PRIVATE SECURITIES LITIGATION IN CHINA: OF PROMINENCE AND PROBLEMS

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I. INTRODUCTION

The Securities Law of China was promulgated on December 29, 1998, and came into effect on July 1, 1999. The passage of this comprehensive law represents a beginning of an end to a confused and diffuse patchwork of regulations that have been issued to date. A long overdue piece of legislation,[1] it has been received amidst fanfare and has been touted by the government as a "guarantor of the healthy growth of the securities market."[2]

Aimed at bringing order to the nation's chaotic share markets, the Securities Law toughens penalties on trading and gives greater power to market regulators. Severe liabilities are attached to, and fines and sanctions are provided for, various prohibited acts. In particular, Chapter 11, comprising thirty-six articles, is devoted exclusively to this subject. The administrative sanctions to be imposed include the forfeiture of unlawful income, fines, and business license revocation. It is particularly to be noted that seventeen of the sections impose criminal liability, which is unusual for a commercial law. The abundance of criminal offenses under this statute is complemented by the general Criminal Law. The Criminal Law, revised in 1997, makes it criminal for anyone to engage in certain securities frauds, which previously had triggered only civil liabilities and administrative sanctions. Those activities include the fraudulent offering

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1. The first drafting group was formed as early as July 1992 and the legislation underwent many revisions. For a brief account of the legislative history, see SHAOPENG DONG, ZHONGGUO GUSHI ZHENGCE HE CHAOGU [CHINA'S SECURITIES MARKET POLICY AND MARKET SPECULATION] 99-108 (1997), cited in Xian Chu Zhang, A Cornerstone or a Step-stone?: On the First Securities Law of China: Backdrop, Major Contents and Assessment 1 (1999) (unpublished paper) (on file with author).

2. *Zhengquan Fa Shi Zhongguo Zhengquan Shichang Jiankang Fazhan Baozhang* [*The Securities Law to Guarantee the Healthy Development of the Securities Market in China*], XINHUA RIBAO [XINHUA TIMES], Dec. 30, 1998, at 5.

of shares and bonds, insider dealing, making and spreading securities related rumors, inducing investors to deal in securities and market manipulation. Although the new law also touches on the issue of civil recovery for defrauded investors, it does so only very briefly.

This is unfortunate, because effective private remedies have proved an indispensable and essential part in any regime of securities law enforcement. Not only are they the primary method for compensating defrauded investors, but they also provide valuable and necessary additional deterrence against securities fraud, thereby supplementing the enforcement activities of securities regulatory bodies. Under China's current enforcement regime, civil recovery is not accorded a high profile and there is little support for class action suits based on investors' mass tort claims.

Effective enforcement is the bedrock of any investor protection framework. The neglect of private remedies for public investors and the difficulty in enforcing criminal sanctions, coupled with ill-fated self-regulation, give justifiable concerns that the current framework will not rise to the enforcement tasks of the future. The current paternalistic approach to investor protection represents a recipe for failure to either thwart securities frauds or create an aura of effectiveness. Before fundamental changes are instituted, it may be prudent to err on the side of conservatism in ensuring the effectiveness of the long-awaited Securities Law.

II. THE IMPORTANCE OF PRIVATE SECURITIES LITIGATION IN CHINA

A. The Enforcement Regime: An Overview

There are usually three pillars to effective enforcement of securities laws: self-regulation, a public enforcement system in the form of criminal and administrative sanctions, and a private system in the form of civil remedies primarily for defrauded investors. Brief reflection tells us that there are two central variables to the effectiveness of a sanction: probability and severity. Whether the three pillars do well to deter violations in large measure depends on the "right" mix of the two variables.

It is thus tempting to posit that, leaving aside the issue of enforcement cost, optimal enforcement means horrific punishments.[3] Nevertheless, this proposition ignores the possible negative connection between the severity of the punishments and the probability of conviction. At least in democratic countries, the level of procedural safeguards is often a function of the severity of the punishment. Hence, the higher the severity, the greater the procedural safeguards normally become. Meanwhile, neither judges nor the public would tolerate gruesomely severe punishments unless they were extremely certain of the guilt of the accused. As punishments become even more severe, the judicial system responds by making the probability of conviction ever more minute, something not necessarily to be deplored. Further, high severity, low-probability harm frequently fails to deter even law-abiding citizens, let alone the white collar wrongdoers and securities violators, who tend to be high risk-takers.[4] As the probability of conviction drops, they are sufficiently myopic to ignore the severity. For those high risk-takers, effective deterrence would probably require a markedly higher probability and lower severity. While it is hard to say with any certainty what constitutes the optimal mix, the discussion above will help us to rethink the effectiveness of the three pillars to ensure the compliance with corporate and securities laws.

B. Self-Regulation

While defying precise definition, the term "self-regulation" has been bandied about in China. The ideal behind self-regulation is the belief that most individuals and firms strive to uphold certain norms and practices. Such standards are set by the leading firms—the establishment. Students of old-style self-regulation have identified the conditions for its success in

3. Richard Posner seems to suggest that the optimal severity-probability mix is actually infinite severity with near-zero probability, as every increase in the severity of sanctions is costless, while each increase in the probability of apprehension and conviction is costly. RICHARD POSNER, THE ECONOMICS OF JUSTICE 167 (1981).

4. As one commentator observes, "those committing securities fraud demonstrate strong features of adventurers, speculators and gamblers. The impetus to make big money by exploiting the loopholes in the current system of securities laws and norms, has driven them virtually crazy." *Zhongguo Fang Huan He Kongzhi Zhengquan Qizha Ke Bu Rong Huan [The Prevention and Control of Securities Frauds Allows No Delay]*, XINHUA [XINHUA DOMESTIC SERVICE], Oct. 26, 1998.

England.[5] First, the financial-services community was small and members knew each other well.[6] Second, the community was a homogeneous group.[7] Third, one's reputation among peers was vital, carrying greater weight than potential penalties. Aside from the probable lack of the first two conditions, the elusive nature of reputation alone says much about the fate of self-regulation in China. Reputation restraints are ineffective because reputation losses do not necessarily lead to financial losses. Further, reputation can work both ways. As the late Professor Sutherland wrote in 1949: "The businessman who violates the laws which are designed to regulate business does not customarily lose status among his business associates. Although a few members of the industry may think less of him, others admire him."[8] His cynical but probably accurate assertions were echoed fifty years later by a Chinese commentator: "While the China Securities Regulatory Commission [hereinafter "the CSRC"] has handled a few cases and punished the violators accordingly, market manipulation is not considered something despicable within the securities industry. Rather, many times securities professionals spread rumors about successful cases of market manipulation, full of admiration and jealousy."[9]

Not surprisingly, as an executive poll shows, self-regulation has failed in China, both in general,[10] and in the securities industry in particular.[11] In theory, securities self-regulatory bodies may impose sanctions in the form of censure, warning, dismembership, referring violations to relevant government authorities, etc. Such penalties nonetheless fail to produce any

5. The whole theory of self-regulation and the system of voluntary compliance has been brought into question, even in England. *See, e.g.*, Barry A.K. Rider, *Self-Regulation: The British Approach to Policing Conduct in the Securities Business, with Particular Reference to the Role of the City Panel on Take-overs and Mergers in the Regulation of Insider Trading*, 1 J. COMP. CORP. L. AND SEC. REG. 319 (1978); Michael Clarke, REGULATING THE CITY: COMPETITION, SCANDAL, AND REFORM (1986); Betty M. Ho, *Rethinking the System of Sanctions in the Corporate and Securities Law of Hong Kong*, 42 MCGILL L.J. 603; James J. Fishman, *A Comparison of Enforcement of Securities Law Violations in the UK and US*, COMPANY LAW., No. 9, 1993, at 163, 165.

6. *See* NORMAN S. POSER, INTERNATIONAL SECURITIES REGULATION: LONDON'S "BIG BANG" AND THE EUROPEAN SECURITIES MARKET 85 (1991).

7. *Id.*

8. EDWIN H. SUTHERLAND, WHITE COLLAR CRIME 219 (1949).

9. *See* Feng Guo, *Wan Shan Zhengquan Jiangguan Jizhi Fang Huan Shichang Fenxian [On the Perfection of Securities Regulatory System and Prevention of Market Risks]*, (Aug. 20, 1998) (a paper commissioned by Ca Si Te Jingqi Pinghia Zhongxin [Chinese Economic Monitoring Center] <http://www.chinainfobank.com>(visited Nov. 17, 1999).

10. *See Zhongguo Baihu Shangshi Gongsi Jingliren Diaocha Zhiyi: Shichang Jingzheng Yu Shichang Zhixu [Executive Poll of 100 Listed Companies in China: Market Competition and Market Order]*, ZHENGQUAN SHIBAO [SECURITIES TIMES], Nov. 5, 1998.

11. See Guo, *supra* note 9.

significant deterrent effect for they are too affordable to violators. Thus, whether the Securities Law will become law in action largely turns on whether public and private systems of enforcement will produce enough incentives to deter securities violations.

C. *The Pros and Cons of Public and Private Enforcement*

To begin with, public and private enforcement of securities laws both have their advantages and disadvantages. Private parties are guided by private incentives for litigation. They understandably care more about a possible reward for their efforts than a clean and efficient market. This can lead to both excessive and under enforcement. Given that good management in most publicly held companies is a public good,[12] shareholders who do not monitor the company tend to free ride on the efforts of shareholders who do. In consequence, diffuse public investors usually have strong incentives to vote with their feet rather than with their hands. The free-rider problem will bedevil attempts to enforce duties that arise under corporate and securities laws. Public enforcement thus becomes prominent in those cases where any individual investors are not injured to the extent that justify the expenses and risks of bringing a lawsuit, as well as in cases where civil sanctions do not suffice to deter violations or where the violators are judgment proof.[13]

Having said the above, it is undeniable that public enforcement has its disadvantages. First, securities administrators world-wide share the complaint of insufficient funds and manpower. The CSRC has a staff of approximately three hundred, twenty-seven of whom work with its Enforcement Branch. Meanwhile, the CSRC is charged with a broad range of legislative, regulatory, investigatory, and disciplinary responsibilities, from granting various licenses to approving IPO prices. Investigation of securities fraud is often labor-intensive, expensive, time-consuming, and burdensome. Given its resources, the CSRC necessarily will continue to expend undue energy overseeing a complicated system rather than cleaning

12. Another problem in China is that currently, in two-thirds of the listed companies, almost all of which were transformed from state-owned enterprises, the holdings of the state or state-owned entities amount to 60 to 70 percent, whereas stocks owned by private investors make up only 30 percent of the securities market. *See* Dong Jian, *State Owns Too Big A Chunk in Listed Companies: Interview with Liu Shaobo of the Guangdong Securities Association*, CHINA ECON. NEWS, Nov. 10, 1997, at 6-7.

13. The collective action problem may justify a possible role for the CSRC in civil actions. In this regard, China would do well to follow the suit of Ontario, a leading jurisdiction of Canada, where the Ontario Securities Commission may bring civil actions on behalf of others, such as issuers or mutual funds, who fail to prosecute diligently for the accountability of gains achieved in insider trading. *See* Securities Act, R.S.C., ch. S-5 § 135 (1) & (2) (1990) (Ont.).

up abuses. The problem is compounded by its lack of any enforcement tradition and a dearth of trained personnel.

Second, securities law enforcement is plagued by a number of overlapping, competing organizations with no shared purposes. While in general the CSRC is entrusted with investigation of securities fraud, the police will take over this responsibility when the fraud appears to be a crime, the prosecution of which lies in the discretion of the prosecutor.[14] Nonetheless, it is not the job of the police to monitor the securities market, and the prosecutor has too many other cases to devote much time to securities crimes, with which it is least familiar. Neither the police nor the prosecutor are likely to take securities fraud as seriously as they do murders and robberies. Because securities enforcement is spread out among many competing agencies that lack coordination and shared goals, enforcement problems can be ensured.

Third, if organizational theory is right in suggesting that administrative agencies will serve their private interests in exercising their discretion,[15] certain institutional biases of the CSRC can be predicted. Administrative agencies are risk-averse and tend to protect themselves from outside criticisms. While no administrative bodies want their decisions to be overturned on the ground that they were unfair or made arbitrarily, the penalties of the CSRC for securities violations are rightly subject to judicial review.[16] Because a high failure rate reflects adversely on its public image, the CSRC may attempt to sacrifice the severity of sanctions for the certainty of its penalties.[17] Indeed, it is not a novel insight that securities watchdogs often let violators get off the hook too easily. For a similar reason, the CSRC may pursue those cases more amenable to prosecution and conviction, despite their relative unimportance compared

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14. Other bodies that may claim jurisdiction to pursue fraud are the central bank, the Office of General Auditor, the Ministry of Supervision (China's Ombudsman), and the disciplinary committee of the ruling party and their local branches.

15. *See generally* ANTHONY DOWNS, INSIDE BUREAUCRACY (1967). Based on empirical studies, Professor Daniel Langevoort argues that the practice of the SEC shows characteristics consistent with organizational theory. *See* Daniel C. Langevoort, *The SEC as a Bureaucracy: Public Choice, Institutional Rhetoric, and the Process of Policy Formulation* 47 WASH. & LEE L. REV. 527, 531 (1990).

16. *See* Zhengquan Fa [Securities Law], CHINA LAW & PRACTICE, Vol. 13, No. 1, Feb. 1999, chapter 11, §210. Judicial review nonetheless does not apply to licensing activities of the CSRC.

17. "In the worst cases, a threat of judicial review may be used as a tool to pressurize the authority into abandoning a certain course of action or agreeing to impose a lesser penalty on the applicant." Raymond Tang, Judicial Review and Due Process in the Enforcement of Securities Law- the Hong Kong Experience, Address to The LAWASIA 15th Biennial Conference (Aug. 28, 1997) (transcript available at <http://www.hksfc.org.hk/eng/speeches/rt970828.htm> (visited Nov. 17, 1999)). Mr. Tang is Chief Counsel of the Securities & Futures Commission of Hong Kong.

to alternative cases with a lower probability of conviction.[18] Another explanation for this is that administrative agencies and the bureaucracy in general tend to aggrandize themselves and engage in turf battles. Turning a case to the police for investigation and the prosecutor for criminal prosecution is not only cumbersome, but also makes the CSRC lose most of its control over the case.[19]

Clearly, the Securities Law stiffens criminal liabilities in a bid to deter violations. Applying criminal sanctions to corporate and securities offenses is nonetheless challenging because, although punishing the company may not achieve the same deterrent effect as punishing the individual criminal, the crimes are often organizational wrongs. Thus, while certain individual actors per se would be charged for offenses such as manipulation of the securities market, the mens rea requirement that the actors committed the offense intentionally becomes a hurdle too hard to overcome. There is also a danger that the wrong person may be fined or put in jail.[20] The latter prospect looms large because the immediate offenders are often low-placed employees who are mere tools of their supervisors, while the supervisors manage to evade prosecution.[21]

Moreover, as in many other places, in China the application of criminal sanctions is sporadic and lenient. In November 1998, China witnessed its first case in which two individual offenders were sentenced to imprisonment of two and three years respectively for securities fraud.[22] Many reasons exist for the inability of government authorities to uncover and prosecute securities fraud, not least of which are the difficulties

18. Professor Grundfest, director of the Roberts Program for Law, Business & Corporate Governance at Stanford University and former commissioner of the SEC, commented that because the SEC has the discretion as to whom to sue, how to sue, and how to settle, this may give rise to interesting litigation patterns. Joseph A. Grundfest, Securities Laws and Corporate Governance: The Advent of a Meltdown?, Remarks at the Reliance National Panel Discussion and Q&A, (May 13, 1999) (transcript available at <http://securities.standford.edu/report/transcripts/990513.html> (visited Nov. 11, 1999)).

19. The SEC of the U.S. prefers civil penalties to criminal ones, even when the latter are also available. Commentators have suggested that this is because it can administer them. *Cf.* Barry Rider, *Policing the City--Combating Fraud and Other Abuses in Corporate Securities Industry*, 41 CURRENT LEGAL PROBS. 47 (1988))(discussing effectiveness of securities regulation in the U.K.).

20. For a detailed explanation of this possibility, see Ho, *supra* note 5.

21. In recent discussions about the drafts of the revised Accounting Law, many deputies of the National People Congress pointed out that the instructions or high pressure of bosses has been the primary reason for company accountants to fabricate accounting records. *See* Siyi Ni & Yuan Yue, *Zhongguo Ni Yancheng Kuajiye Weigui Zhaojia Xingwei [China Contemplates Severe Punishment for Accounting Violations and Fabrications]* XINHUA RIBAO [XINHUA DAILY], Aug. 24, 1999.

22. This case is generally regarded as the most serious fraud case in the history of the securities industry in China. *See Zhongguo Zhengquan Diyi Pian An Hua Shang Juhao [The No. 1 Securities Fraud Case in China]*, JINGJI RIBAO [ECONOMIC DAILY], Aug. 10, 1999.

inherent in the prosecution of such fraud. Fraud schemes are usually sophisticated, complex, and difficult to unravel. Another reason for the paucity of prosecutions is the high burden of proof required. As both American and British investigators of insider trading have identified, the standard of proof presents one of the most difficult problems in developing a successful case against a suspect.[23] As discussed above, procedural safeguards often increase in proportion to the severity of sentences. In order to achieve a criminal conviction, a prosecutor in China must prove "the [alleged] facts to be clear and the evidence to be strong and solid,"("*shi shi qing chu zheng ju que zhuo*"). In practice, such a requirement resembles the common law standard that the prosecutor must prove the allegation beyond reasonable doubt. Thus, the imposition of criminal sanctions may be self-defeating.

Compared to public enforcement, a system of civil remedies has some obvious advantages. First, private actions serve as the primary vehicle for compensating defrauded investors. They provide direct incentives not only for market participants to refrain from violating securities laws, but also for victimized investors to detect, report, and assist in the apprehension of violators. Crime victims are known for preferring simply to forget what had happened.[24] A civil system handles this problem of risk-aversion by giving incentives to increase the probability of conviction. Since victims get restitution if the wrongdoer is convicted, they have incentives to report crimes, assist the police, and prosecute the case. This might dramatically raise the probability of punishment at a reasonable cost. Conversely, without the incentive provided by possible civil recovery, investors would not trouble themselves to inquire into and complain about abnormalities to the regulators, which is one of the primary sources of leads for detection of securities law violations in the U.S. Second, it is much easier to establish liability in civil cases because one needs to show a balance of probabilities, a far less burdensome standard of proof.[25]

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23. *See* John M. Naylor, *The Use of Criminal Sanctions by UK and US Authorities for Insider Trading: How Can the Two Systems Learn from Each Other (Part II)*, COMPANY LAW., No. 5, 1990, at 83, 89.

24. *See* BRUCE BENSON, THE ENTERPRISE OF LAW: JUSTICE WITHOUT THE STATE 151-52 (1990). Failure to report rape is a well-known example of this trend.

25. In the United Kingdom, the Stock Exchange is responsible for prosecuting insider dealings. A member of the Stock Exchange once commented that in as many as three of every four cases he has enough proof to meet the civil standard but not criminal standards. *See* Naylor, *supra* note 23, at 58.

Commentators argue that the certainty of a sanction has greater deterrent value than its severity.[26] Severe punishment with low probability would fail to provide deterrence. This is particularly true with high risk-takers such as securities violators. For them, effective deterrence would probably require a considerably higher probability. A private enforcement system has clear advantages over a public one largely because the probability of sanctions will be significantly increased. Meanwhile, the severity of a sanction such as the disgorgement of gains is sufficient because fraud schemes are primarily calculated for financial gains. The relatively ideal mix of probability and severity means that civil sanctions can act much more as a deterrent than criminal sanctions. While criminal sanctions, particularly imprisonment, must be reserved for the most egregious cases, the deterrent value of a civil system should be explored further.

III. MAJOR IMPEDIMENTS IN THE CIVIL SYSTEM FOR SECURITIES VIOLATIONS

As indicated above, private litigation should occupy an essential position in the enforcement regime of securities laws. A lamentable fact is that the current civil system in China is riddled with structural impediments so numerous as to make securities civil actions virtually nonexistent. Unless those impediments are removed, civil actions will not pose a real threat to securities violators.

A. Causes of Action

Neither the Company Law of 1993 nor the Securities Law allows investors to sue other than on enumerated and often very narrow grounds. The former statute affords shareholders with a variety of rights common to common law jurisdictions. The superficial similarity in such rights conceals an important difference: those rights are usually provided without any mention of remedies for their breach. The only exception may be Section 111, which provides that when the resolutions of shareholders or directors contravene laws and regulations and prejudice the interests of shareholders, a shareholder may apply to the court for an order restraining such acts. No mention is made of the damages issue. Further, the

26. *See* J.C. Coffee, Jr., *Corporate Crime and Punishment: A Non-Chicago View of the Economics of Criminal Sanctions* 17 AM. CRIM. L. REV. 419, 423, 465-68 (1980).

Company Law does not provide for derivative actions, or the fiduciary duty and duty of care of corporate directors, let alone for oppression remedies.[27] Clearly, investors will not feel comfortable relying on the provisions of the statute to bring legal action.

The primary purpose of the Securities Law is purportedly to protect investors. Interestingly, "liability-creating facts" provided under it are very limited, too. Among the few causes of action it enumerates, the most important is misrepresentation made in the offering documentation in connection with the distribution of securities. Section 63 of the law provides that issuers and underwriters are liable to investors for any financial losses in the course of trading in securities that resulted from any false or misleading statement or material omission in prospectuses, accounting reports, annual and interim reports, and other materials. Those directors, supervisors and managers of the issuers and underwriters responsible for such misrepresentation, shall also be jointly and severally liable for such losses. Section 202 further provides that in connection with the offering, listing or trading of securities, those professional bodies which provided accounting reports, legal opinions or asset evaluation reports, are jointly and severally liable for the damages of the injured parties. However, such liability will not attach unless they commit "*nong xu zuo jia*" (literally, "intentional misconduct") in relation to such documentation. Civil liability is also created for the directors of a listed company which fails to enforce an obligation owed by its large shareholders to disgorge their gains when they deal in the securities of the company within a proscribed period of time. Further, Section 192 reiterates a general principle that securities firms are liable for acts beyond the authority of their customers. In many more cases, however, acts are proscribed or prescribed without any mention of civil consequences. While the common law courts are divided on whether a right of private cause of action shall be implied under such circumstances,[28] Chinese courts have traditionally hesitated to act without sufficient basis. Therefore, for example, private citizens have no cause of action against an insider dealer for losses they may have suffered.

27. Section 241 of the Canadian Business Corporation Act ("CBCA") provides that if the interests of any security holder, creditor, director or officer are unfairly disregarded, a court can grant a remedy. *See* Canada Business Corporations Act, R.S.C., ch. C.44, §241(3)(1985)(Can.) The concept of oppression remedy was originally introduced in England but was expanded in Canada. *See* Brian R. Cheffins & J.M. Dine, *Shareholders Remedies: Lessons from Canada*, COMPANY LAW., No. 5, 1991, at 89.

28. For a comprehensive account of this issue, see Ho, *supra* note 5, at 619-23.

In a sense, the Securities Law represents a retreat from pre-existing provisions. For example, pursuant to Section 77 of the *Interim Ordinance on Share Issuance and Trading* (hereinafter "IOSIT") promulgated in 1993, those who contravene the provisions of the IOSIT and cause losses to others shall be liable for compensating the injured for the damages in accordance with the law. A similar catchall provision can be found in Section 23 of the *Interim Measures on the Prevention of Securities Frauds* (hereinafter "IMPSF").[29] An interesting question arises of whether investors may take legal action on grounds other than those enumerated under the Securities Law. It appears possible; Section 2 of the Securities Law expressly provides for the survival of other laws and regulations, unless there is a conflict or inconsistency with the former. Ostensibly, the public investor now has a broad variety of causes of action for breach of a statutory provision enacted for his benefit under the IMPSF and IOSIT, but practical and procedural obstacles remain.

B. Proof of Causation

The current state of law has left open the issue of causation between the defendant's wrongdoing and the plaintiff's financial injury. For example, it is silent on the question of whether reliance has to be proven when the issuers and numerous other classes of persons are sued for damages for a material misrepresentation in the prospectus. Presumably, the answer is yes because this is an essential element of tort law.

However, proving causal connection can be extraordinarily difficult for the plaintiff. Share prices fluctuate for more than one reason. It is frequently difficult to say that "but for" a particular misrepresentation, the investor would have made his investment decisions otherwise. Canada and the United States address this thorny problem by creating a rebuttable presumption that unless proven to the contrary by the defendant, a purchaser of a security has relied on the defendants' misrepresentations.[30] In consequence, plaintiff investors are not obliged to prove that they read or relied on the misrepresentation in making their investment decisions.

29. It reads that "those committing fraud against customers with resulting losses to investors, are liable for damages in accordance with the law." The frauds under the IMPSF are defined to encompass "insider trading, deceiving customers, market manipulation and false misrepresentation in connection with the offering, trading and related activities of securities."

30. *See* Securities Act, R.S.O., ch. S-5 § 130(1) (1990)(Ont.); *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). Ontario is a pioneer in securities regulation in Canada.

Without this presumption, recovery for plaintiffs would be prevented in too many cases.

This point is borne out in a recently decided landmark case. In December, 1998, a disappointed shareholder of Hongguang Industrial Co. Ltd., a Shanghai-listed company, filed a lawsuit against the board of directors of Chengdu Hongguang Holdings Co. Ltd. and certain related professional services firms for losses totaling 3,136.5 yuan (US$378), which she suffered in dealing with the shares of the company. The company was authorized by the CSRC to offer shares publicly in May 1997. According to the CSRC, the company had been engaged in fraudulent behavior, such as inflating profits while concealing negative financial information before and after it went public. The plaintiff alleged that she relied on the misrepresentation in the prospectus and other communication made by the company and sustained losses as a result. She requested that the 24 defendants bear joint and several liability for her losses. While the facts of the case are straightforward and undisputed, the court dismissed the case primarily for the lack of causal connection between the plaintiff's injury and the wrongdoing of the defendants.[31]

C. Class Action Rules

The class action suit testifies to the genius of the market economy, where one's pursuit of self-interest is converted into a laudable contribution to society. Public investors in a listed company usually do not have incentives to sue because the expected recovery will be dwarfed by the costs.[32] The problem of collective action has been largely diminished in the U.S., whose plaintiff-friendly class action system enables small claimants to pool their claims and resources to command the full attention of big players in the markets. In consequence, the mechanism of class action can accord equal footing to the common man in his dispute with the large corporation. Such suits frequently provide the only practical way to compensate defrauded small investors.

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31. This case has attracted wide media attention both in China and abroad. *See Alleged Stock Fraud Spurs Landmark Shanghai Case*, CHINA DAILY, Jan. 13,1999; Trish Saywell, *Demanding Action*, FAR E. ECON. R., May 13, 1999, at 43; *Shanghai Yi Fayuan Shouli Gumin Zhuang Gao Shangshi Gongsi Chengdu Hongguang An [A Shanghai Court to Hear a Shareholder Action Against the Listed Cheng Du Hongguan Industrial Co. Ltd.]*, XINHUA NEWS AGENCY, Dec. 16, 1998.

32. The financing problem also justifies the adoption of a contingency fee system, under which attorneys are allowed to be paid on contingency, at least in class action cases. Chinese law continues to be silent on this issue.

The American experience reminds us that the effectiveness of civil remedies provided under securities statutes largely depends on the applicability of the class action device.[33] Once again, a "deemed reliance" provision becomes prominent. In China, while issues of law and fact do not have to be certified as "common" in order for a class action to proceed, the court has to be satisfied that the members of the class have similar claims and defenses. In the context of lawsuits based on prospectus misrepresentation, this means that each plaintiff must prove that he actually relied on a misstatement or omission in connection with the purchase or sale of stock. As the U.S. Supreme Court once noted, "requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, because individual issues then would have overwhelmed the common ones."[34] The presumption of reliance makes it more likely that the questions of law or fact common to the members of the class will predominate over individual questions, as required. Further, it provides a means for a class of defrauded investors to show reliance for the absent class members.

The American experience shows that actions based on misrepresentation in the prospectuses particularly lend themselves to a class action suit. The federal class action device, as it has developed over the years, is well suited to these types of claims. For example, Rule 23 as it stands now, among other things, makes the judgment in a class action binding on all class members unless they affirmatively elect to be excluded.[35] It thus enables a class member to obtain a judgment for class members who did not appear in the action. This makes the prosecution of class action economically feasible. Further, in the event a class action is settled, the settlement must be approved by the court.[36]

In contrast, the law of class actions is underdeveloped in China. Technically speaking, China does not have specific rules for class action. Such action is rather subsumed under the general rubric of "representative action" for a class of uncertain numbers. The Civil Procedure Law provides

33. *See* LOUIS LOSS, SECURITIES REGULATION 1819 (2d ed. 1961), quoted in Green v. Wolf Corp., 406 F. 2d 291, 295 (2d Cir. 1968); Esplin v. Hirschi, 402 F. 2d 94, 101 (10th Cir. 1968).

34. Basic Inc., 485 U.S. at 242.

35. Fed. R. Civ. P. 23 (c)(2).

36. Fed. R. Civ. P. 23 (e).

for it in only two brief provisions, Sections 54 and 55, which have not been clarified by the equally scant discussion of a later judicial interpretation.[37] Further, the rules so far developed are unduly restrictive. There are few controls over the selection of the representative of the class or over the carriage of the case. When a litigation representative, elected by class members or designated by the court, acts on behalf of those class members registered with the court within a prescribed period of time, the results of the litigation will be binding only on those members and those unregistered class members who are not time barred from lawsuit. Prior consent must be secured from represented class members with respect to any changes in waivers and admission of the claims. What shall happen in the case of failure to obtain such consent? The law is silent. In practice, the skeletal nature of such provisions has led to the reluctance of Chinese courts to hear class action cases. Effective enforcement by private action requires a wholesale reform of the current system.

IV. OTHER PROBLEMS AND DIFFICULTIES

A. Vague Terminology

China's legislation is often characterized by its general and broad wording. This again proves true with certain provisions of the Securities Law. Section 202 is a case in point. It imposes civil liability on professional organizations such as law and accounting firms for any misrepresentation that can be characterized as "*nong xu zuo jia.*" No guidance is given as to what this magic term means. A literal interpretation would suggest that it requires at least actual knowledge before liability can attach. From the plaintiff's viewpoint, to prove this is an arduous task, particularly when, as is frequently the case, the evidence is entirely circumstantial. To require in such cases that a fact finder must find specific intent to deceive or defraud would for all intents and purposes disembowel the private cause of action under Section 202 and reduce the degree to which attorneys, accountants and other professionals encourage full and complete disclosure. The actual usefulness of this provision is called into question.

37. *See Zuigao Renmin Fayuan Guanyu Shiyong Zhonghua Renmin Gonghehuo Minshi Susong Fa Ruogang Wenti De Yijian [Opinion Concerning Certain Problems in the Application of the General Provisions of Civil Law]*, MINSHI SIFA SHIWU QUANSHU [A PRACTICAL GUIDE TO CIVIL ADJUDICATION] 1009 (Lixin Yang, ed. 1994).

B. State Seizure of Illegal Gains

Private litigants are not altruists. They do not bother to hunt down violators who are unable to pay. Under Section 207 of the Securities Law, civil damages shall rank superior to fines. However, this offers potential plaintiffs little consolation. Rather, they will find very disturbing Section 209, which stipulates that "any unlawful income and fine collected against securities violation shall be forfeited to the state." The priority of confiscation over civil compensation in any event threatens to wipe out any hopes of investors for justice, as the unlawful income of securities offenders most likely come from the pockets of victimized investors.

While China is often scorned for the gap between law on paper and law in action, on this matter Section 209 actually means what it says. In 1997, Mingyuan, a listed company, was found guilty of falsifying profits, which significantly drove up the prices of its shares by about ten times. Notwithstanding that the sum in question originally came from the pockets of the investors, the CSRC decided that the unlawful proceeds should go to the state treasury, leaving 107,000 investors uncompensated.[38] The enactment and subsequent enforcement of such a puzzling provision not only offends one's sense of justice, but also further provides disincentives for victims to help in the detection and prosecution of securities fraud.

C. English Rule

While the term "English rule" sounds alien to most Chinese lawyers, the idea is not. It is a general rule well recognized by Chinese courts that the losing party should pay the litigation costs, usually exclusive of attorney fees, of the prevailing party. Unless provided otherwise in statutes, there is no reason why the courts should treat securities cases differently. The problem is that individual investors would inevitably be deterred from filing meritorious cases because they could not take the risk of being exposed to a fee award if they fail to prevail. In class action lawsuits, in particular, public investors frequently find their potential recovery disproportionate to the their potential liability under a fee shifting

38. For the CSRC decision, see *Zhongguo Zhengquan Jiandu Guanli Weiyuanhui Guanyu Hainan Minyuan Xiandai Nongye Fazhan Gufen Youxian Gongsi Weifan Zhengquan Fagui Xingwei De Chufa Jueding [CSRC Decision Concerning Penalties Imposed on Hainan Minyuan Modern Agricultural Development Co. Ltd. For Its Violations of Securities Regulations]* (April 27, 1998) in ZHONGGUO ZHENGQUAN WEIYUANHUI GONGBAO [CSRC BULLETIN], No. 4, 1998, at 52-53.

rule. It is crucial that the fee-shifting rule, adopted by Chinese courts in most cases, be changed to a plaintiff-friendly one. The author proposes that the parties pay their own legal bills, but on this matter, discretion may be left to the court.

D. Enforcement

The list of difficulties does not end here. Like other developing societies faced with the problems of modernization, the gap between law and practice is very wide in China. Enforcement probably presents the most serious obstacles for the development of the Chinese legal system.[39] Inefficient enforcement of court rulings is bound to further erode the incentives of potential plaintiffs to take legal action.

To sum up, from the viewpoint of fraud victims, suing for recovery is certain to be an exercise fraught with uncertainties and roadblocks. Those difficulties lead to disincentives for public investors to detect and prosecute frauds and assist in the anti-fraud campaigns of the government. The lack of an effective and cost-effective system of private remedies promises to shatter the already faltering confidence of the investing public in the market and to create a tragedy of the commons.

V. CONCLUDING REMARKS

Realizing that China does not have a stock market proportionate to the size of its economy, the government expects the securities market to play a more significant role in consolidating China's economy. Whether this goal can be reached depends on the level of protection afforded to investors and on popular perception that the securities market presents a level playing field.

In China, the system of self-regulation has basically failed to play any significant role in monitoring the securities market. This shall come as little surprise because this destiny is preordained by the inherent weakness of self-regulation. Securities law enforcement should be structured in a way that makes most of the advantages of both public and private enforcement.

39. By the end of June of 1999, more than 850,000 court rulings, involving U.S. $31.2 billion dollars, failed to be executed in China due to interference from various authorities. *See Courts Vow To Carry Out Verdicts*, CHINA DAILY, August 18, 1999.

As Anthony Neoh, the former Chair of the Securities and Futures Commission in Hong Kong, noted: "The Chinese market is very unsophisticated; and so are its regulators."[40] While realizing its importance, as the Securities Law evidences, the government takes a heavy-handed approach to the issue of investor protection. The thrust of this law is to regulate the market with tightened administrative and criminal penalties, coupled with unbridled powers granted to the regulator. The role of civil remedies, particularly securities class actions, has largely been overlooked. The problem of adequate protection is addressed as though it were a problem mainly of the severity of sanctions imposed for securities violations or of the sufficiency of the powers for the regulator. This, albeit important, is not the whole, nor even the most important aspect of the problem. What the legislators fail to realize is that the regulator and public enforcement both have their limitations. In contrast, an effective system of private remedies can provide much better deterrence given its relatively appropriate mix of the probability and severity of its sanctions. Unfortunately, private securities litigation in China is inhibited by so many roadblocks insuperable to public investors as to make private securities litigation nonexistent. The absence of a rebuttable presumption of reliance, the limits on class action proceedings, the uncertain status of contingency fees and causes of actions for securities violations, the use of the English rule, and the deficiencies in the liability rules in the Securities Law, among other things, contributes to the difficulties and disincentives of ordinary investors to seek recovery by civil action.

There are no rights without remedies. Right now is a good time for the government to have a close look at the approach it takes to investor protection. A wholesale reform of the current system, which is fundamentally flawed, should be elevated to a burning priority, if the government is serious about any attempts to curb the fraudulent practices and frequent volatility that characterize the fledgling securities market. Unless specific rules for civil recovery for securities violations and fraud are detailed by the corporate and securities laws, the government will continue to be frustrated by the fact that ordinary people in China either let their savings sit idly in banks or treat the stock markets like casinos.

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40. *A Good Beginning*, CHINA ECON. R., No. 3, March 1999, at 19.