

Original Paper

The Construction of Chinese Securities Fraud Rules

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Abstract

Building an effective and fair legal system is one of the ultimate goals of China's capital market construction. To protect minority investors, changes has been made in recent years, especially rules about securities fraud. Though China constantly reform its securities regulation system, whether is it a perfect solution to transplant the regulation in US securities market remains unknown. This article is to critically examine China's securities fraud regulation, both from the perspective of practice and theory. It is argued that the impact of these changes has the common goal and that they will make profound basis on capital market.

Keywords

Securities Regulation, The Reform of Chinese Securities Law, Legal Transplantation

1. Introduction

In recent years, the regulation of China's securities market has been constantly explored. The whole fundamental structure was established by 1988 PRC Securities Law. The revised rules in misrepresentation in the 2019 revision of the PRC Securities Law and the following rules in 2022 made significant progress in dealing with the false statement on the securities market.

False statements in the securities market refer to significant false, misleading, omitted, or inappropriate disclosure of information related to securities issuance, trading, and related activities disclosed by relevant entities or actors in the securities market. Such deceptive information results to investors participating in securities or trading activities without understanding the true situation. Due to the basis of the modern securities market is a such common sense, that the market can function well under the circumstance that the company provide all subjective information, including financial and operating status, while the investors are able to make rational judgement on investment. The main responsibility of government or other regulative department is to maintain information disclosed by listing and listed company is fully, reliable and timely.

It is no doubt that the fairness and the effectiveness of the whole securities market would be drastically weakened if the false statements can not be restrained properly. Thus, restraining false statement through legal enforcement is an essential way to maintain the order of the securities market and leverage the market's self-regulation function. After the disclosing of misrepresentation, the further punishment will not only focus on the liability of involved company, such as penalty and dismissing qualifications of public co-operates, but also aiming at compensation for loss of concerned investors. Above all, observing the securities regulation from a broad perspective of institutional evolution can provide a background framework for understanding China's corporate capital system reform and its potential impact on the capital market.

2. The History of PRC Securities Law

The Securities Law of the People's Republic of China, which was implemented in 1999, has formed the initial framework of China's securities legal system (Fang, Tian & Yanfei, 2022). The whole legal system of capital market has been in progress in past 30 years. The Securities Law had been revised for twice at 2005 and 2019. The whole securities regulation system has been enriched by judicial interpretation from the Supreme Court of PRC and administrative rules from the State Council, beside that judicial cases plays a role in legal practice related to capital market.

With the unprecedented thriving of capital market, the fraud and deceit became a serious problem, as the companies engage in financial fraud during the issuance stage or make false statements during the operation period. Thus, the relative lack of civil liability and investor protection has become an unneglectable shortcoming of this law (Hu, 2016). It was not until 2002 that the Supreme People's Court enacted Certain Provisions of the Supreme People's Court on the Trial of Civil Compensation Cases arising from Misrepresentation in the Securities Market (Judicial interpretation 2002), which marked the beginning of the introduction of a new tort law regime in China-the tort of misrepresentation (Fang, Tian & Yanfei, 2022). The tort of misrepresentation is a product of the historical development of Anglo-American tort law (Ban, 2017), and the creation and application of its system are closely related to the institutional environment in which Anglo-American tort law arose and exists (Jeong, 2015).

3. Restrain Securities Fraud: From the Perspective of Comparative Law

3.1 Dealing with Securities Misrepresentation

From the perspective of comparative studies, the concept of misrepresentation was first used in England (Purshouse, 2018). Subsequently, the term misrepresentation was gradually used in securities law and became an important concept in the early regulation in the UK (Ernst, 1943, pp. 549-550). In the case of the United States, although there is no uniform statutory provision for misrepresentation in transactions, state courts generally recognize tort law remedies for types of misrepresentation (Affiliated UTE Citizens of Utah et al. v. United States et al. 406 U.S., 1972, p. 128; Blackie v. Barack,

524F.2d891, 1975; Shi & Zhou, 2015, p. 217), and the United States has also enriched the tort of misrepresentation by providing tort law remedies for misrepresentation in special areas through the provisions of special laws such as the Advertising Act and the Securities Exchange Act (Karpoff, Lee & Martin, 2007).

3.2 Stones from Other Mountains: Legal Transplantation in Securities Law (Traditional Chinese proverb, n.d.)

Legal transplantation is a difficult and continuous process, and it is important to deeply understand and grasp the historical motives and realistic appearance of the creation and development of the misrepresentation tort system, which is an essential foundation for the successful completion of the transplantation of law; and a prerequisite for the establishment of a comprehensive misrepresentation tort system in China (Gao & Wang, 2016). The initial legal transplantation was a special type-Chinese securities regulation learned from the United States, coupled with the residual influence of traditional systems, manifested as a mixed system of securities regulation.

The content of the Securities Law 2019 has made great effort on regulating fraud, including strengthening information disclosure regulations, increasing the protection system for investors, increasing the punishment for illegal and irregular activities, and clarifying market manipulation and insider trading behavior. The content of the Securities Law (2019) includes provisions similar to those of the US Securities Law of 1933 and the Securities Exchange Law of 1934, most of the revise can be seen as prototype from securities regulation from US. The judicial interpretation of 2002 has made a more comprehensive regulation of the tort of misrepresentation in securities issuance and securities trading in the form of the special law.

4. The Imperfect Securities Fraud Rules

The Chinese mode of regulation is certainly conducive to specific problem-solving and enhancing the relevance of institutional regulation, but the special law provisions lacking general law support are inherently inadequate (Guo, 2003, pp. 95-99). Although the current establishment of China's misrepresentation tort system has drawn on the theories of the common law system, there are still dilemmas in judicial practice that cannot be perfectly integrated with China's domestic securities market, including the problems of expanding the application of the permitted evidence, unclear determination of the substantial standard, insufficient improvement of the causation rules, and the weak function of the class action mechanism (Tang & Li, 2022, pp. 61-72).

First, the Chinese Supreme Court stated that the new judicial interpretation can also be applied to misrepresentations occurring in equity markets other than national securities trading venues (Lin, Fu & Zhou, 2022, pp. 43-50). The core of the securities misrepresentation tort system lies in the presumption of causation, and the "reference" application means that this presumption needs to be extended beyond its original scope of application, the such phenomenon needs to be alerted and the limits of its application need to be analyzed. When discussing the application or "reference" application of the tort

system of securities misrepresentation, we should not focus entirely on whether the object of the transaction in question constitutes a nominal “security” but should pay attention to the rule of presumption of causation as its essence and be alert to the great power of the presumption of causation (Fan, 2016, pp. 1495-1511). The Court should be alert to the great power of the presumption of causation and evaluate the liability for securities fraud in an appropriate and fair manner.

Second, there is a theoretical deficiency in China’s judicial practice regarding the determination of the materiality of securities misrepresentations. Whether a misrepresentation is a material is only one of the factors to be considered when administrative penalties are imposed by administrative authorities such as the Securities Regulatory Commission. Even if a misrepresentation is not material, it may be subject to administrative penalties. At the same time, it is inconsistent with the current legal provisions and judicial interpretations as the defendant are not allowed to prove the basic facts found in the administrative penalty decision in a civil action for misrepresentation. And a phenomenon has also been noted that limiting the defendant’s opportunity to raise the defense that false statements are not material does not necessarily benefit small and medium-sized investors (Cox, 1997, p. 497). For example, attorneys’ fees and expert witness fees are unavoidable expenses, so small and medium-sized investors as a whole are at a disadvantage in a civil action for misrepresentation (Fox, 2009).

Moreover, the core of the fraud on the market theory is that the stock price accurately and time reflects the public information disclosed by the perpetrator of the misrepresentation, so that an investor’s investment transaction based on stock price fluctuations may be presumed to have relied on the information disclosed by the perpetrator, but such reliance cannot be presumed when the information has no effect on the stock price (Langevoort, 2007). In the United States, the Supreme Court held that a defendant could rebut the presumption of a causal link in a transaction since the misrepresentation had no effect on the price of the stock (Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2014). In this regard, China’s courts should also allow defendants to rebut the presumption of causation on this ground, preventing civil litigation from becoming “insurance” for investors’ investments.

5. The Judicial Progress of Securities Fraud Case

In the absence of general legislative regulation of misrepresentation infringement, only the special type of misrepresentation infringement is provided for, which will inevitably lack generalization and abstraction of the general elements of misrepresentation infringement and easily bring legal loopholes in the special law regulation (Li, 2015, p. 250). These challenges in the misrepresentation tort regime were further addressed by the promulgation of the 2022 Supreme People’s Court Regulations on the Trial of Civil Compensation Cases for Misrepresentation Infringement in the Securities Market (Fang, Tian & Yanfei, 2022). The newly revised judicial interpretation has the important significance of improving the liability system for misrepresentation and promoting the progress of civil liability adjudication rules (Tang & Li, 2022, pp. 61-72). The new judicial interpretation introduces the fraudulent market theory and scientifically designs the logical system of civil compensation for

misrepresentation tort.

Nevertheless, the litigation system of securities investors still need to be activated further. It is to be noted that existing empirical studies show that one of the main problems reflected in the low filing rate of misrepresentation cases in China is the lack of investor confidence in the civil compensation mechanism and the fact that the existing litigation mechanism does not yet provide a strong litigation tool for injured investors (Tang, 2019, pp. 58-59). In addition to the “implied entry and express exit” litigation mechanism in the United States, there still a large space to explore when it comes to the subject of building a class action system that is consistent with the Chinese securities market (Xu, 2020, pp. 61-73). Such issues should be considered, for example, the proper and reasonable identification of the scope of rights holders, the clarification of the scope of authorization of insurance institutions, and the expansive effect of class action results.

6. Case Shock the Market: Kangmei Case

Kangmei Pharmaceutical Co., Ltd. (hereinafter referred to as Kangmei Pharmaceutical) was established in 1997 and listed on the Shanghai Stock Exchange in 2001. It is a listed company that focuses on the production and sales of traditional Chinese medicine decoction pieces. During the period from 2015 to 2018, Kangmei Pharmaceutical Company’s operations expanded in disorderly manner, and engaged in financial fraud. The controlling shareholder and related-parties occupied funds for private purposes, leading to insolvency and delisting. The controller of the company was held criminally responsible for manipulating the securities market and engaging in illegal disclosure or non disclosure of important information. In November 2021, Kangmei Pharmaceutical was fined 5 million yuan on charges of cooperative bribery. Soon after, the local Court in Guangzhou has made a judgment, which is also the first securities false statement liability dispute in China, that Kangmei Pharmaceutical has compensated 52037 investors with a loss of 2.459 billion yuan.

6.1 Determination of False Statements in the Case

In the “2016 Annual Report”, “2017 Annual Report”, and “2018 Half Year Report” disclosed by Kangmei Pharmaceutical, there is a false increase in operating income, interest income, and operating profit, a false increase in monetary funds, and a failure to disclose the non-operational occupation of funds by controlling shareholders and their related parties. This constitutes the act of making false records of major events that inconsistent with facts, causing significant omissions in disclosure. There are false records in the audit reports of Kangmei Pharmaceutical’s financial statements in 2016 and 2017 issued by accounting firm. Thus, the court confirmed the fact that Kangmei Pharmaceutical had false records and major omissions, and found that the case had false statements.

6.2 Factual Causation between the Plaintiff’s Investment Losses and the False Statements

Article 18 of the “Several Provisions of the Supreme People’s Court on the Trial of Civil Compensation Cases Caused by False Statements in the Securities Market” stipulates: “If an investor has the following circumstances, the people’s court shall determine that there is a causal relationship

between the false statement and the damage result: (1) the investor invests in securities directly related to the false statement; (2) the investor buys the securities before the disclosure date or correction date on or after the implementation date of the false statement; (3) the investor incurs losses due to selling the securities or continuing to hold the securities on or after the disclosure date or correction date of the false statement". According to the provisions of this judicial interpretation, it shall be presumed that there is a causation between the loss of investors and the defendant's false statement behavior.

6.3 Compensation Liability

Article 69 of the Securities Law of PRC (2014 Amendment) set the rule that the issuer or listed company hold the compensation liability in false misrepresentation. The directors, supervisors, senior management personnel, other directly responsible personnel, the controlling shareholder or actual controller of the issuer or listed company shall bear joint and several compensation liability with the issuer or listed company, except for those that can prove that they are not at fault. Thus, the Kangmei Pharmaceutical is liable for compensation for the losses suffered by the investors involved in the case.

7. Conclusion

This article briefly reviews the history of China's securities law legislation and revision, and analyzes the reference of China's capital market regulation to foreign securities markets, especially the United States. In response to fraudulent behavior in the securities market, China's securities regulatory mechanism is rapidly improving, but there are still some problems in this mixed regulative system. Strengthening ex ante regulation and establishing a connected litigation system are possible directions for future. This article attempts to illustrate the legislative and judicial changes in recent years through a framework review of China's securities regulation, and indicates that these changes will have a profound impact on the Chinese capital market.

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