

Washington International Law Journal

Volume 12 | Number 3

5-1-2003

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Recommended Citation

Guiping Lu, Comment, *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. 781 (2003).

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PRIVATE ENFORCEMENT OF SECURITIES FRAUD LAW IN CHINA: A CRITIQUE OF THE SUPREME PEOPLE'S COURT 2003 PROVISIONS CONCERNING PRIVATE SECURITIES LITIGATION

Guiping Lu[†]

Abstract: On January 9, 2003, China's Supreme People's Court issued a new ruling with detailed provisions governing private securities litigation involving disclosure of false or misleading information. The new ruling is expected to play an important role in regulating and developing China's securities markets by providing a necessary judicial safeguard against infringement upon investors' interests.

The new ruling, however, is unlikely to achieve its expected effect due to various procedural and substantive hurdles to investor access to judicial recourse. The built-in procedural hurdles either make it very difficult for securities investors to bring private actions, or, in some circumstances, deprive them of any possibility of recovery. Such procedural hurdles are reflected in provisions relating to standing, jurisdiction, prerequisites to private actions, and class actions. In addition, causation provisions of the new ruling present a substantive hurdle to investors' civil remedies and may, in effect, prevent investors who sell securities on the basis of a false representation from recovery. This Comment concludes that China's Supreme People's Court needs to remove the procedural and substantive hurdles if it wishes to provide necessary judicial protection for the interests of securities investors.

I. INTRODUCTION

On January 9, 2003, China's Supreme People's Court ("SPC") issued a new ruling with detailed provisions governing private securities litigation involving false representation ("2003 SPC Provisions").¹ Justice Li Guoguang of the SPC remarked that the 2003 SPC Provisions were the first comprehensive judicial interpretation in the area of private securities litigation in China.² He claimed that this judicial interpretation would play

[†] The author would like to thank Professor Donald C. Clarke for his comments and suggestions and Professor Tang Xin for his help during the writing process. The author would also like to thank the *Pacific Rim Law & Policy Journal* editorial staff for their help and support.

¹ See 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 False Representation], at <http://202.84.17.28/csnews/20030110/319983.asp> (last visited Apr. 30, 2003) [hereinafter 2003 SPC Provisions]. The 2003 SPC Provisions were adopted by the SPC on December 26, 2002, and took effect on February 1, 2003. *Id.*

² See Hao Min, Wei Zhengquan Shichang Fazhan Tigong Sifa Baozhang: Zuigao Renmin Fayuan Fuyuanzhang Li Guoguang Tan Guiding Lijie Yu Shiyong [Providing Judicial Safeguard for the Development of the Securities Market: SPC Vice President Li Guoguang Addresses the Interpretation and

an important role in regulating and developing China's securities markets by providing a necessary judicial safeguard against infringement upon investors' interests.³

This Comment examines the legal impediments facing a securities investor who wishes to bring an action for false representation pursuant to the 2003 SPC Provisions. It argues that the 2003 SPC Provisions are unlikely to achieve their expected effect due to procedural and substantive hurdles to investor access to judicial recourse for redressing injuries caused by false representation.

Part II of this Comment provides an overview of the concept of securities fraud and enforcement of securities fraud law in China. Part III introduces the 2003 SPC Provisions. Part IV discusses the 2003 SPC Provisions' procedural hurdles to bringing a private action for securities fraud involving false representation, focusing on the standing requirement, jurisdiction, prerequisites to a private action, and class actions. It argues that the built-in procedural hurdles have either made it very hard for securities investors to bring private actions, or in some circumstances, have deprived them of any possibility of recovery. Part V examines the causation rules of the 2003 SPC Provisions as a substantive hurdle to private actions. It reveals that these causation rules will, under certain circumstances, prevent investors who sell securities on the basis of a false representation from receiving any recovery. Part VI concludes that a strong securities market requires not only an efficient public enforcement system, but also an effective private enforcement system that allows and encourages private parties to seek judicial recourse to redress injuries caused by securities fraud. It stresses that China's SPC needs to remove the procedural and substantive hurdles if it wishes to provide necessary judicial protection for the interests of securities investors.

II. AN OVERVIEW OF SECURITIES FRAUD AND ENFORCEMENT OF SECURITIES FRAUD LAW IN CHINA

China first defined the concept of "securities fraud" in the 1993 Provisional Measures on Prohibition of Securities Fraud ("Provisional Measures").⁴ In 1998, the Chinese legislature codified the securities anti-

Application of the Provisions], ZHONGGUO ZHENGQUAN BAO [China Securities], Jan. 10, 2003, at 1, available at <http://202.84.17.28/csnews/20030110/319593.asp> (last visited Apr. 30, 2003).

³ *Id.*

⁴ See Jinzhi Zhengquan Qizha Xingwei Zanxing Banfa [Provisional Measures on Prohibition of Securities Fraud] [hereinafter Provisional Measures], 1993 Zhonghua Renmin Gongheguo Fagui Huibian [1993 Collected Laws and Regulations of the People's Republic of China] [hereinafter FAGUI HUIBIAN]

fraud provisions of the Provisional Measures in the first national securities law.⁵ This law enumerates and defines forms of securities fraud in detail, focusing on fraudulent acts of insider trading,⁶ market manipulation,⁷ client deception,⁸ and false representation⁹ in securities issuing, trading, and other related activities.

To curb securities fraud, China has relied on public enforcement by imposing administrative and criminal sanctions¹⁰ on perpetrators of insider trading, market manipulation, and false representation.¹¹ Earlier

622. The State Council, China's highest executive branch, approved the Provisional Measures on August 15, 1993. *Id.*

⁵ See *Zhonghua Renmin Gongheguo Zhengquan Fa* [The Securities Law of the People's Republic of China] [hereinafter *Securities Law*], 1998 FAGUI HUIBIAN 55, arts. 5, 63, 67, 71, 72, 73 & 161. The Securities Law was adopted on December 29, 1998 by the Standing Committee of the National People's Congress, and took effect on July 1, 1999. As used in this Comment, "securities fraud law" is a generic term that includes not only the Securities Law and the Provisional Measures, but also all other Chinese laws, regulations, and judicial rulings and interpretations governing securities fraud.

⁶ Insider trading includes trading on insider information by directors, supervisors and senior management of an issuing company; shareholders with at least five percent interest in the company; senior management of controlling shareholders of the company; individuals who can obtain relevant information concerning the trading of its securities by virtue of their positions in the company; employees of the securities regulatory authorities; employees of securities intermediaries; and other persons the securities regulatory authorities so prescribe. *Id.* art. 68.

⁷ The Securities Law defines "market manipulation" as fraudulent acts in carrying out combined or successive sales or purchases by amassing funds or shareholdings or using advantages in terms of information, thereby manipulating securities trading prices, whether individually or in collusion with others; colluding with another person to mutually trade securities at a prearranged time, price and method or to mutually buy and sell securities not held by them, thereby affecting the price or volume of securities traded; buying or selling securities from or to oneself without transfer of ownership of the securities by means of making oneself the other party to the transaction, thereby affecting the price or volume of securities traded; or manipulating securities trading prices by other means. *Id.* art. 71.

⁸ "Client deception" covers fraudulent activities of securities intermediaries and their employees. Under the Securities Law, such activities include purchase or sale of securities on behalf of a client in violation of the client's instructions; failure to provide a client with written confirmation of a transaction within the prescribed period; misappropriation of securities entrusted by a client for purchase or sale, or of funds in a client's account; purchase or sale of securities in a client's account for one's own purpose, or purchase or sale of securities on one's own account under a client's name; inducing a client to make an unnecessary purchase or sale of securities in order to obtain commissions; and other acts contrary to a client's instructions, or acts detrimental to a client's interests. *Id.* art. 73.

⁹ The Securities Law defines "false representation" as misrepresentation made by issuers, securities companies and professional intermediaries in disclosure documents and professional opinion letters relating to the issuing and trading of stock. *Id.* arts. 63, 161. With respect to the misrepresentation by the issuers and securities companies, it can be in the form of false records, misleading statements, or material omissions in the prospectus, financial reports, interim reports, annual reports, and other ad hoc disclosure documents. *Id.* art. 63.

¹⁰ See WANG LIANZHOU & LI CHENG, FENG FENG YU YU ZHEGNGQUAN FA [Ups and Downs in the Drafting of the Securities Law] (2000). The authors noted that Chapter 11 of the Securities Law, which addresses legal liabilities, focused more on criminal and administrative sanctions, and that attention to civil liabilities was insufficient. *Id.* at 466, 468.

¹¹ The Securities Law expressly recognizes private remedies for "client deception." Securities companies that deal without, or contrary to, their clients' instructions, or misappropriate the securities and funds in their clients' account are liable for damages incurred by their clients in addition to administrative

administrative regulations imposed civil liabilities on insider traders as well as administrative penalties,¹² but the Securities Law did not incorporate the civil liabilities provisions.¹³ Like insider trading, market manipulation does not carry civil liability under the Securities Law; and only administrative and criminal penalties are available as means of enforcement.¹⁴

Although the Securities Law explicitly provides that those who make false representations shall be liable for the losses investors incur,¹⁵ Chinese courts have been reluctant to hear private cases and have even been hostile to securities investors by denying them private remedies.¹⁶ This reluctance

and potential criminal penalties. See Securities Law, *supra* note 5, arts. 192 & 193. See also Provisional Measures, *supra* note 4, art. 23 ("Those committing client deception with resulting losses to investors should be liable for damages in accordance with law."). Jia Wei, a Chinese SPC justice, noted that client deception in most circumstances occurred in a one-on-one situation, and therefore, a particular investor could be the victim of tortious conduct; an individual suit under these circumstances would thus be appropriate. See Jia Wei, *Caiyong Jiti Susong Tiaojian Shang Bu Jubei* [Conditions for Adopting the System of Group Actions Are Not Ready Yet], ZHONGGUO ZHENQUAN BAO [CHINA SECURITIES] Electronic Version, October 29, 2002, at <http://202.84.17.28/csnews/20021029/292554.asp> (last visited Apr. 13, 2003).

¹² See Provisional Measures, *supra* note 4, art. 13. Article 13 explicitly provides that administrative penalties, such as fines and confiscation of illegal gains from insider trading, shall be imposed on insider traders, but it only generally provides that insider traders should also be penalized according to other laws and regulations. See *id.* It thus implies that courts may impose possible civil and criminal sanctions under other Chinese laws and regulations. See also Gupiao Faxing Yu Jiaoyi Guanli Zanzing Tiaoli [Provisional Regulations on Administration of Issuing and Trading Shares] [hereinafter Provisional Regulations], 1993 FAGUI HUIBIAN 587, art. 77 (providing generally that those who violate the Provisional Regulations shall be liable for damages). The State Council issued the Provisional Regulations on April 22, 1993. *Id.* at 587.

¹³ See HU GUANGZHI, NEIMU JIAOYI JIQI FALU KONGZHII YANJIU [A STUDY OF INSIDER TRADING AND ITS LEGAL RESTRAINT] 315 (Falu Chubanshe [Legal Publishing House], 2002).

¹⁴ Under Article 183 of the Securities Law, illegal gains from insider trading shall be confiscated and insiders may be penalized by a fine of not less than the amount of and not more than five times the illegal gains. Securities Law, *supra* note 5, art. 183. If the insider trading constitutes a criminal offense, criminal liability shall be imposed according to law. *Id.* Similar administrative and potential criminal penalties may be imposed on stock market manipulators under Article 184 of the Securities Law. *Id.* art. 184. See also Provisional Measures, *supra* note 4, arts. 15, 16 & 17 (imposing only administrative sanctions on market manipulators).

¹⁵ Securities Law, *supra* note 5, arts. 63, 161 & 202.

¹⁶ See Zheng Shunyan & Chen Jie, *Gumin Jiang Shunzhen Su Hongguang Gongsu Gaoji Guanli Renyuan Ji Zhongjie Jigou Xujia Chenshu Peichang An* [Suit by Shareholder Jiang Shunzhen for damages against senior management of the company of Hongguang and professional intermediaries for false representation], in JINRONG FA DIANXING ANLI JIEXI (Di Yi Ji) [ANALYSIS OF TYPICAL CASES OF FINANCIAL LAW (I)] 228-29 (Wu Zhipan & Tang Haomang eds., 2000). See also Jinanshi Lixiaqu Renmin Fayuan Dui Liu Zhongmin Su Bohai Jituan Xujia Chenshu Gupiao Jiaoyi Sunshi Peichang Jiufen An Yishen Panjue [Judgment of the Lixia District People's Court of Jinan Municipality for Liu Zhongmin v. Bohai Group] [hereinafter *Liu Zhongmin v. Bohai Group*] (1996) (on file with author). In *Liu Zhongmin v. Bohai Group*, a securities investor sued a listed company for false representation. *Id.* A Jinan City district court denied the investor's request for relief and reasoned that the fluctuation of the stock price was directly caused by the change in the relationship between demand and supply, which might have been caused by many factors, and that the plaintiff investor failed to prove the existence of a causal connection between his loss and the defendant company's disclosure of false and misleading information. *Id.* The plaintiff appealed, but the appellate court affirmed the district court's decision, finding that the plaintiff had not presented sufficient evidence to prove causation between the defendant's misconduct and the plaintiff's

culminated in China's SPC issuing a circular on September 21, 2001 ("2001 SPC Circular"), which imposed a temporary ban on acceptance by lower courts private securities fraud suits on the ground that legislative and judicial conditions were not ripe for hearing such cases.¹⁷

Since the issuance of the 2001 SPC Circular, however, the SPC seems to have gradually realized the importance of establishing a private securities litigation system to supplement the public enforcement of securities fraud law. On January 15, 2002, the SPC issued another circular ("2002 SPC Circular"). This circular lifted the temporary ban imposed by the 2001 SPC Circular and allowed securities investors to bring suits for false representation after the China Securities Regulatory Commission ("CSRC") or its local branches had imposed administrative sanctions.¹⁸ About a year later, the SPC promulgated the 2003 SPC Provisions with more detailed provisions concerning private securities suits involving false representation.

loss. See Jinanshi Zhongji Renmin Fayuan Dui Liu Zhongmin Su Bohai Gongsigupiao Jiaoyi Peichang An Ershen Panjue [Judgment of the Intermediate-Level People's Court of Jinan Municipality for Liu Zhongmin v. Bohai Company] (1998) (on file with author).

¹⁷ See Zuigao Renmin Fayuan Guanyu She Zhengquan Minshi Peichang Anjian Zan Buyu Shouli De Tongzhi [Circular of the Supreme People's Court Concerning Temporary Non-acceptance of Securities Civil Compensation Cases], at <http://www.tz-lawyer.com/trace/t7.htm> (last visited Mar. 28, 2003) [hereinafter 2001 SPC Circular]. The 2001 SPC Circular provides:

The capital market in our country is currently at a stage of continuing regulation and development. A lot of problems have occurred. Such problems include insider trading, deception, market manipulation, and other fraudulent activities. These activities have harmed the integrity of the stock market, injured the legitimate interests of investors, and affected the safe and healthy development of the stock market. They should be gradually rectified and regulated. Currently, these fraudulent activities have presented to courts new situations and questions worthy of emphasis and study. But, due to current legislative and judicial limitations, [courts] are not ready to accept and to hear such cases, yet. Upon discussions, [it is decided that lower courts] shall not for the time being accept such private suits brought for the fraudulent activities.

Id.

The issuance of the 2001 SPC Circular delayed a trial pending in the Chongan district court in Wuxi, Jiangsu province against Shenzhen-listed Guangxia (Yinchuan) Industry Co. Ltd. and its financial auditor, in which about one thousand shareholders sued for damages for the company's artificial inflation of profits, and a suit against Yorkpoint Science & Technology Co. Ltd. by about 363 minority shareholders in Beijing and Guangzhou for stock price manipulation. See Bei Hu, *Call for Trial Guidelines in Civil Actions Courts Told to Stop Accepting Cases Involving Damage Claims by Investors Pending Internal Consultations*, SOUTH CHINA MORNING POST, Sept. 26, 2001.

¹⁸ See Zuigao Renmin Fayuan Guanyu Shouli Zhengquan Shichang Yin Xujia Chenshu Yinfa De Minshi Qinqian Jiufen Anjian Youguan Wenti De Tongzhi [Circular of the Supreme People's Court Concerning Issues Relating to Acceptance of Civil Tort Suits Filed Due to False Representation on the Securities Market], available at http://www.legaldaily.com.cn/gb/content/2002-01/16/content_30562.htm (last visited Mar. 28, 2003) [hereinafter 2002 SPC Circular].

III. THE 2003 SPC PROVISIONS

Like the 2002 SPC Circular, the 2003 SPC Provisions only apply to private securities suits involving false representation.¹⁹ The following is a brief introduction to some key articles of the 2003 SPC Provisions.

A. *Definition of False Representation*

Article 17 defines "false representation" as a misrepresentation made by a person with a disclosure duty in violation of securities laws and regulations in the process of issuing or trading securities.²⁰ A false representation can be made in the form of materially false records and misleading statements, material omissions, or inappropriate disclosures.²¹

B. *Potential Plaintiffs*

Under Article 2, potential plaintiffs include individuals, legal persons, and other organizations investing in primary or secondary securities markets.²² However, Article 3 provides that the 2003 SPC Provisions do not apply to private suits relating to transactions conducted outside the approved securities markets, nor do they apply to secondary market transactions directly negotiated between the parties.²³ In effect, Article 3 excludes investors in private placements and transactions involving transfers of shares held by state-owned companies from the coverage of the 2003 SPC Provisions.²⁴

¹⁹ See 2003 SPC Provisions, *supra* note 1, art. 1. After the SPC issued the 2002 SPC Circular, Justice Li Guoguang stated that the 2002 SPC Circular did not address private suits for insider trading and market manipulation, but that acceptance of such suits was merely a matter of time. See *Neimu Jiaoyi Caozhong Shichang Ye Hui Naru Minshi Peichang*, ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES] Electronic Version, Feb. 3, 2002, at <http://202.84.17.28/csnews/20020203/188395.asp> (last visited Apr. 30, 2003). He further noted that the SPC would decide to accept all such cases at an appropriate time, when market conditions and a relevant legal framework were ready. *Id.*

²⁰ 2003 SPC Provisions, *supra* note 1, art. 17.

²¹ *Id.* Under Article 17 of the 2003 SPC Provisions, "false records" refers to non-existing records included in disclosure documents; "misleading statements" are statements which have material influence on investors and cause them to misjudge about their investment decisions; "material omissions" means failure to include all information, or the act to include only part of the information that should be disclosed; "inappropriate disclosure" is a failure to make necessary disclosure during the appropriate period or in a legally-prescribed way. *Id.*

²² *Id.* art. 2.

²³ *Id.* art. 3.

²⁴ It remains to be seen whether these investors can bring private suits for losses caused by false representations.

C. Potential Defendants

Article 7 enumerates individuals and organizations that may become defendants in a private securities fraud action involving false representation. The potential defendants include: (1) promoters and controlling shareholders; (2) issuers or listed companies; (3) underwriters; (4) listing sponsors; (5) professional intermediaries, such as accounting firms, law firms, and asset appraisal firms; (6) senior management members, such as directors, supervisors, and executives of the firms listed in (2), (3), and (4) above and individuals employed by the professional intermediaries listed in (5) who are directly responsible; and (7) other organizations and individuals that have made false representations.²⁵

This list incorporates provisions of the relevant articles of the Securities Law: Article 63 (providing liability for issuers, underwriters and their respective directors, supervisors and officers),²⁶ Article 72 (prohibiting government employees and media staff from fabricating and disseminating false information),²⁷ and Articles 161 and 202 (providing liability for professionals and professional firms).²⁸ It also incorporates Article 17 of the Provisional Regulations (providing joint and several liability for promoters or their directors and lead underwriters).²⁹ The listing sponsors or

²⁵ 2003 SPC Provisions, *supra* note 1, art. 7.

²⁶ Article 63 provides that issuers and underwriters should be liable for damages incurred by investors for false representation; further, responsible directors, supervisors and officers of the issuers and underwriters will be jointly and severally liable. Securities Law, *supra* note 5, art. 63.

²⁷ Article 72 prohibits government employees and mass media personnel from fabricating and disseminating false information that would seriously affect securities trading. *Id.* art. 72. The potential defendants listed in this article can be categorized under Article 7(7) of the 2003 SPC Provisions ("other organizations and individuals that have made false representation"). By fabricating and disseminating false representations, they are arguably manipulating securities price. Therefore, the fraudulent activity at least constitutes a hybrid of "false representation" and "market manipulation," for the latter of which no private actions are currently permitted. Of course, the plaintiff can choose to sue for false representation. As to liability, it is not clear whether they will be jointly and severally liable with the issuers and/or underwriters.

²⁸ Under Articles 161 and 202, professionals and professional intermediaries, like accounting firms, law firms, and asset appraisers, shall check and verify the truthfulness, accuracy and completeness of the reports they produce, and shall bear joint and several liability if they make false representations in their own reports. *Id.* arts. 161 & 202. For example, if auditors falsify accounting data in the auditor's report, the auditors will be jointly and severally liable with issuers or listed companies; in contrast law firms and asset appraisers would not be liable for the false information in the auditor's report. Also, Article 7(6) of the 2003 SPC Provisions appears to indicate that only those professionals who are directly responsible will be liable, in which case managing partners of the professional firms will be able to escape liability. See 2003 SPC Provisions, *supra* note 1, art. 7.

²⁹ The Provisional Regulations require promoters or their directors and lead underwriters to sign the prospectus, and to guarantee that they shall be jointly and severally liable for false representations. See Provisional Regulations, *supra* note 12, art. 17.

controlling shareholders³⁰ were not specified in the Securities Law or the Provisional Regulations as potential defendants, but are now explicitly made potential defendants in the 2003 SPC Provisions.³¹

D. Form of Private Suits

Under Article 12, plaintiffs may choose to file individual or joint suits.³² Article 13 provides that when multiple plaintiffs sue the same defendants for the same false representation, and some of the plaintiffs sue individually while others sue jointly, a court may "notify" those plaintiffs who have filed individual suits to join in one action.³³ The court may also consolidate two or more joint suits arising out of the same false representation.³⁴ Under Article 14, the number of plaintiffs in a joint suit must be fixed before the case is heard.³⁵ Where the plaintiffs are numerous, they may elect two to five representatives.³⁶

E. Prerequisites

Under Article 6, prerequisites to a private securities action include the imposition of an administrative or criminal sanction on those who have made a false representation.³⁷ Under Article 5, plaintiffs may bring suits only after the decision to impose the administrative or criminal sanction is made.³⁸

³⁰ Holding thirty percent of the shares seems to be enough to constitute "control." See Shangshi Gongsi Zhili Zhunze [the Code of Corporate Governance for Listed Companies], art. 31. The CSRC issued the Code of Corporate Governance for Listed Companies on January 7, 2002. An English translation is available on the CSRC official website at <http://www.csrc.gov.cn/CSRCSite/eng/edepl/rule/frzl02042901.htm> (last visited Apr. 9, 2003).

³¹ 2003 SPC Provisions, *supra* note 1, art. 7.

³² *Id.* art. 12.

³³ *Id.* art. 13. This language is a direct translation of Article 13. For a further discussion of joint suits, see *infra* Part IV (D).

³⁴ *Id.*

³⁵ *Id.* art. 14.

³⁶ *Id.* Under this article, each of the representatives may hire one to two litigation agents, i.e., attorneys. *Id.*

³⁷ *Id.* art. 6.

³⁸ *Id.* art. 5.

F. Damages

The 2003 SPC Provisions allow recovery of actual damages.³⁹ These damages are calculated, under Article 30, by considering the difference between the buying and selling price, commissions and stamp duty paid by investors with respect to a subject security, and interest as computed in reference to the bank deposit interest.⁴⁰

Despite the expectation, the 2003 SPC Provisions are unlikely to promote private enforcement of securities fraud law. As explained in Parts IV and V below, the procedural and substantive hurdles imposed by the 2003 SPC Provisions have substantially circumscribed investor access to judicial recourse to redress injuries caused by false representation, and in some circumstances, have altogether precluded investors from bringing suits.

IV. PROCEDURAL HURDLES

The 2003 SPC Provisions provide investors with limited access to judicial recourse to civil remedies for false representation. The built-in procedural hurdles have either made it very hard for investors to bring private actions, or in some circumstances, deprived them of any possibility of recovery. These procedural hurdles are primarily reflected in the provisions regarding standing, jurisdiction, prerequisites to a private action, and class actions.

A. No Standing Even When Injured

The 2003 SPC Provisions unreasonably deny civil remedies to investors who sell securities on the basis of a false representation because they cannot meet the standing requirement even when they are actually injured by the false representation. The 2003 SPC Provisions' standing rule can be considered as a modification of the purchaser-seller standing rule endorsed by the United States Supreme Court.⁴¹ Under this modified

³⁹ *Id.* art. 30.

⁴⁰ *Id.*

⁴¹ A federal court of appeals first articulated the purchaser-seller standing rule in *Birnbaum v. Newport Steel Co.*, 193 F.2d 461 (2d Cir. 1952). Under the *Birnbaum* rule, only a buyer or a seller of securities can bring a private action under Securities and Exchange Commission Rule 10b-5. *See id.* at 464. The United States Supreme Court reaffirmed the purchaser-seller standing rule in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). The Court in *Blue Chip Stamps* noted:

Three principal classes of potential plaintiffs are presently barred by the *Birnbaum* rule. First are potential purchasers of shares, either in a new offering or on the Nation's

purchaser-seller standing rule, investors who sell securities on the basis of a false representation may have no standing to bring a private action even when the false representation has caused their losses.

Articles 1 and 2 of the 2003 SPC Provisions provide that an investor who has subscribed for or traded securities, and who has been injured by a false representation made by a person bound by a duty of disclosure, may bring a private action.⁴² These provisions appear to suggest that either a purchaser or a seller of the securities will have standing to sue for damages.

However, an in depth analysis of damages calculation formulas of these provisions demonstrates that an investor who sells securities on the basis of a false representation may not be able to bring a private action because he or she could not meet the "injury" requirement of the standing rule. Under Article 31, an investor's damages are calculated by taking into account the average purchase price of a security and the average sale price of the subject security if the investor sells the subject security prior to a "cut-off date."⁴³ If the investor sells the subject security after the cut-off date, or still holds the subject security after the cut-off date, the investor's damages are calculated by comparing the average purchase price and the average closing price during the period between the day when a false representation is exposed or the day when the information correcting the false representation is disseminated to the market and the cut-off date.⁴⁴ The cut-off date is the last day of a "bounce back" period between the day when the false representation is exposed or the day when the corrective information is disseminated to the market and the day determined as follows: (1) the day when the aggregate trading volume of the security affected by the false representation reaches one hundred percent of the defendant company's listed shares; (2) the thirtieth trading day beginning on the date on which the false representation is exposed or the date on which the corrective information is disseminated if the day cannot be decided under (1) above

post-distribution trading markets, who allege that they decided not to purchase because of an unduly gloomy representation or the omission of favorable material which made the issuer appear to be a less favorable investment vehicle than it actually was. Second are actual shareholders in the issuer who allege that they decided not to sell their shares because of an unduly rosy representation or a failure to disclose unfavorable material. Third are shareholders, creditors, and perhaps others related to an issuer who suffered loss in the value of their investment due to corporate or insider activities in connection with the purchase or sale of securities which violate Rule 10b-5.

Id. at 737-38.

⁴² 2003 SPC Provisions, *supra* note 1, arts. 1 & 2.

⁴³ *Id.* art. 31.

⁴⁴ *Id.* art. 32.

before a court hears the case; (3) the day when the security is delisted; or (4) the day preceding the day when the trading of the security is suspended.⁴⁵

Under the above damage calculation formulas, an investor who sells securities on the basis of a false representation may not be able to demonstrate losses even when the investor is actually injured. For a hypothetical example, assume that Listco, Inc. is a software development company listed on the Shanghai Stock Exchange. Supersoftware, Inc., a giant multinational software company, is interested in acquiring Listco because of the new software technology that Listco developed during the past few years. On January 10, 2003, Supersoftware approached Listco with a merger proposal and the two companies started preliminary merger discussions. News about the possible merger started spreading immediately on the market. Listco's stock price jumped from \$10 per share to \$15 per share over the next few days. On January 15, Listco made a public announcement in a nationally circulated newspaper, stating that the management and the directors of the board of Listco were not aware of any corporate development that would have resulted in the abnormal price fluctuation in company shares during the past few days. After seeing Listco's announcement on January 15, Investor sold his shares in Listco at \$15 per share on January 15. Investor originally bought his shares in Listco at \$5 per share on January 1. On January 30, Listco made a second public announcement after it had reached a preliminary merger agreement with Supersoftware, and as a result its stock price skyrocketed to \$30 per share that day. Upon investigation, the CSRC found that Listco's first announcement made on January 15 was materially misleading, and therefore constituted a false representation under the 2003 SPC Provisions.

In this hypothetical, Investor would not have standing to sue Listco because the false representation did not cause him to suffer any losses under the above damage calculation formulas of the 2003 SPC Provisions. Article 30 of the 2003 SPC Provisions limits Investor's losses, if any, to actual damages caused by the false representation.⁴⁶ Such losses generally include the difference between the original purchase price and the sale price during the bounce back period as specified in Articles 31, 32 and 33, multiplied by the number of shares Investor held in Listco.⁴⁷ As applied to this hypothetical, this damage formula would compare the price Investor originally paid to purchase the subject security on January 1 (\$5 per share) with the sale price on January 15 (\$15 per share). This comparison shows

⁴⁵ *Id.* art. 33.

⁴⁶ *Id.* art. 30.

⁴⁷ *Id.* arts. 30, 31, 32 & 33.

that Investor actually made a profit from the January 15 sale. Because Investor did not incur any losses, Investor would not be able to meet the injury requirement of Article 1 for bringing a suit.

The above hypothetical illustrates that the combination of the Article 1 injury requirement and the damage provisions of the 2003 SPC Provisions may, in effect, preclude a suit by investors who sell securities after defendants make a false representation. As a result, only investors who buy stock on the basis of false information may have standing to bring suit under these circumstances.

To avoid this result, the SPC should have adopted a damage formula, taking into account the difference between the selling price on January 15, when Listco made the materially misleading statement, and the average closing price during a bounce back period (e.g., a thirty-day period) after dissemination of any information correcting the misleading statement.⁴⁸ Under this proposed modified formula, the damage calculation in this hypothetical would require a comparison between the selling price on January 15 and the average closing price during the bounce back period from January 30 to March 2 (a thirty-day period).⁴⁹

⁴⁸ Article 33(2) of the 2003 SPC Provisions uses the thirty-day period as one of the bounce back periods to calculate the average closing price under Article 32. *Id.* arts. 32 & 33.

⁴⁹ This proposed modified formula is similar to the general damage calculation formula under Section 21D(e) of the Securities Exchange Act of 1934, codified at 15 U.S.C. § 78u-4(e), a damage formula used in a private securities suit in the United States, except that the latter uses a ninety-day period (instead of the thirty-day period) and the mean trading price (instead of the average closing price). *See* 15 U.S.C. § 78u-4(e) (2003). § 78u-4(e) provides:

(e) Limitation on damages

(1) In general. Except as provided in paragraph (2), in any private action arising under this title [15 U.S.C. §§ 78a et seq.] in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

(2) Exception. In any private action arising under this title [15 U.S.C. §§ 78a et seq.] in which the plaintiff seeks to establish damages by reference to the market price of a security, if the plaintiff sells or repurchases the subject security prior to the expiration of the 90-day period described in paragraph (1), the plaintiff's damages shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the security and the mean trading price of the security during the period beginning immediately after dissemination of information correcting the misstatement or omission and ending on the date on which the plaintiff sells or repurchases the security.

B. Burdensome Jurisdictional Requirements for Investors

The jurisdiction rules of the 2003 SPC Provisions generally hinder plaintiffs and favor defendants, especially issuers and listed companies. Under Articles 9 and 10, an intermediate-level court⁵⁰ at the place where a defendant is located⁵¹ has original jurisdiction over a private suit involving false representation.⁵² Where there is concurrent jurisdiction because of multiple defendants, the case is tried by the intermediate-level court where the issuer or listed company is located.⁵³ If an investor first brings an action against a defendant other than the issuer or the listed company, and later moves to join the issuer or listed company, the court may join the issuer or listed company, and remove the case to a court where the issuer or listed company is located.⁵⁴

The procedural hurdles imposed on investors' civil remedies by these jurisdictional rules exist in at least three related respects: territorial jurisdiction limitations, basic-level court jurisdiction limits, and local judicial protectionism. Collectively these procedural hurdles will make it difficult for investors, particularly small investors, to seek judicial recourse, and may even preclude small investors from bringing suits.

(3) Definition. For purposes of this subsection, the "mean trading price" of a security shall be an average of the daily trading price of that security, determined as of the close of the market each day during the 90-day period referred to in paragraph (1).

Id.

⁵⁰ Generally, China has four levels of courts. See Donald C. Clarke, *Power and Politics in the Chinese Court System: The Enforcement of Civil Judgments*, 10 COLUM. J. ASIAN L. 1, 6-15 (1996). The highest is the SPC. See *id.* Below it are thirty provincial-level supreme courts (a province in China is roughly an administrative equivalent to a state of the United States). See *id.* Intermediate-level courts are established immediately below the provincial-level supreme courts primarily in medium to large-sized cities administered by the provinces. See *id.* Basic-level courts are established at the county level and at the level of administrative districts within large cities. See *id.* Under China's Civil Procedure Law, intermediate-level courts are the courts of original jurisdiction in the following cases: important cases involving foreign interests; influential cases within their jurisdictions; and cases designated by the SPC. See Zhonghua Renmin Gongheguo Minshi Susong Fa [Civil Procedure Law of the People's Republic of China] [hereinafter Civil Procedure Law], 1991 FAGUI HUIBIAN 9, art. 19. All courts at the four levels can serve as courts of first instance or original jurisdiction depending on the importance and nature of the case. *Id.* arts. 18, 19, 20 & 21.

⁵¹ The "location" of a corporation is understood as its principal place of business or the location of its major office. See Zuigao Renmin Fayuan Guanyu Shiyong "Zhonghua Renmin Gongheguo Minshi Susongfa" Ruogan Wenti De Yijian [Interpretation of the Supreme People's Court on Questions Concerning the Implementation of the "Civil Procedure Law of the People's Republic of China"] [hereinafter the 1992 CPL Interpretation], 3 Zhonghua Renmin Gongheguo Zuigao Renmin Fauan Gongbao [Gazette of the Supreme People's Court of the People's Republic of China] 70, art. 4 (1992).

⁵² 2003 SPC Provisions, *supra* note 1, arts. 9 & 10.

⁵³ *Id.* art. 9.

⁵⁴ *Id.* art. 10. However, if the investor does not move or agree to join the issuer or listed company as an additional defendant, the court cannot remove the case. *Id.*

The first problem with the jurisdiction rules is the limitation on territorial jurisdiction. Fraudulent disclosure of information by issuers or listed companies harms both small investors and institutional investors. The limitation on territorial jurisdiction may, in effect, preclude small investors from bringing suits. When a small investor residing in the south of China is required to file a suit with a court located in the north where the listed company is located, the small investor is not likely to attempt legal action, considering the small amount of damages he or she may recover from the action and the cost of traveling and litigation. In contrast, if securities class actions were permitted, the small investor would be less affected by the territorial jurisdiction limitation.⁵⁵ Because the 2003 SPC Provisions do not permit securities class actions, they should, at minimum, give investors the option to file suits with courts in Shenzhen or Shanghai, where both stock exchanges are located, or anywhere the defendant company has an office or has conducted substantial business activities.⁵⁶

Second, because only intermediate-level courts may hear private suits involving false representation, the 2003 SPC Provisions may, in effect, prevent defrauded investors from getting timely judicial remedies due to the limited number of intermediate-level courts and the potentially large number of suits. From January 15, 2002, when the SPC issued the 2002 SPC Circular, to January 9, 2003, when the SPC promulgated the 2003 SPC Provisions, Chinese courts nationwide accepted about 900 private securities suits involving false representation.⁵⁷ Most of these cases were brought in six intermediate-level courts in five cities: Shanghai, Chengdu, Yinchuan, Jinan, and Harbin.⁵⁸ For example, the second civil litigation department of the Yinchuan municipal intermediate-level court has a total of five judges, but the number of investors who have been injured by the false representation of Guangxia (Yinchuan) Industry Co., Ltd. is up to 100,000.⁵⁹ Because the 2003 SPC Provisions allow only permissive joinder,⁶⁰ where the plaintiffs' consent must be obtained before cases can be consolidated,⁶¹

⁵⁵ For a discussion of securities class actions, see *infra* Part IV (D).

⁵⁶ Under Article 29 of the Civil Procedure Law, courts at the place where a defendant is located or where tortious conduct occurs have territorial jurisdiction. Civil Procedure Law, *supra* note 50, art. 29. Tortious conduct by means of disclosure of false or misleading information arguably occurs at any place where the false or misleading information spreads and affects investors' investment decisions. Thus, investors should be permitted to file suits in such locations.

⁵⁷ See Hao, *supra* note 2.

⁵⁸ See *Civil Law on Fraud Evolves*, CHINA DAILY, Jan. 10, 2003.

⁵⁹ See Jia, *supra* note 11.

⁶⁰ See 2003 SPC Provisions, *supra* note 1, arts. 12, 13 & 14. For more discussions about joinder and class actions, see *infra* Part IV (D).

⁶¹ See *infra* notes 80-86 and accompanying text.

investors may at least theoretically have to wait for years before their cases can be heard by the court. Allowing cases to be heard in basic-level courts⁶² may enable victimized investors to get timely judicial recourse.⁶³

Local judicial protectionism is the third, and perhaps most serious, problem with the jurisdiction rules. Because “[e]very aspect of local courts, including personnel, budgets, benefits, employment of children, housing, and facilities, is controlled by local Party and government organs, as are promotions and bonuses,”⁶⁴ local courts where issuers and listed companies are located may be reluctant to rule or execute judgments against the issuers and listed companies.⁶⁵

C. *Unreasonable and Burdensome Prerequisites to Private Actions*

The 2003 SPC Provisions impose unreasonable and burdensome prerequisites to investors’ private actions by requiring investors to wait until there is an administrative or criminal sanction before filing suits. The prerequisites delay the investors’ judicial remedies, and may even deprive the investors of any possibility of recovery.

Under Articles 5 and 6, victimized investors cannot bring private suits until an administrative or criminal sanction has been imposed.⁶⁶ Under Article 5, a private claim alleging securities fraud involving false

⁶² It is unclear why basic-level courts lack authorization to hear such cases. The policy could be explained by the fact that basic-level court judges often lack the experience and expertise to hear such complicated cases. However, judges of intermediate-level courts generally do not have the necessary experience or expertise either. One solution could be to allow securities law experts to serve as pro tempore judges. China’s Civil Procedure Law endorses such a practice. See Civil Procedure Law, *supra* note 50, art. 40 (providing that a civil tribunal may be composed of both judges and judicial assessors).

⁶³ Of course, when cases are tried in different courts at different times, there is a risk of inconsistent or varying adjudications that may establish incompatible standards of conduct for defendants. However, with the limitation on bringing a securities class action under the 2003 SPC Provisions, the same problem may still occur despite trying cases in the same court, because plaintiffs may not agree to the consolidate their cases. Accordingly, the best solution would be to allow the plaintiffs to file a securities class action.

⁶⁴ See Clarke, *supra* note 50, at 42 (citing Chen Youxi & Xue Chunbao, *Zaocheng Fayuan Zhixing Nan De San Da Jiben Yinsu* [The Three Major Reasons Why Courts Have Difficulty in Execution], ZHEJIANG FAZHI BAO [ZHEJIANG LEGAL SYSTEM], Aug. 16, 1990, at 3).

⁶⁵ For an extended discussion of local judicial protectionism and its effect on execution of judicial judgment in China, see *id.* at 41-49.

⁶⁶ See 2003 SPC Provisions, *supra* note 1, arts. 5 & 6. Article 6 provides that when bringing such a suit, an investor must present to the court, *inter alia*, either an administrative sanction decision or a court’s criminal penalty judgment. *Id.* art. 6. This administrative sanction prerequisite requirement is similar to a provision in the 2002 SPC Circular, which required a plaintiff to base his or her suit on an effective administrative sanction decision made by the CSRC or its local branches. See 2002 SPC Circular, *supra* note 18, art. 2. The new administrative sanction prerequisite provision allows an investor to sue when there is an administrative sanction decision made by the Ministry of Finance or other administrative agencies in addition to that made by the CSRC or its local branches. See 2003 SPC Provisions, *supra* note 1, arts. 5 & 6.

representation accrues as of the day when the CSRC or its local branches issue a decision to impose administrative sanctions on the party that has made the false representation; when the Ministry of Finance or other administrative agencies or organizations with the authority to impose administrative sanctions issue their sanction decisions; or where no administrative penalties have been imposed, when a suspect has been convicted by the court, and the criminal sanction imposed on the suspect has taken effect.⁶⁷ Where there are multiple administrative sanctions, or both administrative and criminal sanctions, the limitation period starts as of the day when the first administrative or criminal sanction is issued.⁶⁸ If an appeal is made, or an administrative suit is brought by the sanctioned party, the court may stay the securities fraud civil proceedings.⁶⁹ Under Article 11, if the administrative sanction is withdrawn after the appeal or administrative suit, the court should rule to terminate the civil proceedings.⁷⁰

The administrative sanction prerequisite places investors' private right of action at the mercy of administrative agencies, particularly the CSRC.⁷¹ China has long been a planned economy and businesses used to be run

⁶⁷ 2003 SPC Provisions, *supra* note 1, art. 5. The 2003 SPC Provisions have adopted the statute of limitation period of the General Principles of the Civil Code of the People's Republic of China. *See id.* art. 5; Zhonghua Renmin Gongheguo Minfa Tongze [The General Principles of Civil Law of the People's Republic of China] [hereinafter the Civil Code], 1986 FAGUI HUIBIAN 1, arts. 135, 137 (providing a general two-year limitation period for bringing a civil action, commencing on the day when the plaintiff knew or should have known that his or her rights have been infringed). The 2003 SPC Provisions differ from the Civil Code in when a civil claim accrues.

⁶⁸ *See* 2003 SPC Provisions, *supra* note 1, art. 5.

⁶⁹ *See id.* art. 11. There are other grounds for tolling the limitation period. Although the 2003 SPC Provisions are silent about those other grounds, the relevant provisions of the Civil Code should apply. Under the Civil Code, a limitation period tolls during the last six months if the plaintiff cannot exercise his or her right of claim due to events of force majeure or other impediments, and shall resume when the grounds for tolling the limitation period cease to exist. *See* Civil Code, *supra* note 67, art. 139. For what constitutes "other impediments," commentators have suggested that, as long as the impediments are not under the plaintiff's control, and have in effect precluded the plaintiff from bringing a claim, they should be deemed as falling within the definition of "other impediments." Therefore, the period should be tolled during the legal incapacity of the plaintiff to sue as a result of his or her incompetency during the last six months of the limitation period. *See* ZHONGGUO MINFA [CHINESE CIVIL LAW] 612 (Tong Rou et al. eds., Falu Chubanshe [Legal Publishing House], 1990). In addition to the tolling provisions, the Civil Code also specifies that the limitation period will discontinue when the claimant commences a suit or claim, or the other party agrees to perform his or her obligations, and that a new limitation period shall start from the time of the discontinuance. *See* Civil Code, *supra* note 67, art. 140.

⁷⁰ 2003 SPC Provisions, *supra* note 1, art. 11.

⁷¹ Jiang Ping, a professor at the China University of Law and Politics in Beijing, noted that "[t]he courts should be the final institution where individual investors can seek final judicial redress," and that the investors should be entitled to civil remedies if they can prove the misconduct of listed companies at courts. *See* Meng Yan, *Investors Need to Be Protected*, CHINA DAILY, Mar. 18, 2002. Jiang Ping made the comment after the SPC issued the 2002 SPC Circular, which required a plaintiff to base his or her suit on an effective administrative sanction decision made by the CSRC or its local branches. *Id.* The 2003 SPC Provisions inherit the administrative sanction prerequisite sanction from the 2002 SPC Circular.

almost entirely by the government. During this current period of transition from the planned economy to a market economy, the Chinese government still takes a paternalistic approach toward businesses, particularly state-owned companies. Because state-owned companies constitute the bulk of listed companies in China, the government has more incentives to ensure they survive than to censure them or allow investors to sue them.⁷² Even if the CSRC and other securities market regulators are willing to diligently prosecute securities fraud, they are burdened by other administrative responsibilities and do not have adequate resources.⁷³

The administrative sanction prerequisite is also problematic because it deprives securities investors of the private right of action otherwise available under the Civil Procedure Law. Article 111 of the Civil Procedure Law expressly mandates courts to accept a civil suit if the four conditions specified in Article 108 are met.⁷⁴ However, Article 108 does not require an administrative sanction as one of the conditions necessary for a plaintiff to file a private suit. In addition, Article 6 of the Civil Procedure Law requires courts to hear civil cases independently without interference from administrative agencies.⁷⁵ As a result, the administrative sanction

⁷² Chen Dagang, Chief Legal Counsel of the CSRC, remarked that consideration should also be given to the ability of listed companies to pay when awarding investors damages in a private securities suit. See Haomin Liwu, *Zhengjianhui Shouxi Lushi Tan Zhengquan Minshi Peichang*, ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES], Dec. 18, 2002, at 5. Chen said that the securities market would not exist without listed companies if the listed companies all went bankrupt because they had to pay damages. *Id.* He further noted that there was no need to sue listed companies that had made false representation before the enactment of the Securities Law to "claim old debts." *Id.*

⁷³ See Wenhai Cai, *Private Securities Litigation in China: Of Prominence and Problems*, 13 COLUM. J. ASIAN L. 135, 139-140 (1999). See also Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Market*, 48 UCLA L. REV. 781 (2001). Professor Black noted that one of the core institutions necessary for a strong securities market is a securities regulator "that: (a) is honest; and (b) has the staff, skill, and budget to pursue complex securities disclosure cases." *Id.* at 790. He further noted:

Honest, decently funded regulators and prosecutors are essential. They tend to be taken for granted in developed countries, but are often partly or wholly absent in developing countries. Funding is often a hidden problem. The securities regulator may have a minimal budget, or may be hamstrung by salary rules that prevent it from paying salaries sufficient to retain qualified people or to keep them honest.

Id.

⁷⁴ See Civil Procedure Law, *supra* note 50, arts. 108 & 111. Article 111 requires courts to accept filing of civil suits if the following four conditions of Article 108 are met: (1) the plaintiff is an individual, legal person or other organization, who is directly related to the suit, (2) there must be a specific defendant, (3) the plaintiff must have specific claims and facts and reasons supporting such claims, (4) such claims are within the judicial authority of courts, which have jurisdiction. *Id.* arts. 108 & 111.

⁷⁵ *Id.* art. 6.

prerequisite provisions should be found invalid because it conflicts with Articles 6 and 108 of the Civil Procedure Law.⁷⁶

The criminal sanction prerequisite requirement of the 2003 SPC Provisions is equally problematic because it requires a higher degree of culpability applicable to criminal conviction in private securities fraud cases involving false representation.⁷⁷ Under Articles 5 and 6, when no administrative sanctions are imposed, investors can bring a private action for damages only after courts impose criminal penalties.⁷⁸ Such a criminal sanction prerequisite represents a significant hurdle to investors and may, in effect, help perpetrators of securities fraud escape civil liability. For example, it is quite possible that a trial court could find an individual guilty of securities fraud, but that his or her actions do not rise to the level of criminal liability. In such a case, the private investor would be precluded from any civil remedy unless the CSRC or other administrative agency takes over the case and imposes administrative sanctions.

D. *No Class Actions*

The SPC's refusal to allow investors to use class action rules under Article 55 of the Civil Procedure Law to bring private securities suits creates another substantial procedural hurdle to investors' access to judicial recourse. The rules allowing investors to file individual or joint suits under Article 54 of the Civil Procedural Law are problematic because they do not promote judicial efficiency and do not prevent injustice to small investors.⁷⁹

⁷⁶ The administrative sanction prerequisite provisions of the 2003 SPC Provisions should be found invalid due to its conflict with Articles 6 and 108 of the Civil Procedure Law, because the Civil Procedure Law was enacted by the National People's Congress, China's legislature. Jia Wei remarked that "the SPC can only issue judicial interpretations with respect to issues arising from the application of law, but can not make law." See Jia, *supra* note 11.

⁷⁷ The criminal sanction prerequisite also deprives investors of the right to bring supplemental civil suits in a criminal proceeding. See Song Yixin, *Zhengquan Minshi Peichang Anjian Qianzhi Tiaojian de San Dian Sikao Huo Zhiyi* [Three Issues or Questions Concerning the Prerequisite to Private Securities Suits], at <http://www.syxlawyer.com.cn/119.htm#b2> (last visited Apr. 13, 2003). Song, a partner with Shanghai Wenda Law Offices, noted that victimized investors should be allowed to supplement a private action to a criminal proceeding, and that a court should exercise its supplemental jurisdiction over such a private suit under Article 31 of the Criminal Procedure Law, which provides that if criminal activities causes economic losses to a victim, the convicted criminal shall be liable to the victim in addition to the criminal penalty. *Id.*

⁷⁸ See 2003 SPC Provisions, *supra* note 1, arts 5 & 6. On February 8, 2003, a court in Qingdao City accepted the first suit against a listed company brought by seven investors after the imposition of criminal sanctions. See Wang Lu, *ST Dongfang An Yi Bei Shouli* [The Suit against ST Dongfang Has Been Accepted], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES], Feb. 11, 2003, at 4.

⁷⁹ Class actions are "an essential procedural device for private enforcement" of securities laws because victims of securities law violations "frequently have lost relatively small amounts of money on an individual basis. . . . Unless small investors are permitted join forces in a class action, large scale securities

Under the 2003 SPC Provisions, plaintiffs may choose to file individual suits or to join in one action.⁸⁰ The provisions regarding joint suits are modeled on Article 54 of the Civil Procedure Law and relevant provisions of a judicial interpretation.⁸¹ A joint suit pursuant to Article 54 is referred to as a representative suit with a fixed number of litigants,⁸² or as one of the two categories of class action litigation.⁸³ Joint suits under Article 54 are divided into two categories: mandatory joint suits and permissive joint suits.⁸⁴ The 2003 SPC Provisions are not clear about whether the joint suits allowed thereunder are mandatory or permissive. Because investors may choose to file individual suits under the 2003 SPC Provisions,⁸⁵ it seems reasonable that those joint suits are permissive rather than mandatory.⁸⁶

Article 55 of the Civil Procedure Law governs class actions where the number of litigants is not fixed.⁸⁷ It provides that in a suit where the number of litigants on one side is high at the time the suit is filed⁸⁸ and they have common object of litigation, the court may issue a notice detailing the facts of the suit and the relief sought and notifying potential claimants to register with the court within a specified period of time.⁸⁹ Those who register with the court may elect two to five representatives; and the court may suggest

violations cannot be remedied. Nor can defendants effectively achieve the global resolution they seek when resolving such matters." David J. Bershad et al., *A Dissenting Introduction*, in *SECURITIES CLASS ACTIONS: ABUSES AND REMEDIES*, 5 & 12 (1994).

⁸⁰ 2003 SPC Provisions, *supra* note 1, art. 12. See *supra* Part III (D) for more information.

⁸¹ See Hao, *supra* note 2.

⁸² *Id.* Li Guoguang described the joint suit under Article 54 as a representative suit with a fixed number of litigants.

⁸³ See Note, *Class Action Litigation in China*, 111 HARV. L. REV. 1523, 1526-1527 & n.2 (1998). The other category of class actions in China is a suit pursuant to Article 55 of the Civil Procedure Law. *Id.* In this Comment, "class actions" are used to refer to actions brought pursuant to Article 55 of the Civil Procedure Law. Actions brought under Article 54 of the Civil Procedure Law are essentially permissive joint suits. See *infra* notes 84-86 and accompanying text.

⁸⁴ See 1992 CPL Interpretation, *supra* note 51, art. 60.

⁸⁵ See 2003 SPC Provisions, *supra* note 1, art. 12.

⁸⁶ A mandatory joint suit is a non-separable suit. See MINSHI SUSONG FAXUE JIAOCHENG [A STUDY OF CIVIL PROCEDURE LAW] 137 (Beijing University Press, Liu Jiaxing, ed., 1994). Courts must decide such a suit in one action. *Id.* Examples of mandatory joint suits include those involving joint ownership of property, joint loans owed by a borrower and a guarantor, and claims against joint tortfeasors. *Id.* at 133-34. Permissive joint suits (also called "ordinary joint suits") are joined purely for judicial efficiency purposes. *Id.* at 138. They can be separated or filed individually. See *id.* at 138-39. Consent of parties must be obtained before courts decide to join such suits. See *id.* 139.

⁸⁷ See Civil Procedure Law, *supra* note 50, art. 55. See also *Class Action Litigation in China*, *supra* note 83, at 1527.

⁸⁸ Under the 1992 CPL Interpretation, the SPC defined "numerous" to be ten or more persons. See 1992 CPL Interpretation, *supra* note 51, art. 59.

⁸⁹ See Civil Procedure Law, *supra* note 50, art. 55. The 1992 CPL Interpretation requires a notice period of at least thirty days. See 1992 CPL Interpretation, *supra* note 51, art. 63.

representatives or even designate the representatives unilaterally if they are unable to elect representatives.⁹⁰

Both Articles 54 and 55 provide that the representatives' actions are binding on those they represent.⁹¹ The court's decision in an Article 55 suit has a preclusive effect because it is binding on those who have not registered with the court, but bring subsequent suits within the limitation period.⁹² This preclusive effect, together with the notification mechanism built in Article 55, makes Article 55 an ideal existing procedural device before China adopts securities class action procedures.⁹³ However, the drafters of the SPC refused to incorporate Article 55 into the 2003 SPC Provisions. The SPC instead requires multiple plaintiffs to elect to sue jointly under Article 54 or separately.⁹⁴

The SPC's refusal to allow class actions pursuant to Article 55 creates at least two problems: judicial inefficiency and injustice to small investors. First, it causes judicial inefficiency because a court may not be able to consolidate numerous suits brought by investors against those who have committed securities fraud involving false representation.⁹⁵ To consolidate individual suits brought by different investors, a court must obtain consent from the investors⁹⁶ because joinder of suits is permissive rather than

⁹⁰ See Civil Procedure Law, *supra* note 50, art. 55; 1992 CPL Interpretation, *supra* note 51, art. 61.

⁹¹ See Civil Procedure Law, *supra* note 50, arts. 54 & 55. Both articles specify that the represented parties must consent to a change of the representatives, withdrawal of any relief sought by the representatives, acceptance of the opposing parties' demand by the representatives, or settlement. *See id.* For more discussion about class actions brought under Articles 54 & 55 of the Civil Procedure Law in contexts other than securities litigation, see *Class Action Litigation in China*, *supra* note 83.

⁹² See Civil Procedure Law, *supra* note 50, art. 55 (providing that a court's decision is binding on those who bring subsequent suits within the statute of limitation).

⁹³ It is unclear what securities class action rules China will likely adopt. Jia Wei remarked that the class action system of the United States is not suitable for China because China lacks necessary market and legal conditions. *See* Jia, *supra* note 11. For Chinese commentators' discussion about the difference between China's representative/joint suits rules and those in the United States, see Zhuang Shuzhen & Dong Tianfu, *Woguo Daibiaoren Susong Zhidu Yu Meiguo Jituan Susong Zhidu De Bijiao Yanjiu* [A Comparative Study of China's Representative Suit System and the Class Action System in the United States], 2 FASHANG YANJIU [LAW AND BUSINESS RESEARCH] 77-82 (1996).

⁹⁴ See 2003 SPC Provisions, *supra* note 1, arts. 12 & 13. *See also* Hao, *supra* note 2.

⁹⁵ Surprisingly, a court in Qingdao City requested a plaintiffs' attorney, who represented sixty-one investors, to file seven separate suits rather than one joint suit. *See* Li Dongping, Zhengquan Minshi Susong Yudao Xin Wenti [New Issues Have Emerged as to Civil Securities Suits], ZHENGQUAN SIBAO [SECURITIES TIMES], Apr. 9, 2003, available at http://www.cnstock.com/cjxwzx/hgbd/t20030409_396848.htm (last visited Apr. 13, 2003). The sixty-one investors were divided into seven small groups with ten investors being in one group. *Id.* Another court in Haerbin City made a similar request. *Id.* Three hundred and eighty-one investors will have to file separate small group suits. *Id.* One possible explanation for such a request is that the courts or individual judges can report that they have handled more cases during a particular period if they separate the joint suits into small group suits. There is an incentive for them to do so particularly when they are required to try a certain number of cases during a specific period.

⁹⁶ See Civil Procedure Law, *supra* note 50, art. 53.

mandatory under the 2003 SPC Provisions.⁹⁷ For example, if one percent of the 100,000 investors of Guangxia (Yinchuan) Industry Co., Ltd.⁹⁸ chose to file individual suits, or did not agree to join their suits, the Yinchuan intermediate court would have to hear at least 1000 cases against the same defendant company for the same charge of fraudulent disclosure of false information. Thus, judicial resources are used inefficiently and the investors may not obtain timely judicial remedies due to inadequate judicial resources.⁹⁹ In contrast, if Article 55 was the governing procedural rules for this type of suit, the court might need to hear the case just once. The refusal to allow class actions under Article 55 of the Civil Procedure Law also causes judicial inefficiency because the court's decision does not preclude subsequent suits.

The SPC's refusal to allow class actions pursuant to Article 55 of the Civil Procedure Law also causes injustice to small investors because it may preclude them from bringing suits to seek recovery. Small investors will not sue if the potential recovery does not justify their expenses and costs of litigation.¹⁰⁰ Accordingly, injuries small investors incur as a result of false representation are likely to be left unredressed.¹⁰¹

⁹⁷ See 2003 SPC Provisions, *supra* note 1, arts. 13 & 14. See also *supra* notes 84-86 and accompanying text.

⁹⁸ See Jia, *supra* note 11 and accompanying text.

⁹⁹ Practically, investors may wish to join in one action given possible small claims and large litigation costs. But separate suits are very likely for several reasons: the parties may have conflict of interests; the investors and their attorneys may not be able to agree about who will be representing the plaintiff investors; and some investors may choose to sue only the lead underwriter or a professional firm, while other investors may want to sue the issuer or listed company. In the last scenario, different courts may have jurisdiction over different suits brought by different investors. See 2003 SPC Provisions, *supra* note 1, art. 10. Under Article 10 of the 2003 SPC Provisions, if a plaintiff investor brings a suit with a court against a lead underwriter, for example, and does not agree to join the issuer or listed company for purposes of forum shopping, the court cannot remove the case to another court in which other investors have brought suits against the issuer or listed company.

¹⁰⁰ See Harry Kalven Jr. & Maurice Rosenfield, *The Contemporary Function of a Class Suit*, 8 U. CHI. L. REV. 684, 686 (1941) (noting that individuals exposed to group injuries might be "in a poor position to seek legal redress, either because they do not know enough or because such redress is disproportionately expensive[.]" and that "[i]f each is left to assert his rights alone if and when he can, there will at best be a random and fragmentary enforcement, if there is any at all").

¹⁰¹ There are, of course, exceptions. See Xiao Mu, *Woguo Zhengquan Minshi Peichang Anjian Kaichuang Hejie Xianhe* [Settlements for Securities Civil Compensation Suits Have Started in Our Country], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES], Nov. 12, 2002. Peng Miaoqi brought a suit against a listed company for false representation claiming a loss of 1312.12 yuan (around USD\$ 158), and settled her suit for 800 yuan (around USD\$ 96). *Id.* But see Wang Lu, *ST Jiabao Xujia Chenshu An Jiean* [The False Representation Case of ST Jiabao is Concluded], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES], Jan. 28, 2003. The defendant in this case is the same company as in the suit brought by Peng Miaoqi. *Id.* It is the first case that Chinese courts have ever decided pursuant to the 2003 SPC Provisions. *Id.* A total of twenty-five investors sued the defendant company. *Id.* One possible explanation for why only such a small number of investors decided to seek legal redress for the fraudulent

V. SUBSTANTIVE HURDLE

In addition to the procedural hurdles addressed above, the 2003 SPC Provisions' causation rules present a substantive hurdle to investors' recovery.¹⁰² Under Article 18, courts should find a causal connection between defendants' false representation and plaintiffs' injuries under the following circumstances: if the securities investors' purchase is directly connected with the false representation; when the investors purchase the subject securities during the period between the day when defendants make the false representation and the day when the false representation is exposed, or when the information correcting the false representation is released; and when the investors incur losses from selling the subject securities after the false representation is exposed or the corrective information is released, or from continuing to hold the subject securities.¹⁰³ Article 19, however, provides that courts should find no causal connection under each of the following circumstances: the plaintiffs sell the securities prior to the day when the false representation is exposed or the corrective information is released; the plaintiffs make the investment after the day when the false representation is exposed or the corrective information is released; the plaintiffs purchase the securities knowing that the defendants have made false representation; the losses are caused by securities market risks other than the false representation; or the investment is not made in good faith, but is made to manipulate the securities price.¹⁰⁴

Under the above causation rules, investors who sell their securities during the period between the day when the defendants make the false representation and the day when the false representation is exposed ("exposure day"), or when the corrective information is released, will not have the benefit of a presumed causal connection under Article 18. Courts will find no causal connection between the investors' losses and the defendants' false representation under Article 19. This, in effect, denies the investors any possibility of recovery.

disclosure of false information by the defendant company is that many small investors might have decided not to sue because they could not justify litigation expenses.

¹⁰² See Wang Lu, *Touzizhe Fenfen Chesu* [Investors Withdraw Their Cases One After Another], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES], Feb. 12, 2003, at 1. This article indicates that many investors who brought suits against four listed companies had to withdraw their suits because they found that there was no causal connection between the defendants' fraudulent disclosure and their losses under Article 19 of the 2003 SPC Provisions. *Id.*

¹⁰³ See 2003 SPC Provision, *supra* note 1, art. 18.

¹⁰⁴ *Id.* art. 19.

These causation rules are especially unfair to investors who sold their subject securities prior to the exposure day on the basis of the defendant's disclosure of false information depicting a pessimistic picture of the defendant company's performance. The unfairness may be further aggravated by the fact that the 2003 SPC Provisions are not clear about what day constitutes the exposure day. Under Article 20, the exposure day is the day when the act of false representation is first exposed in nationally-circulated media, such as newspaper, radio, and television.¹⁰⁵ Some interpret the exposure day as the day when the CSRC's administrative sanction is made public.¹⁰⁶ Courts appear to have adopted this interpretation.¹⁰⁷ Under this interpretation, investors who sell a subject security at a loss, after they learn from nationally-circulated media that the CSRC has started an investigation of possible false information by a listed company, but before the CSRC sanction is made public, would not be able to recover. Article 19 would find no causal connection between their losses and the false representation by the listed company because they have sold the subject security before the exposure day.

To illustrate this substantive hurdle, assume that a pharmaceutical company listed on the Shanghai Stock Exchange issued a false pessimistic press release on February 1, 2003. On that day, the company's stock fell from \$10 to \$5 per share because of the false representation. The abrupt fluctuation of the company's stock price caught the attention of the CSRC, which started an investigation on February 2. News about the CSRC investigation started spreading on the market. China Securities, a nationally circulated newspaper, reported on the CSRC's investigation of the possible fraudulent disclosure of false or misleading information on February 10. The company's stock price dropped to \$3 per share on that day. Investor originally bought 1000 shares of the company at \$2 per share on the primary market. On February 10, Investor sold his stock at \$3 per share. On March 1, the CSRC concluded its investigation and found that the company's press release on February 1 constituted a false representation under the 2003 SPC Provisions. It turned out that the company had developed a new medicine capable of curing AIDS, and that the Board of Directors of the company had

¹⁰⁵ *Id.* art. 20.

¹⁰⁶ See Wang, *supra* note 102.

¹⁰⁷ See Zhu Yin, *Jiabao An Yinchu Xin Huati: Jizhunri Yu Jizhunjia Ruhe Queding* [The Jiabao Case Has Revealed a New Issue: How to Determine the Cut-off Date and the Average [Sale] Price], ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES] Electronic Version, January 28, 2003, at <http://202.84.17.28/csnews/20030128/326100.asp> (last visited Apr. 30, 2003). In a suit against a listed company, Jiabao, the court adopted the exposure day as the date when the CSRC's administrative sanction decision was made public. *Id.*

been discussing a stock option plan for the directors and officers of the company. The purpose of the pessimistic press release on February 1 was to benefit the directors and senior management members by allowing them to have a low stock option exercise price.

The CSRC sanctioned the company, its directors, and officers. The sanction was made public on March 1. On March 2, the company made a second press release upon CSRC's request, disclosing its discovery of the new AIDS medicine. The stock price of the company skyrocketed to \$15 per share that day.

In this hypothetical, Investor would not be able to recover any losses. Investor must have purchased the stock during the period between February 1 (the day for the first false press release) and March 1 (the exposure day when the CSRC sanction was made public) to have the benefit of the presumed causal connection under Article 18 of the 2003 SPC Provisions. Because Investor sold his stock prior to the exposure day (March 1), a court would find no causal connection between his losses and the company's false representation pursuant to Article 19.

A possible solution to the above problem is to adopt the "fraud on the market theory" endorsed by the United States Supreme Court.¹⁰⁸ As applied to this hypothetical, such a theory would entitle Investor a rebuttable presumption of reliance on the defendant company's first false press release. Therefore, unless the defendant company proves otherwise, the court will find that Investor's sale of the subject securities is caused by the defendant company's first false press release, and thus Investor will be able to recover any losses incurred.

Unless China's SPC adopts the fraud on the market theory, the existing causation rules of the 2003 SPC Provisions will continue to deny recovery to investors, who otherwise are in the same situation as this hypothetical investor.

¹⁰⁸ The United States Supreme Court adopted the fraud on the market theory in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). The Court stated:

The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. . . . The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.

Id. at 241-42 (citing *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3rd Cir. 1986)). For more discussion about the fraud on the market theory, see ARTHUR R. PINTO & DOUGLAS M. BRANSON, *UNDERSTANDING CORPORATE LAW* 352-53 (1999).

VI. CONCLUSION

In his article "The Legal and Institutional Preconditions for Strong Securities Markets," Professor Bernard Black addresses some of the important features of a strong securities market, stating that it rests on a complex network of legal and market institutions that in part ensure that minority shareholders receive "good information about the value of a company's business."¹⁰⁹ There is no doubt that a diligent securities regulator and sophisticated prosecutors are essential to protecting interests of securities investors. However, an effective judicial system that allows and encourages private parties to enforce securities fraud law is also indispensable.

Chinese courts have historically been hostile to investors by either dismissing private securities suits for lack of causation or simply refusing to accept them. The drafting of the 2003 SPC Provisions provided China's SPC with an opportunity to change that image. Unfortunately, the SPC passed up that opportunity. The procedural and substantive hurdles of the 2003 SPC Provisions to private securities actions for false representation have either made it difficult for securities investors to bring suits because of jurisdictional limitations and prerequisites to a private action, or denied them any possibility of recovery due to lack of standing or causation. In particular, the disallowance of securities class actions not only affects the efficiency of the judicial process in redressing investors' injuries, but also denies civil remedies to small investors. Given these and other impediments imposed by the 2003 SPC Provisions, these provisions are not likely to be as effective as some have hoped in providing securities investors with necessary judicial safeguard against infringement upon their interests.

¹⁰⁹ See Black, *supra* note 73, at 783.

