

Legal Consideration on the Internet Finance Supervision

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Abstract: On March 5, 2014, Premier Li Keqiang submitted the government report deliberated by Twelfth Session, Second Meeting of the National People's Congress, which proposed “accelerate the development of Internet Finance, improve Internet Finance supervision and coordination mechanism, monitor the flow of foreign capital closely, and protect from the systematic and regional finance risks”. It is the first time “Internet Finance” occurred on the official reports. The Central People's Government has sent the message of the encouragement and support on the market innovation, also they accepted that the new Internet Finance industry should be conducted and regulated. The paper first introduces the operational model of Internet Finance, differs it from the traditional finance industry. And then analyzes the current law and explores the endogenous risks, in the hope of searching for better solutions to supervise Internet Finance and accelerate its development.

Introduction

“Improving the financial market” and “encouraging financial innovation” are the important tasks of the “Decision on Some Major Issues Concerning Comprehensively Deepening the Reform” proposed by the Third Plenary Session of the 18th CPC Central Committee. Meanwhile, the Decision also proposes “We will carry out reform measures and stability standards for financial oversight, improve the mechanism for oversight and coordination in the financial sector.” Along with the deep integration between Internet and Finance Industry, Internet Finance becomes a newly emerging business model, which impacts the development of the traditional Finance Industry.

Newly Emerging Internet Finance Industry

Modern Information Technology represented by Internet such as mobile payment, social networks, search engine and cloud computing, would subversively influence the finance models. [1] Internet Finance has the features of financing, payment and transaction intermediary. The prosperity is mostly reflected in the advent of Third-party Payment, Peer to Peer Lending and Crowd Funding.

The main models of the newly Emerging Internet Finance

1) Third-party Payment

Early in the 20th century, payment services of the traditional financial institutions have been impacted by Internet information technology. In 1995, US Security First Network Bank operated, providing a lot of financial services on Internet. The popularity of E-bank business also enlarges service channel of Delivery versus Payment. But only when the Third-party Payment came up, Internet Delivery has seized real chance to make a breakthrough. Third-party Payment means independent institutions guaranteed by specified economy strength and credit, provides a platform for the users to finish the delivery and payment with banks, by signing with them. Third-party Payment and Bank Payment on Internet are different from access threshold, business scope, and supervision mechanism.

2) Peer to Peer Lending

Peer to peer lending (hereinafter referred to as P2P) points at the financial lending transaction operated directly between the borrowers and loaners, without the traditional financial intermediaries. Peer to peer lending emerged in 2005. It focuses on providing credit business differing from traditional

financial institution, especially when the credit resource is hard to obtain during the credit crisis [2]. That is to say, P2P is fundamentally the information platform of merchandising creditor property. Concerning the existing P2P models in our country, they mainly contain Financing Information Intermediary, Creditor Property Transfer Intermediary, Guarantees Intermediary and so on, regardless of whether they have this qualification. Until December 31, 2013, the total turnover of P2P loan platform in our country has reached 89.71 billion yuan, which increased 292.4%; the number of the P2P loan platform is totally 523, grew by 253.4%. [3]

3) Crowd Funding

Crowd funding is the financing model completed by a large crowd who uses social networks. [4] The basic model is that fund raisers use fund-raising platform to publish the financing needs on Internet, also describe its financing plan and purposes, then the interested investors will be voluntary to provide funding, and they will ask for the stockholders' equity reward. Difference from minority sophisticated investors' (e.g. VC, PE, Business Angel) financing, crowd funding set out to raise capital from an unknown crowd, individual investors just only invest small amounts of money. In short, Crowd funding platform is essentially the one used for transferring stockholders' equity.

The main features of Newly Emerging Internet Finance Industry

Report on Implementation of China's Monetary Policy in the second quarter of 2013 released from People's Bank of China has pointed that, Internet Finance helps to resolve the information asymmetry and credit problem depended on analysis of big data, provide more targeted special service and more diversified products. The report has admitted the advantages of Internet Finance. To find the theoretical basis for providing Internet Finance a blooming future, we should understand and grasp the characteristics of it.

1) Symmetry Information

To traditional finance institution, the cost of collecting the investment enterprise information is too high, since investment enterprise resource is dispersed and complicated, especially the micro-enterprise, and the data is difficult to process and applicate effectively. By the Internet Finance, both side of the transaction can search the information recorded by the social network, from this, they can be conscious of the company or individual property, credit and so on. Then it will increase the utilization efficiency, and solve the asymmetric and pyramid-scheme information problem.

2) Diversity of Services

Through improving the financial resources liquidity on Internet, Internet Finance has extended the service objects and contents in contrast with traditional Finance. First, it reduces the threshold for access, making more small investors break through the limited factors such as area to participate in Internet Finance. In addition, combining the characteristics of the tradition finance, it has expanded finance services content, not only payment services, but also financing and much more. For example, Jingdong Anniversary in 2014 —“6.18 Anniversary”— provided “Jingdong Finance” to the public. Four business, including Supply Chain Finance (Jingbaobei), Consumption Finance (Jingdong Baitiao), E-bank Online (E-bank Wallet) and Platform Services (Jingdong Treasury), has integrated into Jingdong business and opened "Internet + Retail + Finance" model. Diversification of Internet Finance also has demonstrated its flexibility and innovation.

3) Convenient and Efficiency Way

Compared with traditional lending and payment business, both suppliers and demanders of Internet Finance can match and trade directly on Internet, avoiding complicated operation process, and cash flow is more direct and convenient, greatly optimizing the allocation efficiency of financial resources. For example, Jingdong Finance supply chain online has carried out the lending scale of over 10 billion in the periods of just one month, creating an industry miracle. [5] By integrated dealing with the data of sales, purchase and financial, then achieving automated approval and risk control, Jingbaobei has shorten the financing process within less than 3 minutes, while the tradition one spent per day. Another example is Jingdong Baitiao[6], the maximum line of credit reaches 15,000 yuan, and the users can choose flexible terms of payment, either deferred payment up to 30 days, or installment spread up to 24 months.

Compared with tedious application and credit procedure of traditional bank, Jingdong Baitiao users can complete the relevant formalities within one minute on Internet, and the service fees charged is half of similar business of bank.

Related Regulations and Risk of Internet Finance

Internet Finance is in a newborn stage so far, although no specified laws and regulations, there are some relevant effective rules on it, such as Contract Law, Securities Law, Company Law and Criminal Law.

1) Third-party Payment

People's Bank of China has released *Administrative Measures for the Payment Services Provided by Non-financial Institutions* (Order of the People's Bank of China, No.2 [2010], hereinafter referred to as NO.2 Order) in June, 2010. NO.2 Order formulated that third payment service should obtain the business license and be administrated by People's Bank of China; the minimum registered capital for setting up an enterprise who engages in nationwide or province-wide payment business is 100 million and 30 million yuan; supervision contents involve online payment, prepaid bankcard issuance and acceptance, bankcard acceptance and other payment services identified by People's Bank of China.

2) Peer to Peer Lending

P2P is the Information Intermediary platform of direct folk lending, in this meaning, it does not exist the illegal qualification issues. Under the premise of not touching on the Criminal Law meaning of "Illegal Fund-raising", lending between the natural persons, or person and corporate are lawful as long as it doesn't violate the mandatory provisions of law. The provisions about loan contract from effective *Contract Law* indirectly affirmed the legitimacy of folk lending, Article 211 provided that, "Loan contract between natural persons are agreed to pay interest, but it cannot violate the provisions of the relevant limit borrowing rates". *Official Reply of the Supreme People's Court on Issues concerning How to Determine the Validity of Lending between Person and Enterprise* (Interpretation No. 3 [1999] of the Supreme People's Court) indicated clearly that "Lending between person and non-financial enterprise belongs folk lending, it could be identified effective as long as there is real intent-indication between both parties."

3) Crowd Funding

Crowd funding would be under the constraint of Securities Law and Company Law. First, crowd funding raises capital towards unspecified objects, actually having the nature of public offering securities. The harsh regulations about public offering securities is prescribed by Article 10 of Securities Law [7], it shall be reported to the certain securities regulatory authority. The startup company initially established from the crowd funding is hard to meet this regulation. Second, Company Law requires that, Limited Liability Company shall be established by no more than 50 shareholders, while the Joint Stock Limited Company shall not be less than 2 but not more than 200 promoters. However, the eminently characteristic of crowd funding is that the investment from individual investor may be really small, but the number of the investors is so large, it could easily exceed the restriction on the maximum number of shareholders.

The Endogenous Risk of Internet Finance

As a newly developing industry, Internet Finance is the inevitable outcome of the development of social economic and technology. The Third Payment started earlier than the other two models, the supervision circumstance is relatively complete, and the risks are also tended to be in control state gradually. But the network finance platform is still young, risks are increasingly frequent, it cannot make contributions to the maintenance of normal financial order, and even have a negative impact on newly developing Internet Finance.

China has not yet issued the specific regulations on Internet Credit business, which is in a gray area. Dazzling operations of the Lending model makes it difficult to define loan business on law. By now, there are hundreds of Internet Loan enterprises in China. Some P2P enterprises have broken the law line

of Internet Loan, the enterprise essences turn from third-party intermediary to the financial institution of taking in deposits or lending. Industry Self-regulated standard has not yet established. More seriously, there is no regulation on the supervision institution or responsibility, no qualification review on the enterprises, it is also unable to supervise their funding security. By the end of 2013, dozens of "run off" event has occurred in Internet Credit Corporation. The founder of TAOJINDAI Company disappeared with one million yuan only a week after website operating. On December, 2012, YOUYIDAI closed down the business suddenly, all staff disappeared with the amount of more than 2000 million. The occurrence of several "Illegal Fund-raising" and "running off with the money" events brings a negative impact on the development of Internet Finance.

On the other side, the systematic risks of Internet Finance are also quite high. Firstly, most of Internet Finance service offers are the Internet company or private lending company without Internet payment license, of which the operations have not been officially certified legal. Secondly, without the complete credit system, it is unable to establish an effective punishment mechanism. Since the Internet Finance platform cannot connect to the People's Bank credit system, the platform itself is lack of effective examination on debtors' credit standard, loan purpose and repayment ability, it easily leads to difficult issues, such as bad credit rate, failing to recovery of loss.

Reinventing Legislative Logic on Internet Finance Supervision

Law is like organism, shall change with the development of social life, and seek changes in its longevity. Otherwise, it would limited to rigid, also cannot meet the needs of the community. [8] Return to the reality contexts of China, Internet Finance industry not only need the supporting and guidance policies, but also the legal regulation. What the Internet emphasizes is the spirit of open, share and innovation, while the Finance pays attention on security, privacy and steady. As one of the Internet Finance models, Third-party Payment is also a mean of monetary settlement. People's Bank of China issued Administrative Measures for the Payment Services Provided by Non-financial Institutions (Order of the People's Bank of China, No.2 [2010]), Detailed Rules for the Implementation of the Administrative Measures for the Payment Services Provided by Non-financial Institutions (Announcement of the People's Bank of China, No.17 [2010]) and Measures for the Custody of Clients' Reserves of Payment Institutions (Announcement of the People's Bank of China, No. 6 [2013]). They are the rules supervising on Third-party Payment, and most of them are comparatively complete. However, except the Third-party Payment, P2P and Crow Funding are facing the "three-no" embarrassed situation, no access threshold, no trade standards and no supervision institution. There for, this chapter focuses on the latter two models.

Guarantee the safety of Third Party Custody

On August 25, 2011, Notice of the General Office of China Banking Regulatory Commission on Warning of Risks Associated with Peer-to-Peer lending was promulgated (No. 254 [2011] of the General Office of China Banking Regulatory Commission, hereafter referred to as "No. 254 [2011] of Notice"). No. 254 [2011] of Notice indicated that, the access threshold of P2P is quite low, and P2P is without any efficient and powerful supervision; since the legislation is not yet complete, it is lack of regulations on legal character and supervision responsibility of P2P. That is the same as Crow Funding. To strengthen the reasonable supervision, P2P and Crow Funding should be characterized as information intermediary platform, but not the capital intermediary. The essence of P2P and Crow Funding are the information platforms of direct debt financing and equity financing. In these business, they cannot provide the services for taking in deposits or transferring funds, neither using their own-funds for lend activities. The most important is, it is forbidden to become the capital pool, otherwise, Internet Finance platform would become a tool for illegal fund-raising. But the fact is usually the opposite, a number of P2P platform in China has explored the business scope and investors by operating the capital pool. That is the fundamental reason why people criticized P2P as "Pang Scheme". Carrying out Third Party Custody service helps to solve this problem. Third Party Custody refers to the

fund received or paid by the investors is directly managed by the third independent institution, which is often operated by the bank with corresponding fund custody qualification. By the Third Party Custody mechanism, fund from debtor will be operated by the investors, and each fund flow would be required to note remittance details and record, which is helpful to prevent the risk that P2P owners misappropriate investors' funds, or run off with the money. Third Party Custody mechanism is not only good for solving the problem that Internet Finance enterprise misappropriate funds on purpose, but also help the Internet Finance platform to get rid of the charges of illegal fund-raising.

Establishment of Information Disclosure Mechanism

Although fund raisers' information on Internet is more open and complete, it is difficult to guarantee the genuineness and validity of the information sources. Besides, P2P and Crow Funding enterprises do not belong to the financing institutions, they cannot get in and refer to the credit system from People's Bank of China. To make sure the maximum protection of genuineness and validity of customer information, fund raisers should fulfill the reasonable obligation of information disclosure, include basic situation, financing purpose and proposal of financing projects. The dynamic implementation procedure of fund raisers' information disclosure is required to be under the supervision from investors. Simultaneously, Internet financing platform should establish objective credit system, or set up Third-party Credit System timely. Certainly, the obligation of information disclosure cannot be too strict, if not it will increase fund raisers' cost and weaken its flexible advantage. Moreover, Internet financing platform shall take mandatory obligation of information disclosure, disclose regular bad debt. Bad debt rate should be controlled within a certain range, which will promote to fulfill their better duty of judging funding raisers' capability. Anyone who fails to perform the obligation should be ordered to correct their mistakes, improve their control and can be imposed with appropriate penalties simultaneously by the supervision institution.

Especially in the Crow Funding Platform, as one party of stockholder's equity transaction, investors' legality and genuineness will affect financing operations. Crow Funding Platform not only needs to disclose the funding raisers' information, but also strictly examine the investors' identity and other information. On the other hand, Crow Funding should pay attention on the limited number of shareholders by Securities Law and Company Law. For example, a Limited Liability Company is in need of financing, its shareholders number has been 40. According to current legislative clauses, the left quota to subscribe equity is just 10. Some financing platforms find out some way in order to avoid requirement of limited number. They first subscribe equity in the name of 10 investors, and then they will distribute their share to more investors, who can just bear the small part. In fact it violates the mandatory provisions of law. No matter the dormant shareholders or shareholders on behalf of shareholding, they should be counted in the total number.

Construction of Information Security Guarantee Mechanism

As a platform for information exchange, there are a lot of resources about financing participants' identity and transaction, which may include funding raisers, guarantors, investors and so on. Constructing Information Security guarantee mechanism is helpful to further protect participants' personal private and trade secrets of enterprises. Although Tort Law, Anti-Unfair Competition Law and Contract Law have provisions on protecting information security, basic legislation is not enough for specific financing business. For this reason, People's Bank of China put forward Interim Measures for the Administration of the Basic Data of Individual Credit Information (Order No.3 [2005] of the People's Bank of China), Measures of Administration of Financing Institution Users for Basic Data of Individual Credit Information, Rules of Handling of Objections to Individual Credit Information and a series of rules and regulations, to strictly protect individual information by regulating not only on the information collection, preservation and application, but also on supervision measures on authorized inquiry, restricted use, safety insurance, query records, violation penalties and so on. To guarantee information security of all the financing parties, it is feasible to draw on the practice from People's Bank of China, establish the information security guarantee mechanism to adapt to the specific characteristics

of Internet Finance activities, clarify the information security protection from all parties, especially the financing platform. [9]

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- [6] Jingdong Baitiao is the credit service toward the users from Jingdong, which is just used for consumption in Jingdong. It is Essential different from the virtual credit card which is strictly prohibited by China Banking Regulatory Commission.
- [7] Article 10 of Securities Law: A public issuance of securities shall meet the requirements of the relevant laws and administrative regulations, and shall be reported to the securities regulatory authority under the State Council or any department as authorized by the State Council for examination and approval according to law. Without any examination and approval according to law, no entity or individual may make a public c issuance of any securities. It shall be deemed as a public issuance under any of the following circumstances: (1) Making a public issuance of securities towards unspecified objects; (2) Making a public issuance of securities to accumulatively more than 200 specified objects; (3) Making a public issuance as prescribed by any law or administrative regulation. For any securities that are not issued in a public manner, the means of advertising, public inducement or public issuance in any disguised form shall not be adopted thereto.
- [8] Quoted from Wang Zejian: *Research on Civil Law and Cases: volume 1*, China University of Political Science and Law Press, 1997, pp.293.
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