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Investors' Day in Chinese Court:  
Civil Compensation in Fraudulent Information Disclosure Cases

The Chinese government's ambition to build "a socialist system with Chinese characteristics" or socialist market economy is a new human invention. In this effort, China can borrow some experiences from mature market economy countries, but it will encounter unique problems. Only under this backdrop can we fully understand many legal concepts blended with hybrid of Chinese characteristics that may seem illogical to western readers. Shed in such light, this note aims to explain the newly issued interpretation by the Supreme People's Court on Civil Compensation Cases Involving Fraudulent Information Disclosure In the Securities Market.<sup>1</sup>

This note argues that though the new interpretation is a big step toward investor protection, it will not be able to achieve its goal of establishing individual investors' confidence. In interpreting the Securities Law, the Court played a role of poor legislature by compromising various special interests and serving the state's goal. Lower courts have little discretion in their handling of such cases. Thus, it evidences China's central planning mentality and distrust of judiciary branch. Individual investors' right to compensation is conditioned on the state's public law enforcement, which can sway in the winds of public policy. Such a law will further discredit courts' role in individual

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<sup>1</sup> Shao Zongwei, Civil Law on Fraud Evolves, China Daily, Friday, Jan. 10, 2003, available 2003 WL 3052453. The Chinese text of the new interpretation is available online at <http://www.chinacourt.org/sfjs/detail.php?id=45827>. The English translation was completed by the author and not available to the public.

protection and hamper investors' enthusiasm, which is contrary to the expressed goal of the Securities Law.<sup>2</sup>

The note will first give a brief description of China's securities market and development of securities law. Since the note focuses on the new interpretation, it will not expand to a discussion of the complexity of the market itself. Because the Supreme People's Court interpreted the Securities Law when it applies to civil compensation cases involving fraudulent information disclosure, the note will discuss the relevant provisions of the Securities Law. The second part of the note will describe in detail the new interpretation. It will explain possible reasons behind some provisions and their implications to the securities market. Because Chinese securities law is indebted in part to the law in U.S., the note will try to elucidate some legal concepts in the Securities Law and the interpretation by looking at the U.S. leading cases. The note then concludes that for fear of instability the Supreme People's Court again refused to take primary responsibility for protecting citizens' rights.

## **I. Development of Securities Market and Law in China**

Establishment of investor confidence and nourishment of the infant Chinese securities market are both complementary and conflicting in current China's legal development. Securities markets in China are designed in part to draw in private

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<sup>2</sup> Zhonghua Renmin Gongheguo Zhengquan Fa (Securities Law of the People's Republic of China) (hereinafter the Securities Law) (passed Dec. 29, 1998 by the Ninth Standing Committee of the National People's Congress in its sixth session, effective July 1, 1999), translated in CHINA L. & PRAC., Feb. 1999, at 25, also available at <http://www.csrc.gov.cn/CSRCSite/eng/elaws> . The general preamble states that the purpose of the Securities Law is to regulate the issuing and trading of securities, to protect investors' rights, to maintain social and economic order, to protect public interest, and to promote the development of socialist market economy. The Securities Law, Art. 1.

investors without ceding control of state-owned enterprises.<sup>3</sup> The government, state banks and state enterprises are the main issuers of securities and main shareholders.<sup>4</sup> Almost all the listed companies are the beneficiaries of the government favoritism.<sup>5</sup>

China in 1983 converted for the first time a State Owned Enterprise ("SOE") into a stock corporation, issuing minority shares to private investors while the State maintained majority control. Such limited privatization at that time served the sole purpose of raising capital for the ailing SOEs.<sup>6</sup> The Shanghai and Shenzhen National Stock Exchanges opened in 1990 and 1991 respectively. In order to insulate the domestic RMB market from volatility of the international capital market, domestic investors can only invest RMB in the A shares, whereas, foreign investors invest foreign currency in the B share market. The Shanghai and Shenzhen markets have grown significantly in their short history. Today they have 1,200 listings, a market capitalization of around \$500 billion, and some 66 million individual investors.<sup>7</sup>

In March 1987, China issued its first national securities regulation, "Interim Regulation Governing the Administration of Bonds for Enterprises." In April 1993, China set up a two-tiered regulatory system comprised of the State Council Securities Commission ("SCSC") and China Securities Regulatory Commission ("CSEC"). The two commissions jointly drafted several regulations including the Interim Regulation on the

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<sup>3</sup> Gu Minkang & Robert C. Art, *Securitization of State Ownership: Chinese Securities Law*, 18 MICH. J. INT'L 115, 126.

<sup>4</sup> Cheng Tao & Bo Ruijian, *Zhengquanfa Tonglun (General Introduction to Securities Law)* 14 (1994).

<sup>5</sup> The Weakest Link, *The Economist*, A Survey of Asian Finance, 11, Feb. 8, 2003.

<sup>6</sup> Daniel M. Anderson, *Taking Stock in China: Company Disclosure in China's Stock Market*, 88 GEO. L. J. 1919, 1940 (2000) (asserting that China allowed the conversion of SOEs in the 1980s so that "idle personal savings could be channeled into ailing state enterprises"); Gu & Art, at 125 (noting that one purpose of the Chinese securities market is "to absorb money from Chinese citizens, which is then channeled into productive enterprises controlled by the state"); Matthew D. Latimer, *Gilding the Iron Rice Bowl: The Illusion of Shareholder Rights in China*, 69 WASH. L. REV. 1097, 1099 (1994) (discussing the fact the Chinese securities market developed out of a need "to obtain new sources of capital for Chinese industry and to relieve the state's financial organs from the burden of finding investment funds").

<sup>7</sup> The Weakest Link, 10.

Administration of the Issuing and Trading of Stocks of 1993 and the 1993 Company law, as amended in 1999.

In 1998, the Standing Committee of the People's Congress enacted the first systematic Securities Law. The system of investor protection, especially protection of small and medium-sized investors, is largely borrowed from developed countries.<sup>8</sup> In its preamble, the Securities Law aims to regulate issuing and purchasing of securities and to protect investors' legal rights.<sup>9</sup> The law requires listed companies' continuous disclosure and forbids fraud, inside trading and market manipulation in issuing and trading securities. In Section 63, if the share prospectus, measures for offer of corporate bonds, financial or accounting report, listing report document, annual report, interim report or ad hoc report announced by an issuer or securities underwriting company contain or contains any falsehood, misleading statement or major omission, thus causing losses to investors in the course of securities trading, the issuer or the company shall be liable for the losses and the responsible director(s), supervisor(s) and/or the manager of the issuer or the company shall be jointly and severally liable for such losses.<sup>10</sup>

The Securities Law authorizes the CSRC to pursue administrative action if an issuer of securities makes fraudulent disclosure in Section 177. If an issuer of securities fails to disclose information in accordance with relevant regulations or the information

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<sup>8</sup> In 1994, the CSRC and the United States Securities and Exchange Commission signed a memorandum of understanding that the SEC would assist China in developing its regulatory framework and drafting a body of national securities law. Gu Minkang & Robert C. Art, *Securitization of State Ownership: Chinese Securities Law*, 18 MICH. J. INT'L L. 115, 124; Andrew Xuefeng Qian, *Why Does Not the Rising Water Lift the Boat? Internationalization of the Stock Markets and Securities Regulatory Regime in China*, 29 INT'L LAW 615, 627 N. 58; *China Securities Regulator to Visit Singapore, Hong Kong*, THE STRAIGHTS TIMES (Singapore), Nov. 30, 1995, Money at 2 (noting that China worked with Singapore, Hong Kong and the United States to develop its securities regulation).

<sup>9</sup> The Securities Law, § 1.

<sup>10</sup> The Securities Law, § 63.

disclosed contains a falsehood, misleading statement or major omission, the securities regulatory authority shall order the issuer to take remedial measures and impose a fine of not less than 300,000 Yuan<sup>11</sup> but not more than 600,000 Yuan. The persons directly in charge and all other persons directly responsible shall be given a disciplinary warning and also be fined not less than 30, 000 Yuan but not more than 300,000 Yuan. If the offense constitutes a crime, criminal liability shall be pursued according to law.

If the issuer fails to announce its listing documents or submit the relevant reports on schedule, the securities regulatory authority shall order it to take remedial measures and impose on it a fine of not less than 50,000 Yuan but not more than 100,000 Yuan.<sup>12</sup>

However, this provision only allows administrative sanctions to the state regulatory authority and does not specify civil compensation action by injured investors. The fine is capped at 100,000 Yuan, which is de minimus compared to the loss injured investors suffered when their stock suddenly crashed.<sup>13</sup> Zhu Shaoping, the chief of the National People's Congress Financial and Economic Committee, said that the compensatory clauses in the existing law are too general to work. "A right is meaningless if it cannot be protected in legal proceedings," complained Jiang Ping, a law professor who advocated judicial protection of stockholders.<sup>14</sup>

Despite the enactment of the Securities Law, Chinese securities markets suffer rampant fraudulent disclosure. According to a study of companies listed on the Shanghai Securities Exchange, nearly fourteen percent of the items in the annual

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<sup>11</sup> Yuan is Chinese dollar and its exchange rate is 8.2772 per U.S. dollar in December 2002, <http://www.pbc.gov.cn/baogaoyutongjishuju/2002S5.htm>

<sup>12</sup> The Securities Law, § 177.

<sup>13</sup> E.g. 363 shareholders of Yorkpoint Science & Technology demanded 24.6 million Yuan in a class action filed against the company for its institutional price manipulation. China to Protect Stock Investors' Interests, [http://english.peopledaily.com.cn/200111/29/print20011129\\_85620.html](http://english.peopledaily.com.cn/200111/29/print20011129_85620.html)

<sup>14</sup> China to protect stock investors.

reports were not acceptable.<sup>15</sup> One commentator even suggested that currently most of the information disclosed was either incorrect or forged.<sup>16</sup>

Investors welcomed the Securities Law that expressly imposes civil liability on issuers for fraud and brought lawsuits immediately after its enactment. However, to grievance of the injured investors, courts repeatedly refused to take jurisdiction over civil compensation cases brought by individual investors. In 1996, Liu Zhongming brought the first civil action against Bohai Group for making fraudulent statement.<sup>17</sup> The trial court ruled for the defendant and the appellate court affirmed. Again in 1998, several plaintiffs sued Hongguang Shiye for civil compensation, and the trial court of Shanghai Pudong New District dismissed the case for lack of jurisdiction.

On September 21, 2001, the People's Supreme Court told the lower courts to halt nearly 900 compensation cases regarding fraudulent statement, inside trading and market manipulation for further interpretation of the Securities Law.<sup>18</sup> On January 15, 2002, the Court publicized its opinion that lower courts have jurisdiction of civil compensation action involving fraudulent statement (1.15 Opinion). The 1.15 opinion opened floodgate for numerous such actions including several class actions. However, before the promulgation of the new interpretation, only two cases have been settled and the plaintiffs won the statutory compensation. One court dismissed a case without prejudice because not all defendants have been duly served with the CSRC's administrative sanctions paper.

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<sup>15</sup> Tang Yuewei et al., *Accounting and Finance in China* 142 (3d. ed. 1994)

<sup>16</sup> See Han Zhiguo, "there is No basis for delisting in China," *Shanghai Securities News*, January 8, 2001.

<sup>17</sup> Gushi Huangyan Zhongxu "Nashui" -Zhuanjia Ping Sifa Jieshi (Lies in Securities Markets Should Finally Be "Taxed" – Experts Comment on the Judicial Interpretation), *Economy Watch Journal*, Jan. 13, 2003, available at <http://business.sohu.com/62/16/article205711661.shtml>

<sup>18</sup> Court VP Lays Down Fraud Law, *China Daily*, Dec. 13, 2002, available at 2002 WL 103964416.

Such disregard of the Securities Law and slow recognition of investors' rights by the Chinese judges is appalling when scholars and lawyers all agreed that strong financial markets depend on healthy investor psychology.<sup>19</sup> Articles in Business Week, Financial Times, The New York Times attributed the inability of the stock market to stage a lasting rally to the fact that the scandals have offended investors so much that they are now unwilling to put their capital at risk any more.<sup>20</sup> Investors are voting with their wallets and reevaluating the market downward to reflect their perception of real corporate profitability, trust and credibility.<sup>21</sup> If China can boost its investor confidence in the domestic securities market, cash hungry companies, especially small to medium sized private companies, can tap the huge savings and spin off another expansion of industrialization. In 2002, the total savings account increased from 8567.44 billion Yuan to 94307.13 billion Yuan.<sup>22</sup> On the other hand, those blue chip SOEs went offshore to other well regulated securities market. Mainland Chinese companies now make up 35% of Hong Kong's stock market capitalization. In 2001-02 the mainland accounted for the biggest chunk of the world's international share offers when giants such as China Mobile, China National Offshore Corporation and Bank of China listed in Hong Kong.<sup>23</sup>

Because the securities market and privatization are new development only in recent years, the government and corporations do not have mature understanding of capital market. The old planned economy still has its legacy in their belief that

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<sup>19</sup> Lerach, at 120.

<sup>20</sup> "“You can see it in the stock prices,’a hedge fund manager said.” Bowe & Chaffin, Problem for All of Corporate America, Knock-on Effects, FIN. TIMES, June 27, 2002, at 22.

<sup>21</sup> Anthony Bianco, The Angry Market, Investors Are Repricing Stocks to Reflect a More Honest Picture of Earnings, Options and the future, BUS. WEEK, July 29, 2002, at 32.

<sup>22</sup> Jin Rong Ji Gou Beng Wai Bi Shou Zhi Ping Heng Biao (2002) ( The Balance Sheet of Financial Institutions), available at <http://www.pbc.gov.cn/baogaoyutongjishuju/2002S0.htm>

<sup>23</sup> the Weakest Link, 10.

corporations and their employees are the de facto owners. Even though the legal owner of companies before the reform are the state government, which is still true for State owned enterprises,<sup>24</sup> managers and employees had great control of the companies because of life long employment and employment benefits including housing and medical benefits. Excessive government intervention often prevents the securities market from being self-regulated.

Popular attitude towards privatization also hinders the due recognition of private rights. Zhengzhou Baiwen, a listed company once d as the stare of the department store sector and a model of reform for SOEs, fabricated statements using highly questionable accounting methods and was one.<sup>25</sup> Only two years since its flotation in the Shanghai Stock Exchange, its annual sales halved to 3,360 million Yuan and recorded a loss of 523 million Yuan.<sup>26</sup> On March 3, 2000, its biggest creditor Cinda brought bankruptcy action against Zhengzhou Baiwen.<sup>27</sup> Anthony Neoh said that medium and small investors could sue the directors, but he also conceded that there was not specific law allowing such a civil action.<sup>28</sup> Interestingly enough, Zhengzhou Baiwen's employees companied: "we don't understand why Cinda is trying to bring out company to an end . . . [W]e believe that Zhengzhou municipal government and Henan provincial government will not allow us to go bankrupt."<sup>29</sup>

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<sup>24</sup> Cindy A. Schipani & Liu Junhai, Corporate Governance In China: Then And Now, 2002 COLUM. BUS. L. REV. 1, 5 (asserting that "State ownership was considered the highest form of public ownership and the goal of socialism.") Schipani, at 5, fn. 6.

<sup>25</sup> Wei Xinjiang, People's Republic of China: The Legal Features of Chinese Capital Markets in the Light of the Zhengzhou Baiwen Case, Comp. Law, 2002, 23(3), 100.

<sup>26</sup> Wei, at 101.

<sup>27</sup> Wei, at 101.

<sup>28</sup> Shi Zhengmao & Li Qiaoning, Anthony Nioh: Small and Medium-sized Investors Have the Right to Bring a Suit Against Zhengzhou Baiwen, FINANCIAL & ECONOMIC TIMES, Dec. 5, 2000.

<sup>29</sup> Guo Hongchao, ST Zhengzhou Baiwen Will Not Necessarily Go to Bankruptcy, FINANCIAL & ECONOMIC TIMES, Jan. 4, 2000.

The government and law makers see the securities market primarily as a good tool of the capital system to bail out the financially red SOEs.<sup>30</sup> They do not view the common stock owners as ultimate owners of public companies; instead, they believe that investors make money by manipulating the stock market. The corporations use the stock market as a free ATM machine and their sole mission is to get listed by cooking books. Their stock price rarely reflects the return.<sup>31</sup> Some scholars argued that without change of the government officials' mindset inherited from the planned economy, the Chinese stock market will not be on the right track no matter how harsh the administrative or criminal penalty is.<sup>32</sup>

On January 9, 2003, the People's Supreme Court issued the long delayed Interpretation on Civil Compensation Concerning Fraudulent Information Disclosure in the Securities Market, which became effective on February 1, 2003.<sup>33</sup> 1.9 Interpretation supercedes and supplement the Notice the Court issued on January 15, 2002.<sup>34</sup> The new interpretation expanded and clarified the 1.15 Opinion. To certain degree, the interpretation signals a turning point that law makers and judiciaries recognize that investors are the true owners of public companies and they should get compensated if their property rights are violated.

## **II. The People's Supreme Court's Interpretation: Protection of Investors?**

### **A. Prerequisite conditions and Statute of Limitation**

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<sup>31</sup> Song Fengming (Professor in Tsinghua University Business School) & He Jia (Professor in Hong Kong Chinese University Business School), Gu Shi Ying Que Ding Tou Zi Zhe Ben Wei Xin Gai Nian (The Stock Market Should Adopt New Concept With Focus on the Investors), Zhong Guo Zheng Juan Bao (China Securities Journal), Feb. 22, 2003, available at [http://www.cnstock.com/ztyj/hgjj/t20030222\\_377238.htm](http://www.cnstock.com/ztyj/hgjj/t20030222_377238.htm)

<sup>32</sup> Song & He.

<sup>33</sup> (Hereinafter "1.9 Interpretation") Available at <http://www.chinacourt.org/sfjs/detail.php?id=45827>. Only Chinese version is available when this note is written.

<sup>34</sup> 1.9 Interpretation, § 37.

We will see one of the most unique characteristics of Chinese law in the general provisions. The new law lists conditions before plaintiffs can bring civil actions. (1) the CSEC, its agencies, the Finance Ministry, or other administrative agencies with power of administrative sanctions publicize its decision of administrative sanctions against defendants or (2) the people's court has convicted defendants for criminal charges.<sup>35</sup> If defendants appeal for reconsideration of the administrative sanctions or file an administrative action, the court may set aside the trial. If the administrative sanctions are vacated, the court shall dismiss the case with prejudice.<sup>36</sup> Compared to the 1.15 Notice, this new interpretation has expanded the court's jurisdiction. The 1.15 Notice only allows civil action if the CSEC or its agencies have issued administrative sanctions against defendants.

Thus, investors' right to compensation is preconditioned on either defendants' administrative sanctions or criminal conviction. Such an interpretation has no textual basis in the Securities Law and defies the authority of the Legislature. Section 63 of the Securities Law states that the issuer or the company whose reports "contains any falsehood, misleading statement or major omission, thus causing losses to investors" shall be liable for the losses and "the responsible director(s), supervisor(s) and/or manager of the issue or the company shall be jointly and severally liable for such loss." The securities regulatory authority is required to supervise the reports<sup>37</sup> and authorized to seek administrative sanctions against issuers for violation of the disclosure

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<sup>35</sup> 1.9 Interpretation, § 5(1)-(3).

<sup>36</sup> 1.9 Interpretation, § 11.

<sup>37</sup> The Securities Law, § 65.

requirement.<sup>38</sup> The individual rights maintaining civil action and the public law enforcement through administrative actions are parallel in the Securities Law.

This provision will seriously inhibit proper enforcement of the Securities Law. To some degree, the new interpretation tries to strike a balance between protecting investors' rights and limiting frivolous lawsuits. The same argument has been made in the U.S. when corporations, accounting firms, Wall Street bankers and big law firms lobbied the Congress to enact the Private Securities Litigation Reform Act of 1995 ("PSLRA"). Proponents of the PSLRA argued that more onerous requirement of securities litigation would enhance capital formation, increase employment and benefit investors and the U.S. economy.<sup>39</sup> Within A few years after the enactment of the PSLEA, "the Chicken came home to roost."<sup>40</sup> Even in the halcyon days of the late 1990s there were a few people who warned that underneath the contemporary veneer of prosperity and profit laid widespread fraudulent profits, inflated asset values, and executive chicanery. According to the Wall Street Journal, "the companies currently listed on the market that symbolized the New Economy have not made a collective dime since the fall of 1995."<sup>41</sup>

Chinese government is notoriously infested with corruption. Though China has been trying to clean up its gigantic team of functionaries, the government is still running on "guanxi," or personal relations.<sup>42</sup> The CSRC, like other nations' securities regulatory

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<sup>38</sup> The Securities Law, § 177.

<sup>39</sup> William S. Lerach, *Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders*, 8 Stan. J.L. Bus. & Fin. 69, 78 (2002).

<sup>40</sup> Robert Southey, *the Curse of Kehama* (1810).

<sup>41</sup> Steve Liesman, *Heard on the Street, NASDAQ companies' Losses Erase 5 years of Profit*, WALL ST. J. Aug. 16, 2001, at C1.

<sup>42</sup> Contact, *Guanxi, and Dispute Resolution in China* xviii (Tahirih V. Lee 1997) (defining "guanxi" as informal and personal relationships that cultivate mutual loyalty, and were formed to circumvent intrusion by the state); Jerome A. Cohen & John E. Lange, *the Chinese Legal System: A Primer for Investors*, 17

bodies, is so understaffed and poorly funded that frequent abuses are casually overlooked or inadequately investigated.<sup>43</sup> Before the formation of CSRC, the People's Bank of China ("PBC"), China's central bank, was the regulatory body of the securities market.<sup>44</sup> On August 10, 1992, local PBC officials conspired with the local governments and took for themselves share applications forms intended to be distributed to the public for sale.<sup>45</sup> Such rampant corruption of the enforcement bodies will certainly slow down the cleansing process of the securities market.

Under the new interpretation, investors' claim against the market abuse flimsily depends on state's law enforcement. Such a scheme may encourage further market abuse as long as the abusers can maintain *guanxi* with government officials. The CSRC claims to be the watchdog of the securities market, but like all other government branches in China its image in the general public is not transparent and fair in law enforcement. It is thus unlikely that this new interpretation will boost investors' confidence.

Only if we read the interpretation through the lens of Chinese culture and legal tradition can we understand the rationale behind the law. Ever since the Confucius

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N.Y.L. SCH. J. INT'L & COMP. L. 345. 349-50 (discussing the importance of *guanxi* within Chinese culture and the relations between government and private entities); Steven R. Salbu, *Extraterritorial Restriction of Bribery: A premature Evocation of the Normative Global Village*, 24 YALE J. INT'L L. 223, 250 (1990) (noting *guanxi* is a network of personal relationships that the Chinese, among other cultures, are encouraged to use to achieve their objectives).

<sup>43</sup> Cohen & Lange, *supra* note, at 140 (noting the lack of resources available to develop the regulatory institution).

<sup>44</sup> Yao Chengxi, *Stock Market and Futures Market in the People's Republic of China* xvii, 77 (1998); Qian Xuefeng, *Transforming China's Traditional Banking Systems Under the New National Banking Laws*, GA. J. INT'L & COMP. L. 479, 486 (1996) (noting that the PBC

<sup>45</sup> Simon Holberton, *Impasse or Impetus on the Road to Reform: Riots in Southern China Pose a Dilemma for the Leadership's Programme of Liberalization*, FIN. TIMES (London), Aug. 12, 1992 at 12 ("Small investors were angry at having been allegedly cheated by corrupt officials out of the chance to participate in the local stock exchange's latest round of share issues."); Ann. P. Vandeveld, *Realizing the RE-Emergence of the Chinese Stock Market: Fact or Fiction?* 30 VAND. J. TRANSNAT'L L. 579, 592 N. 74 ("Significant fraud and abuse occurred under the decentralized leadership of the PBC, prompting citizen riots in Shenzhen on August 10, 1992.").

school dominated other philosophical schools, including the Legalist school, civil action did not develop as an independent body of law in China; rather, it served like a maid to the administrative and criminal law for the overall purpose of the empire's stability. In Chinese dynasties, administrative courts and judicial courts were the same body and the head of each administrative court functioned as executive, judge and legislator. Private lawsuits were frowned upon in the public and discouraged by the government. The administrative court regarded parties to the lawsuit as "dadan diaomin" (

However, even with such daunting conditions for civil compensation, investors may find the law a big step toward endorsing their rights in court. In 2002 alone, the CSRC sanctioned seventeen companies, and investigated additional seventeen companies.<sup>46</sup> The Ministry of Finance sanctioned four companies. Six companies are under criminal prosecution, of which one was found guilty at trial.

## **B. Jurisdiction**

Court where the issuer or listed company is located has jurisdiction over such actions. If defendants are not issuer or listed company, court where defendant is located has jurisdiction. With defendant's motion or all the plaintiffs' consent, court can order the issuer or listed company to join as co-defendants and remove the case to the court with jurisdiction over the issuer or listed company. Without defendant's motion or plaintiff's consent, court may order the issuer or listed company to join but shall not remove the case.

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<sup>46</sup> Shangzhengbao Touzizhe Weiquan Zhiyuantuan Xujia Chengshu Minshi Peichang An Redian Zuizhong (Shanghai Securities Journal Investor Protection Legal Aid Volunteers Report on Civil Compensation in Fraudulent Disclosure Cases), Shanghai Securities Journal,

Thus, in most cases, plaintiffs have to file their complaints in courts of the issuer or listed company. This new interpretation hampers investors' ability to see wrongdoers. Given China's vast geographic area and uneven development of judicial system, individual investors will probably find it economically infeasible to travel thousands of miles for a few thousand dollars. This new interpretation puts the burden on plaintiffs when defendants are usually big corporations with superior resources.

It is also clear that the People's Supreme Court regards the issuer of listed company primarily responsible for the wrongdoing, or believes that the issuer of listed company has been unjustly enriched from others' wrongdoing. Lower courts have substantial discretion to join the issuer of listed company in civil compensation actions.

### **C. Defendants**

Defendants in fraudulent disclosure civil action include:

- (1) promoter, control shareholders;
- (2) issuer or listed companies;
- (3) securities underwriter
- (4) persons who recommended the securities
- (5) accounting firms, law firms, asset evaluator
- (6) directors, supervisors, managers and other senior management persons of the above entities.
- (7) Catchall provision.

In 1994, the U.S. Supreme Court issued a ruling that law firms, accountants, banks, and others who knowingly “aid and abet” a securities fraud are not liable under federal law.<sup>47</sup>

In the Securities Law, it is prohibited for state functionaries, employees of the news media, stock exchange, securities companies, securities registration and clearing institutions, securities trading service organizations and public intermediary organizations and their employees, as well as the Securities Industry Association and the securities regulatory authority and their staff members to fabricate and disseminate false information, thereby seriously affecting securities trading.<sup>48</sup>

**D. What constitutes fraudulent statement**

- (1) Fabricated: when a person with duty to record state non-existing facts in the disclosure documents
- (2) Misleading: when a person in the disclosure statement or in the media makes statements which significantly causes investors make wrong judgment in their investment
- (3) material omission: when a person with duty to disclose does not in disclosure documents wholly or partially record facts that should be recorded.
- (4) nondisclosure: a person with duty to disclose does not disclose information within the deadline.

This new interpretation does not materially expand the duty of disclosure set forth in the Securities Law. Under Article 59, the documents for the issuing and listing of shares or corporate bonds announced by companies shall be truthful, accurate and

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<sup>47</sup> Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

<sup>48</sup> The Securities Law, § 72-.

complete; they may not contain any falsehoods, misleading statements or major omissions.

In Section 60, Companies whose shares or bonds are listed for trading shall, within two months following the end of the first held of each fiscal year, submit to the securities regulatory authority under the State Council and the stock exchange an interim report with the following contents and announce the same:

- (1) the company's financial and accounting reports and business situation; (what accounting principles?)
- (2) major litigation involving the company;
- (3) the particulars of any changes in the shares or corporate bonds already issued;
- (4) any important matters submitted to the shareholders' general meeting for consideration; and
- (5) other matters specified by the securities regulatory authority under the Sate Council.

Article 61, Companies whose shares or bonds are listed for trading shall, within four months following the end of each fiscal year, submitted to the securities regulatory authority under the State Council and the stock exchange an annual report with the following contents and announce the same:

- (1) a brief account of the company's general situation;
- (2) the company's financial and accounting reports and business situation;
- (3) a brief introduction to the directors, managers and the senior management persons and information with respect to their shareholdings;

(4) the details of shares and corporate bonds already issued, including the name list of the 10 shareholders who hold the largest numbers of the shares in the company and the number of shares by each of them; and

(5) other matters specified by the securities regulatory authority under the State Council.

Section 62, when a major even occurs that may considerably affect the price at which a listed company's shares are traded and that is not yet known to the investors, the listed company shall immediately submit an ad hoc report on the details of such major event to the securities regulatory authority under the State Council and to the stock exchange and make the same known to the general public. In the report the essence of the even shall be stated clearly.

For purpose of the preceding paragraph, the term "major event" means:

- (1) a major change in the company's business guidelines or scope of business;
- (2) a decision made by the company concerning a major investment or major asset purchase;
- (3) conclusion by the company of an important contract which may have an important effect on the company's assets, liabilities, rights, interests or business results;
- (4) incurrence by the company of a major debt or default on an overdue major debt;
- (5) incurrence by the company of a major deficit or incurrence of a major loss exceeding 10 percent of the company's net assets;
- (6) a major change in the external conditions of the company's production of business;
- (7) a change in the chairman of the board of direction, no less than one third of the directors or the manager of the company;

- (8) a considerable change in the holdings of shareholders who each hold not less than 5 percent of the company's shares;
- (9) a decision made by the company to reduce its capital, to merge, to divide, to dissolve, or to apply for bankruptcy;
- (10) major litigation involving the company, or lawful cancellation by a court of a resolution adopted by the shareholders' general meeting or the board of directors;
- (11) other events specified in laws or administrative regulations.

The PSLRA of 1995 the “safe harbor” eliminates liability for even intentionally false financial projections and forecasts.<sup>49</sup> The new interpretation does not reserve any safe harbor for false information. If the company makes statements that will significantly cause investors to make wrong judgment, the company is guilty for making misleading statement.

## **E. Loss Causation**

### Elements of Causation

- (1) the securities that plaintiffs invest must have direct relationship with fraudulent statement
- (2) plaintiffs bought the securities between the date when the fraudulent statement was made and the date when the statement was exposed or corrected.
- (3) Plaintiffs suffer loss when they sell the securities or keep holding the securities.

The court will not find loss causation if

- (1) plaintiffs sold the securities before the date when the statement was exposed or corrected
- (2) plaintiffs invested after the date when the statement was exposed or corrected.

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<sup>49</sup> 15 U.S.C. § 78u-4(f)

- (3) Plaintiffs invested despite their knowledge of fraudulent statement
- (4) the loss is wholly or partly caused by the securities market's system risk.
- (5) Malicious or manipulative investment.

Fraudulent statement is exposed in national media such as newspaper, journal, radio, TV. Fraudulent statement is corrected when defendants voluntarily announce correction in the media that the CSRC designated as a reporter of the market information.

It is not hard to imagine the following scenario. An investor bought the securities before the date when the fraudulent statement was made. When the media exposed the fraudulent statement or the CSRC initiated an administrative action against the listed company for the wrong doing, its stock plummeted to a price even lower than prior to the time when the fraudulent statement was made. Under the new interpretation, the investor cannot sue the listed company for compensation because the second element was not met.

The most troubling and criticized provision is that court cannot find loss causation if plaintiffs sold the securities before the date when the statement was exposed of correct. ST<sup>50</sup> Dongfang (East) is a good example to analyze this issue. ST Dongfang was a blue chip stock before the sudden plunge of its price. Between July 16, 2001 and September 10, 2001, its stock price decreased about 50% from 17.44 Yuan<sup>51</sup> to below 9

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<sup>50</sup> Unprofitable companies will have "special treatment" by the CSRC and "ST" is placed before the company symbol. The price of ST stock can only change five percent over or under the previous day's closing price. Shanghai Stock Exchange Stock Listing Regulations, §§ 9.1.1-3, <http://www.sse.com.cn/cs/zhs/xxfw/flgz/html/t23001.htm#9>, see also, Forced delisting rules may be too strict for investors, South China Morning Post, Feb. 27, 2001, available at 2001 WL 14784278.

<sup>51</sup> Yuan is Chinese dollar and its exchange rate is 8.2772 per U.S. dollar in December 2002, <http://www.pbc.gov.cn/baogaoyutongjishuju/2002S5.htm>

Yuan.<sup>52</sup> The company made three public announcements. On July 25, 2001, it said that “up till now, the company has disclosed all required information. It will honor its duty of disclosure and disclose the company’s information completely, accurately and punctually.” However on September 10, the company announced that it was under investigation by the CSRC and cautioned its investors against investment risk. On October 15, the company again announced that it had problem in information disclosure and profit determination, and the investors should follow the CSRC’s investigation.

Under the new interpretation, the ST Dongfang’s investors must prove that they did not sell stock before the date when ST Dongfang corrected its wrongdoing or its wrongdoing was exposed in the media even though the CSRC had initiated its administrative action and ST Dongfang’s three officers received criminal conviction.<sup>53</sup> The question thus becomes which date is the exposure or correction date. Some investors might be more experienced and started selling their stock when they saw the July 25 announcement. The July 25 announcement is hardly a correction or exposure of fraudulent statement. Even September 10 is not the exposure or correction date. Thus, those injured investors who sold before these dates cannot have a claim against ST Dongfang even though the company has made fraudulent statement. The new interpretation focused instead on the exposure or correction, not the wrongdoing itself. Such a scheme further encourages the insider information and market manipulation since investors raced to dump their stock due to the uncertainty of civil compensation at court. On the other hand, this interpretation also signals that investors should not sell their stock when the stock price goes down. They should keep the stock and wait for

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<sup>52</sup> Peoples Daily, Jan. 24, 2003, available at <http://www.peopledaily.com.cn/GB/jinji/35/159/20030124/913695.html>.

<sup>53</sup> People Daily, Jan. 21, 2003.

administrative action. Such a scenario is unrealistic and counter-productive. Individual investors cannot foresee that every price fluctuation is caused by fraudulent statement. The inefficient and corrupt government law enforcement and unpredictable civil action further make this new interpretation harsh to individual investors.

Furthermore, this loss causation element induces wrongdoers to postpone the announcement or to use ambiguous words so that they may argue in the court that the correction or exposure date is much later and those who sell their stock before that date do not meet the loss causation element. When the wrongdoers know the investigation by the CRSC is imminent, they can make numerous announcements in the media hinting that they are in some trouble but never expressly admit their wrongdoing. Most reasonable investors probably would have sold their stock before the CRSC's formal investigation. Thus, in the end, the wrongdoers can reduce the amount of damage claim to minimum.

One securities lawyer involved in these cases estimated that plaintiffs in 10-30% of the almost 900 pending cases would not be able to prove the loss causation.<sup>54</sup> In one such case, plaintiffs sold their stock before the fraudulent disclosure was exposed when the CRSC issued its administrative sanctions against Sanjiu Yiyao Limited Co. for failing to disclose its 16.9 billion Yuan transaction and transfer of 1.243 billion Yuan to its subsidiaries. The six plaintiffs had voluntarily moved to dismiss the case.<sup>55</sup>

Before the promulgation of the new interpretation, one Justice of the Supreme People's Court remarked that "when calculating the losses of the investors, judges should be able to distinguish between the fluctuation of stock prices caused by the

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<sup>54</sup> Guo Ji Jin Rong Bao (International Finance) C-7, Jan. 23, 2003, available at [www.peopledaily.com.cn/GB/jinji/35/159/20030123/913069.html](http://www.peopledaily.com.cn/GB/jinji/35/159/20030123/913069.html).

<sup>55</sup> Guo Ji Jin Rong Bao, Jan. 23, 2003.

dissemination of fraudulent information and that caused by other elements.”<sup>56</sup> To the contrary, the new interpretation arbitrarily decides that losses are not caused by “the dissemination of fraudulent information” if investors sell their stock before the exposure or correction of the fraudulent information. Such a scheme can help speedy trial considering the inexperience of lower court judges. However, a law that does not correctly reflect the social reality can dangerously lead the public to lose confidence in rule of law, when China is transforming from rule of man to rule of law.

#### **F. Liability<sup>57</sup>**

Defendants are jointly and severally liable. The new law imposes strict liability on the promoter, issuer or listed company. All other defendants are not liable if they can prove their innocence in the wrongdoing.

Directors, executives, managers and other higher level managerial employees of the defendant companies are jointly liable with their companies if they:

- (1) participate in making the fraudulent statement; or
- (2) know or should know the fraudulent statement but do not expressly oppose the statement;
- (3) catchall provision.

The Securities Act of 1933 and 1934 create an extensive scheme of civil liability. Private plaintiffs may sue under the express private rights of action contained in the Acts and under private rights of action implied by the terms of §10(b) of the 1934 Act.<sup>58</sup> The SEC adopted Rule 10b-5 in 1942, which cast the proscription of §10(b) in similar

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<sup>56</sup> Court Vice-President Lays Down Fraud Law, China Bus. Info. Network P13, Dec. 13, 2002, available at 2002 WL 101713657.

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<sup>58</sup> Superintendent of Ins. Of N.Y. v. Bankers Life & Casualty Co., 404 U.S. 6, 13, n. 9 (1971).

terms.<sup>59</sup> The U.S. Supreme Court however held that private plaintiffs may not bring a 10b-5 action for acts not prohibited by the text of 10(b) and in cases considering the scope of conduct prohibited by 10(b) emphasized adherence to the statutory language, “the starting point in every case involving construction of a statute.”<sup>60</sup> The Court rejected the SEC’s argument that the broad congressional purpose behind the 1934 Act to protect investors from false and misleading information suggested that negligent act could violate 10(b).<sup>61</sup> The Court reasoned that the use of words “manipulative,” “device,” and “contrivance” denotes an unmistakable congressional intent that the 10(b) only proscribed “intentional or willful conduct designed to deceive or defraud investors.”<sup>62</sup>

The new Chinese law holds the issuer or listed company strictly liable for any falsehood, misleading statement or major omission. The law thus does not require scienter of the issuer company. Such an interpretation may seem harsh on its surface, but it has reasonably presumed fraud on the part of the defendant company when courts only take jurisdiction over cases in which defendant companies already have

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<sup>59</sup> Section 10(b) states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe.

15 U.S.C. 78j.

Rule 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 CFR §240.10b-5 (1993).

<sup>60</sup> Ernest & Ernest, 425 U.S. 185, 197 (1976).

<sup>61</sup> Ernest & Ernest, at 198.

<sup>62</sup> Ernest & Ernest, at 198.

administrative sanction or criminal conviction. Considering the rampant fraud in information disclosure in the Chinese securities market, only serious violators can get the CSRC's attention. Another factor for this seemingly harsh interpretation is that lower Chinese courts are often unfamiliar with the complicated Securities law and incompetent to judge scienter.<sup>63</sup> Strict liability at least guarantees injured investors compensation from the enriched listed companies.

### **G. Damages**

If the fraudulent statement causes the securities to be delisted, plaintiffs shall get back the price they paid for the securities plus interest. Plaintiffs' damage in the civil action is limited to the actual loss.

### **Conclusion**

Stability has always been a major concern of every government in Chinese history. It is now an obsession when the economic reform disenfranchised a large proportion of population and new social order is still in its nascent formation. The Supreme People's Court joined the government for the common goal of social stability by authorizing individuals to voice their rights under limited conditions. The interpretation conditions individuals' rights on administrative action and criminal conviction of defendants. Such an interpretation has no textual basis in the Securities Law and evidences a quasi but incompetent legislative role the Supreme People's Court played in balancing individual rights and state interest. Redrafting by the Court will disrupt the systematic law the Securities Law aims to create and renders investors and companies disrespectful of the law. Though the Supreme People's Court is responsible

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to the National People's Congress and its Standing Committee,<sup>64</sup> the Court here again aligns itself with the administrative body.

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<sup>64</sup> The Constitution of the People's Republic of China, Art. 128, available at <http://english.peopledaily.com.cn/constitution/constitution.html>