Enforcement Strategies in The Chinese Capital Market

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Abstract

This chapter discusses the varieties of enforcement channels to protect investors, especially minority shareholders in the Chinese capital market. These channels include public enforcement by regulators such as the China Securities Regulatory Authority and the stock exchanges, and private enforcement in the form of litigations enabled by corporate and securities laws. Furthermore, alternative dispute resolutions are increasingly popular to resolve disputes. In this chapter, it is argued that all these enforcement channels together function as part of a comprehensive and integrated regulatory strategy to provide the much-needed law in action to support the phenomenal economic and financial growth in the country.

Biography of the Authors

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Introduction

With the establishment of stock exchanges in the 1990s, Chinese capital markets have made remarkable progress and have played an increasingly important role in China's economic development. By the end of 2018, 3,584 companies were listed on Shanghai and Shenzhen Stock Exchanges (SHSE and SZSE),[1] with a total market capitalisation of RMB43.5 trillion, accounting for 48% of China's GDP, second to the US globally.[2] However, 87% of stock accounts were individual investors, representing 85% of the total securities trading volume.[3] As a vulnerable group of market participants, many Chinese individual investors are low or middle incomers, and lack basic financial and investment knowledge. Thus, it is particularly important to protect them through strong enforcement of securities law.

Public enforcement and private enforcement are two broad enforcement strategies of securities law. Their functions and deficiencies have been widely discussed in literature.[4] For instance, public enforcement has advantages over the power to investigate and impose severe penalties. By contrast, private enforcement plays an important role in compensating investors, which public enforcement usually cannot perform. But private litigation also has its own weakness that investors tend to encounter obstacles of high cost and burden of proof, which may hamper the effectiveness of such remedies. In addition, alternative dispute resolution (ADR) is also increasingly being adopted as an important tool to settle disputes alongside the court systems in capital market.

Regarding shareholder protection law, China, along with Russia and France, were the top performers in 2013 amongst 30 countries, according to the Shareholder Protection Index compiled by the Cambridge Centre for Business Research.[5] In

[1] In addition to the stock exchanges, the National Equities Exchange and Quotations (NEEQ, known as the New Third Board) was established in Beijing in 2012. It is an over-the-counter national securities trading markets for Chinese small and medium size companies who cannot list on the main board markets. By the end of 2018, 10,691 companies were listed on the NEEQ. See more information at <http://www.neeq.com.cn/en/about_neeq/introduction.html> accessed 29 September 2019.

[2] CSRC, Annual Report 2018, 27, available at <http://www.csrc.gov.cn/pub/newsite/zjhjs/zjhnb> accessed 15 September 2019.

[3] Ibid, 33.

[4] E.g. John Coffee, 'Law and the Market: The Impact of Enforcement' (2007) 156 University of Pennsylvania Law Review 229; Howell Jackson & Mark Roe, 'Public and Private Enforcement of Securities Laws: Resources-Based Evidence' (2009) 93 Journal of Financial Economics 207.

[5] Dionysia Katelouzou and Mathias Siems, 'Disappearing Paradigms in Shareholder Protection: Leximetric Evidence for 30 Countries, 1990-2013' (2015) 15 Journal of Corporate Law Studies 127, 134.

contrast and as the focus of this chapter, it is perceived that the law in action may remain a concern. For example, the World Justice Project's Rule of Law Index 2019, placed China at 12th out of 15 countries in the East Asia and Pacific region, and 82th out of 113 countries and jurisdictions worldwide.[6] Veteran investors may still be haunted by the Yin Guangxia scandal and the resulting suspension of all securities-related lawsuits by the Supreme People's Court (SPC) between 2001 and 2003.

However, after more than a decade since the episode, there has been much improvement in the Chinese regime and there are multiple monitoring and enforcement mechanisms as the deterrence to fraudulent market activities. Therefore, this chapter provides a comprehensive analysis of China's securities enforcement involving public enforcement, private enforcement and ADR. Each section addresses one enforcement mechanism, followed by a conclusion at the end.

1. Public Enforcement

The China Securities Regulatory Commission (CSRC) plays a key role in the regulation and supervision of China's securities industry. Established in October 1992, the CSRC is a ministry-level government agency directly under the State Council. It is responsible for formulating securities rules and regulations, and investigating major market misconducts or violations as well as issuing administrative and non-administrative sanctions.[7]

To exercise its responsibilities, the CSRC's headquarters in Beijing are complemented by its 38 regional offices and two stock exchanges. The regional offices are the frontline supervisors of their respective jurisdiction including the oversight of listed companies, the investigation of misconduct, the implementation of investor protection initiatives and investor education.[8] In 2011, the CSRC launched a pilot project granting three regional offices in Shanghai, Guangdong and Shenzhen with the authority to issue administrative sanctions against minor infractions. In October 2013 all regional offices were granted with such authority.[9]

[6] 'World Justice Project Rule of Law 2019', available at <https://worldjusticeproject.org/our-work/research-and-data/wjp-rule-law-index-2019> accessed 15 September 2019.

[7] For more functions of the CSRC, see the CSRC's website <http://www.csrc.gov.cn/pub/newsite/zjhjs/zjhjj> accessed on 4 September 2019.

[8] The duties and functions of the regional offices were outlined in the 'Provisions on the Regulatory Functions of Regional Offices of the CSRC' issued by the CSRC on 29 October 2015.

[9] Before 2011, the regional offices only were allowed to issue non-administrative sanctions, see 'Zhengjianhui Shidian Xiafang Xingzheng Chufaquan' (CSRC Attempts to Decentralise Administrative Sanctions), available at <http://finance.ifeng.com/roll/20101102/2811349.shtml> (accessed 4 September 2019).

1.1.Procedures for Regulatory Enforcement

The CSRC promulgated 'Implementation Measures for the Case Investigation' on 11 March 2008 to prescribe the procedures of investigation, hearing, filing and enforcement. Pursuant to the Implementation Measures, the CSRC's Enforcement Bureau was assigned to supervise case investigation and enforcement, and to coordinate the handling of cross-country cases. To strengthen its control over listed companies' governance, the CSRC can conduct the on-the-spot inspection on listed companies by means of photocopying documents and materials, examining the objects, interviewing and inquiring company officers.[10]

The CSRC will publish its investigation results if misconduct is detected, but If the infringements are only minor then the CSRC will give an internal warning to the company or securities firm and there will be no public disclosure of either the investigation or its outcome. Public admonishments take four main forms, which are public criticism, public condemnation, official warning, and monetary fines. Public criticism and public condemnation are the two mildest forms of admonishment, followed by official warning and then fine (which is the most severe). For individuals, the sanctions can include criminal prosecution with severe penalties. The CSRC can also freeze or seal up the illegal capital, securities, and other properties or important evidence in market misconduct cases.[11]

To restore trust in the capital market, the CSRC launched an internet-based public inquiry platform for dishonesty records in 2012, where the public can access information on records of administrative sanctions and market-entry bans imposed on market participants.[12] All market participants including legal and financial practitioners, listed companies and their managers and major shareholders, fund companies and their managers, financial intermediaries, are recorded in these credit files. In addition, the SPC and CSRC exchange information on dishonest individuals who are subject to enforcement actions by

[10] Article 2 of ' Measures for the Spot Inspection of Listed Companies' issued by the CSRC on 13 April 2010.
[11] Article 3 of 'Measures of CSRC for Freezing and Sealing' issued by the CSRC and revised on 23 May 2011.
[12] The establishment of the credit database was provided by the 'Interim Measures for the Supervision and Administration of Credibility of Securities and Futures' which were issued by the CSRC on 25 July 2012. Then they were replaced by the 'Measures for the Supervision and Administration of Credibility of Securities and Futures' which were enacted on 2 November 2017 and took effect on 1 July 2018, available at <http://www.csrc.gov.cn/pub/newsite/flb/flfg/bmgz/zhl/201805/t20180515_338128.html> accessed 15 September 2019.

any courts in China.[13] The integrity of credit database provides confidence to investors and enhances the enforcement strategy in securities markets.[14]

1.2.Enforcement Intensity of the CSRC

The CSRC has been traditionally labelled as 'toothless tiger' owing to its ineffectiveness in identifying and prosecuting fraud, lack of independence from the state and the susceptibility to political pressures.[15] Thus this section aims to analyse the enforcement actions taken by the CSRC to see whether it functions or not in Chinese securities markets.

The enforcement intensity by the CSRC is illustrated by the figures on its enforcement outputs including the number of enforcement actions and the amount of fines and disgorgement in Figure 1. In 2011, the CSRC investigated 209 cases, disqualified 11 market participants and issued 57 administrative sanctions at the value of RMB 348 million.[16] In 2018, the administrative sanctions were intensified with 310 orders made (5.4 times of those in 2011), resulting in RMB 10,641 million in fines and disgorgements (30.6 times of those in 2011), and 22 market-entry bans against 50 individuals.[17] All hit a new record high. Insider trading, non-compliant information disclosure and market manipulation were the main types of misconduct in the market. However, these figures reveal little information without further comparison to other countries. The following therefore compares the enforcement outputs between China and the US, perceived as one of the jurisdictions with strongest securities enforcement.[18]

Figure 1: A Summary of the CSRC's Penalties in 2011-18

[13] Ibid, pursuant to the Article 8 of the new Measures, there are three types of information collected on the database: basic information, positive information and negative information. Basic information is referred to the personal details of legal persons and organisations. Positive information includes commendations, rewards or appraisal granted by the CSRC or other national industrial organisations. Negative information include information on the status of fulfilment of public commitments, investigation by public security, administrative and criminal penalties as well as civil liabilities

[14] Junhai Liu, 'Qianghua Ziben Shichang Chengxin Jianshe de Ruogan Sikao' (Some Thoughts on Enhancing Credibility in the Capital Market) (2012) 2 Securities Law Review 649.

[15] See e.g. Daniel Anderson, 'Taking stock in China: Company Disclosure and Information in China's Stock Markets' (2000) 88 Georgetown Law Journal 1919; and Gongmeng Chen et al, 'Is China's Securities Regulatory Agency a Toothless Tiger? Evidence from Enforcement Actions' (2005) 24 Journal of Accounting and Public Policy 451.

[16] The CSRC's Annual Report 2011, 30-31.

[17] The CSRC's Annual Report 2018, 60.

[18] Coffee, and Jackson find that the intensity of securities enforcement actions in the US appears to be strikingly higher than other major jurisdictions. See Coffee (n 4); and Howell Jackson, 'Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implication' (2007) 24 Yale Journal on Regulation 253.

Year	Administrative Sanctions	Market-Entry Bans	Disgorgements and Fines (RMB million)
2011	57	11	348
2012	56	8	437
2013	79	21	728
2014	158	18	470
2015	177	11	1100
2016	221	21	4280
2017	224	25	7479
2018	310	22	10,641

Sources: the CSRC's Annual Reports 2011-18.

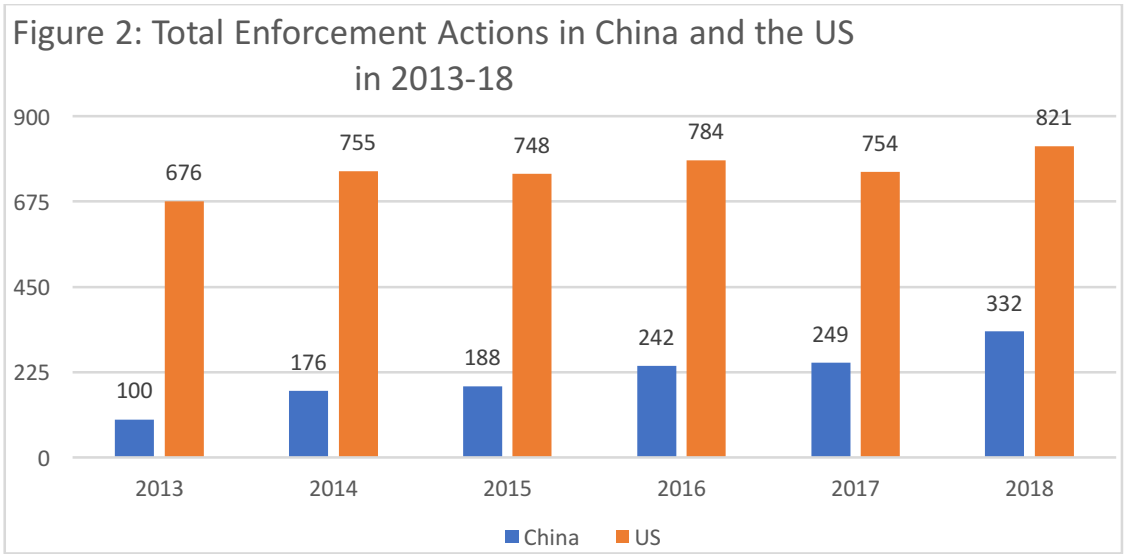
At first glance China's public enforcement output was far below than the US in terms of enforcement actions, disgorgements and fines in Figures 2 and 3. In 2013, the CSRC took 100 enforcement actions (15% of the US) and imposed $102 million financial penalties (3% of the US). But the ratio has dramatically increased in recent years, for instance, 40% of the US in enforcement actions and 38% of the US in financial penalties in 2018. Taking into account the fact that the US's market capitalisation was approximately five times larger than that of China at the end of 2018,[19] China's enforcement record may not be as weak as it seems. Moreover, considering that the CSRC's regulatory budget was far below than that of the SEC (roughly 10%) as in Figure 4, the CSRC's enforcement intensity seems to be justifiable given the limited resource to which it has access.[20]

The CSRC is moving towards using administrative measures and sanctions in a more vigorous way, including through the imposition of larger monetary penalties and bans on the full range of market participants. According to the IMF's financial sector assessment on China, the CSRC's enforcement powers to

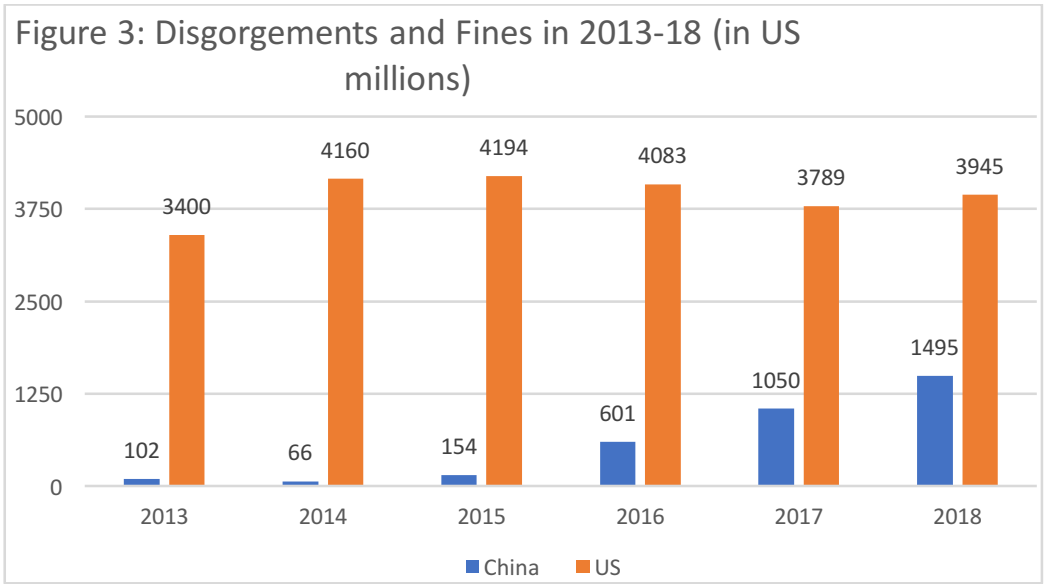
[19] By the end of 2018, China's stock market capitalisation was $6,325 trillion while the US's was $30,436 trillion. See the World Bank, 'Market Capitalisation of Listed Domestic Companies', available at <https://data.worldbank.org/indicator/cm.mkt.lcap.cd?name_desc=false> accessed 11 September 2019.

[20] This observation is also consistent with the studies by Flora Huang, 'In Defence of China's Public Enforcement in Equity Market' (2010) 21(10) International Company and Commercial Law Review 327; and Tianshu Zhou, 'Is the CSRC Protecting a "Level Playing Field" in China's Capital Markets: Public Enforcement, Fragmented Authoritarianism and Corporatism' (2015) 15(2) Journal of Corporate Law Studies 377.

impose appropriate sanctions continue to be enhanced.[21] The level of fines and penalties increased for both administrative sanctions and criminal offences, including in the latter case the terms of imprisonment. But criminal sanctions, in particular imprisonment, need to be used more vigorously to punish the most egregious violations and send clear deterrence message to the market.

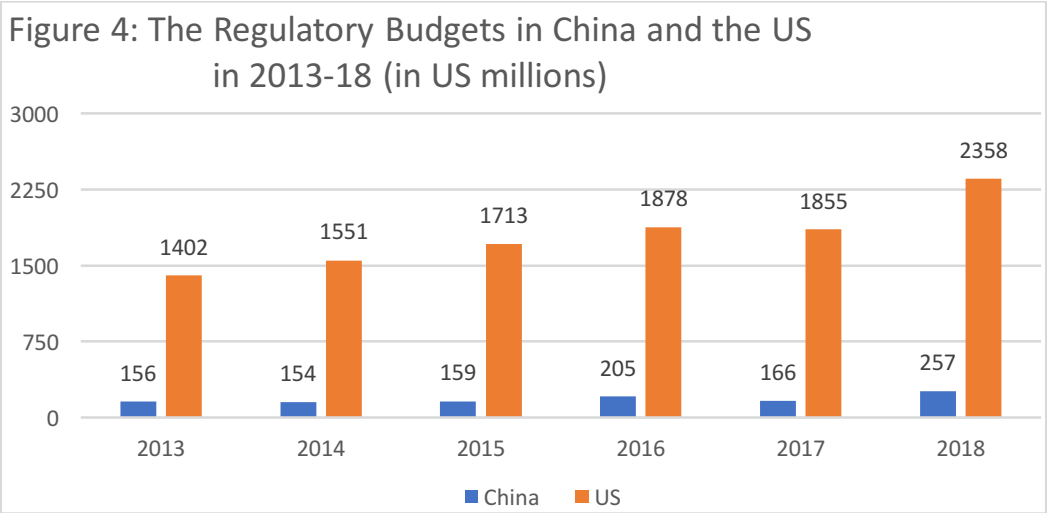


Sources: the CSRC's Annual Reports 2013-18; and the SEC's Division of Enforcement Annual Report 2018 and the Year-by-Year SEC Enforcement Statistics 2013-18.



[21] IMF, 'PRC: Financial Sector Assessment Program- Detailed Assessment of Observance of the IOSCO Objectives and Principles of Securities Regulation' (2017), 6-7, available at <https://www.imf.org/en/Publications/CR/Issues/2017/12/26/Peoples-Republic-of-China-Financial-Sector-Assessment-Program-Detailed-Assessment-of-45517> accessed 16 September 2019.

Sources: the CSRC's Annual Reports 2013-18; and the SEC's Division of Enforcement Annual Reports 2013-18.



Sources: the CSRC's Financial Reports 2013-18 and the SEC Agency Financial Reports 2013-18.

1.3.Reputational Sanctions by the Stock Exchanges

As a self-regulatory body, Chinese stock exchanges have four primary regulatory tools for the violation of their listing rules: correction orders (*Zeling gaizheng*), circulated criticism (*Tongbao piping*), public criticism (*Gongkai qianze*) and punitive damages (*Chengfaxing weiyuejin*).[22] The first three tools mainly are reputational sanctions while punitive damages were newly introduced in 2018 as extra-compensatory damages to punish the defendant for his wrongful conduct. Correction orders are generally issued for only minor infractions. Circulated criticism is slightly more serious, but is still relatively minor notice to unusual company arrangements or activities. A public criticism (*gongkai qianze*) is the most serious step of reputational sanctions taken by the exchanges against listed companies.

The use of public criticism as a regulatory device was originated in the London Stock Exchange, and then borrowed by the Hong Kong Stock Exchange.[23] Chinese exchanges, in turn, modelled their practice on Hong Kong. A study by

[22] Shanghai Stock Exchange Listing Rules 2019, ch. 17, available at <http://www.sse.com.cn/lawandrules/sserules/main/listing/stock/c/c_20190430_4801807.shtml> accessed 18 September 2019; and Shenzhen Stock Exchange Listing Rules 2018, ch.17, available at <https://www.szse.cn/lawrules/rule/listed/stock/P020190228665756581243.pdf> accessed 18 September 2019.

[23] Benjamin Liebman and Curtis Milhaupt, 'Reputational Sanctions in China's Securities Market' (2008) 108(4) Columbia Law Review 929, 948.

Armour and others shows that penalised companies suffered a significant reputational damage including abnormal share price loss and negative reactions from trading partners and third parties.[24] This is also consistent with the observation from Chinese markets that public criticisms have significant effects on listed companies and their executives. Abnormal stock price returns occur in response to corporate disclosure of the underlying misconduct giving rise to the criticisms, as well as in response to the announcements of the criticisms themselves.[25]

The stock exchanges may issue public or non-public sanctions against listed companies depending on whether the market misconduct is minor or serious. The 'Standards of Public Criticism on the Listed Companies on SME Board' published by the SZSE in 2013 provide a list of market misconducts subject to public criticism.[26] The degree of the infringement depends on its effect, the amount of money involved, frequency, the duration of its violation and the conclusion of such violations by the relevant administrative and judicial authorities. The listed company or their directors and senior officers which have ever been publicly condemned by the stock exchange within the recent 12 months are prohibited to issue public securities.[27] Compared to 57 orders of public criticism issued by the two stock exchanges in 2017, the numbers of such sanctions increased 40% to 80 orders in 2018.[28] The reasons for the increasing number of these sanctions are probably public pressure arising from unsatisfied performance of the stock market and the enhancement of frontline supervision of the stock exchanges.[29]

Both the exchanges and CSRC have the enforcement power of securities regulations, but what are the relationships between them? Firstly, the exchanges mainly take actions against the breach of disclosure compliance by listed

[24] John Armour et al, 'Regulatory Sanctions and Reputational Damage in Financial Markets' (2017) 52(4) Journal of Financial and Quantitative Analysis 1429.
[25] Liehman and Milhaupt (n 23).
[26] The 'Standards of Public Criticism on the Listed Companies on SME Board' is available at <http://www.szse.cn/lawrules/rule/listed/smeboard/P020190228665753355052.pdf> accessed 11 September 2019.
[27] Articles 11 and 39 of the 'Administrative Measures for the Issuance of Securities by Listed Companies' issued by the CSRC on 5 May 2006 and revised on 10 September 2008.
[28] In 2017, 21 public criticism orders were made by the SHSE (35 in 2018) and 36 orders were made by the SZSE (45 in 2018). See regulatory sanctions and disciplinary punishment from the websites of SHSE <http://www.sse.com.cn/disclosure/credibility/supervision/measures> and SZHE <http://www.szse.cn/disclosure/supervision/measure/index.html> accessed 15 September 2019.
[29] 'RIjun dui 62 qi Yichang Jiaoyi Caiqu Cuoshi: jiaoyisuo Yixian Jianguan Zhineng Zengjiang' (Sanctions on 62 Market Transactions Every Week: Strengthening the Frontline Supervision of the Stock Exchanges), (Securities Times, 6 August 2018), available at <https://www.sac.net.cn/tzzyd/zxsd/wqbh/201808/t20180806_136117.html> accessed 29 September 2019.

companies while the CSRC deters major market misconduct such as manipulation and insider dealing. But the CSRC can appoint the exchanges to conduct investigation and evidence collection in severe cases.[30]

Secondly, in contrast to administrative and non-administrative sanctions by the CSRC, the exchanges as self-regulatory organisations have no power to issue administrative sanctions. But their non-administrative sanctions such as public criticism, have brought significant reputational costs to listed companies.[31] In addition, the exchanges have listing authority to monitor listed companies' compliance with listing obligations and two powerful weapons, such as temporary suspension of trading and delisting, to discipline them.[32] All these enforcement actions taken by the stock exchanges can also serve as evidence of misrepresentation and consequently prompt securities civil suits.

Thirdly, the stock exchanges can determine the violations of the parties and implement corresponding self-regulatory measures based on the administrative penalty decisions and regulatory actions which have been made by the CSRC or judicial judgement.[33] If there is any violation undiscovered by those CSRC' sanctions and judicial judegment, the stock exchanges may further implement self-regulatory actions.

2. Private Enforcement

There is little doubt that private litigations serve as an indispensable part of the securities enforcement system. Distinct from the systems in other jurisdiction, Chinese securities litigation entails a dependence on public enforcement, typically prior to 2003 when the courts were absent in dealing with private securities actions.[34] China has recently started to implement a general policy to promote investor protection in the development of capital markets. This section looks at the legal development of private enforcement in China, particularly two forms of private litigations, namely derivative action and class action.

2.1. Legal and Judicial Development

[30] CSRC, 'CSRC Entrusts Shanghai and Shenzhen Stock Exchanges to Conduct Investigation of Cases' published on 22 September 2014.
[31] Wenming Xu et al, 'An Empirical Analysis of the Public Enforcement of Securities Law in China: Finding the Missing Piece to the Puzzle' (2017) 18(2) European Business Organisation Law Review 367, 371.
[32] See Articles 55 and 56 of the Securities Law 2014.
[33] SZSE, 'Self-Regulatory Measures and Disciplinary Actions 2018', Article 7.
[34] Jin Sheng, 'Private Securities Litigation in China: Passive People's Courts and Weak Investor Protection' (2015) 26(1) Bond Law Review 94.

The first Chinese securities law 1998 provided civil liability for market misconduct in principle, but there were no detailed provisions to implement the remedy. With a sudden outbreak of corporate scandals in 2001, many investors brought lawsuits for compensation loss resulting from those scandals. In this respect, three important notices on private securities litigation were issued by the SPC in 2001, 2002 and 2003 respectively.

The SPC First Notice 2001 temporarily prohibited lower courts from accepting civil compensation claims over market misconduct, owing to 'legislative and judicial limitations at that moment'.[35] However, this notice attracted severe criticism by many, and the public pressure forced the SPC to lift the temporary ban by issuing the Second Notice 2002. The second notice permitted courts to selectively accept misrepresentation cases, but not those claims arising from insider trading and market manipulation.[36] This notice only had five brief provisions, leaving many issues unaddressed. Some critics have argued that Chinese courts screened and selected financial disputes on account of incomplete law, the incapacity of courts to react to changing financial markets and the political consideration of maintaining social stability.[37] Then the SPC issued the Third Notice 2003 which contained 37 detailed provisions to set up a relatively complete legal framework for private securities litigation in China.[38] For instance, it stipulated the different types of misrepresentation, the scope of eligible plaintiffs and potential defendants, the availability of defences, the rebuttable presumption of causation and reliance, and the calculation of damages. All these have served as useful guidelines for bring and hearing securities cases in China.

A unique feature of the SPC Third Notice 2003 is the procedural prerequisite to require a prior criminal judgement or administrative sanction by the relevant bodies, notably the CSRC, if a securities civil suit is to be brought.[39] The reason is that the courts lack the resources and expertise to decide the complicated questions in securities markets, better putting the CSRC as a specialised regulatory body to handle that issue. However, many argue that the prerequisite should be removed as it limits the scope of private securities litigation.[40] Investors

[35] The 'Notice of the SPC on Temporary Refusal of Filings of Securities-Related Civil Compensation Cases' was issued by the SPC on 21 September 2001.

[36] The 'Notice of the SPC on Relevant Issues of Filing of Civil Tort Dispute Cases Arising from Misrepresentation on the Securities Market' was issued by the SPC on 15 January 2002.

[37] Tao Huang, 'The Screening Mechanism of Financial Legal Disputes in Chinese Courts (Zhongguo Fayuan Shouli Jinrong Anjian de Shaixuan Jizhi Pingxi) (2011) 1 The Jurist 114.

[38] The 'Provisions of the SPC Concerning the Acceptance and Trial of Civil Compensation Securities Suits Involving Misrepresentation' was issued by the SPC on 9 January 2003.

[39] Ibid, Article 6.

[40] E.g. Junhai Liu, 'The Need for Introducing 10 Times Fine Penalty in the Capital Market: Learn from the "Financial Disclosure Scandals of Kangmei & Kangdexin"' ("Liangkuang Caiwu Shijian" Tuxian Ziben Shichang xu

may not be able to bring suits in the event that the CSRC fails to take appropriate action due to factors like limited resources and even corruption problems.

In line with the SPC rules, the Securities Law was subsequently revised in 2004 and 2014 to contain 48 provisions regarding criminal liabilities, administrative sanctions, fines and civil liabilities for violation of securities law.[41] This is a significant development because the Securities Law as a national law enjoys a higher level of legal force than other rules by the CSRC, thereby providing a more solid foundation for private securities litigation.

On the other hand, the CSRC has taken an active role in developing mechanisms aimed at enhancing the ability of investors to exercise their rights. In particular, the Investor Services Corporation (ISC), created in 2014, can provide support for small and medium-sized investors in bringing civil lawsuits against violators. A pilot program has been implemented whereby the ISC has bought a small package of shares (100 shares) from a number of listed companies, which in turn allows it to exercise rights as a shareholder.[42] In 2017, the ISC held shares of 3003 listed company and won in the Shanghai Hile Biotech case on the behalf of its minority shareholders for first time.[43]

2.2.Derivative Action

Direct action and derivation action are two major judicial remedies for aggrieved shareholders as access to justice. Direct actions are available when shareholders assert their own rights such as participatory and information rights. By contrast, it is controversial whether and to what extent actions by shareholders on behalf of the company against managerial misconduct should be allowed. Advocates call derivative actions 'the chief regulator of corporate management' as it mitigates the principal-agent problem between shareholders and directors.[44] But opponents view them as a 'stopgap' measure in corporate law.[45] Derivation

Yinjin 10 Bei Chengfaxing Peichang Zhidu), (Chinatimes, 17 May 2019), available at <http://www.chinatimes.net.cn/article/86599.html> 16 September 2019.

[41] Chinese Securities Law was issued by the Standing Committee of the National People's Congress on 29 December 1998 and took effect on 1 July 1999, and then revised in 2004 and 2014.

[42] The 'Expanding the Shareholding Pilot Program' was initiated by the ISC and approved by the CSRC on 17 May 2017, available at <http://www.isc.com.cn/exercise/201705/t20170517_171505.shtml> 18 September 2019.

[43] 'ISC Wins the First Shareholder Lawsuits' (Toufu Zhongxin Shouli "Gudong Susong" Shengsu), (Xinhua News, 11 May 2018), available at < http://www.xinhuanet.com/2018-05/11/c_1122819787.htm> accessed 17 September 2019.

[44] E.g. Cohen v. Bene cial Industrial Corp, 337 US 541 (1949), 548; and Arad Reisberg, Derivative Actions and Corporate Governance: Theory and Operation (OUP 2007), 20-24.

[45] Roberta Romano, 'Shareholder Suit: Litigation Without Foundation' (1991) 7 (1) Journal of Law, Economics, & Organisation 55, 55.

actions are believed to be frivolous and motivated by the settlement fees that the lawyers hope for. Despite the controversy in their functions and the considerable diversity in different countries, derivative actions are gradually becoming a global phenomenon owing to the convergence of legal systems and the improvement of shareholder protection.[46]

Derivation action was codified into Chinese company law 2005.[47] It states that a director, a supervisor or any senior officer shall be liable for any losses of the company if he/she violates any provisions of laws, or administrative regulations, or the articles of associated of the company in performance of his/her official duties.[48] Derivative action also applies to the situation where any members of the liquidation group violate law or regulation and thus cause losses to the company during the course of liquidation.[49]

The key differences of derivative actions between China and other countries have been summarised by Huang.[50] For example, a procedural prerequisite is required in order to avoid the abuse of derivative actions, similar to the US demand requirements. Eligible plaintiff may commence a derivative suit under three alternative circumstances: (i) where the relevant body of the company refuses to bring an action after the receipt of written request from the shareholders; (ii) where the body has failed to bring an action within 30 days of the date of receipt of the request: (iii) where failure to promptly institute legal proceedings could cause possibly irreparable harm to the company's interests.[51] In addition, compared to the 'American Rule' by which litigants pay their own expenses, China adopts the same 'loser pays' model as the UK.

Since the introduction of the derivation action in 2005, 50 derivative suits had been reported by the end of 2010.[52] Surprisingly, all the suits involved private companies (limited liability companies, LLC) and no cases were brought against public companies (companies limited by shares, CLS). One key factor contributing to the lack of derivative suits against listed companies may lie in the

[46] Mathias Siems, 'Private Enforcement of Directors' Duties: Derivative Action as a Global Phenomenon' in Stefan Wrbka et al (eds), Collective Actions: Enhancing Access to Justice and Reconciling Multilayer Interests? (CUP 2012), 116.

[47] Chinese company law was promulgated on 29 December 1993, then amended five times in 1999, 2004, 2005, 2013 and 2018.

[48] Chinese Company Law 2018, Article 151 (Article 152 of Company Law 2005)

[49] SPC, 'Provisions of the Supreme People's Court on Some Issues about the Application of the Company Law of the People's Republic of China (II)' which was enacted on 5 May 2008 and came into force on 19 May 2008, Article 23.

[50] Flora Huang, 'Derivative Actions in China: Law and Practice' (2010) 1 Cambridge Student Law Review 246, 252-256.

[51] Chinese Company Law 2014, Article 151.

[52] Robin Hui Huang, 'Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis' (2012) 27(4) Banking and Finance Law Review 619.

standing requirement. Any individual shareholders in CLS must hold alone or jointly more than 1% of the company's shares for at least 180 consecutive days before the commencement of the action.[53] But in LLC, there is no shareholding threshold, no length of shareholding requirements, nor any requirement with respect to the timing of the share acquisition. It is reasonable for such differing treatment because the abuse of derivative action in LLC is supposed to be rare because the shareholders of LLC normally have substantial shareholdings and are closely involved in corporate management.[54] Another reason behind this rationale is that corporate governance in CLS is generally greater than that of LLC. Further, while disgruntled shareholders of CLS have the avenue to leave the company by selling their shares on the stock market, LLC does not have a liquid market for their shares.

Besides the standing requirements, lack of incentives is also blamed for the fewer derivative suits in China. Even if shareholders satisfy the rather stringent standing requirement, they still may be reluctant to bring an action due to economic and practical concerns. As discussed earlier, shareholders in China who file a derivative suit may encounter huge financial costs under the 'loser pays' regime. In particular in a suit against public company, the monetary claims are likely to be even larger in value and accordingly the legal costs would be correspondingly higher. This may create a prohibitive effect on the widely dispersed minority shareholders in listed companies intending to bring derivative suits. However, the financial difficulties had been solved by the SPC's Interpretation to the Company Law in 2017, requiring that the company should cover the reasonable expenses paid by the shareholder for participating in the action.[55] In return the winning interests of the derivative action belong to the company.[56]

Another factor underlying the inactive use of derivative action in China may be the less liberal discovery rules of civil procedures.[57] In principle, the party asserting a claim has the burden of producing evidence to prove the claim. Article 64 of the Civil Procedure Law (CPL) gives a court the discretion to investigate and collect any evidence if the court deems this necessary for the trial of the case.[58] But this necessity is subject to the possibilities of harming the interests of

[53] Chinese Company Law 2018, Article 151 (Article 152 of Company Law 2005)
[54] Randall Thompson and Robert Thomas, 'Public and Private Faces of Derivative Lawsuits' (2004) 57 (5) Vanderbilt Law Review 1747, 1784-1785.
[55] Article 26 of the 'Provisions of the Supreme People's Court on Several Issues concerning the Application of the Company Law of the People's Republic of China (IV)' (SPC Interpretation No. 16 [2017] which was published by the SPC on 25 August 2017.
[56] Ibid, Article 25.
[57] Guanghua Yu, 'Derivative Actions in China: Path Dependence Revisited' (2016) 11 (1) Journal of Corporate Law Studies 151, 158.
[58] Chinese Civil Procedure Law was promulgated on 9 April 1991 and amended three times in 2007, 2012 and 2017.

the state and the societal interest or the rights of others.[59] The Company Law only has one provision Article 97 governing the collection of evidence. A shareholder is entitled to inspect, among other things, minutes of shareholder meetings, resolutions of the board of directors, resolutions of the supervisory board, and records of financial reports. If the misconduct is not discussed at any of the meetings of the board of directors, the supervisory board, or the shareholders, Article 97 may not be helpful. The SPC even requires plaintiffs in misrepresentation cases to provide evidence of any administrative penalty decision or written criminal judgment in addition to other materials. Minority shareholders in China may have to rely upon the facts or evidence disclosed in administrative penalty decisions or criminal judgments to commence derivative actions. Therefore, the less liberal discovery rules largely reduce the frequency of derivative action cases.

2.3.Class Action

Another debated issue in relation to private securities litigation is class action. The American experience has shown us that the effectiveness of civil remedies provided under securities statutes largely depends on the applicability of the class action device.[60] In China the absence of class actions is blamed for severely impeding its securities litigation.[61] Chinese courts have been historically inhospitable fora for adjudicating group disputes and individuals have often been reluctant to use the courts.[62] The SPC Second Notice 2002 stated that 'the litigation form for securities civil action can be individual action or joint action, and it is not appropriate to use the form of class action'.[63] The courts' difficulties stem from the complexity of cases involving large numbers of litigants and from courts' own lack of resources. However, the SPC has recently changed its stance in class action by encouraging the establishment of such action on the SHSE's Science and Technology Innovation Board (also called 'STAR Market') in 2019.[64]

Although class actions (*jituan susong*) are not formally prescribed in Chinese law, investors can bring either an individual action (*dandu susong)* or a joint action

[59] SPC, 'Certain Provisions of the Supreme People's on Evidence in Civil Procedures' issued on 21 December 2001, Article 15.
[60] Wenhua Cai, 'Private Securities Litigation in China: Of Prominence and Problems' (1999) 13 Columbia Journal of Asian Law 135, 147.
[61] Sheng (n 34), 112.
[62] Benjamin Liebman, 'Class Action Litigation in China' (1998) 111 Harvard Law Review 1523, 1525.
[63] SPC Second Notice 2002 (n 36), Article 4.
[64] Article 13 of 'Certain Judicial Opinions on the Establishment and Registration System of the SHSE STAR Market' promulgated by the SPC on 20 June 2019.

(*gongtong susong*) in securities litigation.[65] The court can decide whether such suit should be filed as individual or joint action at its discretion. CPL Article 52 sets forth the rules for joint litigation. If there are two or more persons as either plaintiff or defendant and the subject matter of the action is the same or of the same category, the individual actions can be combined into a joint litigation, with the consent of the parties. If the number of plaintiffs or defendants reaches ten and more, the representatives are elected by the litigants.[66] Many actions taken by the representatives are binding on all the litigants. Certain actions, however, including claims modifications or waivers and negotiated settlements, must be approved by all the litigants.[67] In this regard, many commentators have referred to joint actions as 'class actions'.[68]

Chinese joint actions and the US's class actions share some similarities but also have distinctions.[69] For example, both have multiple plaintiffs and the binding effect of the judgement of the action on the members of plaintiff who have not participated in the lawsuit. However, in contrast to the US's opt-out rule, the Chinese joint actions adopt the opt-in rule where the unknown plaintiffs at the time the lawsuit is filed can become members of a class by later bringing suits within the prescribed time limit.[70] In such a case, Chinese court may issue a public notice to explain the claims.

3. Alternative Dispute Resolutions (ADR)

Although litigation is viewed as a traditional way to resolve securities disputes, it may not be a viable choice for many cases due to the cost, efficiency and technical concerns. The rising popularity of ADR can be explained by the increasing caseloads of the traditional courts and regulators, the perception of lower costs and the greater control by the parties.[71] Mediation and arbitration are two popular dispute settlement mechanisms. The main difference between them is that in arbitration the arbitrator hears evidence and makes a binding decision while mediation is a negotiation with the assistance of a neutral third party. Arbitration is generally a more formal process than mediation.

[65] The SPC Third Notice 2003 (n 38), Article 12.
[66] CPL Article 53.
[67] CPL Article 54.
[68] Liebman (n 63, using the term 'class action' to describe suits brought under articles 54 and 55 of the Civil Procedure Law); and Guiping Lu, 'Private Enforcement of Securities Fraud Law in China: A Critique of the Supreme People's Court 2003 Provisions Concerning Private Securities Litigation' (2003) 12 Pacific Rim Law & Policy Journal 795.
[69] Robin Hui Huang, 'Rethinking the Relationship between Public Regulation and Private Litigation: Evidence from Securities Class Action in China' (2018) 19 Theoretical Inquiries in Law 333, 341.
[70] CPL Article 54.
[71] Gianna Totaro, 'Avoid Court at All Costs' (the Australian Financial Review, 14 November 2008).

The judicial system in China has been overstretched in recent years by the large and ever-increasing caseload. According to the SPC's annual work report, more than 12.2 million cases were referred to the courts in 2011, representing a year-on-year increase of 4.4 per cent.[72] This has posed significantly challenges for China's courts due to the resources constrains, particularly in securities disputes which are usually more complex and technical.

A typical feature of Chinese securities disputes is 'big numbers, small value', which means that securities disputes are big in the total number of cases, but small in the value of the individual claim.[73] Since the SPC had made it clear that class action was not the proper form to resolve securities dispute in 2002,[74] there was limited litigation channel for most small investors, in terms of the high cost of the litigation and small value of judicial awards. Thus, the SPC and CSRC decided to conduct a pilot program of diversified resolution in securities disputes from 2016 with a primary focus on securities dispute mediation.[75] The success of the pilot program paved the way for the national advancement of securities dispute mediation. On 13 November 2018, the SPC and CSRC jointly issued 'Opinions on Comprehensively Advancing Establishment of Diversified Resolution Mechanism of Securities and Futures Disputes' to provide a practical non-litigation channel for small investors. They subsequently provided 10 typical securities disputes with examples to illustrate how to handle such disputes via diversified resolution mechanisms.[76]

In China Article 176 of the Securities Law empowers the Securities Association of China (SAC) as the statutory body to mediate securities disputes. In addition, other bodies such as the stock exchanges also provide platforms for non-litigation means. To promote investor protection and centralise mediation by resolving all kinds of securities disputes in an effective and harmonious manner, the ISC can mediate disputes and represent investors in court. Since then, the ISC has largely replaced the SAC and the stock exchanges as the main body to handle investor claims and disputes. In order to enhance the binding effect of mediation, the mediation agreements reached through notarisation, arbitration and the judicial system, can apply for compulsory enforcement by the courts.[77]

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[72] Bin Huang, 'Judicial Costs and Efficiency: Justice Products also Need to be Good-Quality at Low Price' Renmin Fayuan Bao (People's Court News) 9 May 2012.

[73] Robin Hui Huang, 'Securities Dispute Mediation in China' (2015) 10(2) Journal of Comparative Law 177, 178.

[74] SPC Second Notice 2002 (n 36), Article 4.

[75] 'Notice on Implementing the Pilot Program of a Multi-Dimensional Dispute Resolution Mechanism for the Securities and Futures Industries in Certain Regions of China (No. 149 [2016] of the SPC) was issued by the CSRC and SPC on 25 May 2016.

[76] 'Top 10 Model Cases Involving Diversified Resolution of Securities and Futures Disputes' was issued by the SPC on 1 December 2018, at the SPC's website <http://www.court.gov.cn/zixun-xiangqing-133471.html> accessed on 6 September 2019.

[77] Article 15 of the Civil Procedure law and also the joint Pilot Program 2016 (n 75).

According to the SPC's report, China's mediation system has made significant progress in terms of the number of mediation centres and mediators as well as the cases accepted since 2016 when the joint pilot program was issued. The number of mediation centres grew from 5 in 2016 to 55 in 2018 with appropriately 2000 mediators. There were reportedly 9,116 cases accepted in 2016 – 2018 and 81.28% among those accepted cases were successfully mediated in which investors were compensated with RMB 1.5 trillion.[78]

With respect to another type of ADR – arbitration, the Arbitration Law governs all types of arbitration, including securities arbitration.[79] In particular, a compulsory arbitration clause must be incorporated in the articles of association of a Hong Kong-listed Chinese company whereby disputes between such company and its shareholders must be arbitrated via either a Chinese or Hong Kong's forum.[80] The 'Notice on Arbitration of Securities Disputes' was promulgated by the CSRC on 11 October 1994, requiring all securities organisations and stock exchanges to sign agreements to arbitrate any disputes on the issuance or trading stocks, and designated the China International Economic and Trade Arbitration Commission (CIETAC) as the supervisory body. The CIETAC has published the arbitration rules on financial transaction disputes that cover securities and futures.[81] In 2004, the State Council and the CSRC jointly issued another 'Notice on the Arbitration of Securities and Futures Contract' to expand the scope of securities arbitration to disputes regarding trading of futures contracts.[82]

Data released by the Ministry of Justice of China showed that 544,535 arbitration cases were accepted by 255 Chinese arbitration institutions in 2018.[83] Among

[78] SPC, 'An Evaluation Report on Diversified Resolution Mechanism of Securities and Futures Disputes' 1 December 2018, available at <http://www.court.gov.cn/zixun-xiangqing-133481.html> accessed 30 September 2019.

[79] China's Arbitration Law was enacted on 31 August 1994 and amended twice in 2009 and 2017. The current version took effect on 1 January 2018.

[80] Article 163 of the 'Mandatory Provisions of Articles of Association of Companies Seeking Overseas Listing' was enacted by the CSRC on 29 September 1994, available at <http://www.csrc.gov.cn/pub/newsite/flb/flfg/bmgf/wz/jnss/201012/t20101231_189756.html> accessed 9 September 2019.

[81] 'Arbitration Rules on Financial Disputes' was enacted by the CIETAC on 4 November 2014 and came into effect on 1 May 2015, available at <http://www.cietac.org/index.php?m=Page&a=index&id=66> accessed 9 September 2019.

[82] For the full text of the Notice, see the CSRC's website <http://www.csrc.gov.cn/pub/newsite/flb/flfg/bmgf/zh/fyyzc/201012/t20101231_189615.html> accessed 9 September 2019.

[83] Qimeng Wei, '2018Nian Quanguo Zhongcai Jigou Chuli Anjian 54Wan, Biaode Zonger jin 7000Yiyuan' (The Number of Arbitration Cases Reached 540,000 with the Value of 700 Billion in China in 2008), (China Youth Daily, 28 March 2019), available at <https://shareapp.cyol.com/cmsfile/News/201903/28/web200589.html> accessed 9 September 2019.

these, roughly 22.1% and the highest were financial disputes. The total amount of these financial disputes reached RMB 233.4 billion (roughly 33.6% and the highest).[84] But it is unclear how many cases are related to securities arbitration due to the data shortage. ADRs have gradually been the key to protect vulnerable investors and lay out a solid foundation for building an investor-friendly legal environment in the Chinese capital market.[85]

4. Conclusion

During three decades of capital market development, China has gradually developed a multilevel legal framework for securities enforcement. The securities law is the main legislative component; the regulatory bodies and courts supplement the law with administrative and judicial regulations and rules.

Public enforcement and private enforcement are used simultaneously and complement one another. While the CSRC as a statutory regulatory authority, intensify its actions by issuing a record high number of administrative and non-administrative sanctions against market misconduct in 2018. Stock exchanges which are mandated by the Securities Law to practice self-regulation also use reputational sanctions as a powerful tool of punishment and deterrence in the capital market.

In contrast to the higher intensity of public enforcement, the role of the judicial system in effective resolution of private litigation is still a challenge, although the exercise of private rights is evolving. Various obstacles preclude private enforcement from playing a significant role in market regulation. Hence, the CSRC has taken an active role in developing mechanisms aimed at enhancing the stability of investors to exercise their rights. The ISC can present investors in court and assists small and medium-sized investors in bringing civil lawsuits against violators, although there is no consensus in the use of class action.

Along with public regulation and litigation, the CSRC and the SPC jointly issued a pilot program in 2016 to enhance the use of ADRs, in particular mediation to provide a practical non-litigation channel for small investors. An increasing number of disputes have been resolved by mediation owing to its lower cost and great flexibility, marking an important development in the landscape of China's securities enforcement. All these enforcement channels together function as part of a comprehensive and integrated regulatory strategy to provide the much-

[84] Ibid.

[85] Junhai Liu and Guang Yang, 'Jinkuai Chengli Quanguo Zhengquan Qihuo Jiufen Tiaojie Zhongxin' (Hurry Up to Establish A Centralised Mediation Centre for Nationwide Securities Disputes), (China Securities Journal, 7 June 2017).

needed law in action to support the phenomenal economic and financial growth in China.

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