

# Legal Commentary

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## How Registration-based Reform Impacts Dispute Resolution

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On February 17, 2023, the China Securities Regulatory Commission (CSRC) announced rules related to the registration-based stock issuance system, marking a full transition to the “registration-based” era, 33 years after the establishment of China’s capital markets. In four years since President Xi’s November 2018 announcement of the registration-based pilot reform of the Shanghai Stock Exchange’s (SSE) STAR Market, more directly impactful on market participants than the construction and practice of the offering and trading system may be regulatory actions and dispute resolution. In these intervening years, we have witnessed a comprehensive revision of the Supreme People’s Court’s Judicial Interpretation of False Statements issued nearly 20 years ago, the integration of the bond markets with cross-market administrative enforcement and unified legal applicability, the establishment of a Chinese-style securities class action mechanism and the first “representative litigation”, a decrease in the “shell” value of listed companies and the corresponding transfer of civil liability from issuers to intermediaries, and regulatory storms waged by the CSRC and the downfall of certain high-profile enterprises.

The full roll-out of the registration system is necessary for the maturity of the capital markets, accompanied by adhering to market discipline and solving problems in the market operation in accordance with the rule of law. If the various institutional regulations are the “bones” of China’s capital markets, then the dispute resolution system which properly applies relevant regulations and resolving disputes among market participants are the “feathers” supporting the continuous and stable operation of the market.

Dispute resolution in capital markets typically reflects the game of market participants and the market’s understanding of the rules. Therefore, it is of great significance to understand and predict the impact of the full implementation of the registration system on dispute resolution in China’s capital markets.

### **“False statement” rules expected to become the main provisions for dispute resolution among China’s capital market participants**

The registration-based reform aims to return the power of decision-making back to the market and allow investors to judge the quality and value of issuers. Comprehensive, sufficient, and effective information disclosure is the foundation for ensuring investors’ access to necessary information and making independent decisions. Therefore, the reform further establishes the disclosure-centered registration system framework.

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Emphasizing the business judgment of investors does not mean the government will stand idly by. On the contrary, since the implementation of the registration system, the CSRC has clearly strengthened its enforcement efforts and proactively made negative comments toward information disclosure violations, including those by intermediaries. These regulatory actions have become the practical basis for investors to claim civil compensation based on the legal liability system for false statements under the Securities Law. The core status of false statements rules in capital markets dispute resolution under the registration system can be understood from the following three aspects.

Firstly, false statements are the natural result of violation of disclosure obligations. China has always been equipped with administrative and criminal mechanisms to combat illegal acts of information disclosure, but the results have been unsatisfactory. The civil liability system for false statements can maximize market forces by demanding large civil damage claims from the perpetrators of illegal information disclosure, which will force them to comply with the laws and regulations cautiously. The civil compensation for false statements is the most effective regulating force as tested by the developed market, especially for those who are liable for negligence and to whom the application of criminal and administrative liabilities is limited, such as the managers and directors of listed companies and various intermediaries.

Secondly, the characteristics of the capital markets require the overriding application of special rules in securities law over the general rules of civil and commercial laws. The rules on public offerings, centralized bidding, and net settlement determine that the securities offering and trading should follow the most stringent commercial nominalism. Article 117 of the Securities Law stipulates that the results of transactions conducted according to trading rules developed in accordance with the law may not be changed, except where a securities exchange intervenes. Thus, the general civil and commercial rules such as “recession” and “return of property acquired as a result of contract” are not applicable to securities trading activities. Even fraudulent offerings that directly affecting the implementation of the purpose of the contract need to be dealt with through the false statements system without altering the transaction results.

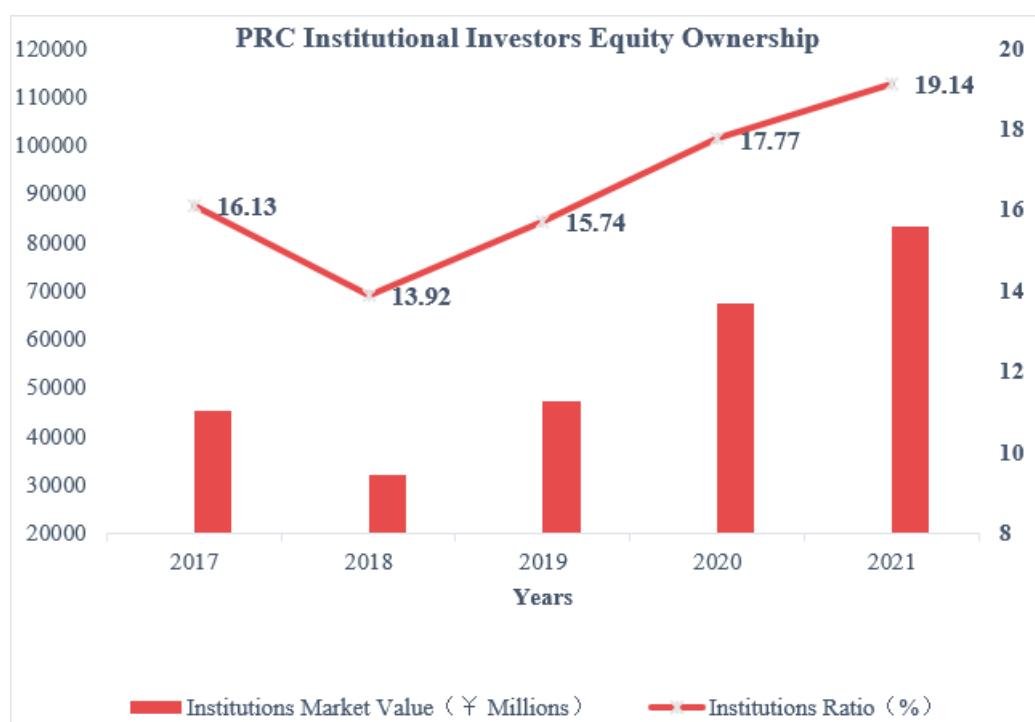
Thirdly, information disclosure is a fundamental requirement of registration-based capital markets. The scope of false statements rules covers all types of securities. In addition to stocks and bonds, non-traditional securities as specified in Article 2 of the Securities Law are also subject to information disclosure requirements. At the same time, China has not yet clearly distinguished between public and private offerings with respect to information disclosure principles and intermediary performance standards. Therefore, different shades of information disclosure requirements and false statements liability have generally existed for a variety of securities activities. Some capital market activities not regulated by the CSRC due to historical reasons also have distinct securities characteristics, such as inter-bank market bonds and regional equity market transactions. Trends in these areas are also prelude to a return to the essence of the Securities Law and uniform legal application.

Therefore, it is not an exaggeration to say that the head of the registration system is information disclosure and its tail is regulating false statements. The full roll-out of the registration system implies that the regulation of false statements will become some of the important rules to resolve disputes in China’s capital markets.

**The protection mechanisms for Chinese investors are constantly improving, with an increased proportion of professional investment institutions, China’s investors’ willingness and ability to protect their rights have greatly strengthened**

The full registration system will form a “sellers responsible, buyers beware” market environment, which poses higher requirements for China’s investor protection mechanisms. Relevant system construction has also been thriving in recent years. The newly revised Securities Law 2019 established the system of special representative litigation in security disputes. In 2021, the China Securities Investor Services Center (ISC) represented tens of thousands of investors in the “Kangmei Pharmaceuticals case”, marking the beginning of Chinese-Style securities class actions.

At the same time, the registration reform will also bring about profound changes in the structure of capital market investors. For a long time, China’s capital markets were dominated by individual investors. The market structure has changed slightly in recent years, but there is still a huge difference between the developed markets such as the UK and the US (where institutional investors account for more than 60% of the market value of shares). After the full implementation of the registration-based system, the gap between individual investors and institutional investors in obtaining information, industry knowledge, technical support, and information processing and understanding will become more apparent. It can be expected that through the market mechanism process, the proportion of institutional investors will increase further.



Source of data: Statistical Yearbooks of Shanghai Stock Exchange during 2018-2022

The combination of these factors will have a profound impact on China’s capital markets dispute resolution field. On the one hand, China’s unique investment protection mechanism, represented by the ISC and special representatives, allows the “national team” to participate in civil disputes in the capital markets, becoming the strongest force beside regulatory agencies to combat securities violations. On the other

hand, institutional investors are significantly higher in terms of professional level and quality of rights protection than individuals, and they can effectively use their advantages in manpower, financial resources, and market information to uncover false statements. Additionally, they are motivated by the institutional responsibility requirements and have extensive experience in evidence preservation and lawyer selection, making them the most powerful opponents in related civil lawsuits.

Finally, although the legal requirement of “preliminary proceedings” has been abolished, false securities statement lawsuits are still mainly based on administrative or criminal investigations. Under the full registration-based system, the disclosure of information is shifting from “regulator-led” to “investor-led”. Perhaps, professional short sellers who specialize in false statement investigations, such as Muddy Waters and Hindenburg Research in the US, will also emerge in China’s capital markets one day in the future.

### **Full implementation of the delisting mechanism and normalization of intermediaries’ civil liabilities**

Delisting is an important component of the registration-based system. While emphasizing market orientation at the entry gate, exits must also implement legal standards more strictly. There must be “life” and “death” to create a healthy ecosystem for the capital markets with “survival of the fittest.” With the full implementation of the registration-based system, the delisting mechanism will enter a new phase of “normalized” operations, with valuable enterprises flowing in and problem enterprises accelerated out.

As delisting involves the interests of many parties, the problem that the process of delisting is stubborn and slow had been very significant in the past two decades before the pilot registration reform. Many listed companies facing delisting risks seized the turning space and used their own listed entity qualifications for capital operations, realizing “resurrection” through “shell selling.” In this situation, even if losses were suffered due to false statements or other violations, investors could always be redeemed from the listed company without having to pursue the responsibility of intermediaries. Objectively, this reduced the liability risks of other market participants.

The four-year pilot registration-based reform and its two-year implementation of the delisting rules have had significant effects. In 2022, the number of delisted companies in China reached a new record high with a total of 43 companies delisted, 42 of which were forcibly delisted, including one that was delisted due to serious financial fraud violations. The opening of the supply side and the normalization of the delisting mechanism have greatly suppressed the “shell” value of listed companies, which has also eroded the “safety cushion” between investors and intermediaries. Faced with delisted companies that have no hope of recovery, investors directly target intermediaries with deep pockets.

Meanwhile, strong support for investor rights protection is found in the newly revised Securities Law and the Judicial Interpretation on False Statements, recent judicial precedents, and increasing regulatory intensity. The volume of compliance incidents and lawsuits claiming compensation against intermediaries is skyrocketing. Suing intermediaries becomes a standard action for investors to protect their rights. With the full implementation of the registration-based system, securities disputes arising due to delisting have become an important arena for fierce competition among all parties.

It is foreseeable that as the registration system reform deepens, the securities regulatory intensity will

continue to increase. Specifically, companies that have been “eliminated” by the market will undoubtedly become the focus of regulation, and intermediaries, and even directors and supervisors of the listed companies, will continue to be under pressure. At the same time, after a company delists, the civil compensation system becomes the last line of defense for investor rights protection, directly affecting market confidence. Therefore, based upon the previous construction of judicial rules and accumulated practical experience, judicial authorities will deal with related disputes more professionally and carefully.

Considering the impact of the full roll-out of the registration-based system as discussed above, intermediaries are expected to be heavily scrutinized by the combination of securities regulation and judicial review in the dynamic regulation of listed companies. Only by fulfilling their due diligence can intermediaries better enjoy the benefits of market development and promote the full registration-based system.

### **Regulatory pressure will further increase with the transformation of CSRC’s functional orientation. Effectively responding to securities regulation will become an important component of dispute resolution in China’s capital markets**

After the full implementation of the registration-based system, it is foreseeable that the numbers and scales of the listed companies will run up high. The regulatory targets will be more complex and diverse. In the long run, while the CSRC has devolved the listing approval power, the securities regulation activities in China may change as follows.

#### **Firstly, the establishment and improvement of coordinated enforcement at the horizontal and vertical level regulatory system.**

On the horizontal level, the *Opinions of the General Office of the CPC Central Committee and the General Office of the State Council on Strictly Cracking Down on Illegal Securities Activities in Accordance with the Law* emphasizes the need to strengthen the cooperation among the CSRC and public security, judiciary, and market regulation authorities, integrate criminal, administrative, and civil legal means, and form a joint force to effectively crack down on securities illegal activities.

At the vertical level, the current regulatory tools of the CSRC include administrative penalties, administrative regulatory measures, self-discipline measures at the exchange and association level, etc., and a multi-level regulatory toolkit system that is in line with the characteristics of China’s capital markets has been initially formed. The CSRC’s administrative penalty procedures have become increasingly standardized and mature with the promulgation of documents such as the *Rules of the China Securities Regulatory Commission on Administrative Penalty Hearings*, the *Organizational Rules on the Administrative Penalty Commission*, and the *Measures for Administrative Penalties for Securities and Futures Violations*. However, there is no systematic regulation for non-penalty administrative measures, and the procedures for administrative regulation need improvement, such as filing, investigation, determination, and relief. After full implementation of the registration-based system, in order to follow the principle of “equivalency of fault and punishment”, the CSRC is likely to increase the frequency of using regulatory measures to effectively regulate the numerous securities violations and use this as a leverage to continue to improve the multi-level regulatory tools, including administrative penalties, regulatory and

self-discipline measures.

**Secondly, give importance to the application of technological means in regulation and enhance the construction of technology-based regulation.**

The CSRC emphasized in a press briefing on the full implementation of the registration-based system that “it will adapt to the requirements of the full implementation of the registration-based system, accelerate the transformation of regulation, promote the construction of technology-based regulation, and effectively improve regulatory capacity.”

“Construction of technology-based regulation” includes the effectively utilizing technologies such as big data, AI, and blockchain to establish a surveillance and early warning system for the securities and futures markets, building a new regulation enforcement model based on technology, improving the regulation enforcement efficiency, strengthening the identification and early warning of serious violation risks, and achieving effective prevention, timely detection, and precise enforcement. Currently, the CSRC has demonstrated high technological regulatory capabilities in surveillance to provide early warning of insider trading, market manipulation, and other securities violations. In the future, with the development of AI and the increasing need for regulatory practice after the full implementation of the registration-based system, the CSRC will increasingly rely on technology-based regulation in more areas to find and dispose of various securities and futures violations in a timely manner.

**Thirdly, the undertaking system for parties in administrative enforcement of securities and futures is further implemented and more administrative reconciliation cases are emerging.**

In 2015, CSRC’s *Measures for Implementing the Pilot Program for Administrative Reconciliation* and the *Interim Measures for Administration of Administrative Reconciliation Payments* established an initial framework for administrative reconciliation in the areas of securities and futures. In 2021, the PRC State Council issued the *Measures for Implementation of the Rules for Undertakings Made by the Parties to Securities and Futures Administrative Law Enforcement*. Based upon these Measures, in 2022, the CSRC issued the *Provisions on the Implementation of the Rules for Undertakings Made by the Parties to Securities and Futures Administrative Law Enforcement* and the *Measures for Administration of Funds Paid for Undertakings Made by Parties to Securities and Futures Administrative Law Enforcement*, further perfecting the administrative law enforcement and undertakings procedures for the securities and futures industry.

However, due to the high threshold to launch enforcement and undertakings procedures, after years of implementation, the actual number of cases having successfully applied these rules is low. After the full implementation of the registration-based system, it is expected that the administrative law enforcement and undertakings procedures will apply increasingly to cases in which the violations are not serious and being corrected by effective measures, the investors’ losses can be compensated, and adverse effects mitigated.

**Civil liability for market manipulation, insider trading, and other significant securities violations have entered a practical stage, and relevant judgment rules are gradually being established**

When the Securities Law was amended in 2005, it stipulated that those who manipulate the market and engage in insider trading should be held liable for compensating the losses caused to investors. However, these two types of securities violations differ from false statements as they do not target specific investors, and it is very complex in the determination of causation and civil losses. Although there have been studies and discussions on the civil liability issue for more than ten years, judicial practice developed very slowly. In terms of compensation for market manipulation, attempts can be traced back to the “Yi’an Technology” incident in 2001, but due to the lack of legal basis, the court eventually did not file the case against numerous individual investors. Since then, in two other cases, Beijing’s Courts rejected the investors’ cases on the grounds that the claimants failed to establish the causation between investment decisions and losses incurred due to market manipulation. In terms of insider trading, in the 2009 “Pan’s Case” and the “Huang’s Case” in 2012, the court declined the claimants’ cases also mainly on the grounds of no causation. The Supreme People’s Court has yet to issue any corresponding judicial interpretations.

Recently, cases decided in favor of the investors as plaintiffs have started to emerge in both types of disputes. In the first civil compensation case of market manipulation, a Chinese pharmaceutical company listed on the stock market manipulated stock prices by releasing false information. More representatively, the case of a nature person manipulating the stock price of P2P Financial Information Service Co., Ltd. that was tried by Shanghai Financial Court in 2022 involved multiple severe violations such as continuous trading, wash sale, false declarations, and manipulation by information asymmetry. For insider trading, there is only one civil case, the “xxx Securities Company’s Fat-Finger Error case”. However, judgments in this case in 2016 have not triggered the emergence of similar disputes.

Generally speaking, the judicial practice in pursuing civil liability for market manipulation and insider trading is far less developed than that of false statements; however, it is likely to enter a period of rapid development after the full registration reform. One reason is that existing cases have drawn on the successful experiences of false statement cases in terms of core judicial logic, namely registration-based capital markets are centered on information disclosure. In the future, with the further development of false statement dispute rules and theories, the handling of civil liability disputes arising from other illegal securities behaviors will also be improved. On the other hand, what is more important is that the full implementation of the registration-based system is a milestone in China’s steady approach to “market-oriented and law-based” capital markets. Under this background, the establishment and improvement of civil liability legal systems and judicial rules will be given higher priority. In a public occasion, at the Annual Conference of Financial Street Forum 2022 held in Shanghai in November 2022, Wenxue Lin, Head of the Civil Adjudication Tribunal No.2 of the Supreme People’s Court, clearly stated that “[f]raudulent offerings, insider trading, and market manipulation are the ‘tumors’ of the capital markets. We need to start to study the civil compensation issues arising from insider trading and market manipulation.”

Therefore, the impact of full implementation of the registration-based system on China’s capital markets is deeply rooted in culture and ideas and reflected in practice, which will further promote the development of major legal issues such as civil liabilities for insider trading and market manipulation in China’s capital markets.

## ***Important Announcement***

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