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# THE IDENTIFICATION AND GOVERNANCE OF ILLEGAL FUNDRAISING CRIMES IN CHINESE INTERNET FINANCE

**Abstract**

P2P network lending, equity crowdfunding, entrusted wealth management, and private equity funds are essential industries in the field of Internet finance in China at present. However, some variants of these industries in practice, such as the direct or indirect collection of funds, illegal absorption of public deposits, fraudulent fund-raising, severely damages the legitimate rights and the interests of investors, endanger financial security and social stability, and they are also suspected of illegal fund-raising crimes. For judicial practice, P2P online lending and Internet entrusted financing are the areas where illegal fund-raising crimes happen most frequently. 2/3 illegal fund-raising crimes happened in recent years are relevant to P2P online lending and Internet entrusted financing. Illegal fund-raising crimes related to P2P online loans have the following traits: self-financing, "shadow banks," self-insurance and credit enhancement, the establishment of capital pools, and pseudo-platform operations. The crime of illegal fund-raising in equity crowdfunding is mainly manifested in the collection of funds, financing for unspecified investors, and the problem of inducement. The crime of illegal fund-raising in entrusted wealth management is mainly to publicize financial information, explicit or implicit guarantee commitments, sales of wealth management products for unqualified investors, and to borrow legal forms for fund collection. The crime of illegal fund-raising in private equity funds is mainly not in conformity with the management regulations of private equity funds, to introduce unqualified investors, to implement a guaranteed return of principal and interest, and to break through the system of qualified investors, and so on. To promote the criminal governance of illegal fund-raising crimes in the Internet finance field, the judiciary should adjust the current single loose criminal policy into the one that combines leniency with rigidity, perfect the criminal law system of illegal fund-raising behaviors in the field of Internet finance, strengthen the connection between punishment and execution, explore specialized case-handling mechanism, and implement a case guidance system.

**Keywords:** Internet finance, the crime of illegal fund-raising, criminal governance

## 1. Introduction

In recent years, Internet technology and information and communication technology have made breakthroughs to promote the rapid integration of Internet and finance. The essence of Internet finance is finance. Therefore, the essential attribute of financial management risk does not change, however, because of the virtual and cross-regional nature of the Internet, Internet finance magnifies the concealment, contagion, universality, and immediate risk of traditional finance. Meanwhile, due to the outbreak of Internet finance in China in a short period of time, the initial development of the industry endures the barbarous growth period, which is characterized by the lack of threshold, rules and supervision. Much hypocritical innovation implements illegal crimes by using the name of Internet finance.

P2P network lending, equity crowdfunding, entrusted wealth management, and private equity funds are essential forms in the field of Internet finance in China at present. They play dominant roles in promoting small and medium-sized enterprises and serving the real economy, which have been encouraged and valued by national policies. However, the innovation of Internet finance co-exists with risks and opportunities. P2P network lending, equity crowdfunding, entrusted wealth management, and private equity funds alienated in practice. The direct or indirect collection of funds, illegal absorption of public deposits, and running away with money, severely damages the legitimate rights and the interests of investors, and endangers financial security and social stability. The above negative influences cast a shadow over the healthy development of Internet finance. Its financial risks are far more challenging to control than the traditional one. For instance, according to the data published by China Banking and Insurance Regulatory Commission, the number of illegal fund-raising crimes happened all over the country is 5693, up 12.7 percent over last year and the total number of money involved in the cases is 354.2 billion yuan, up 97.2 percent over last year. Among them, cases happened in 2018 in Internet finance area are up to 30%. The amount of money and people are up to 69% and 86% respectively. It is true that in the context of deeply integrating Internet and finance and the rise of “Internet plus” as a national strategy, we should encourage the Internet finance to innovate. However, the alienation formats of Internet finance, especially these who are out of compliance, break the law, or deviate from the typical shape, are possibly suspected of the illegal fund-raising crime. It is not only the practical need to protect legitimate rights, the interests of investors, and curb the illegal fund-raising in Internet finance, but also a dominant guarantee to promote Internet finance. We need accurate judgment, recognition and criminal regulation to achieve the above goals. At present, the theory field mainly focus on the legal application, judicial determination, property disposal, and prevention strategies of traditional

illegal fund-raising, especially for some economic crimes related to the public. Little attention has been paid to the identification and criminal regulation of illegal fund-raising crimes in Internet finance, especially the equity crowdfunding, entrusted wealth management, and private equity funds. Therefore, in order to deepen the theoretical research on the crime of illegal fund-raising in Internet finance, and to promote effective governance of illegal fund-raising disorder, this paper attempts to discuss the crime of illegal fund-raising which breeds from some Internet finance industries, such as P2P online lending, equity crowdfunding, entrusted wealth management and private equity funds.

## 2. The Model of P2P Network Lending

### 2.1. The concept and criminal risk of P2P network lending

P2P network lending (peer-to-peer lending) refers to a direct debit between individuals through the Internet platform (Liu and Chen, 2017). The borrower may not provide loan collaterals. As long as borrowers pass the review of platform, borrowers can then issue the loan information, including the amount, interest, repayment method, and time, to accomplish the self-service loan. According to the information above, the lender can decide the amount he needs to loan on his own. The lending platform is a kind of information intermediary stage, which is responsible to investigate the economic power of borrowers and the authenticity of loan information. The platform can also charge account management fee and service fee.

According to the relevant regulations of the ’Guiding Opinions on Promoting the Healthy Development of Internet Finance’ and ’Interim Measures on the Management of Business Activities of Internet Lending Information Intermediaries’ issued by the CBRC and other ministries, P2P online lending is a legitimate business model. Its platforms are also positioned as information intermediaries. The platforms can provide loan matching services, but cannot offer self-financing, form capital pool, provide personal credit enhancement service, deadline mismatch, or offline promotions. Otherwise, it would be illegal. The illegal lending behavior violate financial laws, even reach the bottom line of criminal law, and is suspected of illegal fund-raising crimes (mainly the crime of illegally absorbing public deposits), which should be subject to criminal penalties.

The behavior patterns and types of illegally raising funds by using P2P are various, thereby their alleged charges are different. Some scholars believe that, from a theoretical perspective, the alienation of P2P platforms may be on charges of arbitrarily setting up financial institutions, illegally absorbing public deposits, fundraising fraud, high-profit loans, illegal business operations, or false advertising (Li, 2015). Such conclusion is the result of analyzing from an

ought perspective. However, seeing this issue from the practical status, the main relevant crimes are illegal absorption of public deposits and fraudulent fund-raising. Besides, the content of related judicial interpretations published by the supreme court also aims at the above two types of crimes.

The Article 176 and 192 of Chinese Criminal Law separately regulate the crimes of illegal absorption of public deposits
and fraudulent fund-raising. Apart from the different criminal objects and accomplishment criteria, the bound between the above two crimes is criminal purpose. The crime of fraudulent fund-raising have the purpose of illegal possessing, while the crime of illegal absorption of public deposits does not. The two crimes, especially the crime of illegal absorption of public deposits, are the main accusations and are like the Sword of Damocles swing on the P2P issue. Certainly, when identifying the crimes of behaviors such as stages directly or indirectly raise money to form capital pools or actors disappear after absorbing a large amount of money, the conclusion should comes from the actual acts and the legal relations based on the acts. Seeing from the 319 verdicts which are related to using P2P to illegally raise funds, published by China Judicial Documents Network in 2019, the top six provinces are Zhejiang (64), Beijing (54), Jiangsu (40), Tianjin (38), Shanghai (22), Guangdong (18). The verdicts published by the above six provinces contribute more than 70%. The six provinces all have prosperous economy, active private lending and financing, which provide rich soil for P2P illegal fund-raising crimes. Analyzing from the distribution of accusations, 267 verdicts belong to the crime of illegally absorb public funds, 46 verdicts belong to crime of fraud in financing, 7 verdicts belong to the crime of obstructing company orders, 2 belong to the crime of organizing or leading pyramid schemes and 1 belongs to crime of illegal business operation (Figure 1.).

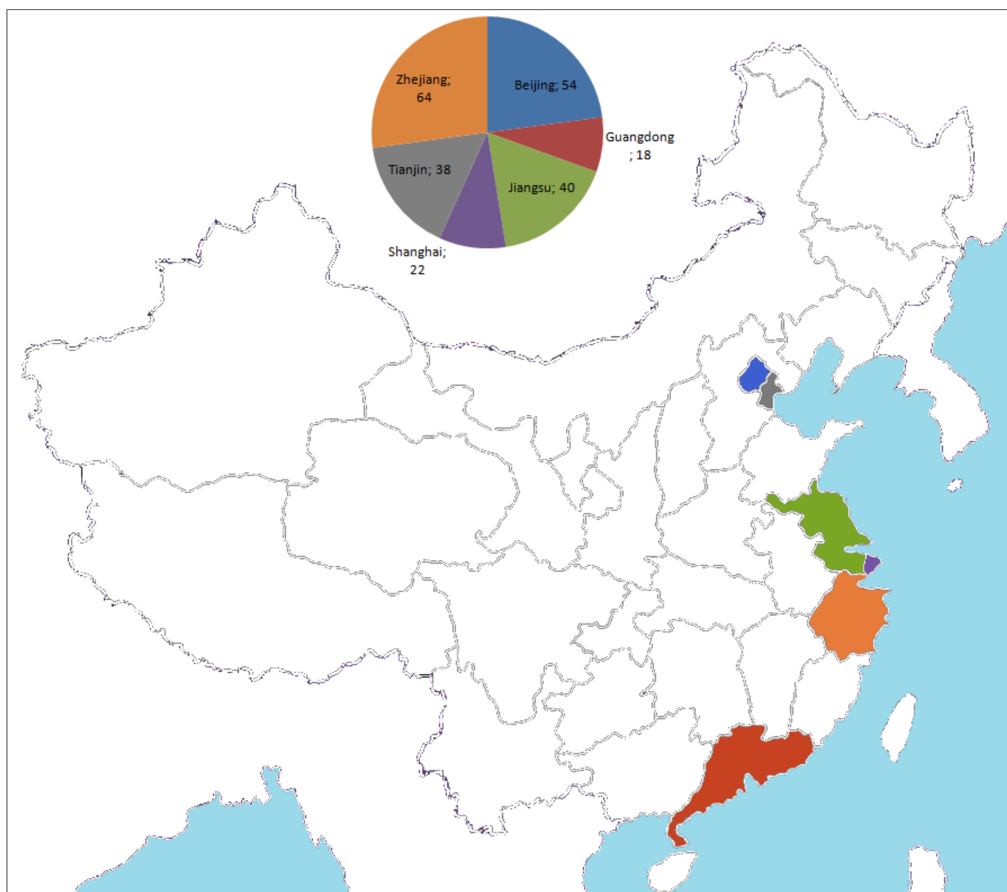


**Figure 1: The top six provinces are related to using P2P to illegally raise funds in China (2019)**
*Database: Chinese Judicial Document Network,* Edited by Antal Forró

### 2.2. Identification of the Crime of Illegal Fund-raising in P2P Online Lending

Analyzing from the judicial practice, P2P online loan platforms are suspected of the illegal fund-raising crime, mainly manifested in the following situations.

#### 2.2.1. Self Financing

Some enterprises set up so-called P2P platforms to illegally absorb public funds by utilizing fictitious borrowers and targets. The funds raised are either used in the production and operation of the enterprise itself, external investment, or making profit on re-lending, with the primary purpose of financing themselves. Take Lin Zhengrong's case as an example, Lin illegally set up a "Wuhan loan" P2P platform, using its website to issue fake targets, enticing investors with high returns. Lin illegally absorbed more than 8 million yuan from 46 people. More than 2 million yuan were used to daily running of Zhe Shang Family Co., which is the company that the platform attached to. Another more than 2 million yuan were spent on the decoration of the

affiliated hotels.[1] It can be seen from the above that the funds illegally absorbed in this case, apart from paying high interest to investors, are mostly used for the operation of the enterprise and the decoration of affiliated hotels, which is essentially self-financing. This illegal fund-raising behavior mode is mainly suspected of the illegal fund-raising crime, as the platform operators do not have the purpose of illegal possessing.

#### 2.2.2 “Shadow Banking”

"Shadow banking" refers to the credit intermediary system that is outside the banking regulatory system and may cause problems such as systemic risk and regulatory arbitrage. There are four main factors causing systemic risk in shadow banking: term mismatch, liquidity transformation, credit transformation and high leverage (Ba, 2013). Many P2P platforms in China already have these elements. For example, some P2P platforms provide a guarantee of principal and income for investors by themselves or by introducing third-party guarantee companies to provide principal and interests assurances, in order to accomplish credit transfer. In this way, the borrower’s credit risk, which is supposed to be taken by investors, transfers to the P2P stage or the third party. From the foreign operating mode of P2P online loan platforms, Prosper, Lending Club and other online platforms do not provide guarantees, which are related to their mature credit system. These platforms use a personal credit scoring system, and determine to lend funds or not according to the minimum credit score made by the system. Besides, in order to attract investors, some other platforms offer repurchase target services at any time, thus provide liquidity conversion. This type of "shadow banking" has the primary functions of a bank, while its fund absorption behavior is an illegal fund-raising crime. The above behaviors actually are in line with the constitutions of the crime of illegally absorbing public deposits.

#### 2.2.2. Self-insurance

In the process of financing, some P2P platforms violate the law to provide "credit enhancement" services, and some may promote that a particular company or institution shall provide guarantees for loans. When examining whether the guarantee institution constitutes a crime, pay attention to check deeply. If it is self-financing and self-protection, it belongs to the practice of an illegal fund-raising crime. Take Kuailu Group, the investor of the film "Yewen 3," for example. It was accused of the box office fraud by a large number of netizens during the time that the film released in early 2016, thereby its self-protection and self-financing investment

1 Wuhan City Intermediate People’s Court of Hubei Province (2017). Hubei 01 Zhong Zi Criminal Ruling No. 209

were revealed. The borrower, the platform, and the bonding company are all subsidiaries or affiliated companies of Kuailu Group. It means that Kuailu Group's film and television corporation, as the borrower, relying on the group's affiliated bonding company to finance itself through their P2P platform, which is a typical case of "self-financing and self-insurance." For new types of warranty, it is necessary to track the source of guarantee funds substantially (Pan, 2018). There are many types of financing guarantees in the current financial market, which have far exceeded the fixed assets or the guarantee professional companies in our impression. The new types of financing guarantees include pledges of lease rights of shops, taxi operation rights, quality of bank management, life insurance policies, pollution rights, pledges of dynamic inventory, repurchase of credits, and other charges. If their funds come from themselves, they are still self-financing and self-insurance.

#### 2.2.4. Capital Pool Forming

The P2P platform establishes a capital pool, which makes a large number of funds actually in the hands of the platform operator. It can efficiently operate the capital pool to conceal the platform risk, manipulate the target, and do other activities. It damages the legitimate rights and interests of investors severely and disrupts the order of the financial market. This is also a principal reason why even after platforms collapse the responsible persons of platforms are able to abscond. For example, in the case of Sun's illegal absorption of public deposits, the "Tiancheng Loan" platform earns interest differentials by absorbing deposits and then looking for a borrower's mode of issuing loans. The platform set up a capital pool to hold investors' funds and used them to repay the loans that were due before. Such behavior belongs to illegal fund-rising crime.[2] It is evident that "Tiancheng Loan" collects funds before looking for borrowers. In this way, the investors' funds entered the account of the platform. They established a capital pool, which maintained the operation of the platform by robbing Peter to pay Paul until its collapse. Their behaviors are definitely in line with the typical illegal fund-raising crime. Besides, some P2P platforms design their borrowing needs into various financial products and sell them to investors, so that investors' funds can enter the accounts of the platforms, which is also an illegal fund-raising crime of setting up capital pools.

2 Gangcheng District People’s Court of Laiwu City, Shandong Province(2016). Lu 1203 Chu Zi Criminal Ruling No. 4

### 2.2.5. Pseudo Platform Operation

The so-called pseudo-platform operation means that without authentic financing demands, P2P platforms publish false financing information in order to occupy public funds illegally. As long as they absorbed the public funds, they abscond right away. "Pseudo-platforms refer to the so-called 'platforms' created by certain actors who have held the intention of 'absorbing the money' from the beginning, using the concept of Internet finance. (Liu, 2016)" In essence, the pseudo-platform is to carry out fund-raising fraud in the name of the P2P platform, which ultimately loses the intermediary feature and becomes a tool for criminals to collect funds. In judicial practice, there are two main types of pseudo-platforms: one is a P2P platform, particularly for fund-raising fraud. The second is a platform that has no intention of illegal possession originally but conducts fund-raising fraud later. For example, in the case of Ge Gaofeng's fund-raising fraud, Ge used "Lianchuang Wealth" as a platform to fabricate borrowers and targets without obtaining financial business permissions. He transferred illegally absorbed funds to his account. Except for a small part of the funds, which are used to return the investor's principal and interest, the vast majority of them have been squandered or purchased real estate and vehicles in the name of Ge and others.[3] In this case, "Lianchuang Wealth" is a pseudo-platform with the intention of illegal possession, which is in line with the criminal composition of the crime of fund-raising fraud.

The above models generally are able to include various forms of illegal fund-raising crimes on the P2P platform in practice. It is worth emphasizing that the illegal fundraising behavior discussed in this article does not include "illegal fundraising risks caused by unqualified borrowers." The absorption of public deposits by the unqualified borrower belongs to the illegal fundraising category of the borrower, not illegal fundraising by the operator. If the borrower is the operator, then the problem is back to numerous ways of illegal fundraising of the P2P platform. If the P2P platform is fully conscious that the borrower does not qualify, it still acquiesces to the false borrower to issue false information for illegal fundraising to promote the business, even implements services such as advertisement promotion and payment settlement. In this regard, it cannot be punished as an accomplice in illegal fundraising crime because there is no intention of joint crime (intention liaison) between the platform and the unqualified borrower. However, it still violates criminal law. It is assistance behavior of neutral business. It should be punished with the crime of assisting cybercriminals.

3 Ningbo City Intermediate People’s Court of Zhejiang Province(2015). Zhe Yong Yi Chu Zi Criminal Ruling No. 119

## 3. The Model of Equity Crowdfunding

### 3.1. The concept and method of equity crowdfunding

As an essential form of crowdfunding, equity crowdfunding means that a company can raise funds through a crowdfunding platform, and venture investors can obtain equity. Its main advantages are lower funding costs and the lack of bank-like financial intermediation. Investors take equity directly as the form of investment and hope to attain equity appreciation in the future.

There are two main types of initiators of equity crowdfunding: The first one is that they have entrepreneurial projects and creativity, but lack of funds to invest. The other type is that their ideas have been put into practice, but the subsequent funds is lacking. There are also two main types of supporters of equity crowdfunding projects. One is individuals with investment intention and idle funds. These investors consult with initiators and agree with their creative ideas. The others are the government and large enterprises. Through the crowdfunding platform, the government and large enterprises can use the state-supported start-up capital to fund entrepreneurs in a more targeted and effective way. The main methods of equity crowdfunding include the following: first, direct equity investment. The fundraiser submits the project to the crowdfunding platform for review. After obtaining permission, the project will be issued on the platform. When the investor selects the project, the fund will be invested through the crowdfunding platform. Although it does not belong to the public issue of shares, it still cannot break through the relevant restrictions about the number of shareholders. For example, the number of shareholders of a limited company shall not exceed 200, and the number of shareholders of a limited liability company shall not exceed 50, which shall not exceed the red line stipulated by law. Second, it is a combined investment by using both online and offline way. This two-stage investment is designed to circumvent the current restrictions on equity financing. After the project information is displayed, and the potential investor gets the intention, the operation will go offline, where the equity investment will be conducted following the Company Law and other legislations. Alternatively, it can screen investors online, only open project information to accredited investors, and set a high threshold for investors by invitation. In China, the behaviors of equity crowdfunding mainly regulate by the Securities Law. According to the regulations, no unit or individual may publicly issue securities without approval. Equity crowdfunding generally does not meet the conditions for the approval of public issuance of bonds, so it can only be issued in a closed way. *All Private Equity Crowdfunding Suggests Management Approach (trial)* stipulates that private equity crowdfunding should be non-public offering. Meanwhile, it outlines a series of principles,

including investors, must be specific objects. Besides, *the Implementation Plan for the Special Rectification of Internet Financial Risks* also puts forward a series of requirements for the compliance operation of equity crowdfunding. First, the number of people participating in crowdfunding shall not exceed 200. Second, it shall not adopt any advertisement, the public, and issuing shares in any way. Third, no self-raised funds is allowed. The last is that the raise must only open to specific investors.[4] The platform shall rigorously fulfill the obligation to verify the identity of the financers and the authenticity of the project before carrying out crowdfunding activities. Meanwhile, the platform also needs to screen investors. Only qualified investors who have been registered and have passed the asset strength review are qualified to participate in crowdfunding. Of course, the financers should also provide real information to the platform, such as the approval documents, feasibility reports and prospects.

### 3.2. The Identification of the Illegal Fundraising Crime in the Equity Crowdfunding

Equity crowdfunding is generally realized through online crowdfunding platforms. The purpose of financers is to raise funds, so the financing behavior in the process of crowdfunding is essentially a sort of fundraising behavior. In the absence of a small-amount exemption system in China, if the financing behavior exceeds the limit of the number of people and carries out public publicity with returns on profits, it is likely to be suspected of illegal fundraising crime. Seeing from the criminal verdicts of illegal fundraising crimes related to the equity crowdfunding, published by China Judicial Documents Network in 2019, all of 21 verdicts are made by Basic People's Courts. Among them, 6 are made in Shanghai, 5 in Jiangsu, and Anhui, Fujian, Shanxi have 2 respectively and Jiangxi, Guangdong, Chongqing and Zhejiang have 1 verdict respectively. Analyzing from the distribution of accusations, 11 verdicts belong to the crime of illegally absorbing public deposits, 7 belong to the crime of organizing or leading pyramid schemes, 1 belongs to the crime of fraud in financing and 1 belongs to the crime of contract fraud. To be specific, the crime of illegal fundraising in equity crowdfunding is mainly manifested in the following situations.

#### 3.2.1. The Problem of Fund Collection

Equity crowdfunding generally consists of three parties, sponsors, investors, and crowdfunding platform. The necessary process of equity crowdfunding can be divided into six steps: design the program, review the program, publish the program, publicity, financing, and return profits.

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4 General Office of the State Council (2016). Guo Ban Fa No.21, Implementation Plan for Special Rectification of Internet Financial Risks.

After the project sponsor releases the project on the platform, the financing process needs some time to be completed. Investors generally transfer funds to the account that the platform appoints (or the escrow account), which objectively causes the fund collection of the platform and generates capital risk. At present, there is no effective restraint mechanism to prevent improperly managing and using funds. The absence of restraint brings significant risks of security to investors' funds (Yang and Su, 2019). This alienation in illegal crowdfunding represents in two ways. First, the third-party crowdfunding platforms collect investors' funds, then attract projects online, and promise to repay capital and interest to investors. Second, crowdfunding platforms and project companies are actually under the same group. So platforms are not a third-party one. The crowdfunding platform is financing the company of the group and promising to repay capital and interest to investors (Yin and Liu, 2018). In the process of financing, the equity crowdfunding platform shall audit the project sponsors' qualifications. For qualified ones, it is generally inappropriate to consider it as a crime barely because the funds are only collected during the crowdfunding process and paid to the project sponsor after the financing achieved. However, when the financing occurs before the fundraising account is set up, that is, when there is no crowdfunding project, the financing behavior occurs. It is an empty bid financing or financing for related parties. All three are in line with illegal fundraising. For the sponsors of the projects, in order to break the financing limit of a single platform, they raise funds for the same project on multiple platforms in the same period, or raise funds in other public places. If the funds raised exceed the needs of the project, it is also suspected of illegal fundraising crimes.

### 3.2.2. The Issues on Unspecific Investors

According to the provisions of the Securities Law, no unit or individual may issue securities publicly or use advertising, public persuasion, or other public means, without legal approval. In essence, equity crowdfunding relies on online platforms to raise funds by selling shares, which is similar to issuing securities. Equity crowdfunding is an integral part of Internet finance. The natural openness of the Internet makes the equity crowdfunding inherently have the property of raising funds from the non-specific public. Some people believe that the operation mode of equity crowdfunding should be strictly controlled, or particular ways should be taken to circumvent the restrictions of the Securities Law. However, such circumvention is often unreliable from the perspective of legal explanation (Yang and Su, 2014). The author believes that when considering whether the equity crowdfunding platform is involved in the crime of illegal fundraising, the conclusion need to base on substantive examination. We need to know

that equity crowdfunding is raising money from specific investors. If the crowdfunding platform adopts real-name authentication in investors' verification and sets up a strict asset evaluation process, then the investors of the platform are not non-specific public, but directed investors. However, If the platform does not have high requirements of real-name authentication, but only requires identity registration without conducting investors' substantive verification, it cannot be considered as raising funds from specific investors.

#### 3.2.3. Inducement Problems

The legal equity crowdfunding platform is primarily an information intermediary platform collecting intermediary fees for profit. The platform objectively and neutrally reviews the fund raiser's project and releases the project information after reviewing. Then, investors can choose the project to invest according to their investment preferences. However, in order to avoid illegal fundraising, some platforms indicate in the instructions that they cannot use equity, debt, or funds as returns to supporters. Meanwhile, the sponsors and the platform do not promise any financial benefits to the supporters. Some platforms regard netizens' registration of the sponsors' projects as a purchase rather than an investment (Yin and Liu, 2018). The author believes that if the project sponsor did not promise a fixed return on principal and interest, but signed a supplementary contract, a guaranteed contract, whose essence was to promise the principal or a minimum return. This behavior has the characteristics of a passive, investment, and guarantee. It also meets the inducement characteristics of illegal fundraising crimes. Therefore, there is a more significant risk of taking criminal responsibility.

## 4. The Model of Entrusted Financing

### 4.1. The Concept and Type of Entrusted Financing

#### 4.1.1. The Concept of Entrusted Financing

Entrusted financing varies from broad and narrow. In a broad sense, entrusted financing refers to the fact that the client entrusts its property to others to obtain benefits. It covers extensive areas, for instance, handing over your own house to an intermediary agency and allow it to rent the house. The lessor does not directly sign the contract with the lessee. Regardless how much rental income that the intermediary receives, the lessor receives a fixed income. Entrusted financing in the narrow sense only refers to financial management activities in the financial market, that is, entrusting its funds to institutions or individuals for investment activities. According to the proportion agreed by both parties, lessors and agency share profits. This article is based on the field of cyber-finance crimes, so it talks about the concept of entrusted financing

in a narrow sense. It is limited to the client's delivery of funds to the trustee for income. Financial markets call this a fiduciary investment management or asset management business.

#### 4.1.2. The Type of Entrusted Financing

According to whether the trustee is a financial institution, entrusted financing consists of financial entrusted management and private entrusted financial management. Financial entrustment refers to that the entrusting party gives the funds to the formal financial institutions for financial services. Because financial institutions' products are strictly approved in advance, they are less likely to involve in illegal fund-raising crimes. In practice, the high incidence of financial crime is that the staff of financial institutions does not bring the absorbed funds into the institutions' accounts. They cooperate with external institutions or individuals to transfer clients' funds to other investment activities. This behavior is known as a "flying document." In this case, the staff of institutions may commit a joint crime of illegal fundraising. Financial institutions are civilly liable to investors for compensation. In private entrusted financing, the principals entrust their assets to non-financial institutions or natural persons, and the trustees shall conduct financial management and investment on behalf of their clients. Private entrusted financing accounts for a large proportion in the capital market but lacks supervision. Non-governmental entrusted financing is one of the most severe areas of the crime of entrusted financing illegal fundraising. Many private financial institutions and individuals hide their illegal fundraising intentions under the name of financing.

With the development of Internet finance, Internet investment has also entered the sight of ordinary investors. Internet investment and financing refer to the business of selling investment and financing products on a third-party or other online payment platforms through the network (SPC, 2015). At present, Yu 'E Bao from Alibaba and Financial Manager from Tencent are typical Internet financial products. Internet investment and financial products are similar to traditional financial products. In form, investors entrust their funds to institutions or individuals for management. The difference lies in the saling channels. Internet investment and financing operate through mobile Internet platforms rather than traditional online sales channels. There is no need for investors to sign a paper contract, while they can operate through the Internet or mobile APPs. This makes the investment more accessible, cheaper, and free from capital barriers. The following content of this article takes the Internet entrusted financing as a foothold to analyze the identification of illegal fundraising crimes in entrusted financing.

### 4.2. The Identification of Illegal Fundraising in Entrusted Financing

In reality, there are often criminal acts of illegal fundraising or disguised illegal fundraising in the name of entrusted wealth management. Seeing from the verdicts related to using entrusted financing stages to illegally raise funds in 2019, published by Chinese Judicial Document Network, the amount of criminal verdicts is 283. The top six provinces are Tianjin (36), Jiangsu (29), Hunan (20), Anhui (14), Beijing (13), Hebei (12). The amount of relevant verdicts in other provinces is less than 10. Seeing from the distribution of accusations, 285 verdicts belong to the crime of illegally absorbing public deposits, 28 belong to the crime of fraud in financing, 2 belong to the crime of contract fraud and 1 belongs to the crime of illegal business operations. The following chapters will analyze the manifestations of the crime of fraud in financing happening in the area of entrusted financing and the kernels of distinguishing such crime (Figure 2.).

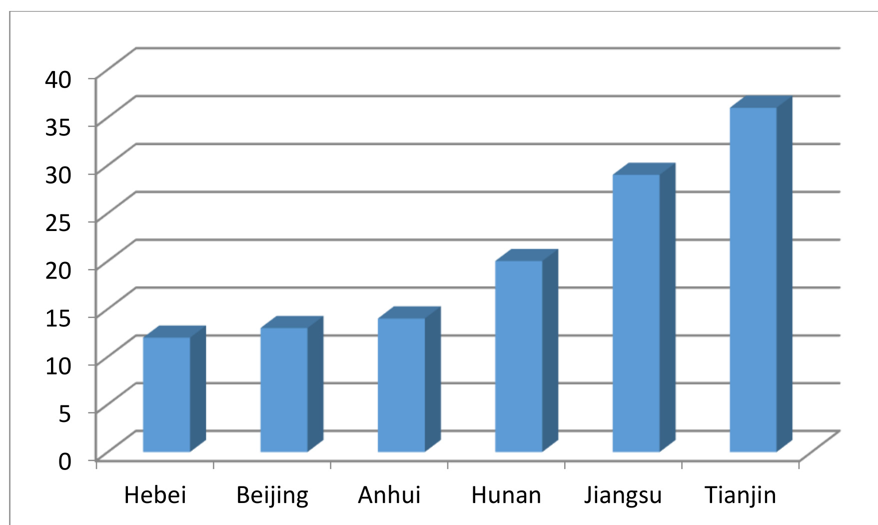


**Figure 2: The top six provinces are related to using entrusted financing stages to illegally raise funds in China (2019)**

*Database: Chinese Judicial Document Network,* Edited by Antal Forró

#### 4.2.1. Judgment Points of Illegal Fundraising Crimes in Entrusted Financing

To judge the illegal fundraising behavior in entrusted financing, we should chiefly investigate from the following four aspects. First, whether there is a guarantee clause. Because contracts that contain the articles of guaranteed earnings violate the principle of risk-sharing in entrusted financing. Therefore, such contracts have the induce characteristic of illegal fundraising crime. Second, whether the entrusted financial contract aims at a specific object, entrusted financing contract is an one-to-one contract. However, if the actor accepts to sign a large number of contracts with the unspecified majority, then it conforms to the social characteristics of illegal

fundraising crime. Third, the direction and the way to using the funds. Specifically, it is necessary to consider whether the actor can reasonably use the entrusted funds. If the trustee does not carry out the investments and the operation activities saying in the agreement but invests the funds in high-risk areas, it will cause the high safety risk to public funds. In this case, the actors generally can be charged with illegal fund-raising crimes. Fourth, the severity of the risk that behaviors bring to investors' funds and whether it causes losses. The harm degree of public funds safety is a critical factor to consider. The chief criterion to distinguish the legal entrusted financial behavior from criminal behavior not only lies on the difference between behaviors. More importantly, it is necessary to consider whether the results of acts have reached the harmful degree stipulated in the criminal law. If the behavior meets the constitutive requirements of the illegally absorbing public deposits, meanwhile also endangers the safety of public funds, the actor's criminal responsibility should be investigated. Otherwise only can administrative penalty can be given to actors.

### 4.2.2. The Manifestation of the Crime of Illegal Fundraising in Entrusted Financing

In practice, the entrusted financing behavior which is suspected of illegal fundraising crimes, have characters as followings:

#### 4.2.2.1. Publicize the Financial Information

Most of the trustees in the private entrusted financing are investment consulting companies. Unlike financial institutions, establishing consulting firms does not have high entrance barriers, strict risk control mechanisms, and standardized operation rules. Some trustees run open false publicity, conceal risks when publicizing to the unspecified majorities. Its forms of publicity include making promotional calls to people, sending text messages to potential customers, holding "public lectures". Sometimes, they set up several preferential terms to attract customers, overemphasize prospects of profits, but rarely warn risks.

#### 4.2.2.2. Explicit or Implicit Guarantee

The trustee accepts the client's carte Blanche and makes a guarantee commitment. Also, the client shall bear the investment risk of violating the contract. This is the fundamental property of entrusted financing. For example, some entrusted financial contracts, both the principal and the agent agreed on the guarantee terms, and the agent ensures the return and interest to the principal. Some trustee sets up a limited partnership with investors as common partners. Investors put money into the partnership enterprise in the name of a limited partner. Then, they

agreed to invest in the project of the contract. The agent promised in the partnership agreement to pay benefits, on schedule due to repurchase investors share in the partnership, to complete the limited partner withdraws from the receivable. There are many types of private entrusted financial contracts. There are asset management, entrusted investment, entrusted asset management, and information consulting service agreement. In some cases, formal contracts and supplementary agreements are signed together in order to avoid the minimum guarantee limitation. The formal contract does not reflect any guaranteed return, which is in full compliance with the legal form of the investment contract, While the commitment to a guaranteed return lies in the supplementary agreement.

#### 4.2.2.3. Selling Wealth Management Products to Unqualified Investors

Generally speaking, private entrusted financing belongs to the autonomous field. The state has no prohibitive provision on the conditions of the trustor, and then the trustor has the right to dispose of his property. However, as for Internet entrusted financing, it has certain restrictions for social attributes. Internet financial platforms have gathered plenty of consumers. Therefore, it has the characteristics of available product promotion, convenient product sales, and low cost. For example, sales of traditional financial products such as Yu 'E Bao (money market fund) have multiplied in recent years. Under existing laws, there are only two formal financial products that can be sold to the public online: public security investment funds and insurance products. Other financial products, even legal ones, cannot be sold publicly online. Trust products and private products; for example, can only be privately recruited to qualified investors, whereas selling to the public is strictly forbidden. However, in practice, plenty of disguised network sales model appears. For example, the "Group Purchase": The financial institution has no permission to sell products to the public, so institutions buy products on behalf of investors. Besides, a variety of illegal financial products, called "asset management, also took advantage of Internet sales. (Peng, 2018)" According to relevant laws and regulations, asset management products (i.e., financial products) shall not be publicly issued or sold on the Internet without permission. Otherwise, it may constitute an illegal fundraising crime. Besides, in the field of entrusted financing through the Internet, the network platform must use the funds for the agreed financial activities and cannot use them for other purposes. Platform’s profits come from the management fees charged from investors, rather than from spreads, which means that platforms agree a lower rate of return with investors and make higher profits from issuers. If online platforms use the invested funds for other purposes, such as high-interest lending,

stock trading, futures and other activities, or earn interest margin through entrusted financing, their behaviors will change from entrusted financing to illegal fundraising crimes.

#### 4.2.2.4. Fund Collecting Disguised in Legal Forms

In practice, some trustees use the guise of responding to national calls, protecting the environment, pension construction, ecological investment, financial innovation, and other publicity concepts, and use plantation and breeding industry development, high-tech industry research and development, cultural relics protection, cultural industry development, fund-raising, and other projects to attract investors. If the above behaviors involve an unspecified group of people (non-specific objects) as investors, or if the number of people exceeds 200, it is suspected of illegal fundraising.

## 5. The Model of Private Equity

### 5.1. The Concept and Type of the Private Equity

#### 5.1.1. The Concept of the Private Equity

Private equity funds refer to investment funds raised and established by private investors within China. Private equity funds have following characteristics: first, the issuance of private equity funds bases on record system, which is needless of the examination of the CSRC. As a result, their disclosure obligations extent is much lower than those of public funds. Meanwhile, the issuing cost is low, and the way is accessible, the operation form is flexible. The sponsor and the manager have considerable autonomy in project selection, fund management, and investment. Second, it can only raise funds through non-public means. Private equity cannot publicly advertise in any media. It can only inform the qualified investors through specific channels. At the same time, it is strictly prohibited to release information to unqualified investors. Third, the target can only be a few specific qualified investors. Qualified investors generally have sufficient assets, risk control ability, and risk identification ability. They can obtain the necessary investment information quickly. Therefore, they can choose matching private equity funds to invest according to their risk tolerance and scope.

#### 5.1.2. The Type of the Private Equity

According to different organizational forms, private equity funds can be divided into corporate private equity funds, contractual private equity funds, partnership private equity funds. The operation of a company forms the corporate private equity funds. Investors become shareholders of the company by purchasing a particular share, and assume the company's debts

to the limit of the investment amount, and enjoy the corresponding shareholders' rights at the same time. Contractual private equity funds generally complete through the form of trust. Investors and the trust company draw up a special trust deed to clarify their respective rights and obligations. In practice, a trusted company is usually the initiator, and the funds raised will be managed and invested by itself or by a specialized investment adviser. The fund manager can make professional management and investment decisions by his name. General and limited partnership private equity funds are two specific types of partnership private equity fund. The former one refers to that the sponsor operates the fund in the name of the partnership, which is responsible for the daily management of the project's operation and assumes unlimited responsibility for the funds. The latter one refers to commonly investors put in their capital, assume limited liability with fund share for limitation. Limited partners, whose income comes from the distribution of fund income, generally do not participate in the operation of the fund.

### 5.2. The Identification of Illegal Fundraising Crimes in Private Equity

Private equity is known as the "rich man's game" because of its high risk. In the process of private fund financing, promoters and managers break the relevant regulations, making the public funds face significant risks, which may be suspected of illegal fundraising crimes. Seeing from the criminal verdicts in 2019 which are related to using private equity to raise funds illegally, published by Chinese Judicial Documents Network, there are 87 relevant verdicts. The top six provinces are Beijing (29), Hubei (7), Tianjin (5), Shanghai (5), Hunan (5), Shanxi (5). The amount of verdicts in other provinces is less than 5. From the perspective of accusations' distribution, 74 verdicts belong to illegal absorbing public deposits, 5 belong to the crime of fraud in financing, 5 belong to the crime of organizing or leading pyramid schemes and 4 belong to the crime of contract fraud. The following chapters analyze the identification of illegal fundraising behavior in private equity funds merely from the aspects of the initiation, methods, means, and objects (Figure 3.).

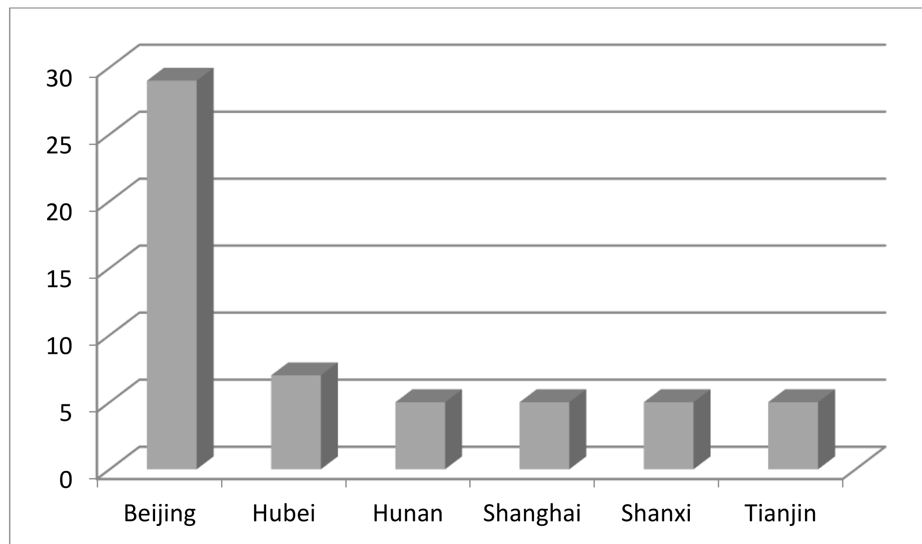


**Figure 3: The top six provinces are related to using private equity to raise funds illegally in China (2019)**

*Database: Chinese Judicial Document Network,* Edited by Antal Forró

### 5.2.1. Violate Private Equity Fund Management Requirements

According to the "*Opinions on Handling Criminal Cases of Illegal Fundraising*," which jointly issued by the three departments on January 30, 2019, the identification of the illegality of private equity funds can refer to the departmental rules following the national financial management laws and regulations formulated by the CSRC and other administrations, or to the state's provisions of the relevant regulatory documents such as the financial management regulations, measures, and implementation rules. On June 30, 2014, the CSRC issued the interim measures for the supervision and administration of private equity investment funds. The interim measure is an essential basis for judging whether a financing behavior of private fund is compliant. According to article 5 (2) of the "*Interim Measures for the Supervision and Administration of Private Equity Funds*," although the establishment of private equity management institutions and the issuance of private equity funds in China need not be "legally approved by relevant authorities," private equity financing must be registered and filed. Specifically, although private fund financing is exempted from approval and adopts the record system, it does not mean that the establishment of a private fund does not have any threshold requirements, and also does not meant that there is no illegal situation. If private fund managers are not legally established, have not gone through the registration procedures with the fund industry association, or have gone beyond the scope of private equity operations for private placement, then all behaviors above have the characteristics of "illegality". Private equity funds implement private fund manager registration and record system, so there is no need of approval,

however, we cannot analogize that, as long as register puts on record, no illegal situation would happen.

#### 5.2.2. Promote to Non-qualified Investors

Compared with public funds, the core of private funds is "non-disclosure." Private equity funds are prohibited from public or disguised public promotion. Article 92 of the "*Securities Investment Funds Law*" stipulates: "non-publicly raised funds shall not collect funds from units and individuals other than qualified investors, and shall not promote funds to specific objects through public media such as newspapers, radio stations, television stations and the Internet, or through lectures, reports and analysis meetings."

However, many private equity institutions in private insurance often entrusted other institutions or personnel to sell. There is a large part of the sales staff who are former or current bank staff. Based on their bank work experience, they usually have a lot of customer resources. The author believes that securities intermediary companies or investment consulting companies, third-party sales agencies can recommend private equity fund information to qualified investors. This is a legitimate channel for private equity promotion. However, the recommendation here must be the information push between the compliance subjects. If an information promoter makes a blind pitch without evaluating the qualification of the recipient or makes a blind telemarketer, lacking the procedure of determining specific object, and the published content belongs to the private fund promotion, then even promoter adapt a point-to-point method, the promoting way still should be considered as opening to unspecific people, because the participants are unspecified majorities and they are randomly selected. At this point, some of these behaviors may be suspected of illegal fundraising crimes.

#### 5.2.3. Guarantee a Fixed Return on Principal and Interest

Private equity investment has a variety of risks, such as management and technology. Therefore, before the issuance, investors should be informed of the risk that the principal and expected returns cannot be guaranteed. After being aware of the potential risk, investors make decisions and bear losses on their own. Article 15 of the "*Interim Measures for the Supervision and Administration of Private Investment Funds*" stipulates that "private equity managers and sales institutions shall not promise to investors that their principal shall not be subject to loss or minimum return." In practice, private equity investment contracts are usually accompanied by other types of contracts. The terms of contracts vary in terms of whether or not principal and interest are guaranteed. In criminal cases involving private equity funds, in order to circumvent

prohibitions of law, the actor does not directly promise to repay capital and interest or pay return but uses words such as "expected return," "guaranteed return" and "loss guarantee" to hide real purposes. The key to judge whether a contract has the incentive of capital preservation and interest payment lies in whether the actor conceals or guides the investor to underestimate the investment risk. "Expected return," in essence, is to make investors mistakenly believe that the investment does not have any risk, and private equity institutions will be able to repay the interest on schedule to them. This is a clear departure from the high risk and returns nature of private equity. It turns equity investment into debt investment. Those things are in line with the characteristics of illegal fundraising crime of inducement and then suspected of illegal fundraising crime.

#### 5.2.4. Break through the Qualified Investor System

A private equity fund is a high - return and high - risk investment. It should be for a small number of "qualified investors." Qualified investors refer to specific investors. They have to meet the pre-set requirements that laws set for specific securities or investment projects. They have corresponding rights and behavioral capabilities so that they are suitable to participate in those transactions and investments (Guo, 2012). These qualified investors are capable of protecting themselves. Therefore, investment risks will not harm public interest. The private placement behavior truly breaks through the qualified investor system. In essence, it extends the object of raising funds to the public who has no self-protection ability, so it may directly endanger the safety of public funds.

From the establishment of private funds, there were requirements on the number and capital strength of investors. According to the *Interim Measures for the Supervision and Administration of Private Equity Funds*, there are two types of qualified investors. The first type of investors are those who have rich investment experience and strong financial risk tolerance, such as institutional investors, the other are who meet the legal conditions and be recognized as qualified investors. Those qualified investors must have financial knowledge and experience, which can accurately identify investment risks. Therefore, they can make a clear decision after weighing the value against the risk. Meanwhile, they also have a higher risk-bearing capacity, which is directly reflected in the economic strength, that is, the assets or the maintenance of a considerable income level. In the process of illegally fundraising, many investors are the elderly, middle and low class. They do not have fund and investment experiences, needless to mention relevant professional background. Besides, their economic income and asset evaluation do not meet the requirements of the *Interim Measures for the*

*Supervision and Administration of Private Investment Funds*. Therefore, they cannot identify and take risks.

When judging whether an individual or institutional investor is qualified, deep and substantive examination shall be conducted. According to *Investment Fund Law*: If investors directly apply for private equity funds, its number of investors can not exceed 200. If the private fund is organized as a limited or partnership company, the number shall not exceed 50. If a company is established through one single financing project, the total number of shareholders shall not exceed 200. However, in practice, some fund managers, investors take a variety of ways to circumvent the regulations. For example, in the form of a partnership or a proxy, one investor collects funds from others and participates in fund raising projects in his name. Although the apparent number of shareholders is less than 200, however, after "penetration check," it will be found that the total number of investors involved exceeds 200, and most of them do not meet legal requirements. In order to avoid the number limitation, some fund managers divide one project into multiple parts, and finance each part separately. However, from the perspective of the way to collect the funds and the use of them, all parts belong to a same program. The above behavior involves the crime of illegal fundraising.

## 6. Conclusion

Above all, seeing from criminal verdicts related to the crime of illegally raising funds in Chinese Internet Finance, published by Chinese Judicial Documents Network in 2019, the number of verdicts about P2P online lending is 319, the number of verdicts about equity crowdfunding is 21, the number of verdicts about entrusted financing is 283 and 87 verdicts are related to the area of private equity. Obviously, illegal fund raising criminal cases are concentrated in P2P online lending and entrusted financing areas and cases in these two areas are dominated among all cases, therefore, these two areas should be the emphasis of criminal policies and criminal regulations. In order to effectively control the illegal fundraising crimes in the Internet finance field such as P2P online lending, equity crowdfunding, entrusted financing and private equity fund, and to improve the healthy development of Internet finance, the author proposes to improve the criminal governance of illegal fund raising in Internet finance from three aspects: criminal policy, legislative regulation and judicial governance.

### 6.1. Adjust Criminal Policy of the Crime of Illegal Fundraising in the Internet Finance Field

For Internet finance, including P2P network lending, equity crowdfunding, entrusted financing, China now is adopting a moderately loose supervisory policy[5], which aims to spare the space for financial innovation. This loose policy inevitably affects the criminal policy of illegal fundraising behavior on those formats. As these crimes are statutory criminals, the relevant policies have strong dependence on financial development policies. Two policies are tightly linked. Therefore, the criminal policy of illegal fundraising is actually also lenient. However, with the Internet financial chaos of illegal fundraising crimes, it is necessary to adjust the recent loose criminal policy to tempering one with mercy. In sum, we propose to adjust the current single loose policy and establish a criminal policy of combining punishment with leniency : on one hand, regarding the general violations of P2P platforms, the light criminal circumstances, as well as the subjective malignancy of the secondary business personnel in the illegal fundraising crimes, we should strictly control the boundary of criminal law intervention, and play the full role of the decriminalization function of Article 13 of the Criminal Law. For actors whose function is not outstanding in a case or normal workers, judiciary should punish them leniently. On the other hand, for the fundraising fraud criminals and criminals committing serious crimes who have severe subjective viciousness and play major roles in joint crimes, we must severely crack down on such conduct, expand the application of property punishment, and increase the magnitude of punishment.

### 6.2. Perfect the Regulation System of Criminal Law for Illegal Fundraising Crimes in Internet Finance and Increase the Sanctions.

First, incorporate relevant content of judicial interpretation into the provisions of criminal law. Clear regulations need to be made basing on the elements of Article 176 of Criminal Law, which is “illegally absorbing public deposits or absorbing public deposits in disguise”. It is helpful to highlight the deterrent function of criminal law, increase the magnitude of punishment for illegal fundraising crimes, fully play to the leading and promoting roles of criminal law in ensuring financial security and regulating society.

Second, we propose to put the crime of financial fraud, including the crime of fundraising fraud, into the section “the crime of disrupting financial management order” in the fourth quarter of Chapter 3. Due to the dual nature of financial crime and property crime of financial fraud

5 Guidance on Promoting the Healthy Development of Internet Finance, 20 July 2015. <http://www.mof.gov.cn/index.htm >

offence, including it in the section of “the crime of disrupting financial management order” is not only beneficial to achieve the purpose of protecting the financial management order, but also resolve the problem that the place this crime lies is contrary to the classification of traditional criminal law. Moreover, it can meet the need to curb the crime of financial fraud from regulating the whole financial market, and is more conducive to achieving the practical purpose of fighting financial fraud (Liu, 2017).

Third, we suggest improving the penalty allocation for the crime of illegally absorbing public deposits and fundraising fraud and adding qualification penalty. Therefore, it is necessary to add relevant qualification penalties, and prohibit criminals engaging in related occupations within a certain period of time from the date when the execution of the penalty completes. In addition, considering that the range of the sentencing on illegally absorbing public deposits is too narrow and the statutory penalty is comparably light, we suggest adding another sentencing level for this crime, that is, “if the amount is particularly large or has other particularly serious circumstances, more than ten years in prison and fines ranging from 500,000 to less than 5 million yuan.”. This solves the problems that the punishment level for the crime of illegally absorbing public deposits is too narrow, and the lever function of criminal law is not obvious.

### 6.3. Improve the Efficiency of Judiciary

First, this article propose to improve the connection between criminal cases and administrative cases. This article suggest coordinating from the national level, strengthening the linkage between administrative law enforcement and criminal justice, and promoting the establishing of an unified “online convergence and information sharing” platform. Through the platform, we can complete cases’ online transfer and acceptance, information process tracking, and law enforcement dynamic monitoring to prevent the phenomenon of using administrative penalties to substitute for criminal punishments. Second, this article propose to explore the professional case-handling mechanisms for illegal fundraising crimes in International Finance. This new type of crime is related to public, professional area, and Internet. The identification of case clues, the determination of behavior, the examination of evidence, the application of law, and the standard of prosecution are different from traditional financial crimes (Huang 2018; Li and Hu 2016). We need to improve the professional quality through the process of investigating, prosecuting, and judging, including establishing specialized case-handling agencies in police, procuratorates, and courts and improving the professional quality of illegal fundraising case-handling in ITFIN. Third, this article propose to actively promote the case guideline system of illegal fundraising crime. Closely connecting with new situations and problems encountered in

the current financial judicial practice, the judicial authorities can choose typical, difficult, or new types of criminal cases of illegal fundraising on P2P platforms timely, then explore and analyze the legal spirit, legal principles, legal rules and case-handling concepts, case-handling methods, and case-handling skills in these cases. Adopting the method such as collecting typical cases and publish legal documents in this way, judiciary can precisely understand relevant criminal law rules and judicial interpretation and the case guideline system provide targeted and authoritative professional guidance and references.

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