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REFORMING CHINA'S SECURITIES CIVIL ACTIONS: LESSONS FROM PSLRA REFORM IN THE U.S. AND GOVERNMENT-SANCTIONED NON-PROFIT ENFORCEMENT IN TAIWAN

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I. INTRODUCTION

How should securities law be enforced?

Different jurisdictions have different preferences and beliefs regarding the enforcement of securities law. Continental Europe and other civilian jurisdictions tend to rely on public enforcement as the primary enforcement tool.[1] China, where administrative and criminal liability dominate securities law, is no exception. China only recently introduced several civil liability provisions.[2] Indeed, China has only allowed civil claims by groups of defrauded investors since 2002, and even then the cause of action is restricted to misrepresentation.[3] Other restrictions include a prerequisite of administrative or criminal sanctions,[4] and the requirement that all litigants be ascertained before trial.[5] The limited enforcement efforts made by China's overburdened regulatory authorities and the inadequacy of civil remedies have led some scholars, in China and abroad, to advocate the adoption of U.S.-style class action suits.[6]

U.S. class actions represent the opposite end of the spectrum from the Chinese system. U.S. courts have long recognized the importance of class actions as a supplement to government regulatory efforts.[7] Class actions are seen as a useful procedure for achieving economies of scale in

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[1] Guido Ferrarini & Paolo Giudici, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case*, *in* AFTER ENRON – IMPROVING CORPORATE LAW AND MODERNIZING SECURITIES REGULATION IN EUROPE AND THE US 159, 160 (John Armour & Joseph A McCahery eds., 2006).

[2] In the most recent 2005 amendments of China's securities law, there are over 30 administrative liability provisions, 18 criminal liability provisions, over 30 administrative liability provisions and only 4 civil liability provisions on 4 specific violations. *See* Zhengquan Fa [Securities Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006) 2005 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 586 (P.R.C.) [hereinafter Securities Law (P.R.C.)].

[3] *Infra* II.A.

[4] Zuigao renmin fayuan guanyu shenli zhengquan shichang yin xujiachengshu yinfa de minshi peichang anjian de ruogan guiding [Several Provisions of the Supreme People's Court on Hearing Civil Compensation Cases Arising From False Statement on the Securities Market] (promulgated by the Sup. People's Ct. Adjudication Comm., Dec. 26, 2002, effective Jan. 9, 2003) [hereinafter Provisions on Hearing Civil Compensation Cases (P.R.C.)], §6.

[5] *See id.* §14.

[6] Sanzhu Zhu, *Civil Litigation Arising from False Statements on China's Securities Market*, 31 N.C. J. INT'L L. & COM. REG. 377, 403 n.135 (2005).

[7] RACHAEL P. MULHERON, THE CLASS ACTION IN COMMON LAW LEGAL SYSTEMS: A COMPARATIVE PERSPECTIVE 63-64 (Hart 2004); Myriam Gilles & Gary B. Friedman, *Exploding the Class Action Agency Costs Myth: The Social Utility of Entrepreneurial Lawyers*, 155 U. PA. L. REV. 103, 108-111 (2006).

litigation, enhancing law enforcement, and deterring misconduct that will adversely affect the interests of multiple parties.[8] Indeed, empirical studies have confirmed the value provided by the strong private enforcement environment prevalent in the U.S.[9]

Still, U.S. class actions are not without social costs and critics. A typical criticism is that the disproportionate number of frivolous actions brought reduces shareholder welfare on average.[10] Common concerns by foreigners include the fear of "legal blackmail" (a "flood of litigation") and conflicts of interest for attorneys ("entrepreneurial litigation).[11] Perceived abuses by such lawyer-driven entrepreneurial litigation were so severe as to lead to the enactment of the Private Securities Litigation Reform Act ("PSLRA") of 1995.[12] PSLRA reform aimed to increase the role played by institutional investors by establishing the rebuttable presumption that the lead plaintiff is the person with the largest financial interest in relief.[13] It is hoped that the greater financial interest for the lead plaintiff will provide sufficient incentive to supervise what had previously been often unrestrained lawyers' self interest.[14]

But, another approach to the problem exists. Like most civilian jurisdictions, Taiwan relies primarily on public enforcement. However, Taiwan also employs a government-sanctioned non-profit organization, the Securities and Futures Investors Protection Center, to help mitigate inadequate public enforcement. This is essentially a hybrid approach,

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[8] Theodore Eisenberg & Geoffrey P. Miller, *Incentive Awards to Class Action Plaintiffs: An Empirical Study*, 53 UCLA L. REV. 1303, 1304 (2006).

[9] Cross-listing by European firms in the U.S. results in permanent increases in stock value and greater liquidity on home exchanges, by signaling to investors that a firm has implemented stricter corporate governance procedures which are necessary to withstand the strong private enforcement mechanisms that operate in the U.S.: Stefano M. Grace, *Strengthening Investor Confidence in Europe: U.S.-Style Securities Class Actions and the Acquis Communautaire*, 15 J. TRANSNAT'L L. & POL'Y 281, 286 (2006).

[10] John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1534 (2006).

[11] For Europe, *see* Stefano M. Grace, *supra* note 9, at 285. For Australia, *see* Bernard Murphy & Camille Cameron, *Access to Justice and the Evolution of Class Action Litigation in Australia*, 30 MELB. U. L. REV. 399, 405, 409 (2006). For England, *see* RACHAEL P. MULHERON, *supra* note 7, at 72-77.

[12] Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 and 18 U.S.C.).

[13] *See* Securities Act of 1933 § 27(a)(3)(B), 15 U.S.C. §§77k, 771(a)(2) (2000); Securities Exchange Act of 1934 § 21D(a)(3), 15 U.S.C. §78u-4(f) (2000); JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION 756-57 (Aspen 2006).

[14] Stephen J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA*, 106 COLUM. L. REV. 1489, 1493 (2006); Kevin P. Roddy, *Nine Years of Practice and Procedure Under the Private Securities Litigation Reform Act of 1995*, SL020 ALI-ABA 749, 756 (2005).

relying on a non-private/commercial institution, with some independence from the government, to fulfill the need for generating public goods.

In this article, we examine all three approaches in an attempt to answer the question of how securities law might best be enforced in China. Part II sets out the context of China's securities civil actions and highlights the shortcomings of the current regime. Limitations in both public and private enforcement regimes in China indicate that reform is necessary. Part III analyzes U.S. class actions as a possible model for China's proposed reform. The merits and limitations of U.S. class actions are discussed, with particular attention to the current regime's failure to achieve the goals of deterrence and compensation. This results from the misalignment of the interests of the lawyers driving such litigation with the public good. Just as pertinently, the enactment and implementation of PSLRA provides valuable insight into the inadequacies of the U.S. model, which China should try to avoid reproducing.

Drawing on the latest empirical studies and scholarship on the PSLRA reform and implementation, Part III examines the surprising findings regarding the active role of public institutional investors (e.g., public pension funds) vis-à-vis private intuitional investors (e.g., mutual funds, insurance companies, and banks) and a shocking implication overlooked in those studies. The enactment of PSLRA confirms the interest misalignment problem operating in lawyer-driven entrepreneurial litigations. The implementation of PSLRA reveals that only public institutional investors are taking up the active role intended by PSLRA. This is due to the presence of public/social interest in the calculus of these public institutional investors, which also leads them to commence more socially beneficial litigations, such as targeting individual defendants who are actually responsible for fraud.[15] Synthesizing these analyses, one must conclude that since the efficiency of lawyer-driven entrepreneurial litigation does not equal efficiency in producing public goods (deterrence and compensation), there is an important role to be played by institutions motivated at least partly by public interest, in private enforcement. These institutions are arguably no less efficient or effective in producing public goods.

Building on this conclusion, we proceed in Part IV to discuss Taiwan's approach of utilizing a government-sanctioned non-profit organization ("NPO") to fill the gap between public and private enforcement. While the government can undeniably exert considerable

[15] Coffee, *supra* note 10, at 1581; James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587, 1636 (2006).

influence on this government-sanctioned NPO, the NPO still enjoys some independence by virtue of its official legal status, independent funding source, and level of expertise. This independence, though limited, will help safeguard the interest of investors' compensation from being offset or diverted by competing government interests.[16] This will be particularly useful in the context of China, where government and regulatory authorities are hugely concerned with the stable development of the State-Owned Enterprises ("SOEs").[17] However, we also note that there is room for improvement in terms of the transparency and independence of this NPO.

Drawing on the analysis of U.S. and Taiwanese models, we argue in part V that due to limitations in China's current legal infrastructure, political and social considerations, and different rationales for civil actions, the U.S. model is unsuitable for Chinese reform. On the other hand, considering the lessons learned from the enactment and implementation of PSLRA reform in the U.S., and China's political and social considerations, we propose that an improvised Taiwan-style model is what China should work toward. The Taiwanese model would allow China to maximize its limited judicial resources in its attempt to improve securities law enforcement. Since our focus is on the reform of China's securities civil actions, we do not propose any concrete reform plans for the U.S. model. Nonetheless, we highlight in the conclusion some implications the implementation of PSLRA reform has for future U.S. reform. We do not disturb the long-held recognition of the importance and desirability of relying on private enforcement to supplement public enforcement. However, we also see a strong case for relying on non-government institutions motivated at least partly by public interest (whether a public pension fund or a government-sanctioned NPO) to supplement public and private enforcement.

II. SECURITIES CIVIL ACTIONS IN CHINA

[16] *E.g.*, lobbying efforts by the securities industry and listed companies to promote a less regulated securities market.

[17] *See* HUI HUANG, INTERNATIONAL SECURITIES MARKETS: INSIDER TRADING LAW IN CHINA 15 (Kluwer Law Int'l 2006) (explaining that stable development of SOEs is to be achieved by raising funds for state-owned enterprises and to help those enterprises get out of financial distress); Walter Hutchens, *Private Securities Litigation in China: Material Disclosure About China's Legal System?*, 24 U. PA. J. INT'L ECON. L. 599, 626 (2003). In fact, China's company law, securities law and stock market were mainly designed to improve the performance of the inefficient SOEs. GUANGHUA YU, COMPARATIVE CORPORATE GOVERNANCE IN CHINA 41 (Routledge 2007). *See also* Liu Chunyan & Huang Yuncheng, *Meiguo jian guan zhi du xuan zhe ji dui wo guo zheng quan shi chang jian guan de ji shi* [*Lesson from US's Choice of Regulatory Control System on China's Regulatory Control of Securities Market*], [2005] 12 ZHONGGUO JIN RONG BEN YUE KAN [CHINA FIN. MONTHLY] (P.R.C.) 47, 48.

A. A Brief History

Since the central government first set up stock exchanges in Shanghai and Shenzhen in the early nineties,[18] the Chinese securities market has developed under the close supervision of government regulatory authorities.[19] This differs markedly from the U.S., where the securities market began with little government intervention.[20] Moreover, the Chinese government's development of the securities market is driven by a clear goal of assisting SOE reforms.[21] Given this highly "public" context surrounding China's securities market, it is hardly surprising to find a predominance of administrative penalties and criminal charges in its regulations.[22] A whole series of regulations and statutory amendments were passed in the last twenty years to tackle the problem of securities fraud. All of this legislation shares one characteristic – all comprehensively provide for administrative and criminal sanctions for securities fraud but are brief and vague on stipulations regarding civil liabilities.[23] This has resulted in procedural difficulties for claimants seeking civil redress in this novel area of law, with courts refusing to hear

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[18] HUI HUANG, *supra* note 17, at 9-10.

[19] Several Chinese stock exchanges were formed by Chinese citizens and foreigners in China in the early twentieth century. However, the pursuit of the socialist economy after the PRC establishment in 1949 dictated the shutting down of these exchanges. Securities and securities trading also ceased to exist for a period of more than thirty years. *See id.*, at 7-8.

[20] Hutchens, *supra* note 17, at 626; Cui Hongmin et al., *Fa she hui xue kuang jia xia de zheng quan ji tuan su song de zhi du jia zhi* [*Institutional Value of Class Action of the Securities Under the Frame of Legal Sociology*], 6(2) CHONGQING JIAO TONG XUE YUAN XUE BAO (SHE KE BAN) [J. CHONGQING COMM. INST. (SOC. SCI. ED.)] (P.R.C.) 25, 27 (2006).

[21] Hutchens, *supra* note 17, at 626; Yan Liu, *A Neglected Dimension of the Development of Corporate Governance Standards in China: The Advent of Private Litigation Against Corporate Fraud in Securities Markets* in CORPORATE GOVERNANCE POST-ENRON: COMPARATIVE AND INTERNATIONAL PERSPECTIVES 343 (Joseph J. Norton et al eds., The Brit. Inst. of Int'l and Comp. L. 2006). *See also* HUI HUANG, *supra* note 17, at 15 (discussing how stability of SOEs can be achieved). GUANGHUA YU, *supra* note 17, at 41 (highlighting that China's company law, securities law, and stockmarket were designed to improve the performance of inefficient SOEs).

[22] Sanzhu Zhu, *supra* note 6, at 379; Guiping Lu, *Private Enforcement of Securities Fraud in China: A Critique of the Supreme People's Court 2003 Provisions Concerning Private Securities Litigation*, 12 PAC. RIM L. & POL'Y J. 781, 783 (2003).

[23] Sanzhu Zhu, *supra* note 6, at 380. Even the most recent 2005 amendments of the Securities Law (P.R.C.) only provide that there is a civil liability for compensation for violation of the insider trading, market manipulation and misrepresentation provisions without elaborating much on how should this civil liability be quantified: §76, 77 & 79, Securities Law (P.R.C.), *supra* note 2. As seen later in II.A, non-explicit stipulation of civil liability can be a real hindrance for bring claims in Chinese court.

victims' claims on the basis that the legislation did not expressly provide for civil liability.[24]

Three circulars were issued by the Supreme People's Court between September 2001 and January 2003 to clarify the situation. The background and socio-legal dynamics of these three circulars are perhaps best illustrated by the case of Daqing Lianyi, the pioneer securities civil compensation case, which was affected by all three circulars.[25] During a flurry of administrative and criminal actions against securities fraud allegedly committed by several listed companies in China, Daqing Lianyi was sanctioned for false representation by the Chinese securities regulatory authorities in March 2000.[26] These administrative sanctions led to many civil compensation claims by the defrauded investors. However, the courts were reluctant to hear this flood of cases (without class actions, there were many individual civil claims arising out of each instance of securities fraud).[27] This reluctance culminated in a decree by the Supreme People's Court on September 24, 2000, temporarily suspending the hearing of civil securities claims.[28] This temporary suspension was lifted three months later by the Notice of the Supreme People's Court on Relevant Issues of Filing of Civil Tort Dispute Cases Arising from False Statement on the Securities Market.[29] The next day, a law firm published a newspaper advertisement expressing its intention to help investors recover claims against the company, its directors, and

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[24] Sanzhu Zhu, *supra* note 6, at 381; Guiping Lu, *supra* note 22, at 784; Guo Wei, *Nanchan de zhongguo suoge zhengquan minshi suopei an – Daqing Lianyi an gongtong susong xuaner weijue* [*Miscarriage of China's First Securities Civil Compensation Case – Daqing Lianyi Joint Action Litigation Remains Unsettled*], SHANGWU ZHOUKAN [BUSINESS WEEKLY] (P.R.C.), Mar. 15, 2003, at 60, 61.

[25] Liang Shubin, *Haerbin: "Zhongguo zhengquan minshi peichang diyi an" quanbu zhijie* [*Haerbin: "China's Number One Securities Civil Compensation Case" is Over*] (Feb. 1, 2007), *available at* http://news.xinhuanet.com/local/2007-01/31/content_5680177.htm (last visited Mar. 14, 2008).

[26] Guo Wei, *supra* note 24, at 60; Ling Dai, *The Judicial Application of the Causation Test of the False Statement Doctrine in Securities Litigation in China*, 15 PAC. RIM L. & POL'Y J. 733, 733 (2006).

[27] Sanzhu Zhu, *supra* note 6, at 381; Guiping Lu, *supra* note 22, at 784; Guo Wei, *supra* note 24, at 61; PENG BIN, ZHONGGUO ZHENGQUAN FAXUE [CHINA SECURITIES LAW] 449 (Gaodeng Jiaoyu 2005).

[28] Zuigao renmin fayuan guanyu she zhengquan minshi peichang anjian zan buyu shouli de tongzhi [The Notice of the Supreme People's Court on Temporary Refusal of Filings of Securities-Related Civil Compensation Cases] (promulgated by the Sup. People's Ct., Sept. 21, 2001, effective Sep. 21, 2001) (P.R.C.).

[29] Zuigao renmin fayuan guanyu shouli zhengquan shichang yin xujiachengshu yinfa de minshi qinquan jiufen anjian youguan wenti de tongzhi [The Notice of the Supreme People's Court on Relevant Issues of Filing of Civil Tort Dispute Cases Arising from False Statement on the Securities Market] (promulgated by the Sup. People's Ct., Jan. 15, 2002, effective Jan. 15, 2002) (P.R.C.).

intermediaries.[30] The law firm received 679 litigation authorizations from claimants[31] and promised to charge fees only upon the action's success.[32] Meanwhile, the firm had commenced actions for three of the claimants in independent actions, while another firm had filed two suits for two other claimants. There was, however, considerable delay because the courts did not know how to proceed.[33] This was only resolved a year later by the Provisions on Hearing Civil Compensation Cases (P.R.C.),[34] which provide a more detailed exposition of the relevant procedures. The law firm quickly sent out notices based on these new directions to the original 679 claimants. But despite the firm's best efforts, only 381 remained (in two actions, one with 107 claimants, the other with 274). Many of the original 679 claimants could not be reached, their contact details having changed during the intervening year.[35] However, the courts continued to delay with regard to these group actions, and there were suggestions of splitting them into smaller groups of 20 to 30.[36] In the end, 464 investors received judgments of RMB 8,836,000, with the proceedings separated into 99 actions.[37]

B. Key Features of Provisions on Hearing Civil Compensation Cases (P.R.C.)

Several scholars have provided comprehensive accounts of the Provisions on Hearing Civil Compensation Cases (P.R.C.) in English,[38] so the regulation's details will not be reproduced here. This paper focuses on the key procedural features of the regulation that materially affect a defrauded investor in pursuing a civil claim.

1. Limited Scope

The judicial circulars only instruct the courts to handle civil securities cases relating to misrepresentation. Other forms of securities fraud, such as insider trading and market manipulation, remain

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[30] Guo Wei, *supra* note 24, at 61; Hutchens, *supra* note 17, at 642.
[31] Guo Wei, *supra* note 24, at 61.
[32] *Id.*
[33] *Id.* at 62.
[34] *Supra* note 4.
[35] Guo Wei, *supra* note 24, at 62.
[36] *Id.* at 63. Indeed this suggestion was later adopted: PENG BIN, *supra* note 27, at 461-463.
[37] Liang Shubin, *supra* note 25.
[38] Sanzhu Zhu, *supra* note 6, at 388-407; Guiping Lu, *supra* note 22, at 786-789; Hutchens, *supra* note 17, at 628-649.

temporarily suspended.[39] The main justifications provided by the Supreme People's Court were: (1) the law is comparatively limited in other forms of securities fraud; (2) misrepresentation is more easily determined as it has a clear actor; and (3) misrepresentation threatens the cornerstone of the modern securities market, i.e., a disclosure regime.[40] Needless to say, there are ample criticisms by scholars. This provision is inconsistent with the Securities Law, which did not restrict civil liability to misrepresentation.[41] By refusing to hear all cases concerning other forms of securities fraud, the People's Supreme Court, in first promulgating the Notice of the Supreme People's Court on Temporary Refusal of Filings of Securities-Related Civil Compensation Cases (P.R.C.)[42] and only lifting the restriction for misrepresentation in the Provisions on Hearing Civil Compensation Cases (P.R.C.), was arguably acting *ultra vires*.[43] Moreover, the comparatively limited law existing with respect to other forms of securities fraud does not translate to a lesser problem in those areas. For example, various empirical studies have strongly suggested that insider trading is widespread in China.[44] This provision substantially limits the civil redress available to defrauded investors.

2. Prerequisites

One of the key features of the Provisions on Hearing Civil Compensation Cases (P.R.C.) is the prerequisite of an administrative sanction or criminal judgment. Article 6 provides that a plaintiff must base his civil compensation claim on an administrative sanction or criminal judgment. Article 5 further provides that the limitation period (two years) of the civil action begins on the decision date of the

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[39] PENG BING, *supra* note 27, at 450; Tan Qiugui, *Zhengquan minshi peichan anjian susong chengxu ruogan wenti fenxi* [*Analysis of Certain Problems Regarding Securities Civil Compensation Cases*], 27(1) XIANDAI FAXUE [MODERN LAW SCIENCE] (P.R.C.) 125, 125 (2005).

[40] Tan Qiugui, *supra* note 39, at 125.

[41] In the old Zhengquan Fa [Securities Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, effective Jul. 1, 1999) (P.R.C.) [hereinafter Securities Law (1998) (P.R.C.)] which was in force before 2004, there was a general provision of Article 207 which provides that there is a civil compensation liability for any violation of the Securities Law. The most recent version of the Securities Law also provides that for civil compensation liability for misrepresentation, insider trading, market manipulation and fraudulent broker conduct: Securities Law (P.R.C.), *supra* note 2, § 69, 76, 77 & 79.

[42] *Supra* note 28.

[43] Though this charge must be mitigated by the fact in the old version of the Securities Law in force at that time, only misrepresentation by the issuer and its officers have civil liability explicitly stipulated: Securities Law (1998) (P.R.C.), *supra* note 41, § 63.

[44] HUI HUANG, *supra* note 17, at 43.

administrative sanction or criminal judgment. The Supreme People's Court explained that this prerequisite is more of an evidentiary requirement— a claimant must show that the misrepresentation is serious enough to merit the court's consideration.[45] The plaintiffs may also sue defendants who are not directly implicated by the administrative sanction or criminal judgment.[46]

The main justification of this requirement is the Supreme People's Court's lack of resources and expertise.[47] In view of the courts' limited capacity in handling a potentially large number of cases, it is designed to be a temporary measure. Also, the administrative securities regulatory authorities are much more competent in dealing with this highly technical and specialized area of the law, and the plaintiff's evidentiary burden will be eased. Another notable consideration is that an unrestricted hearing of false representation cases would impede the securities market's stable development.[48]

This requirement has been heavily criticized by scholars in China[49] and abroad.[50] On the legal front, this prerequisite is contrary to China's Securities Law[51] and Code of Civil Procedure.[52] It severely reduces the scope of investors' claims. Investors are left without any remedy in cases where no actions are taken by regulatory authorities or prosecutors, even if regulatory authorities or prosecutors have detected securities fraud but, out of policy considerations, have chosen not to take action. These criticisms are valid. However, we express reservations about whether this prerequisite really is, as some have claimed, a

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[45] PENG BIN, *supra* note 27, at 452.
[46] *Id.*
[47] *Id.*
[48] *Id.*
[49] *Id.* at 451. *See also* Tan Qiugui, *supra* note 39 at 128; Cui Hongmin et al., *supra* note 20 at 27.
[50] Sanzhu Zhu, *supra* note 6, at 389-393; Guiping Lu, *supra* note 22, at 795-798; Hutchens, *supra* note 17, at 634-640.
[51] There is no mention, express or implied, of this requirement in either the Securities Law (1998) (P.R.C.), *supra* note 41, or the Securities Law (P.R.C.), *supra* note 2. Moreover, article 207 of the Securities Law (P.R.C.) (1998) and article 232 of the Securities Law (P.R.C.) provides that civil compensation liability shall prevail if there are insufficient assets to simultaneously satisfy the civil compensation liability and fines/financial penalty. This prerequisite of administrative or criminal sanctions is arguably contrary to the "civil liability comes first" principle demonstrated in this article 232. *See also* PENG BIN, *supra* note 27, at 417-418.
[52] Mingshi susong fa [Code of Civil Procedure] (promulgated by the Nat'l People's Cong., Apr 4, 1991, effective Apr 4, 1991) (P.R.C.). Under article 111 of the Civil Procedure Law (P.R.C.), the court must hear the case if the 4 conditions in article 108 are satisfied. This prerequisite is over and above the stipulated four conditions. Moreover, article 6 stipulates that the courts shall independently hear the cases without interference from administrative agencies.

"devastating weakness"[53] or "unreasonable."[54] The Supreme People's Court's justifications are persuasive. The lack of expertise and resources of the courts, especially in the field of securities law, are valid criticisms of the Chinese judiciary. They also justify the restriction of cases which the courts may hear. Overwhelming court resources with a flood of cases would only result in further delay, which would not assist claimants. As acknowledged by the Supreme People's Court, this restriction is a temporary but necessary measure taken in light of current circumstances.[55]

In addition, this measure must be evaluated vis-à-vis the Chinese investment profile. Unlike most mature capital markets, where institutional investors constitute over 50% of the total investment, in China institutional investors only make up about 1/3 of the market.[56] The majority of these retail investors are ignorant,[57] highly speculative,[58] and irrational.[59] They blindly enter the stock market despite the government's repeated warnings and corresponding control measures.[60] The argument that such investors should be compensated for false representation and other securities fraud is not particularly compelling given their disregard of the economic rationales that form the basis of these securities offenses. While this argument is less applicable to more sophisticated institutional investors, it is worth noting that institutional investors in China are generally passive in securities class actions. Of the nearly 1000 securities civil suits brought since 2000, none have been brought by the 100-plus

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[53] Hutchens, *supra* note 17, at 634.

[54] Guiping Lu, *supra* note 22, at 795.

[55] PENG BING, *supra* note 27, at 451.

[56] Wallace Wen-Yeu Wang & Jian-Lin Chen, *Bargaining for Compensation in the Shadow of Regulatory Giving: The Case of Stock Trading Rights Reform in China*, 20 COLUM. J. ASIAN L. 298, 343 (2006). *See also* Han Yonghong, *Gumin yu zhengfu tiaokong zhence duidu* [*Share Investors Betting Against Government Market Control Policy*], LIANHE ZAOBAO (Sing.), May 22, 2007 for April 2007 statistics.

[57] *Zhongguo gumin banshu "mengzai guli"* [*Half of China's Share Investors are "Clueless"*], LIANHE ZAOBAO (Sing.), May 24, 2007. (A survey shows that more than half of the Chinese investors only know "a little" or less about the stock market).

[58] Yi Ruimin, *Baifuqin: gumin pingjun chigu jin 20 tian – Zhongguo gushi touji qifen qiangjing* [*Baifuqin: Share Investors only Hold Shares for an Average of 20 Days – China's Stock Market is Highly Speculative*], LIANHE ZAOBAO (Sing.), May 24, 2007. (On average, Chinese investors hold shares for an average of only 20 days.)

[59] *Zhongguo gushi guore pianli jingji luoji* [*China's Stock Market is Overheated and Deviating from Economic Rationale*], LIANHE ZAOBAO (Sing.), May 15, 2007. Notwithstanding the fact that the company suffered a loss of over RMB 200 million in the previous year, the share price of a company increase sharply by more than three times because of a rumor of takeover that has been repeatedly denied by the company. Indeed, shares which are on the verge of delisting (either because of no profit for two years or caught engaging in accounting fraud) actually increase by 150% on average in the first 5 months of 2007 while stock index only increase by 50%.

[60] Han Yonghong, *supra* note 56.

investment funds.[61] Seen in this light, the efficient market justifications of securities law enforcement[62] are certainly less compelling with respect to China.

In any case, it would be unwise to allow such investors free reign to initiate actions to recover their losses. The fear that the courts would be overwhelmed by frivolous cases brought by irrational investors, who blame the government and the market (but not themselves) for their trading losses, is not far-fetched. Many commentators have agreed that "excessive and unsupervised private enforcement may compromise important social goals."[63] There are also several social costs, including: (1) weak cases will impose litigation and enforcement costs not internalized by the private plaintiff; (2) excessive private enforcement will compromise the ability of administrative agencies to exercise prosecutorial discretion and make use of complex procedural and substantive provisions to control abuses under the statutes; (3) reliance on courts as the primary vehicle for screening inappropriate theories will inevitably lead to inconsistent interpretations of the law without agency oversight and control in the broad range of cases filed.[64] Hence, we agree with the Supreme People's Court that this prerequisite is necessary as a temporary measure.

3. Contingency Fees and Litigation Fees

China does have one aspect favoring the private enforcement of securities law – contingency fees. Article 4 of the Procedure Rules on the Charging of Law Firms (P.R.C.)[65] and Article 93 of the Behavior

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[61] Wan Guangjun, *Xujia chenshu minshi peichang yuangao wenti yanjiu - ping zhengquan touzi jijin bu qisu xianxiang* [*Study on Problem of Plaintiff in Misrepresentation Civil Compensation – Critique on Phenomenon of Passivity in Litigation by Securities Investment Fund*], 18(3) HENAN GUANGBO DIANSHI DAXUE XUEBAO [JOURNAL OF HENAN RADIO & TV UNIVERSITY] (P.R.C.) 23, 23 (2005). *See also* Chao Xi, *Institutional Shareholder Activism in China: Law and Practice: Part I*, 17(9) INT'L COMPANY & COM. L. REV. 251-262, 251 (2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=938455.

[62] For a critical analysis of the efficient market hypothesis, *see* COX, HILLMAN & LANGEVOORT, *supra* note 13, at 111-115. The various irrational economic behaviors identified, such as loss aversion, over-confidence, herd mentality, inappropriate reaction to information, can only be exacerbated in the Chinese context of 1) the dominance of retail investors, 2) the short history of securities markets development, and 3) the highly speculative nature of the China's securities markets.

[63] Dayna Bowen Matthew, *The Moral Hazard Problem with Privatization of Public Enforcement: The Case of Pharmaceutical Fraud*, 40 U. MICH. J.L. REFORM 281, 338 (2007).

[64] *Id.* at 333.

[65] Lüshi shiwu suo shoufei chengxu guize [Procedure Rules on the Charging of Law Firms] (promulgated by Ministry of Law, Mar. 19, 2004, effective May 1, 2004) (P.R.C.). It refers to Articles 4 and 7 of the Lüshi fuwu shoufei guanli zanxing banfa [Provisional Procedures for

Criterions for the Practice of Lawyers (for Trial Implementation) (P.R.C.)[66] allow fees to be calculated as a proportion of the subject matter. Furthermore, Article 96 of the Behavior Criterions for the Practice of Lawyers (for Trial Implementation) (P.R.C.) envisions fees based on litigation outcome.[67] Thus, as demonstrated in the case of Daqing Lianyi, above, lawyers may offer to charge only clients who have won. This is more liberal than some European nations, which at most allow limited forms of contingency fee agreements.[68] While contingency fee agreements may result in a windfall for attorneys and also possibly lead to conflicts of interest, such fee agreements do provide greater access to justice for those who otherwise would not be able to afford the high costs of litigation. The Daqing Lianyi case could not have proceeded as far as it did had the initiating lawyers not promised to charge fees only upon winning.

In China, litigation costs (court fees) are borne by the losing party,[69] although they must first be advanced by the plaintiff.[70] While not expressly provided for in the statutes, some Chinese courts have in practice directed the loser to bear the other party's attorneys' fees.[71] This "loser pays" rule is commonly adopted in jurisdictions in Europe[72] and Australia,[73] and is useful in preventing a flood of cases. It also helps deter non-meritorious litigation.[74] The U.S. rejected this rule in order to facilitate greater access to justice, but there are valid criticisms that substantial litigation costs may encourage the settlement of non-meritorious cases.[75]

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the Administration of Lawyers' Service Charges] (promulgated by the Ministry of Law, Mar. 3, 1997, effective Mar. 3, 1997, no longer effective) (P.R.C.).

[66] Lüshi zhiye xingwei guifan (shixing) [Behavior Criterions for the Practice of Lawyers (for Trial Implementation)] (promulgated by the Chinese Lawyer Association, March 20, 2004, effective March 20, 2004) (P.R.C).

[67] This type of fee arrangement is allowed provided the fees are clearly stipulated at the start.

[68] Grace, *supra* note 9, at 287. *E.g.*, the UK and Ireland permit "no-win-no-pay" fee arrangements not tied to a percentage of award recoveries. Germany, Netherlands and Italy have rejected such fee agreements completely.

[69] Susong feiyong jiaona banfa [Measures on the Payment of Litigation Costs] (promulgated by St. Council, December 19, 2006, effective April 1, 2007) (P.R.C.), §29.

[70] *Id.* §28.

[71] Yang Lianzhuan et al., *Lun shengsu fang de lüshi feiyong yingyou baisufang chengdan [Arguing that Lawyer Fees of Victor should be Borne by the Loser]* (2002), http://article.chinalawinfo.com/article/user/article_display.asp?ArticleID=2320 (last visited Mar. 14, 2008).

[72] Grace, *supra* note 9, at 303.

[73] Murphy & Cameron, *supra* note 11, at 410.

[74] Grace, *supra* note 9, at 289.

[75] *Id.* at 290 (Although there is Rule 11 of the Federal Rules of Civil Procedure in the United States to punish non-meritorious suits by making attorneys pay some or all of the other side's fees, this is not as substantial as the "loser pays" rule and is not frequently utilized).

4. Joint Action

Article 12 of the Provisions on Hearing Civil Compensation Cases (P.R.C.) provides that the claimant may choose to file individual or joint suits. If there are several plaintiffs suing a single defendant for a single misrepresentation, and some of the plaintiffs are in joint suits, then the court may "notify" the plaintiffs in individual suits that the suits will be joined under Article 13, which also provides that the court has the power to join two or more joint suits into a single joint suit.

a. Rights of Representatives

Article 14 provides that two to five litigant representatives may be elected by the plaintiffs, where the number of plaintiffs is large. *Prima facie*, litigant representatives' rights under Articles 54 and 55 of the Civil Procedure Law (P.R.C.) are limited. The litigant representatives need the plaintiffs' consent before they can reach a settlement with the defendant.[76] Given the typically large number of plaintiffs in securities civil actions, such a requirement would impede the Supreme People's Court's express emphasis on settlement.[77] Article 15 of the Provisions on Hearing Civil Compensation Cases (P.R.C.) is specifically designed to tackle this problem before commencement of the action, litigant representatives be given special authorization by the plaintiffs to settle.[78]

While not specifically provided for in the Provisions on Hearing Civil Compensation Cases (P.R.C.), the Supreme People's Court did opine that a litigant representative should: 1) be a member of the group of represented plaintiffs with interests similar to the other represented plaintiffs; 2) have the appropriate litigation capacity; and 3) be able to properly carry out the duty of litigant representative and act in the *bona fide* interests of the represented plaintiffs.[79] This excludes lawyers as litigant representatives.

b. Registration Requirement (Opt-in)

A provision of great significance vis-à-vis class action suits is Article 14, which requires that the number of plaintiffs be ascertained and

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[76] The litigant representatives also require plaintiffs' consent for amendment or discontinuation of the claim.

[77] Provisions on Hearing Civil Compensation Cases (P.R.C.), *supra* note 4, § 4.

[78] This includes the amendment or discontinuation of the claim.

[79] PENG BING, *supra* note 27, at 463.

confirmed before the hearing. Indeed, Article 4 of the previous Notice of the Supreme People's Court on Relevant Issues of Filing of Civil Tort Dispute Cases Arising from False Statement on the Securities Market (P.R.C.)[80] had already expressly prohibited securities class actions. This prohibition is perplexing, because there were no provisions in China's law allowing such class actions in the first place.[81] In any case, the requirement that the number of plaintiffs be ascertained and confirmed before the hearing is still restrictive vis-à-vis existing Chinese law. Besides the standard joint action provided for in Article 54 of the Code of Civil Procedure (P.R.C.),[82] Article 55 also provides for a joint action in circumstances where there are many parties with similar claims, but the actual number of parties is not known at the time the case is filed.[83] This potentially useful joint action is excluded by Provisions on Hearing Civil Compensation Cases (P.R.C.).[84] The Supreme People's Court reasoned that a huge number of claimants would require an uneconomical and lengthy notification period. Moreover, in the U.S. there is no equivalent intermediary agency that provides a registry for investors and the calculation of losses. It is thus impractical to rely solely on the courts to undertake these tasks.[85]

Chinese scholars acknowledge that the exclusion of U.S.-style class action suits is consistent with the Civil Procedure Law.[86] They are nevertheless critical of the exclusion of the Article 55 joint action for unascertained plaintiffs.[87] Indeed, the economic justification given by the Supreme People's Court cannot stand because requiring investors to bring separate actions would consume even more judicial resources. Viewed pessimistically, the Supreme People's Court's economic justifications may relate chiefly to its own interests. Restricting joint actions to an ascertained number of plaintiffs would not result in more separate claims being filed since litigation costs would prevent most investors from

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[80] *Supra* note 29.

[81] Shen Ling, *Woguo zhengquan qinquan susong xingshi de goujian* [*Formulation of Our Country's Mode of Securities Torts Litigation*], 223 CAIJING KEXUE [FINANCE AND ECONOMICS] (P.R.C.) 17, 18 (2006).

[82] *Supra* note 52.

[83] As provided in Article 55, the court may issue a public notice to inform all persons whose rights are similarly affected to register within a specified period. Notably, not only is the court's ruling binding on all those who have registered with the court, but is also applicable to those who have not registered with the court but who have brought lawsuits within the prescribed limitation period.

[84] PENG BING, *supra* note 27, at 460; Sanzhu Zhu, *supra* note 6, at 403; Guoping Lu, *supra* note 22, at 800..

[85] PENG BING, *supra* note 27, at 461.

[86] *Id.* at 460; Tan Qiugui, *supra* note 39, at 128.

[87] PENG BING, *supra* note 27, at 461 n.1; Tan Qiugui, *supra* note 39, at 129.

making separate claims. Hence the net result would be the Supreme People's Court hearing fewer cases from fewer plaintiffs.

5. Summary: The Need for Reform

In summary, the current Chinese securities civil action mechanism is, on the whole, not favorable towards the bringing of civil claims by defrauded investors. The limitation of civil claims to misrepresentation cases, and the prerequisite of having administrative sanctions or a criminal judgment, present immediate restrictions on the type of cases which the court may hear. Even if the claims survive this initial exclusion, claimants face practical difficulties in bringing civil actions. The claimants must be ascertained and confirmed before the hearing starts, which essentially requires the lead plaintiff or rallying lawyer to individually contact and obtain authorization from all the potential claimants before the action begins. The legality of contingency fee arrangements in China does help facilitate the civil claims. But, given the relatively short limitation period of two years, and the significant transaction costs related to tracing these claimants (lacking a central shareholders' registry), many of the defrauded investors would still be deprived of their civil claims. Without the availability of civil remedies, these private investors lack both the ability and incentives to assist the China Securities Regulatory Commission ("CSRC") in securities law enforcement, which is bad news for the resource-limited CSRC.[88] Indeed, public enforcement of securities law is weak in China.

In general, administrative bodies are inevitably under-staffed and under-trained for the task of effectively supervising an entire securities market, and China is no exception.[89] In the Chinese context, the main regulatory body, the CRSC, was established by the State Council in 1992 in response to incidents arising from ambiguity in the securities law and its administration. The CRSC was intended as a single market regulatory body, but met with strong resistance from all other existing regulators, such as the People's Bank, local governments, and even the stock exchanges. It took four years for the CSRC to successfully obtain full control over the stock exchanges and the securities industry.[90] However, this may have overburdened the CSRC. Unlike Western nations, where

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[88] HUI HUANG, *supra* note 17, at 255.

[89] William I. Friedman, *One Country, Two Systems: the Inherent Conflict Between China's Communist Politics and Capitalist Securities Market*, 27 BROOK. J. INT'L L. 477, 512 (2002); HUTCHENS, *supra* note 17, 638; Yan Liu, *supra* note 21, at 365.

[90] Yuwa Wei, *The Development of the Securities Market and Regulation in China*, 27 LOY. L.A. INT'L & COMP. L. REV. 479, 489 (2005); HUI HUANG, *supra* note 17, at 17-19.

securities exchanges play a significant role in regulating listed companies, in China the CSRC maintains close supervision and control of these matters.[91] Self-regulatory organizations in China lack a strong business culture and are too weak to curb serious securities fraud.[92] There is also a possible conflict of interest, with China's securities regulatory authorities also having to keep one eye on the initial overall objective of setting up the securities market (the need to provide a financing platform for SOEs).[93] Public prosecutors, with their large caseload of more serious crimes, such as murder and robbery, are also unlikely to place particular emphasis on securities fraud.[94]

There are also risks of undue influence on the administrative process, which is not as transparent as court proceedings, exerted through political influence and personal connections. [95] Government administrative bodies face a conflict of interest when SOEs (which still constitute the bulk of listed companies in China) are involved.[96] They would be wary of the prospect of bankruptcy or significant losses from excessive civil compensation.[97]

The deficiency in both private and public enforcement in China has led some scholars, in China and abroad, to advocate the adoption of U.S.-style class action suits.[98] In the next part, we examine the merits of this proposal.

III. SECURITIES CLASS ACTIONS IN THE U.S.

This part first sets out the basic features of securities class action in the U.S. and then discusses the merits of the U.S. securities class action and PSLRA reform.

A. Basic Features

1. Prerequisites and Conditions for Class Actions

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[91] Chenxia Shi, *Competition in China's Securities Market: Reform of Current Regulatory System*, 3 LOY. U. CHI. INT'L L. REV. 213, 225 (2006).
[92] GUANGHUA YU, *supra* note 17, at 60; Yan Liu, *supra* note 21, at 343.
[93] Liu Chunyan & Huang Yuncheng, *supra* note 17, at 48.
[94] Friedman, *supra* note 89, at 27. Despite clear provisions on criminal liability in misrepresentation (or false disclosure) and the numerous cases of misrepresentation, criminal prosecution is rarely instituted for misrepresentation cases: GUANGHUA YU, *supra* note 17, at 58.
[95] Sanzhu Zhu, *supra* note 6, at 391-392.
[96] Hutchens, *supra* note 17, at 638.
[97] Guiping Lu, *supra* note 22, at 797.
[98] Sanzhu Zhu, *supra* note 6, at 403 n.135.

The basic prerequisites of a class action suit are provided by Rule 23(a) of the Federal Rules of Civil Procedure. These include that 1) the class is so numerous that a joinder of all members is impracticable, 2) there are questions of law or fact common to the class, 3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and 4) the representative parties will fairly and adequately protect the interests of the class. The maintenance of the class action will further require that 1) separate actions by or against individual members will either result in inconsistency or detriments to the other members' interest, 2) the action of the party opposing the class is generally applicable to the class, or 3) the class action is a superior method for fair and efficient adjudication of the controversy.[99]

2. Opt-out Mechanism

One of the key features of the U.S. class action is the opt-out mechanism.[100] The judgment or settlement of the class is directly and automatically binding on any persons who have not elected to opt-out within the prescribed time limit. Such persons will receive the benefits of the judgment or settlement, but lose the right to bring a separate action. Access to justice is the basic justification for class actions, and the opt-out mechanism ensures the inclusion of those claimants who are unable to bring proceedings themselves either because of transaction costs or lack of resources.[101] Other considerations include efficiency and the avoidance of multiple proceedings. For those jurisdictions which adopt the opt-out mechanism, this outweighs the objections arising from the annexation of another legal right without express consent and possible abuses by entrepreneur lawyers.

3. Contingency Fees

Another key characteristic of U.S. class actions is the crucial role played by contingency fees. Law firms in securities class actions typically charge fees based on a common fund created by the suit.[102] For

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[99] FED. R. CIV. P. 23(b).

[100] Manual for Complex Litigation, 268 (4th ed. 2003).

[101] *See* MULHERON, *supra* note 7, at 37-38 for a good summary of the arguments for and against this opt-out mechanism.

[102] Task Force on Contingent Fees, Tort Trial and Insurance Practice Section of the American Bar Association, *Report on Contingent Fees in Class Action Litigation*, 25 REV. LITIG. 459, 462 (2006).

many years, the fees were calculated as a percentage of the fund.[103] Courts also experimented with using a Lodestar (in which the attorneys' reasonably expended hours are multiplied by the reasonable hour rate and multiplied again by a risk factor)[104] and the hybrid Lodestar "Cross-Check" (this relies on a percentage fee which may be reduced if it too greatly exceeds the Lodestar).[105] However, calculating fees by percentage remains the dominant method,[106] with an average of around 20%.[107] Contingency fees provide incentives for lawyers to organize and pursue class actions, and indeed, in the U.S., class actions are often lawyer-initiated and lawyer-driven.[108] Notably, the U.S. rejected the "loser pays" rule[109] which is an effective deterrent, where adopted, to the widespread use of class actions.[110]

4. PSLRA Reform

PSLRA was enacted to tackle perceived abuses by plaintiffs' lawyers in class action securities litigation.[111] These included frivolous and unmeritorious claims to elicit settlements ("legal blackmail"), "grotesque" attorney fees (as described by Judge Richard Posner),[112] and agency problems between lawyers and the class.[113] In essence, PSLRA responds to the problems caused by securities class actions initiated and managed by attorneys whose incentives are not consistent with, and possibly detrimental to, the interest of corporations, shareholders and the society.[114] Indeed, PSLRA attempted to reform securities class actions on three fronts.[115] First, the substantive requirements of recovery, such as discovery, scienter, causation, and damages, are raised. This is designed to eliminate unmeritorious suits.[116] Second, a greater role is envisaged for the lead plaintiff, in particular for institutional investors. This is now

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[103] *Id.* at 467.
[104] *Id.* at 467-468.
[105] *Id.* at 470-471.
[106] *Id.* at 472.
[107] *Id., but cf.* Cox & Thomas, *supra* note 15, at 1599 (historical average of 32% of recovery).
[108] Gilles & Friedman, *supra* note 7, at 135.
[109] Grace, *supra* note 9, at 285.
[110] Europe: Grace, *supra* note 9, at 303; Australia: Murphy & Cameron, *supra* note 11, at 410-412.
[111] Choi & Thompson, *supra* note 14, at 1489.
[112] Task Force on Contingent Fees, *supra* note 102, at 466.
[113] *See* Roddy, *supra* note 14, at 756-757.
[114] Choi & Thompson, *supra* note 14, at 1490; COX, HILLMAN & LANGEVOORT, *supra* note 13, at 754.
[115] Choi & Thompson, *supra* note 14, at 1493.
[116] *Id.*

determined by reference to the financial interest at stake in the litigation.[117] It is hoped that the lead plaintiff's greater financial interest will provide sufficient incentive to supervise the lawyer's self interest, which had previously often gone unrestrained.[118] Third, lawyers are subject to closer judicial scrutiny. In every securities fraud class action, the court is required to review whether sanctions should be imposed for bringing frivolous claims.[119] The attorneys' fees must also be reasonable.[120]

B. The Merits of U.S.-style Class Action Suits

1. General Critique

Common rationales given for class actions are to ensure consistency in litigation outcome, promote access to justice,[121] and achieve judicial economy.[122] The social utility of private litigation ultimately rests on compensating victims and deterring future violations.[123] Indeed, U.S. courts have recognized the importance of class actions in supplementing government regulatory efforts.[124] Empirical studies have shown that strong private enforcement measures help mitigate agency costs by aligning the interests of management with those of outside shareholders.[125] While public enforcement theoretically offers the two advantages of incorporating social costs and having stronger investigative powers, it is, in reality, not the most efficient enforcement mechanism. Nor does it provide resources adequate to realize the theoretical advantages.[126] Private actions supplement regulatory enforcement and assure greater compliance with securities law.[127]

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[117] Securities Act of 1933 § 27(a)(3)(B), 15 U.S.C. §§ 77k, 771(a)(2); Securities Exchange Act of 1934 § 21D(a)(3), 15 U.S.C. § 78u-4(f) (2000).
[118] Choi & Thompson, *supra* note 14, at 1493; Roddy, *supra* note 14, at 756.
[119] Securities Act of 1933 § 27(c); Securities Exchange Act of 1934 § 21D(c).
[120] Securities Act of 1933 § 27(a)(6); Securities Exchange Act of 1934 § 21D(a)(6).
[121] There are four aspects to the objective of "access to justice." First, to the facilitate enforcement of substantive law. Second, to overcome the disproportionately high legal cost of bringing a small claim. Third, to balance the playing field between the parties vis-à-vis the big corporation defendant. Fourth, to ensure timeliness of the claim: MULHERON, *supra* note 7, at 53-55.
[122] MULHERON, *supra* note 7, at 47-60.
[123] Eric Helland, *Reputational Penalties and the Merits of Class-Action Securities Litigation*, 49 J.L. & ECON. 365, 367 (2006).
[124] MULHERON, *supra* note 7, at 63-64.
[125] Grace, *supra* note 9, at 285.
[126] Ferrarini & Giudici, *supra* note 1, at 195.
[127] COX, HILLMAN & LANGEVOORT, *supra* note 13, at 746.

Class actions are a useful procedure for achieving economies of scale in litigation, enhancing the enforcement of laws and deterring misconduct that adversely affects the interests of multiple parties.[128] Without the aggregating device of class actions, the liability system would not be able to operate due to under-deterrence.[129] European firms that cross-list on U.S. exchanges experience permanent increases in stock value and greater liquidity on their home exchanges, having signaled to investors that the firm has implemented stricter corporate governance procedures necessary to withstand the strong private enforcement mechanisms that exist in the U.S.[130] Weak legal enforcement also results in a high premium for control.[131] If adequate private enforcement mechanisms are unavailable in Europe, European investors will likely continue to seek protection under U.S. securities laws when possible.[132] This positive impact on investor confidence will be an important consideration for a developing securities market like China's.

U.S. class actions are not without social costs and critics. A typical criticism is that a disproportionate number of frivolous actions reduce average shareholder welfare.[133] Common concerns by foreigners include the fear of legal blackmail and conflicts of interest for attorneys.[134] But it is worth noting that the introduction of class action procedures per se does not necessarily lead to the much-feared flood of litigation. The potentially huge financial rewards driving attorneys in the U.S. are a combination of factors, such as the frequent granting of exemplary awards, the use of civil juries (which are not sympathetic toward deep-pocket defendants) and the absence of the "loser pays" rule. These procedures are neither the prerequisite of class actions nor are they commonly adopted by other jurisdictions.[135] U.S. class actions are heavily influenced by the rationale of deterrence. Regulatory enforcement is supplemented by private enforcement. But some jurisdictions are not receptive to this.[136]

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[128] Eisenberg & Miller, *supra* note 8, at 1304.
[129] Ferrarini & Giudici, *supra* note 1, at 198.
[130] Grace, *supra* note 9, at 286.
[131] Ferrarini & Giudici, *supra* note 1, at 198.
[132] Grace, *supra* note 9, at 286.
[133] Coffee, *supra* note 10, at 1534.
[134] For Europe, *see* Grace, *supra* note 9, at 285. For Australia, *see* Murphy & Cameron, *supra* note 11, at 405 & 409. For England, *see* MULHERON, *supra* note 7, AT 72-77.
[135] MULHERON, *supra* note 7, at 72-77; Grace, *supra* note 9, at 287-290; Murphy & Cameron, *supra* note 11, at 410-412.
[136] MULHERON, *supra* note 7, at 65 (In fact, the Scottish Law Commission stated that sole proper object of civil action is to obtain compensation.).

2. Purpose of Class Actions: Compensation or Deterrence?

The merits of U.S. class actions must be evaluated vis-à-vis the objectives they are designed to achieve, which scholars commonly cite as compensation and deterrence. John Coffee opines that U.S. securities class actions are not achieving the goal of compensation.[137] Indeed, statistics show that securities class action settlements recover only a small percentage of investor losses.[138] Moreover, settlements must be further discounted by the costs investors have to bear: substantial attorneys' fees and expenses, increased Directors' and Officers' ("D&O") insurance premiums, and the possible costs of disruption and stigma to the corporation.[139] Myriam Gilles and Gary B. Friedman further argue that compensation should not be the guiding basis of class actions.[140] From a historical perspective, class action litigations were originally justified primarily by the deterrence of future wrongdoings.[141] It was the emergence of a plaintiff's class action bar in the early 1980s, and the corresponding concerns of huge fees and legal blackmail, which shifted the focus to compensation.[142] Gilles and Friedman also reason that compensation does not matter even in securities fraud class actions where damages are more significant, as the amounts at stake are still so low that even institutional investors do not feel compelled to file claims.[143] They rebut the efficiency myth, that the alternative to the class action is thousands of individual claims, because typically there will be no case at all.[144] The conclusion is that the chief aim of class actions should be the forced internationalization of social costs, despite the possible moral discomfort with entrepreneurial wealth-creation by plaintiff's class action lawyers.[145] Elizabeth Burch echoes this focus on deterrence.[146]

If deterrence is or should be the chief aim of class actions, it is telling that Coffee rightly claims that this goal is also not being achieved.[147] The lack of deterrence is due to the fact that it is the

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[137] Coffee, *supra* note 10, at 1545-1547.
[138] Elizabeth Chamblee Burch, *Reassessing Damages in Securities Fraud Class Actions*, 66 MD. L. REV. 348, 371-372 (2007).
[139] Coffee, *supra* note 10, at 1546.
[140] Gilles & Friedman, *supra* note 7.
[141] *Id.* at 108-111.
[142] *Id.* at 111-116.
[143] *Id.* at 137; Burch, *supra* note 138, at 372.
[144] Gilles & Friedman, *supra* note 7, at 139.
[145] *Id.* at 162.
[146] *Id.* at 380.
[147] Coffee, *supra* note 10, at 1547-1556.

corporation and the insurer who pay the bill, not the parties who are actually culpable. This is for several reasons. First, there are agency costs when corporate executives are sued alongside their corporation as co-defendants in securities litigation, as commonly occurs in the U.S.[148] This is aggravated by the rule providing that the restricted limitations on corporate indemnification of liabilities arising under the federal securities law do not include settlement payments or defense costs where defendants do not admit liability.[149] This rule in fact creates strong incentives to settle so that individual defendants can escape any risk of personal liability. Moreover, D&O insurance schemes, where "corporate entity coverage" means allocation of liability (90% have it), become seemingly unnecessary when one insurer covered the exposure of virtually everyone.[150]

The limitation on deterrence expounded by Coffee is echoed by Eric Helland's recent economic analysis.[151] Helland points out that when a board is accused of fraud in a shareholder class action, the directors only suffer a reputational penalty in situations that are either in the top quartile of settlements, or where the SEC has initiated a case[152] – i.e., the board members' personal reputational capital remains unscathed in most securities class action brought by private litigants. Indeed, diversified shareholders are the ones who must bear the cost of fraud through enterprise liability even though they are not responsible for the fraud.[153] It is not just a zero-sum game between the investors, but one where as much as 30% of the recovery pays for litigation costs.[154] A natural reform proposal to enhance the deterrence effect would be to provide various incentives for private litigants to go after individual defendants.[155]

Indeed, it is worth noting that the detection of many types of securities fraud requires a centrally organized detection and enforcement system rather than overstretched courts.[156] A strong SEC-style regulatory regime provides more protection for investors than any other regulatory regime in the world.[157] More than half of the recent settlements in the

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[148] *Id.* at 1566-1567.
[149] *Id.* at 1567-1568.
[150] *Id.* at 1570.
[151] Helland, *supra* note 123.
[152] *Id.* at 366.
[153] Burch, *supra* note 138, at 368.
[154] *Id.* at 374.
[155] *See* Coffee, *supra* note 10, at 1572-1584.
[156] Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 828 (2006).
[157] *Id.* at 829.

U.S. involved accounting fraud allegations.[158] Coffee acknowledges that there are some categories of companies and frauds that are largely beyond the reach of securities class actions, namely, smaller companies[159] and instances of fraud not involving financial reporting.[160] These point to the inherent limitations of securities class actions, for which Coffee does not offer proposals for reform. Reliance on private enforcement results in a disproportionate enforcement of "easy-to-prove-and-high-compensation" fraud cases to the neglect of other securities frauds, which may be more detrimental to social utility.

All of these concerns only demonstrate the limitations inherent in relying on private parties driven by self-interest to achieve social utility goals through a private enforcement regime. Indeed, the "privatization" of enforcement methods (securities class actions by private lawyers and plaintiffs) does face a misalignment between the incentives of "private attorneys general" and the public good.[161] Excessive and unsupervised private enforcement may compromise important social goals.[162]

It is clear that the efficiency of lawyer-driven private enforcement does not equate to efficiency in the production of public goods, namely deterrence and compensation. One solution to the problem is to try to realign the parties' interests. But this solution could become a never-ending cat-and-mouse game, in which the private parties will always seek to exploit any loophole. The other solution, relied on in PSLRA, is to envisage a greater role in litigation for parties who are actually interested in it.

3. Role of Institutional Investors Post-PSLRA

An important aspect of PSLRA reform is to increase the role played by institutional investors through the rebuttable presumption that the person with the largest financial interest in relief be the lead plaintiff.[163] It is hoped that the greater financial interest involved for the

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[158] Sherrie Raiken Savett, *Securities Class Actions Since the 1995 Reform Act: A Plaintiff's Perspective*, SL085 ALI-ABA 497, 511 (2006). This is possibly due to the changes brought about by the PSLRA reform. Roddy, *supra* note 14, at 757.

[159] *See also* Choi & Thompson, *supra* note 14, at 1497-1498 where the higher costs imposed on plaintiff's attorney firms due to the PSLRA may further aggravate this lack of deterrence for small company.

[160] Coffee, *supra* note 10, at 1543-1545.

[161] Matthew, *supra* note 63, at 282.

[162] *Id.* at 338.

[163] Securities Act of 1933 § 27(a)(3)(B), 15 U.S.C. §§ 77k, 771(a)(2); Securities Exchange Act of 1934 § 21D(a)(3), 15 U.S.C. § 78u-4(f) (2000); COX, HILLMAN & LANGEVOORT, *supra* note 13, at 756-757.

lead plaintiff will provide sufficient incentive for them to supervise the lawyer's self interest, which had previously often gone unrestrained.[164] This approach is essentially targeted at the compensatory aspect of class actions, but is also useful in reducing frivolous claims.

The empirical findings on institutional investors have been mixed. The total value of cases settled has increased dramatically in recent years.[165] Of these, institutional investors have higher settlement amounts than other class action securities fraud plaintiffs.[166] This could be due to more effective monitoring of litigation.[167] It could also be due to institutional investors cherry-picking their cases.[168] Another goal behind empowering institutional investors is to enable the lead plaintiff to engage in meaningful negotiations over attorney fees.[169] While evidence exists suggesting that some institutional investors negotiate fee agreements more favorable to the shareholder group,[170] this approach would not work if there is no class member with a sufficient stake to warrant undertaking the responsibility as the lead plaintiff.[171] This is not uncommon. Given the dispersed shareholding context in the U.S. where even the largest shareholder does not hold more than 5% of outstanding shares, the lack of enthusiasm by institutional investors is a cause for concern.[172]

What is interesting is the role played by public institutional investors (e.g., public pension funds) as opposed to private institutional investors (e.g., mutual funds, banks, or insurance companies). While institutional investors' participation increased dramatically after PSLRA, the increase mainly represents public pension funds and not private institutional investors.[173] This likely reflects the fact that, for institutional investors, notwithstanding their substantial shareholdings in the company, litigation is not a commercially positive net present value transaction.[174] Also, private institutional investors may face possible conflicts of interest in bringing such class action suits, and may not want to jeopardize their commercial relationships with corporate bodies.[175] Here, public institutional investors, such as public or union pension funds, do not face

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[164] Choi & Thompson, *supra* note 14, at 1493; Roddy, *supra* note 14, at 756.
[165] Savett, *supra* note 158, at 509; RODDY, *supra* note 14, at 757-759; Choi & Thompson, *supra* note 14, at 1499.
[166] Choi & Thompson, *supra* note 14, at 1505.
[167] *Id.* at 1505.
[168] *Id.* at 1506.
[169] Task Force on Contingent Fees, *supra* note 102, at 478.
[170] Choi & Thompson *supra* note 14, at 1505.
[171] Task Force on Contingent Fees, *supra* note 102, at 479.
[172] Cox & Thomas, *supra* note 15, at 1606.
[173] Choi & Thompson, *supra* note 14, at 1504; Sherrie Raiken Savett, *supra* note 158, at 508.
[174] Choi & Thompson, *supra* note 14, at 1504.
[175] Cox & Thomas, *supra* note 15, at 1609-1610.

these commercial restraints, and are indeed the overwhelming majority of institutional investors appearing as lead plaintiffs.[176]

While the goals of public institutional investors in these actions may be affected by the fact that they often continue to hold stakes in the company and are not particularly eager to seek maximum compensation which they would indirectly bear, they are also more concerned with prospective reform of the company's corporate governance structure.[177] Cox and Thomas suggest that institutional investors would go after insurers and officers responsible for the fund.[178] Indeed, public pension funds offer higher fee awards for recoveries from individual defendants, which result in plaintiff's attorneys seeking recoveries from individual defendants.[179] This is highly relevant to the deterrence effect of class actions, currently inadequate according to Coffee, as the individual defendants who are actually responsible are not paying the class action bill.

4. Implications: The Need for a Public Institution

The enactment and implementation of PSLRA reform highlights the inadequacies of an over-reliance on private enforcement by contingency fee-driven attorneys. The misalignment of the interests of these attorneys and the social interest in securities law enforcement inevitably results in sub-optimal enforcement. PSLRA reform tried to realign the interests by envisioning and encouraging a greater role for institutional investors in litigation. Yet the empirical studies on post-PSLRA securities class actions strongly suggest that the key to successful reform does not lie with institutional investors. Rather, the materialization of the social benefits of class actions requires institutions which are at least partly motivated by public interest (in the case of PSLRA reform, public pension funds).

Prima facie, only institutions have the necessary resources to initiate and supervise class actions. This is in fact the underlying assumption of PSLRA reform, which imagines a greater role for institutional investors.[180] Even the Australian Law Reform Commission recommended that commercial litigation funders should be allowed to

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[176] *Id.* at 1610. There is a general lack of conflicts of interest involving extramural relations between the issuer and fund manager of a public pension fund: Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, *in* INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE 105, 128 (Theodor Baums et al. eds., 1994).

[177] Cox & Thomas, *supra* note 15, at 1636; Romano, *supra* note 176, at 128.

[178] Cox & Thomas, *supra* note 15, at 1636.

[179] Coffee, *supra* note 10, at 1581.

[180] Cox & Thomas, *supra* note 15, at 1593.

fund class actions, which are increasingly recognized by courts as making positive contributions towards the aims of legislation and accommodating the commercial realities of class action litigations.[181]

But as the statistics of post-PSLRA class actions reveals, it is public institutional investors, particularly public pension funds, who are accepting the burden of acting as lead plaintiffs. More pertinently, their actions are not driven solely by the maximization of monetary gain, but also include prospective reform of the company's corporate governance structure. They also target individual defendants. Such practice may not bring the highest monetary return but maximizes deterrence. These actions can be explained by the political pressure and corresponding social policy considerations which drive institutional investors.[182] Indeed, trustees of pension fund boards are fixed by statute and often include state officials.[183] The presence of individuals with political aspirations on boards also mitigates the free rider problem,[184] since these social and political entrepreneurs benefit personally from activities which may enhance their personal reputation.[185]

This implies that the "public" aspect is just as relevant as the "institutional" aspect. While "public" is traditionally associated with "inefficiency" and "corruption,"[186] PSLRA reform shows that in situations where the benefit of public goods is so widely dispersed as to present a strong collective action problem (even intuitional investors' shareholdings are too dispersed to provide sufficient incentive), a "public" element is necessary for the effective production of public goods. This goes to the very root of the assumption underlying the U.S. school of thought on securities law enforcement, namely a preference for enforcement driven by private rather than public interest. However, as the failure of U.S. class actions in achieving the twin goals of deterrence

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[181] Murphy & Cameron, *supra* note 11, at 434-435.

[182] K. A. D. Camara, *Classifying Institutional Investors*, 30 IOWA J. CORP. L. 219, 235 (2005). They have also often taken the lead on social-responsibility issues such as environmental protection, workers' rights, and human rights in foreign regimes. *See also* Romano, *supra* note 176, at 111-119 on the "social investment" by public pension fund which includes investing to stimulate local economic activities, prohibition from investing in firms doing business with countries like South Africa, Northern Ireland and Iran, and even to support affirmative action goals.

[183] Romano, *supra* note 176, at 110.

[184] The situation where the activist bears the costs of activism while the rest of the firm's investors receive the benefits.

[185] Romano, *supra* note 176, at 128.

[186] In the context of US public institutional investors, there is the emerging practice of "pay-to-play" practices pursued by some large plaintiffs' law firms where the law firms made political or other contributions to the decision makers of these public institutions. *See* Cox & Thomas, supra note 15, at 1611-1615. *See also The Boot's on the Other Foot*, THE ECONOMIST, May 27, 2006, at 68.

and compensation shows, efficiency in private enforcement is not the same as efficiency in the producing the social utility of enforcement. This is especially so considering the huge social cost in the form of frivolous actions and wealth-transferring litigations[187] imposed on the public by entrepreneurial lawyers.

The lesson of the enactment and implementation of PSLRA reform – the important role played by institutions motivated at least partly by public interest in a privatized enforcement environment – has important implications for the development of China's securities class action regime. At the very least, future Chinese reform would do well to employ the useful enforcement function provided by this type of institution. In the next part, we examine the case of Taiwan, where a government sanctioned non-profit organization plays a significant role in the securities civil actions regime.

IV. TAIWAN'S GOVERNMENT-SANCTIONED NPO

China relies heavily on administrative regulatory authorities enforcing securities law, while the enforcement of U.S. securities law depends on private securities class actions brought by entrepreneurial lawyers. Taiwan, distinct from both, utilizes a government sanctioned non-profit organization to supplement her public and private enforcement efforts.

A. Organizational Characteristics

1. Organization

The Securities and Futures Investors Protection Center ("Investors Protection Center") was established pursuant to Article 7 of the Securities Investor and Futures Trader Protection Act (Taiwan).[188] The relevant competent authority regulating the Investors Protection Center is the Securities and Futures Commission of the Ministry of Finance.[189] Under Articles 11 and 15 of the Securities Investor and Futures Trader Protection Act (Taiwan), the directors and supervisors of the Investors Protection Center are appointed by the Securities and Futures

[187] These are litigations against firms which amount to mere wealth-transfers between shareholders of the firm, thus having only insignificant deterrence effects and limited compensatory benefits.

[188] Zhengquan touziren ji qihuo jiaoyiren baohufa [Securities Investor and Futures Trader Protection Act], § 7 (2002), Fagui Huibian (Taiwan).

[189] *Id*, § 3.

Commission. At least two-thirds of the board of directors and board of supervisors must be independent scholars and experts, while the remaining members are selected from the nominees of the contributing securities and future market organizations.[190] In practice, there is a heavy presence of former or retired government officials.[191]

2. Funding

The organizations in the list of contributing securities and future market organizations stipulated in Article 7 of the Securities Investor and Futures Trader Protection Act (Taiwan) are required to contribute a certain amount of assets[192] for the purpose of establishing the Investors Protection Center. These organizations are further required to make ongoing contributions to the Investors Protection Center's protection fund, based on the securities and futures market activities they handle.[193] In other words, securities and futures market activities handled by the organizations are "taxed" with the proceeds going to the Investors Protection Center.

3. Operations

Besides bringing securities civil actions on behalf of investors,[194] the Investors Protection Center provides several other services. The Investors Protection Center serves as a portal for consultations and complaints by investors relating to securities and futures regulations and transactions. [195] The Investors Protection Center has a mediation

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[190] Securities Investor and Futures Trader Protection Act (Taiwan), §11 (board of directors), §15 (board of supervisors). The relevant securities and future market organizations are listed in Article 7, Securities Investor and Futures Trader Protection Act (Taiwan). They include Taiwan Stock Exchange Corporation, Taiwan Futures Exchange Corporation, GreTai Securities Market, Taiwan Securities Central Depository Company, Chinese Securities Association, Securities Investment Trust and Consulting Association of the R.O.C., Federation of Futures Industry Associations, all securities fiancé enterprises and other securities- or futures-related organizations or enterprises designated by the competent authority.

[191] The résumé of the current Investors Protection Center's Chairman is dominated by government appointment: Securities and Futures Investor Protection Center, http://220.130.32.146/english/service/00.aspx (last visited Mar. 14, 2008). This observation is further confirmed from the interaction of the author Wallace Wang with members of the Center and the securities industry.

[192] Precise amount to be determined by the competent authority.

[193] Securities Investor and Futures Trader Protection Act (Taiwan), *supra* note 188, §18. For example, Article 18(1) provides that every securities firm must contribute 0.00000285 of the total volume of consigned securities trades.

[194] Article 28, Securities Investor and Futures Trader Protection Act (Taiwan).

[195] *See* http://220.130.32.146/english/service/00.aspx (last visited Mar. 14, 2008)

committee, as required by Article 22 of the Securities Investor and Futures Trader Protection Act. The committee provides mediation for civil disputes involving securities and future investors.[196] The Investors Protection Center provides a transaction safety net for investors. Under Articles 20 and 21 of the Securities Investor and Futures Trader Protection Act, the Investors Protection Center would compensate investors for their losses if a securities or futures firm were unable to pay due to financial difficulties. The Investors Protection Center is also authorized by related government agencies to enforce disgorgement provisions against certain share transactions by insiders and majority shareholders.[197]

4. Legal Nature of the Investors Protection Center

The Investors Protection Center is classified as a foundation,[198] but there is a significant government presence in its establishment and operation. As mentioned above, the Investors Protection Center is established pursuant to a statuary provision. Besides the power to appoint directors and supervisors of the Investors Protection Center, the Securities and Futures Commission also has the power to amend the Investors Protection Center's articles of incorporation and operating rules, and to conduct inspections of the Investors Protection Center as necessary for the protection of securities investors and futures traders.[199] The contributions to and usage of the protection fund are also within the purview of the Securities and Futures Commission.[200] All of these are backed up by legal sanctions.[201] This is certainly different from the investor protection non-profit organizations in Japan and Korea, which are established by civil groups.[202]

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[196] *See* http://220.130.32.146/english/service/02-1.aspx (last visited Mar. 14, 2008)

[197] *See* http://220.130.32.146/english/service/05-1.aspx (last visited Mar. 14, 2008). Article 157 of the Securities and Exchange Law (Taiwan) stipulates that directors, supervisors, managers or shareholders holding more than ten percent of the shares of a company who sell shares within six months after acquisition, or repurchase them within six months after its sale, shall return any profits realized from the sale or purchase.

[198] Securities Investor and Futures Trader Protection Act (Taiwan), *supra* note 188, § 5.

[199] *Id.* § 16.

[200] *Id.* § 18-20.

[201] *Id.* § 39, 40.

[202] *See* Curtis J. Milhaupt, *Nonprofit Organizations as Investor Protection: Economic Theory and Evidence from East Asia*, 29 YALE J. INT'L L. 169, 175-177, 179-181 (2004).

B. Class Actions by the Investors Protection Center

The principal purpose of the Investors Protection Center is to bring civil compensation claims on behalf of defrauded securities investors. Under Article 28, the Investors Protection Center may bring an action in its own name with respect to a single securities or futures matter. This section describes the key features of this class action.

1. Prerequisites

Before the Investors Protection Center may bring an action under Article 28 of the Securities Investor and Futures Trader Protection Act (Taiwan), it must satisfy three discernible prerequisites. First, the action must be for the protection of the public interest and within the scope defined in its articles of incorporation. Second, the matter must be injurious to a majority of securities investors. Third, it must be empowered by no fewer than 20 securities investors. These prerequisites ensure that the Investors Protection Center does not undertake frivolous litigation and concentrates its resources on bringing litigation with spill-over social benefits.

2. Opt-in Structure

As in most civilian jurisdictions, civil actions initiated by the Investors Protection Center are essentially opt-in in nature. The Investors Protection Center requires empowerment by securities investors in order for them to claim losses. If other investors with claims in the same matter empower the Investors Protection Center prior to the conclusion of oral proceedings or the examination of witnesses in the court of first instance, then the Investors Protection Center may expand the claims to include the claims of these investors.[203] In the same vein, investors may withdraw their claims prior to the conclusion of oral proceedings or the examination of witnesses in the court of first instance, although Article 29 of the Securities Investor and Futures Trader Protection Act (Taiwan) provides that the court may order, *ex officio*, that these securities investors resume the proceedings. The Investors Protection Center is required to disburse the compensation it receives in an action to the securities investors who

[203] Securities Investor and Futures Trader Protection Act (Taiwan), *supra* note 188, §28.

empowered it to initiate the action.[204] It may deduct necessary expenses for procedures but is not entitled to seek remuneration for itself.[205]

3. Extent of Empowerment

The default rule under Article 31 of the Securities Investor and Futures Trader Protection Act (Taiwan) provides that the Investors Protection Center shall be empowered to perform all procedural acts in relation to an action, including executing waivers, accepting liability, and withdrawing or entering into a settlement. This differs from Article 70 of the Code of Civil Procedure (Taiwan), [206] which requires special authorization before the litigation agent may execute waivers, accept liability, or withdraw/enter into a settlement. This is to facilitate action by the Investors Protection Center. The empowering investor may restrict or limit the right of the Investors Protection Center in relation to this matter, but must set out the restriction in a written instrument or memorandum to the court. An investor's restriction is also not extended to other empowering investors.

4. Procedural Advantages

The Investors Protection Center enjoys several procedural advantages when bringing a civil action for securities investors under Article 28 of the Securities Investor and Futures Trader Protection Act (Taiwan). One of the most important procedural advantages necessary to ensure the viability of the Investors Protection Center's operation is exemption from deposits for an injunction or attachment application[207] and for appeals.[208] Given the large claim amount typical of securities civil actions and the usual deposit amount of one third of the claim, the Investors Protection Center's financial resources would not be able to cope without this exemption. Article 35 of the Securities Investor and Futures Trader Protection Act (Taiwan) also exempts the Investors Protection Center from court costs for the portion of the litigation amount in excess of NT 100 million. This helps ensure that the compensation recovered by the Investors Protection Center is not subjected to potentially significant court fee deductions before reaching the hands of investors.

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[204] *Id.* § 33.
[205] *Id.*
[206] Fagui Huibian (Taiwan).
[207] Securities Investor and Futures Trader Protection Act (Taiwan), *supra* note 188, § 34.
[208] *Id.* § 36.

5. Comparison with Normal Class Action Suits

Article 44-2 of the Code of Civil Procedure (Taiwan) was amended in 2003 to provide for a joinder action for multiple parties whose common interests have arisen from the same public nuisance, traffic accident, product defect, or any other kind of single transaction or occurrence. The notable advantage of this joinder action is that the relevant public notices for joinder (which include publication in newspapers or other similar means of communications) are advanced by the national treasury. This joinder action also has the advantage in terms of litigation fees[209] and the selection of one's lawyer.[210] However, the litigants in this type of group civil action are typically consumers and lack resources. Without a waiver of the significant court deposit, such as that currently enjoyed by the Investors Protection Center, the collective action problem typical of such group claims remains a real obstacle.

C. Public Choice Theory and Analysis of the Investors Protection Center

1. Governmental Agency vs. Government-Sanctioned NPO

Government organization is a response to the impediment of high transaction costs for obtaining a collective decision, especially in the provision of public goods.[211] However, bureaucratic members are driven by their own self-interest and may fail to produce the optimal amount of public goods.[212] They also may be subject to corruption and political pressure.[213]

One theory by Burton Weisbrod explains NPOs as a response to government and market failures in the supply of public goods.[214] The non-distribution constraint of the NPO may also make it a more trustworthy

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[209] Fagui Huibian (Taiwan), *supra* note 206, §77-22: Portion of court costs in excess of NT% 600,000 may be temporarily exempted.

[210] The court has the power under Article 44-4 of the Code of Civil Procedure (Taiwan), *supra* note 206, to appoint attorney to represent the joinder action. *See also* Code of Civil Procedure (Taiwan), § 77-25: The compensation to be paid to such appointed attorney shall be determined in the discretion of the court or the presiding judge.

[211] DENNIS C. MUELLER, PUBLIC CHOICE III 39 (Cambridge University Press 2003).

[212] *Id.* at 362.

[213] Ferrarini & Giudici, *supra* note 1, at 196.

[214] Milhaupt, *supra* note 202, at 181.

producer of public goods than for-profit firms.[215] Curtis Milhaupt suggests that the Taiwanese model presents a novel twist, in which the government turns to an NPO to overcome issues relating to asymmetric information and trust problems.[216] Yet the heavy involvement of the government in setting up and operating the Investors Protection Center raises a fundamental question: if this Investors Protection Center is so similar to a typical government administrative branch, is there any value in setting up a government-sanctioned NPO instead of simply setting up a specific administrative body?

We think the answer is yes. Even though the Investors Protection Center owes its existence to a statutory act and its appointment is subject to the approval of government regulatory authority, it is able to achieve some degree of independence due to several factors. First, it is legally classified as a foundation[217] and not subject to direct government control. The government is restrained by public perception from over-utilizing its appointment power to control the foundation. Second, and perhaps more importantly, the Investors Protection Center has an independent source of funding, so its operations are not directly dependent on the government budget. This prevents the government from directly disciplining the Investors Protection Center by reducing its annual operation budget. Third, the level of expertise involved[218] means that the Investors Protection Center, like experts in a bureaucracy, enjoys some form of power of expertise, which allows it some freedom.[219] This independence, while limited, helps safeguard the interest of investors' compensation from being offset by competing government interests.[220] This will be particularly useful in the context of China, where the government and regulatory authorities are very concerned with the stable development of the SOE[221] and may compromise investor compensation as a result.

Efficiency is a major concern for NPOs, especially considering that agency problems are most severe in contexts where performance is difficult to evaluate and there is no market competition.[222] The relatively short history of the Investors Protection Center prevents a proper evaluation of its effectiveness and efficiency. The Investors Protection Center has brought several successful high profile actions against

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[215] *Id.* at 182.
[216] *Id.* at 196.
[217] Securities Investor and Futures Trader Protection Act (Taiwan), § 5 (2002).
[218] This includes the difficulty of defining the relevant public goods, here investor protection
[219] MUELLER, *supra* note 211, at 361.
[220] *E.g.*, lobbying efforts by the securities industry and listed companies to promote a less regulated securities market.
[221] *See supra* note 17.
[222] Milhaupt, *supra* note 202, at 203.

securities fraud, suggesting that it is at least contributing positively towards investor protection. However, due to significant litigation costs, the Investors Protection Center often piggy-backs its civil class actions on criminal actions. This severely hampers the efficiency of the action since the action is commenced after the criminal action concludes.[223] The Taiwanese NPO is certainly not a perfect solution. However, it is worth noting that while U.S. private attorneys are highly motivated in pursuing class actions against firms, given the strong financial incentive, their efficiency and effectiveness in bringing class actions does not necessary translate into efficiency and effectiveness in producing public goods.

2. Critique of the Investors Protection Center

The above discussion confirms the merits of utilizing government-sanctioned non-profit organizations to supplement public and private enforcement. While the Investors Protection Center is far from a perfect solution, it is, at the very least, an appropriate improvement in an enforcement environment where private/civil enforcement is traditionally not emphasized. Such a non-governmental public institution may also prove useful in supplementing private enforcement in the U.S., in light of the findings of empirical studies after the implementation of PSLRA. The Investors Protection Center's constraints against frivolous suits and its focus on social benefits and interests are attractive vis-à-vis lawyer-driven entrepreneurial litigations. This is especially so considering that lawyer-driven entrepreneurial litigations are not efficient in producing public goods.

The short history of the Investors Protection Center prevents an in-depth evaluation of its actual operations. However, we identify certain areas in need of improvement. First, the transparency of the Investors Protection Center's decision and operations should be improved. Currently, the Investors Protection Center is not legally obliged to and does not in fact publish the basis of its decisions and actions, including decisions whether to commence an action, and the terms of settlement. Such a lack of transparency has caused some understandable disquiet among securities market participants about the potential arbitrariness of decisions and possible undue influence by other interests. This is aggravated by the dominant government presence in the Investors

[223] Wang Wen-Yeu & Zhang Yiming, *Fei yingli zuzhi zhudao de zhengquan tuanti susong – lun touziren baohu zhongxin* [*Securities Group Litigations Initiated by Non-profit Organizations – Critique on Investors Protection Center*], 15 YUEDAN MINSHANG FA [YUEDAN CIVIL & COMMERCIAL LAW] (Taiwan) 5, 27 (2007).

Protection Center. Wallace Wang's interviews with numerous securities market industry professionals confirm the prevalence of this perceived lack of independence.[224] Accurate or not, this perception by securities market participants could undermine the success of the Investors Protection Center. A government-sanctioned NPO like the Investors Protection Center is designed to supplement public and private enforcement. If it is perceived as just another government regulatory authority, then the purpose and intended benefits of the Investors Protection Center (here, safeguarding investor protection from compromise or diversion by other government interests) cannot be fully realized.

Hence, we suggest that the Investors Protection Center improve the transparency and independence of its operation. The Investors Protection Center should publish the reasons for its decisions on whether to commence an action in order to dispel public discomfort toward apparent black box operations. The settlement terms should also be published.[225] Similarly, the appointment mechanism of the Investors Protection Center should be modified to reduce the regulatory authority's involvement. For example, a proportion of the board (e.g., one-third) should be independently appointed without requiring the regulatory authority's approval. This enhancement in the transparency and independence of the Investors Protection Center will allow it to better fulfill its role of investor protection, rather than merely carrying out prevailing government policies.

V. REFORMING CHINA'S CIVIL ACTIONS

Having examined U.S. class actions and Taiwan's government-sanctioned NPO, this part discusses the implications of these models for Chinese reform. We explain why U.S.-style class action is not suitable for Chinese reform and argue that the Taiwanese model, with the necessary improvements in transparency and independence, is preferable at the current stage.

A. Why U.S.-Style Class Actions Are Not Suitable for China

[224] *Id.* at 28.

[225] The Center currently refuses to publish the terms of the settlement on the ground that it is a private agreement between the parties. However, the Center can only initiate action to protect the public interest as required under Article 28 of the Securities Investor and Futures Trader Protection Act (Taiwan). Hence, public interest can and should override the supposedly private nature of the settlement to compel disclosure.

There are essentially three reasons why U.S.-style class actions are not a suitable model for China. First, the lack of legal infrastructure in China relating to private enforcement means that it would be premature to rely heavily on private actions to supplement public enforcement. Second, political and social considerations are against the U.S. model. Third, the deterrence-oriented U.S. model is not suitable vis-à-vis China's emphasis on compensation as the justification for civil enforcement.

1. Lack of Legal Infrastructure

a. The Judiciary

China's judiciary and legal education system were almost entirely halted during the Cultural Revolution period (1966-1976) and have only resumed since 1980.[226] While professional requirements for judges have been significantly raised since the 1990s,[227] the lack of qualified judges and judicial independence are still significant problems facing the Chinese judiciary.[228] Indeed some senior judges may themselves view the judiciary as subject to current political priorities,[229] as evidenced by the self-imposed prerequisite issued by the Supreme People's Court. Serious institutional defects exist whereby local courts are dependent on local governments for funding and control.[230] These institutional defects, coupled with local governments' anxiety to ensure the viability of large listed enterprises in its jurisdiction, undermine the courts' impartiality. Given the current developmental stage of the Chinese judiciary, it would be unwise to overburden the courts with such a pro-active role in the enforcement of securities law, an area with complex and far-reaching policy considerations.

b. Lawyers

The development of the legal bar in China, like that of the judiciary, was greatly impeded by the Cultural Revolution and only resumed in 1980. Moreover, many lawyers were persecuted for having defended "bad people."[231] Indeed, the general cultural distain for lawyers

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[226] Jianli Song, *China's Judiciary: Current Issues*, 59 ME. L. REV. 141, 143-144 (2007).
[227] *Id.* at 145.
[228] *Id.* at 146-147.
[229] *Id.* at 147.
[230] Chris X. Lin, *A Quiet Revolution: An Overview of China's Judicial Reform*, 4 ASIAN-PAC. L. & POL'Y J. 256, 295 (2003).
[231] For an account of the historical development of the Chinese bar, *see* Wang Liming, *Woguo lüshi zhidu de fazhan* [*Development of Our Nation's System of Lawyer*] (2001),

in Chinese society and the relatively less urgent nature of reinstating the legal bar (as compared to the judiciary) do not favor the development and growth of the Chinese bar.[232] Although the Chinese bar has developed rapidly over the past decades,[233] the limited economic scale of Chinese law firms nevertheless prevents them from advancing high litigation costs upfront in securities class actions. They are thus unable to take full advantage of the permitted litigation-facilitating contingent fee structure. This is likely to impede the emergence of a class action bar in the near future and prevent the wholesale adoption of the U.S.-style private enforcement model.[234]

c. *Investors*

The enactment and implementation of U.S. PSLRA reform suggest both the inadequacies of a private attorneys general model in civil enforcement and the importance of institutions that have a public dimension. The predominance of unsophisticated retail investors in Chinese securities markets (highlighted above)[235] further contributes to the unsuitability of the U.S. model. Indeed, institutional investors in China, as in the U.S., are also generally passive in securities class actions. While there have been nearly 1,000 securities civil suits in response to various false disclosure scandals since 2000, none of them have been brought by the 100-plus investment funds.[236] This is contrary to the original intent of introducing into investment funds the requirements for investment fund contracts and investor expectations.[237] There are two possible reasons: first, some of the fund's investors may have participated in fraud,[238] and second, the incentive problem, that the fund management company's management fees are unaffected by the fund's performance.[239] The usual commercial conflicts of interest affecting private institutional investors

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http://article.chinalawinfo.com/article/user/article_display.asp?ArticleID=35842 (last visited Aug. 17, 2007).

[232] For a recent anecdotal account about the lack of respect and attractiveness of the lawyer profession, see Wu Qingshu, *Lüshi, ni weisheme bu zhengqi? – Lüshi zhiye lunli yu lixiang de chongjian* [*Lawyer, Why are you not Striving? – Rebuilding Lawyer Professional Ethics and Ideals*] (2006), http://article.chinalawinfo.com/article/user/article_display.asp?ArticleID=38465 (last visited Aug. 17, 2007).

[233] Wang Liming, *supra* note 231.

[234] Shen Ling, *supra* note 81, at 21.

[235] *See Supra* Part II.B.2.

[236] Wan Guangjun, *supra* note 61, at 23. *See also* Chao Xi, *supra* note 61, at 251.

[237] Wan Guangjun, *supra* note 61, at 24.

[238] *Id.* at 24.

[239] *Id.* at 25.

also apply in China.[240] China's lack of public institutional investors exacerbates the problems of investors lacking the resources (retail investors) or incentives (private institutional investors) present in the U.S. model.

2. Political and Social Considerations

One reason China is reluctant to introduce U.S.-style class action suits is the political risk entailed in a group becoming an interest group, which status may pose a threat to China's political regime.[241] Private litigation actions may also threaten the foundational basis of a socialist market economy under the current market conditions in which state-owned assets remain the leading player,[242] especially before the split-share structure reform.[243] The comparative rarity of listed companies (which must also go through numerous hurdles for administrative approval) and widespread socio-economic influence and government financial income, means that the government is understandably unreceptive towards such actions.[244]

The development of China's securities market is also relevant. Unlike the U.S. where the securities market began without significant government intervention, China's securities market developed under close governmental supervision.[245] Securities trading (and the majority of other private economic activities) were halted after the PRC was founded. It only emerged after ten years of economic reform aimed at restructuring and developing the national economy, which was suffering in the aftermath of ill-conceived economic policies and political disruptions of the previous decades.[246] Indeed, private securities actions in the U.S. are not engineered from the top down. They evolved in a fashion that was probably not expected by the drafters of the Securities Act of 1933.[247] The Chinese government may be reluctant to surrender its presence and

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[240] Chao Xi, *supra* note 61, at 258-261.

[241] Zhong Zhiyong, *Meiguo zhengquan susong yu woguo zhengquan minshi susong xinshi zhi wanshan* [*US Securities Class Actions and the Improvement of Our Nation's Mode of Securities Civil Actions*], 190 XIANDAI CAIJING [MODERN FINANCE & ECONOMICS] (P.R.C.) 72, 74 (2005); *see also* Hutchens, *supra* note 17, at 654.

[242] Zhong Zhiyong, *supra* note 241, at 73. State-owned listed companies dominate the two stock exchanges in China: GUANGHUA YU, *supra* note 17, at 55.

[243] Wallace Wen-Yeu Wang & Jian-Lin Chen, *supra* note 56, at 343.

[244] Cui Hongmin et al., *supra* note 20, at 27.

[245] *Id.* at 27.

[246] Chenxia Shi, *supra* note 91, at 217-218.

[247] Hutchens, *supra* note 17, at 658.

influence in securities law enforcement to parties driven purely by private interest.

The fact that U.S. class actions often result in a wealth transfer from shareholders who must bear the cost of the fraud through enterprise liability, even though they are not responsible for the fraud,[248] has added implications for China's securities market, which is dominated by state-owned enterprise and state-owned shares.[249] Having the state pay a large compensatory bill would be both politically undesirable and limited in deterring future misconduct. The strict enforcement of civil liability motivated solely by private interest is inconsistent with the government's political goal of maintaining some symbolic large SOEs as key components of the economy.[250]

On the social front, the idea of an entrepreneurial lawyer driven by the potential of reaping huge fees is inconsistent with the Chinese perception of justice, which views a lawyer as a judicial intermediary with a significant obligation to the public interest.[251] Neither is the Chinese culture litigious in nature.[252] These social factors, while not decisively detrimental on their own, further counsel against importation of the U.S. model.

3. Differing Emphases of Civil Actions: Deterrence versus Compensation

As discussed above in III.B.2, the primary justification and guiding principle of U.S. class actions has traditionally been deterrence. However, deterrence is not universally accepted as the justification for civil actions. Civilian jurisdictions usually see enforcement as public enforcement and dislike the concept of the private vindication of the public interest.[253] It is worth noting that even the Scottish and Australian

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[248] Burch, *supra* note 138, at 368.

[249] PENG BING, *supra* note 27, at 37. The split share structure reform does not seek to materially alter this, at least in the foreseeable future. The transfer of state-owned shares is still subject to several restrictions and approval of State-owned Asset Supervision and Administration Authority: Gufen youxian gongsi guoyou guquan guanli zanxing banfa [Provisional Measures for State Shares Management in Limited Stock Company] (promulgated by St. Council Economic Reform Comm. & St. Admin. of Stated-owned Assets, Nov. 3, 1994, effective Nov. 3, 1994), § 29.

[250] GUANGHUA YU, *supra* note 17, at 61.

[251] Cui Hongmin et al., *supra* note 20, at 26; *see also* Milhaupt, *supra* note 202, at 199.

[252] Milhaupt, *supra* note 202, at 198.

[253] Ferrarini & Giudici, *supra* note 1, at 160.

law reform commissions are not particularly receptive to the deterrence objective of class actions when they argue for introducing class actions.[254]

China is no different. China's securities regulatory authorities have to keep one eye on the initial overall objective of setting up the securities market (the need to provide a financing platform for state-owned enterprise).[255] The use of "prerequisites," which implies the exclusion of citizen-initiated investigation and the "prosecution" of securities law violations, strongly reflects the tendency toward government intervention.[256] This is in fact a subrogation of civil liability under public and administrative liability. There is also a huge imbalance in terms of liability in the Securities Law (P.R.C.), which has 18 criminal liability provisions, over 30 administrative liability provisions, and only four civil liability provisions. There is currently no consensus among Chinese scholars regarding the precise nature of Securities Law (P.R.C) (whether it is a regulatory act, administrative act, or private law).[257] All of these strongly suggest that the role of civil claims in Chinese securities law is mainly of a compensatory nature, with the deterrence objective amply dealt with by comprehensive administrative and criminal liability.

If compensation is the primary justification of civil actions in China, then U.S.-style class action is not a suitable model, given how miserably it fares on the compensation aspect.[258] Indeed, huge contingency fees and the misalignment of interests between attorneys and class members inevitably results in high costs for recovery. We are not suggesting that deterrence is not a valid and important goal of civil actions. Our point is that if China wishes to achieve compensation as the primary goal of its civil actions, then the U.S. model is not suitable. Indeed, the political and social factors alluded to in the previous section are likely to prevent a heavy emphasis on the deterrence rationale for civil actions.[259]

B. Why Taiwan's Model is a Good Interim Measure

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[254] MULHERON, *supra* note 7, at 65. The Scottish Law Commission stated that sole proper object of civil action is to obtain compensation.

[255] Liu Chunyan & Huang Yuncheng, *supra* note 17, at 48.

[256] *Id.*at 48; *see also* Cui Hongmin et al., *supra* note 20, at 27.

[257] Zhang Yujun, *Cong touzizhe quanyi baohu kan woguo "zhengquan fa" xiugai* [*Looking at Our Nation's "Securities Law" Amendment from the Perspective of Protecting Investors' Rights and Interest*], ZHENGQUAN SHICHANG DAOBAO [SECURITIES MARKET REPORTER] (P.R.C.), May 2005, at 4, 6-7.

[258] *See supra* Part III.B.2.

[259] Since this will suggest that the government is failing in its role of public enforcement.

In the same vein, there are three reasons that an improvised Taiwanese model is suitable for the next stage of Chinese reform: (1) the maximization of limited judicial resources, (2) compatibility with the current legal framework, and (3) political acceptability. We do not dispute that the Taiwanese model is not perfect, and does not represent a total solution. However, we argue that a government-sanctioned NPO would be a useful tool to help supplement public and private enforcement in China, at least at the present stage where enforcement is severely deficient in both aspects. The "public interest" nature of the organization is also crucial for maximizing limited judicial resources by focusing on meritorious suits with spill-over social benefits. We leave open the question of whether the Taiwanese model is the best long-term solution. We also stress that the transparency and independence of this type of government-sanctioned NPO should be improved to ensure that it can effectively supplement public and private enforcement.[260] Transparency and independence are even more critical vis-à-vis protecting the interests of investors in China's relatively homogenous political environment, where the entire government is tightly held by the ruling Communist Party.

1. Maximization of Limited Judicial Resources

Perceived abuses by lawyers filing frivolous suits and thereby carrying out legal blackmail, are an important motivation behind U.S. PSLRA reform. These suits impose significant social costs while providing minimal deterrence. The negative social impacts of frivolous suits would be magnified by China's limited judicial resources. Also, as noted above in III.B.3, class actions brought forward by public institutional investors tend to produce greater social utility in terms of deterrence and compensation. Hence, a public institution in the form of a government-sanctioned NPO can allow the maximization of China's limited judicial resources by bringing actions which are both meritorious and have significant positive social utility spin-off (e.g., specifically pursuing responsible officers, rather than the corporation itself, for greater deterrence). The non-distribution constraint of an NPO is also an effective built-in safeguard against frivolous litigation.[261]

2. Fit with China's Current Legal Framework

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[260] *See supra* Part IV.C.2.

[261] Milhaupt, *supra* note 202, at 202.

Introducing the Taiwanese model would not require a dramatic change in China's legal framework. Like China's current requirements, Taiwan uses an opt-in model. Given that one of China's Supreme People's Court's justifications for rejecting China's "Article 55 representative action for unknown parties" is the lack of an intermediary agency providing a registry for investors and the calculation of losses,[262] an equivalent Investors Protection Center could also adequately fulfill this practical requirement. Moreover, China has already adopted a similar state-sponsored NPO in the realm of consumer protection.[263] This consumer protection organization is tasked with investigating and mediating consumer complaints.[264] It also supports consumers in initiating legal actions against infringers of consumer rights.[265] The Taiwanese model only requires one significant extension to this existing consumer protection model – the right to bring actions on behalf of investors.

3. Political Acceptability

As explained above, political considerations in China militate against U.S.-style class actions. Nonetheless, development of the securities market will ultimately require the significant presence of private enforcement and remedies for investors. The Chinese government recognizes this, as evidenced by the inclusion of civil liability provisions in the most recent Securities Law amendments. Introducing a government-sanctioned NPO to initiate class actions on behalf of investors would allow the Chinese government to signal its commitment to investor protection, while retaining some control over the proceedings. The independence enjoyed by this NPO, while limited, would help protect investors' compensation from being outweighed or diverted by competing government interests, such as ensuring the stable development of SOEs.[266]

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[262] PENG BING, *supra* note 27, at 461.

[263] C. David Lee, *Legal Reform in China: A Role for Nongovernmental Organizations*, 25 YALE J. INT'L L. 363, 414-419 (2000).

[264] Zhonghua Renmin Gonghe Guo xiaofeizhe quanyi baohu fa [Law of People's Republic of China on the Protection of Rights and Interests of Consumers] (promulgated by Standing Comm. Nat'l People's Cong., Oct. 31, 1993, effective Jan. 1, 1994) (P.R.C.), § 32(4).

[265] *Id.* § 32(6). This is usually in the form of legal advices or arranging law firms for consumers: Lee, *supra* note 263, at 417.

[266] Hutchens, *supra* note 17, at 626. This is to be achieved by raising funds for state-owned enterprises and to help those enterprises get out of financial distress. *See also* HUI HUANG, *supra* note 17, at 15. In fact, China's company law, securities law and stock market were mainly designed to improve the performance of the inefficient SOEs: GUANGHUA YU, *supra* note 17, at 41.

An NPO would also serve as a useful intermediary shield for disgruntled investors: better that a mob of disgruntled investors surround the Investors Protection Center than the Securities Exchange or Government Regulatory Authority Office. Moreover, the public and government-sanctioned nature of this NPO may encourage the Chinese government to grant certain procedural advantages, as with the Investors Protection Center in Taiwan. This would allow the NPO to more effectively fulfill its role of producing public goods, while lowering the political risk that the securities class actions may induce the formation of an organized interest group.

In any case, sudden liberalization and changes are not conducive to a transitional economy like China. While the limitations of an NPO would mean it may not be the most socially optimal solution imaginable, it is a move in the right direction and at the right pace.

VI. CONCLUSION

In this paper, we analyzed the different civil enforcement regimes of China, the U.S., and Taiwan, to consider how China might reform her securities civil actions. We highlighted the shortcomings of U.S. class actions in achieving the goals of deterrence and compensation. More importantly, we examined the implementation of PSLRA reform and the surprisingly active role of public institutional investors. Recognizing the importance of institutions motivated by public interest in class actions, we discussed Taiwan's use of a government-sanctioned NPO to supplement public and private enforcement. Indeed, we argued that due to China's limited legal infrastructure and political and social considerations, the Taiwanese model, with some improvements in transparency and independence, would be more suitable for Chinese reform at the present stage. The social costs of the U.S. model, we believe, would be aggravated in China and would outweigh possible benefits. On the other hand, the Taiwanese model would allow the maximization of China's limited judicial resources and improve the enforcement environment at a suitable pace.

We recognize that the Taiwanese model is only useful as an interim measure. Government-sanctioned NPOs may supplement public and private enforcement but can replace neither. In the long run, developing the securities market and the rule of law will still require China to strengthen its private enforcement regime. We leave open the question of whether the U.S. model may be appropriate at this later stage. However, with respect to the U.S., we wish to highlight the implications

of empirical findings related to PSLRA implementation. The surprisingly proactive role of public institutional investors vis-à-vis private institutional investors demonstrates the important role to be played by institutions motivated at least partly by public interest.

Since our focus is on the reform of securities civil actions in China, we do not propose any concrete reforms for the U.S. model. Nonetheless, we think that some rethinking of the U.S. model is necessary. We do not deny the long-held recognition of the importance and desirability of relying on private enforcement to supplement public enforcement. However, the enactment of PSLRA and the shortcomings of U.S. class actions in achieving the goals of deterrence and compensation clearly indicate that the efficiency of lawyer-driven entrepreneurial litigation does not equal efficiency in the production of public goods. While institutions and organizations motivated by public interest suffer from inefficiency and possible corruption arising out of this "public" interest, they are arguably no less efficient or effective in producing public goods. Indeed, the self-initiated targeting of individual defendants (greater deterrence) and other corporate governance improvement by public pension funds suggests that these institutions may in fact be more efficient and effective in producing public goods. We think that future reform efforts in the U.S. should look not only into strengthening public enforcement and refining the private enforcement requirement. Rather, it is worth considering a third option to supplement public and private enforcement – non-government institutions motivated at least partly by public interest, in the form of government-sanctioned NPOs, civil NPOs, or public institutional investors.