7 Controlling misrepresentation in securities markets

Is private enforcement trivial in China?

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7.1 Introduction

This chapter will evaluate the enforcement strategies on controlling public companies' misrepresentation in China's stock markets. Some research suggests that China has already implemented some legal rules in protecting investors (Howson 2008: 186; Shim 2005: 375). However, the enforcement of these legal rules is still problematic. Many argue that a considerable gap between the 'law on paper', and the 'law in practice' exists in China's investor protection regime (Liu 2006: 311; Miles and He 2005: 279; Opper and Schwaag-Serger 2008: 245). This chapter, therefore, focuses on the enforcement of securities law.

The enforcement strategies in relation to securities law can be broadly divided into two categories. First, public enforcement is usually conducted by an administrative regulator. Second, private enforcement usually arises, where private parties sue public companies or their executives. These strategies usually serve different functions. As summarized by Rose (2008):

> Commission enforcement operated primarily to deter securities fraud in order to promote society's collective interest in the integrity and efficiency of the capital markets; private enforcement, by contrast, operated primarily to compensate defrauded investors for their discrete losses – much like a common law claim for misrepresentation and deceit
>
> (Rose 2008: 1310)

Some scholars have argued that private enforcement is trivial in China. For example, Pistor and Xu claim that private enforcement of investor rights has virtually been absent in China so far, not because of lack of demand for them, but because courts have restricted investor lawsuits (Xu and Pistor 2005: 184). Some US lawyers similarly argued that the public enforcement of which the China Securities Regulatory Commission (CSRC) takes charge should play a dominant role in regulating China's securities markets, because public enforcement under State-administrative-control is consistent with China's regulatory culture, and social-political reality (Clarke 2008; Layton 2008).

Liebman and Milhaupt also argue that 'civil liability' is not yet a 'major concern' for most listed companies (Liebman and Milhaupt 2008: 929). However, these arguments are usually based on an analysis of individual cases, but lack the support of systemic empirical evidence. Against this academic background, this chapter uses *misrepresentation* as a sample, to examine whether private enforcement of securities law is trivial in the Chinese context, as some scholars have argued. To answer this question, two types of evaluation will be performed in this chapter. First, private enforcement will be empirically compared with public enforcement in the Chinese context. Second, the data from private enforcement in China will be compared with that from the US, where private enforcement is far more prevalent. This chapter will be organized as follows. Section 7.2 introduces some basic information about China's securities markets, including the seriousness of misrepresentation, and the deeper implications behind this phenomenon. Section 7.3, briefly introduces the research methodology of this chapter. Section 7.4, illustrates the data regarding private and public enforcement in China's securities markets. Section 7.5 (by investigating the empirical data) will substantially evaluate the private enforcement of China's securities law. Finally, a conclusion will be drawn and presented.

7.2 Some basics about China's securities markets

7.2.1 Agency cost in China's securities markets and misrepresentation

There is little doubt about the seriousness of insider misrepresentation in China's stock markets. In accordance with the interpretation of the Chinese Supreme Court, misrepresentation includes: a major failure to disclose information; false statement; and a postponement/delay in disclosure (which are all breaches of the relevant rules of the securities law).[2] Empirical research shows that the vast majority of the CSRC's enforcement actions are against misrepresentation as defined by the Chinese Supreme Court. This particular type of misbehaviour accounted for nearly 65 per cent of all CSRC's enforcement actions during 1999–2003 (see Table 7.1).

The deeper implications behind misrepresentation in China's stock markets should be investigated. In its essence, misrepresentation is a result of information asymmetry between 'insiders', and 'outsiders'. The insiders' upperhand in access to corporate information usually triggers the problem of 'conflict of interest'. In economic terms, this is usually called the agency-problem or principal-agent problem. First, an introduction to the general agency cost problems in China that give rise to misrepresentation will be presented. Second, will be an introduction to how public and private enforcement works in the Chinese context. On Chinese stock markets, listed companies can be divided into two groups based on their identity. One group are listed as State-owned enterprises (SOEs). The other group are private listed companies not

Table 7.1 Types of securities rules violations and number of enforcement actions 1999–2003

Breakdown of enforcement actions	*Number of occurrences*	*Percentage*
Panel A: By violation type	6	2.16
Illegal share buyback	22	7.91
Inflated profit	7	2.52
Assets fabrication	10	3.60
Unauthorized fund use change	51	18.35
Postponement/delay in disclosure	51	18.35
False statement	7	2.52
Fund provision violation	78	28.06
Major failure to disclose information	7	2.52
Major shareholder embezzlement	39	14.03
Others	278	100.00
Total		

(Source: Huang (2010: 39).)

controlled by the State. As of the end of January 2013, there were 2,443 listed companies on China's stock markets. Of these, 953 of them are controlled by the State. These companies occupy nearly 51.4 per cent of the total share value of all listed companies.[3]

Listed SOEs are still the major forces on the Chinese stock markets, and their problems are therefore important and representative. Similar to Western companies, SOEs are formally incorporated. According to Xi, by corporatizing SOEs the Chinese leadership intended to separate government administration from enterprise management, release the State from its unlimited responsibility for SOEs, raise funds to diversify SOE risks, and consequently, improve enterprise efficiency (Xi 2005: 95). Separation between ownership and management, nevertheless, triggers an agency cost problem. This problem can be divided into two levels. First, is the 'vertical agency problem' between corporate owners and managers. This problem arises where a manager, whilst being an agent, nevertheless pursues his or her own interest at the expense of the principal's interests. The second agency problem is the 'horizontal agency problem'. This is a problem between majority and minority shareholders. Here, majority shareholders may improperly use their overwhelming voting power to depress minority shareholders' interests by squeezing them out without fair compensation, or misleading minority shareholders' investment by misrepresentation. Fortunately, although these two types of agency issues can coexist, they are usually mutually exclusive. Some studies indicate that the 'agency cost' between shareholders, and executives is not a key issue in jurisdictions dominated by concentrated ownership (Cheffins 1999: 5; Cheffins 2000: 41). Majority shareholders hold the residual right to claim corporate property, and the voting right to control the fundamental business decisions of the corporation. Therefore, they have both the incentive, and the ability to supervise the directors' performance

(La Porta *et al.*, 1999: 54). By contrast, in jurisdictions with dispersed ownership, not much focus is placed on the agency costs between majority shareholders, and minority shareholders, as fewer powerful block-holders exist in this type of market.

Although ownership in most Chinese companies is concentrated, both types of agency problem are equally serious. In the course of Chinese economic reform, and in seeking the autonomous management of SOEs, the government tends to delegate independent decision-making power to the executives of SOEs.[4] However, it has not developed an efficient system to supervise the conduct of those SOE managers (Xu *et al.* 2007: 93; Yang 2005: 8). Listed SOEs are usually supervised and controlled by their parent companies. In order to form a listed company, a promoter – usually a large SOE – has to contribute its essential operating assets (e.g. factories, workshops, or production lines) to the listed company. A listed company is a legally separate enterprise from its State-owned parent company, though; in reality it usually maintains a strong relationship with its parent company. Consequently, it is common for directors or managers in the listed company to also hold positions in the parent company (Liu 2006: 316). The main reason behind the weak supervision of SOEs is the 'absent owner problem' (*Suoyou Zhe Quewei*). State-owned parent companies usually encounter incentive problems in supervising their listed subsidiaries. As the majority shareholder, the parent company has a residual claim to the profits made by a listed company. However, State-owned parent companies, similarly to State agencies are organized by individuals. The persons who are appointed to check and supervise listed SOEs, do not have property rights in those companies. Rather, they are simply government officials who earn a salary based on the governmental hierarchy, that is, around three times that of an unskilled worker. Wary of social unrest, the State does not want to pay SOE managers and also the supervisory officials in a manner that would make them too far detached from lower level workers (Tang and Wang 2007: 179). Arguably, promoting a listed SOE's decent market performance could be beneficial to an officials' political fortune. However, even this incentive is suspicious. As mentioned above, a listed SOE that takes over essential assets from its parent company is usually equipped with the best production line and the best-trained employees. More importantly, the parent company has to bear all sorts of burdens (e.g. debts, redundant personnel, etc.) that occurred before its separation from a listed subsidiary. These advantages guarantee listed SOE's strong productivity. Taking all these factors into consideration, majority shareholders may have little incentive in supervising the executives' operation in listing SOEs. With this loose internal control system, executives can make considerable illegal profits by engaging in false disclosure, and insider trading.

Another major concern regarding corporate governance in China is the fact that the board of directors sometimes merely 'rubber stamps' decisions, and is controlled by a dominant shareholder, who may take advantage of this control to undermine minority shareholders' interests by self-dealing,

manipulating share price, and misrepresentation. Indeed, there has long been a serious issue with controlling shareholders engaging in 'tunnelling activities'. A number of cases in China have shown that the manipulation of a few insiders; can trigger thousands of individual investors to suffer a loss of their investments.[5] According to a study of 173 listed companies in China, samples in which block-holders had illegally appropriated company assets constituted 37 per cent of all samples (Zhang and Wu 2003: 24). For listed SOEs, their interdependence with their controlling shareholders gives rise to 'stealing' activities on a wide range of fronts. Officials who control the parent SOE may move the listed SOE's assets to the special purpose vehicle, owned by a related party (e.g. friends or relatives). This type of related-party transaction naturally is closely connected with misrepresentation, as it cannot be properly disclosed to the general public. However, more commonly cases relating to 'tunnelling activities' do not involve appropriating a listed SOE's asset for personal benefit. As already highlighted, parent SOEs contribute their best-equipped facilities to subsidiaries in order to list them. However, maximizing profits is not the only demand made of an SOE by the government. The government usually expects SOEs to bring multiple benefits – e.g. stabilizing society by providing full employment, or providing strategic control of a particular industry, where this cannot be achieved through proper regulation (Clarke 2006: 150). A parent SOE cannot fulfil all these tasks by itself It may, therefore, sometimes need to strengthen other entities of the group by distributing the profits of its listed subsidiary, between these entities. As some scholars have pinpointed 'many SOEs are debt-ridden enterprises "repackaged" for listing and continue to be controlled by their parent companies who having successfully seen to their IPO look towards them as cash cows for ready milking' (Tang and Wang 2007: 151). It seems that, in order to conceal improper profit distribution or corporate loans, misrepresentation to investors is inevitable.

For private listed companies, the horizontal agency problem is less complicated. Some leading Chinese entrepreneurs have shown a strong desire to expand their business empire by owning several listed companies, and a number of other business entities. However, such a super-sized business network does not always bring benefits and can, in fact, sometimes be a troublesome burden. According to statistics, 2002–5, the market regulator investigated nearly 40 corporate groups, relating to more than 200 listed companies. Most cases investigated involved illegal loans between members of a corporate group, or undisclosed related party transactions (Cai 2005: 105). The main reason for these corporate scandals is that corporate groups are overloaded with a large number of business entities. Some corporate group owners overestimate their capacity, and recklessly become involved in several different business sectors. Business failure in one sector may easily trigger pressure from lenders, or local government, which has granted a preference policy (e.g. a license authorizing a corporate group to use a certain kind of natural resource during a certain period). Therefore, related party transactions, illegal corporate guarantees,

and false disclosure are usually employed to conceal the negative effects of business failure. In private listed companies, these manipulating strategies are employed in 'traditional tunnelling activities' as well, which move companies' assets to majority shareholders' own pockets.

7.2.2 Public and private enforcement against misrepresentation in China

Both public enforcement and private enforcement can be applied in the context of regulating misrepresentation. In contrast, other types of misbehaviour by market participants, e.g. manipulation of share price, or insider trading, are mainly regulated by public authorities in China. Only a small number of private enforcement cases can be found (Zhou 2013). This is the main reason why this chapter takes misrepresentation to test these two enforcement strategies. The CSRC is the market regulator who takes charge of public enforcement in China's stock markets. In accordance with the Securities Law 2005[6] the CSRC has an enforcement power against market participants. In accordance with Article 193, the CSRC is authorized to impose a fine on issuers and public companies, conducting misrepresentation (including disclosing misleading, false information, or conducting a major omission in information disclosure). The range of this fine is between RMB300,000 (c. EUR26,145) and RMB600,000 (c. EUR72,289). The executives and any other person directly responsible for misrepresentation shall be given a warning, and a fine ranging from RMB30,000 up to RMB300,000.

Private enforcement is the other key component of the enforcement strategy in controlling market participants' misrepresentation. During the period 2002–3, in order to ease the tension between aggrieved investors, and State-owned listed companies, the Supreme Court issued a groundbreaking Notice[7] confirming that local intermediate courts are capable to hear securities litigations against misrepresentation. The Notice provided a workable legal regime for the private enforcement of securities law. In some respects, it was enacted in a plaintiff-friendly way. For example, it gives plaintiffs an autonomous position from which to choose which eligible parties they would like to sue. This means plaintiffs could pursue their interests by bringing litigation action against a 'deep pocket' defendant. Additionally, the provision applied a two-year statute of limitations to private securities litigations, rather than the standard one-year special statute of limitations (Xi 2006: 495). Nonetheless, private enforcement is subject to administrative, and criminal sanctions (public enforcement). In other words, aggrieved investors can only file a lawsuit against a party who has received an administrative fine from the CSRC, or another administrative body like the Ministry of Finance on the basis of fraudulent disclosure, or parties convicted for misrepresentation by a court. The private enforcement regime has been integrated into the Securities Law 2005. However, the pre-trail condition is still not removed under the formal legislation.[8]

7.3 Research methodology

In order to collect empirical evidence, a fundamental question is how to evaluate public and private enforcement of securities law. Existing research provides several examples. The evaluation of law enforcement in stock markets can be divided into macro and micro levels. At the macro level:

> research puts great emphasis on *disclosure requirements* and *liability rules*. Both of these are supposed to be essential elements that influence the enforcement of securities law. With respect to private enforcement, these scholars focus on the distribution of the *burden-of-proof* between plaintiff and defendant. With respect to public enforcement, they evaluate it by the following criteria: (i) supervisor's independence, (ii) investigative powers of the supervisor, (iii) administrative sanctions, (iv) criminal sanctions for violations of securities laws. These scholars build a positive relationship between enforcement of securities law, and stock market performance. Similar to their other research, the conclusion is that legal origin plays a major role in financial market development
>
> (La Porta *et al*. 2006: 1)

Djankov *et al*. developed another formal index of public enforcement, based on whether the regulator can sanction a specified insider transaction, namely: '(1) fine for the approving body; (2) jail sentences for the approving body; (3) fines for [principal wrongdoer]; and (4) jail sentence for the principal wrongdoer' (Djankov *et al*. 2008: 435). Another major contributor to this field, the World Bank, uses financial sector development indicators (FSDI) to assess the institutional environment of financial markets. This research divides the institutional environment into three tiers. In the mid-tier level environment, it considers the investor environment. It is argued that private enforcement plays a more important role in prompting financial markets than public enforcement (World Bank 2006). In contrast, Jackson and Roe use a different index system to conduct similar research. In respect of public enforcement, they argue that evaluating enforcement ability by reviewing a regulator's power range is not a viable solution. The reason is that the regulator may be 'captured', or due to other reasons, does not exercise its powers. These two scholars, in contrast, use two indicators to evaluate public enforcement, namely staffing levels of securities regulators and budgets. In respect of private enforcement, they use legal indices (a securities disclosure index, a liability index, and an anti-director rights index) and a judicial efficiency index to do their evaluation. Their conclusion is different from previous results. It finds that public enforcement rather than private enforcement is more important in correcting market failure in common law jurisdictions (Jackson and Roe 2009: 207).

However, as some lawyers argued, the results from these macro level comparisons are not accurate. For example, authors may have ignored the functional equivalence rules in different jurisdictions during the comparison (Siems 2005:

531; Siems and Deakin, 2010: 120). Compared with these macro level evaluations, a micro level evaluation can generate more accurate results, although it may bear less theoretical implications. For example, some macro-evaluations suggest that private enforcement plays a more active role in common law jurisdictions (La Porta *et al*. 2006: 1; Djankov *et al*. 2008: 435). However, comparative research by Armour *et al*. on private enforcement of securities law in the UK, and the US shows that in the UK, private enforcement plays a limited role in enforcing securities law (Armour *et al*. 2009: 687; Armour 2010: 213).

This chapter constitutes a micro level research project, focusing on the *ex post* enforcement of securities law. Although *ex ante* regulation is an important tool for the regulator to mitigate market failure, some research has indicated that extensive *ex ante* rule-making activities do not necessarily lead to extensive state involvement in rule enforcement. (Jackson and Gadinis 2007: 1239). As summarized by Coffee: 'enforcement intensity seems inversely related to the intrusiveness of the government's *ex ante* involvement in the market. The closer the central government supervises *ex ante*, the less it relies on sanctions and penalties *ex post*' (Coffee 2007: 257). Given the complicated relationship between *ex ante* regulation and *ex post* enforcement, it is difficult to evaluate both mechanisms in one piece of research.

From a methodological perspective, this chapter employs several standards to evaluate the *ex post* enforcement strategies against misrepresentation. First, focus will be laid on the number of enforcement actions on misrepresentation under the Securities Law 2005 (2006–12). This number can reflect the frequency of the enforcement actions against this particular misbehaviour. Second, focus will be laid on the effect of the enforcement actions during the same period. For private enforcement, the total amount of compensation received by aggrieved shareholders from private litigation will be calculated. Further, the total amount of investors who received compensation through filing litigation before the People's Court will be calculated. For public enforcement, calculation of the total amount of administrative fines imposed by the administrative authority on the market participants based on misrepresentation will be given; also, the number of executives punished by the public regulatory body will be calculated.

7.4 Intensity of enforcement in controlling misrepresentation: rudimentary data

7.4.1 Public enforcement

7.4.1.1 Research methodology

First, I accessed all Administrative Punishment Decisions (Xingzheng Chufa Jueding, available online at http://www.csrc.gov.cn/pub/zjhpublic/ (accessed 4 June 2014)) in the CSRC's website database for the period 2006–12. This generated 348 decisions, which I read to determine whether the decision could

be included in my sample. Finally, 83 cases were found. Then, the following information was collected:

- the number of public enforcement actions in each year;
- the amount of public company's fines;
- the amount of executives' fines; and
- the number of punished executives.[9]

7.4.1.2 Data

Table 7.2 Public enforcement of misrepresentation in China

Year	*Number of punishments against misrepresentation*	*Punished executives*	*Fine on public companies (RMB)*	*Fine on executives (RMB)*	*Total administrative fine against misrepresentation (RMB)*
2006	12	70	4,300,000	5,560,000	9,860,000
2007	11	60	3,800,000	3,200,000	7,000,000
2008	14	81	4,400,000	7,450,000	11,850,000
2009	10	70	2,800,000	3,540,000	6,340,000
2010	14	86	5,100,000	6,200,000	11,300,000
2011	9	71	3,800,000	6,250,000	10,050,000
2012	13	70	4,700,000	4,350,000	9,050,000

7.4.2 Private enforcement

7.4.2.1 Research methodology

The Chinese judiciary system does not provide an official database of judicial cases to the general public. Information about private enforcement, therefore, mainly comes from second-hand material, such as news reports, and journal articles.[10] The data has been collected by the following method: A keyword search was utilized, including the terms 'company's name (punished by CSRC on the basis of misrepresentation)',[11] 'misrepresentation' (*Xujia Chenshu*), and 'private compensation' (*Minshi Peichang*) via Google Chinese website, and Baidu (a Chinese search engine for websites, news, and journal articles). I found 38 cases from 2006–12. All these cases are related to public punishment decisions on misrepresentation. One case is based on criminal punishment. Four cases are based on the punishment decisions issued by the Ministry of Finance. Of the cases, 33 are based on the CSRC's enforcement decisions. This means that about 39 per cent of CSRC's public enforcement decisions are followed by private enforcement actions. This turnover rate is hardly impressive. Next, a summary was made of the following information on private enforcement during 2006–12:

- the number of cases in each year;
- total compensation made by defendant to plaintiffs; and
- the number of plaintiffs.[12]

Nevertheless, some major omissions and inaccuracies still remain, even when a comprehensive search on the above data of each case has been made via the Internet and traditional media.[13] First, it is possible that some private litigation cases against misrepresentation were not captured by the data collection method used. This can be attributed to a lack of media attention given to cases where, e.g. the claimed compensation is minuscule, the number of plaintiffs is very small, or the media have been corrupted by the defendant. Second, the data collected might not always be complete in all cases. Particularly, this holds true when settlements between plaintiffs and defendants were reached due to confidentiality agreements, underlying the settlements. The defendant sometimes requires the plaintiffs, and their lawyers to sign a confidential agreement, which removes their right to disclose key information of the settlement to the general public. Third, while conducting crosschecks: ambiguity of data found in different sources may have contributed to the inaccuracy of the findings. Some crosschecks showed that different news reports expounded different figures. In cases of conflicting data in news reports the source with the higher reputation was given preference, e.g. newspapers or journals on securities markets were viewed as more reliable than Internet-based media. Another problem, is that news reports and even some journal articles are not academic products: they widely used the terms including 'approximately' (*Dayue*), 'nearly' (*Jiangjin*), or 'more than a certain number'(*Da yu mouyi shuzi*) in their descriptions. As a result of the shortage of firsthand material, I keep these terms (which indicate the ambiguity of data) in this article. After having transparently addressed the problems encountered during data collection and evaluation, an objective presentation of the data is still viewed as viable based on the accessible materials. Yet, the data on the intensity of private enforcement might still be considered under-representative, considering the above-mentioned problems.

7.4.2.2 Data

Table 7.3 Private enforcement of misrepresentation in China

Year	*Number of private enforcement cases against misrepresentation*	*Executives' compensation to investors*	*Number of compensated investors (approximately)*	*Total compensation made by public companies to investors (RMB, approximately)*
2006	4	0	7	260,000
2007	7	0	250	189,452,337
2008	5	0	16	670,000
2009	7	0	294	23,855,224
2010	2	0	199	20,650,000
2011	5	0	6842	45,389,265
2012	8	0	210	14,092,880

7.5 Implications

These sets of data provide a preliminary view on public and private enforcement. First, although the number of public enforcement cases is larger than the number of private enforcement cases, the conclusion can hardly be drawn that public enforcement is overwhelmingly advantageous for the enforcement of securities law, at least in misrepresentation cases (see Figure 7.1).

As mentioned, private enforcement against misrepresentation must be based on an administrative decision. Given that courts strictly apply this pretrail condition in each case, the number of private enforcement cases cannot exceed that of public enforcement cases. Furthermore, from a functional perspective, it seems that private enforcement is capable to fulfil its task, namely providing compensation to aggrieved shareholders (see Figure 7.2).

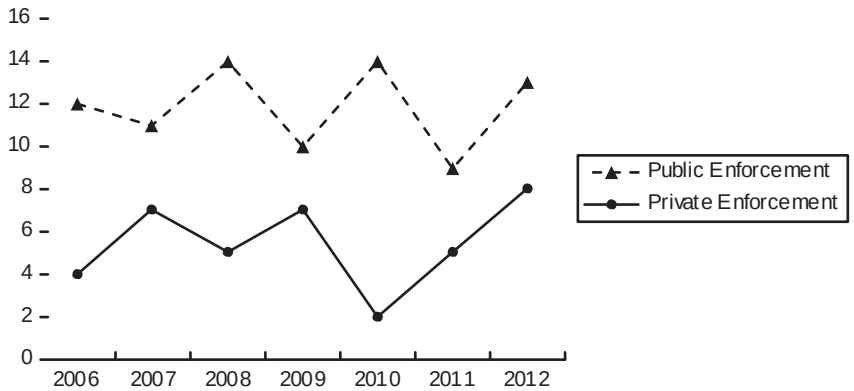

Figure 7.1 Frequency of public and private enforcement on the basis of misrepresentation 2006–12

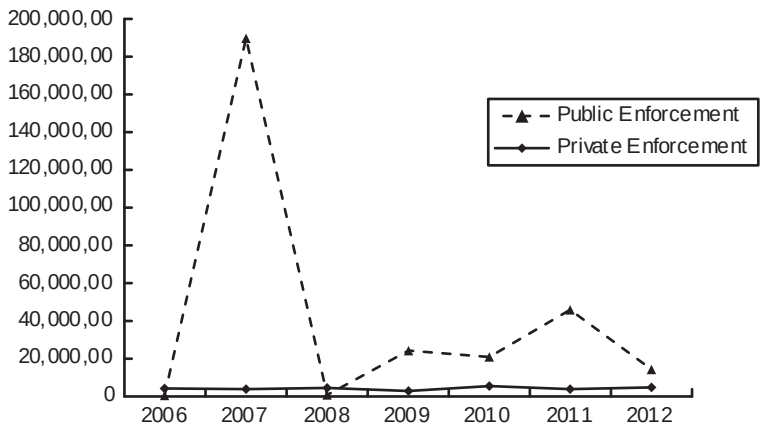

Figure 7.2 Economic burden on public companies on the basis of misrepresentation 2006–12

This function bears further implication. It seems that public and private enforcement can mitigate different levels of agency cost. The CSRC's *ex post* enforcement has considerable effect in controlling vertical agency costs between shareholders, and executives. It consistently imposes fines on executives, and even bans them from the market. During the period 2006–12, 508 executives were punished by the CSRC in misrepresentation cases. The combined total fine on executives reached RMB36,550,000. In this respect, it has a considerable effect on reducing vertical agency costs. Nonetheless, public enforcement plays a less important role in punishing public companies, and majority shareholders who are the major residual claimants. As already mentioned, the CSRC's power to impose fines on public companies is strictly controlled by the Securities Law 2005. Even when the CSRC imposes the maximum fine (RMB600,000) authorized by the Securities Law 2005, Article 193 on public companies, this economic punishment hardly causes any substantial problem. The reason is the companies concerned are usually economically powerful. Private enforcement's major function is to offer compensation to aggrieved shareholders. For this purpose, it usually aims at the deep-pocket wrongdoer, i.e. public companies rather than their executives. Furthermore, compared to public enforcement, private enforcement damages are not capped at any limitation on the amount of compensation. The court can enforce any amount of justified compensation against public companies under the legal framework. Consequently, private enforcement imposes a much larger economic burden on public companies (see Figure 7.2). It also deeply influences majority shareholders' interest by reducing companies' distributable profits. It, therefore, can discourage majority shareholders to instruct their nominee director to engage in misrepresentation. It cures horizontal agency costs. It seems as if both public and private enforcement should be further enhanced under the current legal, and institutional framework.

Second, is a major finding from the empirical data; this is the diversification of location for the courts before which a securities litigation, or securities litigations, have been filed. In accordance with Article 9 of the Supreme Court's Note, private securities litigation should be filed before the local intermediate court located in the city in which the public company (defendant) is formally registered. The empirical data show that during 2006–12, there were 17 local intermediate courts in different provinces in China that were fully engaged in hearing private securities litigation. More interestingly, nearly half of these courts only accepted one case, and no intermediate court accepted more than four cases during this period (see Table 7.4). Therefore, the geographical diversification of judiciary power leads to a lower intensity judiciary practice for each local court. Under these conditions, there is a major problem with this institutional arrangement. A long-standing argument casts doubt on the ability of judges to assess sophisticated market-oriented commercial activities, or on their business judgment (Easterbrook and Fischel 1991: 98–9; Edward, Johnson and Shleifer 2001: 853). The diversification of location for these judiciary resources exacerbates the problem of a lack of expertise. It is

Table 7.4 Chinese courts engaged in hearing securities litigation 2006–12

Number of cases	*Court location*
4	City of Shanghai, Ningxia Province, Guangzhou Province, Zhejiang Province
3	Shangdong Province, City of Chongqing
2	Fujian Province, Henan Province, City of Beijing, Hubei Province
1	City of Tianjing, Hubei Province, Dongbei Province, Jiangsu Province, Shanxi Province, Yunan Province, Heinan Province, Sichuan Province

hard to imagine that a local court, initially addressing complicated securities litigation, can successfully fulfil this task without struggling with the relevant law and evidence. The shortage of judicial expertise is, therefore, a potential problem that could lead to problematic, and potentially unjust judicial decisions. Additionally, driving judges to contribute significant time and effort to learn the implications of complicated financial activities for only one particular case that emerges once every decade, also wastes valuable local judicial resources. Furthermore, when the diversified allocation of judiciary resources is investigated using a comparative lens, it can be regarded as a disadvantage that weakens the role of private enforcement throughout entire institutional settings. Public enforcement by the CSRC, in contrast, is more centrally organized. Although the CSRC has some local branches, their enforcement power is strictly limited.[14] In other words, the power to impose substantial sanctions is accumulated in the hands of the CSRC's headquarters in Beijing. This hierarchical institutional arrangement enables the CSRC to enhance its relevant expertise through consistent enforcement activities. The local courts in widely diversified locations, although still under the loose control of the Supreme Court, have few opportunities to practice and upgrade their expertise in this particular field, as compared to the CSRC. Therefore, the gap of expertise between the CSRC and the court system is compounded by an inefficient institutional structure. Under these conditions, a better arrangement would be to assign all private securities litigation cases to the Intermediate Courts in the cities of Shanghai and Shenzhen. The primary reason for this arrangement is not only that the judges are in more economically developed regions and therefore appear to have more sophisticated expertise in commercial activities (Xu *et al*. 2013) but also that these courts have an obvious advantage in collecting relevant evidence for securities law cases, as they are located in the same cities as the stock exchanges.

After the comparison between public enforcement and private enforcement in China. Now follows a comparison between the intensity of private enforcement between China, and the US.[15] From this comparison, one can analyze whether private enforcement in China is far less intensive, as many assumed. In the US, there were 742 private litigation cases based on class actions involving companies listed at the New York Stock Exchange (NYSE)

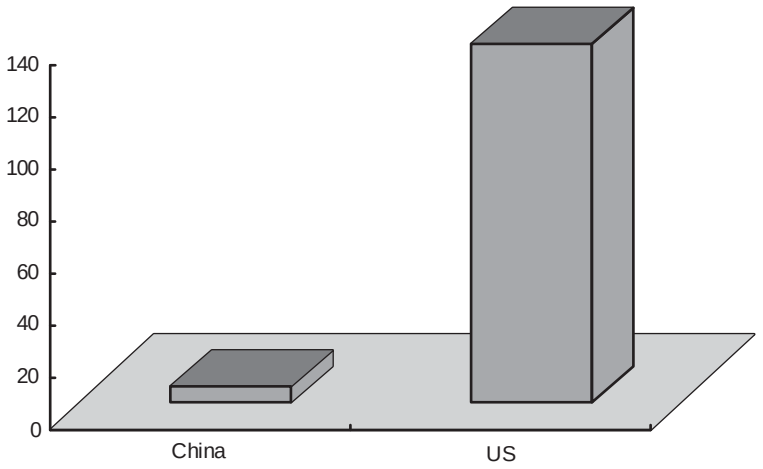

Figure 7.3 Private enforcement actions in China and the US (annual average 2008–12)
(Source: US data: Available online at: http://securities.stanford.edu/ (accessed 14 May 2014).)

and the National Association of Securities Dealers Automated Quotations (NASDAQ) from 2008–12.[16] In other words, on average 148 class action cases, are heard by the Federal and State courts per year. According to statistics presented by Cornerstone Research, the percentage of misrepresentation cases reaches 92.8 on average in all class action cases, within these five years.[17] Consequently, the average figure of misrepresentation cases within these five years is 137. In contrast, during 2008–12, with regard to China's two stock exchanges,: on average 5.4 cases were heard by the Chinese courts per year. These figures are not surprising. Private enforcement is far more intensive, and frequent in the US than in China (see Figure 7.3). However, we should note that this outcome would be somewhat different, if one investigates it from a different perspective. A simple fact is that the market capitalization of NYSE and NASDAQ is about five times larger than that of China's two capital markets.[18] Accordingly, if one looks at the average score per trillion capitalizations, the advantage of the US private enforcement drops considerably (see Figure 7.4). In contrast, if one looks at the average score per thousand listed companies, the overwhelming superiority of the US system emerges again (see Figure 7.5).

Through the comparison of different aspects, a huge gap of private enforcement intensity between China and the US can be identified. This gap can be attributed to the considerable institutional differences. In China, the absence of class actions, and lawyer's contingency fees, in addition to the strict pretrail condition, diminishes the chance for the development of private enforcement. Despite these institutional disadvantages, a deeper difference related

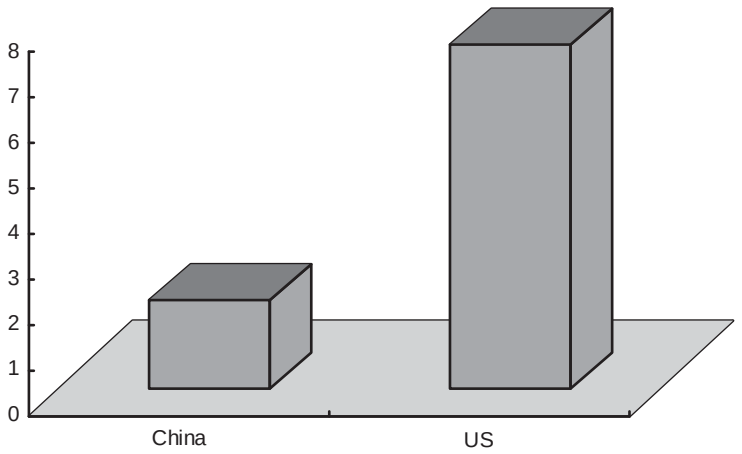

Figure 7.4 Private enforcement actions per trillion stock market capitalizations in China, and the US (annual average 2008–12)

(Source: US data: Available online at: http://securities.stanford.edu/ (accessed 14 May 2014).)

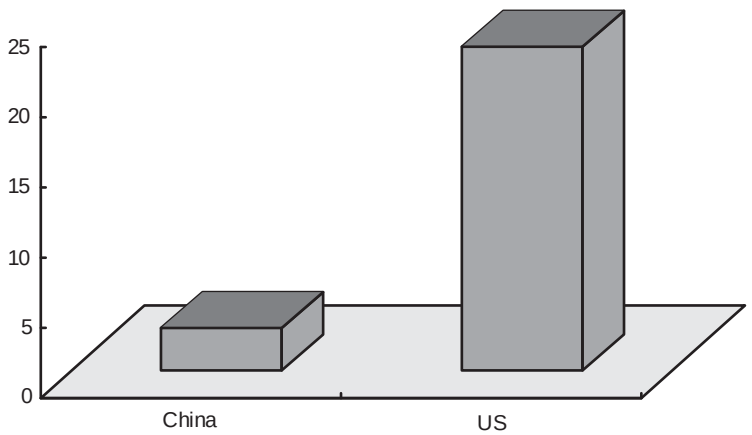

Figure 7.5 Private enforcement actions per thousand listed companies in China, and the US (annual average 2008–12)

(Source: US data: Available online at: http://securities.stanford.edu/ (accessed 14 May 2014).)

to judiciary transparency, and the media environment should not be ignored. Puchniak and Nakahigashi's recent research uses the concept of 'availability heuristic' to explain the dramatic increase of derivative actions in Japan. They firstly summarized that:

> One of the most common mental heuristics that actors rely on when faced with complex decisions is the 'availability heuristic'. According to cognitive research, the availability heuristic commonly causes actors to overestimate the relevance of salient, or memorable events. Instead of making their decisions based on the actual probability of an event occurring, they base their decisions upon the probability of the event occurring according to their memory. Such a mental shortcut can often lead to sub-optimal decisions, as events that are vivid or well publicized leave the actor with the impression that the event is more likely to occur than actual statistical probability would suggest
>
> (Puchniak and Nakahigashi 2012: 59)

These authors then provide some solid evidence to illustrate that media hype is effective in triggering the 'availability heuristic' of market participants. Many over-optimistic and misguided news reports, and the enormous academic fervour that can surround one or two landmark judiciary decisions: can lead to the 'overconfidence bias problem': market participants take a simplified decision-making strategy (commonly referred to as 'mental heuristics'[19]) without carefully weighing the costs and benefits, when filing a derivative action (Puchniak and Nakahigashi 2012: 59–61).

This behavioural law and economics theory also offers an explanation to China's shortage of private enforcement. In China, the media environment of legal, or financial affairs is opposite to that of Japan. In the process of searching for private enforcement cases, a considerable phenomenon cannot be ignored. News reports usually use passive terms, such as 'time-consuming' (*Shijian Rongchang*), 'beset with difficulties' (*Kunnan Chongchong*) and 'deadlock litigation' (*Susong Kunjing*) to describe private enforcement of securities law.[20] These news reports may constitute an availability heuristic, oriented by a negative impression of private enforcement among investors. Furthermore, despite a few landmark cases, financial news reports are reluctant to disclose substantial information on private enforcement, especially the total amount of compensation paid by the public company to investors, and the number of investors who successfully obtained compensation. In many cases, they merely inform the public that a specified case has been filed before a court, but they do not follow up on the progress of a case at trial stage. Accurate data related to these topics is difficult to identify, and obtain. Although some securities lawyers occasionally disclose this information on their personal websites, no non-governmental organization (NGO) or educational institution collects, and discloses the relevant data to the general public systemically.

In respect of the passive terms, and descriptions of the news reports, one explanation is that by this method, financial media try to force policymakers to improve the current institutional regime of private enforcement, e.g. through eliminating the pre-trail condition, and formulating a workable class action system. However, it is difficult to explain the shortage of news reports

that disclose key information on private litigation. There may be a shortage because the accessibility of the judiciary decision is limited even for the media, or maybe because the media are captured by listed companies. No matter what the reason is, the media environment in fact discourages investors' attempts to pursue private litigation by formulating a general impression that private action of securities law in China is troublesome, time-consuming, and unpredictable. In contrast, the transparency and accessibility of judiciary data is far more sophisticated in the US. Educational institutions and consulting companies take advantages of their expertise, academic and market resources: to collect accurate information about securities class actions.[21] These entities also provide professional and scientific analyses of the relevant data. This trajectory enables individual investors to overcome the availability heuristic, and to rationally evaluate the costs and benefits of class action. Consequently, improving private enforcement is not only a task aimed at reforming the institutional setting, but also a task aimed at fostering a wide-range of market forces.

7.6 Conclusion

This chapter resulted in three key findings about public enforcement, and private enforcement of securities law in China. First, based on empirical evidence, public enforcement and private enforcement of securities law serve different functions. The former cures vertical agency costs, and the latter cures horizontal agency costs. Both public and private enforcement strategies should be further promoted. Consequently, even in a transitional economy such as China, private enforcement should not be regarded as a trivial instrument for controlling securities market problems. Although these findings are not powerful enough to provide theoretical feedback on the 'private versus public enforcement' debate between La Porta *et al*. and Jackson and Roe, it still provides an important insight for understanding enforcement strategies in China. Second, the inefficiency of private enforcement in China can be partly attributed to the diversified allocation of judiciary resources, which exacerbates the courts' disadvantage stemming from a lack of expertise, especially compared to the centrally organized public regulator. Third, the comparison between private enforcement in China and the US proves once more the standard argument on China's private enforcement of securities law. – It illustrates that private enforcement in China is under-developed. Providing more investor-friendly legal institutions is an important step in order to improve private enforcement. However, as Clarke has already pointed out, civil society institutions are also important for China's corporate governance, and securities law enforcement (Clarke 2008). As a result, fostering a more balanced financial media environment, and enhancing the accessibility of data on judiciary decisions, is equally important in prompting private enforcement in China.

Notes

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2 Zuigao Renmin Fayuan Guanyu Shouli Zhengquan Shichang Yin Sujia Chengshu Yinfa De Minshi Qinquan Jiufen Anjian Youguan Wenti De Tongzhi (The Notice on Relevant Issues Concerning Accepting Civil Tort Dispute Cases Caused by Misrepresentation on Securities and Several Provisions on Hearing Civil Compensation Caused by Misrepresentation on the Securities Markets) issued by China's Supreme Court on 15 January 2002, Article 17 which states that misrepresentation involves the market participating in a breach of 'relevant law and regulation during their IPO or securities transactions in the secondary market by disclosing false information, misleading information, omitting material information, or not appropriately disclosing information'.

3 A report made by the State-owned Asset Supervision and Administration Commission, for details see 'Gouyou Konggu Shangshi Gongsi Zhan A Gu Zongshizhi 51.4%' (Listed SOEs occupied 51.4 per cent of Market Capitalization) Yicai Network, full text available online at: http://www.yicai.com/news/2013/01/2404678.html (accessed 17 May 2014).

4 According to the Interim Measures for the Supervision and Administration of State-Owned Assets of the Enterprises, Articles 7 and 10: the business decision should be independent from the administrative influence, and a clear separation between ownership and control should be established. It means in principle that the governmental agencies will adopt a 'hands-off' approach on the daily business of the State-owned corporations, and all State-owned corporations should make the 'management decision by their own and take full responsibility for their profits and losses', e.g. see Shipani and Liu (2002).

5 See Shanghai Zhengquan Jiaoyi Suo (SHSE), 'Guanyu Dui Shanghai Lengguang Shiye Gufen Youxian Gongsi Gongkai Qianze de Gonggao (Notice on Public Criticism on Shanghai Lengguang Shiye plc) 11 June 1999. Available online at: http://static.sse.com.cn/sseportal/ps/zhs/ (accessed 29 May 2014) Shenzhen Zhengquan Jiaoyi Suo (SZSE), 'Guanyu dui Beijing Zhongguancun Keji Fazhan (Konggu) Gufen Youxian Gongsi Yuyi Gongkai Qianze de Gonggao' (Notice on Public Criticism on Beijing Zhongguancun Keji Fazhan plc) 28 September 2001. Available online at: http://www.szse.cn/ (accessed 17 May 2014); see also (Jiang, Lee and Yue, 2005).

6 China first passed a Securities Law in 1998. See Zhonghua Renmin Gongheguo Zhengquan Fa (Securities Law of the People's Republic of China), adopted by the 9th Session of the Standing Committee of the Sixth National People's Congress, 29 December 1998, effective 1 July 1999 (hereinafter, Securities Law 1999). The Securities Law of People's Public of China 2005, (Zhonghua Renmin Gongheguo Zhengquanfa 2005) was adopted by the 18th Meeting of the Standing Committee of Tenth National People's Congress, 27 October 2005, effective 1 January 2006 (hereinafter, Securities Law 2005).

7 See in connection note 2.

8 The Securities Law 2005, Article 69 states: 'Where the prospectus … issuing corporate bonds, financial statement, listing report, annual report, midterm report, temporary report or any information as disclosed that has been announced by an issuer or a listed company has any false record, misleading statement or major omission, and thus incurs losses to investors in the process of securities trading, the issuer or the listed company shall be subject to the liabilities of compensation'.

9 From a methodological perspective, 'data transparency' is essential in numerical comparative law. For this point, see Siems (2005). In order to enhance data transparency, a file including more detailed empirical information of both private, and public enforcement has been uploaded on the Internet. Available online at: http://pan.baidu.com/s/1ottA3 (accessed 17 May 2014). The updated file provides more detailed information including: (i) each case's docket number; (ii) the company's name; (iii) the extent of the punishment on the public company in each case; and (iv) the extent of the punishment on each executive in each case.

10 Alternative approaches that provide firsthand materials were sought. While using the largest case law system organized by Peking University, i.e. the *Beida Fabao* system, unfortunately, only two cases about private enforcement against misrepresentation were found. One is the *Daqing Lianyi* case, and the other is the *Huawen Keji* case.

11 As mentioned above, there is a pre-trial condition stating that shareholders can only sue a public company after an administrative, or criminal party is punished by the regulatory authorities, or a court verdict has been administered. Therefore, searching for the name of companies which have been punished by the CSRC using terms such as 'misrepresentation' *(Xujia Chenshu)*, and 'private compensation' (*Minshi Peichang*) on the Internet is a reasonable, and maybe the only method, to search for these types of cases.

12 The uploaded file provides more detailed information including: (i) the name of the defendant (a public company) in each case; (ii) the public enforcement basis of the litigation; (iii) the result of each case (settlement, claim upheld, or claim dismissed); (iv) the quantity of compensation made by public company in each case (if applicable); (v) the quantity of investors who get the compensation in each case (if applicable); (vi) the location of the court which hears the litigation; and (vii) the source of the information.

13 Many lawyers find that the accessibility of judiciary data is quite limited in China, e.g. see Clarke (1996: 201). However, something we should bear in mind is that this kind of inaccuracy of data is not a 'Chinese problem'. Instead, it usually occurs in empirical research on enforcement actions at a micro level. Even in a jurisdiction with a much higher level of administrative, and judiciary transparency, this kind of research still suffers from the problems of 'under-representation of data' and 'incompleteness of data'. Sometimes, estimated data based on the accessible materials is inevitable, e.g. see Armour (2010; see Table 4 and Table 6) and also see Armour *et al*. (2009: 608 and 705).

14 Up to 2013, the CSRC only granted limited law enforcement powers to three branches, located in Shanghai, Guangdong, and Shenzhen. The CSRC reserves its power to review the enforcement by these local authorities in order to prevent the problem of 'local protectionism'. For relevant information, see a report by Founder Securities. Available online at: http://www.foundersc.com/zqyw/13/10/12/5K26403574FS.shtml (accessed 17 May 2014).

15 For public enforcement in China and the US, a similar comparative research has been done; see Huang (2010a).

16 Source: Stanford Law School Securities Class Action Cleaning House, in cooperation with Cornerstone Research. Available online at: http://securities.stanford.edu/index.html (accessed 17 May 2014).

17 See Cornerstone Research (2012: 6). Available online at: http://securities.stanford.edu/clearinghouse_research.html (accessed 17 May 2014).

18 There are about 2,800 listed companies, with a global market capitalization of about US$18 trillion in NYSE (data from NYSE's website). There are about listed 3,700 companies, with market capitalization of about US$1.9 trillion in NASDAQ (data from NASDAQ website). As of the end of January 2013, the capitalization

of China's two capital markets was US$4.1 trillion. The total number of listed companies is 2,443. (See also note 2.)

19 Although simplified decision-making strategies may result in suboptimal decisions, they are commonly used because actors lack the time, cognitive ability, or information to conduct a more thorough analysis (i.e. the actors have a 'bounded rationality') see (Puchniak and Nakahigashi 2012: 59–61).

20 For some examples of the new reports that use passive descriptions, see 'Hangxiao Ganggou An Dui Gumin Fayuan Doushi Xinketi' (Hangxiao Ganggou Case: A New Lesson for Investors and Court), *Xinhua Meiri Dianxun* (Xinhua Daily Telegraph). Available online at: http://news.xinhuanet.com/mrdx/2007–11/27/content_7154961.htm, (accessed 17 May 2014). 'Gumin Weiquan Lajuzhan', (Seesaw Battle of Investors' Protection) *Chutian Dushi Bao* (*Chutian City News*) second edn, September 2010. 'Minshi Susong Lianbai Gumin Weiquan Jubu Weijian' (A Series of Private Litigation Loss: Protecting Investors' Right is Beset with Difficulties) 21CN Caijing (21cn Finance). Available online at: http://finance.21cn.com/newsdoc/zx/a/2013/0713/03/22747421.shtml (accessed 17 May 2014) and also see Yang Yanyan, 'Quanti Anjian de Susong Xingshi jiqi Jiazhi Quxiang' (Group Litigation: Practical Form and Value Orientation) 2011(5) Qinghua Faxue (*Tsinghua Law Journal*) 167–76. This article elaborately records how Chinese lawyers, and media negatively appraise securities litigation cases in which investors get their compensation successfully.

21 See, e.g. Stanford Law School Securities Class Action Cleaning House, in cooperation with Cornerstone Research, and RAND Corporation, a report about public and private enforcement in the US. Available online at: http://www.rand.org/pubs/rgs_dissertations/RGSD224.html (accessed 17 May 2014).

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