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Securities Arbitration in China: A Better Alternative to Retail Shareholder Protection

*By Gu Weixia**

Abstract: 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 that contrast with the paucity of conviction rates are indicative of China's inadequate public securities law enforcement. Private enforcement efforts, such as securities litigation, help address the disconnect between the 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 improving private enforcement in China. After concluding that modeling the U.S. class action system is quite unlikely to work well in China's sociopolitical and socioeconomic context, this 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, this Article proposes a cost-effective and accessible securities arbitration scheme in China for resolving civil compensation claims. This Article argues that the professionalism, procedural flexibility, speed, confidentiality, and cost saving features of arbitration offer much potential as a deterrent and remedial device in addressing the deficiencies of private enforcement of securities regulation during China's economic transition.

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I. INTRODUCTION

Developing a fair, efficient, and orderly securities market is one of China's biggest institutional challenges today. Since initial economic reforms from a planned to a market economy, a high private savings rate and the public's appetite to hold risky securities have contributed to 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,¹ compared to fifty-three

¹ CHINA SEC. REGULATORY COMM'N (CSRC), CHINA SECURITIES REGULATORY

listed companies in 1992.² China's securities market, while only twenty years old, boasted a market capitalization of RMB 21.5 trillion by the end of 2011.³

Despite remarkable progress in setting up its securities market, China has often been criticized for its underdeveloped regulatory regime. Unlike its overseas counterparts, which established security markets to provide finance to enterprises, China established its securities market to assist in the reform of its financially distressed state-owned enterprises (SOEs).⁴ Given the political logic of China's securities market, its 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 law.⁵ Meanwhile, private enforcement of China's Securities Law, such as securities litigation, has played only a limited role in assisting the prevention of market abuse and the regulation of the securities market.

Against the 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 a market promoter and a primary market regulator for listed companies, the CSRC's ability to discipline powerful wrongdoers of fraud is most likely handicapped. It would therefore appear that a further strengthening of public enforcement efforts is unlikely to be a panacea to the weak enforcement of the Securities Law in China. On the other hand, a large body of law and finance literature suggests that strong legal protection for investors is the key to a nation's healthy stock market development and economic growth.⁶ Private enforcement efforts compensate victims of securities fraud and help address the disconnect between the securities regulatory regime and investor compensation. Nevertheless, given the immaturity of China's current legal and institutional framework, various factors preclude private securities

COMMISSION ANNUAL REPORT 2011, at 119 (2012), available at [http://www.csrf.gov.cn/pub/csrf_en/about/annual/201205/P020120515677609374835.pdf](http://www.csrc.gov.cn/pub/csrf_en/about/annual/201205/P020120515677609374835.pdf).

² CSRC, CHINA'S SECURITIES AND FUTURES MARKETS 9 (2004), available at http://www.csrf.gov.cn/pub/csrf_en/about/annual/200812/P020090225529630009496.doc.

³ CSRC, *supra* note 1, at 16.

⁴ YU GUANGHUA, COMPARATIVE CORPORATE GOVERNANCE IN CHINA: POLITICAL ECONOMY AND LEGAL INFRASTRUCTURE 23–41 (2007).

⁵ 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").

⁶ See, e.g., Bernard Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781 (2001); Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. & ECON. 3 (2000); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997).

litigation from playing a significant role in China's market regulation and development.⁷ Therefore, this Article seeks to explore alternative mechanisms for improvement.

Following this introduction, Part II evaluates the current level of legal protection afforded to minority public shareholders of listed companies in China. This Part will also lay down the background information on two alternatives, namely, the introduction of a class action system and a securities arbitration scheme for facilitating private enforcement of the Securities Law. To ameliorate the collective action problem faced by minority shareholders in filing a securities suit, Part III discusses whether directly transplanting the class action system of the United States can supply an optimal amount of private enforcement in China. The United States model was chosen because class actions originated there, and some other countries have either adopted or actively considered embracing the American class action procedures in their recent legal reforms. After answering this in the negative, Part IV next explores the feasibility of utilizing alternative dispute resolution (ADR) procedures to resolve civil compensation claims. This Article concludes that the procedural flexibility, speed, and cost savings of ADR procedures offer much potential as a deterrent and remedial device in policing the corporate misconduct of listed companies in China.

II. THE PARADIGM OF RETAIL SHAREHOLDER 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,⁸ but also to poor corporate governance in listed companies. One of the core governance issues of 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,⁹ 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

⁷ See Marlon A. Layton, *Is Private Securities Litigation Essential for the Development of China's Stock Markets?*, 83 N.Y.U. L. REV. 1948, 1973-76 (2008).

⁸ 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 Move Beyond Practical Solutions to Practical Problems*, 45 COLUM. J. TRANSNAT'L L. 312, 317-18 (2007).

⁹ CSRC, *supra* note 2, at 27-28.

2005.¹⁰ As dispersed individual shareholders have no meaningful influence over the decision-making processes in SOEs, potential conflicts of interest between majority and minority shareholders remain a core corporate governance problem.¹¹

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, creating ample opportunities for connected transactions¹² 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 corporate governance has also been felt abroad in recent years as Chinese companies increasingly seek overseas listings. For instance, a recent report by NERA Economic Consulting stated that eighteen percent of all securities class actions in the United States were filed against Chinese-domiciled companies or companies with principal executive officers in China, and all of these suits dealt with accounting allegations.¹³

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 driven by the goal of assisting SOE reform, securities laws and regulations have failed to provide adequate protection for the rights and interests of public investors in China. While protecting minority shareholders from opportunistic expropriation by management or controlling shareholders has always been a critical principle of corporate governance, it was not the chief concern of the Chinese lawmakers in the early 1990s. The first corporate code in China, the Company Law of 1993, was aimed at providing legal support for the establishment of a modern enterprise system and setting down the political agenda of transforming

¹⁰ Shangshi Gongsi Guquan Fenzhi Gaige Guanli Banfa (上市公司股权分置改革管理办法) [Measures on Administration of Split Share Structure Reform of Listed Companies] (promulgated by the China Sec. Reg. Comm'n, Sept. 4, 2005, effective Sept. 4, 2005) (China).

¹¹ Donald C. Clarke, *Corporate Governance in China: An Overview*, 14 CHINA ECON. REV. 494, 495 (2003).

¹² The "connected transactions" (*guanlian jiaoyi*) are paraphrased as "related-party transactions." See JING LENG, CORPORATE GOVERNANCE AND FINANCIAL REFORM IN CHINA'S TRANSITIONAL ECONOMY 152–53 (2009) (describing the high risk of related-party transactions in SOEs).

¹³ JORDAN MILEV ET AL., NERA ECON. CONSULTING, RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION: 2011 MID-YEAR REVIEW 8–12 (2011), available at http://www.nera.com/nera-files/PUB_Trends_Year-End_1211_final.pdf.

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 among other things expressly prohibits various forms of market misconduct, such as insider trading, market manipulation, and inaccurate disclosure.¹⁴ Substantial revisions to the Securities Law in 2005 improved the system governing the issuance, trading, registration, and settlement of securities.¹⁵ The 2005 revision 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 they better reflected market rules.

Although legal provisions have been improved to address chronic illness within 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 its inadequacies. For instance, Chapter XI of the Legal Liability Chapter of the Securities Law of 1998 is comprised of thirty-six articles, thirty-two of which carry substantive penalties in the form of criminal and administrative liability. The role of civil remedies has been overlooked, 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, local courts have refused to hear most of the securities fraud cases filed by investors in search of civil compensation.¹⁶ This is the case despite the fact that the courts

¹⁴ See Zhonghua Renmin Gongheguo Zhengquan Fa (中华人民共和国证券法) [Securities Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, effective July 7, 1999) (China) [hereinafter 1998 Securities Law].

¹⁵ See Zhonghua Renmin Gongheguo Zhuxi Ling (Di Sishisan Hao) (中华人民共和国主席令(第四十三号)) [Securities Law of the People's Republic of China (revised in 2005)] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006) (China) [hereinafter 2005 Securities Law].

¹⁶ For instance, a Chinese court dismissed an action against Chengdu Hongguang Co. Ltd in 1998 for non-compliance with accounting and disclosure requirements on the grounds that there was no specific procedure for such action in China at that time. Bin Hu & Chenxia Shi, *Directors' Liability for False Statements in the Information Disclosure of Listed Companies in China*, 1 J. AUSTRALASIAN L. TEACHERS ASS'N 67, 69 (2008), [http://www.alta.edu.au/resources/PDFs/JALTA/2008/\(2008\)%20Directors'%20Liability_B%20Hu%20%20C%20Shi.pdf](http://www.alta.edu.au/resources/PDFs/JALTA/2008/(2008)%20Directors'%20Liability_B%20Hu%20%20C%20Shi.pdf). The action against Shandong Bohai Corporation in 1998 for false accounting initially brought by aggrieved investors was similarly rejected. Walter

could have adopted an expansive interpretation of older pieces of legislation, such as the General Principles of Civil Law, to grant relief.¹⁷

B. Inadequate Public Enforcement by the CSRC

Rampant securities fraud in China does not lie solely in the imperfection of the laws. 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 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 establishing the State Council Securities Commission (SCSC) and the CSRC in 1992. The SCSC was a ministerial-level government agency in charge of macro-management of the securities market and was the primary authority for market regulation.¹⁸ The CSRC was then designed as the SCSC's executive branch to supervise the market and securities firms.¹⁹ Yet, the CSRC was merely a non-profit institution (*shiye danwei*) that lacked any substantial supervisory powers and tools to make rules or punish misconduct.²⁰ 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. The CSRC's current mandate is to ensure the orderly and lawful operation of the securities market.²¹

While a nationwide capital market has gradually developed and the

Hutchens, *Private Securities Litigation in China: Material Disclosure About China's Legal System?*, 24 U. PA. J. INT'L ECON. L. 599, 604 n.17 (2003), <https://www.law.upenn.edu/journals/jil/articles/volume24/issue3/Hutchens24U.Pa.J.Int%271Econ.L.599%282003%29.pdf>.

¹⁷ 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, China's Securities Law provides that issuers, underwriters and their responsible directors, and other corporate officers can be liable for losses suffered by investors because of misrepresentations or material omissions in disclosure documents. 1998 Securities Law, *supra* note 14, art. 63.

¹⁸ Guowuyuan Guanyu Jinyibu Jiaqiang Zhengquan Shichang Hongguan Guanli de Tongzhi (国务院关于进一步加强证券市场宏观管理的通知) [Notice of the State Council Concerning Further Strengthening Macro-Administration of the Securities Market] (promulgated by the St. Council, Dec. 17, 1992), item 1(1) (China).

¹⁹ *See id.* at item 1(2).

²⁰ WANG LIANZHOU & LI CHENG, FENGFENG YUYU ZHENGQUANFA (风风雨雨证券法) [THE VICISSITUDES OF THE SECURITIES LAW] 49 (2000) (China).

²¹ 1998 Securities Law, *supra* note 14, art. 166.

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 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 were very unsophisticated.²² Neoh's remark was echoed by a Chinese top economist Wu Jinglian, who unfavorably compared the corruption-ridden market to a "casino."²³

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 thirty-six 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. In 2006, there were still only 289 staff members in the Enforcement Bureau,²⁴ compared to a total of 1,434 companies listed on the two national exchanges.²⁵ Most enforcement staff lacked experience and knowledge in the securities field, which presented a major disadvantage for them in dealing with the complexities of securities crimes.²⁶ Even after the establishment of a special Enforcement Team (*jicha zongdui*) in the CSRC in 2007 to facilitate the investigation of significant securities fraud cases, and a significant increase of total enforcement staff to approximately 600, it appeared that public enforcement efforts remained inadequate.²⁷ Contrary to the severity of insider trading and inaccurate disclosure in China's stock market in 2007,²⁸ the table below²⁹ shows that the number of sanctions imposed by

²² A *Good Beginning*, CHINA ECON. REV. (Mar. 1, 1999, 2:00 PM), <http://www.chinaeconomicreview.com/node/23419>.

²³ JING LENG, *supra* note 12, at 118 & n.4 (citing Wu Jinglian's interview on *Dui hua* (对话) [Dialogue]: *Zhongguo Gushi Buru Duchang* (中国股市不如赌场) [China's Stock Market Is Worse Than Casinos] (China Central Television broadcast Jan. 13, 2001)).

²⁴ Hongming Cheng, *Insider Trading in China: The Case for the Chinese Securities Regulatory Commission* 15 J. FIN. CRIME 165, 168 (2008).

²⁵ CSRC, CHINA'S SECURITIES AND FUTURES MARKETS 3 (2007), available at [http://www.csrf.gov.cn/pub/csrf_en/about/annual/200812/P020090225529643752895.pdf](http://www.csrc.gov.cn/pub/csrf_en/about/annual/200812/P020090225529643752895.pdf).

²⁶ Hongming Cheng, *supra* note 24 (noting that most CSRC enforcement staff members lack knowledge and experience in the securities field).

²⁷ *Zhengjianhui Jicha Zongdui Chengli* (证监会稽查总队成立) [The Establishment of Special Enforcement Team in the CSRC], XINHUA NEWS NET (Nov. 18, 2007), http://news.xinhuanet.com/fortune/2007-11/18/content_7097686.htm.

²⁸ *See id.* at 165 (finding the paucity of insider trading cases and the lack of convictions for insider trading offenses in China).

²⁹ The figures are extracted from CSRC Annual Reports, each of which includes the total

the CSRC from 2007 to 2011 seems rather modest.

Year	2007	2008	2009	2011
Listed Companies	1,530	1,604	1,700	2,342
Cases Closed	405	130	106	N/A
Cases informally investigated	N/A	157	121	N/A
Sanction Decisions	54	77	N/A	68
Companies Sanctioned	26	N/A	23	13
Individuals Sanctioned	155	N/A	218	198

Aside from a shortage of trained personnel and resources, the CSRC further 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,³⁰ regulatory efforts of the CSRC are muddied by political considerations. Fearful of a market collapse and subsequent economic and political repercussions, the CSRC is subject to enormous pressure not to vigorously pursue 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 securities regulators is to ensure a fair, orderly, and robust securities market, they are not in a position to adjudicate any financial remedy for defrauded shareholders who suffer economic losses arising from securities fraud. A well-functioning private securities litigation system can provide additional deterrence against securities fraud, and simultaneously serve as a remedial device for aggrieved investors through the imposition of damages against the perpetrators of fraud.

number of listed companies on the Shenzhen and Shanghai Stock Exchanges at the end of each respective year. See CSRC, CHINA SECURITIES REGULATORY COMMISSION ANNUAL REPORT 2007, at 68, 76 (2008), available at http://www.csrc.gov.cn/pub/csrf_en/about/annual/200812/P020090225529644379854.pdf; CSRC, CHINA SECURITIES REGULATORY COMMISSION ANNUAL REPORT 2008, at 35, 84 (2009), available at http://www.csrc.gov.cn/pub/csrf_en/about/annual/200907/P020090701496625000834.pdf; CSRC, CHINA SECURITIES REGULATORY COMMISSION ANNUAL REPORT 2009, at 50–51, 111–12 (2010), available at http://www.csrc.gov.cn/pub/csrf_en/about/annual/201011/P020101105493830315968.pdf; CRSC, *supra* note 1, at 37, 109–10 (reporting 2011 figures). The CRSC’s 2010 annual report did not contain the relevant figures. See CRSC, CHINA SECURITIES REGULATORY COMMISSION ANNUAL REPORT 2010 (2011), available at http://www.csrc.gov.cn/pub/csrf_en/about/annual/201203/P020120315575855936801.pdf;

³⁰ See KENNETH LIEBERTHAL, GOVERNING CHINA: FROM REVOLUTION THROUGH REFORM 266 (2d ed. 2004) (stating that “typically only SOEs are approved for listing on the . . . stock exchanges,” resulting in very few listed private companies); Layton, *supra* note 7, at 1949.

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

In the first circular, issued on September 21, 2001 (2001 Circular), the SPC imposed a temporary ban on the acceptance by lower courts of civil compensation suits.³¹ Justice Li Guoguang, Vice President of the SPC at the time 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.³² However, the 2001 Circular attracted severe criticism from academics, practitioners, and investors.³³ Subsequently, this ban was partially lifted after just four months.³⁴

In the second circular, issued on January 15, 2002 (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 misrepresentation.³⁵ Additionally, the 2002 Circular requires a lawsuit to

³¹ Zuigao Remin Fayuan Guanyu She Zhengquan Minshi Peichang Anjian Zan Buyu Shouli de Tongzhi (最高人民法院关于涉证券民事赔偿案件暂不予受理的通知) [Circular Regarding Non-Acceptance of Securities-Related Civil Compensation Cases] (promulgated by the Sup. People's Ct., Sept. 21, 2001, effective Sept. 21, 2001) (China).

³² LI GUOGUANG & JIAWEI, ZHENGQUAN SHICHANG XUIA CHENGSHU MINSHI PEICHANG ZHIDU (证券市场虚假陈述民事赔偿制度) [THE CIVIL COMPENSATION SYSTEM OF SECURITIES MARKET MISREPRESENTATION] 2-3 (2003) (China).

³³ *Id.* at 113-14.

³⁴ Zuigao Renmin Fayuan Guanyu Shouli Zhengquan Shichang yin Xujia Chenshu Yinfade Minshi Qinquan Jiufen Anjian Youguan Wenti de Tongzhi (最高人民法院关于受理证券市场因虚假陈述引发的民事侵权纠纷案件有关问题的通知) [Notice of the Supreme People's Court on Relevant Issues of Filing of Civil Tort Disputes Arising From Misrepresentation on the Securities Market] (promulgated by the Sup. People's Ct., Jan. 15, 2002, effective Jan. 15, 2002) (Lawinfochina) (China) [hereinafter 2002 Circular].

³⁵ *Id.*

be filed within two years from the date of the decision.³⁶ On December 26, 2002, the SPC promulgated the “Several Provisions on Trial of Civil Damages Cases Arising from Misrepresentation in the Securities Market” (2003 Circular), which became effective on February 1, 2003.³⁷ The 2003 Circular expanded on the 2002 Circular and provided that both firms and individuals can be named as defendants in a securities suit.³⁸ 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.³⁹ 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

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 adequately promote the private enforcement of China’s securities laws.

One major criticism is that the SPC Circulars unduly restrict the scope of cases for which civil compensation may be sought.⁴⁰ 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*).⁴¹ 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 of compensation even if the CSRC determines liability and imposes administrative penalties against the

³⁶ *Id.*

³⁷ Zuigao Renmin Fayuan Guanyu Shenli Zhengquan Shichang Yin Xujia Chenshu Yinfa de Minshi Peichang Anjian de Ruogan Guiding (最高人民法院关于审理证券市场因虚假陈述引发的民事赔偿案件的若干规定) [Several Provisions on Trial of Civil Compensation Cases Arising from Misrepresentation on the Securities Market] (promulgated by the Sup. People’s Ct., Dec. 26, 2002, effective Feb. 1, 2003) (Lawinfochina) (China) [hereinafter 2003 Circular].

³⁸ *Id.* art. 2.

³⁹ *Id.* art. 7.

⁴⁰ See, e.g., Hutchens, *supra* note 16, at 630–32; Yin Jie (殷洁), Zhengquan Xujia Chenshu Minshi Zeren Zhidu Lun (证券虚假陈述民事责任制度论) [On The System of Civil Liability of Misrepresentation in Securities Fraud], 6 FAXUE (法学) [LEGAL SCI.] 109, 110–11 (2003) (China).

⁴¹ 2003 Circular, *supra* note 37, art. 17.

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 shareholder-plaintiffs must prove the existence of a causal link (*yinguo guanxi*) between the defendant's wrongdoing and the plaintiff's loss.⁴² However, causation would not be established if the affected security was purchased before the misrepresentation was made, or if the security was sold before the relevant misrepresentation was made public.⁴³ Regardless of any loss that might actually have been incurred, defrauded shareholders are effectively excluded from compensation when a listed company fails to disclose material price-sensitive information in a timely manner,⁴⁴ a situation that is not uncommon. In such an example, these shareholders may have sold their shares, thinking that the company's current performance indicated dim prospects. In fact, the company may have withheld material information, causing the share price to rise when the 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 after 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.⁴⁵

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 also 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 costs are major obstacles for aggrieved investors to lodge a private suit to recover losses resulting from securities fraud. While contingency fee arrangements are generally prohibited in China,⁴⁶ the SPC Circulars and the Securities Law remain silent on how

⁴² *Id.* art. 6.

⁴³ *Id.* art. 19.

⁴⁴ SANZHU ZHU, SECURITIES DISPUTE RESOLUTION IN CHINA 186 (2007) (summarizing the criticism from academics, practitioners, and judges on the cumbersome causation rule).

⁴⁵ 2005 Securities Law, *supra* note 15, art. 234.

⁴⁶ Lüshi Fuwu Shoufei Guanli Banfa (律师服务收费管理办法) [Management Measures of Fee Charging for Lawyers' Services] (promulgated by the Ministry of Just., Apr. 13, 2006, effective Dec. 1, 2006) (Lawinfochina) (China). Article 12 expressly provides that outcome-related fees are prohibited in criminal, administrative, state compensation, and class

these lawsuits should be funded. In this light, the general rule is that each side bears their own costs of retaining lawyers at the beginning of the lawsuit.⁴⁷ Should the action fail, plaintiff investors face the consequences of being liable for not only their own costs, but also need to reimburse the litigation expenses of the prevailing defendant, including filing fees and other costs.⁴⁸ 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 shareholders 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% for amounts below RMB 10,000, and a minimum of 0.5% for amounts above RMB 20 million.⁴⁹ Although filing fees are borne by the losing party, plaintiffs usually advance them when the action is brought.⁵⁰ Thus, plaintiffs are immediately presented with a high expense if they seek recovery of any significant funds. The problem is aggravated when a court decides to hold multiple trials for various similar individual claims. This point is borne out in the landmark *ST Dongfang* case.⁵¹ In that case, without offering any justification, the court required, as a condition for accepting the case, that all sixty-one plaintiffs split into

action cases. *Id.* art. 12. 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*). *Id.* art. 4.

⁴⁷ See Chen Lihua Deng 23 Ming Touzi Ren Su Daqing Lianyi Gongsi, Shenyin Zhengquan Gongsi Xujia Chenshu Qinquan Peichang Jiufen An (陈丽华等 23 名投资人诉大庆联谊公司, 申银证券公司虚假陈述侵权赔偿纠纷案) [Chen Lihua v. Daqing Lianyi Co. & Shenyin Sec. Co. for False Misrepresentation], 2005 SUP. PEOPLE'S CT. GAZ. 30 (Heilongjiang High People's Ct. Dec. 21, 2004). In this case, the 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." *Id.*

⁴⁸ While Chinese courts generally award trial costs to the winner, such costs are usually defined as funds paid to the court as filing and other fees and do not include attorney's fees.

⁴⁹ Susong Feiyong Jiaona Banfa (诉讼费用缴纳办法) [Measures of Charging Litigation Fees] (promulgated by the St. Council, Dec. 8, 2006, effective Apr. 1, 2007), art. 13 (Lawinfochina) (China).

⁵⁰ Minshi Susong Fa (民事诉讼法) [Civil Procedure Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 28, 2007, effective Apr. 1, 2008), art. 107 (Lawinfochina) (China) [hereinafter Civil Procedure Law].

⁵¹ See Li Xinyu (李欣玉), *Zhengquan Minshi Susong Xin Wenti, Gongtong Susong Yuangao Renshu Shouxian* (证券民事诉讼新问题 共同诉讼原告人数受限) [A New Problem in Private Securities Litigation: The Number of Plaintiffs in Joint Actions Are Limited], ZHENGQUAN SHIBAO (证券时报) [SEC. TIMES] (Apr. 9, 2003), available at <http://rmrb.com.cn/GB/jinji/35/159/20030409/966783.html> (China).

groups of no more than ten.⁵² As a result, it would appear uneconomical to pursue modest claims, and therefore most resource-poor investors are deterred from seeking redress through litigation and gaining access to justice.

A related criticism is that group litigation (*jiti susong*) rules in China are underdeveloped, and restrictive group litigation rules apply in the context of securities litigation. Article 12 of the 2003 Circular provides that in cases of joint action (*gongtong susong*), the number of plaintiffs must be determined prior to trial.⁵³ Furthermore, plaintiffs must advance substantial filing fees in full 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 in order to aggregate a massive number of claims and seek assent from all the plaintiffs opting into litigation.

This is to be contrasted with the more plaintiff-friendly representative litigation (*daibiaoren susong*) rules under Article 55 of the Civil Procedure Law, which allow cases to be brought by an undefined number of litigants.⁵⁴ The courts are empowered to organize affected individuals into a class by issuing a public notice instructing persons entitled to participate in the action to register with the people's court and opt into litigation within a specific period of time.⁵⁵ Additionally, plaintiffs in Article 55 actions are relieved from paying filing fees upfront.⁵⁶ Similar to the class actions suits in the United States, 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 the lawsuit.

Unfortunately, fearful that listed companies could become a target of rising public anger over endemic market frauds, and due to the apprehension over opening the floodgates to many complex securities cases,⁵⁷ the SPC effectively denies potential plaintiffs from utilizing the more robust representative litigation rules under Article 55 for bringing

⁵² *Id.*

⁵³ 2003 Circular, *supra* note 37, art. 12.

⁵⁴ Civil Procedure Law, *supra* note 50, art. 55.

⁵⁵ *Id.*

⁵⁶ See Zuigao Renmin Fayuan Guanyu Shiyong Zhonghua Renmin Gongheguo Minshi Susong Fa Ruogan Wenti de Yijian (最高人民法院关于使用中华人民共和国民事诉讼法若干问题的意见) [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] (promulgated by the Sup. People's Ct., July 14, 1992, effective July 14, 1992), art. 129 (China) (determining that the filing fees will be borne by the losing party after the case is concluded).

⁵⁷ Bei Hu, *China Urged to Adopt Class Action Suits*, S. CHINA MORNING POST (Nov. 21, 2002, 12:00 AM), <http://www.scmp.com/article/398254/china-urged-adopt-class-action-suits>.

civil compensation claims.⁵⁸ 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,⁵⁹ concerns have frequently been voiced about 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 to no formal education, let alone legal training, prior to assignment to the bench. Coupled with China's short history of securities regulation—a technical, specialized area of the law—it is hardly surprising that judges lack competence to correctly adjudicate securities fraud cases. The technicality and complexity of matters is particularly true in securities cases, where, by engaging in speculative short-term transactions in the marketplace, retail investors may be both the victims of securities fraud as well as contributors to the commission of market misconduct. 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.⁶⁰

4. Summary: The Need for Reform

China has dedicated great efforts to upgrade its securities regulatory regime and to further investor protection in recent 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 upfront in the high filing fee and other expenses in exchange for the negligible compensation that might possibly result.

According to a recent study by Liebman and Milhaupt, only about

⁵⁸ 2003 Circular, *supra* note 37, art. 12; *see also* Civil Procedure Law, *supra* note 50, art. 55 (addressing the difficulties of retail securities litigation by using representative rules).

⁵⁹ For instance, since 2002, all new judges in China are required to possess bachelor's degrees. The SPC further stated that sitting judges under the age of forty are required to obtain a degree within five years or will lose their jobs. Judges who are above the age of forty and lack university education are permitted to stay on if they have completed a training course. *See* Benjamin Liebman, *China's Courts: Restricted Reform* 2007 CHINA Q. 620, 625 (2007).

⁶⁰ *See* Layton, *supra* note 7, at 1967 (arguing that the current legal and political environment does not support a greater role for private securities litigation).

fifteen percent of suit-eligible companies have in fact been sued since the promulgation of the SPC Circulars.⁶¹ While fifteen 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.⁶² 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 eighty percent of these eligible companies have not been sued in practice.⁶³ 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.⁶⁴ According to Yixin Song, a prominent securities lawyer in China, about 10,000 investors, or ten percent of the shareholders who are eligible to sue, had initiated securities-related lawsuits by the end of July 2006, but only about 1,000 of them have obtained some form of redress.⁶⁵ The amount of claimed damages represents less than five percent of the total losses incurred by public investors as a result of securities fraud.⁶⁶ Even if regulators have punished some of the most outrageous manipulators in the securities market, lax enforcement of the law has led to extensive misappropriation and securities fraud on the market,⁶⁷ because the risk of being caught and penalized is slim enough to be negligible, whereas the potential gain from fraudulent activities can be very lucrative. Companies and other wrongdoers are not sufficiently punished for their fraud, which affects public confidence in the market.

III. EMPOWERING SHAREHOLDERS' RIGHTS: THE CLASS

⁶¹ Benjamin L. Liebman & Curtis J. Milhaupt, *Reputational Sanctions in China's Securities Market*, 108 COLUM. L. REV. 929, 943 (2008).

⁶² *Id.*

⁶³ *Id.*

⁶⁴ Katharina Pistor & Chenggang Xu, *Governing Stock Markets in Transition Economies: Lessons from China*, 7 AM. L. & ECON. REV. 184, 193 (2005).

⁶⁵ Song Yixin (宋一欣), *Jiakuai Tuijin Zhengquan Minshi Peichang Fazhi Jianshe (加快推进证券民事赔偿法制建设)* [Accelerate the Development of Securities Civil Compensation System in China], ZHONGGUO ZHENGQUAN BAO (中国证券报) [CHINA SEC. DAILY] (July 27, 2006, 5:35 AM), <http://finance.sina.com.cn/stock/t/20060727/0535821672.shtml> (China).

⁶⁶ Shentu Qingnan & Chang Qing (申屠青南 常庆), *Kelong An Lüshi Weiquan Tuan Jianyi: Jinkuai Sheli Touzi Zhe Baohu Xiehui (科龙案律师维权团建议: 尽快设立投资者保护协会)* [Suggestion from the Lawyers for the Kelong Case: Set Up the Investor Protection Committee As Soon As Possible], ZHONGGUO ZHENGQUAN BAO (中国证券报) [CHINA SEC. DAILY] (July 24, 2006, 9:49 AM), available at http://news.xinhuanet.com/stock/2006-07/24/content_4871138.htm (China).

⁶⁷ Zhong Zhang, *Legal Deterrence: the Foundation of Corporate Governance—Evidence from China*, 15 CORP. GOVERNANCE: INT'L REV. 741, 760 (2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1017406.

ACTION SOLUTION?

The prevalence of securities fraud on the market and the importance of investor protection have led scholars to consider alternative mechanisms for regulatory enforcement.⁶⁸ Under U.S. 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 certification from the court. Therefore, class actions are seen as a useful procedure within economies of scale to overcome the collective action problem in bringing claims that will affect the interests of a group.⁶⁹

One major feature of the American securities class action system is the opt-out provision: persons holding claims concerning questions raised in the class proceeding are bound by any resulting judgments, unless they affirmatively elect to be excluded.⁷⁰ However, the most beneficial aspect of the class action mechanism for potential plaintiffs is that it can 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, where each litigant pays his own legal bill, attorneys under the contingency fee arrangement charge nothing if a case is lost. If the case is settled or successful, attorneys are paid on a percentage of damages recovered, which usually ranges between twenty-five and thirty percent in the United States. Since class members are generally not liable

⁶⁸ See, e.g., Wallace Wen-Yeu Wang & Jian-lin Chen, *Reforming China's Securities Civil Actions: Lessons from PSLRA Reform in the U.S. and Government-Sanctioned Non-Profit Organization in Taiwan*, 21 COLUM. J. ASIAN L. 115, 117 (2008).

⁶⁹ See FED. R. CIV. P. 23(b). Eligible cases under Rule 23 of the Federal Rules of Civil Procedure must meet four threshold requirements: numerosity, commonality, typicality, and adequacy of representation. FED. R. CIV. P. 23(a). 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 implicated where 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. FED. R. CIV. P. 23(b)(1). The second category of action is implicated where "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." FED. R. CIV. P. 23(b)(2). The third category of action is the common question action. FED. R. CIV. P. 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. *Id.*

⁷⁰ FED. R. CIV. P. 23(c)(3).

for the costs of unsuccessful suits, the contingency fee arrangement provides financial incentives for defrauded investors to pursue securities claims 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 in China.

Apart from economic considerations, class actions also help redress the imbalance between the wrongdoers of fraud and minority public shareholders.⁷¹ In the Chinese context, the former are usually connected with powerful local interests, while minority public shareholders have no organized investor groups with comparable capacity. The class action system can thus help these shareholders overcome fears of retaliation from the wrongdoers and assist them in obtaining 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 has much potential as a useful deterrent and remedial device in policing corporate insiders. A growing number of jurisdictions⁷² have actively considered adopting American class action procedures to promote private enforcement.⁷³ In the wake of a series of securities fraud scandals at the turn of this century, some Chinese scholars have also called for the adoption of a U.S.-style class action system to improve shareholders' access to justice.⁷⁴

Nonetheless, the fundamental flaw of the class action system is that unnecessary and frivolous lawsuits may be encouraged for the sole purpose of coercing settlements that are disproportionate to the merits of the plaintiffs' claims.⁷⁵ With the opt-out rule, plaintiffs can commence proceedings on behalf of persons with no individual interest in the litigation, or on behalf of persons unaware of the existence of the class action. The

⁷¹ 2 HERBERT B NEWBERG & ALBA CONTE, *NEWBERG ON CLASS ACTIONS* 478 (4th ed. 2002).

⁷² Lisa Rickard, *The Class Action Debate in Europe: Lessons from the U.S. Experience*, *EUR. BUS. REV.*, <http://www.europeanbusinessreview.com/?p=273> (last visited Jan. 15, 2013). For example, the European Union, New Zealand, Singapore, South Africa, and the United Kingdom.

⁷³ *See id.* (pointing out, however, the potential for abuses and economic burdens of importing the U.S. class action system).

⁷⁴ *See, e.g.*, Pan Jianfeng & Chen Fuyong (潘剑锋&陈福勇), *Lun Zhengquan Minshi Qinquan Peichang Anjian de Susong Fangshi* (论证券民事侵权赔偿案件的诉讼方式) [*On the Action Form of Civil Torts Compensation Cases Concerning Negotiable Securities*], 22 *ZHENGFA LUNTAN* (政法论坛) [*POL. SCI. & L. TRIB.*] 77 (2004) (China); Tang Weijian & Chen Wei (汤维建&陈巍), *Fengxi Celüe: Woguo Jituan Susong Zhidu de Yizhi Lujing Tanxi* (缝隙策略: 我国集团诉讼制度的移植路径探析) [*Strategy of Limited Application: Transplanting Foreign Experience to Reform the Mass Litigation System in China*], 1 *ZHENGZHI YU FALÜ* (政治与法律) [*POL. SCI. & L.*] 111 (2008) (China).

⁷⁵ Robert D. Cooter & Daniel L. Rubenfield, *Economic Analysis of Legal Disputes and Their Resolution*, 27 *J. ECON. LITERATURE* 1067, 1075–82 (1989).

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 United States are often inclined to settle low value claims early on, regardless of the underlying merits.⁷⁶ 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 a risk of abusive litigation has even deterred the legal profession in the United Kingdom from adopting a similar system.⁷⁷

It is said that even for meritorious litigation, class actions “produce wealth transfers among shareholders that neither compensate nor deter.”⁷⁸ Class action suits divert corporate resources from focusing on their normal activities.⁷⁹ Additionally, significant fee awards and settlement amounts result in higher director and officer insurance premiums. These premiums, together with increased operating costs and settlement sums, are ultimately passed on to shareholders.⁸⁰ 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 enrich entrepreneurial lawyers at the expense of average shareholders.⁸¹

Opt-out class actions also present a serious conflict of interest between class members and their attorneys. Because attorneys acting for the class will both be paid and recoup significant out-of-pocket expenditures if the litigation is successfully concluded, they often have a strong financial

⁷⁶ DEBORAH R HENSLER ET AL., CLASS ACTION DILEMMAS: PURSUING PUBLIC GOODS FOR PRIVATE GAIN 119–20 (2000).

⁷⁷ The introduction of a class action system was initially proposed in the Finance Bill 2010, but the proposal was subsequently dropped in the rush for the May 2010 General Election. *Class Actions: A Global Update*, ALLEN & OVERY (Jan. 18, 2011), <http://www.allenoverly.com/publications/en-gb/Pages/Class-Actions—A-Global-Update.aspx>.

⁷⁸ John Coffee, *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1534 (2006).

⁷⁹ It was reported that “between 1999 and 2004, one major U.S. drug maker spent \$25 billion [USD] on legal costs and reserves to fight class action lawsuits, while devoting only \$19 billion [USD] to research and development.” Rickard, *supra* note 72 (brackets in original).

⁸⁰ See COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 78 (2006), http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

⁸¹ See, e.g., Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487, 494–98 (2007); John Coffee, *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 302–05 (2007).

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 they are appointed to guard.⁸² The risk of conflict is further exacerbated by the lack of protection the class action procedure offers class members, who are typically given 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 settlement to investor losses ratio ranged between two and three percent, even though settlement payments have dramatically increased over the years.⁸³ Plaintiff attorneys, however, received massive fee awards that were disproportionate to the time and effort expended in a case. In the landmark case *Kamilewicz v. Bank of Boston Corp.*, a settlement was reached in which each of the individual class members was awarded USD 8.76, while class counsel received USD 8.5 million in fees.⁸⁴

The above analysis reveals that, while the class action system and the contingency fee arrangement can help police corporate management, they are unlikely to substantially improve the prospects for a minority shareholder. The problems that plague class actions in the United States may vary in importance if 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 also encourage unnecessary litigation 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 listed companies to succumb to large settlement amounts. This may threaten current share prices and even force the companies into dissolution in extreme cases,⁸⁵ which may in turn inhibit the privatization reform process of SOEs that the securities market in China

⁸² See John Coffee, *Understanding the Plaintiffs' Attorney: The Implications of Economic Theory for Private Enforcement of Law through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 701–04 (1986).

⁸³ It is reported that “[t]he average settlement amount from 2002 and 2007 rose to USD 40.5 million, about two and a half times the average settlement amount of USD 16.3 million from 1996 to 2001.” U.S. CHAMBER INST. FOR LEGAL REFORM, SECURITIES CLASS ACTION LITIGATION: THE PROBLEM, ITS IMPACT AND THE PATH TO REFORM 9 (2008), www.instituteforlegalreform.com/get_ilr_doc.php?docId=1213.

⁸⁴ 92 F.3d 506, 508–09 (7th Cir. 1996).

⁸⁵ See Richard M. Philips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAW. 1009, 1028–29 (1996).

is designed to assist.⁸⁶ As the U.S. experience illustrates, these bounty-hunter class actions may lead to over-enforcement, and hence, over-deterrence of securities fraud, which may dissuade foreign companies from entering the country's securities market.

In addition to the perceived risk of abuse, institutional differences between the United States and China may operate as a key impediment to the modeling of the U.S.-style class action regime in China. Unlike their U.S. counterparts, a major hurdle confronting shareholders in China is limited access to legal representation. The Chinese 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 (Guiding Opinion).⁸⁷ The Guiding Opinion stipulates that lawyers handling mass suits (*qunti anjian*) are subject to supervision and guidance of the judicial administration departments.⁸⁸ A mass suit is defined as an action where either side consists of ten or more individuals bound by common questions of law or fact.⁸⁹ Lawyers are also required to report to the responsible government agencies as soon as they discover any sign that suggests potential intensification of the conflict, or any action on their clients' part that may threaten social stability.⁹⁰ The absence of unrestricted access to legal representation casts doubt as to whether the class action system can dramatically enhance shareholders' recourse to justice. 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 extremely difficult to handle.⁹¹

A related concern is that most of China's local people's courts lack independence.⁹² Although China's Constitutional Law recognizes the

⁸⁶ "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." WORKING GRP. ON PRIVATISATION & CORP. GOVERNANCE OF STATE OWNED ASSETS, ORG. FOR ECON. CO-OPERATION & DEV., STATE OWNED ENTERPRISES IN CHINA: REVIEWING THE EVIDENCE 3 (2009), <http://www.oecd.org/corporate/corporateaffairs/corporategovernanceofstate-ownedenterprises/42095493.pdf>.

⁸⁷ Zhonghua Quanguo Lüshi Xiehui Guanyu Lüshi Banli Quntixing Anjian de Zhidao Yijian (中华全国律师协会关于律师办理群体性案件的指导意见) [Guiding Opinion on the Handling of Mass Suits by Lawyers] (promulgated by All China Law. Ass'n, Mar. 20, 2006, effective Mar. 20, 2006) (China).

⁸⁸ *Id.* art. 1(3).

⁸⁹ *Id.* art. 1(1).

⁹⁰ *Id.* art. 2.

⁹¹ 1 DANIEL FUNG ET AL., ARBITRATION IN CHINA: A PRACTICAL GUIDE ¶ 24-08, at 702 (2004).

⁹² Chinese local courts are funded and subsidized by the relevant local people's

independence of the courts as a whole,⁹³ local governments control local courts through their control of the budget and their power to appoint, promote, and remove judges.⁹⁴ This is especially problematic in light of China's current issues with widespread protectionism and corruption.⁹⁵ Local courts may not be able to fend off local political party and governmental pressures, potentially violating due process and independent judicial decision-making. The risk of undue interference is particularly imminent if the interest of the government or 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, claims are also subject to extensive oversight by the judicial committee (*shenpan weiyuanhui*), which essentially decides how important or politically sensitive cases should be decided.⁹⁶ As judges rarely resist the committee's determination or recommendation, the independent decision-making process is undermined. Besides, the performance of judges is evaluated based on the number of cases they process.⁹⁷ Since a class action is likely to disadvantage the court's caseload, judicial hostility towards class actions may intensify should they be implemented in China.⁹⁸

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 the Chinese securities context. Class actions provide the means through which a group of aggrieved shareholders are organized into

government. See ALBERT CHEN, AN INTRODUCTION TO THE LEGAL SYSTEM OF THE PEOPLE'S REPUBLIC OF CHINA 200-04 (4th ed. 2011).

⁹³ XIANFA art. 126 (1982) (China); Zhonghua Renmin Gongheguo Renmin Fayuan Zuzhi Fa (中华人民共和国人民法院组织法) [Organic Law of the People's Courts of the People's Republic of China] art. 4 (promulgated by the Standing Comm. Nat'l People's Cong., July 5, 1979, effective Jan. 1, 1980) (Lawinfochina) (China).

⁹⁴ XIANFA art. 127 (1982) (China) (stating that while the SPC supervises the adjudicative work of all lower level people's courts, it has no power over their budgets).

⁹⁵ 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 WIS. INT'L L.J. 221, 258-59 (2009) ("[L]ocal protectionism must be prevalent unless the court can relieve itself from the budget constraints.").

⁹⁶ See CHEN, *supra* note 92, at 186.

⁹⁷ Benjamin Liebman, *Class Action Litigation in China*, 111 HARV. L. REV. 1523, 1533 (1998).

⁹⁸ *Id.*

a class, which has the potential to destabilize society and, understandably, trigger anxiety in the government. Some local judges have even publically expressed that mass actions are politically too risky,⁹⁹ and that political stability is preferred to other market values.¹⁰⁰ In this light, Chinese courts have historically been inhospitable to investors seeking compensation for losses resulting from securities fraud, and it is unlikely they will be more hospitable in the near future.

IV. SECURITIES ARBITRATION: AN ALTERNATIVE OUT

Having concluded that modeling the U.S. class action system in China is quite unlikely to supply the optimal level of private enforcement to police corporate misconduct and deter securities fraud in China, this Part explores how to reform the present system of securities fraud litigation in a way that balances the competing interests of state control, social stability, and minority shareholder protection. 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 privately enforcing securities regulation. This Part focuses 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 mechanisms such as mediation and arbitration have been gaining popularity in settling 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.¹⁰¹ 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 party arbitrators, who are usually appointed by the disputing parties' agreement. Compared to litigation, arbitration is less formal, emphasizing equity and efficiency above strict observance of legal norms.¹⁰²

The speed and cost savings associated with ADR offer much appeal in the settlement of financial disputes. Arbitration is cheaper and speedier than litigation because, rather than having generalist judges who must rely upon the assistance of experts—possibly prolonging the hearing and

⁹⁹ Hutchens, *supra* note 16, at 645.

¹⁰⁰ Nicholas C. Howson, *Judicial Independence and the Company Law in the Shanghai Courts*, in *JUDICIAL INDEPENDENCE IN CHINA: LESSONS FOR GLOBAL RULE OF LAW PROMOTION* 134, 147 (Randall Peerenboom ed., 2009).

¹⁰¹ JACQUELINE NOLAN-HALEY, *ALTERNATIVE DISPUTE RESOLUTION IN A NUTSHELL* 62 (2d ed. 2001).

¹⁰² *Id.* at 138.

increasing costs— arbitration allows parties to appoint experts knowledgeable about industry customs to serve as arbitrators. 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 U.S. Supreme Court upheld the enforceability of pre-arbitration agreements to settle disputes between broker-dealers and their customers.¹⁰³ In addition, the Financial Industry Regulatory Authority (FINRA) offers U.S. investors the option to resolve disputes via mediation or arbitration, the latter of which is more popular. Throughout 2012, a total of 4,299 arbitration cases were filed through the FINRA process, parties agreed to mediation in 572 cases, and 776 cases were closed through mediation.¹⁰⁴ 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 minibonds claims between banks and investors arising from the collapse of Lehman Brothers in 2008.¹⁰⁵ In a similar vein, the Financial Ombudsman Service (FOS) was established in the United Kingdom to resolve consumer financial disputes.¹⁰⁶ The FOS provides free and independent advice to consumers on resolving disputes with financial companies. According to figures revealed by TheCityUK, an independent body established to promote the financial and related professional services industries in the United Kingdom, the total number of disputes that have been resolved through arbitration and mediation reached a total of 34,541 in 2009, up seventy-eight percent from 19,384 disputes resolved in 2007.¹⁰⁷

Mediation and arbitration are also popular dispute settlement alternatives in China. 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 listed abroad. Article 163 of the Notice on the Implementation of the “Mandatory Provisions of Articles of Association of Companies Seeking Overseas Listing” (*Guanyu*

¹⁰³ 490 U.S. 477 (1989).

¹⁰⁴ *Dispute Resolution Statistics*, FIN. INDUSTRY REG. AUTHORITY, <http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/> (last updated Dec. 18, 2012). In 2010, 5,680 cases were filed through the FINRA arbitration process, parties agreed to mediation in 823 cases, and 497 cases were closed through mediation. *Id.* In 2011, 4,729 new arbitration cases were filed, parties agreed to mediation in 659 cases, and 783 cases were closed through mediation. *Id.*

¹⁰⁵ Gu Weixia, *ADR and Financial Disputes in Hong Kong: The Lehman Brothers Experience and the Way Forward*, *ASIAN DISP. REV.*, Jan. 2011, at 20, 20.

¹⁰⁶ *See* FIN. OMBUDSMAN SERV., <http://www.financial-ombudsman.org.uk/> (last updated Mar. 12, 2012).

¹⁰⁷ THECITYUK, *DISPUTE RESOLUTION IN LONDON AND THE UK 2010*, at 1 (2011), available at <http://www.thecityuk.com/research/our-work/reports-list/dispute-resolution-in-london-and-the-uk-2010/>.

Zhixing Dao Jingwai Shangshi Gongsi Zhangcheng Bibei Tiaokuan de Tongzhi) provides for a compulsory arbitration clause whereby disputes between a Chinese corporation listed in Hong Kong and its shareholders must be arbitrated under the HKIAC or the China International Economic and Trade Arbitration Commission (CIETAC).¹⁰⁸ In addition, the SPC Circulars provide legislative support for the use of ADR methods in settling civil compensation claims arising from misrepresentations in the disclosure documents of listed corporations. 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.¹⁰⁹ 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, the courts are the only dispute resolution mechanism for aggrieved shareholders in China to recover financial losses from the wrongdoers of securities fraud. Drawing upon the global ADR trend, and bearing in mind the need to improve shareholders' access to justice, defrauded shareholders who have suffered financial losses resulting from securities fraud should be provided with an additional avenue to resolve civil compensation claims in a cost-effective and expeditious manner. Unduly legalistic procedures should be avoided to keep resolution simple for average retail shareholders.

In view of the institutional experience in the United States and Hong Kong, a securities arbitration scheme should be introduced in China for the resolution of civil compensation claims that fall within the scope of the Securities Law. Even though securities arbitration has not achieved full legal efficacy in China, the securities industry has widely agreed for some time now that a dispute resolution scheme combining low cost and high efficiency is necessary.

¹⁰⁸ Guanyu Zhixing Dao Jingwai Shangshi Gongsi Zhangcheng Bibei Tiaokuan de Tongzhi (关于执行《到境外上市公司章程必备条款》的通知) [Notice on the Implementation of the "Mandatory Provisions of Articles of Association of Companies Seeking Overseas Listing"] (promulgated by the China Sec. Reg. Comm'n, Aug. 27, 1994), art. 163 (China), available at http://www.csrc.gov.cn/pub/newsite/ssb/ssflfg/bmgzjwj/ssgszl/200911/t20091110_167714.htm.

¹⁰⁹ 2003 Circular, *supra* note 37, art. 4. The 2003 Circular instructs 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. *Id.*; Civil Procedure Law, *supra* note 50, at ch. 8 (providing mediation principles and procedures).

1. Theoretical Merits of Securities Arbitration

While arbitration procedures bear many resemblances with 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 each case. Unlike litigation, where there is a need to explain technical matters to generalist judges, the use of experts in arbitration allows for speedy resolution of disputes. Hence, arbitration satisfies the securities market's need for an industry-specific type of dispute resolution.¹¹⁰ Second, parties to arbitration can tailor procedures to fit the circumstances of a particular case. Accordingly, relevant issues can be identified more 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.¹¹¹ Further, arbitration ethical rules require arbitrators to maintain all information revealed during a case in strict confidence.¹¹² Hence, arbitration is particularly appealing for preserving 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 well-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, dispute resolution based on 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 (*de jure and de facto*) 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.¹¹³ Moreover, the speed and cost savings associated with

¹¹⁰ This is particularly true in China, because judges are generally less experienced in dealing with commercial disputes. See *supra* notes 59–60 and accompanying text.

¹¹¹ Zhongguo Guoji Jingji Maoyi Zhongcai Weiyuanhui Zhongcai Guize (2012 Ban) (中国国际贸易仲裁委员会仲裁规则 (2012 版) [China International Economic & Trade Arbitration Commission Arbitration Rules (2012 Edition)] (promulgated by China Council for the Promotion of Int'l Trade & China Chamber of Int'l Com., Feb. 3, 2012, effective May 1, 2012), art. 36 (China), available at <http://cn.cietac.org/Rules/index.asp> (providing that an arbitral tribunal may not hear cases in an open session) [hereinafter 2012 CIETAC Rules].

¹¹² Zhongcaiyuan Shouze (仲裁员守则) [Arbitrators Code] (promulgated by China Intl Econ. & Trade Arb. Comm'n, Apr. 6, 1993, amended May 6, 1994), art. 13 (China).

¹¹³ For instance, in the past decade, several highly sensational cases involving listed corporations have occurred, such as *Shenzhen Kondarl (Grp.) Co.* in 2000, and *New NongKai Global Invs. Ltd.* and *Xin Jiang Hops Co.* in 2003. Numerous lawsuits have been filed against these listed corporations, which have been involved in corporate malpractice. Unfortunately, the process of settling these lawsuits is often blocked by procedural issues.

arbitration offer 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 mechanism 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.¹¹⁴

Stability of the securities market is a particularly important goal in China, because the securities market is still in its infant stage. Arbitration may help China realize this goal. As mentioned before, arbitration keeps disputes confidential, preventing sensitive information from becoming widespread. Through the confidential and stable process of arbitration, greater stability in the securities market may be achieved at minimal cost and maximum efficiency. Therefore, arbitration may serve to both protect the interests of minority shareholders and maintain social order in the securities market.¹¹⁵ In this sense, securities arbitration has the potential to enhance social stability.¹¹⁶

2. Institutional Setup of the Securities Arbitration Scheme

Creating a new entity at the national level to oversee the securities arbitration scheme would be a costly and time-consuming option. For this purpose, it would be most cost effective for future civil compensation claims to be woven into one of the pre-existing arbitration resources in China. This Article suggests that China International Economic and Trade Arbitration Commission is the most appropriate forum for the following reasons.

CIETAC is the most experienced forum for commercial arbitration in China, and handles the majority of such disputes at a price that general market players can afford.¹¹⁷ CIETAC was founded in 1956 under the auspices of the China Council for the Promotion of International Trade (CCPIT) to aid the CCPIT in promoting international trade by providing an impartial forum for resolving foreign-related disputes. Since then, it has transformed from a quasi-judicial dispute resolution body to a truly modern

before the substantive issues are treated and damages are paid. *See* 1 FUNG ET AL., *supra* note 91, ¶ 24-04, at 700-01.

¹¹⁴ *Id.* ¶ 24-20.

¹¹⁵ *Id.* ¶ 24-25.

¹¹⁶ Confidentiality is another aspect of arbitration that China may desire because China often does not favor public exposure of its companies.

¹¹⁷ LIJUN CAO, THE FOUND. FOR LAW, JUSTICE & SOC'Y, CIETAC AS A FORUM FOR RESOLVING BUSINESS DISPUTES 1-2 (2008), http://www.fljs.org/sites/www.fljs.org/files/publications/FLJ%20BS%20Cao%20pb_c.pdf.

international commercial arbitration institution. Currently, it is the largest and busiest arbitration institution in the world in terms of annual caseload.¹¹⁸ It is also the leading arbitration commission in China, administering a wide array of domestic and foreign-related disputes, including disputes that involve international trade and investment, financial leasing, and service contracts.¹¹⁹

CIETAC's popularity in the international arbitration community can partly be explained by its commitment to bring its arbitration procedures in line with international practice and standards. The CIETAC Rules have been revised seven times since its inception, and its 2005 amendments (2005 CIETAC Rules) addressed some of the most common criticisms of CIETAC procedures.¹²⁰ Most noticeably, for the first time, a procedure was introduced for the selection and appointment of arbitrators not listed in the CIETAC Arbitrator Panel (*zhongcaiyuan mingce*).¹²¹ Prior to the introduction of this rule, CIETAC had adopted the panel system, where only those CIETAC-Panel-listed arbitrators could be appointed.¹²² This widening of potential arbitrators will dramatically increase the pool of experts and foreigners available to serve on a CIETAC tribunal and will have a significant practical impact on increasing the parties' procedural autonomy.¹²³ Although CIETAC must confirm such an appointment,¹²⁴ in the words of one scholar, "such confirmation is more of a formality and the appointment of foreign arbitrators is most unlikely to be objected without a good reason."¹²⁵ This reform was coupled with measures to strengthen arbitrator impartiality. The 2005 CIETAC Rules provide that an appointed arbitrator must declare any matters that may raise reasonable doubts about his or her independence and impartiality and request withdrawal.¹²⁶ This should enhance the independence of the arbitrators. In May 2012, CIETAC carried out further amendments to its arbitration rules (2012 CIETAC Rules)

¹¹⁸ GU WEIXIA, ARBITRATION IN CHINA: REGULATION OF ARBITRATION AGREEMENTS AND PRACTICAL ISSUES ¶ 2.025 (2012).

¹¹⁹ *Id.*

¹²⁰ See Gu Weixia, *China's Arbitration: Restricted Reform*, in THE DEVELOPMENT OF THE CHINESE LEGAL SYSTEM: CHANGE AND CHALLENGES 271, 273 (Guanghua Yu ed., 2011).

¹²¹ Zhongguo Guoji Jingji Maoyi Zhongcai Weiyuanhui Zhongcai Guize (2005 Nian Xiuding) (中国国际经济贸易仲裁委员会仲裁规则 (2005 修订)) [China International Economic & Trade Arbitration Commission Arbitration Rules (2005 Revision)] art. 21(2) (promulgated by China Council for the Promotion of Int'l Trade/China Chamber of Int'l Commerce, Jan. 11, 2005, effective May 1, 2005) (Lawinfochina) (China) [hereinafter 2005 CIETAC Rules].

¹²² Gu Weixia, *The China-Style Closed Panel System in Arbitral Tribunal Formation—Analysis of Chinese Adaptation to Globalization*, 25 J. INT'L ARB. 121, 146 (2008).

¹²³ *Id.*

¹²⁴ 2005 CIETAC Rules, *supra* note 121.

¹²⁵ JINGZHOU TAO, ARBITRATION LAW AND PRACTICE IN CHINA 120–21 (2d ed. 2008).

¹²⁶ 2005 CIETAC Rules, *supra* note 121, art. 25.

in accordance with developments in the Chinese market, in particular, to reflect the international trend of enhancing flexibility of arbitral proceedings.¹²⁷ The 2012 CIETAC Rules, following the lead of the 2005 CIETAC Rules, put greater emphasis on arbitrator impartiality. For example, Article 28 of the 2012 CIETAC Rules requires the CIETAC Chairman, for the first time, to consider the nationalities of the parties when appointing an arbitrator in the absence of the party agreement.¹²⁸

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 development¹²⁹—CIETAC has retained its financial autonomy. The steady increase of the arbitration caseload has generated impressive income from arbitration fees, and as such, CIETAC is less prone to administrative interference.¹³⁰

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, the predecessor of CSRC, had designated CIETAC as the arbitral tribunal for disputes between securities firms or between securities firms and stock exchanges.¹³¹ At the time of this designation, the Securities Law was still being drafted. The 1993 draft of the Securities Law proposed that a securities arbitration commission be set up within the China Securities Association, but this proposal was ultimately removed from the 1994 draft of the Securities Law.¹³² Both the 1998 Securities Law and 2005 Securities Law failed to mention this earlier proposal to establish a specialized securities dispute arbitration tribunal.¹³³ On the other hand, the State has emphasized CIETAC as a forum for resolving securities disputes.

As a national arbitration commission, CIETAC is headquartered in Beijing, with three sub-commissions in Shanghai, Shenzhen, and Tianjin.¹³⁴

¹²⁷ 2012 CIETAC Rules, *supra* note 111.

¹²⁸ *See id.* art. 28.

¹²⁹ Gu Weixia, *supra* note 120, at 274–76 (explaining the inherent institutional defects of local arbitration commissions).

¹³⁰ *See generally* CHINA INT’L ECON. & TRADE ARB. COMMISSION, <http://www.cietac.org> (last visited Jan. 6, 2013).

¹³¹ *See* Guowuyuan Guanyu Zhiding Zhongguo Guoji Jingji Maoyi Zhongcai Weiyuanhui Wei Zhengquan Zhengyi Zhongcai Jigou de Tongzhi (国务院关于指定中国国际经济贸易仲裁委员会为证券争议仲裁机构的通知) [Notice of the SCSC on Designation of CIETAC as Arbitration Organization for Securities Disputes] (promulgated by the Sec. Comm’n of the St. Council, Aug. 26, 1994, effective Aug. 26, 1994) (China).

¹³² *See* SANZHU ZHU, SECURITIES REGULATION IN CHINA 69–70 (2000).

¹³³ SANZHU ZHU, *supra* note 44, at 216.

¹³⁴ Sub-commissions include CIETAC Shanghai Sub-Commission, CIETAC South China

It has also established twenty-one liaison offices in different regions and in different business sectors to promote its arbitration practice.¹³⁵ Its broad geographical presence and nationwide resources provide convenient hearing venues through which civil compensation cases lodged by retail shareholders 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 nationwide arbitration networks. Moreover, it may fully leverage the CIETAC panel's financial and securities expertise as well as existing resources, such as finance, manpower, information technology, and premises.

3. *The Arbitration Process*

i. Eligibility Requirements

This Article proposes that at the initial stage of the arbitration scheme, shareholders should only be permitted to bring “follow-up” actions seeking compensation against a listed corporation and other relevant wrongdoers after the CSRC or other competent administrative agencies decide that the conduct in question constitutes a Securities Law violation. This proposal draws from the success of the Lehman Brothers-Related Investment Products Dispute Mediation and Arbitration Scheme in Hong Kong, where investigative powers remain with the Hong Kong Monetary Authority (HKMA) and Securities and Futures Commission (SFC), while the HKIAC is mainly responsible for adjudication.¹³⁶ Retaining the powers of the CSRC to deal with regulatory breaches while introducing CIETAC to exclusively award damages would avoid duplication of powers and, in addition, would recognize the effective division of responsibility in financial dispute resolution.¹³⁷ To parallel civil actions, a limitations period should also be set so that a claim is ineligible for arbitration if two or more years have elapsed from the date of the decision, similar to the provisions under the SPC Circulars.¹³⁸ Once civil discovery mechanisms in China improve, shareholders should be allowed to bring “stand-alone” actions, entitling parties affected by Securities Law violations to take civil action for

Sub-Commission (in Shenzhen), and the CIETAC International Economic & Financial Arbitration Center (in Tianjin). *About Us: Introduction*, CHINA INT'L ECON. & TRADE ARB. COMMISSION, <http://www.cietac.org/index/aboutUs/47601fd516b2517f001.cms> (last visited Jan. 6, 2013).

¹³⁵ Examples include grain, commerce, construction, finance, leather, and wool transactions. *Id.*

¹³⁶ Gu Weixia, *supra* note 105, at 20–23.

¹³⁷ *See id.* at 22–23.

¹³⁸ 2003 Circular, *supra* note 37, art. 5; 2002 Circular, *supra* note 34, art. 2.

the recovery of damages suffered, regardless of the outcome of criminal or administrative investigations.

Critics have attacked the requirement of a prior administrative sanction or criminal judgment before the initiation of a civil compensation suit on the grounds that this requirement deprives investors of their statutory right to a private action.¹³⁹ This is because under Article 6 of the Civil Procedure Law, courts are required to hear cases independently without interference from administrative agencies.¹⁴⁰ 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 their connections (*guanxi*).¹⁴¹ This would limit civil litigation rights and the availability of compensation to defrauded investors who suffer economic losses. Moreover, according to Zhu, changing government policies may prevail through administrative agencies at the cost of public investors' legal rights and interests.¹⁴²

These are indeed valid criticisms of the securities enforcement regime in China. However, 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,¹⁴³ but there is also an absence of an elaborate discovery mechanism in China, which is likely to place potential claimants in 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 Supreme People's Court formulates the scope and procedure for inspection.¹⁴⁴ In addition,

¹³⁹ See, e.g., Guiping Lu, *Private Enforcement of Securities Fraud Law in China: A Critique of the Supreme People's Court 2003 Provisions Concerning Private Securities Litigation*, 12 PAC. RIM L. & POL'Y 781, 797 (2003).

¹⁴⁰ Civil Procedure Law, *supra* note 50, art. 6.

¹⁴¹ Guiping Lu, *supra* note 140, at 795–98.

¹⁴² SANZHU ZHU, *supra* note 44, at 204.

¹⁴³ For instance, Article 34 of the Company Law provides that shareholders are allowed to consult and copy the articles of association, records of shareholder meetings, resolutions of board meetings, and financial reports. Zhonghua Renmin Gongheguo Gongsifa (中华人民共和国公司法) [Company Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006), art. 34 (China). Shareholders are entitled access to the company's accounting books upon submitting a written request stating their motives, but the company has the discretion to decline such a request if it finds the request as being pursuant to any improper purpose that may damage the legitimate interest of the company. *Id.*

¹⁴⁴ Civil Procedure Law, *supra* note 50, art. 61.

parties have no duty to respond to the adverse party's requests to produce documents, depose witnesses, or even answer questions prior to trial. Production of evidence may be compelled only when the people's court considers it necessary for adjudicating the case in question.¹⁴⁵ As defrauded shareholders lack the means to obtain information about the fraud or misconduct at issue, they can avert difficulties in gathering the necessary information to prove their case if they can rely on evidence gathered during the criminal or administrative investigations. Even in the United States, where information costs are arguably lower, a 2003 study by Cox, Thomas, and Kiku shows that enforcement actions by the U.S. Securities Exchange Commission are usually the foundation for successful private securities lawsuits.¹⁴⁶

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 recent years in improving corporate governance within listed companies. In March 2007, the CSRC started a three-year campaign to strengthen corporate governance within listed companies.¹⁴⁷ During the campaign, listed companies looked into existing corporate governance problems, including misappropriation of corporate funds, inadequate internal controls, and irregular operations at meetings of directors, shareholders, and supervisory boards. The listed companies then made rectification measures.¹⁴⁸ It was reported that this campaign resolved many governance problems and promoted a culture of corporate and shareholder autonomy.¹⁴⁹ The report also stated that the listed companies gained greater awareness of standard operations and improved their governance levels during the campaign.¹⁵⁰

ii. The Arbitration Procedure

CIETAC should devise a set of procedural rules in line with its 2012

¹⁴⁵ *Id.* art. 64.

¹⁴⁶ James Cox, Randall Thomas & Dana Kiku, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 763 (2003).

¹⁴⁷ CORP. GOVERNANCE COMM., ORG. FOR ECON. CO-OPERATION & DEV., Pub. No. DAF/CA/CG(2010)3/REV2, CHINA COUNTRY STUDY: SELF-ASSESSMENT AGAINST THE OECD PRINCIPLES OF CORPORATE GOVERNANCE 6–8 (2011), <http://www.oecd.org/dataoecd/43/52/46931890.pdf>.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

Arbitration Rules to administer claims arising out of the securities arbitration scheme.¹⁵¹ In order to commence an action, potential claimants should submit an arbitration application together with filing fees. Upon receipt of the claim and fees, CIETAC's Secretariat decides whether the case is eligible to proceed. In this regard, CIETAC's Secretariat has the discretion not to process cases that are clearly frivolous or vexatious. Arbitration proceedings should commence only after the Secretariat has decided that proper requirements have been complied with.

Once a case is accepted, either party may request CIETAC to informally resolve the claim through mediation prior to the appointment of an arbitral tribunal. If both parties agree 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 a mediation process, however, nothing exchanged between the parties or the mediator may be relied on by the parties in subsequent judicial or arbitration proceedings unless the parties agree otherwise. Additionally, the claimant will be barred from litigating the case further in court after arbitration.¹⁵²

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-upon arbitrator or a panel of three arbitrators;¹⁵³ the latter choice of an arbitration tribunal is more common. To further inject public confidence into the securities arbitration scheme, CIETAC should impose additional safeguards in the arbitrator selection process beyond the requirements of the 2012 CIETAC Rules. CIETAC should provide parties with information on each arbitrator's education, employment history, prior arbitration awards, and other relevant background information during the arbitrator selection process. The parties could use the information to strike arbitrators with potential conflicts of interest with the witnesses, issues, or securities in the case.¹⁵⁴

As the Hong Kong Lehman Brothers-Related Investment Products

¹⁵¹ See 2012 CIETAC Rules, *supra* note 111.

¹⁵² *Zhonghua Renmin Gongheguo Zhongcai Fa* (中华人民共和国仲裁法) [Arbitration Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 31, 1994, effective Sept. 1, 1995) (China), art. 5, available at http://www.npc.gov.cn/englishnpc/Law/2007-12/12/content_1383756.htm [hereinafter Arbitration Law].

¹⁵³ *Id.* art. 30.

¹⁵⁴ 2012 CIETAC Rules, *supra* note 111, arts. 24–28. For background information on the arbitration procedure, see Geoffrey Chan & Terence Tung, *Commencement of Arbitration and Arbitration Proceedings*, in 1 FUNG ET AL., *supra* note 91, ¶¶ 9-01 to 9-06, at 137–38.

Dispute Mediation and Arbitration Scheme reveals, adopting a complaints-based approach in dealing with a multitude of individual cases may result in a slow dispute resolution process.¹⁵⁵ In this light, procedural rules should be fine-tuned and group arbitration rules should be incorporated to accommodate a number of claims involving similar questions of law or fact.¹⁵⁶ In these cases, the first part of the proceeding should deal with the issue of the defendant's liability, and the second part of the proceeding should deal with the application of legal principles to individual cases, and where appropriate, the assessment of damages to be paid to individual members.

Finally, this Article proposes charging both securities arbitration claimants and defendants a fee similar to 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 envisaged that the enhanced private enforcement through arbitration will encourage more corporate compliance in China. Greater shareholder protection can, in turn, change China's business culture and macroeconomics in the long run.

iii. Relationship with the Securities Regulators

Structurally, the securities arbitration scheme and the securities regulators should be operationally independent so as to prevent any political and administrative intervention. For this purpose, it is desirable that, instead of being under the shelter of the political party or the central government, the securities arbitration scheme operates exclusively on its arbitration fees revenue.

The relevant securities regulators, such as the CSRC and China's two stock exchanges in Shanghai and Shenzhen, should, however, maintain strategic oversight of the securities arbitration scheme. In this light, these regulatory authorities should be empowered in the rulemaking 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 duplicative efforts and the blurring of their respective roles, CIETAC should not have any investigative or disciplinary powers, which are instead within the exclusive purview of the securities regulators. CIETAC should be charged solely with the responsibility of handling civil compensation

¹⁵⁵ See Douglas Arner et al., *Financial Regulation in Hong Kong: Time for a Change*, 5 *ASIAN J. COMP. L.* 1, 33 (2010).

¹⁵⁶ Because securities litigation is substantially dependent upon group litigation, group arbitration in securities disputes is highly desired. This is exemplified by the importance of the group securities litigation statutes in the United States. See Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended at 15 U.S.C. §§ 77k, 77l, 77z-1, 77z-2, 78a, 78j-1, 78t, 78u, 78u-4, 78u-5 (2006)); Securities Litigation Standards Act of 1998, 15 U.S.C. §§ 77p, 78bb(f) (2006) (amended 2010).

claims arising from securities fraud, and as such, will not issue fines, impose sanctions, or take disciplinary actions.

iv. Implementation of the Securities Arbitration Scheme

In the initial stage of the arbitration scheme, a pilot scheme should be launched to test the effectiveness of arbitration in resolving civil securities fraud disputes in China. This pilot scheme is suggested to last for three years to inform the investing public and other parties concerned about securities arbitration. After three years, a full evaluation of the pilot scheme could then be made. If the scheme is successful, this Article suggests that the Chinese legislature pass laws making securities arbitration available nationwide on a continuous and permanent basis.

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 its execution. Accordingly, this Article proposes a lead-in period of six months before implementation of the pilot scheme to organize activities and to promote the awareness and understanding of the service among relevant regulatory authorities, the legal profession, and members of the investing public. During this lead-in period, an industry-wide effort should also be made to solicit comments from securities regulators, scholars, and practitioners to make sure the pilot project is reflective of various interest groups' views. The input given during this lead-in period would later be tested and used to improve the permanent and independent securities arbitration mechanism ultimately adopted.

4. *Concerns of Securities Arbitration*

Notwithstanding the advantages of arbitration and the legislative endorsement of this dispute resolution mechanism, a securities arbitration scheme also raises a few concerns that warrant discussion.

i. 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 over rights and interests in property—other than marital, adoption, guardianship succession, and administrative disputes—between citizens, legal persons, and other organizations that are equal subjects may be arbitrated.¹⁵⁷ Article 3 of the 2012 CIETAC Rules stipulates that CIETAC may accept cases involving international or foreign-related disputes—including disputes related to

¹⁵⁷ Arbitration Law, *supra* note 152, arts. 2–3.

Hong Kong, Macao, and the Taiwan region—and any domestic disputes.¹⁵⁸ Therefore, civil securities fraud claims seem to be arbitrable.

Arguably, arbitration in China should only take place if the parties have previously entered into an 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.”¹⁵⁹ Article 16 of the Arbitration Law further stipulates that an arbitration agreement must be provided in a contract or any other written form of agreement, and the agreement must specify the subject matter to be arbitrated and the arbitration commission to hear the dispute.¹⁶⁰

In 2004, the Legislative Affairs Office of the State Council and the CSRC jointly promulgated a circular on the arbitration of securities and futures contractual disputes (Arbitration Circular).¹⁶¹ The Arbitration Circular is the Chinese government’s most important attempt to promote securities arbitration with the aim of making full use of arbitration’s special advantages such as expedition, flexibility, low cost, and closed hearings. Sadly, the Arbitration Circular excludes disputes between listed companies and public investors from the scope of securities arbitration.¹⁶² As explained by respected commentators, a major issue underlying this exclusion is that public investors usually do not have prior arbitration agreements with listed companies.¹⁶³

To deal with this issue, an arbitration provision should be incorporated in the memorandum or articles of association of a listed corporation to the effect that all its shareholders are entitled to elect arbitration before the CIETAC as a means to resolve civil compensation claims against the corporation. This arbitration provision could also cover securities fraud claims against other entities and individuals such as fiduciaries, employees, and professional advisers. The provision would also include technical 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, and professional advisers should reference such a duty to arbitrate.

¹⁵⁸ 2012 CIETAC Rules, *supra* note 121, art. 3.

¹⁵⁹ Arbitration Law, *supra* note 152, art. 4.

¹⁶⁰ *Id.* art. 16.

¹⁶¹ See Guanyu Yifa Zuohao Zhengquan, Qihuo Hetong Jiufen Zhongcai Gongzuo de Tongzhi (关于依法做好证券, 期货合同纠纷仲裁的通知) [Circular on Managing Arbitration of Securities and Futures Contract Disputes According to Law] (promulgated by the Legis. Aff. Off. of the St. Council & the China Sec. Reg. Comm’n, Jan. 18, 2004, effective Jan. 18, 2004) (China), available at http://www.gx-law.gov.cn/news_show.asp?id=1321.

¹⁶² *Id.*

¹⁶³ SANZHU ZHU, *supra* note 44, at 219.

Corporations that have already been listed on the national stock exchanges can incorporate these arbitration provisions into the corporations' constitutional documents through an amendment. The listing rules can require corporations not yet been listed to include this provision in their constitutional documents before they can be 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 as compatible with Article 16 of the Arbitration Law.¹⁶⁴ While arbitration agreements must be in writing, the Arbitration Law is unclear as to what constitutes written form.¹⁶⁵ The 2012 CIETAC Rules provide that an arbitration agreement is in writing if it is contained in tangible document form such as a contract, letter, telegram, telex, facsimile, EDI, or email.¹⁶⁶ Importantly, 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 binding the corporation and its shareholders while engaged in 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 with the arbitration provision approach proposed above concerns shareholders' notice of such a provision. Effective shareholder notice is critical; otherwise, shareholders could not be said to have consented to and entered into an arbitration agreement. Information related to the arbitration should be disclosed in the pre-dispute arbitration agreement to offer investors an opportunity to make informed decisions. One option is to reference the memorandum and fully incorporate the arbitration provision into the stock certificates issued by a listed corporation. However, many shareholders hold their shares through nominees and would never see the stock certificates that discuss the provision. For these shareholders, an alternative option would be for the corporation to divulge the arbitration provision on the corporation's website, within its annual reports, CSRC filings, and other disclosure documents on a periodic basis. Apart from that, all issuers could be required to attach their memorandum of association to each annual report filed with the CSRC under a new listing rules requirement instead of making reference to previous reports. This should be required 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

¹⁶⁴ Arbitration Law, *supra* note 152, art. 16.

¹⁶⁵ Gu Weixia, *The Changing Landscape of Arbitration Agreements in China: Has the SPC-Led Pro-Arbitration Move Gone Far Enough?*, 22 N.Y. INT'L L. REV., no. 2, Summer 2009, at 2.

¹⁶⁶ 2012 CIETAC Rules, *supra* note 121, art. 5(2).

disclosure clauses should make it clear that arbitration is final and binding on all parties, and that parties who choose arbitration waive their right to seek remedies in court.¹⁶⁷

ii. Deterrent Effect

While confidentiality of the arbitration process and award is an advantage of arbitration, future investors and regulatory authorities may be left in the dark as to the reasoning behind the decisions and the ranges of compensation. A system of arbitrators deciding cases on the basis of facts and circumstances available before them may also produce inconsistent rulings and varying compensation rates. Arguably, this may harm investors because these ad hoc rulings may limit transparency and introduce a high level of unpredictability to the compensation process, which would in turn minimize the deterrent effect of private securities resolutions.

To allay the concern of inconsistent rulings, this Article proposes that a system be developed to categorize investors based on factors relevant to common disputes. This could produce common standards of compensation applicable to various shareholder groups, ensuring a degree of uniformity in compensation awards. To deepen public understanding of securities disputes and increase transparency in the dispute resolution process, the regulatory authorities may consider publishing information regarding securities fraud claims filed against 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, this Article suggests publishing only case synopses on an anonymous basis. Hopefully, sharing information in this manner will promote greater deterrence of securities fraud.

Another concern relates to the deterrence of unmeritorious lawsuits before arbitral tribunals. To prevent the pitfalls of U.S.-styled class actions, this Article suggests providing the CIETAC's Secretariat with the power to decide whether a case is eligible to proceed. Staff working at the CIETAC Secretariat should have discretion not to allow cases to proceed when they are clearly frivolous or vexatious. This screening process could be an important means of deterring unmeritorious claims that only benefit lawyers.

iii. 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 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 have not become

¹⁶⁷ 1 FUNG ET AL., *supra* note 91, ¶ 24-41.

sufficiently equipped to keep up with the pro-arbitration reforms initiated by the SPC.¹⁶⁸ The lack of judicial integrity and quality as well as the unbalanced development among people's courts at different localities may contribute to divergent enforcement records in both court judgments and arbitral awards.

Under the Chinese Arbitration Law, when a party fails to comply with an arbitral award, the other party may seek enforcement by applying to the intermediate people's court in which the recalcitrant opponent is domiciled or owns property.¹⁶⁹ Enforcement may be refused or set aside in limited circumstances, such as when enforcement is against social and public interests or where there are procedural irregularities in the arbitration.¹⁷⁰

Importantly, since 1996, the SPC has stepped up its efforts to both guard against local protectionism regarding arbitral award enforcement and facilitate the execution of arbitration awards. For example, the SPC adopted a series of "pre-reporting" mechanisms (*yuxian baogao*) in handling foreign-related cases.¹⁷¹ Under this "pre-reporting" mechanism, an intermediate people's court is required to report its decision to the higher people's court for approval when it decides to set aside a foreign-related arbitral agreement and award.¹⁷² If the higher people's court decides to uphold the decision, it must report its determination to the SPC.¹⁷³ Hence, the intermediate people's court can only set aside a foreign-related award after obtaining approval from the SPC.

This dual regime could invite arguments of unfair discrimination against national investors in favor of foreign investors. Foreign investors were given access to the Chinese securities market following China's accession to the World Trade Organization. Since 2002, foreign investors have been allowed to invest in RMB-denominated shares of corporations listed on the national stock exchanges under the Qualified Foreign Institutional Investor (QFII) scheme.¹⁷⁴ This, however, contrasts with the

¹⁶⁸ Gu Weixia, *supra* note 120, at 279–80.

¹⁶⁹ Arbitration Law, *supra* note 152, art. 58.

¹⁷⁰ *Id.*

¹⁷¹ See *Zuigao Renmin Fayuan Guanyu Renmin Fayuan Chuli yu Shewai Zhongcai ji Waiguo Zhongcai Xiangguan Shixiang Youguan Wenti de Tongzhi* (最高人民法院关于人民法院处理与涉外仲裁及外国仲裁相关事项有关问题的通知) [Circular of the Supreme People's Court on Issues in the People's Courts' Handling of Foreign-related Arbitrations and Foreign Arbitrations] (promulgated by the Sup. People's Ct., Aug. 28, 1995) (China), available at <http://www.people.com.cn/zixun/flfgk/item/dwjf/falv/9/9-2-1-05.html>.

¹⁷² *Id.* art. 2. For comments on the "pre-reporting" system, see GU WEIXIA, *supra* note 118, ¶ 2.023.

¹⁷³ GU WEIXIA, *supra* note 118, ¶ 2.023.

¹⁷⁴ *Hege Jingwai Jigou Touzizhe Jingnei Zhengquan Touzi Guanli Banfa* (合格境外机构投资者境内证券投资管理辦法) [Measures for the Administration of Domestic Securities Investments by Qualified Foreign Institutional Investors] (promulgated by the China Sec.

enforcement of a domestic award, where grounds for refusing enforcement are very broad and could potentially lead to a complete review of a decision's merits. Furthermore, the fact that the standards for enforcing domestic awards are stricter than standards for enforcing foreign-related awards suggests that the domestic regime is tougher. To illustrate, in an empirical study conducted by Peerenboom, among sixty-three domestic awards handled by one court in a large city in Jiangsu Province, two awards were rejected and thirty-five awards were listed as pending.¹⁷⁵ Hence, the domestic regime seemingly needs careful judicial checks as well, at least no less than the checks on its foreign-related counterpart.

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.¹⁷⁶ 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 claimants' access to judicial recourse by further complicating the process for recovering damages. The substantive review invites possibilities of political intervention in the enforcement process. In the long run, the foreign system is conducive to the development of the capital markets in China, although "pre-reporting" may invite challenges to judicial resources.

V. CONCLUSION

Although China's Securities Law fails to provide an effective private cause of action for shareholders who suffer financial losses resulting from securities fraud, the SPC purported to remedy the situation by issuing three judicial circulars between 2001 and 2003. The SPC circulars initially raised high expectations that they would provide the much-needed judicial safeguards in China for minority shareholders. Despite these expectations, however, restrictive procedural rules and the lack of economic incentives in the initiation of securities fraud suits effectively deprived aggrieved shareholders in China from access to courts and judicial remedies.

The fundamental issue at stake in this context is how to best promote private enforcement while balancing the interests of the State. As the above

Reg. Comm'n & People's Bank of China & State Admin. Foreign Exch., Aug. 24, 2006, effective Sep. 1, 2006, available at http://www.csrc.gov.cn/pub/zjhpublic/zjh/200804/t20080418_14506.htm.

¹⁷⁵ Randy Peerenboom, *Seek Truth from Facts: An Empirical Study of Enforcement of Arbitral Awards in the PRC*, 4 AM. J. COMP. L. 249, 263–65 (2001).

¹⁷⁶ U.N. COMM'N ON INT'L TRADE LAW, U.N. MODEL LAW ON INTERNATIONAL COMMERCIAL ARBITRATION 1985 WITH AMENDMENTS AS ADOPTED IN 2006, art. 34, U.N. Sales No. E.08.V.4 (2008).

analysis reveals, direct transplantation of the U.S.-style class action system and contingency fee arrangements raises concerns related to abusive litigation and market instability. In looking forward, this Article asserts that a cost-effective and accessible arbitration mechanism should be established to promote private enforcement efforts in China for the benefit of minority shareholder protection. The arbitral procedures can and should be simple and accessible for average retail shareholders.

With these principles in mind, and drawing upon institutional experience from the United States and Hong Kong, this Article suggests that a securities arbitration scheme should be introduced as an out-of-court alternative for shareholders to bring securities fraud claims against the corporation and individuals or entities connected to the corporation. The absence of alternative methods in handling securities disputes contributes, at least to a certain extent, to the weaknesses of China's securities market. By utilizing the institutional and rulemaking capacity of the CIETAC, China's premier arbitration commission, the arbitration scheme proposed in this Article stands a better chance of success than the class action proposal. Moreover, a securities arbitration scheme can supply an optimal amount of private enforcement to deter securities fraud, redress defrauded shareholders, and maintain social market order. Hence, it can achieve a better model of retail shareholder protection in China's sociopolitical and socioeconomic conditions.

Understandably, institutional deficiencies in China's judiciary may invite doubts as to the effectiveness of the securities arbitration scheme. It is argued 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.¹⁷⁷ While addressing the local protectionism issue, the SPC's "pre-reporting" mechanism may drain judicial resources and lead to delays. In this respect, the future fine-tuning of the procedural rules in view of the operational experience of the securities arbitration scheme remains open. 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 more effective alternative for 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. In the long run, this improved investor confidence will bring about the healthy development of China's securities market and act as an engine for economic growth.

¹⁷⁷ Gu Weixia, *supra* note 120, at 280.