

**Derivative Action or Securities Arbitration in China:
Seeking A Better Alternative to Retail Shareholder Protection**

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There is a large body of law and finance literature suggesting that strong legal protection for investors is the key to a nation's healthy stock market development and economic growth. Despite remarkable progress in setting up its securities market, China has often been criticized for its underdeveloped regulatory regime. The wide securities fraud scandals in contrast with the paucity of conviction rates are indicative of the fact that public enforcement is inadequate in China. Private enforcement efforts such as securities litigation help address the disconnect between securities regulatory regime and investor compensation. Nevertheless, given the immaturity of China's current legal and institutional framework, various factors preclude private securities litigation from playing an effective role in China's market regulation and development. Against the background, this article seeks to explore alternative mechanisms for improvement of private enforcement in China. Having concluded that modeling the US class action system is quite unlikely to work well in the Chinese socio-political and socioeconomic situations, the article explores how the present system of securities fraud litigation should be reformed in order to balance the competing interests of state control, social stability, and minority shareholder protection in the listed companies. In view of the dominance of retail shareholders in the Chinese securities market and drawing on international experience, a cost-effective and accessible securities arbitration scheme is proposed to be established in China for resolving civil compensation claims. It is argued that the professionalism, procedural flexibility, speed, confidentiality, and cost saving features of arbitration could offer much potential as a deterrent and remedial device in addressing the deficiencies of private enforcement of securities regulation during economic transition in China.

I. Introduction

Developing a fair, efficient and orderly securities market is one of China's biggest institutional challenges today. Since the initial economic reforms from a planned to a

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market economy, a high private savings rate and the public's appetite to hold risky securities have contributed to the impressive growth of the market. The Shanghai and Shenzhen Stock Exchanges were established in 1990, and since then, the number of listed companies has grown exponentially. At the end of 2011, a total of 2,342 companies were listed on the two stock exchanges,² compared to 53 listed companies in 1992.³ China's securities market, while only 20 years old, boasted a market capitalization of RMB 21.5 trillion at the end of 2011.⁴

Despite remarkable progress in setting up its securities market, China has often been criticized for its underdeveloped regulatory regime. Unlike its overseas counterparts where securities markets were established to provide finance to enterprises, the Chinese securities market was established to assist in the reform of its financially distressed state-owned enterprises (SOEs).⁵ Given the political logic of its securities market, China's securities watchdog, the China Securities Regulatory Commission (CSRC), is handicapped in carrying out its regulatory and supervisory mandate. The paucity of securities fraud scandals and the modest conviction rates are indicative of the fact that the CSRC has inadequately enforced the law⁶. Meanwhile, private enforcement of the Securities Law, such as securities litigation played only a limited role in assisting the prevention of market abuse and the regulation of the securities market.

Against this background, this article seeks to explore various mechanisms to promote the enforcement of the Securities Law in China. Due to the conflicting roles of the CSRC both as market promoter and primary market regulator for listed companies, the CSRC's ability to discipline powerful wrongdoers of fraud is most likely to be handicapped. It would therefore appear that a further strengthening of public enforcement efforts *per se* is unlikely to be a panacea to the weak enforcement of the Securities Law in China. On the other hand, there is a large body of law and finance literature suggests that strong legal protection for investors is the key to a nation's

² The latest annual report by CSRC, the CSRC Annual Report 2012 (released on May 15, 2012), p. 4. Available at http://www.csrc.gov.cn/pub/csrc_en/about/annual/201205/P020120515677609374835.pdf (last visited 23 October 2012)

³ CSRC, China's Securities & Futures Markets 2004, p. 9. Available at http://www.csrc.gov.cn/pub/csrc_en/about/annual/200812/P020090225529630009496.doc (visited 15 April 2012)

⁴ Supranote 2, p. 16.

⁵ Guanghua Yu, *Comparative Corporate Governance in China: Political Economy and Legal Infrastructure* (New York: Routledge, 2007), 23-41.

⁶ Gongmeng Chen et al., "Is China's Securities Regulatory Agency a Toothless Tiger? Evidence from Enforcement Actions", 24 J. Acct. & Pub. Pol'y 451, 457 (2005) (stating that the stock markets' "legal and institutional framework is still relatively primitive by Western standards").

healthy stock market development and economic growth⁷. Private enforcement efforts compensate victims of securities fraud and help address the disconnect between securities regulatory regime and investor compensation. Nevertheless, given the immaturity of China's current legal and institutional framework, various factors preclude private securities litigation from playing a significant role in China's market regulation and development.⁸ Therefore, this article seeks to explore alternative mechanisms for improvement.

To discuss these issues, this paper is structured as follows. Following this introduction, Section II evaluates the current level of legal protection afforded to minority public shareholders in listed companies in China. This section will also lay down the background information on the two alternatives, namely, the introduction of a class action system or the securities arbitration scheme in facilitating private enforcement of the Securities Law. To ameliorate the collective action problem faced by minority shareholders in lodging a securities suit, Section III discusses whether a direct transplantation of the class action system of the United States (US) can supply the optimal amount of private enforcement in China. The US is chosen because class actions originated in the US, and some other countries have either adopted or actively considered embracing the American class action procedures in their recent legal reforms. Answering this in the negative, Section IV next explores the feasibility of utilizing alternative dispute resolution (ADR) procedures to resolve civil compensation claims. It is concluded that the procedural flexibility, speed and cost savings of the ADR procedures offer much potential as a deterrent and remedial device in policing corporate misconduct in listed companies in China.

II. The Paradigm of Retail Shareholders Protection in China

Although China is committed to establishing a modern enterprise system to cater to the needs of a market economy, the political logic of China's securities market has contributed not only to the fragmentation of shares,⁹ but also to the poor corporate

⁷ Rafael La Porta, Florecio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, *Legal Determinants of External Finance*, (1997) 52 *J. Fin.* 1131; Rafael La Porta, Florecio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, "Investor Protection and Corporate Governance" (1999) 58 *Journal of Financial Economics*, 3; and Bernard Black, *The Legal and Institutional Preconditions for Strong Securities Market* (2001) 48 *UCLA L. Rev.* 781.

⁸ Marlon A. Layton, "Is Private Securities Litigation Essential for the Development of China's Stock Markets", 83 *New York University Law Review* (2008), 1948.

⁹ To prevent investors from gaining control of SOEs through share ownership, the government created various classes of shares – state, legal-person, individual, and foreign – and predicated ownership on the shareholder's identity. See Sandra P. Kister, "China's Share-Structure Reform: An Opportunity to

governance in listed companies. One of the core governance issues of the listed SOEs is their highly concentrated ownership structure. In order to bring its SOEs within the market's orbit without privatizing their ownership structure, the government owned two-thirds of the equity in listed companies as non-tradable shares,¹⁰ either directly as state-owned shares (*guoyou gu*) or indirectly as legal person shares (*faren gu*), until the launch of a share structure reform program in 2005.¹¹ As dispersed individual shareholders have no meaningful influence over the decision making process in the SOEs, potential conflicts of interest between majority and minority shareholders remain a core corporate governance problem.¹²

Moreover, the dominance of retail shareholders in the Chinese securities market suggests that the risk of actual fraud is heightened. Individual shareholders are given limited access to corporate information and lack professional knowledge on how to evaluate corporate performance, which has given rise to ample opportunities for connected transactions¹³ and misappropriations of corporate assets, particularly with respect to SOEs. Not only is the domestic securities market tainted with widespread insider trading, price manipulation and other fraudulent activities, the impact of poor governance of Chinese companies has been felt abroad when Chinese companies have increasingly sought overseas listings in recent years. For instance, a recent report by NERA Economic Consulting reported that 18% of all securities class actions in the US were filed against Chinese-domiciled companies or against companies with the principal executive officers in China, and the subject matter of such suits being accounting allegations¹⁴.

A. Flawed Securities Framework

Poor corporate governance is also attributable to the poorly drafted corporate and securities laws in China. Given that the development of China's securities markets is

Move beyond Practical Solutions to Practical Problems”, 45 *Columbia Journal of Transnational Law* (2007), at 317-8; see also discussions below.

¹⁰ CSRC, “China’s Securities and Futures Markets 2004”, April 2004, p. 27-28. Available at http://www.csrc.gov.cn/pub/csrc_en/about/annual/200812/P020090225529630009496.doc (visited 16 April 2012).

¹¹ CSRC, “Measures on Administration of Split Share Structure Reform of Listed Companies”, September 2005.

¹² Donald C. Clarke, Corporate Governance in China: An Overview (2003) 14 *China Economic Review* 494.

¹³ The “connected transactions” (*guanlian jiaoyi*) are paraphrased with “related-party transaction”. See Leng Jing, *Corporate Governance and Financial Reform in China’s Transitional Economy* (Hong Kong University Press, 2009), pp.152-153 (stating the high risk of related-party transactions at SOEs).

¹⁴ Jordan Milev, Robert Patton, Svetlana Starykh and John Montgomery, “Recent Trends in Securities Class Action Litigation: 2011 Mid-Year Review”, p.8-12. Available at http://www.nera.com/nera-files/PUB_Trends_Year-End_1211_final.pdf (last visited 10 October 2012).

driven by the goal of assisting the SOE reform, securities laws and regulations have failed to provide adequate protection for the rights and interests of the public investors in China. While protecting minority shareholders from opportunistic expropriation of the management or the controlling shareholders has always been a critical principle of corporate governance, it was not the chief concern of the lawmakers in the early 1990s. The first corporate code in China, the Company Law of 1993, aimed at providing legal support for the establishment of a modern enterprise system and setting down the political agenda of transforming SOEs into joint-stock companies. Although the Company Law spells out basic governance structures for all shareholding companies, the Chinese style shareholding system has difficulty reconciling the dual goals of maximizing shareholder value and maintaining state ownership.

In an effort to maintain a fair and orderly securities market and to protect the interests of investors, China enacted the Securities Law in 1998, which amongst other things expressly prohibits various forms of market misconduct such as insider trading, market manipulation and inaccurate disclosure. The Securities Law was substantially revised in 2005, which improved the system governing the issuance, trading, registration and settlement of securities. It also set down more stringent requirements regarding information disclosure and increased the legal responsibilities on integrity obligations of the shareholders and other officers who are in control of the listed companies. Following the revision, related agencies made corresponding adjustments to other relevant laws and regulation documents to ensure that they better reflect market rules.

Although legal provisions have been improved to address chronic illness of corporate governance, the law overemphasizes the role of the government in the securities arena. Public enforcement through administrative and criminal sanctions holds a more prominent position than private enforcement in China, despite the inadequacies of its enforcement. For instance, Chapter XI or the Legal Liability Chapter of the Securities Law of 1998 comprises of 36 articles, of which 32 carry substantive penalties in the form of criminal and administrative liability. The role of civil remedies has been overlooked, which is evidenced by the fact that there are only two articles on civil liability. In the absence of detailed operational provisions on how private securities suits can be brought, the local courts refused to hear most of the cases filed by investors in search of compensation for their losses suffered as a result of securities fraud.¹⁵ This is so despite the fact that the courts could have adopted an expansive

¹⁵ For instance, the action against *Chengdu Hongguang Co. Ltd* in 1998 for non-compliance with

interpretation of older pieces of legislation such as the General Principles of Civil Law to grant relief.¹⁶

B. Inadequate Public Enforcement by the CSRC

Rampant securities fraud in China does not lie in the imperfectness of the laws *per se*. Overlapping functions of the securities regulatory bodies and resource constraints have both contributed to the weak enforcement of the Securities Law. Until the early 1990s, China did not have a specialized central agency to regulate the securities market. The two stock exchanges were supervised by their local governments with little oversight by the People's Bank of China (PBOC). In the aftermath of stock-related protests in Shenzhen in 1991, the government decided to strengthen securities regulatory oversight by the establishment of the State Council Securities Committee (SCSC) and the CSRC in 1992. The SCSC was a ministerial-level government agency in charge of macro-management of the securities market and the primary authority for market regulation,¹⁷ while the CSRC was then designed as the SCSC's executive branch to conduct supervision of the market and the securities firms.¹⁸ Yet, the CSRC was only a non-profit institution (*shiye danwei*) and lacked any substantial supervisory powers and tools to make rules or to punish misconduct¹⁹. As such, the securities market remained inadequately supervised. It was not until 1998 that the multi-tier regulatory structure was removed and the CSRC became the principal regulator of the securities and futures market. Its mandate is to ensure the orderly and lawful operation of the securities market.²⁰

While a nationwide capital market has gradually developed and the number of listed companies has grown exponentially since the early 1990s, the CSRC was not well equipped to carry out its mandate in its early years of operation. There was no

accounting and disclosure requirements was dismissed by the court on the ground that there was no specific procedure for such action in China at that time. In a similar vein, the action against *Shandong Bohai Corporation* for false accounting in 1998 was rejected the initial cases brought by aggrieved investors.

¹⁶ For example, the General Principles of Civil Law provides that tort victims are entitled to civil compensation. Additionally, the *Governance Standards for Listed Companies*, promulgated by the CSRC and the State Economic and Trade Commission in January 2002 provides that investors can seek compensation through civil litigation when their rights are harmed. More specifically, the revised Securities Law provides that issuers, underwriters and their responsible directors and other corporate officers can be liable for losses suffered by investors because of misrepresentation or material omissions in disclosure documents.

¹⁷ Notice of the State Council Concerning Further Strengthening Macro-Administration of the Securities Market of 17 December 1992, Item 1(1).

¹⁸ *Id.*, Item 1(2).

¹⁹ Wang Lianzhou and Li Cheng, eds., *The vicissitudes of the Securities Law (Fengfeng yuyu zhengquanfa)*, Shanghai: Shanghai Sanlian shudian, 2000, p. 49.

²⁰ Article 166 of the Securities Law of 1998

enforcement bureau or other enforcement offices when it was established in 1993. Three years later, the predecessor of the CSRC Enforcement Bureau, the Complaints Division of the CSRC Legal Affairs Department, was staffed with only four members. During that period, Anthony Neoh, the former Chair of the Securities and Futures Commission in Hong Kong, remarked that both the Chinese market and its regulators are very unsophisticated.²¹ Neoh's remark is echoed by Chinese top economist Wu Jinglian, who unfavorably compared the corruption-ridden market to a "casino".²²

After a decade of operation, the CSRC is much better equipped to carry out its mandate. Unfortunately, its enforcement efforts remain inadequate. To date, it has established 36 securities regulatory bureaus in the provinces, autonomous regions and municipalities. Yet, as with other securities regulators worldwide, the CSRC is confronted with considerable resource constraints in fulfilling its duties. After a decade of operation, there were still only 289 staff members in the Enforcement Bureau in 2006,²³ compared to a total of 1,434 companies listed on the two national exchanges.²⁴ It was said that most enforcement staff lacked experience and knowledge in the securities field, which presented a major disadvantage for them to deal with the complexities of securities crimes.²⁵ Even after the establishment of an enforcement bureau in the CSRC in 2007 to facilitate the investigation of significant securities fraud cases and a significant increase of staff to about 600 to man the bureau, it appeared that public enforcement efforts remained inadequate.²⁶ Contrary to the severity of insider trading and inaccurate disclosure in China's stock market in 2007,²⁷ the table below²⁸ shows that the number of sanctions imposed by the CSRC over the past few years seems rather modest.

Year	2007	2008	2009
Total Number of Listed Companies	1,530	1,604	1,716
Total Number of Cases Closed	405	130	106

²¹ "A Good Beginning", *China Economic Review*, March 1999, No. 3, p.19.

²² Wu Jinglian, "China's Stock Market Worse than Casinos (zhongguo gushi buru duchang)," interview with China Central Television (CCTV) in the "Conversation" ("Duihua") program, 13 January 2001.

²³ Hongming Cheng, Insider Trading in China: The Case for the Chinese Securities Regulatory Commission (2008) 15:2 *Journal of Financial Crime* 165, 168.

²⁴ CSRC, China's Securities and Futures Markets 2007, p.3. Available at http://www.csrc.gov.cn/pub/csrc_en/about/annual/200812/P020090225529643752895.pdf (last visited 16 April 2012).

²⁵ Supranote 20.

²⁶ *Ibid.* (discussing the CSRC's enforcement policies and inadequacy of enforcement).

²⁷ *Ibid.* (finding the paucity of insider trading cases and the lack of convictions for insider trading offences in China).

²⁸ The figures are extracted from the CSRC Annual Reports, the Shenzhen Stock Exchange and the Shanghai Stock Exchange.

Cases placed under informal investigation	N/A	157	121
Total Number of Sanction Decisions	54	77	N/A
Total Number of Companies Sanctioned	26	N/A	23
Total Number of Individuals Sanctioned	155	N/A	218

Aside from a shortage of trained personnel and resources, the CSRC faces a serious conflict of interest in its dual role as primary market regulator and market promoter of the listed corporations. As most listed companies in China are SOEs,²⁹ regulatory efforts of the CSRC are muddled by political considerations. Fearful of a market collapse and the subsequent economic and political repercussions, the CSRC is prone to enormous pressure not to pursue vigorously SOEs for securities fraud.

C. Inadequate Private Enforcement

Ideally, an institutionalized private securities litigation system can complement public enforcement activities of the securities regulators. As the primary role of the securities regulator is to ensure a fair, orderly and robust securities market, they are not in a position to adjudicate on any financial remedy for defrauded shareholders who suffered economic losses arising from securities fraud. A well-functioning private securities litigation system can provide additional deterrence against securities fraud, and at the same time, serves as a remedial device for aggrieved investors through the imposition of damages against the perpetrators of fraud. Nevertheless, various systemic and institutional obstacles, such as procedural difficulties, an absence of financial incentives in bringing securities suits, substantial filing fees, underdeveloped group litigation rules and a lack of judicial infrastructure preclude private enforcement from playing a significant role in securities market regulation in China. These obstacles lead to disincentives for public investors to detect and prosecute frauds and assist in the anti-securities fraud campaigns of the government, as well as contribute to widespread market misconduct.

1. The SPC Circulars between 2001 and 2003

Following the outbreak of market scandals in the 2000s, the inadequacy of the private securities litigation system has become an increasingly serious problem in China. As aggrieved investors continued to file suits at first instance courts, the Supreme

²⁹ Kenneth Lieberthal, *Governing China* (2nd ed) (New York: W. W. Norton, 2004), at 266 (stating that “Normally, only SOEs are approved for listing on the ... stock exchanges,” resulting very few listed private companies); see also Marlon A. Layton, “Is Private Securities Litigation Essential for the Development of China’s Stock Markets?”, 83 *New York University Law Review* (2008), at 1949.

People's Court (SPC) issued three circulars between September 2001 and January 2003 (the "SPC Circulars" hereafter) to clarify the situation.

In the first circular, which was issued on 21 September 2001 (the "2001 Circular"), the SPC imposed a temporary ban on the acceptance by lower courts of civil compensation suits³⁰. Justice Li Guoguang, the then Vice President of the SPC and drafter of the 2001 Circular, justified the SPC's refusal to allow securities litigation on the ground that the local courts lacked resources and experience to hear these cases.³¹ However, the 2001 Circular attracted severe criticism from academics, practitioners, and investors.³² Subsequently, this ban was partially lifted after four months³³.

In the second circular issued on 15 January 2002 (the "2002 Circular"), the SPC instructed lower courts to accept investor suits for misrepresentation on the condition that the company and the relevant persons had been administratively sanctioned or criminally convicted for the same.³⁴ Additionally, the 2002 Circular requires a lawsuit to be filed within two years from the date of the decision.³⁵ On 9 January 2003, the SPC issued the Several Provisions on Trial of Civil Damages Cases Arising from Misrepresentation in the Securities Market (the "2003 Circular"), which became effective on 1 February 2003.³⁶ The 2003 Circular expanded on the 2002 Circular and provided that both firms and individuals can be named as defendants in a securities suit. Individual defendants can include executives, directors, supervisory board members, and controlling shareholders at a listed company, as well as other responsible individuals at professional service firms.³⁷ The 2003 Circular also laid down procedural and evidentiary requirements for bringing securities-related misrepresentation suits.

2. *Technical Constraints of Group Litigation Rules in China*

³⁰ *Circular Regarding Non-acceptance of Securities-related Civil Compensation Cases* [Zuigao Remin Fayuan Guanyu She Zhengquan Minshi Peichang Anjian Zan Buyu Shouli de Tongzhi], issued by the SPC, 21 September 2001.

³¹ Li, Guoguang and JiaWei, *The Civil Compensation System of Securities Market Misrepresentation* (Zhengquan Shichang Xujia Chengshu Minshi Peichang Zhidu) (Beijing: Law Press, 2003), pp.2-3.

³² *Ibid.* pp.113-114.

³³ *Notice of the Supreme People's Court on Relevant Issues of Filing of Civil Tort Disputes Arising From Misrepresentation on the Securities Market* [Zuigao Renmin Fayuan Guanyu Shouli Zhengquan Shichang yin Xujia Chenshu Yinfa de Minshi Qinquan Jiufen Anjian Youguan Wenti de Tongzhi], issued by the SPC, 15 January 2002.

³⁴ *Ibid.*

³⁵ *Ibid.*

³⁶ *Several Provisions on Trial of Civil Compensation Cases Arising from Misrepresentation on the Securities Market* [Zuigao Renmin Fayuan Guanyu Shenli Zhengquan Shichang yin Xujia Chenshu Yinfa de Minshi Peichang Anjian de Ruogan Guiding], issued by the SPC, 9 January 2003.

³⁷ Articles 6 & 7 of the SPC 2003 Circular.

By providing a functional basis for investors to bring a private securities suit, the SPC Circulars raise high expectations in upgrading China's securities regulatory framework, and mark a significant step forward in investor protection. Despite these expectations, however, the SPC Circulars have failed to promote private enforcement of the securities law in China.

One major criticism is that the SPC Circulars unduly restrict the scope of cases for which civil compensation may be sought.³⁸ Relief can only be sought for cases arising from misrepresentation (*xujia chenshu*), which is defined to include false statements (*xujia jizai*), misleading statements (*wudaoxing chenshu*), material omissions (*zhongda yilou*) or improper disclosures (*buzhengdang pilu*).³⁹ The Circulars provide no basis for private litigation based on other forms of securities fraud regulated by the CSRC that have been prevalent on the market, such as insider dealing (*neimu jiaoyi*) and market manipulation (*caozong shichang*). This effectively deprives defrauded investors from compensation even if the CSRC determines liability and imposes administrative penalties against the wrongdoers.

The second line of criticism is that victims of securities fraud may be denied recovery due to restrictive rules on proving causation between the misrepresentation and the resulting financial loss. For shareholders to establish legal entitlement to compensation, Article 6 of the 2003 Circular provides that the plaintiffs shall bear the onus to prove the existence of a causal link (*yinguo guanxi*) between the defendant's wrongdoing and the plaintiff's loss. However, causation would not be established if the affected security was purchased before the misrepresentation was made, or the security was sold before the relevant misrepresentation was made public.⁴⁰ Regardless of any loss that might actually have been incurred, defrauded shareholders are effectively excluded from compensation in not uncommon situations, such as when a listed company failed to disclose material price-sensitive information in a timely manner.⁴¹ In such an example, these shareholders may have sold their shares, thinking that the company's current performance indicated a dim prospect. In fact, the company withheld material information, and the share price went up when the

³⁸ See, for example, Hutchens Walter, "Private Securities Litigation In China: Material Disclosure About China's Legal System?", U. Pa. J. Int'l Econ. L. (2003) 599, 630-632. See also Yin Jie, Zhengquan Xujia Chenshu Minshi Zheren Zhidu Lun [On The System of Civil Liability of Misrepresentation in Securities Fraud], 6 Faxue [Legal Science] 2003107, 110-111.

³⁹ Article 17 of the SPC 2003 Circular.

⁴⁰ Article 18, SPC 2003 Circular.

⁴¹ Sanzhu Zhu, *Securities Dispute Resolution in China* (London: Ashgate, 2007), at 186 (summarizing the criticism from academics, practitioners, and judges on the cumbersome causation rule).

disclosure was made at a later time. Although these shareholders sold the shares at a price lower than what they could have obtained had they waited to sell until the disclosure of the price-sensitive information, they are left with no course of action against the wrongdoers under the SPC Circulars, not even after the wrongdoers have been sanctioned by the courts or the relevant administrative authorities. The imposition of fines or confiscation of proceeds by the administrative authorities could not have assisted the shareholders either, because the fines imposed or the proceeds confiscated go to the State Treasury.⁴²

Another line of attack relates to the absence of financial incentives in bringing private securities suits in China. The matter of costs does not merely affect the efficacy of the private securities fraud suits, but determines whether this procedure will be utilized at all. From an economic point of view, plaintiffs will sue only when the expected award exceeds the litigation costs. However, litigation cost is a major obstacle for aggrieved investors to lodge a private suit to recover losses resulting from securities fraud. While contingency fee arrangements are generally prohibited in China,⁴³ the SPC Circulars and the Securities Law remain silent on how these lawsuits should be funded. In this light, the general rule is that each side bears his costs of retaining lawyers, regardless of the outcome of the litigation.⁴⁴ Should the action fail, plaintiff investors face the prospect of being liable for not only their own costs, but also a significant portion of the litigation expenses of the prevailing defendant, including filing fees and other costs.⁴⁵ Even if the action is successful, investors may not be able to recover their lawyers' fees from the losing party. This potential exposure for a substantial amount of costs, coupled with the absence of litigation funding in China, dissuades many from suing even when they have a meritorious claim.

Substantial filing fees (*anjian shoulifei*) further erode plaintiff investors' incentives to commence litigation. In China, filing fees are calculated on a sliding scale based on the contested amount, with a maximum percentage of 2.5 percent for amounts below

⁴² Article 234, Securities Law.

⁴³ In the *Management Measures of Fee Charging for Lawyers' Services* (promulgated by the Ministry of Justice on 13 April 2006 and came into force on 1 December 2006), Article 12 expressly provides that outcome-related fees are prohibited in criminal cases, administrative cases, state compensation cases and class action cases. Article 4 further provides that lawyers should charge service fees using the government-directed prices (*zhengfu zhidao jia*) and the market-regulated prices (*shichang tiaojie jia*).

⁴⁴ In Daqing Lianyi case, claimants sought to recover all their attorneys' fees from the losing defendant company. The court rejected the claim, suggesting that it was "groundless in law". "Chen Lihua Deng 23 Ming Touziren Su Daqing Lianyi Gongsi, Shenyin Zhengquan Gongsi Xujia Chenshu Qinquan Peichang Jiufen An" [Chen Lihua and Others v Daqing Lianyi Co and Shenqing Securities Company for Damages Arising from False Statements], in *Zuigao Renmin Fayuan Gonggao* [Gazette of the Supreme People's Court] (2005: No. 11) 30.

⁴⁵ While Chinese courts generally awards trial costs to the winner, such costs are usually defined only as funds paid to the court as filing and other fees and do not include attorney's fees.

RMB 10,000 and a minimum of 0.5 percent for amounts above RMB 20 million.⁴⁶ Although filing fees are borne by the losing party, they usually are advanced by plaintiffs when the action is brought.⁴⁷ Thus, plaintiffs are presented with an immediate high expense if they seek recovery of any significant funds. The problem is aggravated when the court decides to hold multiple trials for various similar individual claims. This point is borne out by the landmark *ST Dongfang* case. In this case, it was reported that the court required the sixty-one plaintiffs to be split into groups of no more than ten plaintiffs each as a requirement for accepting the case, without offering any justification.⁴⁸ As a result, it would appear uneconomical to pursue modest claims, and would therefore deter most resource-poor investors from seeking redress through litigation and from gaining access to justice.

A related criticism is that the representative group litigation (*daibiaoren susong*) rules in China are underdeveloped⁴⁹, and restrictive group litigation rules apply in the context of securities litigation. Article 14 of the 2003 Circular provides that in cases joint action (*gongtong susong*),⁵⁰ the number of plaintiffs must be determined prior to trial. Furthermore, substantial filing fees must be advanced by plaintiffs in full upfront when the case is brought, and judgments bind only those who have registered their rights to the court. As shareholders are geographically dispersed across China, this arrangement is likely to require significant upfront costs, say, to aggregate a massive number of claims and to seek assent from all the plaintiffs to opt into litigation.

This is to be contrasted with the more plaintiff-friendly representative litigation rules under Article 55 of the Civil Procedure Law, which allows for cases to be brought by an undefined number of litigations⁵¹. The courts are empowered to organize affected individuals into a class by issuing a public notice instructing persons who are entitled to participate in the action to register with the people's court and opt into litigation within a specific period of time⁵². Additionally, plaintiffs in Article 55 actions are

⁴⁶ State Council, Measures of Charging Litigation Fees (*Susong Feiyon Jiaona Banfa*) (2006), Art 13.

⁴⁷ Art 107, Civil Procedure Law.

⁴⁸ “Zhengquan Minshi Susong Xin Wenti, Gongtong Susong Yuangao Renshu Shouxian” [A New Problem in Private Securities Litigation: The Number of Plaintiffs in Joint Actions are Limited], *Zhengquan Shibao* [Securities Times], 9 April 2003, available at <http://rmrb.com.cn/GB/jinji/35/159/20030409/966783.html> (last visited 16 April 2012).

⁴⁹ Matters concerning the institution of class actions provided for under the Civil Procedure Law and the Opinion on Several Issues Regarding the Implementation of Civil Procedure Law of the PRC [*Zuigao Renmin Fayuan Guanyu Shiyong Zhongguo Renmin Gongheguo Minshi Susong fa Ruogan Wenti De Yijian*] (the “SPC Civil Procedure Law Opinion”), promulgated by the SPC, 14 July 1992 have not been amended since their promulgation in 1991 and 1992, respectively.

⁵⁰ Article 12, SPC 2003 Circular.

⁵¹ Article 55, Civil Procedure Law.

⁵² *Ibid.*

relieved from paying filing fees upfront⁵³. Similar to the class actions suits in the US, the results of the Article 55 litigation will be binding on those who have registered their rights with the court and also those unregistered members who are not time barred from lawsuit.

Unfortunately, fearful that listed companies could become a target of rising public anger over endemic market frauds and due to the apprehension to open floodgates to many complex securities cases⁵⁴, the SPC has effectively denies potential plaintiffs from utilizing the more robust representative litigation rules under Article 55 for bringing civil compensation claims. This deprives investors from the benefits of the economies of scale in litigation that are otherwise available under the existing legal framework, and reduces the effectiveness of private securities litigation in China.

3. Lack of Judicial Infrastructure

Despite recent reforms to strengthen their competence,⁵⁵ concerns have frequently been voiced about the institutional deficiencies of the judiciary. The courts' difficulties stem from the tradition that judges have been selected from non-legal careers and have received little or no formal education, let alone legal training, prior to assignment to the bench. Coupled with the short history of securities regulation, it is hardly surprising that judges lack competence to correctly adjudicate securities fraud cases, which are technical and fall within a specialized area of the law. The technicality and complexity of matters is particularly true in securities cases, where the retail investors may be both the victims of securities fraud, as well as contributors to the commission of market misconduct by engaging in speculative short-term transactions in the marketplace. Not only will judges find it difficult to distinguish violations of the Securities Law from non-violations, they may also encounter difficulties in applying legal principles and assigning culpability across defendants consistently.⁵⁶

4. Summary: The need for reform

⁵³ The filing fees will be borne by the losing party after the case is concluded. See Article 129 of the SPC Civil Procedure Law Opinion.

⁵⁴ Bei Hu, "China urged to adopt class action suits", 21 November 2002, South China Morning Post.

⁵⁵ For instance, since 2002, all new judges in China are required to possess bachelor's degrees. The Supreme People's Court further stated that sitting judges who are under the age of 40 are required to obtain a degree within five years or will lose their jobs. Judges who are above the age of 40 and lack university education is permitted to stay on if they completed a training course. See Benjamin Liebman, *China's Courts: Restricted Reform* (2007) China Quarterly, 620.

⁵⁶ Marlon A. Layton, "Is Private Securities Litigation Essential for the Development of China's Stock Markets?", 83 *New York University Law Review* (2008), at 1967 (stating the current legal and political environment does not support a greater role for private securities litigation).

It is true that China has dedicated great efforts to upgrade its securities regulatory regime and to further investor protection in the past years, but the overall situation is still far from satisfactory. The SPC Circulars failed to provide defrauded shareholders with a cost-effective procedure through which they can gain access to the courts. The absence of economic incentives and the high upfront costs in bringing securities fraud suits deterred most retail investors from achieving recourse through civil litigation. Indeed, few would dare invest in the high filing fee and other expenses upfront in exchange for negligible compensation that might possibly result.

According to a recent study by Liebman and Milhaupt, only about 15 percent of the suit-eligible companies have in fact been sued in the years following the promulgation of the SPC Circulars.⁵⁷ While 15 percent may seem high at first glance, it must be noted that these companies have already been sanctioned by the CSRC or other administrative authorities for misrepresentation in their disclosure documents. Because the factual finding of wrongdoing has already been made, these suit-eligible companies would appear to be easy targets for securities suits. Yet, over 80 percent of these eligible companies have not been sued in practice. Furthermore, only a handful of cases have resulted in the imposition of liability on the defendant, while a small number of cases have been settled after court mediation.⁵⁸ According to Yixin Song, a prominent securities lawyer in China, about 10,000 investors or 10 percent of the shareholders who are eligible to sue have initiated securities-related lawsuits by the end of July 2006, but only some 1,000 of them have obtained some form of redress.⁵⁹ The amount of damages claimed represents less than 5 percent of the total losses incurred by the public investors as a result of securities fraud.⁶⁰ Even if regulators have punished some of the most outrageous manipulators in the securities market, lax enforcement of the law has led to the extensive misappropriation and securities fraud on the market,⁶¹ because the risk of being caught and penalized is so slim as to be

⁵⁷ Benjamin L. Liebman & Curtis J. Milhaupt, "Reputational Sanctions in China's Securities Market", 108 (2008) *Columbia Law Review* 929, 943.

⁵⁸ Katharina Pistor and Chenggang Xu, "Governing Stock Markets in Transition Economies: Lessons from China", (2005) 7(1) *American Law and Economics Review* 184, 193.

⁵⁹ Song Yixin, "Accelerate the Development of Securities Civil Compensation System in China" (Jiakuai Tuijin Zhengquan Minshi Peichang Fazhi Jianshe), *China Securities Daily [Zhongguo Zhengquan Bao]*, July 27, 2006.

⁶⁰ Report by *China Securities Daily [Zhongguo Zhengquan Bao]*, 24 July 2006, available at http://news.xinhuanet.com/stock/2006-07/24/content_4871138.htm (visited 16 April 2012).

⁶¹ Zhong Zhang, "Legal Deterrence: the foundation of corporate governance – evidence from China", *Corporate Governance: An International Review*, Volume 15, Issue 5, pages 741–767, September 2007, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1017406<http://papers.ssrn.com/sol3/papers.cfm?ab>

negligible, whereas the potential gain from fraudulent activities can be very lucrative. Companies and other wrongdoers are not sufficiently punished for their fraud, thus affecting public confidence in the market.

III. Empowering Shareholders' Rights: The Class Action Solution?

The prevalence of securities fraud on the market and the importance of investor protection have led scholars to consider supplementary mechanisms for regulatory enforcement⁶². Under the US federal law, persons with similar causes of action and standing are allowed to pool their claims and resources to bring one single action, after obtaining prior certification from the court. Therefore, class actions are seen as a useful procedure to achieve economies of scale and to overcome the collective action problem in bringing actions that will affect the interests of a group.⁶³

One major feature of the American securities class action system is the opt-out provision. Persons who hold claims concerning questions that are raised in the class proceeding are bound by any resulting judgments, unless they affirmatively elect to be excluded⁶⁴. To facilitate access to the courts, various fee-shifting mechanisms such as the contingency fee arrangement are in place to relieve class members from the financial burden of launching these suits. Contrary to the usual costs rule, whereby each party to litigation pays his legal bill, attorneys under the contingency fee arrangement will charge nothing if a case is lost. If the case is settled or is successful, attorneys will be paid on a percentage of damages recovered, which usually ranges between 25 and 30 percent in the US. Since class members are generally not liable for the costs of unsuccessful suits, the contingency fee arrangement provides financial

stract_id=1017406 (last visited 16 April 2012).

⁶² See, for example, Wallace Wen-Yeu Wang and Jian-lin Chen, "Reforming China's Securities Civil Actions: Lessons From U.S. PSLRA Reform and Taiwan's Government-Sanctioned Non-Profit Organization," (2008) 21 Colum. J. Asian L. 115, p. 117.

⁶³ Eligible cases should meet four threshold requirements under Rule 23 of the Federal Rules of Civil Procedure, namely, numerosity, commonality, typicality and adequacy of representation. In addition, Rule 23(b) provides that a class action may be maintained if one of the three conditions contained therein is satisfied. The first category of action under Rule 23(b) is that the pursuance of separate actions by or against individual class members would either establish incompatible standards of conduct for the party opposing the class, or practically impair the interests of class members who are not parties to the adjudication: Rule 23(b)(1). The second category of action is that the party opposing the class has acted or refused to act on grounds that apply generally to the class, so that the final injunctive relief or corresponding declaratory relief is appropriate respecting the class as a whole: Rule 23(b)(2). The third category of action is the common question action: Rule 23(b)(3). In practice, this requirement is met when the court finds that questions of law or fact common to class members predominate over questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the dispute in question

⁶⁴ Rule 23 of the Federal Rules of Civil Procedure.

incentives for defrauded investors to pursue securities claim that otherwise would not be brought at all.

The most beneficial aspect of the class action mechanism for potential plaintiffs is to overcome cost-related hurdles in bringing an action. While each individual's loss is insufficient to make the undertaking of individual litigation financially viable, the aggregate claims of the plaintiff class may be substantial enough to justify the potential costs. To facilitate access to the courts, various fee-shifting mechanisms such as the contingency fee arrangement are in place to relieve class members from the financial burden of launching these suits. Contrary to the usual costs rule, whereby each party to litigation pays his legal bill, attorneys under the contingency fee arrangement will charge nothing if a case is lost. If the case is settled or is successful, attorneys will be paid on a percentage of damages recovered, which usually ranges between 25 and 30 percent in the US. Since class members are generally not liable for the costs of unsuccessful suits, the contingency fee arrangement provides financial incentives for defrauded investors to pursue securities claim that otherwise would not be brought at all. With the contingency fee arrangement, the class action system could enhance access to justice and provide retail investors with an economic means to obtain redress for corporate misconduct.

Apart from economic considerations, class actions also help redress the imbalance between the wrongdoers of fraud and the minority public shareholders.⁶⁵ In the Chinese context, the former are usually connected with powerful local interests, but there are no organized investor groups with comparable capacity for the minority public shareholders. The class action system can thus help these shareholders overcome fears of retaliation from the wrongdoers and assist them to a remedy should an action be brought by any member of the class on behalf of all members. Seen in this light, private securities litigation offers much potential as a useful deterrent and remedial device to police the corporate insiders. A growing number of jurisdictions⁶⁶ have actively considered adopting the American class action procedures to promote private enforcement.⁶⁷ In the wake of a series of securities fraud scandals at the turn of this century, scholars in China have also called for the adoption of a US-style class action system to improve shareholders' access to justice.⁶⁸

⁶⁵ Herbert B Newberg and Alba Conte, *Newberg on Class Actions* (4th ed) (Colorado Springs, McGraw-Hill Inc. 2001), p 478.

⁶⁶ For example, the European Union, New Zealand, Singapore, South Africa, and the UK.

⁶⁷ See, for example, Lisa Rickard, "The Class Action Debate in Europe: Lessons from the U.S. Experience". Available at <http://www.europeanbusinessreview.com/?p=273> (last visited 12 April, 2012).

⁶⁸ See, for example, Weijian Tang and Wei Chen, "Woguo Jituan Susong Zhidu de Yizhi Lujing Tanxi"

Nonetheless, the fundamental flaw of the class action system is that unnecessary and frivolous lawsuits may be encouraged for the sole purpose to coerce settlements that are disproportionate to the merits of the plaintiff's claims.⁶⁹ With the opt-out rule, plaintiffs can commence proceedings on behalf of persons with no individual litigious interest or persons who do not even know the existence of the class action. The combined effect of the opt-out rule and the contingency fee arrangement hence gives rise to a serious risk that attorneys may simply discover a cause of action, find a plaintiff and then boilerplate a class action suit. Given the litigation costs and the disruptive impact on the company's operations, defendant corporations in the US are often inclined to settle low value compensation claims early on, regardless of their underlying merits.⁷⁰ One possible consequence is that unmeritorious cases are allegedly brought and pursued solely in the hope that the management will offer a handsome settlement to rid itself of the nuisance. Such risk of abusive litigation has even deterred the legal profession in the UK from adopting a similar system.⁷¹

Even for meritorious litigation, class actions are said to reduce average shareholder welfare.⁷² Class action suits divert corporate resources from focusing on their normal activities.⁷³ Additionally, significant fee awards and settlement amounts result in higher director and officer insurance premiums. The premium, together with increased operating costs and the settlement sum, is ultimately passed on to shareholders.⁷⁴ Critics have therefore rightly pointed out that securities class actions are pocket-shifting wealth transfers by shareholders who own shares of the company at the time of settlement to plaintiff shareholders of the securities suit that enriches the

(Transplanting Foreign Experience to Reform the Mass Litigation System in China), *Political Science and Law (Zhengzhi Yu Falu)*, Issue 1, 2008. See also, Jianfeng Pan and Fuyong Chen, "Lun Zhengquan Minshi Qinquan Peichang Anjian de Susong Fangshi" (On the Action Form of Civil Torts Compensation Cases Concerning Negotiable Securities), *The Political Science and Law Tribune (Zhengfa Luntan)*, Issue 3, 2004.

⁶⁹ Robert D. Cooter & Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, (1989) 27 J. Econ. Lit. 1067, 1075-82.

⁷⁰ Deborah R Hensler & Ors, *Class Action Dilemmas: Pursuing Public Goods for Private Gain* (Santa Monica: RAND Institute for Civil Justice 2000), 119-120.

⁷¹ The introduction of a class action system was initially proposed in the Finance Bill 2010, but was the proposal was subsequently dropped in the rush for the May 2010 General Election. See "May Election kills UK Class Action Proposals", the Insurance Insider, 13 April 2010. Available at <http://www.insuranceinsider.com/may-election-kills-uk-class-action-proposals> (last visited 16 April 2012).

⁷² John Coffee, "Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation", 106 (2006) *Columbia Law Review* 1534, 1534.

⁷³ It was reported that between 1999 and 2004, one major drugmaker in the United States spent US\$25 billion on legal costs and reserves to fight class action lawsuits, while devoting only US\$19 billion to research and development.

⁷⁴ Luigi Zingales et al., "Interim Report of the Committee on Capital Markets Regulation", November 2006, 78. Available at http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (last visited 16 April 2012).

entrepreneurial lawyers at the expense of average shareholders.⁷⁵

Opt-out class actions also present a serious conflict of interest between class members and their attorneys. Because attorneys acting for the class will be paid and recoup significant out-of-pocket expenditure if the litigation is successfully concluded, they will often have a strong financial incentive to settle in the shortest amount of time possible and may be tempted to accept suboptimal or heavily discounted settlements at the expense of class members whose interests he is appointed to guard.⁷⁶ The risk of conflict is further exacerbated by the lack of protection of the interests of the class members in the class action procedure, since class members typically play a small role in the litigation. It is thus reported that securities class action suits recover only a small percentage of the alleged investor loss. For instance, between 2004 and 2008, the median ratio of settlements compared to investor losses has ranged between two and three percent, contrary to the dramatic increase in the amount of settlement payments over the years.⁷⁷ Plaintiff attorneys, however, have received massive fee awards that are disproportionate to the time and effort expended in a case. In a landmark case of the *Bank of Boston* settlement, each of the individual class members was awarded US\$8.76 while the class counsel received US\$8.5 million in fees.⁷⁸

The above analysis reveals that whilst the class action system and the contingency fee arrangement can help police the corporate management, they are most unlikely to improve the prospects for a minority shareholder substantially. The problems that plague class actions in the US may vary in importance when applied in China. Should a securities class action system be introduced in China, it may open the floodgates of frivolous or unmeritorious litigation. It may encourage unnecessary litigation if a class action regime were introduced in China which, unlike some other legal cultures, is not a litigious society. Additionally, securities suits may be heavily driven by lawyers with a view to profit from lucrative fee awards, which may expose listed companies to massive private securities fraud litigation on a scale that China can ill afford, as a majority of the listed companies in China are SOEs, or otherwise controlled by the Government. Successful cases, on the other hand, can exert inexorable pressure on

⁷⁵ See, for example, John Coffee, "Law and the Market: The Impact of Enforcement", 156 (2007) *University of Pennsylvania Law Review*, 229, 302-305. See also Tom Baker and Sean J. Griffith, "Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market", 74 (2007) *University of Chicago Law Review*, 487, 495.

⁷⁶ John Coffee, "Understanding the Plaintiffs' Attorney: The Implications of Economic Theory for Private Enforcement of Law through Class and Derivative Actions", (1986) 86 *Columbia Law Review* 669.

⁷⁷ It is reported that the average settlement amount between 2002 and 2007 rose to US\$40.5 million, about two and a half times the average settlement amount of US\$16.3 million from 1996 to 2001, *supranote* 65, pp. 8-9.

⁷⁸ *Kamilewicz v. Bank of Boston*, 92 F. 3d 506 (7th Cir. 1996).

listed companies to large settlement amounts. This may threaten current share prices and even force the companies into dissolution in extreme cases,⁷⁹ which may inhibit the privatization reform process of the SOEs that the securities market in China is designed to assist⁸⁰. As the US experience illustrates, these bounty-hunter class actions may as well lead to over enforcement and hence over deterrence of securities fraud, which may dissuade foreign companies from entering into the country's securities market.

In addition to the perceived risk of abuse, institutional differences between the US and China may operate as a key impediment to the modeling of the US-style class action regime in China. Unlike their counterparts in the US, a major hurdle confronting shareholders in China is the limited access to legal representation. The Government has maintained tight control over the participation of lawyers in joint or mass actions for social stability reasons. In April 2006, the All China Lawyers' Association, a government-backed regulatory body for lawyers in China, promulgated a Guiding Opinion on the Handling of Mass Suits by Lawyers (the "Guiding Opinion").⁸¹ The Guiding Opinion stipulates that lawyers who are engaged to handle a mass suit (*qunti anjian*) are subject to supervision and guidance of the judicial administration departments.⁸² A mass suit is defined as an action where either side consists of ten or more individuals who are bound by common questions of law or fact⁸³. Lawyers are also required to report to the responsible government agencies as soon as they are aware of any signs that suggest potential intensification of the conflict or any actions on their clients' part that may threaten social stability.⁸⁴ In the absence of unrestricted access to legal representation, doubts are casted as to whether the class action system can enhance shareholders' recourse to justice dramatically. Moreover, the existing legal regime fails to offer a fixed solution to issues such as stockholders' standing to sue and the allocation of burden of proof, making private securities litigation

⁷⁹ Richard M. Philips and Gilbert C. Miller, "The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers", 51 (1996) *Business Law* 1009, 1028

⁸⁰ The goals of SOE reform are not simply to enhance corporate productivity and financial performance, but to create an optimal institutional arrangement compatible with the reform of a market-oriented economy. OECD Working Group on Privatisation and Corporate Governance of State Owned Assets, Occasional Paper, "State Owned Enterprises in China: Reviewing the Evidence", January 2009. Available at <http://www.oecd.org/corporate/corporateaffairs/corporategovernanceofstate-ownedenterprises/42095493.pdf> (last visited 20 October 2012).

⁸¹ *Guiding Opinion on the Handling of Mass Suits by Lawyers [Zhonghua Quanguo Lvshi Xiehui Guanyu Lvshi Banli Quntixing Anjian de Zhidao Yijian]*, issued by All China Lawyers' Association, April 2006.

⁸² Article 1(3) of the Guiding Opinion.

⁸³ *Ibid.*

⁸⁴ Article 2 of the Guiding Opinion.

extremely difficult to handle.⁸⁵

A related concern is that most local people's courts in China lack independence⁸⁶. Although China's Constitutional Law recognizes the independence of the courts as a whole,⁸⁷ local governments control local courts through their control of the budget, and power to appoint, promote and remove judges.⁸⁸ This is especially problematic in light of China's current issues of widespread protectionism and corruption.⁸⁹ Local courts may not be able to fend off local Party and governmental pressures that may violate due process and independent judicial decision-making. The risk of undue interference is particularly imminent if the interest of that government or the SOE in that locality is at issue in a case pending before the court. Not only are courts hesitant to allow claims against important local companies or persons, they are subject to extensive oversight by the judicial committees within the court (*shenpan weiyuanhui*) who virtually decides how important or politically sensitive cases should be decided.⁹⁰ As judges rarely resist the committee's determination or recommendation, this encroaches upon the independent decision-making process. Besides, the performance of judges is evaluated based on the number of cases they processed⁹¹. Since it is likely to disadvantage the court's caseload, judicial hostility towards class action may intensify should it be implemented in China.⁹²

During its transition from a planned to a market economy and in the process of developing the rule of law, better shareholder protection through the provision of the private securities class action mechanism is unlikely to be feasible in China's current political-legal landscape. The reluctance to permit private securities litigation, particularly those based on class actions involving a large number of plaintiffs reflects a broader concern relating to social stability. Class actions carry significant political overtones because they are likely to involve politically well-connected local entities or persons. More fundamentally, class actions carry significant political overtones in

⁸⁵ Daniel Fung and Wang Shengchang, *Arbitration in China: A Practical Guide* (Hong Kong: Sweet & Maxwell, 2004), para 24-08.

⁸⁶ Chinese local courts are funded and subsidized by the relevant local people's government. See Albert Chen, *An Introduction to the Legal System of the People's Republic of China* (4th ed) (HK: LexisNexis, 2011), p. 200-204.

⁸⁷ Article 126 of the Constitution, and Article 4 of the Organic Law of People's Courts.

⁸⁸ Article 127 of the Constitution (stating that while the Supreme People's Court supervises the adjudicative work of all lower level people's courts, it has no power over their budgets).

⁸⁹ Gu Weixia, "Judicial Review over Arbitration in China: Assessing the Extent of the Latest Pro-Arbitration Move by the Supreme People's Court in the People's Republic of China", 27 (2009) *Wisconsin International Law Journal*, pp. 258-259 (stating that "local protectionism must be prevalent unless the court can relieve itself from the budget constraints").

⁹⁰ Albert Chen, *An Introduction to the Legal System of the People's Republic of China* (2011), 186.

⁹¹ Benjamin Liebman, "Class Action Litigation in China", 111 (1998) *Harvard Law Review* 1523.

⁹² *Ibid.*

the Chinese securities context. Class actions provide the means through which a group of aggrieved shareholders are organized into a class, which has the potential to destabilize the society and understandably, trigger anxiety in the government. Some local judges have even expressed in interviews that mass actions are politically too risky,⁹³ and that political stability is preferred⁹⁴ to other market values. In this light, Chinese courts have historically been, and are unlikely that they will in the near future, be hospitable fora for defrauded investors to seek compensation for losses resulting from securities fraud.

IV. Securities Arbitration: An Alternative Out

Having concluded that modeling the US class action system in China is quite unlikely to supply the optimal level of private enforcement to police corporate misconduct and to deter securities fraud in China, this section explores how the present system of securities fraud litigation should be reformed in order to balance the competing interests of state control, social stability, and minority shareholder protection in the listed companies. In view of the dominance of retail shareholders in the Chinese securities market, a cost-effective and accessible alternative dispute resolution mechanism may be more feasible in addressing the deficiencies of the private enforcement of securities regulation. The following section will focus on one of the more promising mechanisms in this area, securities arbitration.

A. The Rise of ADR in the Settlement of Financial Disputes

During the last few years, alternative dispute resolution (ADR) mechanisms, such as mediation and arbitration, have been gaining popularity in the settlement of financial disputes. In essence, mediation is a voluntary dispute resolution process in which an independent neutral person, the mediator, helps the parties resolve their disputes and reach a negotiated settlement.⁹⁵ Arbitration, on the other hand, is more akin to litigation than mediation. It is a private means of resolving disputes through the use of neutral third parties known as arbitrators, who are usually appointed by agreement of the disputing parties. As compared to litigation, arbitration is less formal, as it

⁹³ Walter Hutchens, "Private Securities Litigation in Chia: Material Disclosure about China's Legal System?", 24 (2003) U. Pa. J. Int'l Econ. L. 645.

⁹⁴ Nicholas Howson, "Judicial Independence and the Company Law in Shanghai Courts", in Randall Peerenboom (ed), *Judicial Independence in China: Lessons for Global Rule of Law Promotion* (Cambridge University Press, 2009), pp. 135, 147.

⁹⁵ Jacqueline Nolan-Haley, *Alternative Dispute Resolution* (2nd ed, West Group: 2001), 62.

emphasizes equity and efficiency above strict observance of legal norms.⁹⁶

The speed and cost savings associated with ADR mechanisms offer much appeal in the settlement of financial disputes. Rather than having generalist judges who have to rely upon the assistance of experts and may prolong the hearing and increase the costs, arbitration is, by contrast, cheaper and speedier as experts who are knowledgeable about the customs of an industry may be appointed by parties to serve as arbitrators. The recent years have, therefore, seen an increasing worldwide interest in ADR mechanisms to resolve financial and securities disputes. For instance, in *Rodriguez de Quijas v. Shearson/American Express Inc.*, the highest court of the US upheld the enforceability of pre-arbitration agreements to settle disputes between broker-dealers and their customers.⁹⁷ In addition to the affirmation by the court, the Financial Industry Regulatory Authority (FINRA) offers investors the option to resolve disputes via mediation or arbitration of which arbitration is the more popular one. Throughout 2011, a total of 4,729 arbitration cases were filed through the FINRA process and 572 parties agreed to go to mediation.⁹⁸ In Hong Kong, the Hong Kong Monetary Authority appointed the Hong Kong International Arbitration Center (HKIAC) to administer the Lehman Brothers-Related Investment Products Dispute Mediation and Arbitration Scheme to resolve mini-bonds claims between banks and investors arising from the collapse of Lehman Brothers in 2008.⁹⁹ In a similar vein, the Financial Ombudsman Service (FOS) has been established in the United Kingdom to resolve consumer financial disputes.¹⁰⁰ The FOS provides free and independent advice to consumers regarding the resolution of disputes with financial companies. According to the figures revealed by the CityUK, an independent body established to promote the financial and related professional services industry in the UK, the total number of disputes that have been resolved through arbitration and mediation reached a total of 34,541 in 2009, up over three quarters from 19,384 in 2007.¹⁰¹

Mediation and arbitration are also popular dispute settlement alternatives in China.

⁹⁶ *Ibid.*, at 138.

⁹⁷ *Rodriguez de Quijas v. Shearson/American Express Inc.* 490 U.S. 477 (1989).

⁹⁸ The figures in 2010 were that 5,680 cases had been filed through the FINRA process and 497 cases closed through mediation. Source: Dispute Resolution Statistics by FINRA, available at <http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/> (last visited 16 April 2012).

⁹⁹ Gu Weixia, "ADR and Financial Disputes in Hong Kong: The Lehman Brothers Experience and The Way Forward" [2011] *Asian Dispute Review*, 20.

¹⁰⁰ See <http://www.financial-ombudsman.org.uk/>

¹⁰¹ The CityUK, "Dispute Resolution in London and the UK 2010", available at <http://www.thecityuk.com/research/our-work/reports-list/dispute-resolution-in-london-and-the-uk-2010/> <http://www.thecityuk.com/research/our-work/reports-list/dispute-resolution-in-london-and-the-uk-2010/> <http://www.thecityuk.com/research/our-work/reports-list/dispute-resolution-in-london-and-the-uk-2010/> (last accessed 12 April 2012).

Indeed, as early as 1994, Chinese law has recognized arbitration as a legitimate choice for the resolution of intra-corporate conflicts in the context of Chinese corporations that are listed abroad. Article 163 of the Mandatory Provisions of Articles of Association of Companies Seeking Overseas Listing (*Dao Jingwai Shangshigongsi Zhangcheng Bibeitiao*) provides for a compulsory arbitration clause whereby the disputes between a Chinese corporation that is listed in Hong Kong and its shareholders must be submitted to arbitration in China International Economic and Trade Arbitration Commission (CIETAC) or the HKIAC.¹⁰² In addition, the SPC Circulars provide the legislative support for the use of ADR methods to settle civil compensation claims arising from misrepresentation in the disclosure documents of a listed corporation.¹⁰³ Article 4 of the 2003 Circular instructs the people's courts to stress (*zhaozhong*) mediation while adjudicating cases and to encourage settlement of private securities fraud disputes. Seen in this light, ADR could play an important role in handling the large number of securities-related fraud disputes in China. The people's courts have limited resources, but ADR could help ensure timely and efficient proceedings.

B. The Way Forward: Securities Arbitration Scheme

At present, there is no mechanism outside of the courts that can achieve the outcome of dispute resolution where aggrieved shareholders can recover their financial losses from the wrongdoers of securities fraud. Drawing upon this global ADR trend, and bearing in mind the need to improve shareholders' access to justice, it is proposed that defrauded shareholders who have suffered financial losses resulting from securities fraud shall be provided with an additional avenue to resolve civil compensation claims with wrongdoers of fraud in a cost-effective and expeditious manner. Unduly legalistic procedures should be avoided to keep it simple for average retail shareholders.

In view of the institutional experience in the US and HK, it is advocated that a securities arbitration scheme should be introduced in China for the resolution of civil compensation claims that falls within the scope of the Securities Law. Even though securities arbitration has not achieved full legal efficacy, the securities industry has long reached a consensus regarding the necessity of a dispute resolution scheme

¹⁰² See the CSRC webpage on the interpretation of the law, available at http://www.csrc.gov.cn/pub/newsite/ssb/ssflfg/bmgzjwj/ssgszl/200911/t20091110_167714.htm (last accessed 16 April 2012).

¹⁰³ The Rules instruct courts to use mediation as a method of resolving cases concerning misrepresentation in accordance with principles and procedures of mediation set out in the Civil Procedure Law.

combining low cost and high efficiency.

1. Theoretical Merits of Securities Arbitration

While arbitration procedures bear many resemblances with those in court proceedings, arbitration is superior to litigation in resolving securities disputes in three aspects. First, an arbitrator is more familiar with the securities regulatory regime and the commercial realities involved in a case. Unlike litigation where there is a need to explain technical matters to generalist judges, the use of expert determination in arbitration allows for speedy resolution of disputes. Hence, it satisfies the need of the securities market for an industry-specific type of dispute resolution.¹⁰⁴ Second, parties to arbitration can tailor procedures to make them appropriate to the circumstances of a particular case. Accordingly, there is more scope for relevant issues to be identified quickly and accurately to avoid unnecessary delay and expenses. Third, arbitral hearings are carried out in private and the awards are only published in an anonymous manner.¹⁰⁵ Further, arbitrators are required by the ethical rules to maintain all information revealed during a case in strict confidence.¹⁰⁶ Hence, it is particularly appealing to the business confidence. This is especially vital for securities disputes, as the securities market is sensitive, volatile, and responsive to such news.

More importantly, arbitration is suited to resolving civil compensation claims arising from securities fraud in China, and thus complements the weak enforcement of the Securities Law. Because legal development lagged behind economic development in China, the resolution of disputes based on the principles of equity and fairness of arbitration in the securities context offers much flexibility to deal with scenarios where there are gaps between the law in the text and law in reality in China. The use of arbitration also saves scarce Chinese judicial resources by relieving local courts from the need to hear a large number of civil compensation cases when a scandal breaks out, and thus enhances judicial efficiency in China.¹⁰⁷ Moreover, the speed

¹⁰⁴ This is particularly true in China, because judges are generally less experienced than judges in dealing with commercial disputes.

¹⁰⁵ CIETAC Rule (2005), providing that an arbitral tribunal may not hear cases in an open session

¹⁰⁶ Article 13 of the Ethic Rules of Arbitrators of CIETAC, available at the CIETAC website:

<http://cn.cietac.org/Arbitration/ArbitrationRule.shtml><http://cn.cietac.org/Arbitration/ArbitrationRule.shtml> (last visited 16 April 2012).

¹⁰⁷ For instance, in the past decade, several highly sensational cases involving listed corporations have occurred, such as the *Shenzhen Kondarl (Group) Co Ltd* in 2000, *New NongKai Global Investments Ltd* and *Xin Jiang Hops Co Ltd* in 2003, etc. Numerous lawsuits have filed against these listed corporations which have been involved in corporate malpractice. Unfortunately, process of the settlement of these lawsuits is often blocked by procedural issues before the substantive issues are treated and damages paid. See Daniel Fung and Wang Shengchang, *Arbitration in China: A Practical Guide* (HK: Sweet & Maxwell, 2004), para 24-04.

and cost savings associated with arbitration offers a practical and economic alternative for most resource-poor Chinese retail investors to police corporate behavior. Economic analysis of law has occupied an outstanding position in securities research. When determining the pros and cons of a particular dispute resolution related to securities in China, arbitration is expected to prosper because it can offer the most synergies in terms of efficiency and cost-saving. Securities arbitration therefore has the potential to improve shareholders' access to justice in China.¹⁰⁸

Stability of the securities market is particularly important in the context of China because its securities market is still at its infant stage. Arbitration may also realize this dimension of purpose. As was mentioned before, arbitration keeps the disputes confidential and prevents wide spread of sensitive information. Through the confidential and stable progress of the dispute resolution, greater stability in the securities market may be achieved at minimal cost and with maximum efficiency. Therefore, arbitration may serve dual purposes of protecting interests of minority shareholders on the one hand, and of keeping normal social order in the securities market on the other hand.¹⁰⁹ In this sense, securities arbitration may enhance social stability.¹¹⁰

2. Institutional Set-up of the Securities Arbitration Scheme

Creating a new entity at the national level to oversee the securities arbitration scheme would be a costly option and would take a considerable time to implement. For this purpose, it would be most cost effective for future civil compensation claims to be weaved into one of the pre-existing arbitration resources in China. It is suggested that China International Economic and Trade Arbitration Commission (CIETAC) is the most appropriate forum for the following reasons.

CIETAC is the most experienced forum for commercial arbitration in China which handles the majority of such disputes and at a service charge that the general market players can afford.¹¹¹ CIETAC was founded in 1956 under the auspices of the China Council for the Promotion of International Trade (CCPIT) to aid the CCPIT in

¹⁰⁸ *Ibid.* at para 24-20.

¹⁰⁹ Daniel Fung and Wang Shengchang (eds), *Arbitration in China: A Practical Guide* (Sweet & Maxwell Asia, 2004), para 24-25.

¹¹⁰ Confidentiality is another characteristic of arbitration that China may desire because China often does not want public transparency for its firms. For example, China has blocked attempts by the Public Company Accounting Oversight Board of the United States from examining the financial auditing of Chinese firms.

¹¹¹ Lijun Cao, CIETAC as a Forum for Resolving Business Disputes. Available at <http://www.fljs.org/uploads/documents/Cao%231%23.pdf> (last visited 16 April 2012)

promoting international trade by providing an impartial forum for the resolution of foreign-related disputes. Since then, it has transformed from a quasi-judicial dispute resolution body to a truly modern international commercial arbitration institution. Currently, it is the largest and busiest arbitration institution in the world in terms of its annual caseload.¹¹² It is also the leading arbitration commission in China, administering a wide array of domestic and foreign-related disputes, including those that involve international trade and investment, financial leasing and service contracts.¹¹³

CIETAC's popularity in the international arbitration community can partly be explained by its commitment to revise arbitration procedures in line with international practice and standards. The CIETAC Rules have been revised six times since its inception, and its recent amendment to the CIETAC Rules in 2005 appears to have addressed some of the most common criticisms leveled against the CIETAC procedures.¹¹⁴ Most noticeable of all, for the first time, a list procedure was introduced for the selection and appointment of arbitrators who are not on its Panel of Arbitrators List by parties' arbitration agreement.¹¹⁵ Prior to the introduction of this rule, CIETAC adopted the panel system whereby arbitrators from only within its panel of arbitrators could be appointed.¹¹⁶ This widening of potential arbitrators will increase dramatically the pool of experts and foreigners available to serve on a CIETAC tribunal and has significant practical impact on increasing the parties' procedural autonomy.¹¹⁷ Although such appointment needs to be confirmed by CIETAC,¹¹⁸ in the words of one scholar, "such confirmation is more of a formality and the appointment of foreign arbitrators is most unlikely to be refused without a good reason".¹¹⁹ This reform was coupled with measures to strengthen arbitrator impartiality. The revised CIETAC Rules provide that an appointed arbitrator must declare any matters that may raise reasonable doubts about their independence and impartiality and request his withdrawal.¹²⁰ This should inject greater confidence on the independence of the arbitrators. CIETAC has recently indicated an intention to carry out further amendments to its arbitration rules in accordance with the

¹¹² Raymond Leung (ed), *China Arbitration Handbook* (HK: Sweet & Maxwell, 2011), para 4.006.

¹¹³ *Ibid.*

¹¹⁴ Gu Weixia, "China's Arbitration: Restricted Reform", in Guanghua Yu (ed), *The Development of the Chinese Legal System: Change and Challenges* (Routledge, 2011), 273.

¹¹⁵ Article 21 (2), CIETAC Rules (2005).

¹¹⁶ Gu Weixia, "The China-style Closed Panel System in Arbitral Tribunal Formation - Analysis of Chinese Adaptation to Globalization", 25 (2008) *Journal of International Arbitration*, 146.

¹¹⁷ *Ibid.*

¹¹⁸ Article 21(2), CIETAC Rules (2005).

¹¹⁹ Jingzhou Tao, *Arbitration Law and Practice in China* (Kluwer Law International, 2008), at 120.

¹²⁰ Article 25, CIETAC Rules (2005).

developments in the Chinese market by requesting submission of proposals in late 2010.¹²¹

Aside from its emphasis on due process, CIETAC has maintained its institutional independence to a large extent. Unlike many local arbitration commissions, which are financially sponsored by the local treasuries and hence reliant on the local government for survival and development,¹²² CIETAC has retained its financial autonomy. The steady increase of the arbitration caseload has generated impressive income of arbitration fees, and as such, it is less prone to administrative interference.¹²³

From a functional point of view, CIETAC is best equipped to hear securities disputes because it has accumulated experience in handling securities and financial disputes over decades. As early as 1994, the State Council Securities Commission (SCSC, the predecessor of CSRC) designated CIETAC as the arbitral tribunal for disputes between securities firms or between securities firms and stock exchanges.¹²⁴ At the time of this designation, the Securities Law was under draft. A Securities Arbitration Commission was proposed by the 1993 Draft of the Securities Law to be set up within the China Securities Association, dealing with disputes between securities firms and their clients, but this proposal was removed from the 1994 Draft of the Securities Law.¹²⁵ Both the 1998 Securities Law and 2005 Securities Law have failed to mention the earlier proposal on the establishment of a specialist securities dispute arbitration tribunal.¹²⁶ However, the emphasis on CIETAC by the State in resolving securities disputes is reflected.

As a national arbitration commission, CIETAC is headquartered in Beijing, with three sub-commissions in Shanghai, Shenzhen and Tianjin.¹²⁷ It has also established twenty-one liaison offices in different regions and in different business sectors to

¹²¹ CIETAC news, available at <http://cn.cietac.org/NewsFiles/NewsDetail.asp?NewsID=896><http://cn.cietac.org/NewsFiles/NewsDetail.asp?NewsID=896> (last visited 16 April 2012).

¹²² Gu Weixia, "China's Arbitration: Restricted Reform", in Guanghua Yu (ed), *The Development of the Chinese Legal System: Change and Challenges* (Routledge, 2011), pp. 274-276 (stating the inherent institutional defects of local arbitration commissions).

¹²³ CIETAC homepage, available at <http://www.cietac.org> (last visited 23 October 2012).

¹²⁴ The Notice of the SCSC on Designation of CIETAC as Arbitration Organization for Securities Disputes (*Guowuyuan Zhengquan Weiyuanhui Guanyu Zhiding Zhongguo Guoji Jingji Maoyi Zhongcai Weiyuanhui We Zhengquan Zhengyi Zhongcai Jigou de Tongzhi*), issued by the State Council on and effective as of August 26, 1994.

¹²⁵ See Zhu Sanzhu, *Securities Regulation in China* (Ardslay, NY: Transnational Publishers, 2000), pp. 69-70.

¹²⁶ *Ibid.*

¹²⁷ They are CIETAC Shanghai Sub-Commission, CIETAC South China Sub-Commission (in Shenzhen), and the CIETAC International Economic & Financial Arbitration Center (in Tianjin) respectively.

promote its arbitration practice.¹²⁸ Its geographical presence and nation-wide resources may provide convenient hearing venues for which civil compensation cases may be resolved.

Seen from this perspective, inviting CIETAC to be the arbitration institution can take advantage of its established dispute resolution experience and existing nation-wide arbitration resources. Moreover, it may leverage fully the financial and securities expertise within the CIETAC panel, as well as its back office support, such as finance, manpower, information technology, and premises.

3. *The Arbitration Process*

a. Eligibility requirements

It is proposed that at the initial stage, shareholders can only bring “follow-up” actions, seeking compensation against a listed corporation and other relevant wrongdoers after the CSRC or other competent administrative agencies have decided that the conduct in question constitutes an infringement of the Securities Law. The proposal draws experience from the success of Lehman Brothers-Related Investment Products Dispute Mediation and Arbitration Scheme in Hong Kong, whereas investigative powers are resumed with Hong Kong Monetary Authority (HKMA) and Securities and Futures Commission (SFC). HKIAC, on the other hand, is mainly responsible for adjudication.¹²⁹ Retaining the powers of the CSRC to deal with regulatory breaches while introducing CIETAC for damage award would avoid duplication of powers and, in addition, would not confuse the effective division of responsibility in financial dispute resolution.¹³⁰ To be parallel with the civil actions, a limitation period should also be set so that a claim is not eligible for arbitration if two or more years have elapsed from the date of the decision, similar to the provisions under the SPC Circulars.¹³¹ Following an improvement in the civil discovery mechanism in China in the future, shareholders should be allowed to bring “stand-alone” actions, so that parties who considered that they had been affected by an infringement of the Securities Law should be entitled to take civil action for the recovery of damages suffered, regardless of the outcome of criminal or administrative investigations.

¹²⁸ Examples include grain, commerce, construction, finance, leather and wool transactions.

¹²⁹ Gu Weixia, “ADR and Financial Disputes in Hong Kong: The Lehman Brothers Experience and the Way Forward”, (2011) *Asian Dispute Review*, 20-23.

¹³⁰ *Ibid.*, at 23.

¹³¹ Article 2 of the 2002 Circular and Article 5 of the 2003 Circular.

Critics have attacked the requirement for a prior administrative sanction or criminal judgment before the initiation of a civil compensation suit for depriving investors of a statutory right of private action.¹³² This is because under Article 6 of the Civil Procedure Law, courts are required to hear cases independently without inference from administrative agencies. Given that the securities market in China was intended to serve the economic goals of the State, it is conceivable that the prior decision requirement may create opportunities for alleged wrongdoers to escape civil liability by influencing the administrative or criminal investigation process through *guanxi* or bribery.¹³³ This would limit the civil litigation rights and the availability of compensation to defrauded investors who suffered economic losses. Moreover, according to Zhu, changing government policies may prevail through administrative agencies at the cost of the legal rights and interests of the public investors.¹³⁴

These are indeed valid criticisms of the securities enforcement regime in China. However, it is opined that the prior decision requirement is justifiable as a temporary feature of the securities arbitration system in view of the high information costs to bring securities fraud litigation. The stock market in China is heavily dominated by retail investors who lack the requisite skills and means to detect securities fraud. Not only do they have limited access to internal corporate documents,¹³⁵ there is an absence of an elaborate discovery mechanism in China, which is likely to place potential claimants at a disadvantaged position in attempting to ferret out the information necessary to establish a claim. For instance, although the Civil Procedure Law empowers litigant representatives to investigate, collect evidence and inspect the files of a case in question, the scope and procedure for inspection shall be formulated by the Supreme People's Court.¹³⁶ There is, in addition, no duty on a party to respond to the other party's requests for the production of documents, the deposition of witnesses or even to have questions answered prior to trial. Production of evidence may be compelled only when the people's court considers it to be necessary for adjudicating the case in question.¹³⁷ As defrauded shareholders have little means to

¹³² See, for example, 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 and Policy Journal* 781.

¹³³ *Ibid.*, 795-98.

¹³⁴ Sanzhu Zhu, *Securities Dispute Resolution in China* (Ashgate, the United Kingdom, 2007), p.204.

¹³⁵ For instance, Article 34 of the Company Law provides that shareholders are allowed to consult and copy the articles of association, records of shareholders' meetings, resolutions of board meetings and financial reports. Shareholders are entitled access to the accounting books of the company upon submission of a written request which shall state its motives, but the company is at liberty to decline such request if it opines that the shareholders' request is pursuant to any improper purpose which may damage the legitimate interest of the company.

¹³⁶ Article 61 of the Civil Procedure Law.

¹³⁷ Article 64 of the Civil Procedure Law.

obtain information about the fraud or misconduct at issue, they can avert difficulties in gathering the necessary information to prove their case if they could rely on the evidence gathered during the criminal or administrative investigations, thereby easing their evidentiary burden. Even in the US, where information costs are arguably lower, a 2003 study by Cox, Thomas and Kiku shows that enforcement actions by the Securities Exchange Commission (SEC) in the US are usually the foundation of successful private securities lawsuits.¹³⁸

While the CSRC and other administrative authorities are subject to conflicts of interest arising from the ownership structure of the listed companies in China, the policy dynamics are complex. Having pursued market-oriented reforms for more than twenty years, some Chinese leaders may find private securities enforcement a useful tool to play upon local protectionism. In this regard, it is noteworthy that the CSRC has taken a more active role in improving corporate governance at listed companies in recent years. In March 2007, the CSRC started a three-year campaign to strengthen corporate governance at listed companies.¹³⁹ During the campaign, listed companies looked into existing problems in corporate governance such as misappropriation of corporate funds, irregular operations at the boards of directors, shareholders' meetings and supervisory boards, and inadequate internal controls, and rectification measures have been made.¹⁴⁰ It was reported that many governance problems were resolved and the culture of corporate and shareholder autonomy has been promoted.¹⁴¹ It was also said that the listed companies gained greater awareness of standard operations and improved their level of governance during the campaign.¹⁴²

b. The Arbitration Procedure

It is advisable that CIETAC devise a set of procedural rules to administer the claims arising out of the securities arbitration scheme, which should be in line with the CIETAC Rules of 2012.¹⁴³ In order to commence an action, potential claimants should submit an arbitration application together with a filing fee. Upon receipt of the

¹³⁸ James Cox, Randall Thomas, and Dana Kiku, "SEC Enforcement Heuristics: An Empirical Inquiry", (2003) 53 *Duke L. J.* 737, 737-738.

¹³⁹ Organization for Economic Co-operation and Development (OECD), *China Country Study: Self-Assessment against the OECD Principles of Corporate Governance* (Jan 2011), pp. 6-8. The study is available at the OECD database, <http://www.oecd.org/dataoecd/43/52/46931890.pdf> <http://www.oecd.org/dataoecd/43/52/46931890.pdf> <http://www.oecd.org/dataoecd/43/52/46931890.pdf> (last visited 16 April 2012).

¹⁴⁰ *Ibid.*

¹⁴¹ *Ibid.*

¹⁴² *Ibid.*

¹⁴³

claim and the fees, CIETAC's secretariat should decide whether the case is eligible to proceed. In this connection, CIETAC's secretariat should have discretion not to process cases that are clearly frivolous or vexatious. Arbitration proceedings should commence only if the secretariat decides that proper requirements have been complied with.

Once the case has been accepted, either party may request CIETAC to settle the claim informally through mediation prior to the appointment of the arbitral tribunal. If both parties consented to mediate, they will proceed to select a mediator and attempt to reach an agreement. If the mediation process is successful, the parties will sign a settlement agreement, the terms of which may be incorporated into and issued as an arbitral award. Where the mediation process does not result in a settlement, arbitration proceedings will resume. Regardless of the outcome of the mediation process, however, nothing exchanged between the parties or the mediator during the mediation process may be relied on by the parties in subsequent judicial or arbitration proceedings unless the parties otherwise agree. Additionally, the claimant will be barred from pursuing the case further in court even if he wishes to dispute the arbitration award.¹⁴⁴

Where mediation is unsuccessful, the parties will proceed to select and appoint arbitrators. Depending on the amount of damages claimed and the parties' wishes, a case may be heard by a mutually agreed arbitrator or a panel of three arbitrators,¹⁴⁵ but three arbitrators are usually appointed to form an arbitration tribunal. To further inject public confidence in the securities arbitration scheme, it is recommended that CIETAC might impose additional safeguards in the arbitrator selection process that extend beyond the requirements under its 2005 Rules. CIETAC should provide to the relevant parties information on the past education and employment history, past arbitration awards as well as other relevant background information for each of the arbitrators on the panel during the arbitrator selection process. The parties could make use of the information to strike names from the panel of arbitrator that may pose a potential conflict of interest with the witnesses, issues or securities in the case.¹⁴⁶

¹⁴⁴ Article 5 of the Arbitration Law.

¹⁴⁵ Article 30 of the Arbitration Law. One arbitrator is appointed for cases under the summary procedure. These are disputes where the amount claimed does not exceed RMB 500,000, or if the amount claimed exceeds RMB 500,000, where both parties agree to the adoption of the summary procedure.

¹⁴⁶ For background on the arbitration procedure, see Geoffrey Chan and Terence Tung, "Commencement of Arbitration and Arbitration Proceedings", in Daniel Fung and Wang Shengchang (eds), *Arbitration in China: A Practical Guide (Hong Kong: Sweet & Maxwell, 2004)*, paras 9-01 to 9-06.

As the Hong Kong Lehman Brothers-related Investment Products Dispute Mediation and Arbitration Scheme reveals, a complaints-based approach in dealing with a multitude of individual cases may result in a slow dispute resolution process.¹⁴⁷ In this light, procedural rules should be fine-tuned and group arbitration rules shall be incorporated to accommodate a number of claims involving similar questions of law or fact.¹⁴⁸ In these cases, the first part of the proceeding should deal with the determination of the issue of liability of the defendant, while the second part of the proceeding should deal with the application of those legal principles to individual cases, and where appropriate, the assessment of the quantum of damages to be paid to individual members.

Finally, it is proposed that the securities arbitration scheme be offered at a charge to both claimants and defendants along the lines of the existing fee structure for CIETAC arbitrations. The charge is intended to cover the arbitrator's fees as well as CIETAC's administrative expenses. It is believed that the enhanced private enforcement through arbitration will encourage more corporate compliance in China. In the long run, it is envisaged that greater shareholder protection will change China's business culture and macroeconomics.

c. Relationship with the Securities Regulators

Structurally, the securities arbitration scheme and the securities regulator should be operationally independent so as to prevent any potential intervention by political and administrative powers into the scheme. For this purpose, it is desirable that the securities arbitration scheme achieve self-financing by relying on its arbitration fees for operation and development, instead of being under the shelter of the Party or the government.

That said, the relevant securities regulators, such as the CSRC and the two stock exchanges, should be responsible for overseeing the securities arbitration scheme to maintain a strategic oversight. In this light, these regulatory authorities should be empowered, say, in the rule-making arena, to ensure that the enforcement initiatives under the arbitration scheme are complementary to the goals of securities regulation. On the other hand, to avoid duplication of efforts and blurring of their respective roles,

¹⁴⁷ Douglas Arner, Barry Hsu, and Antonio Da Roza, "Financial Regulation in Hong Kong: Time for a Change", 5(1) *Asian Journal of Comparative Law* (2010), pp. 1-47.

¹⁴⁸ Because securities litigation is substantially dependent upon group litigation, group arbitration in securities disputes is highly desired, for example, the importance of the PSLRA and SLUSA in the United States.

it is submitted that CIETAC should not have any investigative or disciplinary powers, which are within the purview of the securities regulators. CIETAC should be charged solely with the responsibility of handling civil compensation claims arising from securities fraud, and as such, will not issue fines, impose sanctions or take disciplinary actions.

d. Implementation of the Securities Arbitration Scheme

In the initial stage, a pilot scheme should be launched to test the effectiveness of arbitration in resolving civil compensation disputes arising out of securities fraud in China. The pilot scheme is suggested to last for three years to inform the investing public and other parties concerned about securities arbitration, so that a full evaluation can be made at the end of the scheme. If the scheme is successful, it is suggested that it should be made available nationwide on a continuous and permanent basis, and arbitration is to be incorporated into legislation accordingly.

Since shareholder claimants will only opt for arbitration if they clearly understand the process, it is vital that the pilot scheme be widely publicized before commencement. In this light, it is proposed that there should preferably be a lead-in period of six months before the commencement of the pilot scheme to organize activities to promote the awareness and understanding of the service among the relevant regulatory authorities, the legal profession and members of the investing public. Dissemination of such knowledge is definitely a good starting point. In addition, an industry-wide effort should be made to solicit comments from securities regulators, scholars and practitioners so as to make the pilot project reflective of various interest groups. In the end, the experience gained during the lead-in period will be upgraded to a permanent and independent securities arbitration mechanism in the future.

4. *Concerns of Securities Arbitration*

Notwithstanding the seeming advantages of arbitration and the legislative endorsement of this dispute resolution mechanism, a few concerns may be raised for the securities arbitration scheme.

a. CIETAC's arbitral jurisdiction

Critics may point out that CIETAC's jurisdiction is limited, and should not be extended to securities claims. CIETAC can exercise jurisdiction over a case if the

subject matter of the dispute is arbitrable and the parties have entered into a valid arbitration agreement. Articles 2 and 3 of the Arbitration Law provide that disputes arising from economic and trade transactions of a contractual or non-contractual nature are arbitrable, whether they are classified as international, foreign-related or domestic. Article 3 of the CIETAC Rules (2005) stipulate that CIETAC may accept cases involving international or foreign-related disputes, disputes related to HK, Macao and the Taiwan region, and any domestic disputes. CIETAC however cannot exercise jurisdiction over disputes arising from marriage, adoption, guardianship, support and inheritance or disputes that a law requires to be handled by administrative authorities. It would therefore seem that civil compensation claims arising out of securities fraud is an arbitrable matter.

It may also be argued that arbitration in China should only take place if the parties have entered into a prior arbitration agreement. Article 4 of the Arbitration Law provides that an arbitration commission may not accept the case if a party unilaterally applies for arbitration in the absence of an arbitration agreement. Article 16 further stipulates that an arbitration agreement shall be provided in a contract or any other written form of agreements.¹⁴⁹ It shall include the parties' agreement to submit a dispute to arbitration, specify the subject matter to be arbitrated and an arbitration commission to hear the dispute.

In 2004, the Legislative Affairs of the State Council and the CSRC jointly promulgated a circular on the arbitration of securities and futures contractual disputes (the "Securities and Futures Disputes Arbitration Circular").¹⁵⁰ The circular is the most recent attempt of the Chinese government on the promotion of arbitration in securities dispute resolution, with an aim to make full use of special advantages of arbitration, such as expedition, flexibility, low cost, and closed hearing. Pitifully, the circular excludes the disputes between listed companies and public investors from the scope of securities arbitration.¹⁵¹ As explained by some learned commentators, one of the major barricades leading to the exclusion is that public investors do not have prior arbitration agreements with listing companies.¹⁵²

¹⁴⁹ An arbitration agreement shall contain (i) the expression of the parties' wish to submit to arbitration; (ii) the matters to be arbitrated and (iii) the arbitral commission selected by the parties.

¹⁵⁰ *Guanyu Yifa Zuohao Zhengquan, Qihuo Hetong Jiufen Zhogncai Gongzuo de Tongzhi (The Circular on How To Manage Well the Arbitration Work of Securities and Futures Contract Disputes according to Law)*, issued by the Legislative Affairs Office of the State Council, January 18, 2004.

¹⁵¹ *Ibid*, Point 1.

¹⁵² Sanzhu Zhu, *Securities Dispute Resolution in China* (Ashgate, 2007), at 219.

To solve the problem, an arbitration provision should be mandated in the memorandum and articles of association of a listed corporation to the effect that all its shareholders are entitled to elect arbitration at CIETAC as a means to resolve civil compensation claims with the corporation. In addition, claims with other potential wrongdoers of securities fraud, such as fiduciaries, employees and professional advisers, could be covered. In terms of technical use, the provision would include details such as the method of selection and appointment of arbitrators, forum choice, and governing laws. For this purpose, employment and service contracts between the corporation and its employees, fiduciaries, professional advisers should reference such duty to arbitrate. Corporations that have already been listed on the national stock exchanges can effect such change by an amendment of the corporations' constitutional documents, whereas the provision shall be made a requirement for listing under the listing rules for corporations that have not yet been listed.

The first issue with this approach is whether such a provision in the memorandum or articles of association amounts to a written arbitration agreement that falls within the meaning of Article 16 of the Arbitration Law. While arbitration agreement in China should be in writing, the Arbitration Law is silent as to what constitutes written form.¹⁵³ In this light, the CIETAC Rules (2005) provide that an arbitration agreement is in writing if it is contained in a tangible form of a document such as a contract, letter, telegram, telex, facsimile, EDI, or email.¹⁵⁴ In this connection, a company's constitutional documents have long been regarded as contracts between the corporation and each of its shareholders and among the shareholders *inter se*. They are deemed to contain covenants on both the corporation and all of its shareholders to observe the terms on the conduct of the corporate affairs. As the arbitration provision forms part of the corporation's memorandum of association, the threshold requirement under Article 16 is likely to be satisfied.

The second issue concerns shareholders' notice of the arbitration provision. Effective shareholder notice is critical, lest shareholders could not be said to have consented to arbitration knowledgeably and entered into an arbitration agreement. Disclosure of information regarding arbitration should be included in the pre-dispute arbitration agreement so as to offer investors an opportunity to make informed decisions. One option is to reference the memorandum and incorporate the arbitration provision fully in the stock certificates issued by the listed corporation. However, many shareholders hold their shares through nominees and would never see the stock certificates that

¹⁵³ Weixia Gu, "The Changing Landscape of Arbitration Agreements in China: Has the SPC-led Pro-arbitration Move Gone Far Enough?", 2009 22(2) *New York International Law Review*, at 2.

¹⁵⁴ Article 5(3) of the CIETAC Arbitration Rules (2005).

discuss the provision. An alternative option would be for the corporation to divulge details of the arbitration provision in the corporation's website, its annual reports, CSRC filings and other disclosure documents on a periodic basis. Apart from that, all issuers could be obliged to attach their memorandum of association to each annual report filed with the CSRC under a new regulatory requirement in the listing rules, instead of incorporating the provision by reference to previous reports. This should be so regardless of whether amendments have been made to the memorandum in that financial year. To bring the arbitration provision to the attention of minority shareholders, some authors argue that the disclosure clauses should be made clear that arbitration is final and binding on the parties; in addition, parties who choose arbitration waive their right to seek remedies in court and no appeal thereto is allowed.¹⁵⁵

b. Deterrent Effect

While confidentiality of the arbitration process and award is an advantage of arbitration, it may be said that this will leave future investors and the regulatory authorities in the dark as to the reasoning behind the decision and the range of compensation. An argument may be made out that this would harm other investors, produce inconsistent rulings and varying compensation rates, as the arbitrator decides a case on the basis of facts and circumstances available before him. This may have the effect of limiting the transparency and introducing a high level of unpredictability to the compensation process, which would in turn minimize the deterrent effect of private securities litigation.

To allay the concern of inconsistent rulings, it is proposed that a system for the categorization for different investors based on factors relevant to the common dispute should be developed. This would allow for common standards of compensation to be applied to various shareholder groups, ensuring a degree of uniformity in the compensation awards. To deepen public understanding of securities disputes and to increase transparency in the dispute resolution process, the regulatory authorities may consider the publication of information regarding the securities fraud claims filed against the wrongdoers as well as cases that have been dealt with. However, given that agreements reached between parties in mediation and arbitration proceedings are private and confidential, we suggest that only a synopsis of cases on an anonymous basis should be published. It is hoped that this sharing of information will promote

¹⁵⁵ Daniel Fung and Wang Shengchang (eds), *Arbitration in China: A Practical Guide* (Sweet & Maxwell Asia, 2004), para 24-41.

greater deterrence of securities fraud.

Another concern relates to the deterrence of unmeritorious lawsuits before the arbitral tribunal. To prevent the critiques of US-styled class actions, it is submitted that CIETAC's secretariat would have power to decide whether the case is eligible to proceed. Staff working at the CIETAC secretariat should have discretion not to proceed cases that are clearly frivolous or vexatious. The screening process by the CIETAC secretariat is important so as to deter unmeritorious claims that only benefits lawyers.

c. Enforcement of the arbitral award

Another concern relates to the enforcement of arbitration agreements and awards. Arbitration agreements and arbitral awards must undergo review by local Chinese courts for enforcement, but it is observed that during the transition from a planned economy to a market economy and in the process of developing the rule of law in China, lower-level courts in China are not sufficiently equipped to keep up with the pro-arbitration reforms initiated by the SPC.¹⁵⁶ The lack of judicial integrity and quality as well as the unbalanced development among people's courts at different localities may have contributed to divergent enforcement records in both court judgments and arbitral awards.

Under the Chinese Arbitration Law, when a party fails to execute an arbitral award, the other party may apply for enforcement at the intermediate people's court where its recalcitrant opponent has its domicile or its property is located at.¹⁵⁷ Enforcement may be refused or set aside in limited circumstances, for instance if enforcement is against social and public interests or if there are procedural irregularities during the proceedings.¹⁵⁸

It is important to note that the SPC has stepped up its efforts as early as in 1996 to guard against local protectionism over arbitral enforcement and to facilitate the execution of arbitration awards. The SPC adopted a series of pre-reporting mechanisms (*yuxian baogao*) in handling foreign-related cases.¹⁵⁹ By virtue of the "pre-reporting", an intermediate people's court is required to report its decision to the

¹⁵⁶ Gu Weixia, "China's Arbitration: Restricted Reform", in Guanghua Yu (ed), *The Development of the Chinese Legal System: Change and Challenges* (Routledge, 2011), pp. 279-280.

¹⁵⁷ Article 58 of the China Arbitration Law.

¹⁵⁸ *Ibid.*

¹⁵⁹ Several Issues regarding the Handling by the People's Courts of Certain Issues On Foreign-related arbitration and Foreign arbitration Matters issued on 28 August 1995

higher people's court for approval if it is minded to set aside a foreign-related arbitral agreement and award.¹⁶⁰ If the decision is upheld by the higher court, such a decision must be further reported to the Supreme People's Court.¹⁶¹ Hence, the intermediate people's court can only set aside a foreign-related award after approval from the SPC has been obtained.

The dual regime may invite arguments of unfair discrimination between national and foreign investors. Foreign investors are given access to its securities market following China's accession to the World Trade Organization (WTO). Since 2002, foreign investors are allowed to invest in RMB denominated shares of corporations listed on the national stock exchanges under the Qualified Foreign Institutional Investor (QFII) Scheme.¹⁶² This is, however, contrasted with the enforcement of a domestic award, where grounds for refusal of enforcement are very broad, and could potentially lead to a complete review on the merits of the decision. Furthermore, the fact that the standards for enforcing domestic awards are stricter than foreign-related awards suggests that the domestic regime is harder. Specifically, in an empirical study conducted by Professor Randall Peerenboom, among the sixty-three domestic awards handled by one court in a large city in Jiangsu Province, two were refused and thirty-five listed as pending.¹⁶³ It appears convincing that the domestic regime needs careful judicial checks as well, at least no less than its foreign-related counterpart. In this light, the different treatment may give rise to concerns about potential violations of the principle of national treatment.

To overcome potential under-enforcement of arbitral awards, China should narrow the grounds for refusing to enforce arbitral awards under the securities arbitration scheme. Appeals on award should be limited to procedural review, which would align the Chinese procedure with international standards.¹⁶⁴ A potentially large scope of review of an arbitral award under the local regime will obliterate the finality of the arbitration award and obstruct shareholder claimant's access to judicial recourse by further

¹⁶⁰ See the SPC Notice on Some Issues Concerning Foreign Arbitration and Arbitration in Foreign Countries, Fa Fa (1995) No.18; Notice on Regulations on the Fee and Time Limit of Recognition and Enforcement of Foreign Arbitration Awards, Fa Shi (1998) No.28; and Notice on Some Issues Concerning Setting Aside Arbitration Awards Related to Foreign Elements by the People's Court, Fa Fa (1998) No.40.

¹⁶¹ *Ibid.*

¹⁶² *Measures for the Administration of Securities Investment within the Borders of China by Qualified Foreign Institutional Investors (Hege Jingwai Jigou Touzizhe Jingnei Zhengquan Touzi Guanli Banfa)*, jointly issued by the CSRC, People's Bank of China, and State Administration of Foreign Exchange, 24 August 2006.

¹⁶³ Randy Peerenboom, "Seek Truth from Facts: An Empirical Study of Enforcement of Arbitral Awards in the PRC", 4 (2001) *American Journal of Comparative Law*, 249.

¹⁶⁴ Article 34 of the *UNCITRAL Model Law on International Commercial Arbitration*.

complicating the process for recovery of damages. The substantive review invites possibilities of political intervention in the enforcement process. In the long run, it is perceived that the foreign system is conducive to the development of the capital markets in China, albeit “pre-reporting” may invite challenges to judicial resources.

V. Conclusion

Although the Securities Law failed to provide an effective private cause of action for shareholders who suffered financial losses resulting from securities fraud, the SPC has purported to remedy the situation through issuance of three judicial circulars between 2001 and 2003. The SPC circulars initially raised high expectations that they would provide the much-needed judicial safeguard against infringement upon interests of the minority shareholders. Despite these expectations, however, due to social, political and economic reasons, restrictive procedural rules and lack of economic incentives in the bringing of securities fraud suits effectively deprive aggrieved shareholders from access to the court and judicial remedies.

From this basis, the fundamental issue at stake is how to best promote private enforcement while balancing the interests of the state. As the above analysis reveals, direct transplantation of the US-style class action system and contingency fee arrangements may give rise to a considerable risk of litigious abuse. In looking forward, it is proposed that a cost-effective and accessible dispute resolution mechanism be established to step up private enforcement efforts in China for the benefit of minority shareholder protection. Unduly legalistic procedures should be avoided to keep it simple and accessible for average retail shareholders.

Thus guided, and drawing upon institutional experience from the US and HK, it is suggested that a securities arbitration scheme should be introduced as an out-of-court alternative under which wrongdoers of securities fraud are required to enter into arbitration at times of a civil dispute upon the wish of the claimant shareholder. It is believed that the absence of alternative methods in handling securities disputes contributes to a certain extent weaknesses in the securities market in China. Through utilizing the institutional and rule-making capacity at CIETAC, the premier arbitration commission in China, this arbitration proposal stands a better chance of success than the class action proposal in the Chinese context. Moreover, a securities arbitration scheme can supply the optimal amount of private enforcement to deter securities fraud and to redress defrauded shareholders. Hence, it can achieve a better model of

minority shareholder protection.

Understandably, institutional deficiencies in the court system in China may invite doubts as to the effectiveness of the securities arbitration scheme. It is observed that lower-level courts in China are not sufficiently equipped, both infrastructurally and professionally, to keep up with the pro-arbitration reforms initiated by the SPC.¹⁶⁵ While addressing the local protectionism issue, the pre-reporting mechanism may drain judicial resources and lead to delays. In this respect, it remains open about the future fine-tuning of the procedural rules in view of the operational experience of the securities arbitration scheme. But just as every coin has two sides, the limitations of the securities arbitration scheme should not undermine its underlying benefits as a workable and even more effective means of private enforcement of securities regulation in China. Strengthening private enforcement efforts will be critical for China to improve its corporate governance landscape and to strengthen investor confidence, which in the long run, will bring about the healthy development of its securities market and act as an engine of economic growth.

¹⁶⁵ Gu Weixia, “China’s Arbitration: Restricted Reform”, in Guanghua Yu (ed), *The Development of the Chinese Legal System: Change and Challenges* (Routledge, 2011), at 280.