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# THE CROSS-BORDER TRANSPLANTATION OF VARIABLE UNIVERSAL LIFE INSURANCE: THE EVOLUTION AND THE REGULATORY CHALLENGES


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ABSTRACT

*Variable universal life insurance, a financial instrument blending in features of both a conventional insurance policy and a securities product, has a long history in sophisticated financial markets such as the United States, yet is new to China's financial system. The variable insurance made in China serves different business purposes than its U.S. counterparts. Notably, it played a salient role as a financing instrument for the hostile bidder in the landmark Baoneng/Vanke hostile takeover attempt. It results in distinctive financial risks emerging from China's regulation institution.*

*Drawing contrast to the United States and employing theories on the economic analysis of regulation, this article examines the previous and current regulatory approaches toward the Chinese version of variable*



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*insurance and criticizes the disoriented regulation philosophy. It argues that the newly promulgated Asset Management Rules are not helpful in recognizing the securities feature embedded in variable insurance, nor do they optimally mitigate the financial risks associated with variable insurance. The policymakers have yet to balance the freedom of financial innovation with the regulation of the financial market. As a result, the regulators would have to sacrifice either the proper functioning of variable insurance or the stability of the financial system.*

***Keywords:*** *variable universal life insurance, regulatory arbitrage, functional regulation, functional convergence of financial products, unit investment trust, China, United States*

## I. INTRODUCTION

A few years ago, variable universal life insurance ("variable insurance") was a novel concept in the eyes of many Chinese insurance practitioners. Few would envision the almost overnight proliferation of variable insurance in China. However, as of today, variable insurance has surged to take up a significant market share in the Chinese financial market, analogous to its counterpart in the United States.

Variable insurance was initially developed and matured in the U.S. market. When transplanted to China by insurers, it seemed to overwhelm the Chinese regulators. As in other markets, financial innovation has outpaced the ability of regulators to deal with it.[1] As Doreen McBarnet puts it, the scholarship would not be surprised to see "the failure of the whole cumbersome apparatus of law itself, destined always to lag behind dynamic business."[2] This article analyzes the serious regulatory challenges that variable insurance brings to the surface of China's financial regulatory framework. This is attributable in part to the fast speed at which variable insurance gained its popularity. It is also in part due to the different regulatory infrastructure that variable insurance faces in China than its counterpart in the United States.

This article reviews the economic driver and regulatory shift behind the booming (and subsequent stagnation) of the variable insurance business in China. A comparative analysis reveals that the Chinese variable insurance products, albeit patterned on their counterparts in the United States, present certain features that distance themselves from their U.S. counterparts. It argues that in response to the financial risks associated with this novel financial product, China's regulators merely treat the symptoms and not the root causes. Despite regulators' rhetoric to the contrary, China's institution-based regulatory structure is unlikely to be overhauled in the short run. Among other issues, it would be difficult, if not impossible, for the regulators to recognize variable insurance as a securities product as the U.S. regulatory structure does.

Above all, the Chinese regulators seem to have underestimated the

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1 For instance, in the United States, the pace of the markets in creating derivative instruments to overcome existing regulation, as one phenomenon of regulatory arbitrage, outstripped the then regulatory framework's ability to adjust. *See, e.g.*, Jonathan R. Macey, *Derivative Instruments: Lessons for the Regulatory State*, 21 J. CORP. L. 69, 70 (1995).

2 Doreen McBarnet, *Law, Policy, and Legal Avoidance: Can Law Effectively Implement Egalitarian Policies*, 15 J. L. & SOC'Y 113, 113 (1988) ("the failure of the whole cumbersome apparatus of law itself, destined always to lag behind dynamic business").

impact of insurers' investments as a conduit for asset management activities. The Asset Management Rules, which bring about sweeping changes to the landscape of the entire asset management industry, do not include variable insurance as one of the asset management businesses under its coverage. Such an approach leaves room for regulatory arbitrage relative to other asset management businesses such as mutual funds, asset management subsidiaries of securities companies, and banks' wealth management business.

Second, the institution-based regulatory approach exacerbates this problem. Financial regulators oversee the financial institutions, together with the financial products they issue, on an institutional basis. The separation of regulatory function renders variable insurance, notwithstanding its substantial similarity to a securities product, subject to the China Insurance Regulatory Commission's ("CIRC's") sole regulation[3] and not that of the China Securities Regulatory Commission ("CSRC"), China's securities regulator. Not deemed as a securities product in China, variable insurance is exempt from the registration requirements of the CSRC,[4] and thereby gets around the mandatory disclosure requirements that are otherwise applicable to securities. Variable insurance policyholders' right to make informed decisions, similar to securities investors, are therefore in jeopardy.

3 The CIRC was merged into the CBRC in 2018 and the combined regulator is now called the China Banking and Insurance Regulatory Commission, or the CBIRC. For convenience, this article uses the term CIRC when referring to China's insurance regulator. The Life Insurance Supervisory Division of the CIRC is the division primarily responsible for the regulation of variable insurance and has made announcements on its enforcement actions. The CSRC has never set foot on the same territory. See, *e.g.*, Announcement of the Life Insurance Supervisory Division of the China Banking and Insurance Regulatory Commission Regarding the Recent Problems Arising out of the Life Insurance Products and Submission of Required Regulatory Reports (中国银保监会人身保险监管部关于近期人身保险产品及监管报告报送有关问题的通报), CHINA BANKING & INS. REGUL. COMM'N (Dec. 30, 2020), http://www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=954679&itemId=925.

4 The registration requirements for a security, as applicable in the U.S. federal securities regulation, was alternatively termed "verification requirements" in China, which functions as a more onerous merit-based pre-approval instead of a registration. China's latest amendment to its Securities Law in 2019 did not materially change the fact that the verification requirements are dominant despite the amended law's addition of registration requirements for issuers listed on its Sci-Tech Innovation Board, or the STAR market. A realistic evaluation of the transition to a registration system analogous to the U.S. is going to be a protracted process, notwithstanding the legislation in paper. *See* Zhengquan Fa (证券法) [Securities Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, effective Dec. 29, 1998, last amended Dec. 28, 2019), art. 9 (staged implementation of the registration system, meaning the existing verification system will remain in place in the foreseeable future). For a historical account of the pre-approval requirements for securities, see Stuart R. Cohn & Miao Yinzhi, *The Dragon and the Eagle: Reforming China's Securities IPO Laws in the US Model, Pros and Cons*, 17 WASH. U. GLOB. STUD. L. REV. 327, 336–41 (2018).

Third, to the regulators' credit, they are aware of the systemic risks associated with variable insurers' practice of borrowing short-term while investing long-term. Nevertheless, the Asset Management Rules, aimed at addressing such risk mismatching, leave variable insurance out of its coverage. The liquidity risk of the variable insurance industry remains.

Fourth, in an arbitrary fashion, the Chinese regulators devoted tremendous regulatory resources to restrict the insurers' ability to issue variable insurance on a case-by-case basis. In particular, the regulators tightened their grip on variable insurance following Baoneng's takeover campaign of Vanke, one of China's largest real estate developers, for fear of the raider's use of variable insurance as a financial instrument for a leveraged buyout.[5] These swinging regulatory responses in effect undermine the viability of the variable insurance business.

This article proceeds as follows. Part I addresses the questions of why variable insurance was transplanted into China and why it did not prosper until recent years. It finds that regulatory changes in the framework for the insurance industry catalyzed the blossom of variable insurance. Similarly, it was the subsequent policy shift that accounted for the withering of the same product.

Part II compares variable insurance in China and in the United States. It finds that while variable insurance made in China resembles a securities product more so than its U.S. counterpart, it is not regulated as such.

Part III forays into the systemic risks embedded in the Chinese version of variable insurance. It criticizes the regulators' arbitrary suppression of variable insurance as a business model, which is not tailored to the inherent risks of the financial product, while disproportionately biasing small- to medium-sized insurers on the market. The negative consequence of such regulatory suppression may be leaving a hidden time bomb while sacrificing the business viability of variable insurance.

Parts IV delves into more deeply rooted structural issues in variable insurance regulation. It argues that despite the worthwhile attempt of the new Asset Management Rules to unify the regulation of wealth management products, it is premature to claim it as a breakthrough to the status quo since Chinese financial regulators still divide their regulatory authorities on an institutional basis. In this sense, to regulate variable insurance as an

5 For a legal analysis of the Baoneng/Vanke hostile takeover, see Xingxing Li, *Activist Investors and under-Enforced Fiduciary Duties: A Reflection on China's Takeover Regulation in the Aftermath of the Baoneng/Vanke Takeover*, 19 HOUS. BUS. & TAX L.J. 167 (2019).

investment company and a security product, as is the approach in the United States, has a much longer way to go than scholars would expect. Part V draws conclusions.

## II. THE WAVE OF INSURERS' EQUITY INVESTMENTS AND THE REGULATORY FRAMEWORK BEHIND THE BOOM

### *A. The Taking Off of Variable Insurance*

Variable insurance is a hybrid of insurance and investment. It provides life insurance to policyholders, but the death benefits and cash value of the policy are based on the performance of investments, which are made through a separate account maintained by the insurance company. A few years ago, Chinese insurance practitioners could not have foreseen the boom in variable insurance. To them, while variable products may be popular in developed markets like the U.S., they do not have many competitive edges compared to wealth management products offered by banks.

Chinese insurers began to spot a huge business opportunity in 2015 when the CIRC, the Chinese insurance regulator (which was later merged into the banking regulator), published a regulation liberalizing the minimum return rate that an insurer can guarantee its policyholders.[6] As a series of efforts aimed at liberalizing interest rates of life insurance products, the CIRC promulgated the "Circular on Certain Matters Concerning the Reform of the Fee Rate Policy in Relation to Variable Life Insurance"("Variable Insurance Fee Rate Circular")[7] as well as the "Rules on the Actuarial Calculations of Life Variable Insurances" ("Actuarial Rules").[8] The Variable Insurance Fee Rate Circular and the Actuarial Rules lifted the cap on the minimum interest rate, previously set at 2.5 percent per annum,[9] that an insurer may commit to its policyholders.[10] Like bank interest rates, fees that insurers charge on their insurance products are tightly regulated in China. The deregulation initiatives marked a milestone in the CIRC's proposal to liberalize the fee

6 Guanyu Wanneng Xing Renshen Baoxian Feilv Zhengce Gaige Youguan Shixiang de Tongzhi (中国保监会关于万能型人身保险费率政策改革有关事项的通知) [Circular on Certain Matters Concerning the Reform of the Fee Rate Policy in Relation to Variable Life Insurance] (published by China Ins. Regul. Comm'n, Feb. 3, 2015) (China) [hereinafter Variable Insurance Fee Rate Circular].

7 *Id.*

8 Wanneng Baoxian Jingsuan Guiding (万能保险精算规定) [Rules on the Actuarial Calculations of Life Variable Insurances] (published by China Ins. Regul. Comm'n, Feb. 3, 2015, effective Feb. 16, 2015), http://www.circ.gov.cn/web/site65/tab6529/info3951810.htm (China) [hereinafter Actuarial Rules].

9 Guanyu Putongxing Renshen Baoxian Feilv Zhengce Gaige youguan Shixiang de Tongzhi (关于普通型人身保险费率政策改革有关事项的通知) [Circular on Certain Matters Concerning the Policy Reform over the Fee Rates of Common Life Insurances] (promulgated by China Ins. Regul. Comm'n, Aug. 1, 2013, effective Aug. 5, 2013), art. 1(2), http://www.circ.gov.cn/web/site0/tab5225/info2525290.htm (China).

10 Actuarial Rules, *supra* note 8, art. 4.

rates charged by insurance products.[11]

Liberalizing rates was the legal catalyst for variable insurance products' popularity in the Chinese insurance market as there was already a strong business case for variable insurance. Following the global wave of quantitative easing in the aftermath of the 2008 financial meltdown, first by the U.S. Federal Reserve, then by the European Central Bank and the Bank of Japan, China adopted a loose monetary policy and has maintained a low interest rate since 2014.[12] With the flooding of easy credit, there was a "safe asset shortage" on the Chinese market, meaning it was hard for the financial institutions to find quality assets to invest in.[13] Good assets quickly drained out when so many financial institutions had so much money to spend. As investment returns became dismal, individual investors were in search of financial products with more optimistic return prospects. Insurance companies saw the market opportunity and quickly rolled out variable insurance products to meet the demand.[14]

Variable insurance is a perfect pitch for Chinese financial consumers. Above all, it sounds like insurance to them—there is "insurance" in the name —and it *is* regulated as an insurance product by China's insurance regulator.[15] Therefore, it paints the rosy image of a prudent, conservative product to Chinese households. The second competitive advantage of

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11 The CIRC launched a three-stage reform initiative aimed at liberalizing the overall fee rates of insurance products. The guaranteed minimum rate of return offered by insurance companies was one of them. The first step the CIRC took was in 2013, when it liberalized the rate of return that a conventional life insurance product can achieve, easing a pricing restriction previously imposed on insurers. The second phase in the CIRC's roadmap was to further liberalize the permissible minimum rate of return that a variable life insurer can offer its policyholders. The third stage was to allow insurance companies to decide the rate of return they offer to participation life insurance policyholders. *See* XIAOLING WU (吴晓灵), 2016 CHINA FIN. POL'Y REP. 109 (中国金融政策报告) (China); Guanyu Tuijin Fenhong Xing Renshen Baoxian Feilv Zhengce Gaige Youguan Shixiang de Tongzhi (关于推进分红型人身保险费率政策改革有关事项的通知) [Notice on Issues Concerning the Reform on the Policies for the Premium Rates Charged by Participating Life Insurance] (promulgated by China Ins. Regul. Comm'n, Sept. 25, 2015, effective Oct. 1, 2015), art. 1 (removal of the mandatory ceiling on expected rate of return offered by participating insurance) (China).

12 The news abounds. *See, e.g.*, Christopher Whittall, Jon Sindreu & Brian Blackstone, *Central Banks Embrace Risk in Era of Low Rates*, WALL ST. J. (Jan. 23, 2017, 10:20 AM), https://www.wsj.com/articles/central-banks-embrace-risk-in-era-of-low-rates-1485133603.

13 *See* Xiaoping Lu, *With the "Safe Asset Shortage" Deteriorating, Asset Management Arms in Insurers Seek Breakthrough by Foraying into Investment Banking Business* ("资产荒"发酵 险资资管谋求投行化"突围"), SHANGHAI SEC. NEWS (上海证券报) (May 20, 2016), http://money.people.com.cn/BIG5/n1/2016/0520/c42877-28365115.html.

14 For statistics about the competitive landscape in the variable insurance market, see Charles Zhou & Steven Zhu, Credit Suisse, *China Life Insurance Sector*, at 24 (June 12, 2017), https://plus.credit-suisse.com/rpc4/ravDocView?docid=_XD2x2AL-YxKG.

15 *See infra* Section I.A.

variable insurance is that its downside is truncated. The guaranteed minimum return[16] ensures the policyholder's benefit is at least better than the interest on a term deposit at a bank—the traditional benchmark on which Chinese households measure their returns.[17] In the wake of the low-interest rate clouding China's asset management industry in recent years, financial consumers' investment returns on comparable low-interest investment products offered by banks, trust companies, or money market funds have been spiraling downward.[18] The weak performance of other asset management products made room for variable insurance to thrive as a novel product in China. With households happily opting in, variable insurance blossomed in China, helping elevate China's insurance market to the third largest in the world in 2016, behind only the U.S. and Japan.[19]

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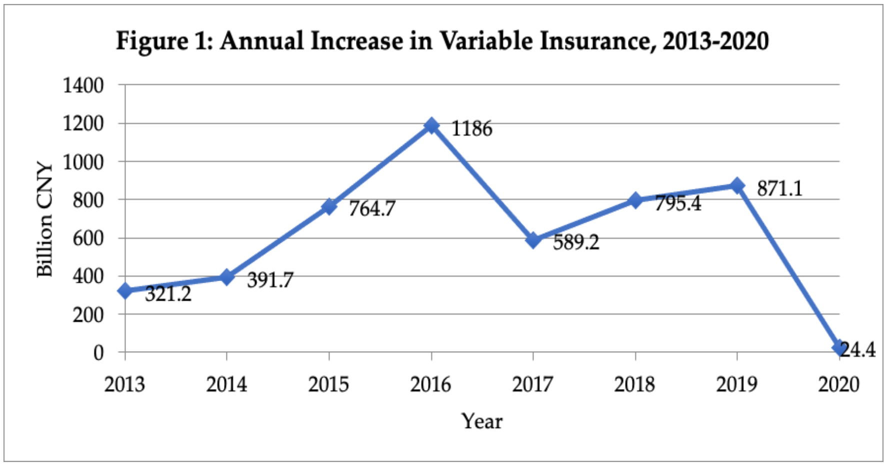
16 *See* Variable Insurance Fee Rate Circular, *supra* note 6; Actuarial Rules, *supra* note 8.

17 Chinese households are more inclined than families in other countries to save their earnings and to deposit their savings with banks. For Chinese household savings and trends, see Chadwick C. Curtis, Steven Lugauer & Nelson C. Mark, *Demographic Patterns and Household Saving in China*, 7 AM. ECON. J. MACROECON. 58, figs. 1 & 4 (2015).

18 A low-interest rate environment tends to prop up asset prices as purchasers have more ample credit made available to them in search of yields. The chase for yield renders financial assets more expensive and, hence, scarcer when the market gets crowder. Such a safe asset shortage can lower the yields of the asset management products offered by banks, trust companies or money market funds, which invest in financial assets as their underlying assets. For an explanation of the linkage between low interest rates and safe asset shortage, see Ricardo J. Caballero, Emmanuel Farhi & Pierre-Olivier Gourinchas, *The Safe Assets Shortage Conundrum*, 31 J. ECON. PERSPS. 29, 34–35 (2017).

19 Shaun Crawford, Luca Russignan & Nilabh Kumar, Ernst & Young, *Global Insurance Trends Analysis 2018: Pursuit of Growth Amid Cautious Optimism*, at 28 (June 2018), https://www.ey.com/Publication/vwLUAssets/ey-global-insurance-trends-analysis-2018/$File/ey-global-insurance-trends-analysis-2018.pdf (citing statistics of Swiss Re Institute).




**Source: CIRC** [20]

Figure 1 above depicts the rapid growth of variable insurance premiums during the early years of 2013-2016, before the drastic change in the regulatory environment disrupted the pace of growth.[21] The growth in premiums was largely attributable to the escalating popularity of variable insurance products.[22] As shown in Figure 1, in 2015 when the Actuarial Rules were published, the insurance industry witnessed an immediate ninety-five percent uptick in premiums paid to variable insurance products. The deregulation initiative resulted in an almost overnight doubling of new variable insurance sold per year. The increase in variable insurance peaked at RMB 1,186 billion[23] in 2016 when the regulatory headwind struck.

20 Comprised from the statistics disclosed by the CIRC on an annual basis. For example, for 2019, the data is available at Stat. Info. Dep't of the China Banking & Ins. Regul. Comm'n, *Summary Statistics for the Operation of Life Insurance Companies* (人身险公司经营情况表) (Jan. 22, 2020), http://www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=887995&itemId=954&generaltype=0 (China).

21 For the regulatory change, see *infra* Section I.C.

22 *Id.* at 29 (summarizing the "short-term savings product" – mainly comprised of variable insurance – driven expansion of life insurance premium growth in China).

23 Approximately USD $170 billion (approximated exchange ratio USD:CNY=1:7). For the USD to CNY conversion rate on Dec. 31, 2016, see *USD CNY Historical Exchange Rate*, CURRENCY CONVERTER, https://www.currency-converter.org.uk/currency-rates/historical/table/USD-CNY.html (last visited June 16, 2021).

### B. *The Investment Mania*

To Chinese insurers, offering a guaranteed minimum return, on their liabilities side, adds pressure for investment performance on their assets side. They are under pressure to outperform similar investment products in the market. This, in part, explains why Chinese insurers made what the public perceived to be adventurous, if not risky, investments—in contrast to their prudential image. Among such investments are Foresea Life Insurance and Anbang Insurance's failed attempts in their hostile takeovers of Vanke, one of China's largest real estate conglomerates.[24]

Upon closer scrutiny, there were two schools of insurers with diverging investment preferences. One school consisted of small- to medium-sized insurers. They were the ones who came under the media spotlight and caught the regulators' special attention. The other school consisted of the bloc of State-owned insurance conglomerates such as China Life, PICC, China Pingan, and CPIC. As the latter lacked the desire to swiftly expand their assets size, they did not face the same pressure to achieve higher investment returns as their smaller competitors. Nor were they as passionate about variable insurance as their rival small- to medium-sized insurers.

This explains why it was largely the small- to medium-sized insurers who took advantage of the deregulation initiative to market variable insurance. For example, by marketing variable insurance, newcomers such as Anbang Insurance had a great leap in their asset sizes, overtaking insurance giants like China Pingan.[25] On the investment end, they began to acquire substantial interests in domestic blue-chip companies on the secondary market.[26] Internationally, they struck a series of high-profile M&A deals.[27] Some other insurers focused on investing in the domestic market. Foresea Life Insurance as a subsidiary of the Baoneng Group, for example, moved to acquire a number of listed companies, the most notable of which was its attempted hostile takeover of Vanke.[28]

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24 For the insurers acting as activist investors to take over listed companies, see Li, *supra* note 5.

25 *See* Nick Ferguson, *Sizing up Anbang*, INS. ASIA NEWS (Apr. 18, 2019), https://insuranceasianews.com/sizing-up-anbang/.

26 *See, e.g.*, REUTERS, *Anbang Insurance Raises its Stake in China Vanke* (Dec. 22, 2015, 8:54 AM), https://www.reuters.com/article/china-vanke-anbang-idUSL3N14B3YM20151222.

27 To list a few examples, Anbang Insurance bought New York's historic Waldorf Astoria hotel, bid for Starwood Hotels & Resorts Worldwide, acquired U.S. insurer Fidelity & Guaranty Life, bought Dutch insurers Fidea and Delta Lloyd Bank. *See* Nisha Gopalan, Opinion, *Anbang Can't Stop Buying*, BLOOMBERG (May 11, 2016), https://www.bloomberg.com/opinion/articles/2016-05-11/china-s-anbang-insurance-needs-to-keep-buying-overseas-assets.

28 Li, *supra* note 5, at 173.

For those insurers eyeing the securities market, their investment style fell onto the two extremes of the spectrum. One group followed the more prudent and conservative approach, investing in low price-to-earnings ratio and high yield blue-chip firms only. The other group, in contrast, engaged in highly speculative trading. Small- to medium-sized insurers also used the premiums from variable insurance sales to fulfill bigger ambitions of building their financial services powerhouses.[29] These insurers were eager to form their financial holding companies.[30]

### *C. The Sharp Turn*

However, the variable insurance industry began to tumble by late 2016. The headwind came from the regulators (as often is the case in China) and not the market. In December 2016, the CIRC issued a rule restricting the expansion of insurers with disproportionate assets derived from the sale of variable insurance products.[31] The rule forbids insurers from opening new branch offices when they reach either of the two following thresholds: (i) the premiums the insurers receive from sale of mid- or short-duration products (variable products)[32] comprise more than fifty percent of the insurers' total premiums;[33] or (ii) the premiums received from the insurers' pre-existing businesses[34] fall below thirty percent of total premium income during the same period.[35] The CIRC made it clear that the restriction was intended to force insurers to shrink the size of their variable insurance products.[36]

The CIRC's rush to intervene in the natural business cycle of the variable insurance industry occurred against the backdrop of Baoneng's hostile takeover bid for Vanke.[37] It was indeed a regulatory response to one major

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29 Ouyang Hui, *The System Roots Behind the Frequent Placards of Chinese Companies*, CAIXIN (Mar. 18, 2016, 9:56 AM), http://opinion.caixin.com/2016-03-18/100921620.html.

30 For example, Anbang Insurance is structuring its financial holding group, which is comprised of insurance, securities, and trust businesses. Foresea Life Insurance is forming a financial group that combines financial, logistics and industrial businesses. *See id.*

31 Guanyu Jinyibu Jiaqiang Renshen Baoxian Jianguan Youguan Shixiang de Tongzhi (关于进一步加强人身保险监管有关事项的通知) [Circular on Certain Matters Concerning the Strengthening of Regulation on Life Insurance] (Dec. 30, 2016) (China).

32 Calculated as of the end of each quarter. *Id.*

33 As of the same quarter. *Id.*

34 Calculated as of the end of each quarter. That is, excluding the additional premiums generated in the new quarter, usually derived from variable product sales. *Id.*

35 CIRC, *supra* note 31, art. 3.7.

36 REUTERS, *China Regulator Tightens Rules on Life Insurance Products* (Mar. 18, 2016, 3:56 AM), https://www.reuters.com/article/us-china-insurance-regulations-idUSKCN0WK0V8.

37 Li, *supra* note 5, at 174, 216–18.

event in the insurance sector. Foresea Life Insurance, a medium-sized insurer with no State-ownership, was a newcomer to the insurance industry. It was established in 2012 as a subsidiary of the Baoneng Group and has since snapped up market shares at a speedy pace by setting up new branches and increasing its premium size.[38] In 2014, its premium size was RMB 34.8 billion.[39] By November 2016, this figure had increased by almost two times, soaring to RMB 97 billion.[40] Variable insurance comprised 79.95% of Foresea's total premiums.[41]

With funds channeled through variable products, Baoneng Group forayed into the securities market. It targeted several blue-chip companies, including Vanke, Gree Electric Appliances (China's top household appliances manufacturer), and CSG Holding (China's leading glass manufacturer).[42] In its attempted hostile takeover of Vanke, Foresea Life Insurance nibbled through the securities market's 25.4% equity interest in Vanke.[43] Vanke management fought back, taking a number of defense measures that included lobbying the regulators.[44] Ultimately, Baoneng's takeover of Vanke came to an abrupt end following an unusual, high-profile condemnation by the CSRC[45] and a subsequent suspension in the variable insurance business by the CIRC.[46]

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38 *See infra* tbl. 1; *see also* Thomas P. Fitzgerald, Winston & Strawn LLP, *2017 Insurance Review*, at 6 (Feb. 2018), https://www.winston.com/images/content/1/3/v2/135129/2017-China-Insurance-Review-MAR2018.pdf (Foresea Life Insurance's total assets prior to the regulatory restrictions imposed in 2017).

39 Li, *supra* note 5.

40 *Id.*

41 *Id.*

42 *See* Yu Nakamura, *Billionaire 'Barbarian' Corners Chinese Blue Chips*, NIKKEI ASIA (Dec. 12, 2016, 5:30 PM), https://asia.nikkei.com/Business/Billionaire-barbarian-corners-Chinese-blue-chips.

43 Li, *supra* note 5.

44 Li, *supra* note 5 at 175–86.

45 Liu Shiyu, *Zai Zhongguo Zhengquan Touzi Jijin Ye Xierhui Di Er Jie Huiyuan Daibiao Dahui Shang de Zhici* (在中国证券投资基金业协会第二届会员代表大会上的致辞) [*Speech on the Second Meeting of Representatives of the China Securities Investment Funds Association*], CHINA SEC. REG. COMM'N (Dec. 3, 2016), http://www.csrc.gov.cn/pub/newsite/zjhjs/ldbz/liushiyu/lsyjhyhd/201612/t20161203_307137.html (China).

46 Fitzgerald, *supra* note 38, at 6–7.

### D. *Improvised Regulatory Responses and the Asset Management Rules on the Horizon*

Then the questions arose: Should variable insurance be condemned when insurers act as activist investors on the securities market, using the product as a financing instrument? More specifically, has variable insurance become a conduit through which insurers get to retain the upsides of their investments while passing the downsides on to the policyholders? To be sure, this article is in no position to make business judgments for the insurers. Nor can it foretell whether insurers' investment decisions will turn out to be profitable. Instead, it is aimed at assessing whether the wave of financial innovation led by variable insurance brought about any financial risks that warrant regulatory intervention.

This article argues that amid the unprecedented wave of hostile takeovers in 2016, Chinese regulators made a premature verdict on variable insurance. Its determination to restrict variable insurance going forward is not economically justified. Moreover, the improvised regulations have yet to be tailored to the systemic risks associated with the Chinese version of variable insurance. As a result, they risk suffocating the development of variable insurance as a helpful market-driven addition to the Chinese financial market.

The most sweeping regulation came in 2018 when multiple financial regulators jointly promulgated the "Guiding Opinions on Disciplining the Asset Management Businesses of Financial Institutions" (the "Asset Management Rules").[47] The Asset Management Rules are widely considered the most influential regulation in overhauling the regulatory framework of China's asset management industry, and more generally, its colossal shadow banking industry. However, one caveat is that variable insurance is still overlooked by the Asset Management Rules as the regulators seem to hold the view that variable insurance is insurance and

47 Guanyu Guifan Jinrong Jigou Zichan Guanli Yewu de Zhidao Yijian (关于规范金融机构资产管理业务的指导意见) [Guiding Opinions on Disciplining the Asset Management Businesses of Financial Institutions] (jointly promulgated by PBOC, CBRC, CSRC & SAFE, Apr. 27, 2018, effective Apr. 27, 2018). Existing products had a grace period until December 2020 to comply with the rules. Asset Management Rules, art. 29. The PBOC subsequently delayed the compliance requirements imposed on banks for one more year, so as to allow banks more time to adapt to the sweeping Asset Management Rules. *See* Chen Jia, *Revised Regulation for Asset Management Products May Be Delayed*, CHINA DAILY (July 24, 2020, 10:03 AM), https://global.chinadaily.com.cn/a/202007/24/WS5f1a4159a31083481725bd0d.html.

hence, not an asset management product.[48]

Therefore, the Asset Management Rules leave intact the existing regulatory landscape for variable insurance. The regulation of variable insurance remains within the CIRC's sole jurisdiction. We should note that prior to the Asset Management Rules, the regulatory responses in the wake of the Baoneng/Vanke takeover battle were ad hoc at best. The government's visible hand forced Foresea Life Insurance to succumb to Vanke's incumbent management.[49] Foresea Life Insurance subsequently vowed to be a passive financial investor only, no longer seeking control over Vanke.[50] In the face of regulatory interventions, Foresea Life Insurance gradually phased out of Vanke.[51]

These ad hoc regulatory responses were mainly aimed at restricting the denounced mid- to small-sized insurers' market entry. The CIRC suspended Foresea Life Insurance's variable life insurance business.[52] It demanded that Evergrande Life Insurance only sell and not buy stocks.[53] Even with the CIRC introducing the "Insurance Company Equity Administrative Rules" (the "Insurance Company Equity Rules"),[54] the regulations disproportionately impact small and medium insurers. The Insurance Company Equity Rules reduces a single shareholder's maximum shareholding in an insurance company from fifty-one percent to thirty-three percent.[55] Furthermore, it raises the qualification for a shareholder of an insurance company, requiring a net asset of no less than RMB 3 billion—1.5 times of the previous requirement of RMB 2 billion.[56]

The disproportionality in impact lies in the fact that, generally, it is non-State-owned, mid- to small-sized insurers that generate a high percentage of their premiums from variable insurance sales (as indicated in Table 1

48 It is hard to ascertain the actual intent behind the carve-out. A similar example is that family trust, while not substantially different from other trust products, is exempted from the rules governing unit trust products in the Asset Management Rules. *Id.*

49 *See* Taurai Muvunza & Terrill Frantz, *Disturbing the Peace: Anatomy of the Hostile Takeover of China Vanke Co.*, at 4, 8–9 (2020), https://arxiv.org/pdf/2003.06019.pdf (discussing the role of the state in the Baoneng/Vanke takeover).

50 Li, *supra* note 5, at 175.

51 Yang Qiaoling & Leng Cheng, *After Failing to Take Over, Baoneng Starts Selling Vanke Stake*, CAIXIN GLOB. (Apr. 18, 2018), https://www.caixinglobal.com/2018-04-18/after-failing-to-take-over-baoneng-starts-selling-vanke-stake-101236220.html.

52 Fitzgerald, *supra* note 38, at 6.

53 *Id.*

54 Baoxian Gongsi Guquan Guanli Banfa (保险公司股权管理办法) [Insurance Company Equity Administrative Rules] (promulgated by China Ins. Reg. Comm'n, Mar. 2, 2018, effective Apr. 10, 2018), http://bxjg.circ.gov.cn/web/site0/tab5176/info4101516.html (China).

55 *Id.* art. 29(1).

56 *Id.* art. 16(6).

below). Mainstream State-owned insurers generally maintain a fair percentage of premiums generated from traditional insurance businesses.

**Table 1: Volume of Variable Insurance Premiums for Selected Small to Mid-sized Insurers in 2016**

| Insurance Company | Variable Insurance Premium (billion CNY) | Percentage as Total Premium |
|---|---|---|
| Evergrande Life Insurance | 49.175 | 92.59% |
| Foresea Life Insurance | 77.587 | 79.95% |
| Huaxia Life Insurance | 132.372 | 75.53% |
| Dongwu Life Insurance | 4.023 | 61.19% |

**Source: CIRC**[57]

In a nutshell, the CIRC closed the door for a select subset of insurers. It deemed these insurers as posing a particular risk to the variable insurance market. Whether the CIRC's action was justified is an open question, and it invites the criticism of whether it banked on selective enforcement: harming small-to medium-insurers while benefiting large, State-run insurers. Unfortunately, these improvised responses failed to address the inherent risks in variable insurance.[58] The root of the inherent risks has yet to be diagnosed, let alone treated. It influences the theme of this article and remains a worthwhile academic inquiry.

57 Qiaoling Yang, *CIRC Dispatches Delegation to Nine Insurers, Aimed at Curbing Universal Variable Life* (保监会派检查组入驻九家险企 整改万能险), CAIXIN WKLY. (Dec 28, 2016), http://finance.caixin.com/2016-12-28/101031250.html.

58 *See infra* Section III.C.

## III. CHARACTERISTICS OF VARIABLE PRODUCTS MADE IN CHINA

First and foremost, although China's variable products were derived from their U.S. counterparts bearing the same name, they have evolved to possess unique characteristics.[59] In the U.S., variable contracts are characterized as unit investment trust security and are, therefore, subject to federal securities regulation under the Securities Act of 1933.[60] Meanwhile, the separate account is regulated as investment company under the Investment Company Act of 1940.[61] It has, in fact, become a derivative instrument.

The regulatory question posed to variable insurance is: should it likewise be regulated as a securities product in China? If so, does China have an institutional setting that would make such a regulatory approach possible? This section summarizes the similarities and differences between variable insurance in China and the U.S. It finds that certain distinctive features of Chinese variable insurance products render them more susceptible than their U.S. counterparts to fall within the ambit of securities products. They charge sales loads comparable to mutual funds, allocate the majority of the premium contributions to the separate account instead of the general insurance account, and typically have a short maturity term, all of which reinforce their securities nature.

### *A. "Separate Account" in the U.S. versus "Separate Investment Account" in China*

In both jurisdictions, a variable contract represents a contractual relationship between the policyholder and the insurance company. Premium payments to an insurance company are allocated to an asset account segregated from other insurance premiums received by the insurer— termed a "separate account" in the U.S. or "special investment account" in China.[62] The insurers maintain the separate accounts or the special investment accounts and keep the assets in those accounts separate

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59 *See infra* in this Section.

60 Discussed *infra* Section IV.D.; SEC v. Variable Annuity Ins. Co. of Am., 359 U.S. 65, 91 (1959) (holding variable annuity contracts are "securities" within the meaning of the 1933 Securities Act and therefore subject to federal regulation).

61 Investment Company Act, 15 U.S.C. § 80a-2(a)(37).

62 Stephen E. Roth, Susan Krawczyk & David S. Goldstein, *Reorganizing Insurance Companies Separate Accounts Under Federal Securities Law*, 46 BUS. LAW. 537, 542–45 (1991) (structure of separate accounts); Tamar Frankel, *Regulation of Variable Life Insurance*, 48 NOTRE DAME L. REV. 1017, 1018 (1973).

from the insurers' own proprietary accounts.[63] One important part in distinguishing the general and separate accounts is that the management of an insurer's general account is subject to U.S. state insurance laws whereas the latter falls within the ambit of federal securities regulation.[64] The insurers use the funds in the separate or special investment accounts to make investments.[65] The proceeds from these investments are accredited to the policyholders after deducting fees.[66]

Central to the architecture of U.S. variable insurance is the separate account. The Investment Company Act defines a separate account as follows:

> [A]n account established and maintained by an insurance company pursuant to the laws of any State or territory of the United States, or of Canada or any province thereof, under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.[67]

The innovation of variable insurance, therefore, is that through a separate account, an insurer is able to play a dual role of conventional insurer and investment adviser.[68] In *SEC v. Variable Annuity*, Justice Douglas ruled that variable annuity contracts were subject to federal securities regulation on the ground that these contracts "contain[ed] to a very substantial degree elements of investment contracts as administered by equity investment trusts."[69] Justice Harlan, in his dissent, similarly recognized "variable annuity contracts contain both 'insurance' and 'securities' features."[70] The separate account is, therefore, in essence, an accounting trick inside an insurance company: it acts as a depository to "separate" certain assets for designated investment purposes from the insurer's assets. The separate

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63 See Matthew C. Turk, *The Convergence of Insurance with Banking and Securities Industries, and the Limits of Regulatory Arbitrage in Finance*, 3 COLUM. BUS. L. REV. 967, 1042 (2016) (insulation of separate account assets from that of general accounts); Roth et al., *supra* note 62, at 550–55 (separate account structures).

64 Roth et al., *supra* note 62, at 542–50 (state versus federal regulation).

65 *Id.* at 551–52.

66 *Id*. at 543 (state insurance provisions generally provide that "the income, gains and losses, realized or unrealized, from assets allocated to the separate account shall be credited to or charged against the account, without regard to other income, gains or losses of the insurer").

67 Investment Company Act, 15 U.S.C. § 80a-2(a)(37).

68 For a general introduction of variable product, see Frankel, *supra* note 62 at 1033.

69 SEC v. Variable Annuity Ins. Co. of Am., 359 U.S. 65, 91 (1959).

70 *Id*. at 95 (Harlan, J., dissenting).

account's independence facilitates the measurement of investment performance for the assets in the separate account.

In the U.S., federal regulation of the separate account has evolved over time. Currently, under the Investment Company Act, a separate account is treated as a separate entity characterized as an investment company.[71] A significant legal consequence is that it does not have to abide by the set of rules governing insurers themselves. Restrictions on insurers' investment are a matter of state law, and many states have put in place such requirements as diversification of investment portfolios and prudent-investment criteria.[72] This is in line with the development of fiduciary duties in trust law. That is, an evolvement from black-letter legal lists of permitted investments,[73] prescribing the types of investments a fiduciary can make, to the prudent investor rule under state laws,[74] the breach of which relies on adjudication by the courts. This distinction in legislation is based on the rationale that insurers' investments that use premium payments in their general accounts are recorded on their balance sheets while assets in the separate accounts are off-balance-sheet. It is the variable contract owners who ultimately take the investment risks and accordingly bear the "income, gains and losses" of the investments.[75]

Mimicking their U.S. counterparts' business strategy, Chinese insurers promote the flexibility of variable insurance. Chinese variable insurance products offer both insurance and investment functions—flexibility other insurance instruments do not otherwise provide. After policyholders pay the premiums, the insurer allocates the funds to two accounts: a "risk insurance account" as part of the insurer's general account and a "separate investment account" distinctive from the insurer's general account.[76] Note that, instead of recording it off-balance sheet, the premiums allocated to the separate investment account are booked on the balance sheet.[77] Meanwhile, the

71 15 U.S.C. § 78c.(a)(19)

72 PETER M. LENCSIS, INSURANCE REGULATION IN THE UNITED STATES: AN OVERVIEW FOR BUSINESS AND GOVERNMENT 41 (1997); *see also* N.Y. INS. LAW § 4240(a)(1)–(2), (7).

73 Robert H. Sitkoff, *Fiduciary Principles in Trust Law*, *in* OXFORD HANDBOOK OF FIDUCIARY LAW 41 (Evan J. Criddle, Paul B. Miller & Robert H. Sitkoff eds., 2019) (historical development from legal lists of permitted investments, to the prudent man rule, to the prudent investor rule).

74 The states in the U.S. adopted the prudent investor rule by opting into the Uniform Prudent Investor Act (Uniform Law Commission 1994). *See* UNIF. PRUDENT INV. ACT (UNIF. L. COMM'N 1994); RESTATEMENT (THIRD) OF TRUSTS §§ 90–92 (AM. L. INST. 2007).

75 15 U.S.C. § 80a-2(a)(37).

76 See Frankel, *supra* note 62, at 1018.

77 Baoxian Hetong Xiangguan Kuaiji Chuli Guiding (保险合同相关会计处理规定) [Measures on the Accounting Treatment Related to Insurance Contracts] (promulgated by Ministry Fin., Dec. 22, 2009, effective Dec. 22, 2009) (China).

income, gains and losses are passed through to contract owners via the intermediary of the separate investment account.[78]

Policyholders have the option to decide what proportion of their premium payments goes to the risk insurance account and what portion goes to the separate account.[79] Over the term of insurance, they may make further adjustments to the total amount of the premium payable each year, the percentage of the premium that goes to the risk insurance account or to the separate account, the maturity term, and so on.[80] Moreover, the contract owners may even withdraw the cash value of the policy, subject to a fee charge—hence, the term "universal" and "variable."[81]

### *B. The Distinctions*

But the similarity stops there. The abovementioned features of Chinese variable insurance open it up to the question of to what extent variable insurance resembles a security, such as a mutual fund unit, or a unit investment trust. Moreover, it also invites questions about the extent to which the separate investment account replicates the U.S. separate account so as to render it an investment company. Below, this section summarizes some of the distinctive features of variable insurance in China, which pose novel challenges to Chinese regulators.

For one thing, insurers make the most of the investment functions by manipulating variable contract owners' ability to freely decide on the portion of funds that are allocated to the separate account. An insurer is mandatorily required to disclose and illustrate to their policyholders which portion of premiums is allocated to the separate account[82] yet is not prohibited from retaining the right to make the initial fund allocation between the general and separate accounts. As a result, variable universal insurance products in China are indeed "fixed" rather than "variable" insurance. In other words, insurers decide for variable contract owners, and

78 See Frankel, *supra* note 62, at 1018.

79 Specimen Variable Universal Life Insurance Contract of Foresea Life Insurance (前海盛世财富终身寿险(万能型)保险合同) (China) (on file with author).

80 See Paul J. Mason & Stephen E. Roth, *SEC Regulation of Life Insurance Products–On the Brink of the Universal*, 15 CONN. L. REV. 505, 551–54 (1983) (description of universal life insurance as a U.S. financial product).

81 *Id.*

82 Renshen Baoxian Xinxing Chanpin Xinxi Pilu Guanli Banfa (人身保险新型产品信息披露管理办法) [Measures for the Administration of the Disclosure of Information on New Life Insurance Products] (promulgated by China Ins. Regul. Comm'n, Sept. 25, 2009, effective Oct. 1, 2009), art. 25.4.1(3) (China).

not the other way around, how to split funds between general account and separate account.[83] The issue is: when the vast majority of funds are allocated to the separate account, variable insurance is in effect turned into a pure investment vehicle.[84] In such scenario, it is akin to an investment company.[85] The existence of the general insurance account, as well as the insurance against death, illness, and so on, then seems more a disguise to circumvent securities regulation than insurance.

More specifically, insurers charge a sales load, termed as "initial fee,"[86] on any funds that are allocated to separate account.[87] Similar to the two percent management fee typically incurred by mutual fund purchases, variable insurers charge a management fee in proportion to the size of the premiums.[88] Thus, the management fee is tied to the size of the assets, not the risk associated with the interests to be insured.

Chinese variable insurance has a short maturity term in sharp contrast to its U.S. counterpart. A typical U.S. variable product has a long maturity term – termed as a pay-in period.[89] Over the pay-in period, a purchaser of the variable contract makes periodic payments of a specified premium. In the pay-in period, a policyholder may terminate the variable contract at little

83 Contrasting "fixed or traditional universal life" is "indexed universal life" and "variable universal life." In the case of indexed variable insurance, insurers link the separate accounts to indexes such as the S&P 500 and track the indexes. Investment returns of separate accounts are calculated based on the performance of the linked indexes. In the case of variable insurance, insurers offer a basket of mutual funds for policyholders to choose from. Policyholders make investment decisions and bear the risks on their own. Variable insurance is called "investment-linked insurance" or "unit-linked insurance" in China and Hong Kong. *See* Chor-Shu Isabel Cheuk, Yuen Mui Wendy Lam, Sze Hang Suzanna Leung & Tze Fai Freddy Pang, *A Study of Financial Sector Regulation in Hong Kong: Towards A New Insurance Regulatory Regime* (2013) (M.A. capstone project, University of Hong Kong, Department of Politics and Public Administration), https://core.ac.uk/download/pdf/38064261.pdf (investment-linked insurance schemes in Hong Kong).

84 Death benefits for certain types of variable insurance—group variable insurance for instance—can be reduced to as low as zero. Variable Insurance Fee Rate Rules, *supra* note 7, art. 2.

85 China does not embrace a similar concept of investment company in its legislation. Instead, a recognized form of investment company is securities investment fund, analogous to mutual fund in the U.S. context. *See* Zhengquan Touzi Jijin Fa (证券投资基金法) [Securities Investment Fund Law], art. 2 (definition of securities investment fund).

86 "*Chushi feiyong*" in Chinese.

87 Variable Insurance Fee Rate Reform Rules, *supra* note 7 art. 11(1).

88 *Id.* art. 11(3).

89 *See, e.g.*, Prudential prospectuses, https://www.prudential.com/personal/life-insurance/variable-life-insurance-performance; Specimen Flexible Premium Variable Universal Life Insurance Policy, John Hancock Life Ins. Co. N.Y., SEC, https://www.sec.gov/Archives/edgar/data/1043846/000119312512253158/d351337dex9926d1.htm (last visited June 16, 2021).

cost.[90] Normally, a pay-in period runs at least 15 years.[91] The long maturity term in U.S. insurance products in part serves a compliance purpose. In order to avoid the fate of being classified as securities, U.S. policies would generally prefer to be whole-life policies.[92] A Chinese variable insurance product, in contrast, has by design a much shorter maturity term. As a general practice, in variable insurance contracts the policyholders are allowed to withdraw—or cash in—the policy as soon as several years after entering into the contract. The mechanism works this way: policyholders would be levied a surrender charge for early termination at a rate that decreased over the years.[93] As a result, by the sixth year, the policyholder's surrender charge for early termination would be down to zero. The effect is that if a contract owner chooses to withdraw—or cash in—his or her policy on the sixth year of the contract, he or she may cash in at no cost. What is worse, aggressive insurance companies that sold variable products through online platforms took the bold move to make the cash values payable in three to six months.[94] Variable contract owners could therefore easily cash in the accumulated units in the insurance in a way that substantially resembles term debt instruments or is analogous to redeeming mutual fund units.

In sharp contrast to its later attitude, the CIRC first endorsed such business practices.[95] It recognized in its rules and regulations variable insurance products as "medium- or short-maturity products."[96] In particular, the Variable Insurance Fee Rate Reform Rules sets forth a cap on the surrender fee that insurers can charge upon policyholders' withdrawal of contract value.[97] It requires that from the sixth year onward no surrender fee

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90 Upon the termination of the variable contract during the pay-in period, a policyholder is entitled to receive the full value of the assets credited to the separate account, after deduction of certain charges for the termination. *See* Prudential Ins. Co. of Am. v. SEC, 326 F.2d 383, 385 (3d Cir. 1964).

91 Prudential Ins. Co. of Am. v. SEC, *supra* note 89, at 385; Specimen Flexible Premium Variable Universal Life Insurance Policy, *supra* note 89, §§ 8 & 13.

92 Frankel, *supra* note 62, at 1022.

93 For example, the early termination penalty fees for variable insurance products issued by Foresea Insurance are three, two, and one percent of the value of funds in separate account for the first year, second year, and third anniversary respectively. *See* Foresea Life Insurance Standard Contract, on file with the author.

94 Nie Fangyi, *Sichuan Cuisine and Universal Life Insurance*, CAIXIN (June 17, 2016, 1:23 PM), http://opinion.caixin.com/2016-06-17/100955844.html.

95 Variable Insurance Fee Rate Reform Rules, *supra* note 7 art. 19.

96 Guanyu Guifan Zhongduan Cunxu Qi Chanpin Youguan Shixiang de Tongzhi (关于规范中短存续期产品有关事项的通知) [Notice on Regulating Products with Mid- to Short-term Durations], art. 1, http://www.circ.gov.cn/web/site0/tab5168/info4023468.htm (China) (in response to the common practice that most products have a maturity term of less than 5 years).

97 Variable Insurance Fee Rate Reform Rules, *supra* note 7, art. 19.

can be charged should variable contract owners unilaterally terminate the contract and "redeem" their cash value.[98] With the regulatory green light, adventurous insurers took advantage of the tactfully crafted short maturity term and rolled out short-term variable insurance as an investment product. It explains why variable insurance experienced a quick boom in China.

As it turned out, these insurers were not entirely to blame when the regulators flip flopped and severely penalized those who were proactive in expanding their variable insurance business.[99] After all, the regulators indulged their product design in the first place, as shown in Figure 1 above.

98 *Id.*
99 *See infra* Section I.C.

## IV. ARE THE SYSTEMIC RISKS OPTIMALLY TAMED?

With the new rules backtracking the deregulation initiatives, it seems further criticism over the regulatory framework for variable insurance is no longer warranted. This section argues to the contrary. The regulatory responses can be viewed as ad hoc at best. They fail to address the systemic risks embedded in variable insurance products. Meanwhile, they work to arbitrarily suppress the business viability of variable insurance, which could have otherwise introduced desirable competition in the asset management market. Indeed, the turbulent evolution of variable insurance regulation is representative of the state of financial regulation in China: the policies are arbitrary, inconsistent, and hard to characterize as market oriented.[100]

### *A. Net Capital Requirements & the Cost of Capital*

The Asset Management Rules target a number of widespread issues in the asset management products' market. They intend to level the playing field by curbing rampant regulatory arbitrage as a result of segregated asset management regulations.[101] The Asset Management Rules mark a milestone for the unification of regulations over asset management products with similar features,[102] which were previously subject to different sets of rules.[103] However, the regulatory purpose is grander than the actual coverage of the Asset Management Rules.

One major reform of the Asset Management Rules requires financial institutions to move off-balance sheet asset management products back on

100 *See* Sebastian Heilmann, *Regulatory Innovation by Leninist Means: Communist Party Supervision in China's Financial Industry*, 181 CHINA Q. 1 (2005) (China's tendency to exercise centralized financial market supervision, which lacks market-driven incentive structures).

101 Historically, asset management corporations were subjected to regulations by various agencies, which had conflicting agendas. They were created to handle state-owned enterprise ("SOE") banks' non-performing loans in the first place yet carried on playing a significant rule in the financial market. This is in part attributable to the emergent regulatory arbitrage opportunities. Today, the type of financial institutions engaging in asset management business are much broader than an asset management corporation alone. *See* Guonan Ma & Ben S C Fung, *China's Asset Management Corporations* 14-15 (Bank for Int'l Settlements, Working Paper No. 115, 2002), (historical supervisory environment for asset management corporations).

102 Asset Management Rules, *supra* note 47 (statement of purposes that it is aimed at "setting unified regulatory standards [for asset management business]").

103 See J.P. Morgan Asset Management, *The Impact of China's Comprehensive 2018 Regulation of Asset Management Products*, at 3 (2018), https://am.jpmorgan.com/content/dam/jpm-am-aem/global/en/liq/insights/liquidity-insights/The-Impact-Of-Chinas-Regulations.pdf (the regulatory arbitrage derived from different rules prior to the unified Asset Management Rules).

to the balance sheet.[104] Booking products off-balance sheet, and thereby getting around the reserve requirements, is common practice in China's shadow banking sector.[105] Variable insurance falls outside the reach of the Asset Management Rules and is booked on the balance sheets of insurers in its entirety.[106] Under Chinese accounting standards, an insurance contract may be broken down into two parts: one that an insurer assumes insurance risk, and the other that the insurer assumes risks other than insurance risk.[107] The latter may be reported as financial assets held by the insurer.[108] But, it is nevertheless booked on the balance sheet as the insurer's liability.[109] In other words, even though the Asset Management Rules are deemed an overhauling regulation, it fails to substantively change the old regulatory institution when it comes to variable insurance.

While the Asset Management Rules put asset management products on equal footing with variable insurance in terms of on-balance sheet treatment, room for regulatory arbitrage remains. Regulatory arbitrage occurs when rules governing capital requirements—which reduce the funds the institutions may use to operate their financial business and thereby limit their profit margins—for similarly functioned asset management products vary from one another.[110] This is in line with the assumption in the rich literature on regulatory competition that the regulated choose among multiple regulatory regimes so as to minimize transaction costs.[111] Where the cost of migration is negligible, firms migrate to the most lenient — least

104 For example, the Asset Management Rules demand, among others, asset management business be spun off from existing financial institutions and thereby be managed by a separate subsidiary. *See* Asset Management Rules, *supra* note 47, art. 13. Those financial institutions whose existing products are incompliant with the requirements of the Asset Management Rules are under pressure to convert the existing products into ones that are permissible under the new regime. Since existing asset management products are off-balance-sheet products, when financial institutions are deprived of the right to engage in asset management business (a.k.a., off-balance-sheet business), the viable option for these institutions would accordingly be converted the products into on-balance-sheet ones. *See Id.* art. 2 (defining asset management business as "off-balance-sheet business of financial institutions").

105 *See* Douglas Elliott, Arthur Kroeber & Yu Qiao, *Shadow Banking in China: A Primer*, 3 ECON. STUD. BROOKINGS 1, 7–8 (2015) (banks' off-balance sheet practice); *see also* Kaiji Chen, Jue Ren & Tao Zha, *What We Learn from China's Rising Shadow Banking: Exploring the Nexus of Monetary Tightening and Banks' Role in Entrusted Lending* (Nat'l Bureau of Econ. Rsch., Working Paper No. 21890, 2016), https://www.nber.org/papers/w21890.pdf (moving assets off-balance sheet by way of entrusted loans).

106 Measures on the Accounting Treatment Related to Insurance Contracts, *supra* note 77.

107 *Id.* art. 1.1.1.

108 *Id.* art. 1.1.2.

109 *Id.* art. 1.1.2.

110 *See generally* Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 230–31 (2010); Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 J. CORP. L. 211 (1997).

111 For classical works, see*, e.g.*, Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 249 (1985); William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303, 304 (1997).

costly – regulatory regime possible.[112] Although regulatory arbitrage may have a positive value in reducing the costs of financial regulation,[113] it also invites criticism over the market failure generated.[114] The far-from united cost of capital is one representative example of the incentives for regulatory arbitrage. For financial products in fierce competition with each other, gaining a competitive edge becomes critical for their success on the market.[115]

While off-balance sheet treatment is no longer an option, financial institutions compete to set capital reserves at as low a level as possible. Variable insurers are no exception in this race. However, insurers are at a disadvantage as they face capital restraints on both sides of the balance sheet — the assets and the liabilities.[116] An insurer's minimum capital requirement is a function of the composition of its asset portfolios (on the assets' end) and the quality of its liability (on the liabilities' end).[117]

To elaborate further, the CIRC first assesses the solvency status of an insurer before it decides on the applicable capital requirement.[118] A solvency ratio refers to an insurer's net assets to its non-life premium income[119] – a key metric for measuring an insurer's ability to meet its debt obligations. It is determined by multiple factors, including the quality of an insurer's assets and liabilities.[120] If the insurer's solvency ratio falls below a certain threshold (e.g., one hundred percent),[121] the CIRC will impose a more stringent capital requirement on the company.[122]

112 Carney, *supra* note 111, at 304.

113 Partnoy, *supra* note 110, at 216.

114 *Id.* at 242–46.

115 *Id.* at 219–20 (regulatory arbitrage in financial derivatives market to exploit comparative advantage).

116 Baoxian Gongsi Changfu Nengli Guanli Guiding (保险公司偿付能力管理规定) [Administrative Rules on the Solvency of Insurance Companies] (promulgated by China Ins. Regul. Comm'n, Oct. 21, 2008, effective Oct. 21, 2008), art. 1.1.2 [hereinafter Solvency Rules]. Solvency ratio—the equivalent of capital ratio—should be no less than 100%. Solvency ratio is calculated based on the following formula: (recognized asset – recognized liability) / minimum capital ≥ 100%. Baoxian Gongsi Changfu Nengli Jianguan Guize Yi Hao: Shiji Ziben (保险公司偿付能力监管规则第 1 号：实际资本) [Solvency Regulatory Rules for Insurance Companies No. 1: Capital] (promulgated by China Banking Regul. Comm'n, Feb. 13, 2015, effective Feb. 13, 2015), art. 3 (China).

117 Solvency Rules, *supra* note 116.

118 *Id.* art. 6.

119 *Solvency Ratio*, OXFORD DICTIONARY OF FINANCE AND BANKING 445–46 (6th ed. 2018).

120 Solvency Rules, *supra* note 116 art. 22.

121 *Id.* art. 3 (the mandatory solvency ratio for an insurance company is 100%); *id.* art. 37 (staggered regulatory requirements for insurers with different solvency ratios).

122 *Id.* art. 38(1).

In contrast, banks under the China Banking Regulatory Commission's ("CBRC's") jurisdiction are governed by a different set of capital requirements. Their capital requirements are determined by the specific types of investments they make.[123] For trust companies, their net capital requirements hinge on their ratings assessed by the CBRC.[124] Trust companies are particularly burdened by the dual reserve mechanism.[125] That is, in addition to meeting the net capital requirements that were in place prior to the promulgation of the Asset Management Rules, trust companies also need to set aside risk reserves.[126]

In a similar vein, for securities companies, the determinants of their capital ratio include the types of products offered and the CSRC recognized ratings for such products.[127] In other words, the capital ratio requirement is not only a function of the underlying portfolios as managed by the securities companies,[128] but also that of the firms.[129] In contrast, fund management companies – equivalent to investment companies in the U.S. context – have to abide by a different set of rules when it comes to capital requirements.[130]

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123 For banks, on-balance-sheet asset management products are subject to capital requirement, whereas off-balance-sheet products are not. See Viral V. Acharya, Jun Qian, Yang Su & Zhishu Yang, *In the Shadow of Banks: Wealth Management Products and Issuing Banks' Risk in China* 8 (Ctr. for Econ. Pol'y Rsch., Discussion Paper 14957, 2019), https://repec.cepr.org/repec/cpr/ceprdp/DP14957.pdf (regulation of on-balance-sheet lending through capital ratio requirements).

124 Xintuo Gongsi Jing Ziben Guanli Banfa (信托公司净资本管理办法) [Administrative Rules on the Net Capital of Trust Companies] (promulgated by China Banking Regul. Comm'n, Aug. 24, 2010, effective Aug. 24, 2010), arts. 13, 16 (risk capital as determinant of net capital) (China). For trust companies, the calculation of their capital requirement is dependent on the risk exposures of their investment subjects, termed as "risk capital." *Id.*

125 Ernst & Young, *China Regulators Jointly Release New Rules to Narrow the Use of Regulatory Arbitrage in the Asset Management Industry* 3 (2018), https://www.ey.com/Publication/vwLUAssets/ey-wealth-and-asset-management-point-of-view-jan-2018-en/$File/ey-wealth-and-asset-management-point-of-view-jan-2018-en.pdf (double reserve mechanism applicable to trust companies).

126 Asset Management Rules, *supra* note 47, art. 17 (the risk reserve is calculated on the basis of 10% of the management fee charged to the AUM).

127 Securities companies with better ratings are allowed to maintain a lower risk-based capital ratio. *See* Zhengquan Gongsi Fengxian Kongzhi Zhibiao Guanli Banfa (证券公司风险控制指标管理办法(2016修正)) [Administrative Rules on the Risk Control Indexes of Securities Companies (2016 Amendment)] (promulgated by China Sec. Regul. Comm'n, Nov. 1, 2006, amended June 16, 2016, effective Oct. 1, 2016); Zhengquan Gongsi Fengxian Kongzhi Zhibiao Jisuan Biaozhun (证券公司风险控制指标计算标准规定) [Rules on the Calculation Standards for the Risk Control Indexes of Securities Companies] (promulgated by China Sec. Regul. Comm'n, Jan. 23, 2020, effective June 1, 2020) (China).

128 Through its asset management subsidiary. *See* Administrative Rules on the Risk Control Indexes of Securities Companies (2016 Amendment), *supra* note 127, art. 6.

129 Administrative Rules on the Risk Control Indexes of Securities Companies (2016 Amendment), *supra* note 127, art. 10.

130 Jijin Guanli Gongsi Zi Gongsi Guanli Guiding (基金管理公司子公司管理规定) (Administrative Rules on the Subsidiaries of Securities Investment Fund Management Companies)

Coupled with the Asset Management Rules, a fund management company engaging in asset management business[131] will now have to meet its capital requirement in accordance with the risks of its assets under management.[132]

In essence, variable insurance and other asset management products[133] are subject to different net capital requirements, notwithstanding the fact that they share a functional resemblance. To illustrate how the capital requirement changes the dynamics of competition in the asset management business, take bank wealth management products as an example. In 2015, China's amended Commercial Banks Law abolished the statutory seventy-five percent loan-to-equity ratio requirement that had been in place for twenty years.[134] Lifting the ban eased the capital requirement imposed on banks. Banks then had less incentive to circumvent the capital requirement by way of packaging loans into off-balance-sheet wealth management products as they had done before.[135] By contrast, the change in the loan-to-equity ratio had no impact on the structuring of variable insurance, which by its nature is not subject to banking regulations. Hence, insurers had the same incentive as before to continue rolling out variable products.

Regrettably, the newly rolled out Asset Management Rules address the systemic risks derived from the asset management businesses in some financial institutions, but not all of them.[136] One of the Asset Management Rules' focuses lies in restraining shadow banking and accordingly forcing banks to move off-balance sheet wealth management products back onto the

(promulgated by China Sec. Regul. Comm'n, Nov. 29, 2016, effective Dec. 15, 2016); Jijin Guanli Gongsi Teding Kehu Zichan Guanli Zi Gongsi Fengxian Kongzhi Zhibiao Guanli Zanxing Guiding (基金管理公司特定客户资产管理子公司风险控制指标管理暂行规定) (Interim Administrative Rules on the Risk Control Indicators of Specific Cleint Asset Management Subsidiaries of Fund Management Companies) (promulgated by China Sec. Regul. Comm'n, Nov. 29, 2016, effective Dec. 15, 2016) (China).

131 Through its subsidiary.

132 Interim Administrative Rules on the Risk Control Indicators of Specific Cleint Asset Management Subsidiaries of Fund Management Companies, *supra* note 130, art. 11.

133 For example, wealth management products managed by banks' asset management arms. The terms wealth management product and asset management product are often used interchangeably in the financial industry.

134 Guanyu Xiugai "Zhonghua Renmin Gonghe Guo Shangye Yinhang Fa" de Jueding (关于修改《中华人民共和国商业银行法》的决定) [the Decision to Amend the PRC Commercial Banking Law] (published by the Standing Comm. Nat'l People's Cong., Aug. 29, 2015, effective Oct. 1, 2015).

135 *See* Wu, *supra* note 11, at 66–67.

136 Asset Management Rules, *supra* note 47, art. 2. The scope of coverage includes the asset management arms of (i) banks, (ii) trust companies, (iii) securities companies, (iv) fund management companies, (v) futures companies, (vi) insurance companies, as well as financial asset investment companies.

balance sheet.[137] Variable insurance launched by insurance companies happens under the radar as do some other asset management products like family trust.[138] The room for regulatory arbitrage is reduced yet remains ample.

*B. Guaranteed Minimum Income Benefit*

Variable insurance has a comparative edge over other asset management products by guaranteeing minimum returns to investors. The Actuarial Rules permit variable products to guarantee minimum returns to their investor policyholders,[139] a practice otherwise strictly prohibited in other financial products. This downside protection shores up investors' confidence as they are assured that their contracts are not exposed to the same level of investment risks as with other investment products. Under the Asset Management Rules, asset management products are no longer permitted to offer express or hidden guarantee of return.[140] The unique ability of insurers to provide minimum income benefits explains, in part, the soaring popularity of variable products immediately following the promulgation of the Actuarial Rules.[141]

Guaranteeing policyholders' minimum income benefit is not a feature unique to Chinese variable insurance. It has long been in existence in U.S. variable products like variable annuities.[142] Variable annuities in the U.S. offer guarantees in various forms such as guaranteed minimum withdrawal benefits and guaranteed minimum income benefits.[143] Similarly, fixed indexed annuities offer a minimum guaranteed return to their contract owners.[144] With the downside truncated, the potential upside is attractive: if the stock market performs well, the underlying contracts' value may exceed the minimum guarantee.[145] This feature plays a core function that, by

137 Asset Management Rules, *supra* note 47, art. 13. See also explanations in *supra* note 104.

138 Guanyu Jiaqiang Guifan Zichan Guanli Yewu Guodu Qi Nei Xintuo Jianguan Gongzuo de Tongzhi (关于加强规范资产管理业务过渡期内信托监管工作的通知) [Notice on Strengthening the Regulation of Trusts in the Transitional Period for Asset Management Business] (promulgated by China Banking Regul. Comm'n, Aug. 17, 2018, effective Aug. 17, 2018).

139 Actuarial Rules, *supra* note 8.

140 Asset Management Rules, *supra* note 47.

141 Actuarial Rules, *supra* note 8, fig. 1.

142 *What Is the Difference Between Fixed and Variable Annuity?*, INS. INFO. INST., https://www.iii.org/article/what-difference-between-fixed-and-variable-annuity (last visited June 16, 2021).

143 Turk, *supra* note 63, at 1042.

144 Matt Van Heuvelen, *Duplicative, Confusing, and Legally Inaccurate: The SEC's Attempt to Regulate Fixed Indexed Annuities*, 35 J. CORP. L. 663, 666–67 (2010) (minimum guaranteed interest rates and the calculation of yields).

145 *Id.* at 667.

guaranteeing a minimum fixed return payable to the policyholders, some investment risks are shifted to, and borne by, the issuer insurers.

The fixed income feature adds some flavor of insurance to a financial product that brinks on a security product. It blurs the boundary between risk-taking investment and insurance. In *SEC v. Variable Annuity*, Justice Douglas held that because the variable annuity in question involved "no element of a fixed return," the issuer of variable annuity products did not genuinely assume the risk of mortality in an insurance sense.[146]

Compared to their U.S. counterparts, the Chinese variable products have yet to be challenged as securities.[147] Chinese insurers transplanted the feature of a guaranteed income from the U.S. for the sake of winning customers over other asset management products. Whether the Chinese regulators made a wise decision in endorsing such a business practice in the Actuarial Rules[148] becomes an open question. If the financial regulators expressly forbid other asset management products from guaranteeing returns to their investors, why should they grant an exemption to variable insurance?

The reason underlying a prohibition of guaranteed return is that financial institutions' guaranteed return renders the market unable to accurately price the risks of financial assets.[149] When a systemic risk substantiates, a financial institution promising a guaranteed return to the investors of an asset management product would have to bail out the product, even if the product is not recorded on its balance sheet.[150] With the existence of the express or implicit guarantee,[151] termed as "rigid redemption" or "rigid payment," the market does not have to factor in the quality of the underlying assets of the financial products. This results in a

146 SEC v. Variable Annuity Ins. Co. of Am., 359 U.S. 65, 70–71 (1959).

147 *See infra* Section IV.D.

148 Actuarial Rules, *supra* note 8, art. 4.

149 Lusina Ho, *Business Trust in China: A Reality Check*, 88 U. CIN. L. REV. 767, 778 (2020) (guaranteed return made possible by the government's backing the financial institution's repayment of investor's assets).

150 Emily Perry & Florian Weltewitz, *Wealth Management Products in China*, *in* THE RESERVE BANK OF AUSTRALIA BULLETIN 59, 60–63 (June 2015), https://rba.gov.au/publications/bulletin/2015/jun/pdf/bu-0615.pdf#page=61 (risks associated with guarantees in wealth management products).

151 Ho, *supra* note 149, at 778. Some financial institutions do not expressly guarantee the returns on asset management products, but nevertheless engage in the bailout activities when risks emerge. They do so out of concern about the negative impacts on their credit ratings, and sometimes at the direction of the regulators out of fear of the public uproar brought about by a failure of the financial products. Hence, it is called a hidden guaranty.

dysfunctional asset-pricing market and spills over the risks associated with asset management products to a wide array of financial institutions.

Moreover, legalizing a minimum withdrawal benefit generates unintended consequences. In China, the guaranteed minimum income benefit functions as a double-edged sword. To insurers, the guarantee gears up their costs in managing variable products. To ensure the guaranteed minimum return, insurers tend to shift their risk preference toward the risk-preferred end, a drift away from their traditional prudential operations.[152]

In 2014, one of its peak years, China's insurance industry churned out an impressive rate of return on investments of 6.3%.[153] Such a rate of return is on the higher end compared to other well-off insurance markets.[154] It is not a coincidence that 2015 subsequently marked the year when hostile takeover activities on China's A-share securities markets, referring to China's Shanghai and Shenzhen stock exchanges trading in Renminbi-denominated shares, peaked.[155] The central criticism over insurers' launch of variable insurance is that this product facilitates and encourages insurers' reckless behavior on the securities market.[156] It deviates from the prudency requirements of insurance companies and subsequently imposes systemic risks on the insurance industry.[157] The impact on business decisions is: after subtracting the guaranteed minimum benefit and covering the costs of management, there would be little room for insurers to maneuver a sustainable profit margin if they did not endure more risk takings.

Another hidden political economy factor underlying the regulators' resentment of variable insurance is that the regulators grew uneasy about variable insurance's transformation into a financing instrument for hostile takeovers.[158] They are not as welcome to hostile takeovers as the text of China's Securities Law suggests.[159] The hostility grows when the bidder is a non-SOE company as opposed to an SOE.[160]

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152 *See, e.g.*, Fitzgerald, *supra* note 38, at 3–6 (insurers' tendency to engage in high-risk acquisitions in search of higher return).

153 China Ins. Regul. Comm'n, *Annual Report of the Chinese Insurance Market 2015*, at 44, chart 6 (2015).

154 For statistics on a list of selected insurance markets, see Org. for Econ. Coop. & Dev., *Global Insurance Market Trends 2017*, at 26, fig. 13 (2018), https://www.oecd.org/daf/fin/insurance/Global-Insurance-Market-Trends-2017.pdf.

155 For the takeover activities in China, see Li, *supra* note 5.

156 *See* Fitzgerald, *supra* note 38, at 8.

157 *Id.*

158 *See* Li, *supra* note 5, at 216–19.

159 *Id.*

160 *Id.*

In sum, in the U.S., variable insurance's fixed minimum return blends insurance features into the financial products. This way variable insurance may escape from being treated as a purely investment product. In China, where regulatory arbitrage between wealth management products remains abundant despite the Asset Management Rules, the provision of a fixed minimum return helps insurers win over investors. Meanwhile, the negative effect of the minimum income benefit skews insurers' risk preference toward the risk-preferred end, jeopardizing the prudential operations that define insurers.

### *C. Mismatch of Long-Term Investment and Short-Term Liability*

The funds in a separate account are primarily used for securities investment purposes on the securities market. With excess volatility features in China's A-share market,[161] returns on securities investments experience a high level of fluctuation. The dilemma is: even though some insurers intend to make long-term investments in the stock market—such that they may avoid the short-term swings on their balance sheets—the variable contract owners can subvert the completion of such a long-term vision by requesting early redemptions.

Insurers have an incentive to make long-term investments in equities, because when they acquire securities for long-term investment purposes, they are permitted to book the equities as an available-for-sale financial asset.[162] Available-for-sale financial assets can be recorded on the balance sheet based on the price of acquisition.[163] The acquisition price is fixed thereby avoiding the fluctuation in price.[164] Whereas, if the securities

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161 For empirical research on the Chinese stock market's volatility, see, *e.g.*, Haiyan Song, Xiaming Liu & Peter Romilly, *Stock Returns and Volatility: An Empirical Study of Chinese Stock Markets*, 12 INT'L REV. APPLIED ECON. 129 (1998).

162 Beginning 2018, IFRS 9 *Financial Instruments* replaced IAS 39 *Financial Instruments: Recognition and Measurement* as accounting standards applicable to Chinese insurers. The transition has profound influence on the insurers' behavior in equity investments. For an explanation on IFRS 9's impact on available-for-sale financial assets, see *IFRS 9 Explained – Available for Sale Financial Assets*, BDO U.K. (Mar. 13, 2017), https://www.bdo.co.uk/en-gb/insights/business-edge/business-edge-2017/ifrs-9-explained.

163 *Id.*

164 Under IFRS 9, upon its acquisition of equities on the securities market, the insurance company can make an irrevocable election to book the fair value of such equities at FVOCI and do not recognize them as equity investments held for trading. The recognition at FVOCI can get rid of subsequent variations in the fair value of the equities shown on the balance sheet when the price of the equities changes rapidly on the securities market. *Id.*; *see also* IFRS, *IFRS 9 Financial Instruments*, https://www.ifrs.org/issued-standards/list-of-standards/ifrs-9-financial-instruments/ (last visited June 16, 2021).

investment is intended as a short-term speculation, the insurers would have to record the securities on their balance sheets as financial assets for trading.[165] The value of financial assets for trading is determined by the market value, that is, the changing stock prices on the securities market.[166] Equity acquisitions booked as financial assets for trading invite unwanted fluctuations on the insurers' balance sheets. Therefore, insurers aiming at smooth figures on their balance sheets, consistent with the prudent image of insurance companies, would prefer the available-for-sale assets route.

However, the short-term nature of variable contract owners may compromise the long-term vision. Similar to mutual fund investors, variable contract owners in China enjoy a comparable right of on-demand redemption.[167] To elaborate, the contractual design enables variable contract owners to terminate and redeem the contracts at minimal cost. Recall Chinese variable contract owners have more rights than their U.S. counterparts to early redemption at little cost beginning a few years into the pay-in period.[168] The variable insurance contracts have in effect been transformed into quasi short-term mutual funds, allowing for quick turnarounds in purchase and redemption.

There is a mismatch between the short-term liquidity promised by at-will redemption and the long-term investments envisioned by the insurers. Analogous to a bank run, when deposits can be withdrawn on demand and bank loans are long-term, if a large crowd of depositors rush to withdraw, it is sure to cause a liquidity crisis for banks and economically damage society as a whole.[169] The banking regulation system resolves this systemic risk by setting aside cash reserves to meet potential withdrawal demand and through deposit insurance.[170] But similar mechanisms are not in place in the regulation of variable insurance insurers since they are non-banking institutions. Although, in theory, variable insurers might not face as high redemption pressure as mutual funds, we should not avoid the question:

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165 *See* Deloitte, *IFRS 9: Financial Instruments – High Level Summary*, at 6 (Apr. 13, 2016), https://www2.deloitte.com/content/dam/Deloitte/ru/Documents/audit/ifrs-9-financial-instruments-en.pdf.

166 *Id.*

167 Specimen Variable Universal Life Insurance Contract of Foresea Life Insurance, *supra* note 79.

168 *See supra* Section II.B.

169 For modeling of bank runs, see Douglas G. Waldo, *Bank Runs, the Deposit-Currency Ratio and the Interest Rate*, 15 J. MONETARY ECON. 269, 273–76 (1985) (highlighting the coordination problem).

170 Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401 (1983) (making the case for governmental provision of deposit insurance to address bank runs in lieu of private ordering); *cf.* George G. Kaufman, *Bank Failures, Systemic Risk, and Bank Regulation*, 16 CATO J. 17 (1996) (emphasizing the principle-agent problem in the governmental provision of deposit insurance).

what if there is high redemption demand someday? Will it present a systemic risk to insurers?

Another analogy is to other financial products with similar economic functions such as mutual funds. On-demand redemption is likewise available in mutual funds.[171] Mutual funds similarly face liquidity challenges. Upon receipt of redemption requests, mutual funds either sell off part of the portfolios under management or seek external short-term financing to meet the liquidity demands.[172] Mutual funds differ from the variable insurance in that on the assets side, fund managers are not legally required to, nor do they have incentive to, make long-term investments.[173] Mutual fund managers' incentive structure skews toward jacking up the size of assets under management ("AUM"), whereby they maximize the management fees charged at a percentage of the AUM.[174] Investments generating long-term returns tend to fall out of the ambit of fund managers' top priorities. Putting aside the agency problem embedded in the compensation structure,[175] there are neither regulatory requirements nor market practices that prompt portfolio managers to invest long term. Hence, the mismatch of long-term investment and short-term liquidity demand is not a key issue in the regulation of mutual fund industry.[176]

This leaves variable insurance in a unique position relative to other asset management products. The systemic instability inherent in the functioning of variable insurance presses for a regulatory response. The CIRC continues to give the green light to the mismatch of long-term and short-term liabilities.[177] They do not seem to be in a hurry to change the status quo and

171 *See* John Morley, *The Regulation of Mutual Fund Debt*, 30 YALE J. ON REG. 343, 365 (2013) (frequency of mutual fund redemptions); Edward Sherwin, *The Cost-Benefit Analysis of Financial Regulation: Lessons from the SEC's Stalled Mutual Fund Reform Effort*, 12 STAN. J.L. BUS. & FIN. 1, 36–42 (2006) (mutual fund unit redemption and fees associated with the redemption).

172 Morley, *supra* note 171, at 352–53 (explanation of mutual fund capital structures).

173 For mutual fund mangers' incentive structure, see generally Danilo Drago, Valter Lazzari & Marco Navone, *Mutual Fund Incentive Fees: Determinants and Effects*, 39 FIN. MGMT. 365 (2010); Keith C. Brown, W.V. Harlow & Laura T. Starks, *Of Tournaments and Temptations: An Analysis of Managerial Incentives in the Mutual Fund Industry*, 51 J. FIN. 85 (1996).

174 Linlin Ma, Yuehua Tang & Juan-Pedro Gómez, *Portfolio Manager Compensation in the U.S. Mutual Fund Industry*, 74 J. FIN. 587 (2019).

175 Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89 (2017).

176 TAMAR FRANKEL & ARTHUR B. LABY, REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISORS ch. 12 (2016). Notice that portfolio managers are subject to their fiduciary duties, which require them to act in the best interests of their clients. *See id.* ch. 13.

177 *See generally* Baoxian Zijin Yunyong Guanli Banfa (保险资金运用管理办法) [Measures for the Administration of the Utilization of Insurance Funds] (promulgated by China Ins. Regul. Comm'n, Jan. 24, 2018, effective Apr. 1, 2018) (China).

seem to sidestep the problem while promulgating one-off regulations. The time bomb remains unexcavated.

### *D. Investment Restrictions and Possible Fiduciary Duty Constraints*

One prescription to cope with the risk mismatch problem may be to mandate investment restrictions on the categories of assets in which separate accounts may invest. This approach aligns with the Chinese government's authoritarian tendency in regulation.[178] Indeed, it is the general approach taken by the insurance regulator when overseeing insurers' investment decisions.[179] The CIRC maintains a list of permissible investments by which insurers have to abide.[180] Such an approach is reminiscent of the legal lists of permitted investments first prescribed in common law trust law.[181] While the more flexible prudent investor rule has become the dominant norm in the U.S. to ensure trustees act in the best interests of beneficiaries in managing investments,[182] the prudent investor rule has yet to permeate the Chinese rules governing the investment behavior of insurers.[183]

But Chinese regulators' attitude toward separate accounts' investment restrictions is more subtle. Between 2014 and 2016, China's insurance industry witnessed a wave of deregulation regarding permissible investments. For instance, the CIRC increased the percentage of an insurance company's total assets[184] that were permitted to be invested in one single blue-chip stock from five percent to ten percent.[185] Furthermore, after an insurance company's investment in equity interests had reached the thirty percent limit, it could increase its shareholding in blue-chip stocks subject to a new cap of forty percent of its total assets.[186] It was against the backdrop

178 *See* Heilmann, *supra* note 100 (pointing out that pervasive government interference and the centralization tendency are the norms in China's financial regulation).

179 *See* Measures for the Administration of the Utilization of Insurance Funds, *supra* note 177.

180 *Id.* art. 6.

181 *See* Sitkoff, *supra* note 73.

182 *Id.*

183 *See* Nicholas C. Howson, *Fiduciary Principles in Chinese Law*, *in* OXFORD HANDBOOK OF FIDUCIARY LAW, *supra* note 73, at 603.

184 As of the end of the preceding quarter.

185 Zhongguo Baojianhui Guanyu Tigao Baoxian Zijin Touzi Lanchou Gupiao Jianguan Bili Youguan Shixiang de Tongzhi (中国保监会关于提高保险资金投资蓝筹股票监管比例有关事项的通知) [Notice of the CIRC on Issues Concerning the Increased Ratio of Insurance Funds Invested in Blue-Chip Stocks] (published by China Ins. Regul. Comm'n, July 8, 2015, effective July 8, 2015), art. 1 (China).

186 *Id.* The cut-off time for the calculation of total assets is the end of the preceding quarter. *See also* Fanhua Zeng, Wei-chiao Huang & C. James Hueng, *On Chinese Government's Stock Market Rescue Efforts in 2015*, 7 MOD. ECON. 411, 415 (2016) (CIRC's encouragement of insurers to invest in the stock market); Li Xing, Swiss Re Inst., *The Chinese Insurance Market*, at appx. I (Feb. 2018) (summarizing

of deregulation that insurance companies escalated their ambitions in hostile takeovers; variable insurance became a superb financing instrument in activist investors' leveraged buyout attempts. Critics even went as far as to blame the stock market crash of June 2015 on insurers with risk-preferred investment strategies.[187]

There was a broader economic background behind the relaxation. In the wake of China's 2015 stock market crisis, in order to stabilize the market, the State Council established a China Insurance Investment Fund with an anticipated AUM of RMB 300 billion to invest in the stock market.[188] Lifting the ban on investments would enable the China Insurance Investment Fund to make sweeping investments on the securities market without stumbling upon the regulatory restrictions. Yet, the China Insurance Investment Fund was not the only beneficiary. Separate accounts became an unintended beneficiary, facing a more lenient regulatory environment than general accounts. The CIRC implicitly permitted insurers to invest up to eighty percent of the funds in separate accounts in the securities market.[189] Small and medium insurers took advantage of this policy change and used it as a catalyst for their rapid expansion.[190]

In this sense, the regulator is partly to blame as it encouraged the small and medium insurers' reckless flood into the securities market in the first place. The regulator subsequently revoked the permission granted to variable insurance, creating uncertainty in the insurance business sector.[191] This policy flip-flop undermined the business's expectation of a consistent

China's insurance investment regulations), https://www.swissre.com/dam/jcr:4e236d6d-8142-441a-b682-ba9f0a8580ae/chinese_ins_market_feb2018_en.pdf.

187 Barry Naughton, *The Regulatory Storm: A Surprising Turn in Financial Policy*, CHINA LEADERSHIP MONITOR, Spring 2017, at 7–8, https://www.hoover.org/sites/default/files/research/docs/clm53bn.pdf (linking hostile takeovers funded by variable insurance products with the 2015 market crisis).

188 Zhongguo Baoxian Touzi Jijin Sheli Fang'an (中国保险投资基金设立方案) [Official Reply of the State Council regarding the Proposal on the Establishment of the China Insurance Investment Fund] (promulgated by State Council, June 29, 2015, effective June 29, 2015) (China). No less than eighty percent of the contributions to the China Insurance Investment Fund came from insurance companies. *Id.* art. 4 (size of the fund).

189 Notice of the CIRC on Issues Concerning the Increased Ratio of Insurance Funds Invested in Blue-Chip Stocks, *supra* note 185. Separate account needs to concurrently abide by the general forty-percent cap on the maximum proportion of total assets that can be invested in equities.

190 Fanhua Zeng et al., *supra* note 186, at 415 (CIRC's encouragement of insurers to invest in the stock market).

191 Baojianhui Guanyu Jinyibu Jiaqiang Baoxian Zijin Gupiao Touzi Jianguan Youguan Shixiang de Tongzhi (保监会关于进一步加强保险资金股票投资监管有关事项的通知) [Notice of the CIRC on Matters Concerning Further Strengthening the Regulation of Stock Investments with Insurance Funds] (promulgated by China Ins. Regul. Comm'n, Jan. 24, 2017, effective Jan. 24, 2017) (China).

regulatory environment. In the aftermath of the Baoneng/Vanke hostile takeover attempt, the CIRC lowered the funds that an insurer can invest in a single listed company to five percent of its total assets.[192] In aggregate, an insurer may only invest up to thirty percent of its total assets in the securities market.[193]

In retrospect, the deregulation initiative did give insurers more leeway to make investment decisions based on their business acumen, freeing them from heavy regulatory restraints. However, deregulation comes at a price. One might argue that in the U.S., state regulators tend not to impose investment restrictions on insurers. Instead, the prudent investor rule as adopted by the states presumes no investment is per se prudent or imprudent.[194] As long as a trustee abides by the principles of risk management, they are permitted to "invest in any kind of property or type of investment."[195] A literal comparison between mandatory investment restrictions in the U.S. and China would be overly simplistic as investment restrictions in these two jurisdictions work under different regulatory environments. The fact that U.S. state laws tend not to mandate investment restrictions should be interpreted against a broader background: common law fiduciary duties function to constrain the behavior of separate account managers under a broader framework of management trust such that they are bound to work in the best interest of contract owners.[196]

The creation of separate account in China shifts investment risks from insurers to variable contract owners yet does not offer adequate consumer protections. The Chinese version of investment restrictions are put into place more to satisfy the prudent requirements of insurers as financial institutions than for other considerations like consumer protection. On the side of financial prudency, the logic is as follows: when investment risks have substantially been transferred to the variable contract owners, the prudency rationale becomes moot. Hence, separate accounts are exempted from investment limitations.[197]

Putting the prudency requirements of financial institutions aside, the regulator should concurrently establish a framework for the protection of

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192 *Id.* art. 9.

193 *Id.*

194 RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. f (AM. L. INST. 2007).

195 UNIF. PRUDENT INV. ACT § 2(e) (UNIF. L. COMM'N 1994).

196 *See generally* John H. Langbein, *The Rise of the Management Trust*, 143 TR. & EST. 52 (2004).

197 For a discussion of insurers' investment limitation and relief granted to separate accounts, see, *e.g.*, J. Robert Ferrari, *Life Insurance Company Investments*, in DAN M. MCGILL, LIFE INSURANCE 840 (1967).

variable contract owners as financial consumers. The complexity of variable insurance makes it difficult to understand, commonplace in other financial products such as annuities.[198] Consumers may find it hard to evaluate the expected risk versus return associated with variable insurance products,[199] the difference between general account and separate account to which their premiums are allocated,[200] and more generally, the difference between variable insurance and other life insurance products.[201]

The divergence in policy concerns for general accounts and separate accounts explains the two contrasting investment strategies we witness in the Chinese market: conservative for the general accounts and aggressive for the separate accounts. When premium payments are allocated to an insurance company's general account, U.S. state laws generally require that they are invested in a prudent way.[202] For instance, since a variable insurance contract needs to meet its death benefit and cash value guarantees, it is therefore required by state laws to invest the premium payments allocated to the general account conservatively.[203] By contrast, net premium payments and subsequent cash value under a variable insurance contract are invested in the insurance company's separate account, which is generally not subject to state law requirements mandating conservative investment.[204] In the case of China, so far as the prudency requirements of insurance companies are concerned, insurers are required to invest their funds in their general accounts in a conservative way.[205] By contrast, separate accounts do

198 Fiona Stewart, *Policy Issues for Developing Annuities Markets* 5–6 (OECD Working Papers on Ins. & Private Pensions, Paper No. 2, 2007), http://www.oecd.org/daf/fin/private-pensions/37977188.pdf (surveying OECD countries on the consumers' understanding of annuities).

199 Measures for the Administration of the Disclosure of Information on New Life Insurance Products, *supra* note 82, art. 25.1.1.

200 The CIRC regulations concerning disclosure of variable insurance do not mandate insurers disclose to variable contract owners the difference between separate account and general account. *Id.* art. 25.

201 Stewart, *supra* note 198.

202 *See, e.g.*, 215 ILL. COMP. STAT. 5/126.1A; *see also* Helmut Gründl, *The Evolution of Insurer Portfolio Investment Strategies for Long-Term Investing*, 2016 OECD J. 1, 33–34 (US states either take the approach to impose limits on insurers' investments in certain types of investments or adopt the prudent person approach to require insurers to invest in prudent assets).

203 *See e.g.*, DEL. CODE tit. 18, § 1305(6) (specific limits on certain categories of investments so as to ensure an insurer makes sound and prudent investments); DEL. CODE tit. 18, § 1333 (the state's authority to set standards for an insurer's prudent investment in derivatives and other financial products).

204 *See, e.g.*, N.Y. INS. LAW § 4240.A(3) ("[T]he insurer may invest in any investments contractually permitted for such separate account, the restrictions, limitations and other provisions relating to investments specified in this chapter shall not apply to such investments, and such investments shall be disregarded, and shall be excluded from admitted assets, in applying the quantitative investment limitations contained in this chapter to other investments.").

205 Baoxian Gongsi Guquan Touzi Zanxing Banfa [保险公司股权投资暂行办法] (Interim

not have to live up to as high a standard as general accounts since investment losses are not borne by insurers.

In other words, China's regulatory framework at one point became the engine boosting insurers' reckless behavior. This explains in part why the public (and the regulators) believed that certain insurers proactively engaged in aggressive investments – as was the case with Baoneng in the Baoneng/Vanke hostile takeover attempt.[206] It is because, on one hand, variable insurers are not curbed by prudential concerns; they enjoy certain exemptions from investment portfolio restrictions that are otherwise imposed on general accounts. On the other hand, they are not subject to substantial fiduciary duty constraints that are required of similar management investment units such as mutual funds.[207] As a result, they are able to cut an implausible comparative advantage over conventional insurers by jeopardizing contract owners' investment interests.

The absence of substantive statutory restrictions on separate accounts has its justification in the U.S., where separate account managers' fiduciary duties are well established under common law.[208] But the same rationale cannot be transplanted to China's scenario. China's insurers are not substantially reined in by similar fiduciary duties. Even though mutual funds have to abide by fiduciary duties set out in the statute, these duties are not fully enforced in practice.[209] The judicial enforcement of fiduciary duties in China has always posed great challenges, in part due to the common law and civil law divide on fiduciary duties[210] and in part due to some regulatory hurdles Chinese regulators put into place that impede fiduciary duties from being sufficiently enforced.[211] Variable insurance products are merely

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Measures for Equity Investments by Insurance Companies) (promulgated by China Ins. Regul. Comm'n, July 31, 2010, effective July 31, 2010), art. 6 (China).

206 Liu Shiyu, then Chairman of the CSRC, infamously denounced activist investors like Baoneng that took advantage of the funds deposited in the separate accounts as "barbarians." He criticized that hostile bidders engaged in leveraged takeover for "using money from illegal sources." Liu, *supra* note 45.

207 In the U.S., variable annuities are regulated as investment products similar to mutual funds. *See* Van Heuvelen, *supra* note 144, at 672.

208 *See* Sitkoff, *supra* note 73.

209 Mutual funds' investment strategies, portfolio arrangements, and substitution of underlying assets may all be integrated into the domain of fiduciary duty. *See* Securities Investment Fund Law, *supra* note 85, art. 9.

210 Nicholas C. Howson, *Twenty-Five Years On—The Establishment and Application of Corporate Fiduciary Duties in PRC Law* 21–28 (L. & Econ. Working Papers, Paper No. 146, 2017), https://repository.law.umich.edu/law_econ_current/146 (application of corporate fiduciary duties in the Chinese Company Law); *see also* Jiangyu Wang, *Enforcing Fiduciary Duties as Tort Liability in Chinese Courts*, *in* ENFORCEMENT OF CORPORATE AND SECURITIES LAW: CHINA AND THE WORLD 162–84 (Robin Hui Huang & Nicholas Howson eds., 2018).

211 Li, *supra* note 5.

required to abide by certain minimum disclosure requirements and substantive requirements of the CIRC.[212] In the heavily intertwined nexus of regulations, however, fiduciary duty is largely missing from the landscape. For example, variable insurance managers are free to transfer shares in the portfolios in the separate accounts and do not have to subject to fiduciary requirements as compared to the U.S.[213]

212 Measures for the Administration of the Disclosure of Information on New Life Insurance Products, *supra* note 199.

213 Guanyu Guifan Renshen Baoxian Gongsi Chanpin Kaifa Sheji Xingwei de Tongzhi [关于规范人身保险公司产品开发设计行为的通知] (Notice on the Regulation of Product Design of Life Insurance Companies) (promulgated by China Ins. Regul. Comm'n, May 11, 2017, effective May 11, 2017) (China). This circular is widely considered as an important regulatory response to the risky investment great leap forward of small- to mid-sized insurers alongside the Baoneng/Vanke takeover warfare. Yet it does not impose any restrictions on the manager's free transfer of underlying shares in the portfolios held in the separate accounts.

## V. THE MORE DEEP-ROOTED PROBLEM: THE MUDDY WATER OF FINANCIAL PRODUCTS IN AN INSTITUTION-BASED REGULATORY STRUCTURE

While the Asset Management Rules reshape the landscape of China's asset management business, they have little effect in addressing the issues in the variable insurance industry. By contrast, other ad hoc and rapidly changing regulations promulgated by the CIRC work to suffocate the business viability of variable insurance. A coherent and efficient regulatory philosophy has yet to be formed. Then, one may raise the question: if the business model of variable insurance was transplanted from the U.S., and it indeed resembles unit investment trust in the U.S., why not simply require them to follow suit and register the separate accounts with China's securities regulator as investment companies? The answer to this question might not be as straightforward as it appears as it requires probing the deeply rooted problems in China's financial regulatory structure.

### *A. Separate Account as a Transplanted Instrument*

Central to variable insurance is the fictional concept of a separate account. To determine the optimal regulatory approach to variable insurance, we need to dive into the nature of the separate account. In a nutshell, both variable annuity contracts and variable contracts maintain separate accounts to which payments by contract owners are applied.[214] By contrast, with respect to "fixed" payment insurance contracts, payments by policyholders are allocated to the insurers' general accounts.[215] They comingle with the assets of the insurers.

A separate account may be viewed as an accounting mechanism. The separate account is a product of U.S. state law.[216] The income, gains, and losses, realized or unrealized, from assets allocated to the separate account are credited to or charged against the account without regard to the other income, gains, or losses of the insurer.[217] U.S. state laws also generally provide that the insurer owns the amounts allocated to the separate account,

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214 For a useful introduction to the historical development of separate account, see George E. Johnson, *The Separate Account: A New Phenomenon in Life Insurance*, 2 FORUM 248 (1967).

215 See Mack Boring & Parts v. Meeker Sharkey Moffitt, 930 F.2d 267, 267–69 (3d Cir. 1991) (explaining the structure of a fixed benefit insurance contract).

216 See generally the Model Variable Contract Law (MDL-260), adopted by the National Association of Insurance Commissioners. The Model Law is the basis for separate account laws adopted by a number of states. VARIABLE CONT. MODEL L. (NAT'L ASS'N INS. COMM'RS 2013); Roth et al., *supra* note 62, at 542 n.20 (1991).

217 *See* Johnson, *supra* note 214, at 249.

and the insurer shall not be, nor hold itself out to be, a trustee with respect to those amounts.[218] Variable contract owners thus neither hold legal title to nor have any beneficial ownership interests in the assets of the separate account. Meanwhile, the features of the separate account enable assets in it to be independent from those in a general account of the insurer.[219] A separate account is, in essence, a funding vehicle, channeling funds paid by contract owners to a pool of investment options. For a general account, the investment return on assets is not directly linked to the cash value or the death benefit payable to contract owners.[220] Instead, it is directly associated with the return on the insurer's assets.[221]

In the U.S., separate accounts are regulated as investment companies under the federal Investment Company Act.[222] One key regulatory requirement for insurers is that insurers cannot unilaterally substitute shares of one underlying fund for another unless they have obtained signoffs from both the SEC and variable contract owners.[223] The SEC scrutinizes the insurance company's interest in substitution.[224] The insurer must seek approval by a majority vote of variable contract owners with a contract value in the subaccount, which invested in the liquidating fund that is being replaced.[225] Moreover, the Investment Company Act generally prohibits or restricts offers to exchange one unit investment trust security for another.[226] As a matter of fact, many contract exchange offers can fit within the statutory exceptions or SEC rules.[227] Unfortunately, all these are missing

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218 VARIABLE CONT. MODEL L. § 1.E (NAT'L ASS'N INS. COMM'RS 2013).

219 Mason & Roth, *supra* note 80, at 515, 550–54.

220 *Id.* at 556, 562–63.

221 *Id.*

222 15 U.S.C. 80a-1– 80a-64. Separate accounts that are registered as unit investment trusts and that offer variable life insurance policies under the Investment Company Act will need to file Form N-6 with the SEC. 17 C.F.R. 239.17c (2002); 17 C.F.R. 274.11d (2002).

223 Investment Company Act , 15 U.S.C. § 80a-26(c) (requiring the SEC to individually approve orders).

224 Other factors that the SEC examines include similarity of investment objectives, relative expenses, and the relevant historical performance of funds. The SEC's approval is conditioned upon a number of representations, including caps on expenses. *Id.*

225 *Id.*

226 *Id.* § 80a-11.

227 For example, there is a retail exception to the restrictions on exchange offers. Section 11 of the Investment Company Act does not apply to "retail" transactions conducted at the point of sale as a result of a recommendation made by a registered representative. *Id.* § 11(a)(A). The SEC has taken the position that section 11 does not cover, except under exceptional circumstances, those exchange offers involving variable contracts issued by unaffiliated insurers. *See* SEC Division of Investment Management, *Letter re: "Retail Exception" to Section 11 (Jun. 19, 2001)*, note 9, https://www.sec.gov/divisions/investment/guidance/nash061901.htm#P58_8260. Moreover, the SEC has adopted Rule 11a-2 to permit certain exchange offers of variable contracts issued by the same insurer

from China's regulatory framework for variable insurance.

### *B. Regulation of Financial Institutions, or of Financial Products?*

A glance over China's financial regulatory structure may leave one with an impression that China adopts a strictly separate regulation structure, analogous to the regulatory framework in the Glass-Steagall Act era.[228] Closer scrutiny reveals a much more complex story. China follows an institutional approach to financial regulation.[229] The regulatory power is divided on a sectorial basis among four financial regulators: the People's Bank of China ("PBOC" – the central bank), the CSRC, the CBRC, and the CIRC.[230] The CIRC was merged into the CBRC in 2018 and the combined regulator is now called the China Banking and Insurance Regulatory Commission (the "CBIRC"), but it was more a combination of the two regulators than a functional consolidation.[231] Take securities as an example. Securities companies are subject to regulation by the CSRC as are all the financial products launched by securities companies.[232] Likewise, banks are jointly regulated by the PBOC and the CBRC.[233]

In recent years, varied forms of financial products emerged, typically in the booming asset management business.[234] In the wake of the financial deregulation before the Asset Management Rules' overhaul, a number of financial institutions were permitted to establish an asset management business, or alternatively, a wealth management business.[235] The asset management products they underwrote bore different names yet shared

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or affiliated insurers without obtaining the SEC approval that otherwise would be prohibited by the Investment Company Act. *Id*.

228 *See generally* Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. BANKING INST. 221 (2000); Roberta S. Karmel, *Glass-Steagall: Some Critical Reflections*, 97 BANKING L.J. 631 (1980).

229 *See, e.g.*, WEIPING HE, THE REGULATION OF SECURITIES MARKETS IN CHINA 171–207 (2018) (examining China's sector-based regulation of the financial institutions); *see also* Franklin Allen, Jun Q.J. Qian & Xian Gu, *An Overview of China's Financial System*, 9 ANN. REV. FIN. ECON. 191, 231 (2017).

230 He, *supra* note 229, at 174–76.

231 Guowu Yuan Jigou Gaige Fang'an (国务院机构改革方案) [Reform Proposal in Respect of Divisions of the State Council] (published on Mar. 13, 2018) (China).

232 He, *supra* note 229, at 185–87 (regulation of securities companies).

233 He, *supra* note 229, at 176–81 (regulation of commercial banks).

234 For an overview, see Torsten Ehlers, Steven Kong & Feng Zhu, *Mapping Shadow Banking in China: Structure and Dynamics* (Bank for Int'l Settlements Working Papers, Paper No. 701, 2018), https://www.bis.org/publ/work701.pdf.

235 He, *supra* note 229, at 181–83 (emergence of asset management companies). Asset management companies were originally referred to the firms set up to handle non-performing loans parceled out by banks in the first place. Now these firms have evolved to become full-fledge asset management companies.

similar economic functions.[236] Sector-wise, China's asset management business witnessed a trend that mimicked the U.S. shadow banking system, growing larger than the core of the banking system.[237] It also shared a similar trend with the U.S., which witnessed a convergence of financial products.[238] By blurring the boundary between index mutual funds, variable annuities, and fixed annuities, U.S. insurance companies were able to offer financial products comparable to those conventionally provided by securities firms.[239] In China, the jurisdiction over similarly functioned asset management products is divided between different regulators. It is an institution-based and sector-based regulatory philosophy: each regulator oversees an institution, irrespective of the economic function of the products that the institution issues.[240] The prosperity of the asset management business requires a supervisor responsible for the overall regulatory landscape, not several segregated regulators, to keep the systemic risks associated with the growing asset management machinery at bay. Yet, the existing financial regulators seem more interested in guarding their regulatory regime turf, rather than succumbing to a consistent and universal policy goal.[241] Dividing regulatory jurisdictions based on the characterization of the financial products (functional regulation) would mean depriving certain regulators of the jurisdiction over some financial products that they conventionally oversee.[242]

The sectoral and institutional approach is inapt with the reality that financial institutions can conduct cross-sectoral business. The conflict intensified when the Chinese regulators stepped in to encourage financial institutions' mixed operations. For example, since 2013, securities companies, insurance companies, and private equity funds have been able to engage in the mutual fund business—traditionally the exclusive territory of a mutual fund company.[243] Commercial banks may establish subsidiaries

236 Douglas Elliott, Arthur Kroeber & Yu Qiao, Econ. Stud. at Brookings, *Shadow Banking in China: A Primer* (2015), https://www.brookings.edu/wp-content/uploads/2016/06/shadow_banking_china_elliott_kroeber_yu.pdf.

237 *Id.* at 16–17 (comparison of China and the U.S. in shadow banking sizes).

238 Turk, *supra* note 63, at 982–89 (the blurry boundary between variable annuities, fixed annuities and mutual funds).

239 *Id.* at 982–84.

240 Hui Huang, *Institutional Structure of Financial Regulation in China: Lessons from the Global Financial Crisis*, 10 J. CORP. L. STUD. 219, 222–27 (2010).

241 *See* Wu, *supra* note 11, at 18.

242 *Id.*

243 Baoxian Jigou Xiaoshou Zhengquan Touzi Jijin Guanli Zanxing Guiding (保险机构销售证券投资基金管理暂行规定) [Interim Rules on the Sale of Securities Investment Funds by Insurance Institutions] (promulgated by CSRC & CIRC, June 3, 2013, effective June 3, 2013), arts. 5–6,

to substantially engage in mutual fund business.[244]

With the endorsement of the government, financial products are increasingly intertwined with each other—so are the financial institutions issuing these products. It is not a trend peculiar to China; the convergence of financial products and financial institutions resonates with what is observed in developed financial systems such as the U.S.[245] To take a simplistic example, prior to the Asset Management Rules, a Chinese bank could loan money to a borrower off-balance sheet without allocating reserves for the loan.[246] Neither did it have to back the loan up with its own capital.[247] The magic formula is that the credit to the borrower was not structured as a conventional loan, which has to be booked on the bank's balance sheet. The loan was packaged as a management product instead.[248] The bank's depositors subscribed to the wealth management product and turned into investors in the wealth management product. The funds raised by the wealth management product was in turn used to finance the borrower. In a typical shadow banking transaction, the bank structures itself as a financial intermediary, not a creditor. The transaction is therefore not subject to the conventional prudency regulation applicable to bank loans. Aware of it or not, depositors (now turned investors) are directly exposed to the risks associated with the loan. It is exactly this kind of off-balance sheet treatment that the Asset Management Rules aim to address.[249]

In a shadow banking transaction involving multiple intermediaries engaging in the asset management business, the risk that the underlying loan may turn sour is not necessarily salient due to the depositors-turned

http://www.gov.cn/gzdt/2013-06/07/content_2422146.htm (permitting insurance companies, insurance brokerages, and insurance agencies to distribute mutual fund products).

244 Shangye Yinhang Licai Zi Gongsi Guanli Banfa (商业银行理财子公司管理办法) [Administrative Measures on the Wealth Management Subsidiaries of Commercial Banks] (promulgated by the China Banking Regul. Comm'n, Dec. 2, 2018, effective Dec. 2, 2018), art. 24(1) (public offering of wealth management products) (China).

245 Turk, *supra* note 63, at 982–89 (the trend of convergence at product level and at firm level).

246 Joel Bowman, *Non-Bank Financing in China*, RESERVE BANK AUSTL. BULL. 9 (Mar. 2018), https://rba.gov.au/publications/bulletin/2018/mar/pdf/non-bank-financing-in-china.pdf (Banks purchase investment products sold by non-bank financial institutions, which are not recorded as "loans." As a result, the borrowers issuing such investment products via the channel of non-bank financial institutions receive the "loans" indirectly through the shadow banking process.).

247 Elliott et al., *supra* note 236, at 7 (off-balance sheet treatment).

248 *Id.* at 8 (forms and structure of wealth management products).

249 Asset Management Rules, *supra* note 47 art. 2 ("A financial institution may not conduct on-balance-sheet asset management business"). To interpret Article 2, in its effort to move off-balance sheet asset management products back on the balance sheet, the regulators in effect require the financial institutions to set up subsidiaries, through which they continue to operate in asset management business indirectly.

investors.[250] This is in part because of the existence of implicit guarantees on the loans,[251] which the Asset Management Rules endeavor to forbid.[252] The Chinese government used to mandate that financial institutions be responsible for resolving any financial crisis that their products brought about.[253] In reality, when a loan underlying an asset management product became nonperforming, the financial institution itself would have to guarantee the full repayment of the original investment amount to investors irrespective of contract terms.[254] This is what is termed "rigid payment" which the Asset Management Rules intend to crack.[255] When a rigid payment is in place, the financial institution or the government endorsing such institution's practice absorbs any downside risks inherent in the products. As a result, the market tends to ignore the quality of the underlying assets of the financial products when pricing these products. The asset pricing function of a market is lost.

It was not only the financial sector to blame; the visible hand of the government played a role in the downward spiral process of the rigid payment phenomenon. It used to be a practice of the government to indulge or even encourage the rigid payment before the Asset Management Rules reversed course.[256] In a worst case scenario, when a financial institution failed, the government was certain to step in and furnish credit to guarantee

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250 *See* Shen Wei, *Wealth Management Products in the Context of China's Shadow Banking: Systemic Risks, Consumer Protection and Regulatory Instruments*, 23 ASIA PAC. L. REV. 91, 104 (2015) ("Most investors . . . mistakenly have the perception that these products are ultimately guaranteed by the state or insured against the consequences of the risks' materializing, as these products are sold at bank counters.").

251 The financial institutions, especially the trust companies, intentionally create a false impression that the wealth management products they offer generate guaranteed returns. In fear of the public outcry, when these products incur a loss, the regulators intervene and demand the financial institutions repay the principal in full. *See* Edward Chancellor & Mike Monnelly, GMO, *Feeding the Dragon: Why China's Credit System Looks Vulnerable*, at 7–9 (Jan. 23, 2013), https://www.advisorperspectives.com/commentaries/2013/01/25/feeding-the-dragon-why-china-s-credit-system-looks-vulnerable.pdf (the tendency of trust companies to "make good any shortfall with their own capital" under pressure from the regulators when the wealth management products may cause losses to investors).

252 Asset Management Rules, *supra* note 47 art. 2 ("[F]inancial institutions, when conducting asset management business, shall not guarantee on the return of principal or the yields.").

253 *See* Emily Perry & Florian Weltewitz, *Wealth Management Products in China*, *in* RESERVE BANK AUSTL. BULL. 59, 65 (June 2015), https://rba.gov.au/publications/bulletin/2015/jun/pdf/bu-0615.pdf#page=61 (financial institutions' implicit guarantee "presumed to be backed by the government").

254 *Id.*

255 Asset Management Rules, *supra* note 47, art. 2.

256 Ho, *supra* note 149, at 778 (governmental bailout of failed trust plans in the form of "rigid payment").

the repayment.[257] This implicit guarantee distorts the real rate on risks, resulting in the mispricing of credit on the market.[258] In this sense, it is a much more plausible move on the part of the Asset Management Rules to crack down on the implicit guarantee.[259]

The institution-oriented regulatory approach also fosters rampant regulatory arbitrage.[260] The financial institutions have every incentive to repackage their products to seek more lenient regulatory treatment while leaving their economic substance intact.[261] In the case of wealth management, a widespread tactic is to deliberately extend the link between the ultimate investor and the end user of the fund raised by inserting layers of conduits – intermediary financial products – in between.[262] The practice muddies the water by creating hurdles for the regulators to see through the overall structure and the economic substance of the products. It was especially successful in the context of Chinese financial regulatory framework, where each regulatory agency is charged with a subset of financial institutions, having no jurisdiction over the other financial institutions beyond its regulatory boundary.[263] For example, a securities company and subsidiary of a fund manager are the common vehicles for getting around the regulatory restrictions.[264] Once the funds travel outside of the banking system and flow into a securities company or a subsidiary of a fund manager, they are no longer under the CBRC's radar despite the fact that they are de facto loans. The convoluted structure moves one financial product outside of the regulatory boundary of any particular regulator that oversees part of, but not all of, the picture. In the face of such systemic risks outside their jurisdiction, an agency's typical behavior is shirking responsibility in spite of their tendency to relentlessly expand their turf.[265]

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257 Paul Krugman, *What Happened to Asia?*, OFF. PAUL KRUGMAN WEB PAGE (Jan. 1998), http://web.mit.edu/krugman/www/DISINTER.html (financial institutions' liabilities are implicitly guaranteed by government and lead to their excess risk lending). Krugman also noted the moral hazards involved.

258 *Id.*

259 Asset Management Rules, *supra* note 47, art. 2 (financial institutions are no longer permitted to guarantee the payment of principal or expected return regarding its asset management products).

260 *See* Fleischer, *supra* note 110, at 230–31.

261 Fleischer, *supra* note 110, at 229.

262 *See* Dan Awrey, *Law and Finance in the Chinese Shadow Banking System*, 48 CORNELL INT'L L.J. 1, 28–35, fig. 4 (2015) (the legal structure of wealth management products); Ehlers et al., *supra* note 234, at 23–26 (typical wealth management product structure chains).

263 The institutional setting is reminiscent of China's divide in regulatory jurisdiction in other areas such as foreign investment. *See* Xingxing Li, *An Economic Analysis of Regulatory Overlap and Regulatory Competition: The Experience of China's Interagency Competition in Foreign Investment Regulation*, 67 ADMIN. L. REV. 101 (2015).

264 *See* Ehlers et al., *supra* note 234, at 9.

265 For responsibility shirking, see Li, *supra* note 263, at 735.

Hence, regulatory arbitrage blossomed.

### *C. Tensions between the Imported Financial Product and the Regulatory Status Quo*

As elaborated in the previous section, systemic risks are imbedded in the fragmented regulatory structure, some of which the Asset Management Rules wish to address yet they remain. Among the remaining obstacles are the sector-based division of financial regulatory power and the lack of a uniform agency that oversees the entire asset management business. Despite attempts to level the playing field at the rule-making level, the lack of a uniform regulatory agency presages the continuation of regulatory arbitrage. The institutional setting dims the prospect for steering variable insurance products onto a correct regulatory track.

The artificial separation of jurisdiction renders the regulatory regime for variable insurance a subprime one. The source of funding—from which channels the funds are pumped into the securities market, and how high the leverage ratio is on the funding end—is not within the ambit of the CSRC's regulatory power. The CSRC is charged with the power to oversee the activities *within* the official securities markets, not outside the markets.[266] Yet to institutional investors, raising funds and utilizing funds are inseparable. There is continuity in their behavior—it is exactly because insurers have listed companies in mind as acquisition targets that they raise funds through variable products.[267] What is the efficiency justification in separating variable insurance regulation other than treating the status quo regulatory structure as a product of historical incidence?[268]

The failure to factor variable insurance into securities regulation is at odds with the important role the insurers play on the securities market. Although in the immediate aftermath of the Baoneng/Vanke takeover, the financial regulators suppressed insurers from investing in the securities market,[269] they have recently removed the ban in an attempt to boost the depressed market.[270] Putting my criticism over the regulators' flip-flopping

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266 Securities Law, *supra* note 4, art. 7.

267 For the motives behind insurance companies' acquisition of listed firms, see Li, *supra* note 5, at 171–76.

268 Similarly, in the U.S., the financial regulatory structure is more a political compromise than a scientific crafting. *See* Frances Rosenbluth & Ross Schaap, *The Domestic Politics of Banking Regulation*, 57 INT'L ORG. 307, 328–29 (2003); Li, *supra* note 263, at 726–28 (banking regulation).

269 Li, *supra* note 5, at 219–20.

270 Guanyu Baoxian Zichan Guanli Gongsi Sheli Zhuanxiang Chanpin Youguan Shixiang de

aside, the insurers are sure to regain their profound influence as institutional investors in the securities market as evidenced by the history of institutional investors in the U.S. and across the world.[271]

The insurers pool funds from variable contract owners, allocate them to the separate accounts, and in turn, invest in a number of markets including the securities market. The CSRC, as the gatekeeper to China's securities market, has no jurisdiction[272] to determine whether variable contracts should be characterized as a securities product of insurance companies in light of their U.S. origins. Neither can the CSRC investigate into whether the funds are raised in a legitimate fashion or are prudently invested to maximize contract owners' interests while minimizing systemic risks. That power rests with the CIRC, the insurance regulator.[273]

Most importantly, amid the controversy surrounding variable insurance, the CSRC is not in a position to challenge insurers' speculative behavior on the securities market by questioning their source of funding. In this sense, one notorious speech given by the CSRC's then-Chairman Liu Shiyu in 2016, savaging insurers' illegality in its sources of funding to buy out listed companies, albeit true, was widely criticized as overstepping into the CIRC's jurisdiction.[274]

### *D. The Securities Registration System for Variable Insurance*

Given China's idiosyncratic institutional details, one possible policy reform to the systemic risks associated with the import of variable insurance is to recognize the securities features of variable insurance products and regulate them as such. The sophisticated U.S. federal securities regulatory framework can be a valuable model to follow. From a comparative law perspective, it would mean that with the transplantation of a financial product of significant importance to the financial market, the regulator should concurrently aim to import the corresponding regulatory scheme that

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Tongzhi (关于保险资产管理公司设立专项产品有关事项的通知) (published by China Banking Regul. Comm'n, Oct. 24, 2018, effective Oct. 24, 2018), art. 2, http://www.cbrc.gov.cn/chinese/newShouDoc/DCD3ED9C2B2A49ABB0EBC90F311CA3C0.html (China).

271 Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 827 (1992) (historical trends in institutional shareholding).

272 For the time being, let us put aside the question as to whether the CSRC has the willingness to do so.

273 WENYU QIAN, CHINA'S INSURANCE REGULATORY AND SUPERVISORY REGIME: ANALYSIS AND ADVICE BASED ON THE COMPARISON WITH EU'S SOLVENCY II SYSTEM 35–42 (2019) (the CIRC's regulatory jurisdiction).

274 Shiyu, *supra* note 45.

has been tested in time.

The best way of eliminating room for regulatory arbitrage between variable insurance and other wealth management products is to require their registration as securities with the CSRC when they possess the elements of a securities product. The evolvement of the U.S. regulatory framework offers a helpful perspective on the similar, although not identical, legal issue facing China's variable insurance today. We will find in its development why variable insurance's characterization as securities products of insurance companies was in dispute and how the dispute has largely resolved in history. To begin with, securities in the U.S. context are broadly defined.[275] Following the statutory definition of section 2(1) of the 1933 Securities Act, a series of precedents over the years greatly broadened the contour of securities within the jurisdiction of the SEC.[276] When federal regulation is justified, the requirements of registration—the core of federal securities regulation—follows with respect to the issuance of securities.[277]

One major difference between securities[278] and non-securities variable products lies in information disclosure. Section 5 of the Securities Act requires that an offer or sale of a security to the public must first have a registration statement filed,[279] and in the case of a sale, be conditioned upon the registration statement becoming effective.[280] An insurer has to submit Form N-6 in order to register the interests of variable insurance contracts.[281] China's Securities Law put in place similar registration requirements that are only applicable to securities.[282] As variable insurance's securities status is not recognized, variable insurance is utterly exempt from China's Securities Law registration and information disclosure coverage.

In contrast with China's CIRC-centered regulatory paradigm, the U.S.

275 Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (2012).

276 For the historical development on the definition of investment contract under Section 2 of the Securities Act, see, *e.g.*, *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), and *Marine Bank v. Weaver*, 455 U.S. 551 (1982).

277 15 U.S.C. § 80a–8 (2012); *see also* SEC, *Updated Disclosure Requirements and Summary Prospectus for Variable Annuity and Variable Life Insurance Contracts*, at 14 (2018), https://www.sec.gov/rules/proposed/2018/33-10569.pdf ("Separate accounts are typically registered as investment companies under the Investment Company Act and also register their securities under the Securities Act by filing a registration statement with the Commission.").

278 This also applies to mutual fund units.

279 15 U.S.C. § 77e (2012).

280 Securities Act of 1933 §§ 3–4, 15 U.S.C. § 77c–d (2012).

281 United States Securities and Exchange Commission, Form N-6, https://www.sec.gov/about/forms/formn-6.pdf (last visited June 17, 2021).

282 Securities Law, *supra* note 4, arts. 2, 9.

regulation of insurance is decentralized under the McCarran-Ferguson Act of 1945.[283] The states are the primary regulator of insurance contracts. The Dodd-Frank Act, albeit promulgating reforms affecting insurance,[284] does little to substantially change the state-led system.[285] At the federal level, the SEC decided that variable life insurance contracts should abide by federal securities laws by as early as 1971.[286] The effect is that variable insurance is not categorized as insurance or annuity contracts, which are exempt from the 1933 Securities Act under section 3(a)(8).[287] Accordingly, variable contracts are treated as securities subject to registration and anti-fraud provisions of the 1933 Securities Act.[288]

In *SEC v. Variable Annuity Life Insurance Co. of America*,[289] the Supreme Court ruled that while state insurance law treated variable annuity contracts as annuity contracts,[290] they nevertheless did not qualify for a section 3(a)(8) exemption under the 1933 Securities Act.[291] The Supreme Court's reasoning was that the insurer assumed no genuine investment risk under the variable annuity contract.[292] Instead, it was the contract owner who assumed the risk.[293]

Similarly, in *SEC v. United Benefit Life Insurance Co.*,[294] the Supreme Court concluded that a flexible fund annuity, which provided benefits based on the performance of the insurer's separate account but guaranteed that after ten years the value of the annuity would at least equal the premiums paid, was a security product.[295] Subsequently, in its rulemaking, the SEC confirmed the securities status of variable life insurance contracts.[296] The

283 McCarran-Ferguson Act, 15 U.S.C. §§ 1011–15 (1947) (federal antitrust law inapplicable to the "business of insurance . . . to the extent that such business is regulated by State Law").

284 *See* Dodd-Frank §§ 501–42, 31 U.S.C. §§ 313–15, 15 U.S.C. §§ 8201–06, 8221–23, 8231–32 (2012).

285 *See* Turk, *supra* note 63, at 1007.

286 For a discussion about the SEC decision, see Frankel, *supra* note 62.

287 15 U.S.C. § 77c(a)(8). Section 3(a)(8) of the Securities Act provides an exemption for any "insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, banking commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia."

288 15 U.S.C. § 77a–aa (2012).

289 SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65 (1959).

290 Variable annuity contracts had the same morality element as annuity contracts.

291 *Id.*

292 *Id.* at 71.

293 *Id.*

294 SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967).

295 *Id.*

296 Investment Company Act Release No. 7644 [1972–1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,207 (Jan. 31, 1973).

securities status of variable life insurance contracts is therefore settled in the U.S.[297] One twist is that in 2009, in *American Equity Investment Life Insurance Company v. SEC*,[298] the D.C. Circuit upheld the SEC's Rule 151A,[299] aimed at excluding fix annuities policies with certain variable payments from securities, on the basis that it was a reasonable interpretation of the Securities Act.[300] But the D.C. Circuit quickly reheard the case, reversed its decision in 2009, criticized the SEC's rulemaking as arbitrary and capricious, and restored the status quo prior to Rule 151A.[301]

Consistent with judicial decisions, U.S. scholarship recognizes that variable insurance resembles a mutual fund.[302] More generally, certain insurance annuities and mutual fund instruments share substantial functional similarities.[303] In fact, the history of U.S. variable insurance confirmed such a characterization in that the insurance industry created variable products to compete with mutual funds in the first place.[304]

In light of U.S. regulatory evolution, it would be appropriate to characterize China's variable insurance as a securities product. The same reasoning should be applicable here: the owners of variable contracts, rather than insurers, bear the investment risks. The China-specific features such as a substantially shorter maturity term pull the Chinese version of variable insurance closer to the end of mutual fund units and away from the other end of a conventional life insurance product.[305]

Yet in China, the issue about whether variable policies should be treated as "securities" under its Securities Law remains unresolved. The reasons are manifold. At first glance, China is influenced by the U.S. in its approach to securities regulation,[306] including the definition of securities. But there are

297 For a historical account of how the securities status of variable contracts was determined, see Mason & Roth, *supra* note 80. *See also* Frankel, *supra* note 62, at 1022–31.

298 Am. Equity Inv. Life Ins. Co. v. SEC, 572 F.3d 923 (D.C. Cir. 2009).

299 17 C.F.R. § 230.151(a).

300 *Am. Equity Inv. Life Ins. Co.*, 572 F.3d at 930–31.

301 Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166 (D.C. Cir. 2010).

302 For the functional similarity between variable annuity and mutual fund, see Lissa Broome & Jerry Markham, *Banking and Insurance: Before and after the Gramm-Leach-Bliley Act*, 25 J. CORP. L. 723, 736 (2000); Van Heuvelen, *supra* note 144, at 672 (commenting the variable annuity at issue in *SEC v. Variable Annuity Life Insurance Co.* was akin to a mutual fund).

303 *See* Russell Hasan, *Annuity Coeptis: Is There a Way to Avoid* American Equity Investment Life Insurance Co. v. SEC *Becoming a Herald for the SEC Gaining Regulatory Control Over All Securities-Related Insurance Products?*, 17 CONN. INS. L.J. 253, 267–68, 285 (2010).

304 Broome & Markham, *supra* note 302, at 736.

305 For the variable insurance's features specific in the China context, see *supra* Section II.B.

306 *See, e.g.*, Wenyan Ma, *The Misappropriation Theory under the Chinese Securities Law – A Comparative Study with Its U.S. Counterpart*, 1 RICH. J. GLOB. L. & BUS. 33 (2000) (the transplantation

a lot of devils hiding in the detail. Most important, "securities" under China's Securities Law is intentionally crafted to cover a small array of specified securities[307] even after its most recent amendments.[308] China's Securities Law narrowly defines securities as only including (i) stocks, (ii) corporate bonds, (iii) depository receipts,[309] (iv) exchange-traded government bonds, (v) public traded mutual fund units,[310] and (vi) "any other securities as lawfully recognized by the State Council."[311] Furthermore, the State Council rarely steps in to classify new categories of securities. Failing to acknowledge economic substance over form, the scope of securities in China is substantially narrower than that under U.S. federal securities regulation.[312]

Indeed, plenty of ink has been poured over the proposition that China should amend its Securities Law to enable a broader array of securities subject to the regulation of the CSRC.[313] Critics, notably Wu Xiaoling, advocate that financial products bearing different names, such as collective asset management products,[314] single asset management products,[315] collective investment units,[316] and so on, are all securities when taking a substance over form point of view.[317] This reason resonates that of the U.S.: they substantially resemble mutual fund units[318] and should be primarily regulated by the CSRC as such.[319] In summary, although China transplanted

of the misappropriation theory into China).

307 Walter Hutchens, *Private Securities Litigation in China: Material Disclosure about China's Legal System*, 24 U. PA. J. INT'L ECON. L. 599, 602 (2003) (tracing the definition of "securities").

308 Securities Law, *supra* note 4, art. 2.

309 *Id.*

310 Investment funds are further defined in China's Securities Investment Funds Law. Securities Investment Funds Law (证券投资基金法) [Zhengquan Touzi Jijin Fa] (last amended Apr. 24, 2015), arts. 13, 50 (establishment of mutual funds company and fund raising for mutual funds).

311 Securities Law, *supra* note 4, art. 2.

312 Mingkang Gu & Robert C. Art, *Securitization of State Ownership: Chinese Securities Law*, 18 MICH. J. INT'L L. 115, 117–19 (1996) (retracing history to narrate why the scope of securities is narrower and more limited than under U.S. federal securities laws); Hutchens, *supra* note 307. Not much has changed in terms of the definition of securities over the years.

313 *See, e.g.*, K. Matthew Wong, *Securities Regulations in China and Their Corporate Finance Implications on State Enterprise Reform*, 65 FORDHAM L. REV. 1221 (1996).

314 *Jihe zichan guanli chanpin* (集合资产管理产品) in Chinese.

315 *Danyi zichan guanli chanpin* (单一资产管理产品) in Chinese.

316 *Jihe touzi jihua fen'e* (集合投资计划份额) in Chinese.

317 Xiaoling Wu (吴晓灵), *Wealth Management Products Should Universally Be Regulated by CIRC* (理财产品应统一由证监会监管), CAIJING, http://stock.caijing.com.cn/20160323/4094550.shtml.

318 More precisely, "securities investment fund units" in the context of Chinese law.

319 *Wealth Management Products Should Universally Be Regulated by CIRC*, *supra* note 317. By "primarily," it means private placement of investment units to qualified investors should be registered with the Association of Funds Industry ("Jijin Hangye Xiehui" in Chinese). *See* Securities Investment Law, *supra* note 4, art. 89.

a series of financial regulatory measures from the U.S., it interestingly failed to grasp the backbone of the U.S. financial regulation—securities registration—and what comes with it—information disclosure.

It would shed more light if we viewed the transplantation of legal rules as a selective process: the CSRC embraces those rules that increase its power while staying away from those that would bestow more burdens than benefits. One example is the disguised forms of securities trading outside of official exchanges. As influential as the CSRC is and considering the high stakes involved, the agency is reluctant to venture out and identify new types of securities. It would mean overstepping the preexisting regulatory jurisdiction of other financial regulators and arousing unsettling frictions with similarly ranked agencies in China's bureaucratic hierarchy.

One side effect of the agency's decision is the burgeoning number of local exchanges (as opposed to national stock exchanges) trading in financial products, ranging from precious metals to commodities.[320] The exchanges are not subject to the jurisdiction of the CSRC and are instead regulated by local financial regulators that have diverging incentives from their central counterparts.[321] The local regulators are prone to a race to the bottom as they compete to offer lax regulation to attract the inflow of trading business.[322] When financial risks associated with the locally regulated financial products erupt beyond control, the regulators tend to shut down the exchanges as opposed to steering them on the right track by characterizing their financial products as securities.[323] In the event that the local exchanges remain open after the financial turmoil, the central

320 Yuwa Wei, *The Development of the Securities Market and Regulation in China*, 27 LOY. L.A. INT'L & COMPAR. L. REV. 479, 488–89 (2005) (historical development of local stock exchanges); Weiping He, *The Regulation of the Financial Sector in China: A Tale of Two Governments*, 18 J. CORP. L. STUD. 339, 350 (2018) (development of local precious metals exchanges and commodity exchanges, and the scandals derived).

321 *See* Heilmann, *supra* note 100, at 5 (local government's inclination to push back on central initiatives in financial regulation).

322 He, *supra* note 320 (discussing tensions between the central government and local governments, and between local governments in the regulation of the financial sector). In their competition for financial resources, the local governments have incentives and objectives deviating from that of the central government.

323 Guowuyuan Guanyu Qingli Zhengdun Gelei Jiaoyi Changsuo Qieshi Fangfan Jinrong Fengxian de Jueding (国务院关于清理整顿各类交易场所切实防范金融风险的决定) [Decision of the State Council on Straightening out and Rectifying Various Types of Trading Venues to Effectively Prevent Financial Risks] (promulgated by State Council, Nov. 11, 2011, effective Nov. 11, 2011) (China); Guowuyuan Bangongting Guanyu Qingli Zhengdun Gelei Jiaoyi Changsuo de Shishi Yijian (国务院办公厅关于清理整顿各类交易场所的实施意见) [Implementation Opinions of the General Office of the State Council on Straightening out and Rectifying Various Types of Trading Venues] (promulgated by Gen. Off. State Council, July 12, 2012, effective July 12, 2012) (China).

government tends not to strip the local governments of the power to regulate the local exchanges. Rather, it merely requires them to be more stringent on the exchanges.[324] In this sense, the central government failed to learn its lesson from the repeated epidemics of securities-like exchanges. Nor did it take the more welfare enhancing initiative and subject the securities-like exchanges to the CSRC's regulation.

The costly lesson from the local exchange epidemic is that "securities" under China's Securities Law should be construed more broadly by analogy to U.S. federal securities regulation. Otherwise, the financial consumers lured to local exchanges lack access to the full-fledged legal protection available to securities investors. Such a proposition also fits into the U.S. definition of securities, which is deeply entrenched in its regulatory philosophy.[325] Unfortunately, a desirable reform is hampered by politics, not due to a lack of evidentiary support. As of today, the financial sector lives with the understanding that the limited scope of securities subject to the oversight of the CSRC is unlikely to change in the foreseeable future. Therefore, it becomes understandable why policymakers repeated the same mistake by not subjecting variable insurance, a hybrid of securities and insurance products, to the regulation of the securities regulator in addition to the oversight of the insurance regulator.

### *E. The Information Disclosure Dilemma*

One over-simplistic reaction to the shielding of variable insurance from the CSRC securities regulatory regime may be to think that as long as there is some agency overseeing and mandating information disclosure regarding variable products, it does not matter which agency it is, be it the CSRC or the CIRC. This objection understates the legal stakes involved.

Administrative agencies have a natural tendency to guard their jurisdictions. Financial regulators' resistance to reorganizing regulatory jurisdictions is accountable for the concurrent regulatory overlaps and gaps in the gigantic asset management industry.[326] The CIRC, out of self-interest,

324 The central government endorses the so-called doctrine of "whoever approves an exchange is charged with the regulation of such exchange" (*shui pi shui guan* in Chinese). *See id.*

325 *See* SEC v. Cap. Gains Rsch. Bureau, Inc., 375 U.S. 180 (1963); SEC v. Ralston Purina Co., 346 U.S. 119 (1953); SEC v. Howey Co., 328 U.S. 293 (1946).

326 Concurrent overlapping and underlapping jurisdictions are present in countries such as the U.S. *See* Gonzales v. Oregon, 546 U.S. 243 (2006) (overlapping and underlapping jurisdictions derived from multiple federal and state entities' interpretation of the Controlled Substances Act); *see also* Jacob E. Gersen, *Overlapping and Underlapping Jurisdiction in Administrative Law*, 2006 SUP. CT. REV. 201, 207–09 (2006) (proposing a theoretic framework for overlapping and underlapping jurisdictions).

has more incentive to decide variable contracts are in the realm of conventional insurance products as opposed to securities. Exempting variable insurance from securities registration with the CSRC opens the door for regulatory overlaps and gaps. To be sure, regulatory gaps may exist despite the fact that one financial product is tightly regulated. As William Buzbee theorizes it, when multiple regulators oversee the same regulatory matter, there will nevertheless be regulatory gaps for even widely denounced regulatory problems.[327] The deficiency is attributable to a tragedy of the "regulatory commons" as he puts it, analogous to the tragedy of the commons in economic term.[328]

In the case of variable insurance in China, the CIRC's motivation to furnish variable insurance with lax regulation lies in its turf war with other financial regulators in winning over insurance companies as its clients. Chinese insurance companies are subject to stringent, if not erroneous, regulatory requirements.[329] To its credit, the CIRC has eased some of those requirements over the years but nevertheless keeps a firm grip on insurance companies.[330] However, its tendency to micromanage insurers' business operations persists.

Now that tremendous resources have been invested in shaping China's securities registration regime—a jurisdiction primarily bestowed to the CSRC—there is no justification for another securities regulatory division within the CIRC. What is more, where financial products can easily go under the radar and not subject themselves to the prevailing securities registration regime (albeit far from perfect and still under development) by cloaking themselves as products not termed "securities," the practice would nullify the efforts to develop a disclosure framework for securities.

The exclusion of variable products from the CSRC-mandated securities

327 William W. Buzbee, *Recognizing the Regulatory Commons: A Theory of Regulatory Gaps*, 89 IOWA L. REV. 1 (2003).

328 *Id.* at 22–23.

329 For example, some rules and regulations governing insurance companies were promulgated out of the concern of maintaining market stability, a regulatory objective alien to the regulators in market economies. *See* Margaret M. Pearson, *The Business of Governing Business in China: Institutions and Norms of the Emerging Regulatory State*, 57 WORLD POL. 296, 314 n.52 (2005).

330 For example, change in an insurance company's shareholding structure as well as corporate form used to be subject to approval. But this requirement has recently been abolished. Guowuyuan Guanyu Quxiao he Tiaozheng Yipi Xingzheng Shenpi Xiangmu deng Shixiang de Jueding (国务院关于取消和调整一批行政审批项目等事项的决定) [Decision of the State Council on Cancelling and Adjusting a Batch of Administrative Approval Matters (2015)] (published by the State Council, Feb. 24, 2015, effective Feb. 24, 2015) (China).

regulatory paradigm means that the CIRC-led information disclosure requirements regarding variable products are doomed to lag behind updates in China's securities regulation over time. As the CSRC securities registration system evolves, the CIRC decision makers face two options: to copy the CSRC's practice or to stay unchanged. If they opt for closely copying the CSRC regulations, they would be recognizing the CSRC as the main driver for securities information disclosure regulation. It would be the act that the bureaucrats are most unwilling to take as it proves that they are maintaining a repetitive regime, which should have been incorporated into the CSRC. It is essentially reinventing the wheel and, hence, a waste of regulatory resources. On the other hand, if the CIRC chooses to stay unchanged, its information disclosure system would become obsolete over time. What is worse than interagency regulatory turf warfare? A separate arbitrary information disclosure system that is susceptible to systemic risks.

Without proper information disclosure, the protection of financial consumers when investing in variable contracts is in jeopardy. Even though variable insurance currently confers a guaranteed minimum payment to its policyholders, the variable contract owners are nevertheless entitled to being aware that (i) they pay premiums for securities-like products, not conventional life insurance; and (ii) the inherent financial risks associated with variable insurance is different from a conventional life insurance product, including how insurance companies make use of consumer premiums.

### *F. Is the Time Ripe For the Functional Regulation of Variable Insurance?*

The proposal to integrate variable insurance's regulation into the regulatory scheme for securities in essence calls for a functional regulation of financial products with securities features. Functional regulation may take two approaches: (i) functional regulation of products, or (ii) functional regulation of institutions.[331] The core theory dates back to U.S. scholarship and requires that like functions should be regulated alike and should not be differentiated by the type of institution carrying out the functions.[332]

While functional regulation seems to be a plausible solution to securities-like financial products on paper, the case study of variable insurance in this article unveils some complications embedded in a

331 Turk, *supra* note 63, at 1041–61 (types of functional regulation).
332 *See* Melanie L. Fein, *Functional Regulation: A Concept for Glass-Steagall Reform?*, 2 STAN. J.L. BUS. & FIN. 89 (1995).

seemingly ideal roadmap. For one, functional regulation of institutions requires a radical move to reorganize financial regulators. Differentiating regulatory treatment on the basis of function would overhaul the status quo and challenge the vested interest groups, which would impede the proposal's political viability. Amid the convergence in economic functions of asset management products in China, there is scholarship advocating the merger of all financial regulators—the PBOC, the CSRC, the CBRC, and the CIRC—into one mega-regulator.[333] Pursuant to the proposed reorganization plan, the PBOC would play a role analogous to the U.S. Federal Reserve Banks, acting as a prudent regulator.[334] Aware of the limitations on the current institutional approach to regulation, scholarship hopes the reorganization would enable a functional regulation structure tantamount to the regime under the Gramm-Leach-Bliley Act of 1999.[335]

This school of thought has several practical difficulties to overcome. First and foremost, despite the emergence of such regulation as the Asset Management Rules, China's current financial regulation model remains institutional regulation—the opposite of functional regulation.[336] In other words, while the regulation shifts toward functional regulation, the regulatory institution remains intact. A shift to functional regulation would entail a reorganization of regulators. Yet, a reorganization of financial regulators is at best a long shot. A regulatory overhaul of this scale is infeasible unless top Chinese leadership is determined to push it forward. It is unlikely, if not impossible, for existing financial regulators to voluntarily surrender the lucrative regulatory power they have enjoyed for decades. The rent-seeking opportunities that come with scrutinizing these financial players are so tempting that no financial regulator is willing to forgo them. The radical shuffling of regulatory functions among financial regulators is at odds with the Chinese government's general preference to undergo gradual regulatory transition – a "stability above all"[337] philosophy – and is

333 For historical development of financial regulation in China, see, *e.g.*, Huang, *supra* note 240, at 220–27, and Fan Liao, *Regulation of Financial Conglomerates in China: From* De Facto *to* De Jure, 12 EUR. BUS. ORG. L. REV. 267 (2011) (objecting to the mega-regulator model while hoping to implement functional regulation through coordination among regulators).

334 *See* Simin Gao, *Anti-'Grey Rhino': Prudential Regulation and Bank Resolution in China*, *in* RESEARCH HANDBOOK ON ASIAN FINANCIAL LAW 274–92 (Douglas W. Arner, Wai Yee Wan, Andrew Godwin, Wei Shen & Evan Gibson eds., 2020). For the role of the U.S. Federal Reserve, see generally the classic opinion by Paul A. Volcker, *The Federal Reserve Position on Restructuring of Financial Regulation Responsibilities*, 70 FED. RSRV. BULL. 547 (1984).

335 Gramm-Leach-Bliley Act, Pub. L. 106-102, 12 U.S.C. §§ 1811–3222 (2012).

336 Heidi Mandanis Schooner, *Regulating Risk Not Function*, 66 U. CIN. L. REV. 441, 457 (categorizing functional regulation and institutional regulation as two general models of regulation).

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sure to invoke fierce resistance from the status quo. While interagency coordination seems promising at a first glance,[338] a bottom-up coordination effort to redress the regulatory overlap and gap is an unrealistic hope.

Second, as Judge Richard Posner pointed out, reorganization is hardly a cure for institutional problems.[339] History has repeatedly shown that reorganizations are doomed to fail, especially those imposed on an agency from the outside.[340] After reorganizing several agencies into one, the surviving agency will be a hybrid; it combines the functions of several agencies, but it seldom streamlines these functions. Reorganization merely transforms an interagency problem into an intra-agency problem. The same is likely to be the fate of a reorganization of Chinese financial regulators if the reorganization is enacted at all.

Last, but not least, the Gramm-Leach-Bliley Act may not be a perfect example for Chinese regulators to follow. The Gramm-Leach-Bliley Act was published under a different institutional setting and for different purposes.[341] The notion of functional regulation was brought forward mainly to furnish academic justification for the Gramm-Leach-Bliley Act.[342] The Gramm-Leach-Bliley Act repealed the Glass-Steagall Act to facilitate business combinations among banks, securities firms, and insurance companies.[343] Under the Glass-Steagall Act, commercial bank holding companies could establish and acquire investment banks,[344] but not vice versa.[345] One effect of the Gramm-Leach-Bliley Act, therefore, was to

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S. Das, Jonathan Fiechter & Tao Sun eds., 2013) ("China has made it clear in several official statements that preserving financial stability is a major economic policy priority. There is a consensus that a consistent macroeconomic policy framework is intrinsic to the country's financial stability."); Yan Liang, *Shadow Banking in China: Implications for Financial Stability and Macroeconomic Rebalancing*, 49 CHINESE ECON. 148, 154 (noting the social stability concerns constantly in the minds of Chinese regulators).

338 Liao, *supra* note 333 (advocating for interagency coordination).

339 RICHARD A. POSNER, PREVENTING SURPRISE ATTACKS: INTELLIGENCE REFORM IN THE WAKE OF 9/11, at 127–31 (2005) (the implausibility of governmental reorganization when there is an intelligence crisis).

340 *Id.* at 158–59.

341 *See* Meredith E. Bock, *Biometrics and Banking: Assessing the Adequacy of the Gramm-Leach-Bliley Act*, 24 N.C. BANKING INST. 309, 315–17 (2020) (review of the legislative history of the Gramm-Leach-Bliley Act); William C. Handorf, *An Examination of the Factors Influencing the Enactment of Banking Legislation and Regulation: Evidence from Fifty Years of Banking Laws and Twenty-Five Years of Regulation*, 24 N. C. BANKING INST. 93, 97–100 (2020) (survey of historical legislative activities related to banking).

342 *See* Broome & Markham, *supra* note 302, at 761–65 (the introduction of functional regulation alongside the Gramm-Leach-Bliley Act).

343 Jonathan R. Macey, *The Business of Banking: Before and After Gramm-Leach-Bliley*, 25 J. CORP. L. 691, 709 (2000).

344 *See, e.g.*, Indus. Ass'n v. Bd. of Governors of the Fed. Res. Sys., 900 F.2d 360 (D.C. Cir. 1990).

345 Banking Act of 1933 (Glass-Steagall) § 21, 12 U.S.C. § 378 (1994).

enable investment banking operations to enter into commercial banking business by establishing or acquiring commercial banks.[346] As Jonathan R. Macey put it, "it is not surprising that the first merger approved under the Gramm-Leach-Bliley Act was the acquisition by a brokerage firm, Charles Schwab, of a commercial bank, U.S. Trust Corp."[347] Functional regulation arguments backed the repeal of the Glass-Steagall Act by requiring regulators to adjust their regulations to the evolving business reality. After the passage of the Gramm-Leach-Bliley Act, the functional regulation rationale had fulfilled its historical task and waned out of the focal point of academic discussions.

However, China has achieved what the Gramm-Leach-Bliley Act endeavored to effect. Institution-wise, Chinese banks can operate across different business sectors including asset management business by establishing their asset management subsidiaries.[348] The already blurred boundaries between different financial institutions are becoming dimmer.[349] Product-wise, insurers can foray into the traditional securities terrain by issuing securities-like variable products. The historical function of functional regulation arguments to advocate for cross-sectoral operation of financial institutions seems obsolete in China. In this sense, the financial sector lacks the incentive to lobby for a policy change toward functional regulation. On the part of regulators, the inertia to adapt to the evolving landscape as elaborated above is not mitigated in a functional regulatory framework.

Functional regulation may be a convenient, yet impractical, response to the regulatory concerns of variable insurance. To accommodate functional regulation, regulators can easily line up to claim concurrent jurisdiction over the same product, such as variable insurance. Such overlapping jurisdiction for one product brings in more complications than efficiencies. Recall that the requirement of functional regulation is to divide regulatory authority based on discrete functions of financial products.[350] It is believed that like functions are regulated alike in this way.[351] But implementing an ideal principle entails great complexities. One implication for an individual

346 Macey, *supra* note 343, at 694.

347 *Id.*

348 Asset Management Rules, *supra* note 47, art. 13 (requiring banks to set up asset management subsidiaries if banks wish to engage in asset management business).

349 Huang, *supra* note 240, at 237.

350 Broome & Markham, *supra* note 302, at 776–77.

351 Fein, *supra* note 332.

institution is that it may end up having multiple regulators overseeing it, each institution scrutinizing one aspect.

Variable insurance poses specific challenges to the notion of functional regulation. It is a hybrid product with mixed features of both securities and insurance. To be consistent with the philosophy of functional regulation, a hybrid product with mixed features of securities products and insurance products ought to be regulated by both securities and insurance regulators. Accordingly, variable insurance ought to be concurrently regulated by both the securities regulator—for the securities element—and the insurance regulator—for the insurance element. Appealing as it may seem, it would give rise to daunting complexity when the functional regulators attempt to allocate between themselves the jurisdiction over one product. The most likely consequence of the turf war is a stacking of regulatory power as we have seen in a number of regulatory domains such as foreign investment.[352] This means the same product has to be approved by multiple regulators as the *different aspects* within the jurisdiction of *different functional regulators* are inseparable from each other in one single product.

Here, functional regulation comes at a cost: one regulator may conduct the examination in spite of another regulator's behavior. In China's context, the securities portion of the product falls within the ambit of the CSRC while the insurance portion within the jurisdiction of the CIRC. But the boundary is far from a clear when it comes to which portion should be administered by the CSRC and which by the CIRC. The regulatory boundary issue is exacerbated in China considering that the Chinese Securities Law's definition of securities is narrowly constructed[353] and Chinese laws have yet to embrace a concept of investment company like that in the Investment Company Act in the U.S.[354]

Even if we contend the regulatory boundary can be drawn with some efforts—that the separate account is a security and the rest remain a conventional insurance policy— can this generalization be carried forward to all other asset management products where functional regulation is supposed to apply? A more likely result could be, similar to the U.S. financial market with the convergence of financial products, the boundary between different financial products is doomed to become increasingly blurry. The regulators would have to first draw a definitional boundary before regulatory categories track the economic function of the financial

352 *See* Li, *supra* note 263.
353 *See supra* Section IV.D.
354 *See supra* Section II.A.

product at issue. Yet, as Lissa Broome and Jerry Markham have long put it, determining the boundary of multiple functions can be arbitrary and indeterminate.[355] The categorization can easily become overinclusive when different products are generalized as sharing similar economic substance.[356]

Rendering one financial product to the oversight of multiple regulators would face a number of practical obstacles in China. China administers a consensus-ruled system in which regulators typically reach consensus, not necessarily through interagency communications or coordination, but via the requirement that one subject of regulation should receive signoffs from each one of them.[357] It is the applicant's obligation to ensure all possible regulators reach consensus amongst each other, not the other way around.[358] Without effective built-in interagency coordination mechanisms, such a consensus-based system imposes tremendous costs on the part of the regulated. Advocating functional regulation for variable insurance is equivalent to reinforcing the consensus-ruled system. It adds to the already rampant regulatory overlap in financial regulation while not necessarily adequately addressing the systemic risk brought about by variable insurance. Is it an effective solution to the regulatory concerns associated with variable insurance? I doubt so. Critics have pointed out that functional regulation leads to the absence of an overall regulator that keeps the systemic risk at bay.[359] Although functional regulation does not necessarily preclude the existence of a mega-regulator, the additional costs associated with functional regulation are genuine.

In a more general sense, the implementation of functional regulation has a number of obstacles to overcome before it can effectively tame Chinese asset management products. These products utilize a chain of Special Purpose Vehicles ("SPVs") sponsored by different financial institutions.[360] Funds flow through these SPVs tunnels before they get from ultimate lenders to the end creditors. As used in this context, an SPV's main purpose is compliance—complying with the licensing and business scope

355 Broome & Markham, *supra* note 302, at 777.

356 Howell Jackson, *Regulation in a Multi-Sectored Financial Services Industry: An Exploratory Essay*, 77 WASH. U. L.Q. 319, 374–75 (1999).

357 Li, *supra* note 263, at 699–700 (the operation of the consensus-ruled system in China's foreign investment regulation as an example).

358 *Id.*

359 Fein, *supra* note 332, at 110. The theme of Fein's article is against functional regulation. And when functional regulation is inevitable, to vest the power of regulating banks' securities activities on the bank regulators as opposed to the SEC.

360 Bowman, *supra* note 246, at 12–15 (illustrating the use of SPVs).

restrictions imposed on different types of financial institutions.[361] Asset management products are in particular geared toward regulatory arbitrage; a substantial proportion of them are created to move bank loans off-balance sheet.[362] It would be difficult, if not impossible, to characterize asset management products by their "functions." How functional regulation may fit in this picture of asset management products poses a much larger question. It would be premature to jump to the conclusion that because of the promulgation of the Asset Management Rules, functional regulation of financial products has been achieved or will likely be fully implemented in China.

361 For example, trust companies set up the most commonly used SPVs, as they are licensed to engage in the broadest scope of business lines among all non-bank financial institutions, including directly making loans. *Id.* at 6.

362 Kerry Liu, *Chinese Asset Management Industry: Its Categories, Growth and Regulations*, 52 CHINESE ECON. 41, 44 (2019) (trust companies serving as tunnels for banks to move their loans off-balance sheet and in turn invest in non-standardized financial products).

## VI. CONCLUSION

Issues related to the legal characterization of variable life insurance are far from settled in China. In the U.S., where China learned the design of variable products, its country-specific regulatory approach includes (i) the registration of variable contracts as securities with the SEC under the Securities Act, and (ii) the regulation of the separate accounts as investment companies under the Investment Company Act.[363]

There is a mismatch between the financial institutions' copying product design and regulators' refusal to follow the regulatory approach in the home country where the products originated. Apart from being a good sample for comparative legal studies, the transplantation of variable insurance coupled with the evolvement of its regulatory framework unveils the systemic risks embedded in a lagging legal infrastructure. While the Chinese version of variable insurance presents a cause for regulatory concern, its regulators seem to be barking up the wrong tree. They miss the correct target while misdirecting tremendous resources to tame the behavior of activist investors and to deprive mid- to small-sized insurers of market access. None of these steps addresses the systemic risks associated with variable insurance.

A number of issues featuring variable insurance can also be found in other asset management products in China. China's colossal shadow banking business underscores the need to consolidate the existing fragmented regulatory regime for asset management products. Protecting financial consumers, eliminating regulatory arbitrage to the extent possible, and addressing the co-existence of over-regulation and under-regulation, and so on are all pressing topics. Moreover, the political hurdle for integrating the regulatory framework for all asset management products is sure to be enormous. Hence, it is premature to conclude that functional regulation is at its dawn in China; it calls for top-down intervention to make a genuine reform possible.

As a general trend, innovated financial products in China are increasingly modeled on their counterparts in the U.S. As a result, we have observed a growing resemblance between the emerging financial products in China and their counterparts in the U.S. In contrast with the swiftly narrowing gap between the financial products in the U.S. and China, China's regulatory approach is severely lagging behind the U.S., leading to its suboptimal regulation of the financial market. The regulators should

363 Roth et al., *supra* note 62, at 539.

refrain from unduly intervening in market participants' business judgments. Neither should they suffocate the development of a socially valuable financial model in exchange for temporary financial stability.