

## Safeguard by Rule of Law for the Fiduciary Construction of Chinese Capital Market

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Received 31 August 2012; accepted 5 December 2012

### Abstract

Fiduciary construction in the capital market requires the safeguard by rule of law, i.e., legislation and enforcement of fiduciary law as well as construction of fiduciary morality and cultural system. As a separate legal category, fiduciary law provides for fiduciary duties and liabilities for entities and individuals in both private and public power sectors and imposes proper penalties on those fiduciaries for their failure in fiduciary duties through a set of consistent legal systems and rules. Legislation in fiduciary law should be based on the *Securities Law*, clarify the fiduciary duties and liabilities of fiduciaries and focus on the arrangement of legislation and enforcement as a whole.

**Key words:** Fiduciary construction; Fiduciary law; Fiduciary duties; Legal liabilities

JIANG Furong, Tony Zhang Lu (2012). Safeguard by Rule of Law for the Fiduciary Construction of Chinese Capital Market. *Canadian Social Science*, 8(6), 141-146. Available from: <http://www.cscanada.net/index.php/css/article/view/j.css.1923669720120806.8219>  
DOI: <http://dx.doi.org/10.3968/j.css.1923669720120806.8219>.

The Constitution is a fiduciary law of public power, just as fiduciary law is the constitution of private power (Tamar Frankel, 2011). Fiduciary principle is always recognized as the basis of conduct, the paramount rule of social interaction and the common value of culture, morality and law. Fiduciary construction of capital market is a systematic project, led by culture, oriented by morality and based on and safeguarded by law. As far as the relationship between fiduciary culture and morality and

fiduciary law, the latter has a role in protecting, or even enhancing, a culture of trustworthiness, while the former makes the latter more effective.

In addition to enhancing the construction of fiduciary morality and culture, what is the most important in the current fiduciary construction of Chinese capital market is the fiduciary construction by rule of law. When more efforts shall be made to strengthen regulatory enforcement and crack down on illegal and irregular behaviors, a special system for fiduciary regulation and restriction shall be established to impose legal penalty and restriction on breach of fiduciary duties. To this end, the following important measures should be taken.

### 1. TAKE STEPS FOR IMPROVING LEGISLATION IN FIDUCIARY LAW

Fiduciary law herein refers to a separate legal category, which specifies the fiduciary duties and legal liabilities for entities and individuals in both private and public power sectors (collectively referred to as “fiduciaries”) and imposes proper penalties on fiduciaries for their failure in performing fiduciary duties through a set of consistent legal systems and rules. Fiduciary law aims at promoting and protecting the interest of entrustors and the society, covering entrusted property and power. It relates to not only private power sector, but also public power sector including governments. As far as governmental powers in the public power sector, the constitution and law of a country derives from fiduciary law. Fiduciary law has a critical role in restricting the temptation for fiduciaries to abuse entrusted power by providing for the duties of loyalty and care of fiduciaries, collectively, fiduciary duties.

Legislation in fiduciary law of capital market requires for sticking to the fiduciary principle in the laws on capital market, which principle should be embodied in specific rules and regulations, such as suitability rule, rule of conflicts of interest and due diligence rule. The

fiduciary principle in the fiduciary law of capital market is a professional principle, which, though closely related to, is different from the bona fide principle in the *General Principles of Civil Law* and the Contract Law of the PRC. The bona fide principle in civil law and contract law requires that one should respect and increase (or at least not damage) the interests of others and social public interests when seeking for his own interests, while the fiduciary principle in fiduciary law as a separate category has special meanings. In China, the fiduciary principle is set forth in the *Securities Law*, the *Company Law*, the *Trust Law*, the *Securities Investment Fund Law* and the *Regulations on the Administration of Futures Trading*, which is applicable to the above-mentioned fiduciaries.

The fiduciary principle is reflected in the fiduciary legislation of capital market mainly by publicity principle and measures, which requires for information disclosure in a timely, truthful, accurate and complete manner, provides for fiduciary duties of fiduciaries, including the duty of loyalty and the duty of care, and imposes penalties for breach by fiduciaries of fiduciary duties, including false statements, misleading statements or material omission in information disclosure. As the first regulation on fiduciaries in the capital market, the *Interim Measures for the Supervision and Administration of Fiduciary Conducts in the Securities and Futures Market* promulgated by China Securities Regulatory Commission (CSRC) on July 31, 2012 embodies and activates the fiduciary principle.

Legislation in fiduciary law of the capital market may be promoted by taking the opportunity of amending the *Securities Law*. In the *Securities Law*, fiduciary principle is not solely a fundamental principle, and more importantly, it constitutes a category or a set of complete duties, which is of a unique value. The fiduciary principle in the *Securities Law* has a special meaning as a separate category. More than seven years has passed since the last amendment to the *Securities Law* in 2005, the regulatory concepts and methods for the securities market in China no longer meet the needs of capital market; therefore, it is the right time to start the amendment to the *Securities Law*, whereby the fiduciary principle as well as its relevant rules should be fully considered.

Since the promulgation of the *Securities Law* in 1998, the fiduciary principle has been established as a fundamental principle. In the amendment of the *Securities Law* under discussion, such principle should be restated and its content further enriched.

There are five goals or purposes of the securities law, i.e. protecting the lawful rights and interests of investors, maintaining public interests, and promoting efficiency, competition and capital formation.<sup>1</sup> The current *Securities Law* of China has, however, not provided for promotion of efficiency, competition and capital

formation;<sup>2</sup> and consequently, there is no clear direction to the development of Chinese securities market and the guidelines of the securities market remains to be further clarified. Therefore, in its coming amendment, the *Securities Law* of China shall rationally adopt the purposes for promotion of efficiency, competition and capital formation. Restatement of the fiduciary principle in the securities law is necessary for realizing the basic purposes of the securities law.

The current *Securities Law* provides for eight basic principles, namely, publicity, fairness and equality; fiduciary principle; compliance with law; separate business and operation; centralized regulation; self-disciplinary management; and auditing supervision. In fact, there are two paramount principles in the securities law: publicity and fiduciary principles. Specifically, the principles of fairness and equality are not uniquely required by the securities law; compliance with law is the basic requirement for all social conducts; centralized regulation and auditing supervision are specific regulatory measures for the securities market; self-disciplinary management is the necessary request of the fiduciary principle; and separate business and operation has become out of mode, and a new system for mixed businesses and functional regulation shall be established on the basis of the conflicts of interest rule embodied in the fiduciary principle.

As known to all, the basic philosophy of securities law is publicity, as “Sunlight is the best disinfectant; electric light the most efficient policeman” (Louis D. Brandeis, 1932). Therefore, the publicity principle is the cornerstone of securities law. This principle is closely related to the fiduciary principle, and essentially it is the intrinsic requirement of the latter and provides specific measures and methods for implementing the latter. Since the *Securities Law* covers both private and public powers, and one of its core tasks is to regulate the entities and individuals entrusted with private and public powers, for which purpose the fiduciary principle is specifically designed. By providing for the fiduciary duties and liabilities of such fiduciaries and proper penalties on fiduciaries for their breach of fiduciary duties through a set of consistent rules and regulations, the fiduciary principle promotes the realization of the purposes of securities law. Looking back on the global securities market, one might find that nearly all financial scandals and significant frauds were related to breach by such fiduciaries of their fiduciary duties. Thus, it may be said that integrity of the capital market remains once fiduciaries (or intermediaries or gatekeepers) in it are well regulated.

The principle of “separate business operation and management” prescribed in Article 6 of the *Securities Law* should be deleted, and mixed business operation and functional regulation shall be adopted. The latest

<sup>1</sup> Section 2 (b) of the US *Securities Act of 1933*.

<sup>2</sup> Article 1 of the *Securities Law of the PRC*.

amendment of the Securities Law of China has reserved space for mixed business operation with specific provisions to come. In the current practice, mixed business operation is common in financial groups in China and the split regulation has moved to the functional and comprehensive regulation in the US. Such move aligns with the trend of expanding the categories of securities in the *Securities Law of China*. Under mixed business operation, securities firms may engage in certain businesses of commercial banks, otherwise, it is hard for them to survive. As far as mixed business operation is concerned, the basic measures for preventing and controlling conflicts of interest including firewall and the Chinese Wall will be the necessary requirement for securities firms to perform their fiduciary duties.

In the coming amendment to the *Securities Law*, the basic position and role of the fiduciary principle in the securities law shall be further clarified and highlighted, and by perfecting the publicity principle mainly reflected in the offering system, the fiduciary duties and liabilities of fiduciaries and remedies for breach of such duties shall be specified with arrangement of related systems.

For the purpose of improving fiduciary legislation of the capital market, besides the *Securities Law* consistent practices shall be adopted in the promulgation of and the amendment to laws and regulations and judicial interpretations including the *Criminal Law*, the *Securities Investment Fund Law*, the *Company Law* and the *Regulations for the Administration of Futures Trading*, the publicity and fiduciary principles shall be observed, and specific provisions on the duties of fiduciaries with public and private powers and corresponding penalties shall be made and detailed.

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## 2. SPECIFY THE FIDUCIARY DUTIES OF FIDUCIARIES

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For the fiduciary construction of capital market, the main parties are fiduciaries entrusted with public and private powers. The duties of such fiduciaries shall be prescribed in detail, that is, specific provisions on and requirements for fiduciary duties shall be clarified.

One of the features of fiduciary duties is subject specificity, that is, such duties only applies to specific subjects, namely, the above-mentioned entities and individuals entrusted with public and private powers. The entities and individuals entrusted with private power include listed companies, intermediaries (securities firms, accounting firms, law firms, fund companies, rating agencies, valuers and other financial intermediaries), partners, agents, trusts and their directors, supervisors, officers, actual shareholders, controlling shareholders and professionals as well as other similar persons participating in market activities; and the entities and individuals entrusted with public power include regulators, self-

regulatory organizations and judicial organs, collectively called “fiduciaries”. Those fiduciaries accept the entrustment of entrustors, hence establishing a specific relationship with them, in which entrustors, especially medium and small investors are in disadvantaged positions in terms of information access and professional knowledge due to information asymmetry, and thus the fiduciaries shall bear specific obligations – fiduciary duties to entrustors. Though the fiduciary principle and its related rules and regulations concerned are mainly designed to regulate the entities and individuals with private powers, they are also applicable to regulatory and judicial agencies, and hence “the CSRC shall take the lead to perform its fiduciary obligations”.

As required by the fiduciary principle, fiduciaries shall act in the best interests of entrustors and beneficiaries, and their acts shall not be affected by their own interests or the interest in conflicts with beneficiaries’ interest. Such requirement is stricter than that of the bona fide principle stipulated in the civil law and the contract law. Fiduciary duties are divided into the duty of loyalty and the duty of care, and the duty of loyalty is related to the entrusted property and power and the duty of care is related to the quality and diligence in performance of services by fiduciaries. The duty of loyalty requires fiduciaries to follow and abide by the directives of entrustment with respect to the entrusted property and power (Tamar Frankel, 2011), to act in good faith in performing fiduciary duties, not to delegate the fiduciary services to others, to account and disclose relevant information to the entrustors, to treat entrustors fairly, and not involve any conflicts of interest with entrustors. The duty of care requires fiduciaries to execute their services and execute them well. Fiduciaries shall follow the following principles: fiduciaries should possess the expertise and use the expert skills they purport to possess; fiduciaries’ performance is evaluated by the process that fiduciaries have adopted in performing their services; care may depend on the kind of “red flags” that the fiduciaries should, but failed to, notice; the duty of care may be affected by the legal risk imposed on the fiduciaries; the evaluation of the fiduciaries’ performance is affected by the reasonable expectations of the parties and the constraints on the fiduciaries; the duty of care may vary depending on different applicable laws; and courts evaluate the performance of highly expert fiduciaries with the aid of other experts in the fiduciaries’ area.

Fiduciary duties aim at reducing entrustors’ risks in two main areas. The first area relates to the risk from the fiduciaries’ misappropriation of entrusted property or power. The second area relates to entrustors’ loss from the faulty performance of the fiduciaries’ services. The third part of fiduciary duties focuses on the assumptions about entrustors’ ability to protect themselves and alternative protections that entrustors can enjoy (Tamar Frankel, 2011). Thus, entrustors and fiduciaries are involved in a

game based on trust and credit, which is determined by entrustors' risks, entrustors' ability to protect themselves and alternative protections that entrustors can enjoy.

Attentions shall be paid to the law and characters of Chinese capital market and efforts shall be made to define the fiduciary rules and specify the self-regulatory requirements for different kinds of institutions and their staff.

Take the suitability rule that embodies the fiduciary principle and fiduciary duties as example.

This rule has been practiced since 2007, which penetrates in the second board, stock index futures, margin trading, asset management, fund sale, brokerage and the bond market. The suitability rule is also considered with respect to investment advisors, "new third board" and certain innovative products. Compared with developed countries, however, such rule lacks the following elements in China: (1) Lack of an investor classification system. Therefore, whenever a new market, business or even product is launched, a new investor access rule may be required. At present, investor access requirements are in place in the second board, stock index futures, margin trading, bond market and "new third board" respectively, but there is no unified investor classification system. (2) Lack of provisions on legal hierarchy. Currently, the suitability rule remains at the level of the CSRC and exchanges, which are not a principle of legislation, hence lack of a system and corresponding provisions on legal liabilities. Finally, compared with overseas practices, the regulation on the behaviors of financial institutions has to be detailed in China.<sup>3</sup>

The suitability rule aims at preventing financial institutions from cheating investors by reason of conflicts of interest. Improper sales still occur in the US market where the suitability rule undergoes over 70-year development since with conflicts of interest, the game between sale recommendations and suitability has become an everlasting theme, like the game between insider trading and other frauds on one hand and information disclosure on the other hand.

Since the suitability rule is developed to prevent financial institutions from cheating investors, the most important function of this rule is to regulate the behaviors of financial institutions, rather than granting investor access permission. It should be noted that developed countries make more efforts to regulate the behaviors of financial institutions while imposing less restrictions on investors. For instance, as to suitability, the regulation by developed countries of financial institutions covers suitability assessment, information disclosure, suitability obligations with respect to certain products, sales requirements, compliance administration and investor remedy and compensation mechanism, but there are

less requirements on investor access, which is based on classification of investors. According to the features of different markets, investors participating in certain products and markets with high risks are required to meet or have certain conditions and qualifications, and hence the provisions on restricting market access by specific types of investors. For example, in the US, it is provided that private equity offering and transfer must comply with the qualified investor system and such equity may only be sold to qualified investors with sound financial strength able to take high risks. For another example, the EU's Markets in Financial Instruments Directive classifies investors into three types: retail clients, professional clients and Eligible Counterparties (ECPs), and gives the maximum regulatory protection to the first type, less to the second type and only light touch protection to the third one.<sup>4</sup> The classification of investors aims at protecting them.

"Legal liabilities" arising from suitability rule may be prescribed in the securities law. Among the rules of self-regulatory organizations, suitability rule is deemed as "professional and ethnic standards". Suitability is deemed as one of the "important philosophical issues" in the US federal securities law.<sup>5</sup>

As far as the provisions on fiduciary duties of fiduciaries in China are concerned, the suggestions are as follows: first of all, a uniform investor classification system and a qualified investor system shall be established. Individual investors may be classified into three categories by their incomes and trading experience, and protected according to different categories respectively. Meanwhile, a mechanism for move of investors among different categories may be adopted. Secondly, based on the original purpose of suitability, the provisions on regulation of behaviors of securities firms may be detailed, including suitability assessment, sale requirements and remedy mechanism for investors. Thirdly, the fiduciary principle shall be emphasized and relevant legal liabilities shall be stipulated in the *Securities Law*, and the securities industry associations shall adopt self-regulatory rules. Finally, exchanges and the securities industry association may assess the market risks relating to new markets and products and determine the investor categories that may be allowed to participate according to the aforesaid uniform investor classification criterion, while no longer having any access requirements respectively.

### 3. SPECIFY FIDUCIARY LIABILITIES

Where there is no penalty, there is no integrity. The fiduciary construction of the capital market calls for explicit provisions on fiduciary liabilities, stricter civil,

<sup>3</sup> On "More" and "Less" of the Suitability Rule in China, *Securities Market Herald*, April 2012.

<sup>4</sup> Id.

<sup>5</sup> Id.



criminal and administrative liabilities and effective enforcement and public confidence in judicature.

Fiduciary law shall be fully implemented and the liabilities and penalties concerned shall be provided for on the basis of the fiduciary duties of fiduciaries. A disciplinary mechanism shall be established, whereby the fiduciary duty and liabilities of intermediaries shall be prescribed in detail, efforts to punish the breach of fiduciary duties shall be intensified and the cost of breach shall be raised. For any breach that may constitute a crime, legal liabilities shall be prosecuted by judicial organs. Besides, a sound civil compensation mechanism for securities tort shall be established to increase the amount of damages and improve the distribution of civil liabilities so as to request those who breach the fiduciary duties to pay necessary economic costs.

As to the coming amendment to the *Securities Law*, firstly, corresponding liabilities and penalties shall be provided for on the basis of the fiduciary duties of fiduciaries. In particular, after the more relaxed registration system replaces the examination and approval system with respect to offering, more efforts shall be made to punish any form of breach of fiduciary duties, including false statement, misleading statement or material omission in information disclosure. Secondly, regulators may impose stricter penalties on such behaviors as inside trading<sup>6</sup>, market manipulation, frauds in ongoing information disclosure, and civil, criminal and administrative legal liabilities shall be enhanced. Thirdly, a sound civil compensation mechanism for securities tort shall be established to increase the amount of damages and improve the distribution of civil liabilities so as to request those who breach the fiduciary duties to pay necessary economic costs. Fourthly, a nation-wide fiduciary data system for the capital market shall be set up to proactively facilitate information sharing and improve information consulting service. More measures shall be taken to encourage and reward those who report irregular behaviors and give full play to the role of the market and the public in supervision; meanwhile, personal information shall be well protected. In such way, a sounder information foundation may be laid for protection of investors. Fifthly, a reward system shall be established to encourage and guide market participants to be credible, play the guidance and disciplinary function and role self-regulatory organizations, promote fiduciary examples and self-regulation in the market and the industry.

Article 69 of the current *Securities Law* has set forth the presumptive fault liability standard with securities service intermediaries and their directors and officers, aiming at intensifying efforts on prosecution for liabilities, which is a manifestation of the fiduciary principle. The

*Interim Measures for the Supervision and Administration of Fiduciary Conducts in the Securities and Futures Market* was promulgated to realize the spirits of the CPC Central Committee and the State Council of “enhancing efforts in punishment and penalty against the breach of faith”, which adopted pointed measures for imposing sanctions and restrictions on illegal behaviors in breach of fiduciary duties, from license examination procedures, restrictions on innovative business, regular inspection arrangements, administrative penalties and no market admission, hence making a good start for dealing with breach of fiduciary duties by rule of law and a helpful exploration into the reconstruction of the fiduciary principle and institutional arrangement for the coming to the *Securities Law*.

With regard to fiduciary liabilities of the entities and individuals entrusted with public power, efforts should be made to reform the administrative law enforcement regime and the working mechanism, where breach of fiduciary duties should be prosecuted. In addition, more efforts shall be made to raise public confidence in judicature, where the people-oriented principle, justice and transparency shall be put into effect in judicial practice. Especially, the fiduciary system shall be improved in judicature to enhance supervision on judicial practice, improve judicial independence and enhance the fiduciary culture construction in rule of law. At the same time, collaborative law enforcement actions with other governmental agencies shall be enhanced to improve inspection and law enforcement works in the capital market. Pursuant to fiduciary law, the fiduciary concept may be used as a critical indicator in assessment of local governments and officials and the sanctions against governments and their officials may be stricter than those applied to ordinary people.

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#### 4. ESTABLISH A SOUND FIDUCIARY DATA MANAGEMENT SYSTEM

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A uniform nation-wide fiduciary data platform is necessary for fiduciary construction of the capital market which is of a virtual character now. A sound fiduciary system covering every sector of the society shall be established and fiduciary data shall be archived to lay a solid foundation for fiduciary construction. From offering and dividend distribution to delisting, efforts shall be made to perfect the information disclosure system, stock to market-oriented reform, reduce administrative interference as much as possible and introduce market-based fiduciary data services for the public. Such platform shall incorporate the basic data on market participants and information on administrative licensing, cases and

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<sup>6</sup> Insider trading relates to information asymmetry and those who possess more information are usually a type of fiduciaries; therefore, insider trading is a kind of misconduct of fiduciaries by breach of their fiduciary duties to engage in trading with inside information.

treatment, self-regulatory management, daily monitoring focuses and fiduciary data shared among ministries and commissions. Furthermore, fiduciary data inquiry services shall be well provided and cases petitioned and reported shall be properly traced under supervision by the market and the public. Regulators shall take the lead in fiduciary construction, promote release of government affairs to the public and sunshine operation, proactively communicate with and give explanations to questions raised by the public, and improve the transparency of regulatory work.

## 5. FOCUS ON ARRANGEMENT OF LEGISLATION AND ENFORCEMENT AS A WHOLE

The fiduciary principle is the cornerstone and pre-condition for the growth of securities market and capital market as a whole, and fiduciary law is the safeguard by rule of law for the fiduciary construction of capital market. In addition to the aforesaid legislative principles and detailed rules and regulations, attentions shall be paid to the overall arrangement and effects between the fiduciary construction of capital market and the coming amendment to the *Securities Law*.

Firstly, legislation shall be considered from an overall perspective. In other words, the concept should be changed from the traditionally single legislation to a comprehensive one. With shift from split regulation to comprehensive and functional regulation, especially with the enhancement of financial innovation, the regulation and institutions concerned shall also be improved accordingly.

Secondly, attention shall be paid to the coordination of legislation as a whole since the overall legislation is a system. In the context of multiple and departmental legislations, the purposes of regulations may conflict with each other in many aspects, which is unfavorable to the development of the capital market as a whole. Thus, lawmakers need to adjust the relationship between securities law and company law, fund law, futures law, related judicial interpretations of the Supreme Court and the regulations of the CSRC, propose corresponding amendments to corresponding provisions in criminal law, procedural law, banking law and insurance law, and adopt

explicit provisions in securities law to properly reduce the arrangement of power-conferring norms and rules. Practically, the legislative purpose, principles, information disclosure system, suitability rule,<sup>7</sup> conflicts of interest rule and insider trading rule, antifraud system and investor protection system of the *Securities Law* as the representative of fiduciary law may be adopted by other laws and regulations under fiduciary law including the *Securities Investment Fund Law* and the *Regulations for the Administration of Futures Trading*, by the provisions on legal liabilities under criminal law regarding the fiduciary duties of officers of companies and insider trading<sup>8</sup> and by the relevant judicial interpretations, and the current banking law, insurance law and trust law may be amended accordingly, so as to lay a foundation for the uniform and comprehensive supervision and enforcement of the capital market. In fact, such coordination shall be achieved not only in financial or securities regulation, but also between the overall regulation and the practice of macro adjustment and control. It is necessary for administrative departments to effect institutional coordination and cooperation; otherwise, the market may not be able to sustain the “extreme burden” of “so many inconsistent policies from so many departments”.

Thirdly, the effectiveness of the overall legislation shall be emphasized. The competent authorities shall strengthen the prosecution for legal liability and penalties, properly combine the liabilities for compensation and penalties and coordinate different prosecution and remedial mechanisms. While advancing the reform on the offering approval system of the CSRC and delegating the relevant examination and approval power, on-going efforts should be made to strengthen the law enforcement authority of securities regulators and highlight the cooperation between the CSRC and courts, procuratorates and public security organs, hence leaving a room for the uniform regulation and law enforcement of capital market.

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<sup>7</sup> See the aforesaid discussions on the suitability rule.

<sup>8</sup> Amendments 6 and 7 to the Criminal Law of the PRC.