

# Rethinking the Relationship Between Public Regulation and Private Litigation: Evidence from Securities Class Action in China

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*China has a civil procedure for collective litigation, which is dubbed Chinese-style class action, as it differs from the U.S.-style class action in some important ways. Using securities class action as a case study, this Article empirically examines both the quantity and quality of reported cases in China. It shows that the number of cases is much lower than expected, but the percentage of recovery is significantly higher than that in the United States. Based on this, the Article casts doubt on the popular belief that China should adopt the U.S.-style class action, and sheds light on the much-debated issue concerning the relationship between public and private enforcement of securities law. The Article also discusses the future prospects of securities class action in China in light of some recent developments which may provide its functional equivalents, including the regulator-brokered compensation fund and public interest group litigation.*

## INTRODUCTION

One of the biggest institution-building challenges today facing China, with the world's second-largest economy at an average gross domestic product

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(GDP) growth rate of nine percent over the past two decades, is to develop a robust, well-regulated securities market to meet the financing needs of promising companies in the future. But what is the proper path to this goal? Academic literature suggests that strong investor protection rules play a key role in facilitating deep and liquid securities markets, and that the effectiveness of an investor protection regime is a function of both substantive rules and enforcement mechanisms.<sup>1</sup> Indeed, the issue of enforcement of securities law has recently become a subject of international debate.

Enforcement strategies of securities law have traditionally been divided into two broad categories, namely public enforcement and private enforcement. In general, public enforcement is initiated by a state official such as a regulator or a prosecutor, while private enforcement takes the form of civil actions by a private party for compensation or rescission. The public vs. private enforcement divide is based on two general criteria. First, public and private enforcers may have differing incentives: the former is usually paid a public servant's salary regardless of case outcomes, whereas the latter is primarily motivated by the prospect of financial gain contingent upon success in litigation. Second, public enforcers are relatively centralized and subject to explicit political control, whereas private claimants are not.<sup>2</sup>

There has been an ongoing debate as to the relative importance of private enforcement versus public enforcement of investor protection laws.<sup>3</sup> What is clear, though, is that each of the two forms of law enforcement has its own strengths and weaknesses. For instance, public enforcement has advantages *vis-à-vis* private enforcement in terms of the power to investigate and impose severe penalties. Private enforcement, however, has its own strengths. To begin with, while the function of deterring misconduct is common to both public and private enforcement, private enforcement also has the important function of

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1 See, e.g., John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229 (2007); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Legal Determinations of External Finance*, 52 J. FIN. 1131 (1997).

2 John Armour, *Enforcement Strategies in UK Corporate Governance — A Roadmap and Empirical Assessment* (Eur. Corp. Governance Inst. Law, Working Paper No. 106/2008, 2008).

3 See, e.g., Rafael la Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *What Works in Securities Laws?*, 61 J. FIN. 20 (2006) (arguing that compared with private enforcement, the importance of public enforcement is at best modest); cf. Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resources-Based Evidence*, 93 J. FIN. ECON. 207 (2009) (finding that public enforcement is more important than private liability rules in explaining financial market outcomes around the world).

compensating investors, which public enforcement usually cannot perform. Furthermore, the regulator is subject to resource constraints and incentive issues in dealing with securities fraud, whereas investors — often driven by lawyers who are dubbed “private attorney-generals” — are relatively well-resourced and well-incentivized in pursuing relevant cases.

Hence, it is important to understand the complex relationship between public regulation and private litigation. On the one hand, as public regulation and private litigation may compete with each other in performing the dual function of compensation and deterrence, the utility of private litigation can be affected by the effectiveness of public regulation. This means that if public regulation is effective in protecting investors, there may be a reduced need for private litigation to be initiated by investors. On the other hand, public regulation and private litigation can be used cumulatively and complement one another. Synergies may be achieved in terms of access to information. The Chinese experience can contribute to such an understanding due to its unique legal regime governing private securities litigation within the context of its political and economic system.

The Article proceeds as follows. Part I briefly discusses the background of China’s securities markets and the legal framework governing private securities litigation in the form of the Chinese-style securities class action. Part II presents empirical findings on the quantity and quality of securities civil actions in China during the first decade after their informal introduction in 2002. Based on the empirical findings, Part III draws implications for the debate on the relationship between public regulation and private litigation. Part IV examines two recent important developments, namely the administrative settlement mechanism and public interest group litigation, which may have a substitution effect with respect to securities class actions. The last Part contains a concluding remark.

## **I. BACKGROUND: THE MARKET AND THE LAW**

### **A. The Chinese Securities Market**

The Chinese securities market is very young compared to most Western markets: the two national stock exchanges — the Shanghai Stock Exchange and the Shenzhen Stock Exchange — were established only in the early 1990s. Despite its short history, the Chinese securities market has made remarkable progress and has played an increasingly important role in China’s economic development. By the end of 2015, about two and a half decades after their establishment, the two stock exchanges were home to an aggregate of 2827 listed companies with a total market capitalization of 53.15 trillion RMB

(roughly 8.19 trillion U.S. dollars), accounted for 78.54% of China's 2015 GDP, and were collectively ranked as the second largest stock market in the world.<sup>4</sup>

The Chinese securities market is comprised primarily of individual investors. By the end of 2015, there were approximately 99,105,300 trading accounts for shares and close-ended funds, most of which were owned by individual investors; in 2015, individual investors represented 87.18% of the total securities trading volume.<sup>5</sup> In general, many Chinese individual investors are low or middle income, and lack basic financial or investment knowledge. They are the gullible and vulnerable group of participants in the securities market, and therefore it is particularly important to protect them through either public or private enforcement of securities law in China.

Another feature of the Chinese securities market is that share ownership of Chinese listed companies is highly concentrated. As noted above, individual investors accounted for a very high proportion of the trading volume in 2015, but as a whole, they held only 23.82% of the total value of stocks.<sup>6</sup> In other words, a large number of individual investors trade very frequently amongst themselves in relation to a relatively small portion of the overall shares. Because most of these listed companies were historically state-owned enterprises, in general, state ownership represents a high percentage of the total value of these listed companies, with the state generally being the largest shareholder. Unlike the United States, where the ownership of listed companies is widely dispersed and the main agency problem is the conflict of interests between the managers and the shareholders, the main agency problem in Chinese listed companies is the conflict of interests between majority shareholders and minority shareholders.

The shareholding structure reform launched in 2005 by the Chinese securities regulator — namely the China Securities Regulatory Commission (CSRC) — has resulted in a general decrease in the level of concentration of the ownership of Chinese listed companies. Even so, ownership concentration in most Chinese listed companies remains high. Drawing on relevant data from Wind Database, a widely used commercial database in China, the following Table shows the shareholding of the largest shareholder in Chinese listed companies from 2004 to 2016.

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4 CHINA SEC. REG. COMM'N, 2015 ANNUAL REPORT OF THE CSRC 14-15 (2016).

5 *Id.* at 16.

6 *Id.*

**Table 1: Shareholding of the Largest Shareholder in Chinese Listed Companies (%)<sup>7</sup>**

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Mean	41.75	40.21	36.46	36.12	36.44	37.04	36.78	36.49	36.80	36.34	35.94	35.01	34.12
Median	39.91	37.63	33.73	34.13	34.47	34.43	34.68	34.50	34.87	34.35	33.82	32.90	32.00

## B. The Regulatory Framework

As the national securities regulator, the CSRC has a number of important semi-legislative, investigative and adjudicative powers. For example, the CSRC can investigate and impose administrative sanctions for securities irregularities. The CSRC's arsenal includes warnings, fines (which can be functionally similar to the disgorgement of profits in the United States), suspensions and cancellations of licenses. The CSRC can also issue a barring order (*shichang jinru*) under which a person is prohibited from undertaking any securities practice or holding any post of director, supervisor or senior manager of a listed company within a prescribed term or for life. Finally, if the case is serious enough to warrant criminal sanctions, the CSRC can refer the case to the Supreme People's Procuratorate to bring criminal charges.<sup>8</sup>

Like many other jurisdictions, China has traditionally relied on the above enforcement strategy, i.e., public enforcement of securities law, to pursue administrative and criminal liability. Only in recent years has China started utilizing private civil litigation brought by aggrieved investors seeking compensation, i.e., private enforcement of securities law.

Under China's first securities law, namely the 1998 Securities Law, while civil liability for market misconduct like misrepresentation was provided for in principle, there were no detailed provisions to implement the remedy. Indeed, the law was silent on relevant issues concerning civil liability, such as who is the eligible plaintiff, how to calculate the damages, and how to bring the suit, thus rendering the private civil liability provision virtually a dead letter. To be sure, the statutory remedies in the Securities Law are not exhaustive, and as regards those committing misrepresentation they could theoretically be based on the general contract law or on the tort regime. However, due to the special nature of on-market securities transactions, for example, their

7 Source: WIND DATABASE, <http://www.wind.com.cn/newsite/edb.html> (last visited Dec. 18, 2017) (China).

8 For a more detailed discussion of the role and power of the CSRC, see ROBIN HUI HUANG, SECURITIES AND CAPITAL MARKETS LAW IN CHINA 30-32 (2014).

being impersonal and anonymous, it is extremely difficult, if not impossible, particularly in terms of the causation and reliance requirement, to bring private civil suits on those conventional grounds.

The above issue was thrust into the limelight in 2001, with a sudden outburst of corporate scandals on the Chinese securities market. Many Chinese investors claimed to have suffered large losses from the corporate scandals, and consequently a spate of civil cases was filed for compensation across the nation. It was against this backdrop that the Supreme People's Court (SPC) issued three important circulars on private securities litigation in 2001, 2002, and 2003.

On September 21, 2001, the SPC issued the first circular (hereinafter the SPC First Circular), instructing China's courts not to accept civil compensation claims over securities market misconduct, on the grounds that the courts were not ready to hear such cases due to "legislative and judicial limitations at the moment."<sup>9</sup> This circular was vehemently criticized by many, and the public pressure forced the SPC to change its position less than four months later. On January 15, 2002, the SPC issued its second circular (hereinafter the SPC Second Circular), lifting the restriction on civil cases arising from misrepresentation, but not those arising from other forms of market misconduct such as insider trading and market manipulation.<sup>10</sup> The SPC Second Circular has only five brief provisions and leaves unaddressed many issues concerning the bringing and hearing of civil compensation suits. Hence, although some cases were accepted according to this second circular, they were all stayed pending further guidance from the SPC. On January 9, 2003, the SPC circulated the eagerly-awaited third instrument (hereinafter the SPC Third Circular), which, while not without problems, contains thirty-seven detailed provisions to set up a relatively complete legal framework for private securities litigation arising from misrepresentation in China.<sup>11</sup>

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9 Zuigao Renmin Fayuan Guanyu she Zhengquan Minshi Peichang Anjian Zan Buyu Shouli de Tongzhi [The Notice of the Supreme People's Court on Temporary Refusal of Filings of Securities-Related Civil Compensation Cases] (Sept. 21, 2001) (China).

10 Zuigao Renmin Fayuan Guanyu Shouli Zhengquan Shichang Yin Xujiachengshu Yinfa de Minshi Qinquan Jiufen Anjian Youguan Wenti de Tongzhi [The Notice of the Supreme People's Court on Relevant Issues of Filing of Civil Tort Dispute Cases Arising from Misrepresentation on the Securities Market] (Jan. 15, 2002) (China) [hereinafter SPC Second Circular].

11 Zuigao Renmin Fayuan Guanyu Shenli Zhengquan Shichang Yin Xujia Chenshu Yinfa De Minshi Peichang Anjian De Ruogan Guiding [Provisions of the Supreme People's Court Concerning the Acceptance and Trial of Civil Compensation Securities Suits Involving Misrepresentation] (effective Feb. 1, 2003) (China) [hereinafter SPC Third Circular].

In the 2005 overhaul of the Securities Law, the legal basis for civil suits on securities misrepresentation was written into the statute, with all detailed aspects left in the SPC Third Circular. This is a significant development, because in the hierarchy of the Chinese legislative system, the Securities Law as a national law enjoys a much higher level of legal force than the rules issued by the CSRC, thereby providing a more solid foundation for private securities litigation over misrepresentation in China. Since the detailed rules are still to be found in the SPC Third Circular, it remains the centerpiece of China's legal regime for private securities litigation.

The SPC Third Circular contains a rather complete set of rules to cover both substantive and procedural issues. For instance, it stipulates the different types of misrepresentation,<sup>12</sup> the scope of eligible plaintiffs,<sup>13</sup> a list of potential defendants,<sup>14</sup> the availability of defenses,<sup>15</sup> the rebuttable presumption of causation and reliance,<sup>16</sup> the calculation of damages,<sup>17</sup> and the territorial jurisdiction rule under which jurisdiction goes to the place where the issuer is established.<sup>18</sup> This set of rules provides very useful guidelines for bringing and hearing private securities cases in China.

### C. Chinese-Style Class Action

Unlike the United States, China does not allow class action suits (*jituan susong*) in private securities litigation. Rather, investors can bring either an individual action (*dandu susong*) or a joint action (*gongtong susong*).<sup>19</sup> The court can, depending on the circumstances, decide whether such suit should be filed as individual action or joint action. If one or both parties to an individual action consist of two or more persons and the object of action is the same or in the same category, as is often the case in securities civil suits, the court can, with the consent of the parties, combine the individual actions into a joint action.

In order to better understand the way in which securities civil action can be brought in China, it is necessary first to look at the broader picture of various litigation forms available in China. The SPC Third Circular was issued in

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12 *Id.* art. 17.

13 *Id.* arts. 2, 3.

14 *Id.* art. 7.

15 *Id.* arts. 21-25.

16 *Id.* arts. 18, 19.

17 *Id.* arts. 29-35.

18 *Id.* art. 9.

19 *Id.* art. 12.

2003 within the framework of the now-repealed 1991 Civil Procedure Law.<sup>20</sup> The SPC Second Circular states that “the litigation form for securities civil action can be individual action or joint action, and it is not appropriate to use the form of *class action*.”<sup>21</sup> Because the term “class action” has never been legally defined in China, there has been confusion as to what the term refers to.<sup>22</sup>

Apart from individual actions, the 1991 Civil Procedure Law also provided for joint action. Under Article 53, if one or both parties to an individual action 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. The 1991 Civil Procedure Law further divided joint actions into two categories: actions in which the number of parties is fixed at the time of filing under Article 54, and actions in which the number of parties is not known at the time the case is filed under Article 55. These provisions were carried over verbatim to the 2007 Civil Procedure Law.<sup>23</sup>

Article 14 requires that the number of plaintiffs in a joint action should be finalized before the hearing, which essentially limits the form of joint actions to the first category.<sup>24</sup> Further, where possible, preference is given to joint actions over individual actions. Under Article 13, where multiple plaintiffs sue the same defendants for the same misrepresentation in standalone individual and joint actions, the court may ask the plaintiffs in individual actions to join the joint action.

It would seem that the term “class action” used in the SPC Second Circular refers to the second category of joint action, i.e., action in which the number

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20 Zhonghua Renmin Gongheguo Minshi Susongfa [Civil Procedure Law of the People’s Republic of China] (passed Apr. 9, 1991, as amended Oct. 28, 2007 and Aug. 31, 2012) (China).

21 SPC Second Circular, *supra* note 10, art. 4 (emphasis added).

22 Wallace Wen-Yeu Wang & Chen Jian-Lin, *Reforming China’s Securities Civil Actions: Lessons from PSLRA Reform in the US and Government-Sanctioned Non-Profit Enforcement in Taiwan*, 21 COLUM. J. ASIAN L. 115, 130 (2008) (“This prohibition [over class action] is perplexing, because there were no provisions in China’s law allowing such class actions in the first place.”).

23 The Supreme People’s Court has provided guidance on the application of the provisions. *See* Zuigao Renmin Fayuan Guanyu Shiyong ‘Zhonghua Renmin Gongheguo Minshi Susong Fa’ Ruogan Wenti de Yijian [Opinion of the Supreme People’s Court on the Several Questions Concerning the Application of the Civil Procedure Law of the People’s Republic of China] (issued July 14, 1992, as amended in Dec. 2008) (China). Although the Civil Procedure Law was amended again in August 2012, effective June 1, 2013, the content of the above provisions remains unchanged.

24 SPC Third Circular, *supra* note 11, art. 14.

of parties is not known at the time when it is filed (hereinafter Chinese-style class action). Chinese-style class actions are similar to U.S.-style class actions in that there are numerous plaintiffs involved and the judgment of the action applies to members of the plaintiff class who have not participated in the lawsuit. However, there are some important distinctions. For instance, unlike the “opt-out” rule that applies to U.S.-style class actions, the Chinese-style class actions follow the “opt-in” rule under which the plaintiffs who have not registered with the court at the time the case is filed can become members of a class by later bringing suits within the prescribed time period.<sup>25</sup> There is no consensus as to the usage of the term “class action” in the context of Chinese law.<sup>26</sup> However, since many commentators have referred to the second category of joint actions as “class actions,”<sup>27</sup> this Article will refer to this type of joint actions as Chinese-style class actions.

## II. HOW HAS THE LAW FUNCTIONED IN PRACTICE?

A unique feature of the SPC Third Circular is the procedural prerequisite that 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.<sup>28</sup> This prerequisite has been a subject of controversy ever since the SPC Third Circular was issued. The SPC’s rationale behind the prerequisite is that the courts lack the resources and expertise needed to decide the complicated question whether there is indeed misrepresentation; rather, the relevant specialized regulatory bodies, notably the CSRC, are better equipped to handle that issue. Critics argue, however, that the prerequisite unduly limits the scope

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25 See Binhua Tu, *Zhengquan Xujia Chenshu Minshi Peichang Zheren Jizhi Ren* [On the Mechanism for Civil Compensation Liabilities for Securities-Related Misrepresentation], 6 FAXUE [LEGAL SCI.] 97 (2003) (China).

26 See, e.g., Donald C. Clarke, *The Private Attorney-General in China: Potential and Pitfalls*, 8 WASH. U. GLOBAL STUD. L. REV. 241, 248 (2009) (using the term “group litigation” rather than “class action” because “China does not have true class actions in the American sense”).

27 See, e.g., Benjamin L. Liebman, *Class Action Litigation in China*, 111 HARV. L. REV. 1523 (1998) (using the term “class action” to describe suits brought under articles 54 and 55 of the Civil Procedure Law); Guiping Lu, *Private Enforcement of Securities Fraud Law in China: A Critique of the Supreme People’s Court 2003 Provisions Concerning Private Securities Litigation*, 12 PAC. RIM L. & POL’Y J. 795, 799 (2003) (“Article 55 of the Civil Procedure Law governs *class actions* where the number of litigants is not fixed.”) (emphasis added).

28 SPC Third Circular, *supra* note 11, art. 6.

of private securities litigation — investors might not be able to bring suits in the event that regulatory bodies fail to take appropriate action due to factors like limited resources and even corruption.<sup>29</sup>

The prerequisite links public regulation with private litigation, thus presenting a good opportunity to examine the long-debated question of how public regulation interacts with private litigation. How has the procedural prerequisite functioned in practice? Is it true that the prerequisite puts an undue limit on the bringing of private securities litigation? Is there any synergy effect the prerequisite has on private securities litigation? These questions will be answered through an empirical inquiry as to both the quantity and quality of securities civil actions in China.

### A. The Number of Cases

According to a recent empirical study, there were a total of sixty-five securities civil cases brought during the decade after private securities litigation was formally permitted in 2002.<sup>30</sup> This is a rather modest number given the high incidence of misrepresentation in China's securities market. Why has the number of cases been so small?

#### *1. Is the Procedural Prerequisite to Blame?*

The prime suspect is the procedural prerequisite, that is, bringing a civil compensation action requires a prior criminal judgement or administrative sanction. Many commentators have argued that the procedural prerequisite may unduly limit the number of securities civil suits. Intuitively, this argument sounds appealing, as the prerequisite naturally has some screening effect, but the deeper question is whether the prerequisite is in fact the primary reason for the small number of cases. I therefore tested the above hypothesis by comparing the number of eligible civil cases that could have been filed to the number of civil cases that have actually been filed.

After careful calculation, the total number of eligible suits was found to be 253.<sup>31</sup> This means that the sixty-five securities civil suits brought represent

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29 See, e.g., Lu, *supra* note 27; Sanzhu Zhu, *Civil Litigation Arising from False Statements on China's Securities Market*, 31 N.C. J. INT'L L. & COM. REG. 377 (2005).

30 Robin Hui Huang, *Private Enforcement of Securities Law in China: A Ten-Year Retrospective and Empirical Assessment*, 61 AM. J. COMP. L. 757 (2013).

31 The cases include 213 eligible sanctions issued by the CSRC and 40 eligible criminal judgements/non-CSRC administrative sanctions during the relevant study period.

only about 25.7% of all the eligible criminal/administrative sanctions which could have led to securities civil suits. To be sure, one cannot expect all eligible cases to be actually brought, but the above suing rate is truly extraordinary low. It is fair to say that even within the boundaries set by the procedural prerequisite, many more securities civil suits could have been brought. Hence, the procedural prerequisite does not seem to be the primary factor contributing to the small number of securities civil suits.

## 2. Is There a Lack of Entrepreneurial Lawyers?

If a securities civil case is eligible to be filed but is not, one possible explanation could be the lack of incentive to litigate on the part of the plaintiff. From a law and economics perspective, a case will not be brought if, viewed *ex ante*, the cost of litigation exceeds the amount of compensation discounted by the probability of success. A distinctive feature of securities civil suits is “large scale, small claim,” that is, overall a large number of investors are injured by the misrepresentation, but individually the injury to each of the investors is small. Hence, most investor plaintiffs would not initiate any action as the costs may well exceed the benefits derived from the litigation. It is in this situation that entrepreneurial lawyers could play a significant role.

The U.S. experience illustrates rather well the role of entrepreneurial lawyers. In the United States, there are many securities civil cases in the form of a class action, and entrepreneurial lawyers are believed to be one of the main reasons.<sup>32</sup> Indeed, 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 under which the legal fees are contingent on the case being successfully litigated or settled. That is, the entrepreneurial lawyer usually bears the costs of litigation, and in case of success withholds a percentage of the amount recovered as his fee. This provides an incentive for the investor plaintiffs, because they will not incur any financial risk, no matter how the case ends up, yet could gain something, however small it might be, in the event of a successful outcome.

The contingency fee system is more commonly known as “risk agency fee” (*fengxian daili Shoufei*) in China, and despite some ambiguity over the law in the books, it has long been used in the context of securities civil actions.

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32 See, e.g., John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 MD. L. REV. 215 (1983); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991).

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, who are also called securities rights lawyers (*zhengquan weiquan lvshi*).<sup>33</sup> Hence, there is no shortage of entrepreneurial lawyers in China. This then makes it even more interesting to ask: Why is the suing rate so low? Why have those entrepreneurial lawyers let almost seventy-five percent of eligible cases slip through their fingers?

### 3. *It Is About the Court, Stupid*

In order to solve the puzzle regarding the exceedingly low suing rate, one needs to look at the possible problems in the litigation process itself. 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 piggyback 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. First, the court appears to have been very inhospitable towards securities civil cases and reluctant to accept them. Second, 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. In the case of Dong Fang Electronics, for instance, it took the court about four and a half years to finish the whole process. The mean trial time for securities civil cases is 13.5 months, while the usual trial time for a civil case is only six months. Finally, according to interviews with plaintiffs' lawyers and judges, even if the plaintiffs receive the long-awaited judgement in their favor, they may still face uncertain enforcement prospects.<sup>34</sup> A combination of these problems may be responsible for the low number of securities civil cases.

There are many factors contributing to the above phenomenon. For instance, most listed companies are former state-owned enterprises (SOEs)

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33 In 2009, sixteen law firms proclaimed their intention to act as securities rights lawyers. *Zhengquan Lvshi Faqi Weiquan Susong Zongdongyuan* [*Securities Lawyers Initiate Their General Mobilization for Rights Litigation*], ZHENGQUAN SHIBAO [SECURITIES TIMES] (June 29, 2009), <http://finance.ifeng.com/money/roll/20090629/854924.shtml>. In general, it is very easy to find a securities rights lawyer by a simple search online.

34 Interview with a judge in an intermediate court, in Beijing, China (Nov. 11, 2011); Interview with a judge in an intermediate court, in Shanghai, China (July 20, 2012); Interview with a lawyer, in Beijing, China (June 18, 2012); Interview with a lawyer, in Shenzhen, China (Jan. 10, 2013).

and thus the courts are naturally cautious about hearing securities civil cases. Further, those cases usually involve a large number of litigants, and if not handled properly they may pose a threat to social stability, which is the top priority of the Chinese government. Finally, the Chinese court is subject to the well-known and deep-rooted problem of local protectionism, because the local courts are dependent on the local government in terms of funding, and personnel decisions relating to the local judiciary are also in the hands of the local government. The problem is particularly severe in the area of securities civil cases, given that listed companies are usually the mainstay of the local economy and thus have significant clout in the local area.

### **B. The Recovery Rate**

Having examined the quantity of cases, let's turn our attention to the quality of the cases in terms of the recovery rate for the plaintiff investors. It is found that in fifty-nine cases, or about 90.7% of the total sixty-five cases under study, the plaintiff successfully received recovery. Further, the ratio of compensation amounts to provable losses is very high, with the mean value being 78.6% and the median 83.1%.<sup>35</sup>

This rate of recovery is impressive by any standard and certainly compares very favorably with overseas data. In the United States, for instance, research shows that the sums recovered in securities private suits represent a small fraction of provable losses. In a 2006 paper, Professors James Cox and Randall Thomas found that the mean and median of the ratio of settlement amount to provable losses were 13.5% and 9.6% in the pre-PSLRA (Private Securities Litigation Reform Act) period, and the situation in the post-PSLRA period is even worse, with the mean and median dropping to 12.3% and 5.1% respectively.<sup>36</sup> Why is the recovery rate in China so high? Below is an attempt to explore some possible reasons.

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35 It is important to note that for various reasons, the costs of securities civil actions are frequently not borne by the listed company, but by its controlling shareholder, which is the state in many cases. This controlling-shareholder-pay pattern in China compares favorably with the U.S. situation where securities class action has been plagued by the so-called circularity problem. Huang, *supra* note 30, at 780.

36 James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1087, 1627 (2006).

### 1. *The Piggyback Effect*

In contrast with the United States where the fact-finding of misrepresentation is often a difficult task, it is not an issue at all for the civil court in China thanks to the piggyback effect, that is, as securities civil cases can be brought only after there has been a criminal or administrative sanction regarding misrepresentation, the civil court can simply refer to the fact-finding in the prerequisite procedure.

The fact-finding exercise usually needs to deal with a number of difficult issues, such as materiality, due diligence and state of mind of the defendant. In the United States, this can lead to a high level of uncertainty as to the basic question of whether the defendant is liable at all, and thus have a significant impact on the likelihood and magnitude of damages generated by securities civil cases. However, for securities civil cases brought in China, the above otherwise difficult issues are not a problem, simply because those issues would have already been dealt with in the administrative or criminal proceedings which are required to be taken before the civil proceedings. This is well illustrated in the widely publicized case of *Daqing Lianyi*,<sup>37</sup> which was the first adjudicated securities civil case in China. In this case, the appellate court, the High People's Court of Heilongjiang Province, found no need to conduct its own investigation into the difficult fact-finding question of whether the defendant committed misrepresentation, and simply piggybacked on the CSRC administrative penalty decision on the wrongdoing of the defendant.

### 2. *Clear and Favorable Substantive Rules*

Apart from the general fact-finding of misrepresentation, there are other difficult issues specific to the filing of securities civil suits, including the establishment of reliance or causation and the measure of damages. As discussed earlier, the SPC Third Circular sets out detailed rules on these issues.

The SPC Third Circular has borrowed from the United States the fraud-on-the-market theory to address the otherwise difficult issue of reliance or causality (*yinguo guanxi*).<sup>38</sup> This greatly facilitates the making of securities civil claims, because in the typical setting of on-market securities transactions, it is usually very hard, if not impossible, to affirmatively establish causation between the impugned misrepresentation and the harm suffered by the investor plaintiff.

Further, the SPC rules on the measure of damages are very clear and certain so that parties to the dispute are able to predict the outcome of the suit,

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37 Chen Lihua v. Daqing Lianyi, Ltd. Co., Second Hearing Civil Judgement, The High People's Court of Helongjiang Province (Dec. 21, 2004).

38 SPC Third Circular, *supra* note 11, arts. 18-20.

including the amount of compensation, with a fair degree of precision.<sup>39</sup> In the United States, by contrast, 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.<sup>40</sup> This uncertainty adds to the difficulty in predicting the litigation outcome, thereby making it more likely that the plaintiff will accept lower compensation.

### III. EVALUATION AND IMPLICATIONS

#### A. The Chinese-Style Class Action as an Alternative to the U.S.-Style Class Action

As noted earlier, securities civil suits in China can be either individual actions or joint actions, but not U.S.-style class actions. Many commentators have criticized this and have suggested that China should adopt the U.S.-style class action. However, a closer examination of empirical findings may suggest otherwise.

One criticism of the current regime is that the current forms for securities civil actions constitute an inefficient use of limited judicial resources because the court does not consolidate multiple suits into one class suit.<sup>41</sup> Realistically, the force of this argument has proved to be widely exaggerated. Some misrepresentations lead to only a small number of suits where the form of litigation would have little impact on judicial resources. Even where there is a large number of suits arising from the same misrepresentation, the consumption of judicial resources may not be significantly more than if the suits were brought as one class action.

In practice, the Chinese court achieves judicial economy through a procedural innovation called “test suits,” under which the court will choose a representative

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39 *Id.* arts. 30-33. The rules may be criticized for being crude and rigid, but they bring the benefit of being simple and easy to apply for the purpose of facilitating the dispute resolution process.

40 A detailed discussion of these measures of damages is well beyond the scope of this Article. The issue has been examined extensively elsewhere. *See, e.g.*, Robert B. Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 *VAND. L. REV.* 349 (1984); Robert B. Thompson, “Simplicity and Certainty” in the Measure of Recovery Under Rule 10b-5, 51 *BUS. LAW.* 1177 (1996); Comment, *The Measure of Damages Under Section 10(b) and Rule 10b-5*, 46 *MD. L. REV.* 1266 (1987).

41 Guo Li & Allan V.Y. Ong, *The Fledging Securities Fraud Litigation in China*, 39 *H.K. L.J.* 697, 710-11 (2009); Lu, *supra* note 27, at 800-01; Wang & Jian-Lin, *supra* note 22, at 130.

suit from the multiple suits arising from the same misrepresentation to be fully adjudicated, and then apply the judgment to the other suits.<sup>42</sup> This creates efficiencies similar to a class action since all the cases arising from the same misrepresentation involve similar legal issues, such as presumption of causation and measure of damages, and differ only in the number of shares each plaintiff gets compensated for. In fact, even if the multiple cases were consolidated into one class action, the court would still need to separately calculate the damages for each plaintiff. Interviews with judges who have heard such cases suggest that there is no significant difference in terms of the substantive issues the court needs to address.<sup>43</sup>

The only difference between the use of test suits rather than class actions is the resulting number of judgments or settlements (for brevity, collectively referred to as judgments in this part). The court will need to issue a judgment for each case in the current system rather than one super-judgment covering all plaintiffs in a class action. However, the making of multiple judgments involves minimal extra work because the first judgment for the model case can serve as a template for the other judgements upon which modifications can be made for items such as the case number, the plaintiff's name and the compensation amount. Additionally, this practice dispels the concern over the inconsistency of judgements for a series of cases arising from the same misrepresentation.

The case of *Dongfang Electronics*,<sup>44</sup> the largest securities civil action thus far in terms of the number of plaintiffs (6989) and cases (2716), exemplifies the above points. The cases were filed either as an individual action or joint action. Faced with the large number of cases arising from the same misstatement, the court chose to hear one exemplary case first on August 24, 2004, and dealt with relevant legal issues such as the presumption of causation, the determination of the relevant dates, the measure of damages and other relevant issues which apply to all the other cases. Thereafter, the court used the exemplary case as a model to hear the other cases, and the issues already addressed in the exemplary case would not be examined again.

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42 Donald J. Clarke, *The Private Attorney-General in China: Potential and Pitfalls*, 8 WASH. U. GLOBAL STUD. L. REV. 250 (2009).

43 Interview with a judge in an intermediate court, in Beijing, China (Nov. 10, 2011); Interview with a judge in an intermediate court, in Shanghai, China (Apr. 21, 2012).

44 Yixin Song, *Dongfang Dianzi An de Weiquan Gushi* [*The Story of Rights Defense in the Case of Dongfang Electronics*], ZHONGGUO ZHENGQUAN BAO [CHINA SEC. NEWS], Nov. 27, 2006.

Another criticism of the current regime is that it does not promote investor protection because it is financially burdensome for a plaintiff to bring an action. Commentators have asserted that “litigation costs would prevent most investors from making separate claims.”<sup>45</sup> The litigation cost in China is comprised mainly of the attorney and court fees. The attorney fee is generally not an issue for the plaintiffs, due to the availability of the contingency fee or risk agency fee system. The court fee, however, could be problematic for some plaintiffs. A plaintiff needs to prepay a filing fee, calculated as a percentage of the claim’s value, when filing a case with the court.<sup>46</sup> The rate of the fee is progressive, depending on the value of the claim, as illustrated in Table 2 below.

**Table 2**

<b>Value of the claim</b>	<b>Rate of the fee</b>
below RMB10,000	fixed at RMB50
between RMB10,000 and RMB 100,000	2.5%
between RMB100,000 and RMB200,000	2%
RMB200,000 and RMB 500,000	1.5%
between RMB500,000 and RMB 1,000,000	1%
between RMB1,000,000 and RMB 2,000,000	0.9%
between RMB2,000,000 and RMB 5,000,000	0.8%
between RMB5,000,000 and RMB 10,000,000	0.7%
between RMB10,000,000 and RMB 20,000,000	0.6%
more than RMB 20,000,000	0.5%

The requirement to pay the filing fee in advance, some commentators argue, may “make it impossible for small plaintiffs to assert large claims.”<sup>47</sup>

45 Wang & Jian-Lin, *supra* note 22, at 130-31.

46 Susong Feiyong Jiaona Banfa [Measures of Charging Litigation Fees] art. 13 (promulgated by the State Council Dec. 29, 2006, effective Apr. 1, 2007). The court fee consists of the filing fee (*anjian shouli fei*) and other litigation fees (*qita susong feiyong*), such as the costs of travel, accommodation, living allowances, and expenses paid to expert witnesses, accountants, translators, etc. As other litigation fees are contingent on actual needs, the focus of this discussion is on the filing fee.

47 Lu, *supra* note 27, at 800-01.

While there is some merit to this argument, the problem is not as serious as suggested by the critics. Interviews with plaintiffs' lawyers and judges suggest that the filing fee has rarely been an insurmountable hurdle for bringing securities civil actions.<sup>48</sup> First, the filing fee does not usually represent a serious financial burden for most investors. The filing fees are calculated on a sliding scale and are generally reasonable. Second, even in those cases where potential plaintiffs are unable or unwilling to pay the filing fee, entrepreneurial lawyers may choose to pay the fee for their clients in exchange for charging a higher risk agency fee. Further, the filing fee is subject to the so-called "loser pays" rule under which the losing party must pay the fee.<sup>49</sup> Since the success rate of securities civil actions is very high in China, the prepaid filing fee will generally be returned to either the plaintiff or the plaintiff's lawyer.

There are several other arguments against transplanting the U.S.-style class action into China. While securities class actions have played an important role in the United States, class actions also cause unique problems, such as strike suits.<sup>50</sup> Further, when looking to foreign experience for solutions to local problems, the compatibility of the foreign experience with local conditions becomes an issue. For instance, the central problem evident in the U.S. class action jurisprudence is perhaps the agency costs in the lawyer-client relationship. Thus, one of the key measures introduced in the Private Securities Litigation Reform Act of 1995 (PSLRA) is the lead plaintiff provision, which seeks to empower the plaintiffs to monitor more effectively the plaintiff's attorney. The role of lead plaintiff is usually played by institutional investors, as the lead plaintiff should be the party with the largest financial interest in the securities litigation.<sup>51</sup> However, for various reasons, it is doubtful that institutional investors in China can perform the role of lead plaintiff. For instance, they are much smaller in number and less powerful than their counterparts in the

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48 Interview with a lawyer, in Beijing, China (Nov. 11, 2011); Interview with a lawyer, in Shanghai, China (Apr. 20, 2012); Interview with a lawyer, in Shenzhen, China (June 6, 2012); Interview with a judge in an intermediate court, in Beijing, China (Nov. 10, 2011); Interview with a judge in an intermediate court, in Shanghai, China (Apr. 21, 2012).

49 Susong Feiyong Jiaona Banfa [Measures of Charging Litigation Fees] art. 29.

50 See, e.g., John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986); William B. Rubenstein, *On What a 'Private Attorney General' Is — And Why It Matters*, 57 VAND. L. REV. 2129, 2163 (2004).

51 Securities Act of 1933 § 27(a)(3)(B), 15 U.S.C. § 77a (2012); Securities Exchange Act of 1934 § 21D(a)(3), 15 U.S.C. § 78a (2012).

United States; further, it does not make much economic sense for them to do so, as it is costly and time-consuming to participate in litigation.

## **B. Public Regulation as an Aid to Private Litigation**

The procedural prerequisite rule has been a subject of heated debate ever since the SPC Third Circular was issued. It has been severely criticized as unduly limiting the scope of securities civil litigation in China. First, the prerequisite, it is argued, can leave investors without remedy if the criminal court or relevant administrative bodies, for whatever reason, fail to address the underlying misrepresentation.<sup>52</sup> Indeed, both the courts and regulators in China may be prevented from effectively responding to securities frauds due to a variety of reasons, such as lack of independence, bureaucratic inefficiency, inadequate enforcement resources, and regulatory capture or outright corruption. A second line of attack upon the prerequisite is directed at the difference in standards of proof between civil proceedings and criminal/administrative proceedings. For instance, the criminal standard of proof, being “beyond reasonable doubt,” is significantly higher than that for civil proceedings, which is the balance of probabilities, that is, the evidence of the party to win is “more forceful.” Yet the prerequisite essentially requires the criminal standard of proof for civil cases, and thus may deprive investors of civil claims arising from securities frauds which fall short of constituting a crime.<sup>53</sup>

On the other hand, proponents of the prerequisite argue that it is necessary for the time being for the following reasons. First, without the prerequisite, there could be a flood of private securities litigation which would disturb the stable development of the securities markets and overstretch the limited resources of China’s judicial system. Second, compared to the Chinese judiciary, the specialist regulatory bodies, notably the CSRC, are more competent to handle complicated securities cases, particularly determining whether any misrepresentation has occurred and who should be held liable. Finally, as discussed above, the prerequisite rule has beneficial evidentiary effects for investors, allowing them to piggyback on the efforts of the regulator or prosecutor in the prerequisite proceedings.

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52 SANZHU ZHU, *SECURITIES DISPUTE RESOLUTION IN CHINA* 167 (2007); Lu, *supra* note 27.

53 The standard of proof for administrative proceedings in China seems to be flexible, and it can range from the civil standard to the criminal standard, depending on the nature of the administrative case. See XIANGJUN KONG, *ADMINISTRATIVE LITIGATION EVIDENCE RULES AND LEGAL APPLICATIONS* 226-27 (2005).

Which side of the debate has more merits? Does the prerequisite unduly limit the number of private securities litigation cases? Is it needed in China's current institutional environment? These questions should be assessed in light of empirical evidence. As mentioned earlier, only a quarter of eligible securities civil suits have actually been brought to date. This suggests that even within the bounds set by the procedural prerequisite, many more securities civil suits could have been brought. Further, the usage of the piggyback benefits of regulatory actions is also seen elsewhere. In the United States, for example, up to fifty-five percent of enforcement actions by the SEC have had parallel securities class actions.<sup>54</sup> Hence, at present, the prerequisite does not seem to be a "devastating weakness," as asserted by some commentators,<sup>55</sup> and there is no pressing need to abolish the prerequisite, at least for now, as there is still much scope for more securities civil cases to be brought even within the confines of the prerequisite.

To be sure, the above view is not to deny the problems with the prerequisite. The main weakness of the prerequisite as a screening mechanism is that it makes civil litigation simply a copycat effort, thereby reducing the utility of "private attorneys general" as a supplement to the regulators in enforcing securities law. In order to harness the power of "private attorneys general" while maintaining some level of control over private litigation, it is necessary to gradually relax the prerequisite so as to expand the scope of securities civil action.

This Article proposes that the procedural prerequisite be extended beyond the administrative penalty decision by the governmental regulators to include the enforcement activities by other relevant entities such as the stock exchanges. As a self-regulated body, the stock exchange is charged with the task of supervising the information disclosure by listed companies and other relevant disclosing entities. To this end, the stock exchanges in Shanghai and Shenzhen have issued their listing rules. If a listed company breaches the listing rules, these rules empower the exchange to take appropriate enforcement actions, including correction orders (*Zeling Gaizheng*), internally-circulated criticism (*Neibu tongbao piping*), public censure (*Gongkai qianze*), punitive damages against the management of the listed company, and referral of the matter to the CSRC for consideration. In addition, the stock exchange has the option of suspending or, in the extreme case, delisting the company. Like the administrative penalty decisions issued by the CSRC, the above enforcement actions taken by the

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54 Verity Winship, *Fair Funds and the SEC's Compensation of Injured Investors*, 60 FLA. L. REV. 1103, 1134 (2008).

55 E.g., Walter Hutches, *Private Securities Litigation in China: Material Disclosure About China's Legal System?*, 24 U. PA. J. INT'L ECON. L. 599, 634 (2003).

stock exchange could arguably also serve as evidence of misrepresentation and consequently prompt securities civil suits.

This proposal would address some structural concerns about the current role of private securities litigation in China. If securities civil suits are strictly limited to the CSRC's enforcement actions, then why not simply empower the CSRC to recover private damages and distribute them to injured investors? In the United States, the SEC has such power under the so-called Fair Funds provisions of the federal securities laws, although they have not done much with it.<sup>56</sup> As noted earlier, the CSRC may not be a good enforcer due to resource constraints, lack of independence and even outright corruption. The above reform proposal could provide a solution to this problem in the sense that it would allow private enforcement independent of CSRC action in certain circumstances. In sum, to enhance the utility of private securities litigation as an enforcement tool, the prerequisite should be relaxed to make private enforcement a more meaningful supplement to public enforcement.

#### **IV. RECENT DEVELOPMENTS: PUBLIC REGULATION AS A SUBSTITUTE FOR PRIVATE LITIGATION**

The preceding discussion suggests that securities class action may piggyback on public enforcement in respect of access to relevant information and evidentiary burden. On the other hand, public regulation may have the effect of substituting for private litigation. As discussed below, in recent years, the CSRC has adopted some regulatory strategies of investor protection which may reduce the need for private litigation.

##### **A. CSRC Administrative Settlement Mechanism**

###### *1. The Wanfu Shengke Case*

In response to the difficulty of bringing private securities litigation, the CSRC has recently tried to use its regulatory power to facilitate settling the compensation issue outside of the courtroom. In 2013, Wanfu Shengke (Wanfu), a company listed on the Shenzhen Stock Exchange, was found to have disclosed false information in its initial public offering (IPO) prospectus. The CSRC imposed administrative sanctions on relevant parties, including PingAn Securities (PingAn) for failing to exercise due diligence in performing its role as the sponsor for the IPO of Wanfu. Interestingly, PingAn made a

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<sup>56</sup> Urška Velikonja, *Public Compensation for Private Harm: Evidence from the SEC's Fair Fund Distributions*, 67 STAN. L. REV. 331 (2015).

public announcement that it would voluntarily set up a fund to compensate the investors who suffered harm from the case. On May 10, 2013, PingAn set up a compensation fund of RMB 300,000,000. Within only two months thereafter, the compensation scheme paid a total of RMB 180,000,000, with the participation of 12,756 investors, representing 95.01% of all eligible claimants and 99.56% of all recoverable loss.<sup>57</sup>

The *Wanfu* case was widely considered as a successful innovation in providing a low-cost, speedy and powerful way for aggrieved investors to obtain compensation.<sup>58</sup> This success again confirms the empirical findings discussed earlier. First, the key problem with China's private securities litigation regime lies in the court. The *Wanfu* case effectively got around the court system, thus avoiding the court-related problems such as the refusal of case filing, the delay in hearing and the enforcement issue. Second, the procedural prerequisite does have important piggyback effects on the handling of compensation claims. Indeed, once the CSRC has dealt with the complex issue as to whether the relevant party has breached disclosure rules, the next step is just to measure damages. Thanks to the clear and favorable rules governing causation and measure of damages, the task of calculating compensation becomes technical in nature, which can be easily figured out by the parties themselves. This may explain why the *Wanfu* case could achieve a very impressive result even without the involvement of the court.

Hence, the *Wanfu* case provides an alternative to private securities litigation in compensating aggrieved investors. It should be noted, however, that the success of the *Wanfu* case relies on the voluntary establishment of a compensation fund by the relevant party. This seemingly private ordering may not be voluntary in the strict sense, as it is actually brokered by the CSRC. It was rumored that the CSRC reduced the severity of the administrative penalty on condition that such a compensation fund would be set up. In the *Wanfu* case, the misstatements made in the IPO prospectus were blatant in the sense that there were many inconsistencies with respect to signatures, dates and monetary figures, which should have been spotted with a very simple formality check. Although the case was egregious, PingAn received a rather mild penalty, including an order to rectify its violations, a warning, confiscation of the

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57 Gui Yanmin, *The Compensation Case Against the Misrepresentation of Wanfu Biotech Completes to Become a New Model of Compensation*, ZHENGQUAN SHIBAO [SECURITIES TIMES] (July 14, 2013), [http://finance.ifeng.com/a/20130720/10222199\\_0.shtml](http://finance.ifeng.com/a/20130720/10222199_0.shtml) (China).

58 CSRC Administrative Penalty Decision No. 48 (PingAn Sec. Ltd. Liability Co., Wu Wenhao & He Tao et al. Seven Responsible Persons) (2013).

sponsorship fee, a fine in the amount of two times the sponsorship fee, and suspension of its license for only three months.

The active role the CSRC plays in the establishment of the compensation fund was later confirmed in the case of *Hailianxun Tech (Hailianxun)* in 2014.<sup>59</sup> Similarly, Hailianxun, a Shenzhen-listed company, was found by the CSRC to have committed misrepresentation in its IPO prospectus, and then set up a compensation fund of RMB 200,000,000. In the administrative penalty decision issued by the CSRC, it is stated that in order to mitigate the harmful effect of the misrepresentation, the controlling shareholders of Hailianxun have voluntarily contributed money to set up a compensation fund for aggrieved investors. In other words, when making the administrative penalty decision, the CSRC will take into account the establishment of a compensation fund. This actually represents a mechanism by which the CSRC settles a case with the market participant.

## 2. *The 2015 Administrative Settlement Measures*

In March 2015, the CSRC issued the Implementation Measures for the Pilot Program of Administrative Reconciliation (Administrative Settlement Measures),<sup>60</sup> in a bid to lay down a statutory foundation for such action as what the CSRC did in the case of *Wanfu Biotech*. The Measures define administrative settlement as a mechanism by which the CSRC can enter into an agreement with the administrative counterpart in respect of such matters as correcting the suspected violation of law, eliminating the adverse consequences of such suspected violation of law, and making administrative reconciliation payments to compensate for the loss suffered by investors.<sup>61</sup> The administrative settlement can be initiated only upon the application of the administrative counterpart, and if a settlement agreement is reached, the CSRC will terminate the process of investigation and law enforcement.

Further, the Measures set out the circumstances where the settlement can be applied.<sup>62</sup> The first such circumstance is when the CSRC has officially docketed a case against market misconduct and completed the necessary investigation procedures, but it is difficult to completely ascertain the facts or legal relation of the case. Second, administrative settlement is conducive to realizing the

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59 CSRC Administrative Penalty Decision No. 94 (Shenzhen Hailianxun Tech Joint Stock Ltd. Co., Zhang Feng, Xing Wenbiao et al. Eighteen Responsible Persons) (2014).

60 Implementation Measures for the Pilot Program of Administrative Reconciliation (effective Mar. 29, 2015) (Administrative Settlement Measures).

61 *Id.* art. 2.

62 *Id.* art. 6.

purpose of supervision, reducing disputes, stabilizing and specifying market expectations, restoring the market order, and protecting the lawful rights and interests of investors. Third, the administrative counterpart is willing to take effective measures to compensate investors for their loss resulting from its or his suspected violation of law. Clearly, this item is a direct response to the cases of *Wanfu* and *Hailianxun*.

In order to prevent the abuse of the settlement agreement, the Administrative Settlement Measures also provide for the circumstances under which the settlement mechanism cannot be used.<sup>63</sup> First, if the administrative counterpart's violation of law is clear in facts, sufficient in evidence, and specific in the application of law, it shall be punished according to law. Second, if the administrative counterpart is suspected of any crime, it shall be transferred to the judicial authority for criminal punishment according to law. Finally, if administrative settlement is determined to be inappropriate by the CSRC: for instance, to close the case by means of administrative settlement may violate the prohibitive provisions of law or administrative regulation or damage the public interest or others' lawful rights and interests.

Further, the CSRC needs to disclose the main content of the settlement agreement, such that the settlement is subject to public scrutiny.<sup>64</sup> The main content of the settlement agreement usually includes the grounds for employing the administrative settlement, the amount of administrative settlement payments to be made by the administrative counterpart and the method of payment, other specific measures that are to be taken by the administrative counterpart to rectify the suspected violation of law and eliminate or alleviate the damage caused by the suspected violation of law, and the time limit for the implementation of the administrative reconciliation agreement by the administrative counterpart.<sup>65</sup>

The Administrative Settlement Measures specifically address the use of the administrative settlement money and its relationship with private securities litigation.<sup>66</sup> It is made clear that where the administrative counterpart causes any loss to the investor due to its or his suspected violation of law, the investor may apply to the management institution of administrative settlement payments for compensation. Importantly, the investor may obtain compensation through the administrative settlement payment procedure, or file a civil damage compensation lawsuit to request compensation from the administrative counterpart. However, if the investor has obtained compensation through the administrative settlement payment procedure, it shall not reclaim

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63 *Id.* art. 7.

64 *Id.* art. 28.

65 *Id.* art. 26.

66 *Id.* art. 35.

compensation for civil damage on the part that has received compensation. In sum, the administrative settlement payment procedure has the effect of substituting for private securities litigation in compensating aggrieved investors.

## **B. Public Interest Group Litigation**

Based on the previous discussions, it seems clear that the real problem with China's securities class action does not lie in the substantive rules, but rather in the way the court handles such action. As discussed earlier, in practice, the courts have been unsympathetic towards securities civil suits, as evidenced by the difficulty and delays in getting a case accepted and heard and the judgment enforcement problems. To be sure, there are many factors contributing to this, including the problem of local judicial protectionism in handling securities civil cases. Local protectionism means that in dealing with litigation, courts are often biased in favor of parties from their own region. This problem is well-known and deep-rooted in China due to the courts' lack of independence — the local courts are dependent on the local government in terms of funding, and personnel decisions relating to the local judiciary are also in the hands of the local government. The problem is particularly severe in the area of securities civil cases, because listed companies are usually the mainstay of the local economy and thus the main source of revenue for the local government.

There are at least two ways to address the issue of local protectionism. The first is to give the plaintiff investors the option of bringing securities civil cases in the courts in the locality where the issuer company is listed, such as Shanghai or Shenzhen.<sup>67</sup> This would allow the plaintiff to avoid bringing action in the local court. The other approach is to make the plaintiff stronger so as to offset the influence of the local protectionism. To this end, the litigation can be brought by a powerful third party on behalf of aggrieved, dispersed investors. One such mechanism is the so-called public interest group litigation (*gongyi tuanti susong*). It is referred to as securities supporting litigation (*zhengquan zhichi susong*) when it is used to bring civil proceedings against securities misconduct.

In 2012, China significantly revised its Civil Procedure Law, introducing the regime of public interest group litigation. The provision governing this regime is couched in very broad terms, stating that an authority or relevant organization as prescribed by law may instigate a suit against conduct damaging to the public interest such as pollution of the environment, or such that infringes

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67 Huang, *supra* note 30, at 793-97.

upon the lawful rights and interests of large numbers of consumers.<sup>68</sup> Although securities fraud is not explicitly mentioned in the provision, there is little doubt that it may, as is often the case in practice, harm a large number of investors and thus give rise to public interest concerns. Importantly, in 2015, the Supreme People's Court made it clear that the acceptance of a public interest group litigation by a people's court does not affect the initiation of an individual action by a victim of the same tort through the traditional litigation route.<sup>69</sup>

The draft amendment to the Securities Law as tabled in April 2015 builds on the above framework of civil procedural law, adding one provision to give effect to the public interest litigation in the context of China's securities market. Under Article 176, investor protection organizations recognized by the CSRC may participate in securities civil cases as the representative of investors who are harmed by securities misconduct such as misrepresentation, insider trading and market manipulation. Although this draft bill has not yet been passed into law due to the market crash of 2015,<sup>70</sup> Article 176 reflects the reality that the public interest group litigation is needed in the context of China's securities markets.

On July 20, 2016, China Securities Small and Medium-sized Investor Service Centre Limited Liability Company (Investor Service Centre, or ISC), at the request of one shareholder of a company named Pi Tu Pi, filed a suit against the company, its actual controller and other seven senior managerial officers for misrepresentation before the Shanghai First Intermediate People's Court.<sup>71</sup> This marked the first private securities litigation brought by a public interest organization (PIO) in China, a mechanism called securities supporting litigation (*zhengquan zhichi susong*). On August 14, 2016, the ISC filed the

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68 Zhonghua Renmin Gongheguo Minshi Susongfa [Civil Procedure Law of the People's Republic of China] art. 55 (passed Apr. 9, 1991, amended on Oct. 28, 2007, and Aug. 31, 2012) (Civil Procedure Law).

69 Zuigao Renmin Fayuan Guanyu Shiyong, Zhongguo Renmin Gongheguo Minshi Susongfa de Jieshi [Interpretation of the Supreme People's Court on the Application of the Civil Procedure Law of the People's Republic of China] art. 288 (issued Jan. 38, 2015, effective Feb. 4, 2015).

70 Fu Zhifeng, *From Crazy Bull to Market Disaster: 2015 Is Destined to Be an Unforgettable Year of China's Securities Market* (Nov. 27, 2015), [http://finance.ifeng.com/a/20151127/14095937\\_0.shtml](http://finance.ifeng.com/a/20151127/14095937_0.shtml).

71 *Shanghai Yizhongyuan Shouli Quanguo Shouli Zhengquan Zhichi Susong* [Shanghai First Intermediate Court Accepts the First Securities Supporting Litigation in China], CHINA COURT (July 26, 2016, 3:02 PM), <http://www.chinacourt.org/article/detail/2016/07/id/2043564.shtml>.

second securities supporting litigation against the misrepresentation of Kangda Xincai on behalf of its eleven investors.<sup>72</sup>

The ISC is set up as a limited liability company with a registered legal capital of three billion yuan, whose business scope includes holding securities, exercising and protecting rights in the capacity of shareholders, and making claims to government agencies and regulators on behalf of small and medium-sized investors. The ISC has five important shareholders, namely China Securities Depository and Clearing Corporation Limited, Shanghai Stock Exchange, Shenzhen Stock Exchange, China Financial Futures Exchange, and Shanghai Futures Exchange. The ISC was established in Shanghai in December 2014 with the approval of the CSRC as an important mechanism to enhance protection of small and medium-sized investors.<sup>73</sup> The ISC is a public interest organization under the direct administration of the CSRC. ISC appears to be one of the investor protection organizations recognized by the CSRC under Article 176, and thus has standing to bring public interest group litigation.

### C. Future Prospects

As discussed above, the CSRC has recently made two important innovations that may have the effect of substituting for private litigation for the purpose of compensating aggrieved investors. Indeed, as the cases of *Wanfu* and *Hailianxun* show, aggrieved investors can get compensated at a very high recovery rate in a very quick way. The interesting question, however, is whether these two innovations will completely eliminate the need for private litigation.

My answer is in the negative. To begin with, the CSRC administrative settlement mechanism will be mainly used in relation to misstatements at the IPO stage. The tenet of the mechanism is to pressure the deep pockets, notably the sponsor, to compensate aggrieved investors. In the case that misstatements are made by a listed company in its continuous disclosure documents, there is usually no sponsor involved.

At a more fundamental level, the administrative settlement mechanism is politically sensitive and thus the CSRC may only use it in strong cases. The administrative settlement mechanism is essentially a bargain between

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72 *Toufu Zhongxin Zhendui Kangda Xincai Zaojia Shangshi Tiqi Zhichi Susong [Investor Service Centre Brought Securities Supporting Litigation Against the Falsified Listing Documents of Kangda Xincai]*, SINA (Aug. 14, 2016, 8:21 PM), <http://finance.sina.com.cn/stock/t/2016-08-14/doc-ixfuxhas1889281.shtml>.

73 It replaces its short-lived predecessor, China Securities Investor Development Centre Limited Liability Company, which was established in January 2013.

the CSRC and the alleged wrongdoer. There are legitimate concerns that the CSRC may shirk its duties or even become corrupted, allowing wrongdoers to buy their way out of legal trouble. In order to curb the potential for abuse, the mechanism should be used in a transparent way and be subjected to adequate checks and balances. But due to the issue of information asymmetry, the level of confidence of the public in the use of this mechanism will depend ultimately on the reputational capital of the regulator. At present, the CSRC must use the mechanism with caution, as it lacks the sufficient level of reputational capital to convince the public that it is using the mechanism properly. In fact, apart from the two cases of *Wanfu* and *Hailianxun*, there has been only one other case to date, namely the case of *Xintai Dianqi*.<sup>74</sup> In this case, Xintai Dianqi was found to have made misstatements in its IPO documents and its sponsor, Xinye Securities, announced its plan to set up a special compensation fund of RMB 55,000,000 on June 28, 2016.

As to the public interest group litigation, it represents an interesting development, but the strong official background of the ISC may prove to be a double-edged sword. On the one hand, the background will certainly help the ISC to bring and litigate cases before the court. On the other hand, however, the CSRC's control or influence over the ISC may make the ISC function like a litigation department of the regulator. Hence, the ISC may bring cases selectively in line with the CSRC's instruction. According to my interview with a lawyer with longtime experience in the area of securities class action in China,<sup>75</sup> the ISC brought the two cases discussed above because the alleged wrongdoers in the two cases did not respect the CSRC's regulatory action, i.e., the ISC-initiated cases came as a punishment to them.

## CONCLUSION

The Chinese-style securities class action differs from its U.S. counterpart in several significant aspects, including its opt-in rule and the form of joint action, but it is designed to perform a similar function of providing collective redress for a large number of victims harmed by the same misconduct. Empirical findings show that the Chinese-style securities class action has played a noticeable and useful role in protecting investors in China, judging both from the quantity

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74 *Xingye Zhengquan Ni She 5.5 Yi Yuan Xintai Dianqi An Peifu Zhuanxiang Jijin* [*Xingye Securities Firm Plans to Establish a Special Compensation Fund of 0.55 Billion Yuan for the Case of Xintai Dianqi*], REUTERS (June 28, 2016), <http://cn.reuters.com/article/xintai-electric-ipo-fraud-doubt-idCNKCS0ZE01K>.

75 Telephone interview with a Shanghai-based securities rights lawyer (Nov. 4, 2016).

and quality of relevant cases brought during the first ten-year period after its formal introduction. In order to further improve it, adequate attention must be paid to the issue of supporting institutions, particularly the court system.

A unique feature of the Chinese-style securities class action is the procedural prerequisite that in order to bring a securities civil suit, there must be a prior criminal judgement or administrative sanction by the relevant regulators. By linking public regulation and private litigation, this prerequisite offers a good opportunity to examine the long-debated question of how public regulation interacts with private litigation. Empirical findings do not support the widely held belief that this procedural prerequisite unduly limits the bringing of private securities litigation, but rather show that it has a piggyback effect in improving the recovery rate generated by private securities litigation in China. This suggests that public regulation may serve as an invaluable aid to private litigation. Hence, it is submitted that there is no pressing need to abolish the procedural prerequisite, but it can be relaxed to make private litigation a more meaningful supplement to public regulation.

The Chinese experience suggests that the relationship between public enforcement and private enforcement is more nuanced than it is conventionally thought to be. The recent developments of public or semi-public enforcement strategies in China, including the administrative settlement mechanism and public interest group litigation, may serve as substitutes for securities class action in the future for the purposes of compensating aggrieved investors. But they have their own problems, which may limit their utility in practice. It is too early to tell whether they may function as expected and to what extent they may substitute for securities class action in China.