



Securities Class Actions under the New Securities Law in China



The Securities Law 2019 Revision (“*The New Securities Law*”) in China, enacted at the end of 2019, represents a significant overhaul of the previous law. It ascertained initial public offering rules from “Approval-based IPO” to “Registration-based IPO”, includes extraterritorial jurisdiction provisions, enhances the securities trading mechanism, tightens information disclosure obligations and significantly increases the cost of breaches and violations. Moreover, the *New Securities Law* also includes a separate provision regarding investor protection and establishes a special representative litigation mechanism, for more western-style securities class actions.

This paper discusses the issues concerning the implementation of the representative litigation mechanism after the *New Securities Law* took effect on March 1st 2020, how it changes the risk exposure of listed companies and their directors, officers & supervisors, and what they can do to adjust to the emerging risks.

Origins of the Anglo-American Class Action

Class actions have been common in the United States for some time, but their history can originally be traced back to the United Kingdom. Due to constraints on punitive damages and allocation of attorney fees, class actions do not prevail significantly in the United Kingdom and the commonwealth countries – except for Australia and Canada. In 1842, the *Equity Rules* of the United States stipulated the class action mechanism into statutory law for the first time. In 1966, the class action was further revised, which led to a substantial increase in cases. Securities class action cases account for roughly 40% of all class action cases in the United States. Securities class actions have played an important role in the development of the US securities market by protecting the interests of the investors.

Establishment of China-style Class Actions under the New Securities Law

The *New Securities Law*, specifically Article 95, provides for specific provisions on securities class actions. According to this provision, securities investors may elect a representative to proceed with a litigation if the following three conditions are met: (1) the allegation is about misrepresentation, insider trading or market manipulation, (2) the subject matter of the litigation is of this same type, and (3) the plaintiff comprises of a large number of individuals.

For those who haven't participated in the litigation but have suffered from the same matter, the court may issue a notice with details of the litigation and notify the investors to register with them within a certain period of time. The judgment and ruling made by the court will be bound to investors who participate in the action.

The *New Securities Law* gives investor protection organizations an important role in special representative litigations. Investor protection organizations may participate in the litigation as a representative, and register for the investors (when they reach at least 50 investors) with the court once their information has been verified by the securities registration and clearing institution. With the opt-out principle, most of the eligible plaintiffs will be included in the litigation. Once a special representative litigation is filed against a listed company or its directors, officers and supervisors, the civil liability and damages they will face could be huge. The opt-out principle under the *New Securities Law* thus enables a US-style class action environment.



Key Issues Arising from the New Securities Law

The Supreme People's Court and the Shanghai Financial Courts have addressed the details about the implementation and execution of the *New Securities Law*, which has provided clarifying supplements to current laws and regulations.

1) *Regulations of the Shanghai Financial Court on the Securities Dispute Representative Litigation Mechanism (Trial)*

Following implementation of the *New Securities Law*, the Shanghai Financial Court issued the *Regulations of the Shanghai Financial Court on the Securities Dispute Representative Litigation Mechanism (Trial)* on March 24, 2020 ("the *Financial Court Regulations*"). The *Financial Court Regulations* reaffirm that the law applies to significant civil disputes resulting from misrepresentation, insider trading, market manipulation etc. in the securities sector. The *Financial Court Regulations* specify case registration, representative appointment, representative rights, trial of the litigation, and court judgment and enforcement on the basis of the general representative litigation under Article 53 and Article 54 of the *Civil Procedure Law*, and the special representative litigation under Article 95 of the *New Securities Law*.

In addition, the *Financial Court Regulations* provide clarity on the special representative litigation under Paragraph 3, Article 95 of the *New Securities Law*, including the requirements of the special representative, method in collecting plaintiff name list, "Opt Out" procedures and legal consequences, the scope of authorities of the special representative, and enforcement of the first-instance judgment if the defendants don't appeal.

2) *Regulations of the Supreme People's Court on Several Issues about Securities Dispute Representative Litigation*

On July 23 2020, the Supreme Court made public the *Regulations of the Supreme People's Court on Several Issues about Securities Dispute Representative Litigation* ("the *Supreme Court Regulations*") which took effect on Jul 31 2020. They provide comprehensive guidance on the jurisdiction of the case, the pre-condition of starting a case, the determination of the plaintiffs and the representative, the procedures of a case, and the allocation of the litigation costs associated with both general representative litigation and special representative litigation.

According to the *Supreme Court Regulations*, the plaintiffs in a special representative litigation do not need to pay the case acceptance fee to the court upfront. The courts can waive the requirement of guarantee from the plaintiffs, if requested by the investor protection organization, allowing investors to preserve their assets. Other provisions allow for situations where the class has not reached the required 50 investors or if there are multiple investor protection organizations involved.



Impact on Listed Companies and Recommendations

The implementation of the *New Securities Law* and the introduction of western-style securities class action to China mean that listed companies, as well as their directors, officers and supervisors, will have much greater exposure to litigation and investigations. The pressing question for senior managers and boards of listed companies is, “How can we best manage these risks?” The following are some suggestions:

- (1) **Strengthening of internal controls** – In order to be compliant with the complex legal and regulatory requirements, listed companies should provide regular training to introduce the updates of regulations from the CSRC, stock exchanges, or any other regulatory authorities to senior executives and board members, in a timely manner. Frequent testing and monitoring should be arranged to ensure that relevant personnel fully understand the requirements and the consequence of failing to implement.
- (2) **Improving disclosure requirements** – The *New Securities Law* has a chapter on information disclosure. In addition to the requirements of “real, accurate, and complete” in the old law, “concise, clear, and easy-to-understand” are added to the *New Securities Law*, which puts forward a higher standard of care for listed companies. In such cases, consulting professional counsel before making information disclosure and seeking guidance from public relations professionals, can mitigate the risk of disclosure breaches and violations.
- (3) **Responding to regulatory inquiries** – It is essential for listed companies to maintain good communication with stock exchanges, CSRC, and other regulatory authorities. When responding to a regulatory inquiry, a listed company must be ready to provide all relevant documents supporting their case in a timely fashion. The listed company should also engage an experienced lawyer to assist them navigating inquiries or investigations, to avoid unnecessary escalation and penalties, which could lead to litigation.

- (4) **Contractual indemnifications** – In order to attract good people and have them perform their duties, Chinese listed companies should consider following the common practice in other regions around the globe by ensuring indemnification provisions are written into the company’s articles of association. Alternatively, having specific contractual indemnities for their directors, and senior executives and supervisors which outline indemnifications afforded to them in the event of legal actions against them would provide comfort to them when making managerial decisions on behalf of the company.
- (5) **Arranging directors’ and officers’ liability insurance (“D&O insurance”)** – Risk transfer through D&O insurance is a common practice with companies in developed capital markets. The *Code of Corporate Governance for Listed Companies in China and Guidance on Establishing the Independent Director System in Listed Companies* outline the recommended use of this insurance. D&O insurance reduces the liability and financial and legal costs on listed companies and their directors, officers and supervisors in shareholder or regulatory actions.

In response to the *New Securities Law* as well as general increased litigation brought by foreign shareholders (when present), demand for D&O insurance has risen substantially. In the first half 2020, AIG has experienced a greater than 400% increase number of D&O insurance enquiries from listed companies compared with the same period in 2019. In response to the *New Securities Law*, AIG has been able to provide specialized cover to address emerging exposures related to controlling shareholders that the new law now addresses. AIG continues to offer Public Offering of Securities Insurance (POSI) for companies going through an IPO together with D&O insurance to create a holistic approach to risk management. Market rates on D&O insurance in general have increased dramatically in some areas as these emerging issues have increased the exposures faced by the commercial insurance marketplace.

The *New Securities Law* represents a necessary evolution in the development of China’s capital markets. It is may evolve with the passage of time given the decisions by and guidance from the courts. The *New Securities Law* is a great leap forward for investor rights. That great leap, however, could result in added risks for listed companies and their senior executives. Navigating management decisions particularly in this current environment is difficult – add on to this the *New Securities Law*, and new challenges might mount. Senior officers, board members and supervisors would do well to continue ensuring that their duty to shareholders is held to the highest standards.



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