# Private Enforcement of Securities Law in China: A Ten-year Retrospective and Empirical Assessment

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# Content

1. Introduction
2. The Legal Framework
3. How popular is private securities litigation in China?
4. How compensatory is private securities litigation in China?
5. Policy Implications
6. Conclusion

# 1. Introduction

- "legal origins" theory
  - effective investor protection laws are a prime factor in shaping financial market development
- Properly enforced
  - By public agencies, notably the regulator (public enforcement) or
  - By investors in the form of civil actions for compensation (private enforcement)
  - Comment:
    - Debate on the relative importance of the two
    - both forms have their strengths and weaknesses
    - Chinese experience

# 2 The Legal Framework

- Background
  - 1998 Securities Law:
    - Provided for civil remedy in principle, but lacked detailed provisions to implement
    - A sudden explosion of misrepresentation scandals in the market between 2000-2002: Dot com boom
  - 2001 SPC Circular:
    - A temporary ban: legislative and judicial conditions were not ripe
  - 2002 SPC Circular:
    - Lifted the temporary ban, but too simple (5 articles only)

- 2003 SPC Third Circular
  - effective from Feb 1, 2003
  - thirty-seven detailed provisions to set up a relatively complete legal framework for private securities litigation arising from misrepresentation
- 2005 Securities Law
  - Confirms the validity of the SPC Third Circular, and
  - does not import all provisions of the latter into it

# Key features

- limited to misrepresentation only
  - Not cover insider trading, market manipulation
- Explicitly compensatory
  - "private securities litigation"="securities civil *compensation cases" [Zhengquan Minshi Peichang Anjian]*
  - Empirical inquiry:
    - to what extent the SPC Third Circular has achieved its stated mission of generating meaningful compensation to aggrieved investors?

- a rather complete set of rules to cover both substantive and procedural issues.
  - different types of misrepresentation
  - the scope of eligible plaintiffs,
  - a list of potential defendants,
  - the availability of defenses,
  - the rebuttable presumption of causation and reliance
  - the calculation of damages,
  - the territorial jurisdiction rule
    - jurisdiction goes to the place where the issuer is established.

- Procedural prerequisite
  - in order to bring a securities civil suit, there must be a prior criminal judgement or administrative sanction by the relevant bodies, notably the CSRC
  - Reason: the courts lack the resources and expertise needed to decide the complicated question whether there is indeed misrepresentation
  - Criticism: unduly limits the scope of private securities litigation?

- NO class action (*jituan susong)*
  - investors can sue either in the form of individual action (*dandu susong) or joint action (gongtong susong)*
    - if one or both parties to individual actions consist of two or more persons and the object of the action is the same or in the same category, the court can, with the consent of the parties, combine the individual actions into a joint action
  - Are the individual action and joint action effective forms of litigation for securities civil cases? Should China adopt the U.S.-style class action?

# 3 How popular is private securities litigation in China?

- Empirical Data
  - How many securities civil cases have been brought during the first decade after this was formally allowed in 2002?
  - Sources of data
    - Two widely-used electronic databases of Chinese law
    - other publicly available sources such as printed material and the internet
    - personal connections to obtain further information by way of private interviews with well-respected lawyers and judges

- sixty-five securities civil cases

TABLE 1: CIVIL CASES ARISING FROM SECURITIES MISREPRESENTATION, 2002-2011

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|---|
| Cases | 0 | 7 | 7 | 5 | 9 | 5 | 6 | 9 | 7 | 10 |

- Within 5-10
- The numbers are generally too low for statistical analysis, and no trend is discernible over time

- Why don’t the Investors Sue More?
  - Hypothesis1: Is the Procedural Prerequisite to Blame?
    - Bringing a civil compensation action requires a prior criminal judgement or administrative sanction

TABLE 2: CSRC SANCTIONS BEING ELIGIBLE UNDER THE SPC THIRD CIRCULAR, 2002-2011

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|---|
| cases | 7 | 16 | 31 | 14 | 24 | 21 | 20 | 22 | 18 | 19 |

- based on review of publically available information on administrative penalty decisions made by the CSRC on its official website.
- a total of 192 eligible sanctions issued by the CSRC

- Under the statute of limitations for private securities litigation,
  - civil suits must be brought within two years of the procedural prerequisite
  - the data in 2000 and 2001 also need to be considered
  - 21 cases located
- criminal judgements and sanctions by other bodies, notably the Ministry of Finance
  - About 40 cases
- Total:
  - 253 cases, and the suing rate is only 25.7%

# Hypothesis 2: Is there a Lack of Entrepreneurial Lawyers?

- From a law and economics perspective, a case will not be brought if, viewed *ex ante, the cost of litigation exceeds the result of* the amount of compensation discounted by the possibility of success
- US experience: due to the free-rider and other collective action problems that make individual suits not cost-effective, the entrepreneurial lawyers are actually the driving force behind securities class actions
  - A key element in this process is the contingency fee system

- China
  - The contingency fee system is more commonly known as “risk agency fee” (*fengxian daili Shoufei)* in China
  - risk agency fees have been used in the context of securities civil actions
  - The availability of the risk agency fee has greatly facilitated the bringing of securities civil suits, and has led to the emergence of many entrepreneurial lawyers in China

# It Is about the Court, Stupid

- If the judicial process were fair and efficient, most, if not all, securities civil cases would present very good litigation opportunities:
  - the civil case could simply piggy-back on the criminal judgment or administrative penalty decision which has already established the factual finding of wrongdoing, and the company's misrepresentation would therefore be an easy target.

- The court, however, has behaved very unsatisfactorily at almost every stage of the judicial process in handling securities civil cases
  - the court appears to have been very inhospitable in accepting securities civil cases
  - even if a securities civil case is accepted, the time the court takes to hear the case is often so long as to make the suit unattractive.
    - The case of Dong Fang Electronics has the longest time between case acceptance and judgement release—about four and a half years
  - even if the plaintiffs receive the long-awaited judgement in their favor, they may still face enforcement problems

# 4 How compensatory is private securities litigation in China?

- Empirical Data
  - in fifty-nine cases, or about 90.7% of the total sixty-five cases under study, the plaintiff has successfully received recovery
  - the ratio of compensation amounts to provable losses is very high

TABLE 4: THE RATIO OF COMPENSATION AMOUNTS TO PROVABLE LOSSES

| | Mean | Median |
|---|---|---|
| Ratio | 78.6% | 83.1% |

- In a 2006 paper, Professors Cox and Thomas found that the mean and median of the ratio of settlement amount to provable losses are 13.5% and 9.6% in the pre-PSLRA (Private Securities Litigation Reform Act) period, and the situation in the post-PSLRA is even worse, with the mean and median dropping to 12.3% and 5.1% respectively.

- Why can't the Defendant Pay Less?
  - 1. The Piggy-Back Effect
    - In China, the civil court can simply refer to the fact-finding of misrepresentation in the prerequisite procedure
    - In the US, the fact-finding of misrepresentation is often a difficult task, due to the unclear concepts such as materiality, due diligence, and scienter

- This eventually will have a significant impact on the likelihood and magnitude of damages generated by securities civil cases in the United States.
- Professors Cox and Thomas have provided empirical evidence in this regard, showing that securities private suits with parallel SEC enforcement actions settle for significantly more than private suits without such proceedings.

## 2. Clear Rules Governing Civil Claims

- Causation
  - China has borrowed from the United States the fraud-on-the-market presumption of reliance or causality
- Measure of damages
  - The SPC Third Circular also contains clear rules on how to calculate compensation
  - parties to the dispute are able to predict the amount of compensation with a fair degree of certainty,

- In the United States, a variety of methods to assess damages has been used and it is hard to predict which method will be adopted in a given case.
  - This uncertainty adds to the difficulty in predicting the litigation outcome, thereby making it more likely for the plaintiff to accept lower compensation.

- 3. Weak Incentives to Defend
  - compared to corporate/entity liability, personal/individual liability generates more deterrence
    - Whether individuals such as directors get sued?
    - who actually bears the cost of a securities civil suit?

- Empirical finding: who get sued?
  - corporate insiders (individuals such as directors and senior management personnel) were listed as co-defendants alongside the listed company in only fourteen out of the total sixty-five cases
    - Even in those cases where corporate insiders are originally sued as co-defendants, the plaintiffs almost invariably drop the cases against them in the process of a settlement.
    - in exchange for having the cases against them dropped, corporate insiders offer a favorable settlement
  - Cf US: corporate insiders almost always are named as co-defendants

- Empirical finding: who pays?
  - the costs of securities civil actions are frequently not borne by the listed company, but by its controlling shareholder
    - In some cases, the controlling shareholder is sued alongside the listed company as co-defendant in securities litigation.
    - In other cases, although the controlling shareholder is not named as co-defendant, an offer of payment is made by them in an effort to settle the case.

- Cf US:
  - private securities suits, particularly those stemming from the secondary market where the plaintiff purchases from another shareholder and not the company, has the so-called circularity problem
  - payments by the listed company to settle a civil suit are tantamount to the shareholders shifting money from one pocket to the other

# 5 Policy Implications

- 1. Should China Adopt the U.S.-Style Class Action?
  - Criticism 1:
    - because the court does not consolidate multiple suits into one class suit, the current litigation form for securities civil action causes inefficient use of limited judicial resources
  - Empirical findings:
    - the court has tried to achieve judicial economy through a procedural innovation called "test suits."
    - there is no significant difference in terms of the judicial costs

- Criticism 2:
  - the current regime does not promote investor protection as it is financially burdensome for plaintiffs to bring action
- Empirical findings:
  - As to the attorney fee, it is not an issue for the plaintiffs due to the availability of the contingency fee/risk agency fee system
  - the filing fee has rarely been an insurmountable hurdle for bringing securities civil actions

- Further considerations
  - Problems with US class action: the lawyer-client agency cost
    - very small settlements for the investor plaintiffs but handsome fees for the lawyers
    - Strike suits
  - Local Conditions in China
    - institutional investors in China may not be able to perform the role of lead plaintiff, at least for the time being
- Conclusion:
  - Serious doubt that China should adopt the US-style class action

- 2. Should the Procedural Prerequisite be Abolished?
  - heavily criticized as unduly limiting the scope of securities civil litigation in China.
    - Both the criminal courts and administrative regulators in China may be prevented from effectively responding to securities frauds for a variety of reasons
    - the difference in standards of proof between civil proceedings and criminal/administrative proceedings

- Empirical evidence
  - Even within the bounds of the prerequisite, many opportunities to bring civil action were missed
  - the prerequisite offers significant piggy-back benefits for those securities civil suits actually filed, alleviating the otherwise crippling hurdle of evidentiary problems in the litigation process
  - Conclusion: there is no pressing need to abolish the prerequisite, at least for now

- Note: the above discussion is not to deny the problems with the prerequisite.
  - it makes civil litigation simply a copycat effort, thereby reducing the utility of “private attorneys general” as a supplement to public enforcement
- Suggestions
  - the plaintiff can sue all potential defendants , not just those explicitly mentioned in the CSRC penalty decision, but positive evidence is required on their participation in misrepresentation
  - extend the procedural prerequisite to include the enforcement activities by other relevant entities such as the stock exchanges

- 3. How can Enforcement in China's Local Environment be Improved?
  - the real problem with China's securities civil action does not lie in the substantive rules, but rather the way the court handles such action
    - the courts have been unsympathetic towards securities civil suits, as evidenced by the difficulty and delays in getting the case accepted and heard and the judgment enforcement problems
  - Why?

- Many reasons
  - Most listed companies are SOEs
  - Social stability concerns
  - the court lacks resources and expertise in hearing securities civil suits
  - Local protectionism
    - an intermediate court at the place where the defendant listed company is located has original jurisdiction over securities civil cases

- Suggestion:
  - the plaintiff should have the option to bring securities civil cases in the courts in the locality where the issuer company is listed, including Shanghai, Shenzhen, Beijing, Tianjin and Wuhan (“Five Cities”)

## Table 5: Geographical Distribution of Cases

| Court | Number of cases | Percentage |
|---|---|---|
| **Shanghai Municipality** | **9** | **14%** |
| First Intermediate (5); Second Intermediate (4) | | |
| **Hangzhou City Intermediate Court** | **5** | **8%** |
| **Shenzhen City Intermediate Court** | **4** | **6%** |
| **Qingdao City Intermediate Court** | **4** | **6%** |
| **Beijing Municipality** | **3** | **5%** |
| First Intermediate (2); Second Intermediate (1) | | |
| **Chongqing Municipality** | **3** | **5%** |
| First Intermediate (1); Fifth Intermediate (2) | | |
| **Twelve Cities (each has two or three cases)** | **29** | **44%** |
| Ha'er Bin Intermediate; Guangzhou Intermediate; Shenyang Intermediate; Chengdu Intermediate; Jinan Intermediate; Kunming Intermediate; Fuzhou Intermediate; Lanzhou Intermediate; Yinchuan Intermediate; Changsha Intermediate; Xiamen Intermediate; Wuhan Intermediate | | |
| **Eight Cities (each has one case)** | **8** | **12%** |
| Tianjin Second Intermediate; Zhengzhou Intermediate; Nanjing Intermediate; Haikou Intermediate; Xining Intermediate; Xi'an Intermediate; Nanning Intermediate; Guiyang Intermediate | | |
| **Total** | **65** | **100%** |

- Altogether, the courts in the Five Cities heard nineteen cases, accounting for close to one-third of all cases
- the judges there are well-educated, and in particular, due to their proximity to the securities markets, are very experienced in handling financial disputes.

- Local protectionism
  - listed companies are usually the mainstay of the local economy and thus the main source of revenue for the local government.
- the local governments in the Five Cities may have less financial need to protect the misbehaving listed companies
  - As of the end of March 2012, there are up to 159 Shanghai-based companies listed on the Shanghai Stock Exchange, accounting for 17.04% of all Shanghai-listed companies; in contrast, there are only four listed companies from the Ning Xia

- The local government of the Five Cities has a high stake in making their own markets strong and competitive to generate revenue and stimulate the growth of the local economy
  - it is crucial that all listed companies be treated equally and fairly by the local courts there

# IV. Conclusion

- Overall, private securities litigation appears to have played a visible role in the enforcement of securities law in China
- cast doubts on the popular belief that China should adopt the U.S.-style class action
- do not support the idea to immediately abolish the procedural prerequisite altogether, but rather suggest a more liberal way to apply it in order to facilitate bringing more securities civil suits
- the plaintiffs be given the option to bring securities civil actions before the courts in the locality where the issuer company is listed