

Clyde & Co Financial Institutions and Directors & Officers Podcast

Episode 5: China's new securities class-action
lawsuit system and its potential impact on the
FID&O market

Transcript

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China's new securities class-action lawsuit system and its potential impact on the FID&O market

Qi'ang Chen:

Hello, I'm Qi'ang Chen, an Associate in Clyde & Co's Insurance Financial & Professional Disputes team. Welcome to this episode of the Financial Institutions and Directors & Officers podcast series.

Today I am joined by Victor Yang, one of the Partners in the team to discuss China's new securities class-action lawsuit system and its potential impact on the FIDO market.

Welcome Victor and thanks for joining us here.

Victor, could you firstly give us a brief introduction to China's securities class-action lawsuit?

Victor Yang:

Hello Qi'ang. Thank you for inviting me here. China's securities class-action lawsuit refers to the representative action legal regime, which includes ordinary representative action and special representative action arising out of misrepresentation, insider trading, market manipulation and other misconducts in the securities market.

Qi'ang Chen:

Can you explain a bit more about the difference between the ordinary representative action and the special representative action?

Victor Yang:

Sure.

Firstly, these two types of actions are subject to different criteria. In summary, the ordinary representative action will be led by individual shareholders, and the special representative action will be led by an Investor protection institution.

Specifically, in an ordinary representative action

(1) The subject matter of action should be of the same category and the number of claimants should be more than 10;

(2) There should be 2 – 5 duly elected representatives.

(3) The Claimants should submit Prima facie evidence (e.g. administrative punishment decision, criminal judgment, self-admission made by the Defendant, disciplinary punishment decision made by stock exchange, etc.

However, in respect of the special representative action, an investor protection institution mandated by 50 or more qualified investors during the announced registration period can participate in legal actions as a representative. Investor protection institution in mainland China refers to two entities, the China Securities Investor Service Center (ISC) and the China Securities Investor Protection Fund Corporation Limited (SIPF)

Secondly, they are subject to different jurisdictions: the Chinese Courts are divided into a four-level court system, i.e. Supreme, High, Intermediate and Primary. There are also special courts (of intermediate level) in China, such as the Shanghai Financial Court etc.

Whilst the Intermediate Court at the domicile of the Defendant has jurisdiction for the ordinary representative action, the Intermediate Court or Special court (i.e. the specialised financial court - intermediate level) in the region where the stock exchange is located will have jurisdiction for the special representative action.

At present only Beijing and Shanghai have Financial Courts. So, a special representative action against a company listed in a city other than Shanghai and Beijing needs to be filed before that regions Intermediate Court.

Qi'ang Chen:

A very useful and interesting summation of the differences between the two actions, would you tell us more about who is entitled to start these two types of representative action?

Victor Yang:

In the context of claims arising out of misrepresentations on securities, qualified claimants refer to investors who have purchased the securities on or after the date on which the misrepresentations were made and before they were revealed or corrected, or investors who have sustained losses as a result of sale of securities, or as a result of continuing to hold the securities on or after the date on which the misrepresentations were revealed or corrected.

If the number of potential claimants cannot be ascertained when legal action is started, the Court may examine the nature and factual background of the alleged securities misconduct to determine the scope of qualified claimants within thirty days from acceptance of the case.

Qi'ang Chen:

Thanks Victor. From your view what is the rationale behind the launch of China's new securities class-action lawsuit system?

VY:

Lawsuits arising out of misrepresentations on securities have surged in recent years in China against the backdrop of intensified investigations into misconduct in the financial market launched by the China Securities Regulatory Commission ("**CSRC**"). Individual investors who have become increasingly assertive of their rights have no doubt contributed to this surge. Whilst search results show that there were only around 5,000 lawsuits arising out of misrepresentations on securities over the past 15 years, the number of cases in 2019 and 2020 were around 12,000 and 10,000 respectively.

In view of the circumstances set out above, the draft revision to the PRC Securities Law was passed last year and took effect on 1st March 2020. In addition to outlining detailed laws and guidance on securities issuance and trading, the takeover of listed companies, information disclosure and so on, it would appear that the revised Securities Law has introduced what may be perceived as certain "aggressive" clauses under Chapter 6 – investor protection with a view to introducing efficiency and consistency into the Securities Class-Action Lawsuit System in China.

Following the revised PRC Securities Law, on 31 July 2020, the Supreme Court of China released the Provisions on Issues of Representative Securities Litigation (effective immediately) ("**Provisions**"), marking the launch of a class-action lawsuit system with "Chinese characteristics". The CSRC also issued a Notice on Investor Protection Institutions Participating in Special Representative Securities litigation ("**Notice**") on the same day, which provided detailed guidance on an investor protection institutions' role in China's securities class-action lawsuit system.

Qi'ang Chen:

Thanks Victor, the launch of a new class-action lawsuit system in China seems necessary and timely given the high number of lawsuits arising out of misrepresentations on securities in recent years which you mentioned earlier. Would you tell us more about the characteristics of the class-action lawsuit system in China?

Victor Yang:

Sure. I think there are three characteristics: low-cost, convenience and the "Opt-Out" Regime under the Special Representative action.

Firstly, the system will be a low-cost claim channel for small and medium volume investors from the following perspectives:

- (1) If a qualified investor who has filed a lawsuit before the registration announcement wishes to withdraw the case and join in a representative lawsuit, the Court shall refund the Court's fee already collected.
- (2) The court shall support the representative's request for reimbursement from the losing Defendant for reasonable costs such as announcement fees, notice fees, lawyer's fees, etc.
- (3) Subject to the Court's discretion, the Court's fee may not need to be paid in advance under special representative action and may be wholly or partially refunded even if the Claimant loses the case.
- (4) Under special representative action, if the investor protection institution, applies for property preservation, the Court may decide not to require provision of security.

Secondly, the system has been designed around convenience.

Prior to issuing the announcement for registration, the Court should review the facts of the disputes and decide the number of investors who are qualified as the Claimant of the representative action, as well as deciding other preliminary issues, so the Court should have a general understanding of the key issues, which will hopefully expedite the proceedings. Further, if representatives cannot be ascertained after two rounds of election, the Court will appoint representatives.

Thirdly, there is a "Opt-Out" Regime under Special Representative action.

China used to adopt the "opt-in" legal regime for securities class actions, which means only when a Court has issued an announcement and when a qualified investor has registered with the Court could the judgments or rulings rendered by the same Court be valid for and binding on the registered Claimant. However, according to the PRC Securities Law, an investor protection institution mandated by 50 or more investors can register the qualified investors with the Court which, forms the "opt-out" legal regime for securities class action in China.

Qi'ang Chen:

Great, thanks Victor.

The press are reporting much more widely on financial scandals, both in the financial papers and in the regular papers, creating a lot of attention around misconduct in the capital markets, can you share your view regarding the impact of alleged misconduct on China's FID&O market?

Victor Yang:

Of course, in light of press coverage and wider public interest in recent scandals, it can be seen that China has been speeding up its "zero tolerance" policy on capital markets misconduct. In my view, China's newly launched securities class-action lawsuit system will increase the risks and costs of committing financial misconduct, and safeguard fairness, order, and the integrity of the capital market in China, which in turn improves the risk awareness of A-share listed companies.

For example, the D&O market in China witnessed a dramatic upsurge in 2020. According to statistics provided by the paper.cn, in the first three quarters of 2021, the number of listed companies that publicly announced the purchase of D&O insurance exceeded 120, an increase of twice that of the same period last year.

Qi'ang Chen:

You said China's newly launched securities class-action lawsuit system will increase the risks, so what are the risks in China that insurers will encounter?

Victor Yang:

In my view, there are three main risks.

Firstly, FID&O Insurers could assume insurance liability provided that the Insured is held jointly and severally liable for misrepresentations on securities.

Secondly, the exclusion clauses may not be legally binding if the insurers failed to discharge its statutory obligation of providing the insurance applicant with sufficient warning of exclusion clauses and express explanation to the contents and legal consequences of the same.

Thirdly, it could be difficult for the insurers to terminate the insurance contract and deny cover based on non-disclosure under the PRC Law.

Qi'ang Chen:

Thanks, with China's securities class-action lawsuit system being in place, and in light of financial misconduct generating greater media coverage, I believe China's FID&O market will grow much faster in the upcoming years compared to historic levels. However, considering the risks facing insurers, do you have any recommendations for them? What should insurers be mindful of?

Victor Yang:

I would like to suggest following three points:

Make sure that the insurance applicant has been provided with sufficient warning of exclusion clauses and express explanation to the contents and legal consequences of the same. (if possible, it is recommended that they obtain a statement signed or stamped by the applicant to confirm that the insurer has fully fulfilled the obligation of providing sufficient warning of and express explanation to the exclusion clauses).

Make sure that the risk questionnaire is specific and precise (for example, in terms of D&O insurance, it is recommended to clarify in the risk questionnaire that the answers should be made after enquiry with all the insureds given the severable nature of the D&O policy, and to set out customised risk questions such as whether the company insured or the individual insured has been investigated or punished by the regulators, whether the insureds have received any type of demand or notice that could give rise to a claim etc.).

Terminate the insurance contract in accordance with Article 16 of the PRC Insurance Law within 30 days upon knowledge of ascertained non-disclosure.

Qi'ang Chen:

Thanks Victor, you provided us with very in-depth insights on China's new securities class-action lawsuit system and some useful recommendations for insurers against its potential impact on the FID&O market. No doubt there will be further development of China's securities class-action lawsuit system in coming years.

Victor Yang:

My pleasure, thanks for inviting me.

Qi'ang Chen:

For those listeners who are interested in learning more about China's securities class-action lawsuit, please feel free to contact us. I hope you've enjoyed this episode and thank you for tuning in.

440

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