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Analysis of Legal Issues Related to Shadow Margin Lending

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Abstract

As a supplement to financing and securities financing, Over-The-Counter financing has always been in the grey area of supervision. Its low-entry threshold, high leverage and low guarantees make OTC Financing one of the "culprits" of the 2015"Stock Crash" in China's stock market. This article will combine the Minutes of the National Court Work Conference for Civil and Commercial Trials and the Shenzhen OTC Lending Guidelines to analyse problems including the validity of the OTC Financing agreement caused by the OTC Financing behavior, the follow-up processing of the capital account after the relevant financing agreement is determined to be invalid, how to bear the loss after the liquidation operation and if the fundraising party have the "forced liquidation right" from a legal perspective.

Keywords: over-the-counter financing, validity of contract, assumption of loss

1. Introduction

As a private financial practice, Over-The-Counter Financing (hereinafter referred to as "OTC Financing") has existed since before the legalization of the "two-financing business" (financing and securities business), but its scale is small and its impact on the financial market order is not significant. When *the Securities Law* was amended in 2005, there was no corresponding legal regulation on this issue. In the early days, OTC Financing was mainly carried out through intermediaries such as pawnbrokers and mortgage guarantee companies in the form of mortgage guarantees, but with the prevalence of bargaining in the securities trading market, OTC Financing gradually evolved with high multiplier bars and low guarantees, especially with the development of China's mobile Internet industry, some of the OTC P2P platforms even put up the slogan of "you only need a thousand Yuan and you can make a big difference". Until 2015, when the Chinese stock market entered a new round of "bull" market, over-the-counter financing began to proliferate, eventually becoming the "culprit" of the 2015 "Stock Crash". The high bar rate of OTC Financing has caused a huge hidden danger to the smooth operation of the securities and financial market order. The national regulatory authorities have started to crack down on OTC Financing but have been unable to tackle the root cause of it. What's more, there is a resurgence trend of OTC Financing. More and more scholars and experts, as well as the national regulatory authorities, have begun to realize that the impact of OTC Financing on the financial market must be correctly evaluated, and the relevant regulatory system must be continuously improved to bring OTC Financing into the scope of regulation in order to promote the sound development of China's financial securities market.

Allocation refers to the financing agreement signed between the relevant financing party and the financing platform, whereby the financing party provides a certain amount of funds (so-called margin) to the financing platform, and the financing platform takes the number of funds provided by the financing party as the base and allocates new funds to the financing party for relevant market operations according to the agreed bar multiplier, while the financing party is required to pay a certain amount of fund management fee or various forms of "funding fee" to the platform. This kind of financing mainly appears in the securities, stock and futures markets, and this article mainly refers to the financing behavior in the stock market. The so-called "Over-The-Counter

Financing" is a concept corresponding to "On-The-Counter Financing", and the "On-The-Counter" and "Over-The-Counter" here are not distinguished from their physical space, but are based on whether the financing business is approved by the regulatory authorities. Any financing and securities business approved by regulatory authorities is called "On-The-Counter Financing", while any financing and securities business without regulatory approval is called "Over-The-Counter Financing". In simple terms, the so-called "Over-The-Counter Financing" is a private financial practice of borrowing other people's money for stock speculation, which is beyond the range of the regulation.

2. Analysis of Common Trading Models

For OTC Financing behavior, trading models include direct transactions between the two parties, financing with the help of P2P platforms and the financing of structured asset management products, etc.

2.1 Direct Transactions Between the Two Parties

In this model, the financing party and the fund provider sign the relevant funding agreement directly, agreeing on the funding bar multiplier and the rate of the use of funds, and the financing party can directly use the account under the name of the fund provider to conduct relevant market operations, with profits and losses at their own expense, and the financing party enjoys certain supervision and "Forced Liquidation Right". This model is the most common model of private "Over-The-Counter Financing" (Luo Ernan, 2019).

2.2 Financing With the Help of P2P Platforms

With the development of China's mobile Internet industry, a large number of "P2P" platforms have emerged in China, aiming to reduce the opportunity cost of related transactions and match transactions as their main business (Wang Shengdou, 2020). In OTC Financing, "P2P" matching platforms are standing between the fund provider and the financing party, matching the financing party's demand through their own research position system and providing the fund provider's account to the financing party. Even though some "P2P" platforms have certain rights of risk monitoring and forced liquidation, fund providers obtain fixed income by providing fund accounts. Although this model is novel and has evolved new features compared to the traditional OTC Financing models with the help of the mobile Internet wave, it is still essentially an "OTC Financing" and does not break away from the range of "OTC Financing".

2.3 Structured Asset Management Product Financing Model

In this model, the fund provider will divide the principals into two levels according to the order of income distribution: the priority general principals are mainly investors seeking low-risk and fixed-income returns, while the shares of the inferior sub-principals are generally subscribed by the fund allocation company. The priority general principal provides funding for the subordinated sub-principal and establishes a trust sub-account within the trust parent account, which is independent of the trust parent account. The sub-account is free to operate in the market until the closeout stop line is hit. The fund provider will establish a forced liquidation line on top of the capital preservation income line, which is generally lower than the capital preservation income line. If the balance of the account is below the forced liquidation line during the market trading day, the financing party needs to replenish the funds in the account to above the forced liquidation line in a timely manner. If the balance of the account is not replenished above the forced liquidation line within the specified time, the fund provider will activate the forced liquidation right in order to guarantee the share of priority funds.

3. Legal Issues Related to OTC Financing

3.1 Determination of the Validity of OTC Financing Contracts

Article 80 of *the Securities Law of China* clearly stipulates that legal entities shall not illegally use other people's accounts or lend their own securities accounts to others. Although this provision prohibits legal entities from engaging in similar OTC Financing activities, it only regulates legal entities but does not restrict unincorporated entities. Therefore, if the fund provider is an unincorporated entity, it is not under the regulation of this article. In reality, the fund allocation company will often open relevant fund accounts in the name of the unincorporated person under its actual control and put these accounts under its own control, and eventually give the fund accounts opened in the name of the unincorporated person to its own demand side through the position allocation system, so the provisions of this article cannot be applied to such OTC Financing (Wang Yuting, 2020).

Article 22 of *the Measures for the Administrative of Securities Registration and Settlement* provides that an investor shall not hand over its own securities fund account to another person for application. In practice, some courts hold that relevant financing agreements are invalid according to Article 22, but most courts hold that this article falls into the range of administrative provisions and is not a mandatory provision on effectiveness. Therefore, this article cannot be directly applied as a legal basis to determine the invalidity of the financing contracts.

Article 117 of *the Securities Law* stipulates: "No entity or individual shall operate a securities business without

the approval of the securities regulatory authority under the State Council." If approval of the regulatory body and the subject of the placement is not taken into account, although the Over-The-Counter Financing and the On-The-Counter Financing are similar regarding the operation, the Over-The-Counter Financing does not include securities financing. There are significant differences between the Over-The-Counter Financing and typical On-The-Counter Financing (i.e., the financing and securities financing business), so they cannot be directly equated with each other, and there is some dispute as to whether they fall into the definition of "Securities Business" under *the Securities Law*.

The relevant provisions of *the Minutes of the National Court Work Conference for Civil and Commercial Trials* make it clear that an OTC Financing contract will be deemed to be a null and void civil contract. *The Minutes of the National Court Work Conference for Civil and Commercial Trials* brings credit trading in the securities market into the scope of uniform national regulation. Unregulated OTC Financing not only blindly expands the scale of credit trading in the capital market, but is also liable to impact the trading order of the capital market. As the main trading methods of the securities market and the core business of securities institutions, financing and securities financing are financial businesses licensed by the State according to the law, and entities or individuals shall not illegally engage in the business of financing without approval according to the law.

Therefore, based on the latest practices in our country and the guidelines of relevant normative legal documents, the validity of OTC Financing agreements in practice will be considered as invalid.

3.2 Subsequent Processing of Funding Accounts after the Relevant Financing Agreement Is Found to Be Invalid

The Civil Code stipulates in detail the process after the civil contract is invalidated or revoked, and it generally adopts the principle that two parties of the contract shall mutually return to each other. However, in the OTC Financing, if such a process is adopted, mechanically requiring both parties of the financing agreement to return the property obtained from each other, it may lead to the situation that only one party eventually bears the full responsibility, thus giving rise to unequal rights and obligations of both parties of the OTC Financing agreement. In practice, when some parties in need of funds suffer economic losses due to wrong market operations, they might claim to the court that their financing agreements are invalid on the ground that the financing agreements signed between them are invalid and order each party to return the property obtained from the other party in accordance with the relevant provisions of *the Civil Code,* in order to transfer the huge economic losses suffered by them and to realize their intention of sharing the huge economic losses. The original intention of *the Civil Code* in fact increase the obligations of the provider of funds and reduce the responsibility of the financing party of funds, resulting in the substantial inequality of rights and obligations between the two parties. Therefore, in order to prevent the parties from taking advantage of the legal provisions to mitigate their economic losses and on the basis of the principle of fairness of *the Civil Code*, *the Shenzhen Intermediate People's Court Judgment Guidelines on Hearing Disputes over OTC Stock Financing Contracts* (hereinafter referred to as the "*Shenzhen OTC Financing Guidelines*") leaves the specific details of the handling of the invalidation of the contract to the discretion of the court rather than to mechanical application. The court will take into account various factors such as the market conditions of the OTC Financing agreement, the process of the parties' market operation and the performance of the relevant financing agreement so that the allocation of the civil liability of the parties concerned will fit the state of the OTC financing agreement at the time it was reached as far as possible and prevent the parties from maliciously using the legal rules to claim the invalidity of the financing agreement and to require both parties to return the property to each other, and eventually prevent the occurrence of unequal rights and obligations between the parties of the financing agreement.

3.3 Whether the Matching Party Has a "Forced Liquidation Right"

In OTC Financing, the establishment of "Forced Liquidation line" is one of the indispensable elements of the OTC Financing agreement. In order to control the risks it may encounter and to monitor the capital account, the fund provider often agrees in the lending agreement that when the market value of the stocks in the capital account reaches the initial agreed market value, the fund provider has the right to force the stocks in the capital account to sell in order to control the risks. In the normal financing and securities financing business, i.e. On-The-Counter Financing, the securities company can dispose of the collateral provided by the financing party when certain conditions are met. The collateral in the financing and securities financing business includes securities stocks, so it can be inferred from this that the national regulatory agencies have the tacit approval of the substantive forced liquidation right enjoyed by securities companies in the financing and securities financing business, while there is a certain controversy in practice as to if the counterparties in OTC financing enjoy the forced liquidation right. *The Shenzhen OTC Financing Guidelines* do not directly deny the forced liquidation right enjoyed by the counterparty, which is in line with the contractual expectations between the parties and helps to balance the interests of the parties in OTC Financing disputes. The right to supervise the stock account and the right to liquidate compulsively is based on the autonomy of both parties. The fund provider has the right to supervise the lending account in order to ensure the safety of its assets, and when the market value of the

assets reaches the liquidation line, the fund provider is granted the right to liquidate based on the contractual agreement, which is to prevent the expansion of losses. If the fund provider does not have the right to liquidate, the loss will continue to grow and the financing party will likewise bear the loss.

3.4 The Assumption of Losses After Liquidation

In *the Shenzhen OTC Financing Guidelines*, there are clear provisions about the assumption of losses caused by forced liquidation of the financing party, which mainly include the following situations:

(1) The first situation is to treat the OTC Financing agreement as an ordinary contract, at the expiration of the contract period agreed between the two parties, the market value of the stocks in the capital account has not yet touched the "Forced Liquidation Line" set by the financing parties, in this case, the rights and obligations of both parties of the financing agreement automatically terminate. If the financing party has made a profit from market operations, i.e, the market value in the fund account is greater than the sum of the amount of the financing fund and the amount of the margin, the fund provider shall return the relevant margin and the profit to the financing party; if the financing party's market operation causes a loss, i.e., the market value of the stock in the fund account is less than the sum of the amount of the matching fund and the margin provided by the fund provider, the fund provider shall return the difference between the margin provided by the financing party and the loss of the stock, and the market loss shall be borne by the financing party alone (Liu Jincheng, 2020).

(2) The second situation is that when the market value of the stocks in the capital account reaches the "Forced Liquidation Line" set by the fund provider, the fund provider forcibly liquidates the stocks in the capital account in accordance with the OTC Financing agreement. Although *the Shenzhen OTC Financing Guidelines* do not explicitly qualify the forced liquidation line set by the fund provider, the guidelines do not deny the validity of the fund provider's position to exert forced liquidation right and consider the provider's actions to be effective. The loss will be borne by the financing party after the forced liquidation of the shares in the funding account is conducted by the fund provider in accordance with the financing agreement.

(3) The third case takes into account the situation where the financing party suffers losses due to the fault of the fund provider. In practice, there may be cases where the fund provider makes faults like the market value of the stocks in the capital account does not reach the "Forced Liquidation Line", the fund provider changes the password of the capital account, or the fund provider temporarily raises the forced liquidation line in order to reduce losses and the financing party' losses is therefore resulted. In such a case, the further loss results because the funding account is out of the market operation of the financing party, so the further loss should be borne by the financing party.

In another extreme practical situation such as the "stock market crash", the "meltdown" mechanism of the stock market is triggered due to the collapse of the financial market, and no market operation can be conducted until the "meltdown state" ends. After the "meltdown", the market value of the stocks in its capital account has already fallen below the forced liquidation line, under such a situation no liquidation can be conducted. This situation is not due to the fault of the financing party, and the losses caused in this case should be borne by the financing party itself (FAN Qianqian, 2017).

4. Conclusion

What is actual is rational. It has not been a long while from the OTC Financing not being taken seriously to getting much attention from national regulatory agencies. From the perspective of the basic need to stabilize the legal order of China's financial market, it is necessary for the national regulatory agencies to include the OTC Financing into the scope of regulation. *The Minutes of the National Court Work Conference for Civil and Commercial Trials* directly determine the OTC Financing as invalid, and the reasonableness of such a "one-size-fits-all" approach is open to question. In the foreseeable future, OTC Financing is bound to exist for a long time as an important supplement to the financing and securities financing business. How to respond to the needs of financial law regulation in a timely manner will be an important issue the regulatory authorities face in the future.

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