

Investment Advisers' Role in Private Equity Investment Trusts

By Tomy Xia and Kelly Xi

Due to systems and mechanisms, it is difficult for trust companies to independently carry on private equity (PE) investments. Therefore, investment advisers have been introduced to PE investment trust products (PE assembled funds trust plans).

Legal status of investment advisers

Article 400 of the *PRC Contract Law* provides that, with the consent of the principal, the agent can sub-delegate. Once consent to the sub-delegation has been obtained, the principal can direct the sub-delegated third party to handle the delegated affairs, with the agent only liable for its choice of third party and any instructions it gives to the third party.

According to Article 30(1) of the *PRC Trust Law*, where there are stipulations in the trust documents the trustee can entrust an investment consultant to handle some trust affairs, including making investment decisions. However, Article 30(2) of the *Trust Law* further provides that if a trustee legally entrusts a third party to handle trust affairs on its behalf, it shall be liable for such third party's handling of trust affairs. As such, it appears that there exist some differences between "trust affairs entrusted to a third party to handle on the trustee's behalf" specified in the *Trust Law* and "sub-delegation" relationship under the *Contract Law*. The reasons are as follows.

Pursuant to the aforesaid provisions, if a trustee entrusts an investment consultant to handle some trust affairs that trustee is still liable for the following: the investment consultant's handling of trust affairs as well as the selection and appointment of the investment consultant (like the "sub-delegation" relationship set forth in the *Contract Law*).

In other words, even for the trust affairs entrusted to an investment consultant by a trustee, the trustee shall be still liable for the trust affairs as if it handled the same by itself. This is a little different from the

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“sub-delegation” in civil law. In fact, considering that there is room for the PRC trust system to improve, in order to protect the interests of the principals and the beneficiaries, and to protect the safety of trust assets, the legislation adopts stricter provisions when enacting the Trust Law compared with the “sub-delegation” under the Contract Law.

It appears that in certain cases where the trustee entrusts an investment consultant to handle trust affairs under the Trust Law, this is not completely equal to the “sub-delegation” relationship under the Contract Law. The investment consultant only enters into an investment consultation contract with the trustee, and only assumes the rights and obligations under the investment consultation contract. But for the principal, the investment consultant is, in fact, the trustee's assistant when the trustee performs its obligations.

Authority of investment advisers

On 25 June 2008, the China Banking Regulatory Commission promulgated the *Operational Guidelines on Private Equity Investment Trusts of Trust Companies* (Yin Jian Fa (2008) No. 45) in which the authority of an investment consultant is specified. Article 21 of the Guidelines provides that after the establishment of a PE investment trust plan, the trust company itself shall handle the trust affairs and independently make investment decisions and carry out risk control.

If there are prior agreements in the trust documents, the trust company can engage a third party to provide investment consulting services, provided that the investment consultant shall not implement the investment decisions on behalf of the trust company. Pursuant to the aforesaid provision, if there are prior agreements in the PE trust documents, the investment consultant can provide investment consulting services for the trustee. But this is provided that the investment decision is made by the trustee in their own name.

Liabilities of investment advisers

First of all, pursuant to the investment consulting agreement between an investment consultant and the trustee, the former shall assume the obligations under the agreement and be liable for breach of contract.

In respect of legal relation of trust, the parties concerned are the principal and the trustee and it is the latter that shall be directly liable for trust assets without any exception – even when the trustee engages an investment consultant to make investment decisions. In case any loss is caused to the trust assets due to the investment consultant's default, at the level of legal relation of trust the trustee shall compensate the principal for the loss caused to the trust assets.

After making compensation, the trustee can recover from the investment consultant pursuant to the investment consulting agreement. In practice, in case the trust assets suffer losses from the investment consultant's default, the trustee can claim compensation from the investment consultant at first. If the investment consultant fails to timely assume the liabilities, the trustee will still be liable for the conduct of the investment consultant: the trustee shall be liable to make compensation for the losses suffered by the trust assets.

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