"Stone from Other Mountains Can Polish Jade": How Chinese Securities Law Could Learn Lessons from US Experience to Enhance Investor Protection and Market Efficiency

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Abstract

This article aims to provide an in-depth and comprehensive analysis of PRC Securities Law 2020 which overhauls China's securities regulatory framework to construct more efficient and transparent capital markets with enhanced investor protection and market integrity. The law constrains regulators' administrative powers in deciding the outcome of IPOs as well as streamline the securities offering procedure. This article pays attention to key reform initiatives proposed by PRC Securities Law 2020, such as the registration-based IPO system, the enhanced investor protection and compensation regime, the cross-border supervision, and the harsher punishments for securities frauds. It also discusses the latest enforcement cases relating to high-profile financial frauds like the Luckin Coffee scandal which resulted in Luckin Coffee being delisted from NASDAQ in 2020. The analysis in the article is accompanied by relevant US securities law in the same area to offer a comparative angle, which is of interest to practitioners, academics and policymakers in major financial centres.

Introduction

Capital markets finance refers to the raising of corporate finance by issuing securities, such as shares and bonds, directly to investors.[1] Over the past three decades, China has established a multi-level capital markets financing system consisting of Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE) main boards, SZSE small and medium-sized cap board, SZSE growth enterprises market, and SSE sci-tech innovation board (star market).[2] Most recently, China launched the Beijing Stock Exchange (BSE) in September 2021 to provide more financing channels for smaller innovative and technological companies in the country.[3] According to the *Financial Times*, China's stock markets ranked as the second largest in the world with a total market capitalisation of all public companies reaching US$10 trillion in October 2020.[4] Despite the considerable size of Chinese capital markets, its regulatory framework is often considered as being left behind the fast-changing market practices due to excessive regulatory intervention into securities offering and trading activities.[5] In December 2019, the Standing Committee of the National People's Congress, the Chinese parliament, passed a major revision of PRC Securities Law that took effect on 1 March 2020.[6] The revision has been considered as the biggest overhaul of China's securities regulatory framework to construct more efficient and transparent capital markets with enhanced investor protection and market integrity. Clearly, the importance of PRC Securities Law 2020 for Chinese capital markets is comparable to that of the Securities Act of 1933 and the Securities Exchange Act of 1934 for the US markets.

As a Chinese proverb says: "Stone from other mountains can polish jade", in other words, securities regulators shall always learn from international best practices to shed some light on domestic regulatory reforms. For many decades, the US securities law framework has remained preeminent in the domestic and global marketplaces.[7] Therefore, this article, whilst discussing the highlights of PRC Securities Law 2020, will draw some comparison with securities regulation in the US including the practices of the Securities and

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[1] Eilis Ferran and Look Chan Ho, *Principles of Corporate Finance Law*, 2nd edn (Oxford University Press, 2014), p.351.

[2] Lerong Lu and Ningyao Ye, "Promoting High-Tech Innovations through Capital Markets Law Reform: Deciphering the Sci-Tech Innovation Board of the Shanghai Stock Exchange" (2020) 35 *Butterworths Journal of International Banking and Financial Law* 140.

[3] James T. Areddy, "China to Launch Beijing Stock Exchange to Steer Investment Into Innovation", *Wall Street Journal*, 2 September 2021, *https://www.wsj.com/articles/china-to-launch-beijing-stock-exchange-to-steer-investment-into-innovation-11630622825* [Accessed 14 February 2022].

[4] Hudson Lockett, "China's stock market value hits record high of more than $10tn", *Financial Times*, 14 October 2020, *http://www.ft.com/content/7e2d1cae-8033-45b1-811c-bc7d4a413e33* [Accessed 14 February 2022].

[5] For example, China has been using a so-called "approval-based IPO system" which grants the China Securities Regulatory Commission (CSRC) a power to censor which companies are qualified for a public listing at Shanghai and Shenzhen Stock Exchanges. Therefore, Chinese companies seeking a floatation of their shares are subject to strict financial assessment as per China's securities law and regulations, and has to obtain an administrative approval by the CSRC's Public Offering Review Committee. See Lerong Lu, "Reforming Corporate Share-Listing Rules in China: Understanding the Rationale and Advantages of the Registration-Based IPO Regime" (2021) 42 *The Company Lawyer* 236.

[6] *Xinhua*, "China's new securities law further liberalizes capital market" (14 January 2020), *http://www.xinhuanet.com/english/2020-01/14/c_138703294.htm* [Accessed 14 February 2022].

[7] Marc I. Steinberg, *Rethinking Securities Law* (Oxford University Press, 2021), p.4.

Exchange Commission (SEC). After this introductory section, this article proceeds as follows. The next section provides an overview of China's capital markets and the evolution of its securities law from 1990 to 2020. We then analyse China's newly established registration-based system for initial public offerings (IPOs) of corporate shares and bonds. The fourth section considers the improvement of investor protection mechanisms, whilst the fifth section discusses the new investor compensation system. The sixth section continues to evaluate the proposed cross-border supervision over securities markets and the section after that studies the stricter punishment regime for committing financial frauds. The final section draws a conclusion.

An overview of China's capital markets and securities law

The history of Chinese capital markets is relatively short. In 1990, China launched its first stock market, the Shanghai Stock Exchange (SSE), and at that time there were only eight public companies being traded. As of 2020, the Chinese markets held over 4,154 publicly listed companies, 134 million investors trading in stock exchanges, and more than 130 securities companies.[8] 2021 is another record year for Chinese capitital markets, for the number of IPOs and total proceeds increased significantly, with 245 new listings and RMB 210.9 billion fund raised in total, up 108% and 51% respectively compared with the first half of 2020. By the end of 2021, the total A-share IPO funding is expected to reach a record high of over RMB 500 billion.[9] China now has three main stock trading venues: SSE, Shenzhen Stock Exchange (SZSE) and Hong Kong Stock Exchange (HKEX), forming a diverse and multi-level capital markets system. They are home to thousands of well-known companies, such as Alibaba, Tencent, ICBC, Petro China, China Mobile and Lenovo.

In 1998, China introduced its first securities market legislation—People's Republic of China (PRC) Securities Law which lays down comprehensive and thorough regulatory rules for securities issuance and trading activities in the country. The legislation took effect from 1 July 1999. Over the past two decades, despite the rapid growth of China's capital markets, the legislation has gone through only one major revision in 2005, along with some minor amendments being made in 2004, 2013 and 2014. In 2019, the Standing Committee of the National People's Congress (NPC), the Chinese Parliament, has passed the second major revision of PRC Securities Law.[10] It took effect on 1 March 2020 and has been considered as the biggest overhaul of the Law since it was firstly enacted in 1998. Undoubtedly, PRC Securities Law 2020 has marked a milestone of further liberalising China's capital markets which have become increasingly appealing to investors in China and globally due to the rise of some high-quality Chinese companies like Alibaba and Tencent. The securities market reform is supposed to play a key role in driving China's further economic growth and social advancement by channelling the spare funds in the society to the cash-hungry companies who need financing. The objective of the reform is to limit the exposure of the economy to potential market risks, to improve the quality of listed companies, and to safeguard the rights and legitimate interests of securities investors in the country. With the refined regulatory rules, China wishes to create a more standardised, transparent, dynamic and resilient capital markets financing system.

Apart from the new PRC Securities Law 2020, Chinese capital markets have undergone a series of regulatory reforms to improve market efficiency and international accessibility. For example, in 2018, the China Securities Regulatory Commission (CSRC), which is the securities markets watchdog in mainland China, devised the legal regime of Chinese Depositary Receipts (CDRs) enabling overseas listed Chinese companies to dual-list their shares back home at either SSE or SZSE.[11] In 2019, the UK and China have jointly launched the Shanghai-London Stock Connect (SLSC) programme to allow public companies and investors in both countries to access each other's capital markets, which has further improved the quality, liquidity and diversity of China's stock markets.[12] As policy-makers in China have been pushing forward capital markets law reforms, we expect to see the fostering of a more efficient and effective capital financing system, which not only benefits domestic businesses who will enjoy more financing options and resources at lower costs, but also provides Chinese citizens and international investors with a chance to cash in on China's fast-growing economy.

The registration-based system for IPOs and corporate bond issuances

The establishment of the "registration-based" IPO system is viewed as the most significant change of the Law, which makes it easier and faster for Chinese companies to list their shares on the A-share market without going through the lengthy and complex approval process from the securities authority as they used to do.[13] Under the

[8] Statistics from *Statista* (29 November 2021).
[9] "A-share IPOs doubled in the first half of 2021 and will remain active in the second half" (2 July, 2021), *PwC*, *https://www.pwccn.com/en/press-room/press-releases/pr-020721.html* [Accessed 14 February 2022].
[10] Xinhua, "China's new securities law further liberalizes capital market" (14 January 2020), *http://www.xinhuanet.com/english/2020-01/14/c_138703294.htm* [Accessed 14 February 2022].
[11] Ningyao Ye and Lerong Lu, "How to Harness A Unicorn? Demystifying China's Reform of Share Listing Rules and Chinese Depositary Receipts (CDRs)" (2019) 30 *International Company and Commercial Law Review* 454.
[12] Ningyao Ye and Lerong Lu, "Building a Eurasian Capital Market: Understanding the Operating Mechanism and Legal Framework of Shanghai-London Stock Connect" (2020) 35 J.I.B.L.R. 67.
[13] There are three different types of shares traded on Chinese stock markets: A-shares stand for Chinese companies that traded on SSE or SZSE and are denominated in yuan; B-shares represent domestically listed foreign investment companies on SSE or SZSE and are traded in foreign currencies; H-shares refer to companies listed on HKEX and are traded in Hong Kong dollars.

previous "approval-based" IPO system, listing applicants have to go through strict financial scrutiny to obtain an administrative approval from the CSRC's Public Offering Review Committee. The securities regulator had been granted enormous power in deciding whether the company applicant will get a listing under the previous IPO regime. Furthermore, a large proportion of the IPO quota had been reserved for state-owned enterprises and companies that had close contact with the authority. As a result, many cash-starved private entrepreneurs who are desperate to raise funds on the Chinese markets are often deferred by regulatory hurdles, such as the difficulty of getting the administrative approval. The pecuniary threshold for listing companies seeking to get listed was also high under the previous listing rules, as they are required to demonstrate making considerable profits over the past few years as well as a strong growth prospect.[14] Therefore, the capital allocation function was not fully achieved by China's stock market, as it mismatched corporations' strong desire for cash with an unachievable threshold to get access to capital markets. For this reason, the Great China stock market failed to attract many high-tech enterprises who, insteading of listing their shares in mainland China, chose to list in New York or Hong Kong, such as Alibaba, Baidu Tencent, JD.com, NetEase and Pinduoduo. The reform aims to create fair competition for all companies by boosting the market vitality and levelling the playing field for start-ups. Considering the inefficiency and opaqueness of the "approval-based" IPO system, China plans to go for a more market-based "registration-based" IPO system, under which substantial examination for listing companies will no longer be done by the CSRC, as long as necessary legal and financial documentations are in place. The "registration-based" IPO system has streamlined the share issuance procedure and it is expected to solicit more fast-growing high-tech firms to float their shares on the Chinese stock market. The new rules have reduced the government's intervention to a larger extent in the capital markets where the new IPOs will gradually become a pure market practice as investors and stock exchanges shall have the say in which companies get listed.

At first, the "registration-based" IPO regime was tested on the star market of the SSE. In July 2019, 25 high-tech companies started trading on the star market and they posed an average gain of 140% on the first trading day.[15] PRC Securities Law 2020 has restated the adoption of registration-based IPO for Shanghai and Shenzhen stock exchanges, and its specific scope and implementation steps will be further defined by the State Council.[16] Following the trial of "registration-based IPO regime" on the star market, the experiment had been expanded into other segments of Chinese capital markets, and has finally been introduced to the main boards of SSE and SZSE. In June 2020, the Chinese regulator announced the adoption of registration-based IPO system by the ChiNext board of SZSE, which is the country's NASDAQ-style board that mainly hosts growth enterprises and innovative start-ups.[17] In October 2020, China's Vice Premier, Liu He, chaired a special meeting of the Financial Stability and Development Committee of the State Council where he emphasised the need to strengthen the further reform and open-up of China's financial system, including the full implementation of the registration-based IPO system.[18]

In this regard, it is helpful to look at the experience of the US which dominates the capital market worldwide to see how it influences the reform of the Chinese securities regulations. First of all, the IPO registration system in the US is an integrated part of its disclosure-based regulation exercised by the Securities and Exchange Commission (SEC). The listing standards are set by each stock exchange. To make it clear, the difference between the registration-based and approval-based systems is not about whether the substantial review is required, but is about whether a judgment on the investment value of the company securities is to be made by the regulators. Although the SEC does use its discretionary power comprehensively to ensure each IPO application contains true, accurate and complete information after the applicant meets all supplementary certification requirements, this kind of substantial review concerning the depth and breadth of information disclosure does not mean that the SEC is making any value judgment on behalf of the market.[19] The SEC only concerns the content quality of the information disclosed by the share issuers. The focus of the SEC's registration review work lies in the form of Comment Letters, by making which the regulator raises reasonable doubts about the information disclosed in the prospectus. The process of the IPO registration is the process of having a two-way dialogue on information exchange. The "registration-based" regime has borrowed the concept of reasonable doubt from the Criminal Procedure Law into the review of securities issuance. Under the merit-based approach, if reviewers have certain doubts or there is a possibility that the issuer does not disclose information in an accurate, complete and timely manner, reviewers will keep asking questions for the

[14] For example, see CSRC, Measures for the Administration of Initial Public Offering and Listing of Stocks (2006), art.33: "An issuer shall meet the following requirements: (1) Having a positive net profit of over 30 million yuan accumulatively for the latest 3 accounting years, which are calculated on the basis of the comparatively low net profits upon deduction of non-regular profits/losses; (2) Having a net cash flow of over 50 million yuan accumulatively, or having a business income of over 0.3 billion yuan accumulatively for the latest 3 accounting years; (3) Having a total amount of stock capital of not less than 30 million yuan before issuance; (4) The proportion of its latest intangible assets (upon deduction of its land use right, right to aquatic breeding and right to mining) in its net assets not being higher than 20%; and (5) Having no uncovered deficit in the latest period."

[15] Shuli Ren, "Chinese Investors Are Playing a Game of Hot Potato" *Bloomberg* (23 July 2019), *http://www.bloomberg.com/opinion/articles/2019-07-23/china-s-nasdaq-style-star-market-risks-burning-out-quickly* [Accessed 14 February 2022].

[16] PRC Securities Law 2020 art.9.

[17] Xinhua, "Registration-based IPO reform of ChiNext a boon for innovative enterprises" (17 June 2020), *http://www.xinhuanet.com/english/2020-06/17/c_139146066.htm* [Accessed 14 February 2022].

[18] "IPOs to enter era of full registration, delisting process to be normalized" *Global Times*, 1 November 2020, *http://www.globaltimes.cn/content/1205330.shtml*.

[19] Louis Loss and Seligman Joel, "Fundamentals of securities regulation" [1983] *Business Law* 716.

issuer until all doubts are explained and eliminated. The great discretion of the reviewers is considered to be a major characteristic of the information disclosure and review mode under the "registration-based" IPO system. On this basis, any issuer, no matter what kind of investment risks exist and how large they are, could issue securities as long as the relevant information is fully disclosed, letting the market itself test the investment value.[20] In other words, if the issuing company fully discloses the information following all regulatory rules, its IPO application is likely to be approved by the authority even if its business prospect might be highly uncertain. To match up with this mechanism, adequate after-IPO remedy mechanism is in place to ensure the fairness and stability of the securities market.[21] Under a "registration-based" IPO regime, the registration review process urges listing companies to disclose sufficient and accurate information for investors to make informed investment decisions, instead of letting the regulator select the best companies for investors, which in reality is impossible.

Apart from the requirements of information disclosure, a powerful and comprehensive law enforcement mechanism including the administrative penalties, the civil litigation for shareholders and even the criminal punishment, is the foundation for the orderly operation of the "registration-based" IPO system. To some extent, the "registration-based" system relies on the ex-post financial supervision and punishment to make up for the lack of ex-ante substantial business review and the in-process inspection from the securities regulator. In the US, the existence of the ubiquitous civil litigation and settlement system, the professional securities lawyer group, the class action system, plus the short-selling mechanism combined constitutes the solid institutional foundations for its highly developed capital market. Therefore, China should not only establish the "registration-based" IPO regime but also improve the overall institutional framework of securities regulation and other supporting mechanisms under which such an IPO regime operates, which will be discussed in the following sections.

The investor protection mechanism

The PRC Securities Law 2020 has made a new chapter (Ch.6) to stipulate various investor protection mechanisms consisting of the following points:

- First, the new legislation distinguishes ordinary investors from professional ones and makes targeted arrangements, namely, better protection, for ordinary retail investors. Investors are divided into ordinary investors and professional investors according to their asset status, financial asset amount, investment knowledge and experience, professional capability and other factors; the criteria for professional investors shall be specified by the securities regulatory authority under the State Council.[22] If investors are deemed as ordinary investors by the Law, they will be subject to a higher level of protection. For example, when ordinary investors have a financial dispute with their securities companies, the securities companies will have the proof of burden to demonstrate that their actions have been in compliance with relevant laws and regulations and that they have not conducted any misleading and fraudulent practices. Otherwise the securities companies would be liable for any losses of the investors they deal with.
- Secondly, the Law has established a collection or delegation system for shareholder rights of public companies, in order to protect minority shareholders and improve corporate governance. The board of directors, independent directors, shareholders holding 1% or more of voting rights of the listed company, or an investor protection institution formed in accordance with laws, administrative regulations or the provisions issued by the securities regulatory authority under the State Council (hereinafter referred to as the "investor protection institution") may, as the solicitor, publicly request shareholders of the listed company to entrust them to attend the shareholders' meeting and to exercise the right to make proposals, the right to vote and other rights of shareholders on their behalf or entrusting a securities company or a securities service institution to do so.[23] This reflects the increasingly dispersed shareholding model in China's capital markets, which calls for an effective collection to enable most shareholders to exercise their rights.
- Thirdly, it has incorporated new provisions concerning bondholder meetings and the bond trustee system. In the public offering of corporate bonds, the bondholders' meeting shall be convened, and the procedures for convening bondholders' meetings, the rules of meetings and other important matters shall be stated in the prospectus; the issuer that offers a corporate

[20] Guichun Xie, "The implementation mechanism for improving the quality of prospectus under the registration-based system: Lessons from the US market" (2020) *Securities Law Review [Zheng Quan Fa Ping Lun]* 152.
[21] Fengqi Cao, "From approval-based system to registration-based system: the core and progress of the new Securities Law" (2020) 4 *Financial Forum [Jin Rong Lun Tan]* 3.
[22] PRC Securities Law 2020 art.89.
[23] PRC Securities Law 2020 art.90.

bond to the public shall retain a bond trustee for bondholders, and enter into a bond trustee agreement; the trustee shall be the underwriter for the current offering or any other institutions recognised by the securities regulatory authority under the State Council; a resolution on the change of the bond trustee may be made at the bondholders' meeting; and the bond trustee shall act with due diligence and perform trustee duties in an impartial manner, and shall not damage the interests of bondholders.[24] This echoes the fast development of corporate bond markets in China and the urgent need to protect the rights and legitimate interests of bondholders.

- Fourthly, the Law has created a compulsory conciliation system for disputes between ordinary investors and securities issuers and brokers. Where an issuer causes any loss to investors due to fraudulent offering, false statements or any other major violation of law, the issuer's controlling shareholder, actual controller or any relevant securities company may entrust an investor protection institution to enter into an agreement with investors who suffer losses to make compensation in advance; it may legally claim compensation from the issuer and other parties jointly held liable after making compensation in advance.[25]
- Last but not least, the Law has clarified the cash dividend system of public companies as a listed company shall specify in its bylaws detailed arrangements and decision-making procedures for the distribution of cash dividends, and protect the right to return on assets of shareholders in accordance with the law.[26]

Furthermore, in order to facilitate the operation of the latest "registration-based" IPO system, the new legislation has explored a unique securities civil litigation system adapting to the current domestic market conditions. The law has introduced the class action for the first time to the Chinese capital markets as an investor protection institution can act as the litigation representative. According to the PRC Securities Law 2020, an investor protection institution mandated by 50 or more investors could register all qualified investors with the People's Court, unless any investor explicitly refuses to be registered.[27] It serves as the "opt-out" legal regime for securities class action. It is praised as an ingenious integration of the "opt-in" representative litigation with the "opt-out" class action which represents a major innovation in securities law with Chinese characteristics.[28] However, such a transplanted way of litigation still needs corresponding procedural design, and its effect waits to be tested in the future judicial practice.

In contrast, as the birthplace of the securities class action lawsuit, the US has developed a mature mechanism through continuous practice and innovation. The US class action system has been transplanted to various countries, but the breadth and depth of the application of the class action system in other jurisdictions are far less than that of the US. Therefore, the US securities class action model has great value as a reference point for improving the Chinese legal practice in this area. Similar to the PRC Securities Law 2020, the US has adopted an "opt-out" based class action mode, and the core of the regime lies in the "opt-out" right of the plaintiff investor. According to the US Federal Rules of Civil Procedure, class members have two opportunities allowing them to withdraw from the lawsuit. The first chance is during the confirmation procedure of the class action. When the court is confirming the scope of the class action, if the investor does not make an explicit withdrawal request within a certain period of time, the judge will include all eligible investors into the scope of the plaintiff automatically and, as a result, the subsequent judgment will apply to them directly. The second chance to withdraw occurs in the reconciliation phase. According to the US Federal Rules of Civil Procedure, if the class action was previously certified under r.23(b)(3), the court may refuse to approve a settlement unless it affords a new opportunity to request exclusion to individual class members who had an earlier opportunity to request exclusion but did not do so.[29] Therefore, the group members in the US have the opportunities twice to withdraw from the US class action, which enhances the investors' ability to exercise their litigation rights and ensures the authenticity of group members' intentions in the submission. Thus, in order to protect non-appearance and anonymous group members under the rules of due process, timely notification by the court is of great importance during the class action.[30]

Another major characteristic of the US class action is that it is often initiated by professional securities lawyers whose strong incentives to lead the group litigation is closely linked with the high litigation cost and the lawyer's remuneration system in the US. Under the contingency fee system, lawyers will normally reach an

[24] PRC Securities Law 2020 art.92.
[25] PRC Securities Law 2020 art.93.
[26] PRC Securities Law 2020 art.91.
[27] PRC Securities Law 2020 art.95.
[28] Under the provisions, subject to satisfaction of certain criteria, investors who have sustained losses due to misrepresentation on securities, insider trading and market manipulation may start "Ordinary Representation Litigation" based on PRC Securities Law 2020 art.95 paras 1–2 or "Special Representative Litigation" based on PRC Securities Law 2020 art.95 para.3.
[29] US Federal Rules of Civil Procedure art.23(e)(4).
[30] Jiangdong Huang and Lei Shi, "Research on China's Securities Group Litigation System—Taking Article 95, paragraph 3 of the new Securities Law as the analysis object" (2020) 3 *Finance Law Journal [Cai Jing Fa Xue]* 124.

agreement with the plaintiff stipulating that: if they win the case, a certain percentage (ranging from 20% to 50%) of the compensation or settlement money paid by the defendant company would be given to lawyers as attorney fees; if they lose the case, no money would be charged to the plaintiff.[31] Such a contingency fee system has inspired a group of active securities lawyers who pay close attentions to the information disclosure of listed companies and the performance of stock markets. Once a misrepresentation in the information disclosure document or an abnormal stock price fluctuation is noticed, a professional investigation will likely be launched immediately. Through the close involvement of professionals, the civil compensation mechanism plays a strong deterrent role in protecting disadvantaged individual investors in securities disputes and the system has become an effective means of policing the securities laws. In sharp contrast, PRC Securities Law 2020 has excluded the possibility for lawyers to initiate class action suits, as the only legal entity to initiate class actions shall be the investor protection institution, who might lack professionalism and incentives compared with the group of securities lawyers. Out of this consideration, the authors suggest that attorneys should be allowed to participate in securities class actions. However, to accommodate China's economic and judicial conditions, the proportion of the contingent fees is suggested to be capped at an appropriate level, based on empirical research results, to prevent the risk of pervasive litigations.

The advanced investor compensation system

An advanced investor compensation system has been set up in the securities market for the first time by the PRC Securities Law 2020, which is another attempt to resolve the problem of civil liability in domestic capital markets.[32] The stable operation and rapid development of the securities market lies in the existence of investor confidence. Clearly, the maintenance of investor confidence depends on a fair market environment. Therefore, the advanced investor compensation system plays an important and indispensable role in protecting investors' rights, contributing to more investor confidence and the stability of the securities market. In China, the first compensation plan was made by the securities sponsor Ping An Securities in the case of *Wanfu Biotechnology*,[33] which set a precedent for advanced compensation in capital markets. In September 2012, the listed company Wanfu Biotechnology was investigated by the CSRC for alleged false statements. Its lead underwriter, Ping An Securities, agreed to contribute money to establish a special fund and entrusted China Securities Investor Protection Fund Co Ltd as the fund manager, to compensate eligible investors and achieve financial reconciliation with those potential plaintiffs.[34] The *Wanfu Biotechnology* case provides guidance for setting up the investor compensation system in the PRC Securities Law 2020. The establishment of such system echoes the principle in the PRC Consumer Rights Protection Law and PRC Social Insurance Law, which tries to strike a balance between public policy and market discipline in order to protect the disadvantaged groups.

The idea of launching the advanced payment system in China was first inspired by the Federal Account for Investor Restitution Fund (hereinafter Fair Fund) in the US. The SEC will set up a fund through administrative proceedings or civil litigations, by using the disgorgement, civil penalties or settlement to formulate a distribution plan to compensate the loss-suffering investors or to reward whistle-blowers. As a mean of public compensation, the Fair Fund has been practised in the US over decades and has become the most effective compensation measure for the victims in securities frauds in the US.[35] Different from China's advanced compensation mechanism, the Fair Fund in the US must be approved by the court after the SEC filed a lawsuit, the essence of which is a public welfare fund guaranteed by judicial procedure.[36] By contrast, the expression "may entrust an investor protection institution" in the newly revised PRC Securities Law 2020 implicitly indicates that the Chinese advance compensation system is not compulsory and it is just one of the possible measures for securities dispute settlement. Due to the insufficient institutional design, the entities of the pre-payment compensation system may lack the motivation to make advanced compensation to the victims of securities frauds before a final judgment is made. Another problem is that the PRC Securities Law 2020 does not provide a legal shelter for the advance payers, which means they may still face the risk of being sued after making such compensation to investors. It is because the settlement agreement between the advance payer and investors is only valid as per substantive law, not in accordance with procedure law. Accordingly, the investors' right to sue in court will still exist after the agreement is settled.

To address the aforementioned problem, offering lighter or mitigated punishment under criminal or administrative laws could be used as an incentive for a securities company which volunteers to adopt the advanced compensation system, as it has proved to be effective in the case of *Wanfu Biotechnology*. In doing so, the commercial reputation of the securities companies

[31] Jonathan R. Macey and Geoffrey P. Miller, "The plaintiffs' attorney's role in class action and derivative litigation: Economic analysis and recommendations for reform" (1991) 58 *The University of Chicago Law Review* 1.
[32] PRC Securities Law 2020 art.93. See the section titled: "The better investor protection mechanism" above.
[33] ***
[34] Shirley Yam, "Ping An's compensation of Wanfu IPO investors a test case", *South China Morning Post*, 15 June 2013, *https://www.scmp.com/business/money/markets-investing/article/1261124/ping-ans-compensation-wanfu-ipo-investors-test-case* [Accessed 14 February 2022].
[35] Urska Velikonja, "Public Compensation for Private Harm: Evidence from the SEC's Fair Fund Distributions" (2015) 67 *Stanford Law Review* 331.
[36] Don Carrillo, "Disgorgement Plans Under the Fair Funds Provision of the Sarbanes-Oxley Act of 2002: Are Creditors and Investors Truly Being Protected?" (2007) 6 *DePaul Business and Commercial Law Journal* 315.

will be maintained whilst the financial losses of individual investors will be compensated in the most efficient way. Another suggestion is to introduce a coherent system to deal with different litigation and mediation mechanisms to avoid the risk for securities companies of being sued after fulfilling the compensation as the advance payer. Either the advance payer or investors should be allowed to apply to the people's courts in China to confirm the validity of the settlement agreement after it is agreed upon by both parties. Only when the investors prove that the settlement agreement is made involuntarily or illegally can they file a lawsuit to the court again in order to maximise the efficiency of the compensation system and to avoid the waste of judicial resources.[37]

The cross-border supervision over Chinese securities market

The introduction of cross-border supervision over the Chinese capital markets in light of fraud cases or misleading information disclosure conducted by overseas-listed Chinese companies (which are known as "Chinese concept stocks" in the US) is another breakthrough of the PRC Securities Law 2020. Under the latest Law, where the offering and trading of securities outside mainland China disrupt the order of the Chinese domestic market and infringe upon the lawful rights and interests of domestic investors, the violator shall be punished in accordance with relevant provisions of the PRC Securitires Law 2020 and shall be subject to legal liability.[38] The newly established long-arm jurisdiction has granted the CSRC more power in policing and punishing illegal activities in the overseas securities markets where Chinese companies are listed.

The securities law has been revised as a regulatory response to the recent financial frauds committed by some high-profile Chinese companies, such as Luckin Coffee. The frequent fraudulent investigations against Chinese public companies have made it an urgent task for the new securities law to impose tougher sanctions on financial frauds and to give the CSRC extra power in ensuring the compliance of securities regulations. Known as China's Starbucks, Luckin Coffee has built a successful coffee empire with more than 4,500 cafes all across the country. In 2019, less than two years after opening its first coffee shop, Luckin Coffee floated its shares on the NASDAQ in the US. In 2020, Luckin Coffee was reported to have deliberately fabricated over $300 million of retail sales through the use of related-party transactions.[39] Its shares were shorted by the US investment firm Muddy Waters Research LLC. Later, Luckin Coffee tried to conceal the fraud by inflating its expenses by more than $190 million by creating a fake operations database and changing its bank records and accounting books.[40] Luckin Coffee was fined $180 million by the SEC for conducting accounting frauds.[41]

The Luckin Coffee scandal dominated the headlines of Chinese and US media for several weeks, soon after the implementation of the PRC Securities Law 2020. Its alleged fraud by the SEC triggered a sell-off the company's shares in the US markets and caused a new round of trust crisis in China's concept stocks. This incident stimulates fierce discussions of enhancing securities regulation and information disclosure rules in China. Some believe that the NASDAQ-listed Luckin Coffee should be held accountable to domestic investors in China by the CSRC's long-arm jurisdiction. Others oppose the application of the long-arm jurisdiction under the securities law as it is a complex legal procedure which should be prudently claimed with the principle of international comity after considering the impacts on domestic markets and investors. In practice, the US is the main advocate for the extraterritorial effectiveness of its domestic securities law, as the country has made some comprehensive methods for assessing jurisdictional standards over the past decades.

The US law concerning the territorial scope of the federal securities law is contained in ss.929P(b) and 27(b) of the 929Y of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010.[42] According to the Act, the so-called "conduct" and "effect" tests have been adopted by courts on an ad hoc basis.[43] Under the "conduct" test, courts have jurisdiction over any foreign securities frauds where "a substantial portion of the fraud occurred in the United States and directly caused the harmed board", which mainly examines whether the behaviours which occurred in the US are critical to the entire securities fraud activity.[44] Under the "effect" test, only when the foreign securities activities have "a foreseeable substantial effect in the United States or upon United States citizens" can the courts have jurisdiction over this foreign activity in the securities area.[45] Therefore, the "effect" test is similar to that stipulated by PRC Securities Law 2020, as they focus primarily on the impacts of the fraud on the domestic capital markets and investors.

The question is to what extent the effect would be considered as "foreseeable substantial" when the courts face litigation of this kind. This could be explained in three aspects by referring to the US judicial precedents. First, the effect should be direct and specific. In the *Bersch* case,[46] it will be insufficient to satisfy the "effect"

[37] Lihua Yang, "On the advance payment system after the revision of the new Securities Law" (2020) 5 *Legal Research [Fa Xue Yan Jiu]* 116.
[38] PRC Securities Law 2020 art.2(4).
[39] Alistair Gray, "Luckin Coffee to pay $180m in accounting fraud settlement", *Financial Times*, 16 December 2020.
[40] Gray, "Luckin Coffee to pay $180m in accounting fraud settlement", *Financial Times*, 16 December 2020.
[41] Gray, "Luckin Coffee to pay $180m in accounting fraud settlement", *Financial Times*, 16 December 2020.
[42] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L No.111-203, ss.929P(b)(2), 27(b), 124 Stat.1376, 1862 (2010).
[43] Erez Reuveni, "Extraterritoriality as standing: A standing theory of the extraterritorial application of the securities laws" (2009) 43 *UC Davis Law Review* 1071.
[44] See *Morrison v Nat'l Austl. Bank Ltd* 547 F.3d 167, 171 (2d Cir. 2008).
[45] See *SEC v Berger* 322 F.3d 187, 193 (2d Cir. 2003).
[46] ***

test if the alleged fraudulent activity only has "an adverse effect on this country's general economic interests of American security prices". In other words, a "general effect" alone would not trigger the extraterritorial jurisdictional effects of the US Securities Law. Secondly, the alleged fraud securities activity should have a high degree of relevance to domestic markets, such as the securities being registered in the US or intended to be sold to US investors. In the *Leasco* case,[47] the American plaintiff alleged that he was induced to purchase securities in London by foreign defendants' fraudulent misrepresentations. The Second Circuit denied extending the application of the 1934 Securities Act to fraud securities activities which have no connection with the US stock exchanges, even though the plaintiff suffered severe losses.[48] To be more specific, if the securities in question have no relevance to domestic capital markets, it would be hard to speculate that the fraudster could reasonably foresee the harmful impact on domestic capital markets when committing the fraud. This kind of impact could be coincidental or accidental. Third, the impact of fraudulent securities activity should be widespread. In the *IIT* case where there were 300 US citizens involved and a total amount of $3 million lost claimed by the plaintiff, the Second Circuit again denied applying the long-arm jurisdiction of the 1934 Securities Act in the territory of Bahamas, on the ground that the losses suffered by American investors accounted for merely 0.5% of the entire trust assets, which is unlikely to reach the extent of material impact.[49] These three criteria could be used as references to the application of the long-arm jurisdiction of the new PRC Securities Law 2020 in the context of fraudulent activities.

The enhanced supervision and harsher punishments for committing financial frauds

The latest revision of the Chinese securities regulation has increased the financial penalties for the violation of securities law substantially, with the upper limit of disclosure violation fines increased from RMB 600,000 ($90,000) to RMB 10 million ($1.5 million).[50] As for the fraudulent issuance of securities, the fine was previously capped at 5% of the total fund raised but it is now increased to 100% of the raised fund.[51] Apart from fines, the PRC Securities Law 2020 has clarified the presumption of the fault and joint liability for the issuer's controlling shareholder and actual controller whenever there is a fraudulent issuance or illegal information disclosure. An issuer who conceals any important fact or fabricates any major false content in its announced securities offering documents shall be fined not less than 2 million yuan but not more than 20 million yuan if it has not offered securities; or if the issuer has offered securities, it shall be fined not less than 10% but not more than one time the amount of funds unlawfully raised; the directly responsible person in charge and other directly liable persons shall be fined no less than 1 million yuan but no more than10 million yuan; where the issuer's controlling shareholder or actual controller organises or instigates the commission of any violation of law prescribed in the preceding paragraph, his or her illegal income shall be confiscated and he or she shall be fined not less than 10% but not more than one time the amount of illegal income; if the person in question has no illegal income or the illegal income is less than 20 million yuan, he or she shall be fined no less than 2 million yuan but not more than 20 million yuan; and the directly responsible person in charge and other directly liable persons shall be fined not less than 1 million yuan but not more than 10 million yuan.[52] Apparently, the severe punishments for financial fraud is bringing the level of disclosure requirements in mainland China in line with that in other major financial centres like Hong Kong, Singapore, New York and London, especially for Chinese companies which list or dual-list their shares abroad.

The new law can be justified by following points. First of all, as discussed, the PRC Securities Law 2020 promotes the transition from the approval-based IPO system to the registration-based IPO system for the companies' public offering of securities, which makes the securities regulator act as the gatekeeper to keep an eye on the listed companies and their financial risks. As a result, the obligation of security exchanges to review and check applicant qualification and information disclosure has become consequential. However, it is unrealistic to endorse every issuer's quality regardless of whether the approval-based system or the registration-based system is employed. The latest registration-based IPO system emphasises that, based on the full disclosure of information, the right to choose which companies to invest in is handed over from the regulator to the market, as the listing companies will be selected by the stock market and investors. However, this does not necessarily mean that the listing threshold is reduced. Moreover, a financial fraud made by securities issuers is normally highly complex and well concealed, which makes it impossible for the regulator and auditing agencies to identify and block any companies with such problems. Take Luckin Coffee as an example, the listing and re-financing team of Luckin Coffee consisted of top investment banks like Credit Suisse, Morgan Stanley, CICC International and Haitong International who serve as joint underwriters, with Ernst & Young being its auditor and King & Wood Mallesons and Jingtian & Gongcheng being its lawyers, together with a large number of institutional investors endorsing its IPO. Even

[47] *Leasco Data Processing Equip Corp v Maxwell* 468 F.2d 1326, 1337 (2d Cir. 1972).
[48] See *Leasco Data Processing Equip Corp v Maxwell* 468 F.2d 1326, 1337 (2d Cir. 1972).
[49] See *IIT v Vencap Ltd* 519 F.2d 1001, 1016 (2d Cir. 1975).
[50] PRC Securities Law 2020 art.197.
[51] PRC Securities Law 2020 art.181.
[52] PRC Securities Law 2020 art.181.

after the Muddy Water's short-selling report was released, two of its underwriters still issued a research report to support Luckin Coffee.[53] Therefore, the ex-ante examination of IPO companies is not always effective, so the securities regulation shall focus on the ex-post supervision during and after the IPO and it has to have a delisting system in place which forces rule-breakers like Luckin Coffee to leave the market.

Furthermore, the independence and professionalism of securities intermediaries should always be maintained by law. Referring to the fraud scandal of Kangmei Pharmaceutical, intermediaries sometimes are no longer the market supervisors after the IPO as they could neglect their duties and even collude with listed companies to seek illegal benefits. Therefore, it is necessary to introduce the audit rotation mechanism in which the exchange of auditors and auditing offices co-exist to improve the independence of external auditing.[54] Another effective method to improve the supervision over market intermediaries could be to expand the investigation of involved lawyers, certified public accountants, and asset appraisers and impose fines on them if necessary. The regulator should pay close attention to the potential interest exchange between listed companies and intermediary agencies. PRC Securities Law 2020 also greatly promotes the standardisation of intermediary institutions. Securities companies should not allow others to participate in centralised securities transactions under their names directly. The law also clarifies the joint liability of the securities companies and directly responsible personnel as sponsors and underwriters if they fail to perform their duties with care and diligence. Meanwhile, penalties for the breach of the duty of care by securities service institutions have been increased from a fine of five times of the original business income to 10 times and they could be suspended or prohibited from the securities service business. The newly revised Measures for the Administration of Stock Exchanges (2020) by the CSRC further explains the self-discipline management measures for abnormal trading behaviours, aiming to help stock exchanges better perform the front-tier supervision duties and prevent the violation of securities law in advance. Without doubt, the establishment of such a risk management and monitoring mechanism gives full play to the pre-warning function of intermediary institutions.[55]

Last but not least, it remains important to establish a domestic securities regulatory authority for those Chinese companies which are listed abroad. Such companies not only represent the reputation of Chinese corporations in the international capital markets, but also have an influential impact on the domestic economy if there is major instability in their share price overseas. According to the CSRC regulation, an integrity supervisory cooperative mechanism with overseas securities and futures regulatory agencies should be in place to achieve information sharing effectively.[56] On this basis, the authors suggest that the illegal acts of untrustworthy directors, senior officers and supervisors be included in the national integrity file database to strengthen the deterrent effect of fraud punishment. Finally, to ensure consistency of implementing PRC Securities Law 2020, the authors suggest relevant authorities, such as the CSRC and the Ministry of Justice, to revise relevant ministrative regulations concerning securities regulation by making reference to the US experience in this area.

Conclusion

PRC Securities Law 2020 is widely considered a milestone in the Chinese capital market, which indicates the marketisation and internationalisation reform of the Chinese economy. The implementation of the new Securities Law aims to prevent and control market risks in a more effective manner, to improve the quality of listed companies and, most importantly, to protect the legitimate interests of Chinese and international investors. Five main changes have been discussed in this article, namely: (i) the registration-based system for securities issuance; (ii) the detailed provisions on investor protection; (iii) the advanced investor protection mechanism; (iv) the extraterritorial effectiveness of the Law; and (v) the harsher punishment for financial frauds. As PRC Securities Law 2020 has endorsed the full implementation of the registration-based IPO regime, it requires more stringent ex-post information disclosure for public companies to ensure that investors are treated fairly as they shall be given sufficient and accurate information by the securities issuers to make informed investment choices. The new market-based IPO system also calls for better protection for retail investors in terms of the special treatment of ordinary shareholders, the delegation of shareholder rights, and probably an US-style class action regime. All these reform measures will be beneficial for the long-term growth of a dynamic and efficient capital financing system in China. Clearly, the law reform is likely to unleash the growth potential of Chinese stock markets and create more business opportunities for investors in China and abroad. It will also generate extra incomes for investment banks, international law firms and other professional services firms dealing with global capital markets.

[53] Selina Wang and Matthew Campbell, "Luckin Scandal is Bad Time for U.S.-Listed Chinese Companies" (30 July 2020), *Bloomberg*, *https://www.bloombergquint.com /businessweek/luckin-coffee-fraud-behind-starbucks-competitor-s-scandal* [Accessed 14 February 2022].
[54] Jianbo Song, Peiqing Zhu and Jiaqi Jing, "The trial is still on the way: The legal responsibility of Kangmei Pharmaceutical for financial fraud under the new Securities Law" (2020) 13 *Finance and Accounting Monthly [Cai Kuai Yue Kan]* 134.
[55] Xiaowan Zhao, "Financial fraud of listed companies and prevention measures—based on the case of Kangmei Pharmaceutical" (2020) 6 *Modern Industry [Xian Dai Gong Ye]* 160.
[56] CSRC, Measures for the Supervision and Administration of Integrity in the Securities and Future Markets (2008), art.6.