 U.S. 56 (1990).
[258] *Id.*

Politicians and scholars have been debating the scope of the definition of "securities" since the legislature first drafted the Chinese Securities Act of 1998. Both during the draft period (from 1992 to 1998) and during the first amendment period (2004 – 2005), some scholars suggested modeling it on the United States' definition of securities, but the legislators rejected this suggestion for concerns that I will analyze in the next few paragraphs, and it was not adopted in the final version of the Securities Act.[259] The 1998 Act gave the term a very narrow scope — including only stocks and bonds. Almost immediately, scholars sought to expand the definition, in order to keep up with the development of the securities market.[260] The 2005 Amendment of the Securities Act added government bonds and shares of investment funds, but nothing more. In 2015, the government started another round of amendments, and expanding the scope of securities has again become a hot topic. The newly effective Securities Act Amendment added three new types of securities, including asset management products, which financial institutions like public fund management companies or securities companies may issue, but which non-bank lenders may not. The Amendment did not cover non-bank lenders' financing activities. What are the Central Government's and some legislators' concerns over

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[259] LIANZHOU WANG, THE LEGISLATIVE HISTORY OF SECURITIES ACT 52-4 (2006).
[260] *Id*, at 55-6.

expanding the scope of securities regulation, especially to non-bank lenders' fundraising activities?

First, the government believes that most non-regulated types of securities are risky and unreliable, and it has little experience with regulating them.[261] Since these different kinds of securities might need special regulation, the government is afraid that it might not be able to regulate them well. More importantly, the government is concerned that regulating risky securities (like P2P lenders' fundraising activities) would mean legalizing them, which might encourage financial institutions to use them more,[262] with the attendant increased risk of societal instability. Therefore, the government would rather wait until it is confident that it can regulate a certain type of security before including it in the Securities Act.[263] I counter this concern by noting that by watching the unregulated securities market, the government should be able to learn about this market and decide how to regulate it. It is also the case that no country knows how to regulate any type of securities before it actually does so. The Chinese government has more than twenty years of regulatory experience. This, therefore, is not a valid concern. Legalizing and regulating P2P lenders' fundraising activities would bring more stability than does leaving them

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[261] *Id,* at 46-7.
[262] *Id.*
[263] *Id.*

unregulated until something terrible happens. The financial market has currently reached a very sophisticated level of development, and the current definition of securities has not kept pace. The Chinese government must respond directly to these new types of financing activities rather than completely forbidding them.

Second, the government is worried about its lack of regulatory resources.[264] Some legislators argue that the government should focus on regulating the several types of most essential securities and should wait until other securities reach a more critical level before it regulates them as well.[265] But limited regulatory resources shouldn't be an excuse for not regulating, especially if this position gives free rein to a type of activity has become a serious threat to society.

Third, the primary aim of securities law in China is to provide a legal channel for firms — especially large, influential, state-owned ones — to raise money from the public.[266] Currently, regulating the market and protecting investors are secondary goals. The government cares more about large firms' ability to raise money and less about whether smaller firms can do so. Thus, the securities law is mainly designed to facilitate large firms' raising money from the public. Allowing P2P lenders to do so as well, and

264 Fei Li, *How to Set the Scope of Securities*, 78 CHINA L. REV. 25 (1999).
265 *Id.*
266 Chenglong Lv, *What Kind of Securities Do We Need in Securities Law?,* 89 POL. & L. 138, 140 (2017).

regulating them, would not affect the large firms, but would create new responsibilities for the government. Thus, the government has chosen to limit the financing tools to the areas that it can best control — stocks and bonds — and to exclude more immature and risky financing tools. However, small and medium firms and P2P lenders also help develop the economy. In fact, the economic value that small and medium firms create now accounts for 60% of the country's economic output.[267] The Chinese government should recognize this and create more financing tools for SMEs in order to promote economic growth.

Fourth, narrowing the definition of securities has made it easier for the government to control firms' fundraising activities. The government believes that control is the primary way for it to maintain financial stability. Forms of fundraising activities other than stocks or bonds are more difficult for the government to identify and the government has less experience in managing them. The government fears that it will not be able to control a broader range of fundraising activities, and that this lack of control will eventually cause instability in the financial market.[268] More importantly, the Chinese Communist Party fears that large firms would issue "wealth management" products as well, and would therefore start to look like banks, but banks over which the government

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[267] National SME Development Report Team, State Administration for Industry and Commerce, The Development of National SMEs in China (Abstract), www.gov.cn (Feb.4, 2017, 4:19PM), *available at* http://www.gov.cn/xinwen/2014-03/31/content_2650031.htm.
[268] PENG, *supra* note 45, at 138.

had no control.[269] If these firms become powerful enough, they might be able to influence crucial industries or even take over part of China's economy, which would be a serious threat to the Party's power. However, regulating the P2P lenders is also an important way to control them. It might be even easier for the government to control P2P lenders once it requires them to follow disclosure or other types of rules. The government can also regulate the size of the firm, the amount of money it can raise, or the number of people it can employ, and thus prevent it from being too overpowering.

From the above analysis, I conclude that the governments' concerns about limiting P2P lenders' fundraising activities or limiting the scope of securities are either invalid or untenable. Expanding the scope of securities law to include P2P lenders and other firms' fundraising activities has many benefits. It would not only ensure that these activities are regulated, but, more importantly, would help China to reduce scandals and achieve financial stability.

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[269] *Id*, at 184.

2. Can Expanding the Scope of Securities Law Help China to Reduce Scandals?

China's current methods for regulating P2P lenders' fundraising activities — administrative crackdown and criminal sanctions — only work when defaults lead to crises. They fail to address the most pressing problems in financing activities that have led to the scandals. The main causes of scandals in P2P lenders' fundraising activities include investors' lack of sufficient information; P2P lenders' use of fraudulent advertisement and statements; and investors having no one to turn to when P2P lenders default or flee with the investment money. Investor protection rules in securities law actually could potentially address these problems and help to reduce scandals.

a. Investor Protection Rules Promote Financial Stability

(1) Investor protection rules can correct the information asymmetry problem

Information asymmetry is the most obvious problem in P2P lenders' fundraising activities, so in 2016, the Chinese government started to require P2P platforms to disclose certain kinds of information.[270]

[270] *See* Interim Measures for the Administration of the Business Activities of Online Lending Information Intermediary Institutions (2016).

Most investors rely on the advertisement, other people's comments, and their own judgment after talking with the salesmen when deciding whether to invest money.[271] Without mandatory disclosure, investors know little about the products that they bought, or the project or firm in which they have invested. They only have general information about the previous performance of the firm, the contract term, and the interest rate that they would receive. They know nothing about the risks of their invested money.

Before the regulation, nearly every P2P platform failed to disclose many important facts. They generally release only broad information, like the total amount of money raised, the projects in which they invested, or the number of borrowers.[272] Some other platforms disclose more specific information periodically, such as the total amount of loans, their profits and costs, and borrowers' overdue rate.[273] Only the platforms that are listed in the stock market have periodic disclosure systems; the vast majority of them do not. Not infrequently, platforms present untrue or misleading information.[274] For example, although investors and borrowers separately sign contracts with the P2P lenders, some platforms might state the fee or interest amount that they are charging the borrowers, but the numbers might be different from the actual fees or interests that borrowers need to

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[271] *See* LINGYI FINANCE, *supra* note 101, at 78 (2017).
[272] *See* LINGYI FINANCE, P2P ONLINE LENDING REPORT (2013, 2014 & 2015).
[273] *Id.*
[274] *Id.*

pay.[275] For offline non-bank lenders, this information asymmetry is even worse, as there is no public space to disclose any financial information. Most information that investors get comes from the salesmen or managers of non-bank lenders. Without sufficient information, investors cannot evaluate the risks associated with the products that they bought. Then when they are told that the non-bank lender has an excellent performance record — which is probably untrue – they are very likely to be attracted and invest their money.

The Chinese government has started to recognize the importance of disclosure in this industry. In 2016, it issued the “Interim Measures for the Administration of the Business Activities of Online Lending Information Intermediary Institutions” (2016 Regulation) and then in 2017, the “Disclosure of Information on the Business Activities of Online Lending Information Intermediary Institutions.” These measures require P2P platforms to disclose relatively specific information to investors, including registration information, some basic information about the platform (shareholders, managers, locations, contacts, etc.), an annual financial report, information about the loans (the amount and number of loans, the amount and number of default, fees, etc.), information about the borrowers (their credit and project information), and important events that might

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[275] Jianwen Sun, P2P network lending platform profit model analysis, Modern Business 117, 118 (2018.12).

affect the operation of the platform (merger, acquisition, bankruptcy filing, closure, criminal charges, etc.).[276] Initially, the enforcement of the disclosure requirement was weak. By the end of 2017, only 346 out of the 1,625 platforms had met any of the Interim Measures' disclosure requirements.[277]

I reviewed 50 platforms at the end of 2017 and noticed that the information that they disclosed was very basic, such as the registration information and the names of managing board members. Only a few of the platforms listed in the stock market posted their financial reports on their website. However, in 2018, when the Central Government decided to enforce the disclosure regulations more strictly, it announced that only platforms that complied would be allowed to remain operation. Since then, the enforcement has improved significantly. According to a WDZJ.com study,[278] among 60 platforms, 90% met the basic information disclosure requirement; almost all platforms met the information about the loans; 10% failed to disclose their important events; one third fully met the registration information disclosure requirement; and one third failed to disclose or only partially disclosed their annual financial report. Almost no platform disclosed sufficient information about its borrowers. I note that the improved enforcement

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[276] Disclosure of Information on the Business Activities of Online Lending Information Intermediary Institutions, art. 9.

[277] LINGYI FINANCE, *supra* note 84, at 96.

[278] Haimei Wang, Manzhi Luo, The Information Disclosure Condition of Mainstream P2P Lenders, wdzj.com (Nov.12, 2019, 12:12PM), https://www.wdzj.com/news/yc/5222319.html.

was partly due to the fact that a large number of platforms had closed. Due to the government's crackdown, only 343 platforms remained operated by the end of 2019,[279] compared to 2,680 in 2016.

Mandatory disclosure would give Chinese investors more extensive and accurate information, which would allow investors to make better investment decisions.[280] The Chinese government has imposed special mandatory disclosure requirements on P2Ps in response to recent scandals in the industry. Although this regulation will provide better protection to investors, it might not be the best way to do this. First, it only applies to P2P lenders, but not to other types of non-bank lenders. In other words, non-P2P non-bank lenders who are also raising money from the public do not need to comply with disclosure rules. Second, the government has not backed up these special mandatory disclosure requirements with sufficient remedies for investors when platforms fail to comply with the rules. The rules only require platforms to rectify their behavior and to comply with the requirement.[281]

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279 Amanda Lee, China's Scandal-Plagued P2P Sector Faces 'Continued Pressure' in 2020 amid Tightening Regulation, south china morning post (Feb.22, 2020, 10:10PM), https://www.scmp.com/economy/article/3045006/chinas-scandal-plagued-p2p-sector-faces-continued-pressure-2020-amid.

280 PENG, *supra* note 45, at 160.

281 *Supra* note 276, art 25.

China's securities regulation has a more developed system. It not only has much more detailed disclosure requirements than the P2P-related regulations do but it also provides remedies. Additionally, I will discuss in the next section, securities regulation both imposes mandatory disclosure, and has other rules that help to reduce the likelihood that platforms will defraud or mislead investors.

Thus, it would be feasible for the Chinese government to expand the definition of securities and to regulate the financing activities of all types of non-bank lenders (including P2P lenders) through securities regulation. But securities regulation can only provide general guidance on information disclosure rules. As I will discuss in the next section, P2P and other types of non-bank lenders are more similar to investment companies. Thus, the mandatory disclosure rules of mutual fund regulation are more useful when it comes to regulating non-bank lenders.

(2) Anti-fraud provisions and liabilities rules prevent or reduce fraudulent and inductive behavior or statements.

Another crucial problem in P2P lenders' financing activities is that it is common for these lenders to use fraudulent or misleading advertisements, make fraudulent or misleading statements, and promise higher interest rates than they can afford in order to attract investors.

According to one P2P platform report, 66.2% of all P2P platforms have used fraudulent advertisement and statements in their financing activities.[282] Another maintained that misleading and fraudulent information characterized fundraising activities all across China.[283] One leading P2P lending company, Ezubao, engaged in several types of fraudulent behavior before it had a repayment problem and was caught by the police in 2015.[284] To gain the public's trust and support, Ezubao advertised its firm and products on several of China's government-controlled and most popular TV stations, as well as in train stations, subways, and buses all across China. The CEO of Ezubao was interviewed in several popular TV programs. Several Central Government Buildings even played its promotional video. Earlier in 2015, it spent around 0.13 billion RMB (19.2 million USD) on advertisements, while the greatest amount of funds it raised was 9 billion RMB (1.30 million USD). The company sponsored several government projects, some influential sports competitions, and social events. It hired or invited prominent economists,

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282 LINGYI FINANCE, *supra* note 84.

283 Frank Tang, Why Ponzi Schemes are Thriving in China Despite Crackdowns, south china morning post (Apr.12, 2018, 08:02PM), *available at* http://www.scmp.com/news/china/money-wealth/article/2104062/chinese-ponzi-schemes-feed-publics-lack-financial-knowledge.

284 Neil Gough, Online Lender Ezubao Took $7.6 Billion in Ponzi Scheme, China Says, nytimes.com (Dec.17, 2017, 7:17AM), *available at* https://www.nytimes.com/2016/02/02/business/dealbook/ezubao-china-fraud.html.?mtrref=www.google.com&gwh=79C985EF2FDDB9D253C8A113E7E6358F&gwt=pay. Leader of China's $9 Billion Ezubao Online Scam Gets Life; 26 Jailed, Reuters (Feb.15, 2018 4:50PM), https://www.reuters.com/article/us-china-fraud/leader-of-chinas-9-billion-ezubao-online-scam-gets-life-26-jailed-idUSKCN1BN0J6; Julie Makinen, Chinese Company Lived the High Life – Until it All Came Crashing Down, Los Angeles Times (Feb.14, 2018 8:08PM), *available at* http://www.latimes.com/world/asia/la-fg-china-shadow-banking-20160203-story.html.

government officials, and the P2P Association leaders to endorse its products publicly or attend its annual meeting. This publicity had an enormous influence on public investors, enhancing their trust in Ezubao and its products. Ezubao hired more than 100,000 salesmen; they didn't need to have any financial background and who were permitted or even encouraged to make misrepresentations to promote the products.[285] Although the police later found that the vast majority of Ezubao's wealth-management products were fake, by the time they made arrests in early 2016, the company had collected 59.8 billion yuan ($9.14 billion) from more than 900,000 investors. Ezubao failed to repay 38 billion yuan (5.7 billion).[286]

Ezubao was an extreme case. Most other P2P platforms might use only one or a few of these tools to promote their products. However, the fact that more than 900,000 investors were attracted to Ezubao shows the effect of these fraudulent advertisements and statements. In fact, P2P lenders' often-fraudulent statements and behavior seem to be the primary reason why investors invest their life savings or make bad investment decisions.[287]

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[285] Bai Yang, Chen Ji, Ezubao illegal fundraising case, People Net (Jan.1, 2017, 01:01AM), available at http://money.people.com.cn/n1/2016/0201/c42877-28099416.html; Ezubao illegal fundraising case investigation, *available at* http://www.xinhuanet.com/fortune/2016-01/31/c_1117948306.htm; *see* also LINGYI FINANCE AND ECONOMIC RESEARCH INSTITUTE, *supra* note 84, at 50.

[286] Gough, *supra* note 284.

[287] SHEN, *supra* note 7, at 200.

Currently, the main course of action is to crack down on these lenders, which can only happen after the scandals come to light. This regulation only has limited deterrence effect, as most P2P lenders are not frequent players; they tend to find the gains from one-shot deception greater than the risk of reputational loss or even of governmental sanction. Even for repeat players, the deterrence effects are not large because as long as they aren't caught, they are safe. More importantly, this regulation does not focus on solving particular issues, such as the use of anti-fraudulent statements, in this market. The result of the current strict enforcement of the crackdown measure has led to the elimination of platforms, but has not resolved the problem of fraudulent activities and statements.

The 2016 Regulation has decreased some of the fraud and dissemination of misleading information,[288] while another regulation strictly restricted advertising for online financing products.[289] However, these regulations are either weakly enforced or impractical. Further, they include no liability rules, and only focus on online platforms, rather than on all non-bank lenders. If China could impose anti-fraud provisions from securities regulation and strongly enforce them, lenders' fraudulent statements or behavior

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[288] China Banking Regulatory Commission, Remarks on "Interim Measures for the Administration of the Business Activities of Online Lending Information Intermediary Institutions," cbrc.gov.cn (Feb.2, 2017, 02:02AM), *available at* http://www.cbrc.gov.cn/chinese/home/docView/63095C65646F4C85902F0CC10D6F6935.html.

[289] General Administration of Industry and Commerce, Central Propaganda Department, Central Stability Office, "Implementing Online Finance Advertising and Implementing the Special Rehabilitation Work for Financial Activities in the Name of Investment and Financial Management," 2016.4.

would be greatly decreased. This would reduce the likelihood that platforms will defraud unsophisticated investors.

(3) Mandatory disclosure addresses certain agency problems that arise between corporate promoters and investors

In China, P2P lenders currently face few mandatory disclosure requirements. It turns out that in many scandals, the executives or managers have embezzled investors' money for personal use or have overcompensated themselves. The CEO of Ezubao embezzled around 1.5 billion RMB (221 million USD) for personal use.[290] In another case, the CEO of Zhongjin embezzled 5 billion RMB (7 billion USD) out of the 39.99 billion RMB (5 billion USD) that the company raised.[291] These two are the most extreme cases, but a large proportion of illegal fundraising cases had the same problem.[292]

There is currently no regulation to solve this problem. The Chinese Securities Act requires mandatory and periodic disclosure of issuers' financial conditions. If this rule

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[290] Online Lender Orchestrated $10.8b Ponzi Scheme, Straits Times (Dec.22, 2019,10:33 AM), https://www.straitstimes.com/business/online-lender-orchestrated-108b-ponzi-scheme.

[291] The Boss of Zhongjin Agreed to the Ponzi Scheme, *available at* http://www.01caijing.com/article/3624.htm.

[292] Li Yanxia, The Overall Situation of Illegal Fundraising in China is Grim: The Cases are Rising and Difficult to Handle, news.cctv.com (Mar.4, 2019, 04:55AM), *available at* http://news.cctv.com/2018/04/23/ARTIno3Y974VNVfEpom5kSZS180423.shtml.

could be applied to P2P lenders, it would give Chinese investors at least one channel by which to monitor potential embezzlement or overcompensation issues.

(4) Related parties' liabilities.

The default of P2P lenders usually results in serious economic losses for investors. In illegal fundraising cases in Beijing in 2015, only an average of 10% of all invested money could be returned. According to one P2P platform report, around 30% of all P2P platforms closed by the end of 2016.[293] Non-bank lenders either fled with the invested money or couldn't afford to return it to the investors.

The related parties' liability rule in securities law could potentially solve this problem or at least reduce the economic losses for investors. If the Chinese government started to regulate P2P lenders via securities law, P2P lenders would need to follow the registration and disclosure rules. According to the Chinese Securities Act, if there is any fraudulent or misleading information in the issuing of the security, the investors can hold liable any underwriters, sponsors, accountants, lawyers, investment consulting agencies, financial advisory institutions, credit rating agencies, asset assessment agencies, or any other institutions that assisted in issuing it.[294] The related party liability rule can help to

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[293] LINGYI FINANCE, *supra* note 98, at 65.

[294] Chinese Securities Act, art. 69 & 173. The Supreme People's Court, Provisions on the Trial of Civil Compensation

decrease the likelihood of fraud. Then if any fraud occurs, investors can sue not only the issuer, but also the related parties and get some money back.

b. Special Rules for P2P Lenders

One major side effect of securities regulation is that complying with its rules has proven to be costly.[295] This is especially the case for Chinese non-bank lenders, since most of them are small and medium-sized financial institutions. If China is going to implement securities regulation, it will also need to impose less demanding investor protection rules.

China can set up some exemptions for P2P lenders. For example, it can exempt P2P lenders from registering with the securities regulation authority, just like the exemptions in Regulation D for small offerings, or for crowdfunding in the U.S. securities law. The exemptions would help China's small non-bank lenders to reduce registration costs while raising money from the public. Non-bank lenders would still need to report to the regulatory agency after they raised funds from the public and follow the mandatory disclosure and anti-fraud rules. But they should be allowed to disclose less and only the most crucial information.

Cases Caused by Fraudulent Statements in the Securities Market.

[295] Securities Industry Association, The Costs of Compliance in the U.S. Securities Industry, Survey Report, sifma.org (Oct.10, 2016, 10:10AM), available at https://www.sifma.org/wp-content/uploads/2017/06/costofcompliancesurveyreport1.pdf.

To sum up, the rise of scandals in the P2P lenders' financing market damages investors' interests and causes social and financial stability. Theses scandals might deter investors from making further investments. Expanding the scope of securities law to include the fundraising activities of P2Ps and other non-bank lenders would ensure that these activities are regulated. More importantly, investor protection rules in securities law would help to reduce scandals and achieve financial stability. Additionally, investor protection rules would encourage investors to continue to invest in this market and promote economic growth. Therefore, instead of issuing additional regulations, China should learn directly from the United States to include the financing activities of P2Ps and other non-bank lenders. However, if it does implement securities regulation, it should, correlatively, impose less demanding rules on P2P lenders, since imposing new strict and complex regulations is costly. Another point to note is that the enforcement of securities regulation should be through private, as well as public, avenues, because investors would have more causes of actions to bring suit against P2P lenders and related parties.

II. Banking Regulation Approach: Capital Requirements

P2P lenders provide similar functions to banks, in that they play a financial intermediation role. Banks take deposits and then use these deposits to provide long-term loans. P2P lenders do not (and legally may not) take deposits directly.[296] Instead, they raise money by selling wealth-management products or by issuing certain types of debt certificates (which are similar to deposits). P2P lenders then use the pooled money for investments or to provide short-term or long-term loans to individuals and SMEs. Both banks and P2P lenders provide a similar service — the transformation of liquid liabilities into illiquid assets (loans).

On the lending side, P2P lenders function similarly to banks when they supply long-term loans. However, these lenders are not banks when they raise money from the general public. Chinese investors (consumers) cannot withdraw funds on short notice or write checks on their accounts with P2P lenders, like bank depositors. But P2P lenders can offer more competitive interest rates than can banks. The government backs banks with deposit insurance in order to militate against the risk of unexpected withdrawals and the maturity mismatch — the disparity between short-term funding and long-term lending — problem. In addition, by law, banks must hold a percentage of their total deposits in cash so as to be able to cover unexpected withdrawals. The mismatch problem is less crucial for non-bank lenders both because although they get short-term funding, they provide both short-term and long-term loans, and because investors cannot freely withdraw their funds

[296] Non-bank lenders used to take deposits from the public, but today taking deposits from the public is rare.

from them. Thus, a legal framework regarding deposit insurance and fractional reserves is not absolutely necessary when regulating P2P lenders.

Despite their differences, P2P lenders and banks face some common problems, as when they engage in complicated and sometimes extremely risky transactions. To ensure that banks are not making risky investments that increase the risks of default and that they maintain enough capital to sustain operational losses and honor withdrawals, the regulatory framework imposes capital requirements on banks. A capital requirement would also be helpful in the situation of Chinese P2P lenders, as it would mitigate the risks of borrower default or risky investments, with the goal of protecting investors.

A. Capital Requirements in the United States and the Basel Capital Accords

A capital requirement specifies the minimum capital-to-asset ratio that an entity must have in order to become or to continue to operate as a bank.[297] In the United States, in order to ensure sufficient capital in the banking industry, regulations were established as early as the 19th century and the free state banking era.[298] A Bank charter was typically

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[297] *See* GEORGE BENSTON, ROBERT EISENBEIS, PAUL HORVITZ, EDWARD KANE & GEORGE KAUFMAN, PERSPECTIVES ON SAFE AND SOUND BANKING: PAST, PRESENT, AND FUTURE 54 (1986); Allen Berger, Richard Herring, and Giorgio Szego, *The Role of Capital in Financial Institutions,* 19 J. OF BANKING & FIN. 393, 401 (1995); Edward Kane, *Three Paradigms for the Role of Capitalization Requirements in Insured Financial Institutions*, 19 J. OF BANKING & FIN 431, 450 (1995).

[298] Hugh Rockoff, *The Free Banking Era: A Reexamination,* 6 J. OF MONEY, CREDIT & BANKING 141, 150 (1974); Randall S. Kroszner and Philip E. Strahan, *Regulation and Deregulation of the US Banking Industry Causes, Consequences, and Implications for the Future*, IN NANCY L. ROSE ED. ECONOMIC REGULATION AND ITS REFORM: WHAT HAVE WE LEARNED? 504-05 (2014).

granted when the requirement of a minimum amount of capital is met. In other words, capital requirements existed well before the federal deposit insurance regulation, which Congress enacted in the 1930s.

Historically, banks had much more equity as funding of their business than they do today. In the 1800s, shareholder capital made up more than 50% of United States banks' capital structure.[299] By the early 1900s, the ratio was about 20%. Through the next 100 years, as the ratio continued shrinking, it seems unnecessary for deposit insurance to make big cushions. Banks became less dependent on shareholder money and more reliant on deposits and short-term cash from money-market funds.

However, in the early 1980s, regulators grew concerned about the declining capital levels, and their demands for higher capital intensified as they perceived that bank activities were becoming increasingly complex, diverse, and risky. After the Latin American debt crisis of 1982, Congress passed the International Lending and Supervision Act of 1983, which culminated in the 1988 Basel Accords (known as Basel I) that established international standards for capital requirements.[300] Since then, the Basel Committee on Bank Supervision (BCBS) has issued two more series of banking

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[299] BENSTON, EISENBEIS, HORVITZ, KANE & KAUFMAN, *supra* note 297, at 43 (1986).
[300] James R. Barth, Stephen M. Miller, A Primer on the Evolution and Complexity of Bank Regulatory Capital Standards 13, Mercatus Working Paper, Mercatus Center at George Mason University (February 2017).

regulations (Basel II and III), which provide recommendations on the standards for setting capital requirements.

Basel I advocated a minimum capital ratio, basing on capital relative to risk-weighted assets (RWAs). Under this simple arrangement, loans with different risk levels are required to meet different marginal capital. The capital adequacy risk (the risk that a financial institution experienced by an unexpected loss), classifies financial institutions' assets into five different risk levels (0%, 10%, 20%, 50%, and 100%). Basel I requested banks operating internationally to have a risk weight of 8% or less. The United States added a leverage standard not included in Basel I itself and also applied Basel I to bank holding companies.

In June 2004, the BCBS replaced Basel I with Basel II—Revised International Capital Framework. Basel II focuses on "three pillars": the minimum capital requirements; supervisory review and market discipline.[301] The United States never fully implemented Basel II because of concerns about competitive equality.[302] By April 2008, 12 of largest

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301 Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards, *available at* https://www.bis.org/publ/bcbs118.pdf.

302 Basel II allowed banks to establish an internal model — an advanced internal ratings-based (A-IRB) approach – that would estimate various aspects of credit risk for the first time. However, it permitted only large banks to do this. Smaller banks could only adopt the BCBS's "standardized approach." Evidence shows that A-IRB banks experienced a large drop in minimum capital requirements, which gave them a substantial competitive advantage over smaller rivals. *See* Ranjit Lall, From Failure to Failure: *The Politics of International Banking Regulation,* 19 REV. OF INT'L POL. ECON. 609, 613 (2012).

banking organizations had nonetheless begun to transition to Basel II, although the financial crisis interrupted the process.

Following the Lehman Brothers collapse in 2008 and the ensuing financial crisis, in December, 2010, the BCBS issued Basel III, which replaced Basel II. Basel III continues to uphold the centrality of the three pillars, while adding more requirements, including mandating banks to maintain a minimum amount of common equity and a minimum liquidity ratio. Basel III also has more requirements for "systemically important banks," or the financial institutions that are "too big to fail." In July 2013, United States regulators finalized rules on Basel III's key capital requirements and the liquidity coverage ratio. Under the transitional arrangements, Basel III applies to virtually all U.S. banks and bank holding companies.

Along with the United States, every participating country adopted the Basel Accords (with some modifications). Further strengthening their effect, much of the developed and the developing world, including China, implemented it as well, in full or in part.[303]

Since the 1980s, under the influence of the Basel Accords, the United States has established an increasingly complex and comprehensive system of capital regulation,

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303 HOWELL E. JACKSON, MARGARET E. TAHYAR, AND MICHAEL BARR. FINANCIAL REGULATION: LAW AND POLICY, 273, 299-300 (2016).

which the Federal Deposit Insurance Corporation (FDIC) supervises. Depository institutions are subject to the risk-based capital guidelines that the Board of Governors of the Federal Reserve System (FRB) issues.[304] Currently, the United States has standardized and advanced approaches for determining the risk-weighting of bank assets that adjust capital requirements based on the asset risk.[305] Since the recent crisis, banks that use the advanced approach and banks on the list of global systemically important banks are now subject to rules even that are more stringent than those for other banks.[306] These banks must do multiple tests to determine their minimum capital requirements, choosing the highest requirement that the tests determine.[307] Overall, the capital requirement for banks mainly focuses on the weighted risk associated with each type of asset that the bank holds, supplemented by a leverage ratio requirement.[308]

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304 FDIC: Capital measures and capital category definition, FDIC (Feb.3, 2020), *available at* https://www.fdic.gov/regulations/laws/rules/2000-4500.html.

305 *See* Comptroller of the Currency, Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 FED. REG. 62018(Oct.11, 2013).

306 Barth and Miller, *supra* note 300, at 6.

307 *Id.*

308 To be adequately capitalized under federal bank regulatory agency definitions, a bank holding company must have a Tier 1 capital ratio of at least 4%, a combined Tier 1 and Tier 2 capital ratio of at least 8%, and a leverage ratio of at least 4%, and not be subject to a directive, order, or written agreement to meet and maintain specific capital levels.

B. How Capital Requirements in Banking Regulation Promote Financial Stability

This analysis shows that the requirements for minimum capital have been evolving over the past few decades, becoming increasingly complex. This section will not explain the rules in great detail, but it aims to prove that capital requirements help promote financial stability by encouraging banks to mitigate risky investments and by protecting depositors.

In a competitive market without these capital requirements, banks have two investment choices: one is to invest in a prudent asset that yields high expected returns and the other one is to invest in risky assets yielding high returns for the bank if the investment pays off but imposes costs on depositors if it fails.[309] Accordingly, banks have two investment results: one is to earn relatively little from a prudent investment, the other one is to earn high returns from a gambling-like investment. Thus, increased competition tends to promote risky investment in the banking sector.[310] Compounding the problem, because information in these instances is generally asymmetric, depositors usually lack sufficient knowledge to be able to assess or react to such bank behavior. In this way, banks are forced to internalize the costs of risky investments through putting more of their own

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[309] Thomas F. Hellmann, Kevin C. Murdock and Joseph E. Stiglitz, *Liberalization, Moral Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough?*, 90 THE AM. ECON. REV. 147, 149 (2000).
[310] *Id.*

capital at risk. They force banks to put more of their own capital at risk so that the banks internalize the inefficiency of risky investments. Once banks have sufficient capital invested, they have an incentive to prefer the prudent asset.[311] This reduces the possibility of their losing huge numbers of deposits and thus protects depositors.

When banks are close to default, shareholders are very likely to have less incentive even to contribute new capital to value-increasing investments. This is because the benefits from their investments would mostly go to depositors.[312] Capital requirements solve this problem, as they give shareholders who increase the bank's capital a greater percentage of the benefits. This function of capital requirements is to reduce the likelihood of bank default.

Capital requirements also serve the function of absorbing operating losses.[313] This does not happen often, especially for banks with long and sound records. In a new bank without much experience, however, operating losses might drive capital below a certain level, possibly leading to financial distress. Capital requirements would prevent such extreme operating losses and ensure that banks maintain their capital at the minimum legal

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311 *Id.*

312 Stewart C. Myers, *Determinants of Corporate Borrowing,* 5 J. OF FIN. ECON. 147, 156 (1977).

313 *See* Martin Svitek, *Functions of Bank Capital,* 29 NARODNA BANKA SLOVENSKA 37, 38 (2001); Douglas W. Diamond & Raghuram Rajan, *A Theory of Bank Capital,* NBER WORKING PAPER 7431 (1999).

level. Additionally, capital requirements ensure that shareholders bear an appropriate level of obligation and that investors get at least some funds back from the capital on hold.[314]

Capital requirements reduce the possibility of risky investments by banks and ensure that they can repay at least some amount of money if the investments fail. The legal requirements help to protect depositors and prevent bank default. The result promotes financial stability.

Legislatures typically establish capital requirements in order to regulate banks. The United States has not broadly expanded the application of its capital requirements to other financial institutions. However, as I will explain below, the functions of this requirement could potentially help China to solve the developing crisis of non-bank lenders.

C. Could Imposing Capital Requirements on Chinese Non-Bank Lenders Help Reduce Scandals?

China's current methods of regulation fail to address the default problem of P2P lenders. This problem is partially due to P2P lenders' risky investment decisions. Although P2P lenders share some of the default risks, their responsibility is limited to the funds they raise. P2P lenders charge borrowers very high interest rates to mitigate the default risks. As a result, P2P lenders have no strong motivation to evaluate borrowers

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[314] *See Id.*

carefully. The Chinese government could solve this problem and reduce the incidence of scandals by adopting the capital requirements of U.S. banking regulation so that P2P lenders would share more of the default risks.

China's P2P lenders do not evaluate borrowers' credibility carefully or even require adequate collateral. They seem eager to make loans to anyone with even minimal credibility. Yirendai, a listed company in Nasdaq, includes the following statements in its advertising: There is "no guarantee or collateral" requirement for borrowing money, and borrowers can receive funds up to 200,000 RMB ($29,000) in as little as 30 minutes.[315] I surveyed the ten largest Chinese P2P non-bank lenders[316] and found that it is fairly easy to get an initial several hundred to several thousand dollars from them immediately,[317] without providing as much as a credit history.

P2P lenders do more extensive evaluations when individuals or small businesses want to borrow more money. However, they lack strong motivation to evaluate borrowers carefully as they do not share the downside of borrower default. Thus, even their more extensive evaluation is inadequate.

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315 *See* Yirendai website, https://www.yirendai.com/borrowguide.

316 The list includes Yirendai, Xinerfu, Honglingchuantou, Renrendai, Wenshangdai, Renrenjucai, Yitongdai, Rongjin Institute, Xiaoniu online, and Dianrong online.

317 The only information that these online platforms ask for is the name and government issued id.

As China does not have a sound credit reporting system, P2P lenders have to establish their own evaluation systems. These usually consider several factors, including the borrower's credit history with the company, the borrower's income, occupation, and age, and a small businesses' profitability. The credit checking process is usually minimal and quick. To mitigate the future costs of default, non-bank lenders typically charge an extremely high interest rate. But even that amount might not be able to cover the costs of default.

P2P lenders not only make careless loans but also tend to lend money to even the most risky customers without capital requirements. For example, Yirendai and another Nasdaq listed company, Xinerfu, categorize their borrowers into several different risk levels based on their credit history.[318] Yirendai put more than 90% of its borrowers in the highest risk category.[319] For both Yirendai and Xinerfu, the default rate was more than 10% by the end of 2017. One report estimates the average default rate of P2P lenders as high as 20%.[320] This dramatic percentage has led to the frequent collapse of non-bank lenders, which negatively affects the financial market.

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318 Sina Finance, More than 90% of Borrowers Pay 40% Annual Interest Rate, Finance.sina.com.cn (Apr.4, 2018, 09:33AM), *available at* http://finance.sina.com.cn/roll/2017-03-21/doc-ifycnikk1346261.shtml.

319 *Id.*

320 Yang Jian-hui & Lin Yan, *Research on the Development and Risk Prevention of P2P Platforms in China*, 19 J. OF SOU. CHINA U. OF TECH. (SOC. SCI. EDITION) 20, 25（2017）.

If capital requirements applied to P2P lenders, these lenders would have the incentive to assess the riskiness of loans more carefully and to make better investment decisions, as long as these lenders don't raise equity from detached investors. Minimum capital requirements would also reduce the likelihood of P2P lenders becoming insolvent. Additionally, these requirements would help the government to monitor the number and size of P2P lenders, giving it the ability to control them more easily.

D. Imposing Capital Requirements on Chinese P2P Lenders

The 2018 Commercial Banks Measures for the Liquidity Risk Management of Commercial Banks includes a capital adequacy ratio requirement that follows Basel III. The China Banking Regulatory Commission is the regulator that oversees and inspects the capital adequacy ratios. But which regulator should monitor non-bank lenders to ensure that they meet this requirement? Should regulators apply similar standards when calculating the risk-based capital level for P2P lenders?

1. Which regulator would best enforce these requirements?

In China, the Securities Regulatory Commission regulates securities and the Banking Regulatory Commission oversees banks. If the legislature were to impose both securities and banking rules on non-bank lenders, these two Commissions would have to regulate them together. Maintaining separate regulation would lead to confusion and inefficiency, or even paralysis. In order to mitigate this inefficiency, the Chinese government has several options. It could give one of the two regulators authority over non-bank lenders; it could create a coordinating body through which these two Commissions would regulate non-bank lenders together; or it could set up a new agency to regulate them.

2. How to Set the Capital Requirements Standard?

Capital requirements could potentially mitigate the systemic risks that P2P lenders create. But should regulators apply the same requirements for minimum capital that banks have or should they establish new standards?

Capital requirements for banks have become increasingly complex over the past several decades. The amount and types of capital that banks must legally maintain vary according to the types of assets they hold as well as by the size of the bank. However, some scholars point out that the current risk-based capital ratio in banking regulation is so complex that it is difficult even for regulators to determine whether a bank is following the regulatory guidelines.[321] Thus, the ratio no longer serves as good determinant of whether banks are adequately capitalized, and might be misleading to both markets and regulators.

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[321] Barth and Miller, *supra* note 300.

P2P lenders are much smaller than banks and are less influential.[322] Furthermore, the investments that P2P lenders make are not particularly complex, as they focus on individual or business loans. A complex, risk-based capital ratio might greatly increase the costs of compliance. Instead, a straightforward, non-risk-based equity ratio might provide better information and simplify the regulatory process. This capital requirement should be based on the fluctuations of the market. But as P2P lenders usually have lower registered capital and often face the funding problem, the capital requirement shouldn't be too high for them.

3. The Chinese Government's Concerns about Imposing Capital Requirements

By raising money from the public and lending money to SMEs and individuals, P2P lenders are already acting like banks. Imposing bank requirements would therefore treat them as such. Currently, the government controls all state-owned banks. It can enforce its policies to achieve its goals and thus control the financial market. But the government does not have the same jurisdiction over private firms. Thus, it fears that if these private firms grow too big, it might lose control of the financial sector. However, as

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[322] Even the top ten largest non-bank lenders are only worth 500 million USD. *See* LINGYI FINANCE, *supra* note 84, at 234.

a way to control the development of the industry, the government could limit the size and number of P2P lenders.

To sum up, imposing capital requirements on P2P lenders could potentially reduce the likelihood of their making risky investments and mitigate the risks of borrower default. In this way, capital requirements would help to reduce scandals and achieve financial stability. If it decides to implement this regulation, the Chinese government will need to decide which regulator can best monitor compliance. In addition, the capital requirements of P2P lenders should be straightforward and non-risk-based, since imposing complex standards would be costly.

III. The Mutual Fund Approach: Investor Protection and Risk Reduction

Although the Chinese government does not consider P2P wealth management products to be open-end mutual funds, they are similar to them in many ways. Some of the principles of mutual fund regulation in the United States – including allowing investors to trade their investments through the platform; requiring a daily valuation of the fund assets; regulating the kinds of borrowers that a fund can have and the kinds of loans that it can make; requiring wealth management funds to maintain strict custody of fund assets; and imposing special disclosure requirements – are therefore helpful. These principles can help

China to regulate P2P lenders while still protecting investors and preventing non-bank lenders' risky investments. This will ultimately promote financial stability.

A. The Similarities and Differences between Wealth Management Funds and Mutual Funds

China's mutual fund regulations do not apply to the way that Chinese P2P lenders raise money from the general public, even though the financing methods of these lenders look similar to those of mutual funds.

1. A Basic Definition of Mutual Funds in the United States and China

In the United States, a mutual fund is a financial vehicle that publicly pools money from many investors and uses that money to invest in securities such as stocks, bonds, and short-term debt.[323] Mutual funds have professional managers and issue shares to their investors. Each investor (shareholder) participates proportionally in the gains or losses of the fund.

Chinese law defines a mutual fund, which it calls a securities investment fund, similarly. But a securities investment fund has a broader scope, as it includes both publicly- and privately-raised funds.[324] In this section, I consider only publicly-raised

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323 Mutual Funds, investor.gov (Feb.19, 2020, 09:19AM), https://www.investor.gov/introduction-investing/basics/investment-products/mutual-funds-and-exchange-traded-funds-etfs.
324 Securities Investment Fund Law of China (2015 Amendment).

securities investment funds. Investors of these funds enjoy income and assume risks to the extent of the respective fund shares that they hold. Securities investment funds can only invest in the stocks, bonds, and other securities that the State Council has defined,[325] and the law specifically prohibits them from investing the pooled money in loans.[326]

Chinese P2P lenders raise money from the public through the sales of wealth management products (WMPs). P2P lenders often pool the proceeds of various WMPs, so as to invest them in a wide range of assets, including individual and SME loans.[327] Current regulations view P2P lenders' wealth management funds as illegal, since they raise money from the public. However, as I discussed in Chapter II, in order to maintain social and financial stability, rather than criminalizing them, China should instead legalize and regulate these WMPs.

2. Similarities between WPMs and Mutual Funds

Chinese law does not define wealth management funds as mutual funds and wealth management funds are not mutual funds. But the two have many similarities.

First, both funds pool money from the general public and are managed by professional investment managers. The main purpose of P2P online platforms and

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[325] *Id*, at art. 73.
[326] *Id.* at art. 74.
[327] SHEN, *supra* note 47, at 60.

investment companies is to make investments, not to operate businesses. Disparate investors can participate in these pools of assets, which are much larger and more diversified than individual investors could create on their own.

Second, the main purpose of the two kinds of funds is to make investments rather than to make loans. Therefore, the funds carry no guarantee of principal and the dividend or interest that investors receive depends mainly on the performance of the investment, including the interest rates of the loans and the default rate. However, platforms usually pay investors an advertised rate of return, which usually covers the loss of investment.

Third, open-end mutual funds can issue shares at any time. Investors buy these shares directly from the mutual fund itself. They are shareholders of the fund, but they do not have any voting rights. They receive returns based on their proportion of the pooled money. As with mutual funds, P2P platforms can raise funds at any time, and offer WMPs directly to investors. But when investors purchase WMPs, they do not get shares of the fund because, as pooling money from the general public is illegal under China's current regulation, this would give the regulators evidence that they are violating the law. Because wealth management funds are established for a fixed term and have a fixed amount of money that they intend to raise, all investors receive units of the fund based on their contribution to it, and get returns based on their contributed units. Whether they are shareholders of the fund or not, investors in both a mutual fund and a wealth management funds own a certain percentage of the fund, do not have voting rights, and get returns based on their contribution to the fund.

Fourth, wealth management funds include some aspects of the "separation of funds and managers"[328] that mutual funds have. The fact that investment companies separate their funds from their managers distinguishes mutual funds from regular securities, and requires special securities regulation. Wealth management fund investors own the fund in which they have invested but have no control over how P2P online platforms manage the fund, the platforms, or any other money. Managers of these wealth management funds do not own the funds but just manage them.

In some ways, wealth management funds have more similarities to money market funds. Both have relatively short maturity rates. According to a report, in the U.S. between 2009 and 2017, the highest average term of loans within a year was 261 days (in 2014), and the lowest was 108 days (in 2012).[329] Thus, both investment vehicles are very liquid short-term investments. Further, both kinds of funds require low initial investment. Money market funds start with even lower minimum investments than average mutual funds do,

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[328] John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation,* 123 YALE L. J. 1228, 1235 (2013).

[329] LINGYI FINANCE, *supra* note 84, at 42.

while investors can contribute to a wealth management pool starting with as little as 100 RMB (around $14 USD).

3. Differences Between Wealth Management Funds and Mutual Funds

Current Chinese regulations do not define wealth management funds as mutual funds for several reasons.

First, the Chinese law only allows institutions that the securities regulatory authority of the State Council has confirmed to manage mutual funds. P2P lenders are not allowed to operate such businesses unless they meet the requirements for establishing a securities investment fund company.[330]

Second, each wealth management fund has a relatively short fixed term,[331] after which it closes. The platforms establish each fund based on the length of the term and advertise a return rate that is usually based on the length of the term — the longer the term, the higher the return rate.[332]

Third, unlike open-end mutual funds, investors cannot easily redeem their part of a wealth management fund. If a platform sells wealth management products, however, it

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[330] Securities Investment Fund Law of China, art. 12. The requirements include – that the registered capital of least 100 million RMB (USD 14.3 million) be paid in currency; that the main shareholders possess a certain number of assets, have good professional performance, and no criminal records; that the executive directors and managers meet certain requirements; and that a certain percentage of the employees have qualified certificates to work in the asset management industry.

[331] The term is usually less than a year. Out of 100 platforms, I have seen only a few that offered a 36-month term.

[332] For example, at renrendai.com, a P2P lender listed three funds in Nasdaq. The one-month fund offered a 5.0% rate of return; the three-month fund, a 6.0% rate; and the 12-month, a 9.0% rate.

might allow investors to trade their investment publicly, in a wealth management fund, This is similar to a closed-end fund that makes its shares tradable among investors.

Fourth, although WMPs cannot and do not legally guarantee returns, platforms usually make the promised return. Under China's current under-developed credit reporting system, investors have few resources by which to evaluate borrowers' creditworthiness. Therefore, platforms are motivated to guarantee returns in order to keep attracting investors.

Fifth, the amount of interest that investors receive does not rely only on the performance of the wealth management fund in question. It also depends on whether the platform is able to attract more investors to repay previous investors and the fees charged on each transaction. This return sometimes depends on the performance of the platform's other wealth management funds, because if a fund loses money, the platform might pay the promised return using money from other funds. Managers of mutual funds in the U.S. are not allowed to do this, due to conflicts of interest.[333]

As for the differences between WMPs and money market funds, the latter usually invest in low-risk products, while wealth management funds usually invest in high-risk loans.

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[333] Investment Company Act of 1940.

Although there are many differences between the two kinds of funds, these are much less significant than the similarities. In the larger picture, wealth management funds look very similar to mutual funds. Therefore, it is reasonable to recommend that for P2P platforms, China adopt some of the principles that guide mutual fund regulation, in order to avoid the risks that both face.

B. Can Mutual Fund Regulation Help to Reduce the Risks that Chinese Wealth Management Funds Impose on Investors and on the Financial Market?

In order to solve manager and sponsor abuse in the operation of mutual funds, and to protect investors, the U.S. Congress passed the Investment Company Act of 1940. There have been similar abuses in the P2P online lending industry in China. Adopting some of the principles of the mutual fund regulation would better protect investors and maintain financial stability in China.

1. The Development and Regulation of Mutual Funds in the United States and China

The United States saw the first wave of investment companies following World War I. The first open-end or mutual fund was created in Boston in 1924. The 1930s saw the heyday of the mutual fund, but its rapid growth came at the expense of the investing public. Before 1940, the regulation of this sector was minimal at best; investors had little control over investment companies. This allowed managers and sponsors to abuse their power to further their own business interests.[334] Managers often took advantage of investors, whose knowledge of the field was unsophisticated. Some investment companies gave inadequate or deceptive reports containing misleading accounts of profits or of the company's performance.[335] Also, as managers were almost completely free to make decisions regarding portfolio investing; they could change their investment policies without the knowledge or consent of the investors.[336] Further, the high liquidity of investment companies' assets frequently encouraged management fraud, larceny, and embezzlement.[337] With this background, many funds failed, and many small, unsophisticated investors lost their investments. Investment company shareholders lost 40% of their investments between 1929 and 1936, based on the SEC's estimation.[338]

In response to the broad array of abuses in the unregulated investment industry, Congress passed the Investment Company Act of 1940 and the Investment Advisers Act of 1940. Recognizing the unique character of investment companies and Congress enacted

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[334] SEC, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 428-29 (MAY 1992); MICHAEL S. BARR, HOWELL E. JACKSON, MARGARET E. TAHYAR, FINANCIAL REGULATION: LAW AND POLICY 950-52(2016).
[335] *Id*, at 952 (2016).
[336] *Id.*
[337] *Id*, at 953.
[338] Paul Roye, Speech by SEC Staff: A Celebration of the 60th Anniversary of the Investment Company Act, sec.gov (Jul.17, 2017, 07:29PM), https://www.sec.gov/news/speech/spch405.htm.

these laws to protect small investors in mutual funds against abuses by the funds' advisers.[339] The Acts provided substantive protections beyond the basic requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934.

Unlike in the United States, the Chinese government itself, rather than the financial market, developed the first Chinese securities investment funds. China established its first investment fund — a closed-end fund – in 1991, and within two years, had established more than 60 such funds. The government introduced and vigorously promoted these funds in order to help state-owned enterprises (SOEs) to raise money from the general public.[340] Many local governments also used this type of vehicle to finance themselves. During its early development stage, China's central bank — People's Bank of China – was in charge of the regulation of securities investment funds. Due to lack of appropriate regulation, this sector developed wildly and the central bank issued several Notices to regulate it, but the point of most of these Notices was to restrict and control the development of the funds, rather than to protect investors. In 1997, the Securities Management Committee of the State Council issued the "Interim Measures for the Administration of Securities Investment Funds." This was still early in the development of

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339 Investment Company Act of 1940.

340 A Comparative Study of Securities Investment Funds between China and the United States, Shanghai Social Science Institute Doctoral Dissertation, 46-7(2006).

the fund industry, and investors had not encountered the many fund manager abuses. The "Interim Measures" aimed to regulate securities and investment funds and protect the parties to the funds. It also established some basic rules, including requiring diversified investment, information disclosure, and separation between the fund and the managers' and sponsors' accounts. However, a more important goal was to develop this industry in ways that ensured a healthy and stable development of the securities market.

Only after China's Securities Regulatory Commission issued the "Measures on Piloting Open-end Securities Investment Fund" in 2001, did the open-end funds start to develop. Until this point, the government had created the market for securities investment funds; it was not an industry that developed naturally. Correlatively, it did not intend the relevant regulation to respond to the problems of its industry but more to implement the government's policy.

In 2003, as the industry started to grow on its own, the government issued the "Securities Investment Fund Law," which it amended in 2015. This Law aims to protect investors and to promote the healthy development of the securities fund market.[341] While it adopts many of the general principles of American mutual fund regulation, it does not specifically mention the protection of small investors. But the assumption that investors

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[341] Securities Investment Fund Law of China, art. 1.

are small and unsophisticated, and thus need special protection, rests behind many of its rules.

The Chinese mutual fund industry has developed rapidly over the past two decades. Its total assets grew from around 34.8 billion USD by the end of 2004 to 1.66 trillion USD by the end of 2017.[342] However, the industry is still far from reaching its long-term potential. That 1.66 trillion USD equals only 6.9% of China's 24.18 trillion of financial assets, meaning that the bulk of the country's money is held in deposits, rather than in mutual funds.[343] In comparison, by the end of 2017, the amount invested in mutual funds in the United States was 22 trillion USD.[344] The Chinese market only accounted for 7.5% of the U.S. market.[345] In 2018, households in the U.S. invested an average of 21% of their assets in mutual funds,[346] while Chinese households only invested 2.7%.[347] According to the 2012 China Household Finance Survey, only 4.22% of households participated in the fund market,[348] while the number has been around 44% over the past

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342 Data from Asset Management Association of China, http://www.amac.org.cn/researchstatistics/report/gmjjhybg/.
343 *Id.*
344 Data from Statista, Mutual funds – Statistics & Facts, *See* https://www.statista.com/topics/1441/mutual-funds/.
345 INVESTMENT COMPANY INSTITUTE, 2017 INVESTMENT COMPANY FACT BOOK (2017).
346 Statista, *supra* note 344.
347 Analysis & Weipin Finance, 2018 China Household Financial Market Analysis Report, cioall.com (Feb.22, 2019, 3:33PM), http://www.cioall.com/uploads/f20181121104620769 37.pdf.
348 LI GAN, ZHI CHAO, YIN NAN, JIA SHU, XU SHUANG, MA LU ZHENG, DATA YOU NEED TO KNOW ABOUT CHINA: RESEARCH REPORT OF CHINA HOUSEHOLD FINANCE SURVEY 2012, 99-100 (2014).

decade in the U.S.[349] Thus, the mutual fund industry is still small compared to the U.S. market, especially if we consider the extremely large number of potential investors in China.

There are many reasons for the limited development of the Chinese market. First, investors are not as attracted to the investment returns that the market offers. For the past two decades, China's securities investment funds have invested primarily in securities or money market funds. As China's securities market has not been stable, Chinese retail investors have lost confidence in it, especially after the 2015 stock market crash.[350] This in turn decreases the attractiveness of securities investment funds. For money market funds, the annual rate of return is between 2% and 3%,[351] which is close to the interest rate that banks offer (currently the annual rate in several big Chinese banks is 1.75%),[352] and much lower than the amount that typical P2P lenders offer. P2P interest rates have declined dramatically from their heyday (the highest average rate was 20% in 2011); in 2017, the

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349 M.Szmigiera, Share of Households Owning Mutual Funds in the United States from 1980 to 2018, Data from Statista, *available at* https://www.statista.com/statistics/246224/mutual-funds-owned-by-american-households/.

350 Shares Have Plunged 30% in Three Weeks and Hundreds of Firms Have Suspended Dealings in mid-2015, *See* Katie Allen, Why is China's Stock Market in Crisis? Guardian (Jul.8, 2016, 08:28PM), https://www.theguardian.com/business/2015/jul/08/china-stock-market-crisis-explained.

351 For example, Tianhong Asset Management Co., Ltd., China's largest money market fund, accounting for 1/7 of China's money in money market funds, offered an average annual interest rate of 2.33% in 2019. Data from fund.eastmoney.com, Eastmoney Net (Feb.22, 2020, 02:12PM), *see* http://fund.eastmoney.com/000198.html.

352 What are the Interest Rates in Big Banks in 2018? JRJ Net (Feb.22, 2018, 06:34PM), http://bank.jrj.com.cn/2017/12/05075123740487.shtml.

average rate of return was 9.64%.[353] But today many P2P lenders can still offer a 5% annual interest rate for a one-month investment.

Second, many ordinary people are not familiar with this type of investment vehicle and thus are hesitant to invest in it.[354] Third, securities investment funds charge a high fee (today, the top ten most popular funds ask an average of 3.5%), while across U.S. funds in 2018, the asset-weighted expense ratio was only 0.48%.[355]

The limited development of the mutual fund market partially explains the popularity of the P2P and other non-bank lending market. On the surface, P2P lenders have the ability to get investors higher returns than those possible through mutual funds. But in a deeper sense, their WMPs meet a useful need as financial intermediaries. This is because these P2Ps or non-bank lenders fill a vacuum in a financial system that previously lacked an intermediary specializing exclusively in short-term loans. In other words, P2P lenders offer investors the advantages that result from the pooling of large numbers of short-term loans.

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[353] LINGYI FINANCE, *supra* note 84, at 42.

[354] LINGYI FINANCE, CHINA P2P LENDING SERVICE INDUSTRY DEVELOPMENT REPORT 52, (2019).

[355] Fund-Fee Study: Three Things to Know About What's Driving Fund Fees Down, Morningstar (May.1, 2019, 11:56AM), https://www.morningstar.com/insights/2019/04/30/us-fund-fee-study.

2. The Risks that Wealth Management Funds Impose

Like the managers who operated mutual funds before the U.S. Congress passed the Investment Company Act, Chinese P2P lenders also abused their power. Many platforms provided deceptive or misleading information to investors. A very obvious example is that even today, after the government has imposed strict information disclosure requirements, the vast majority of the 100 platforms that I reviewed, reported that their borrower default rate is close to zero. Only a few of them reported a 1% default rate. This is too good to be true. Many platforms also changed their investment policies without their investors' knowledge or consent. Some raised money for projects that turned out to be making up loss due to borrower default, or provided guarantees for their affiliates.[356] Among the 3,234 platforms that had failed by the end of 2016, 7% turned out to have defrauded their investors. Because nothing prevents owners and managers of P2P lenders from mixing funds' assets with their own, management embezzlement also exists. Sometimes owners run away with investors' money; of the 3,234 platforms that existed in 2016, 34% closed their websites and disappeared with investors' money, and 15% of the platform bosses maliciously ran away with the money that they had raised.[357]

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[356] LINGYI *supra* note 84, at 54.
[357] LINGYI *supra* note 98, 65.

Another challenge of this business model is that it motivates P2P lenders to originate as many loans as possible, because they profit the moment the underlying loans are serviced. But they do not share the risks of borrower default with investors. As a result, these lenders have no reason not to take risky loans or to screen borrowers carefully. Fund investors have no control over the operation of their funds; they are unable to prevent managers from making risky investments or to monitor a fund's daily performance. The current mandatory disclosure laws are helpful but cannot completely solve the problem.

3. How Can Mutual Fund Regulation Help to Reduce the Risks that Chinese Wealth Management Funds Impose?

The law should impose special disclosure requirements on P2P lenders, looking, in particular for information about fees and past performance. The regulations should not allow wealth management funds to make loans to certain types of borrowers, and should limit the loans to any one borrower to a certain amount or a certain term. The relevant regulations should require wealth management funds to maintain strict custody of fund assets and set up an independent board of directors. It also should allow investors to trade their products freely, at least on the platform in which they have invested. It would also be useful for the law to require daily valuations of the wealth management fund's assets.

First, China can apply some of the special disclosure requirements in mutual fund regulation to P2P lenders. In the U.S., the Securities Act of 1933 and the Securities Exchange Act of 1934 lay out the basic registering and reporting requirements for mutual fund disclosure. But the SEC now requires different and enhanced disclosure of mutual funds. The two most important categories of information that they need to disclose are performance, and fees and expenses. For example, the prospectus that a fund publishes for investors must include a chart or table disclosing the risk/return of the fund over different time periods, and a standard fee table that demonstrates the fees charged for a $10,000 investment over one, three, five and ten years.[358]

The Chinese government has imposed mandatory disclosure on the P2P industry in order to protect investors, and the platforms have gradually complied with this requirement. As I suggest in the securities regulation approach section, China ought to expand the scope of securities to include the fundraising activities of P2P lenders, and should apply the disclosure requirements of securities regulation to P2P lenders. But P2P lenders are more similar to investment companies than they are to ordinary public corporations, and thus the special disclosure requirements for mutual funds should apply

[358] Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Final Rule 74 Fed. Reg. 4546 (Jan. 26, 2009).

to P2P lenders. At the least, China should require P2P lenders to disclose past performance and fees and expenses.

Second, the government should impose strict rules on how wealth management funds make investments, in order to limit risk. For example, U.S. law requires mutual funds to be diversified[359] and prohibits certain risky investments, such as buying securities on the margin and investing in other financial services firms.[360] Similar requirements regarding money market funds in the SEC's Rule 2a-7 provide more direct and useful tools by which China can regulate WMPs. Rule 2a-7 limits a money market fund's average dollar-weighted portfolio maturity to 60 days. China imposes a similar rule on money market funds, but with an average portfolio maturity requirement of 120 days.[361] Short-term maturities allow a fund more flexibility, allowing it to adjust quickly. They also limit volatility, making returns more predictable. Short maturity requirements are also helpful in reducing investment risks, which means that investors in the P2P industry can maintain a more stable return. This is because the loans made by borrowers on P2P lending platforms tend to be riskier. The longer a fund invests in such borrower, the riskier that investment becomes. A short maturity requirement can make sure that a fund can

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359 *See* Subchapter M of the Internal Revenue Code.
360 Investment Company Act of 1940, 15 U.S.C. §§ 80a-12(a).
361 Measures for the Supervision and Administration of Money Market Funds, art. 9 (2016).

change its investment policies quickly if one of its borrowers defaults. Rule 2a-7 and China also have similar liquidity requirements for money market funds.[362] While neither considers loans to be liquid assets, China should follow the SEC's example and mandate that P2P lenders hold at least certain percentage of their assets in cash. This would make the requirement of short maturity even more important as a way to reduce the risks that P2P lenders make on the investments.

Both American and Chinese law require a fund to restrict its underlying holdings to investments that have strong credit ratings.[363] Although China does not offer credit rating for loans, the law could prohibit wealth management funds from making high-risk loans and could ensure that the loans they make to any one borrower do not exceed a certain amount or a certain percentage of the fund.

Third, like mutual fund regulation in both the U.S.[364] and China,[365] the relevant laws should require wealth management funds to maintain strict custody of fund assets and should impose more rigorous remedies or penalties on those that fail to do so. This would prevent managers from mixing their own assets with those of the funds, making it much more difficult for fund managers to embezzlement a fund asset. It would also reduce

[362] *Id*, art. 7 (2016).
[363] *Id*, art. 30 (2016).
[364] Investment Company Act of 1940, 15 U.S.C. §§ 80a–17(f).
[365] Securities Investment Fund Law of China, art.5, art 33-44.

the likelihood of managers running away with those assets. Current regulation already imposes this requirement on P2P online lending platforms, compelling them to separate their own funds from the wealth management funds and to select a qualified bank as the custodian of the funds.[366] In 2017, China's Banking Regulatory Commission issued the "Online Lending Fund Custody Business Guidelines," which gave P2P lenders instructions on how to comply with this requirement.

Despite the detailed instructions about fulfilling this requirement, and strict government enforcement, investors have few remedies when platforms fail to comply with the Guidelines. Further, while the law requires platforms that don't have a custodian to meet the custodian requirement and put one in place,[367] current regulation does not cover what should happen when the custodial institution fails to perform its obligations. Mutual fund regulation imposes more detailed penalties, including fining the fund, warning person in charge, and suspending or revoking the fund's business qualifications.[368] If a fund's management or custodian fails to perform its obligations or causes damage to the fund's assets, it faces the penalties of a correction order and fines, and anyone directly

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[366] Online Lending Fund Custody Business Guidelines, art. 28 (2017).
[367] *Id.* art. 27.
[368] Securities Investment Fund Law of China, art. 124.

responsible or liable faces the penalties of being warned, having the fund's business qualifications suspended or revoked, and being fined.[369]

Additionally, both U.S. and Chinese regulations prohibit anyone from stealing and embezzling fund assets.[370] Chinese law requires that any money that the fund's managers or its custodian steals or embezzles be incorporated into the fund's assets, and anyone involved faces fines.[371] U.S. law imposes both fines and criminal charges. A court can fine anyone convicted up to $10,000 or imprison him for as many as five years, or both.[372] Chinese criminal law imposes similar regulations. As management embezzlement and bosses running away with the raised money are relatively prevalent on P2P lending platforms, it would improve the deterrence effect if China could enforce this type of regulation more effectively.

Fourth, U.S. law requires management investment companies to set up a board of directors (or trustees), at least 40% of whom must not be persons interested in the company.[373] This independent board plays the role of overseeing the funds' operations and protecting the interests of the shareholders. This is important since even rational investors

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369 *Id*. art 123, 146.

370 Investment Company Act of 1940, 15 U.S.C. §§ 80a- 36. Securities Investment Fund Law of China, art. 124, 140.

371 Securities Investment Fund Law of China, art. 124, 140.

372 Investment Company Act of 1940, 15 U.S.C. §§ 80a-36, 49.

373 Investment Company Act of 1940, 15 U.S.C. §§ 80a-2(a) (19).

can be tricked. Despite knowing that many online lending platforms have disappeared without notice, Chinese investors are still pouring their money into P2P online lending platforms. Although this phenomenon seems strange, it is a familiar problem even with rational investors and that has happened in the United States, where there are much better protections for investors. The market and the investor protection rules that I described above can only partially solve the problem. Having this board of directors and eventually developing the securities market would go a long way toward solving this problem.

Chinese law also requires securities investment funds to have a board of directors but does not specify the number of independent directors or emphasize the importance of the board's independence.[374] But a board of directors with certain number of disinterested members can serve as a more reliable "watchdog." It can monitor whether the P2P lenders and their managers are acting against the interests of investors and thus would be an effective way to protect these investors.

Two other rules — redemption and daily net asset value (NAV) calculation – are also important ways to protect investors in mutual fund regulation. The redemption rights give investors the option to exit from the fund, especially when they find that the fund is not operating as they expected. However, this rule is difficult to apply here because there

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[374] Securities Investment Fund Law of China.

is a liquidity mismatch between P2P loans and redeemable wealth management fund shares. The daily NAV calculation rule would ensure that a fund informs its investors of the actual valuation of its portfolios and thus would also help to promote market confidence. However, an accurate evaluation of a fund that invests in consumer or small business loans is difficult to achieve.

C. Summary

Currently, the legality of wealth management funds is a grey area in Chinese law. The Chinese government has been forcing P2P lenders to adopt the information intermediary model or to convert to micro-loan companies. But, as I argued in Chapter I, allowing P2P lenders (or any other type of non-bank lenders) to play a financial intermediary role would have more benefits than costs. Specifically, as financial intermediaries, P2P or other non-bank lenders, would fill a useful role by focusing on short-term loans and providing retail investors with the advantages that result from the pooling of large numbers of short-term loans. The mutual fund model is a good model for the Chinese government to consider as it evaluates the regulation of P2P online platforms, particularly because China already has a developed regulatory system in this sector.

The Chinese government should consider converting P2P lenders into investment companies while combining the securities, capital requirement, and mutual fund regulations. These would help to reduce wealth management fund scandals. There are some additional reforms, i.e., the credit reporting system and the insurance deposit measure, that are also worth considering.

This dissertation does not discuss much about enforcement of these new rules. But it is important to note that although public enforcement still plays an important role, these new rules would open up private enforcement, as they would give investors more causes of actions under which to sue P2P lenders.

We should also consider which regulator would best enforce these rules. Currently, the Securities Regulatory Commission is responsible for mutual fund regulations in China, but it is the Banking and Insurance Regulatory Commission that regulates P2P online platforms. As most of my suggestions have focused on securities regulation — whether for ordinary public corporations or for investment companies – it would be better for the China Securities Regulatory Commission (CSRC) to regulate P2Ps and other non-bank lenders that raise funds from the general public through the sale of WMPs. CSRC specializes in securities regulation. It could consider setting up a special department to regulate non-bank lenders.

Conclusion

The Chinese P2P lending market has developed as the largest in the world. P2P online lending platforms not only provide an alternative source of funding for private enterprises, especially SMEs, but also bring investors more diversified investment opportunities.

Most P2P platforms operate as financial intermediaries that pool money from the public and then lend the pooled money to individuals and small businesses. However, the Chinese government views the financial intermediary model as imposing too many risks on the country's financial and social stability and has therefore prohibited this model. Since 2015, the government has required P2P platforms to function under the information intermediary model, as it believes that this brings lower risks of failure and collapse.

This dissertation argues that the financial intermediary model brings more benefits than costs to the Chinese financial market, because it provides investment diversification and reduces investors' screening and monitoring costs. As P2P lenders adopt the financial intermediary model, which I believe is inevitable, making this model legal would open the door for China's transition from financial repression to financial liberalization.

China intends its regulatory regime to encourage the development of the online lending industry, in the aim of providing an alternative source of funding for SMEs, while at the same time protecting investors from predatory and fraudulent activities. This dissertation argues that the Chinese government should allow P2P lenders to play a financial intermediary role in this picture. As financial intermediaries, P2P or other non-bank lenders, would fill an important need by focusing on short-term loans and providing retail investors with the advantages that result from the pooling of large numbers of short-term loans. The mutual fund model is a good model for the Chinese government to consider as it evaluates the regulation of P2P online platforms, particularly because the government already has a well-developed regulatory system in this sector.

After legalizing P2P lenders' financial intermediary role, the government should regulate these lenders rather than turn a blind eye to them. Through regulation, the government could mitigate the risks about which it is concerned. The State Council should consider expanding the scope of securities and including the WMPs as securities. Securities regulation with information disclosure and anti-fraud rules could protect investors from being misled and defrauded. Capital requirements could prevent intermediaries from making risky investment decisions and would ensure that they absorb operating losses due to borrower default. Mutual fund regulation can keep investors informed and prevent platforms from making risky investments. In addition to these major reforms, there are some additional modifications that are worth considering, including the improvement of the credit reporting system and the insurance deposit support.

Although this dissertation does not discuss enforcement procedures, it noted that enforcement is important to make sure that the suggestions will work in practice. While public enforcement would play an important role, the private actions that investors themselves initiate will increase the chances of these rules being enforced. This will be the future research for this project.

Additionally, as financial intermediaries, P2P lenders can provide SMEs with critical funding. However, as SMEs are inherently risky, P2P lenders are not able to meet all of their funding needs if they want to be sustainable. Therefore, although this dissertation focuses on P2P lenders, the author recognizes that in order to solve the funding needs of SMEs, the Chinese government needs to legalize not only P2P lenders, but also other types of non-bank lenders that play a financial intermediary role. Thus, this dissertation hopes to use P2P lenders as an example of the way that the Chinese government can legalize all types of non-bank lenders with financial intermediary roles, while implementing a broadened and more effective regulatory system to retain control over the financial market and prevent socially devastating collapses.