THE FUTURE OF SECURITIES CLASS ACTIONS AGAINST FOREIGN COMPANIES: CHINA AND COMITY CONCERNS

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In Morrison v. National Australia Bank Ltd.*, the U.S. Supreme Court limited the application of U.S. securities fraud law in transnational situations. The Supreme Court noted that its decision was influenced by international comity considerations. In this Article, we evaluate the availability of class actions in China in cases involving alleged securities fraud. Because we find that the availability of those actions is too limited to fully protect U.S. shareholders, we argue that U.S. investors should be permitted to bring securities fraud class actions against non-U.S. companies whose securities are traded on a U.S. exchange regardless of where those investors entered into the relevant securities transactions.*

Introduction

Securities law is one of the many settings where the intersection of substantive federal law and the standards and policies underlying class actions has given rise to a rich and deep scholarly literature.[1] The issues have also recently drawn the attention of the U.S. Supreme Court, with the Court accepting class action securities law cases in each of the most recent three terms.[2] Globalization of the financial markets brings a third complicating factor to securities fraud class actions. The constellation of class actions, securities law, and transnational factors has come together as securities fraud by Chinese companies has garnered the attention of the mainstream media, scholars, and policymakers.

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1. *See, e.g.*, Barbara Black, *Eliminating Securities Fraud Class Actions Under the Radar*, 2009 Colum. Bus. L. Rev. 802, 803–06; John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 Colum. L. Rev. 1534, 1534–36 (2006).

2. Amgen Inc. v. Conn. Ret. Plans & Trust Funds, 133 S.Ct. 1184 (2013); Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179 (2011); Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869 (2010). See *infra* note 19 for a brief discussion of the *Amgen* and *Erica P. John Fund* decisions.

This Article focuses on the effects of the U.S. Supreme Court's 2010 decision in *Morrison v. National Australia Bank Ltd.*, which upset decades of lower court jurisprudence by holding that the basic U.S. securities anti-fraud provision reaches a narrower set of class actions involving transnational factors than had been permitted by the lower courts.[3] Although the decision is limited to the application of Section 10(b) of the Securities Exchange Act of 1934[4] ('34 Act) and its accompanying Rule 10b-5,[5] it is situated within the set of recent Supreme Court decisions evidencing skepticism of class actions.[6] Congress acted within days of the *Morrison* decision to extend the Securities and Exchange Commission's (SEC) powers to bring securities fraud lawsuits involving transnational companies. However, scholars, securities industry participants, and policy makers are divided over the appropriate scope of private rights of action. At one end of the spectrum, Professor Merritt Fox argues that private rights of action should not be available against a non-U.S. company even if the company is traded on a U.S. exchange unless the company explicitly chooses to be subject to those suits as a bonding mechanism.[7] At the opposite end of the spectrum of potential approaches, a number of institutional investors and others have advocated a return to the standard developed by the lower courts, which permitted a wide range of securities fraud class actions against foreign companies.[8]

This Article is unique in using China's securities law and class action procedures as a lens through which to consider using class actions in transnational securities fraud cases. This is consistent with the Supreme Court's stated concern with international comity, which it voiced in *Morrison* and led it to circumscribe the reach of Section 10(b). China is particularly important for those interested

3. Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2878, 2888 (2010).

4. 15 U.S.C. § 78j(b) (2006).

5. 17 C.F.R. § 240.10b-5 (2012). Unless otherwise stated, for purposes of this Article, references to Section 10(b) include Rule 10b-5.

6. *See, e.g.*, Francis E. McGovern, *Punitive Damages and Class Actions*, 70 La. L. Rev. 435, 437 (2010) ("[T]he Supreme Court has been extremely skeptical of class actions in personal injury cases."); Alexandra N. Rothman, Note, *Bringing an End to the Trend: Cutting Judicial "Approval" and "Rejection" Out of Non-Class Mass Settlement,* 80 Fordham. L. Rev. 319, 323–24 (2011) (noting recent Supreme Court jurisprudence reflects restraint in use of class actions).

7. *See* Merritt B. Fox, *Securities Class Actions Against Foreign Issuers,* 64 Stan. L. Rev. 1173, 1176 (2012) (referring to Section 10(b) securities law class actions alleging trading losses in the secondary markets as "[f]raud-on-the-market" causes of action).

8. *See* Sec. & Exch. Comm'n, Study on the Cross-Border Scope of the Private Right of Action Under Section 10(b) of the Securities Exchange Act of 1934, 49 & n.179, 50–55 (2012) [hereinafter SEC Study], *available at* http://www.sec.gov/news/studies/2012/929y-study-cross-border-private-rights.pdf.

in considering the effects of U.S. securities class action law on foreign companies, investors, and markets. As noted above, securities fraud by Chinese companies has been widely reported in the last few years. Meanwhile, China's influence on the global economy[9] vastly exceeds the relatively limited attention it has received in U.S. securities and class action literature. China's economy, securities markets, regulation, and approach to class actions have all developed rapidly over the past decade, and every indication is that will continue.

Thus, this Article focuses on the limited question of how China's securities regulation, and particularly its attitudes to securities law class actions, should influence the extent to which U.S. investors may bring securities law class actions under Section 10(b) of the '34 Act. The article begins with a discussion of the current legal landscape in the United States and in China. Part I focuses on the United States. It will explain the basic framework of class actions alleging federal securities fraud and highlight the current debates over the effectiveness of those actions. Part I also examines the import of the Supreme Court's decision in *Morrison* for securities fraud class actions and briefly evaluates reactions by scholars and policy makers. Part II turns to securities fraud regulation in China. That section considers the extent to which law in China limits the ability of investors injured by misrepresentations to bring class actions. As with other countries, China's provisions for multiple-party litigation differ significantly from U.S. class actions. As is typical in comparative articles,[10] this Article will refer to China's multiple-party litigation as class actions unless it is discussing a specific provision of China's law or a precise reference is useful for clarity. The section ends with a discussion of the 2012 class action reform in China.

In Part III, the Article analyzes the barriers to class actions in China and shows how those barriers are comparatively both much higher than in the United States and more significant than a facial comparison of the statutory regimes would indicate. It then discusses the implications of 2012 reform in China for that comparative analysis. Part IV opens by presenting two suggested

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9. *See, e.g.*, Zhijun Sheng & Jing Ma, *An Analysis of Emerging China's Economy and its Influence on World Economy,* 2 RES. IN WORLD ECON. 21, 21 (2011) (noting that China is currently the world's second largest economy and expected to overtake the United States by approximately 2030).

10. *See, e.g.*, Deborah R. Hensler, *The Globalization of Class Actions: An Overview,* 622 ANNALS AM. ACAD. POL. & SOC. SCI. 7, 13 (2009) (using the term "class action" for "civil lawsuits on behalf of large numbers of identifiable but absent parties: other actors who would have standing to bring their own lawsuits but are not formally present in court").

U.S. reforms offered by others. The analysis concludes that, in light of Chinese law on securities class actions, the U.S. reform proposals are problematic from the perspective of U.S. investors and international comity. Instead, we recommend a clear, narrow amendment to Section 10(b). Our proposal advocates extending the right of U.S. investors to bring securities fraud class actions against non-U.S. companies whose securities trade on U.S. securities exchanges regardless of where those investors entered into the relevant securities transactions. The proposal balances the comity concerns articulated in *Morrison* with the benefits of investor protection and market integrity.

I. Brief History and Current Status of Class Actions in Securities Fraud Litigation in the United States

Class action lawsuits alleging securities fraud under Section 10(b) are governed by both federal securities and civil procedure laws. Commentators have long debated the extent to which the SEC may be more effective and efficient at enforcing the securities laws than private plaintiffs.[11] In partial response, Congress imposed specific restraints on securities law class actions in the Private Securities Litigation Reform Act of 1995.[12] Still, the basic rules of class actions apply in securities fraud lawsuits. Thus, Rule 23 of the Federal Rules of Civil Procedure (Rule 23) governs certification of classes in those lawsuits.[13] Whether discussing class actions or private rights of action for securities fraud, or both, scholars frequently articulate the underlying goals as some combination of compensation and deterrence.[14] An extensive literature exists, however, considering and disagreeing on whether the U.S. system of private rights of action

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11. *See, e.g.*, James J. Park, *Rules, Principles, and the Competition to Enforce the Securities Laws,* 100 Calif. L. Rev. 115, 123 (2012) (discussing Joseph Grundfest's proposal for the SEC to increase the hurdles for private plaintiffs).

12. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended at 15 U.S.C. §§ 77z-1 to 78u-5 (2006)).

13. *See* Fed. R. Civ. P. 23; United Steel Workers Int'l Union v. ConocoPhillips Co., 593 F.3d 802, 806 (9th Cir. 2010).

14. *See, e.g.*, Black, *supra* note 1, at 806 (referring to "the two rationales—compensation and deterrence—for the federal securities class action"); Coffee, *supra* note 1, at 1538 ("From a policy perspective, the securities class action has two potential rationales: compensation and deterrence."); Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation,* 2009 Wis. L. Rev. 333, 336 ("[P]rivate securities litigation is typically described as serving two goals: compensation and deterrence."); Alexandra Lahav, *Fundamental Principles for Class Action Governance,* 37 Ind. L. Rev. 65, 70 (2003) ("There are two substantive justifications for permitting groups to litigate through the class action mechanism: compensation and deterrence.").

under Section 10(b), and particularly of class actions under the section, is effective in achieving either deterrence or compensation and what to do about the perceived deficiencies.[15]

Section 10(b) prohibits the "use . . . in connection with the purchase or sale of any security . . . [of] any manipulative or deceptive device . . . ."[16] Facially, that language establishes a flexible prohibition on securities fraud. Some recent commentators have argued, though, that the pendulum has swung too far in favor of securities issuers, as Congress and the Supreme Court have cabined the application of Section 10(b) by establishing significant hurdles for plaintiffs. In the authors' view, the most substantial of these hurdles are limitations on discovery, the need to state particularized claims, and the requirement to show loss causation.[17]

To state a securities fraud claim under Section 10(b), a private "plaintiff must allege the following: (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation."[18] Courts continue to struggle with questions about the extent to which plaintiffs must offer proof of various elements of a Section 10(b) case at the class certification stage. This and other issues encountered by courts when certifying a class in a securities fraud case typically require analysis of the intersection of the applicable section of Rule 23 with the elements of a Section 10(b) claim.[19]

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15. *See, e.g.*, Coffee, *supra* note 1.

16. 15 U.S.C. § 78j(b) (2006).

17. *See, e.g.*, Elizabeth Cosenza, *Paradise Lost: § 10(b) after* Morrison v. National Australia Bank, 11 CHI. J. INT'L L. 343, 372 (2011) ("[T]he Supreme Court has recently reinforced the need to construe narrowly the implied private right of action under § 10(b)."); Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5,* 108 COLUM. L. REV. 1301, 1349 (2008) ("Securities class action reform efforts to date have tended to follow the narrowing approach."). *But see* A.C. Pritchard, *Securities Law in the Roberts Court: Agenda or Indifference?*, 37 J. CORP. L. 105, 142–43 (2011) ("*Tellabs, Halliburton,* and *Jones* all rebuffed efforts by lower courts to narrow the gates through which securities class actions could proceed.").

18. *In re* BP P.L.C. Sec. Litig., 843 F. Supp. 2d 712, 746 (S.D. Tex. 2012).

19. For example, in its 2011 decision in *Erica P. John Fund, Inc. v. Halliburton Co.*, the Supreme Court held that loss causation did not need to be proven at the class certification stage, reversing a decision by the Fifth Circuit that a plaintiff must "prove the separate element of loss causation in order to establish that reliance was capable of resolution on a common, classwide basis." 131 S. Ct. 2179, 2184–86 (2011). One issue on which the circuits remain divided is whether plaintiffs must prove materiality in a misrepresentation case before a district court may grant class certification in a case where the plaintiffs seek to rely on the fraud-on-the-market theory. *Compare In re* DVI, Inc. Sec. Litig., 639 F.3d 623, 631 (3d Cir. 2011) (holding that proof of materiality is not required to certify a class that relies on the fraud-on-the-market presumption), *and* Schleicher v. Wendt, 618 F.3d 679, 685 (7th Cir. 2010) (same), *with In re* Salomon Analyst Metromedia Litig., 544 F.3d 474, 481 (2d Cir. 2008)

This Article focuses on the implications of the Supreme Court's decision in *Morrison v. National Australia Bank Ltd.*[20] for the use of class actions in transnational securities fraud settings. In *Morrison,* the Supreme Court considered what has come to be known as an F-cubed case—one where foreign plaintiffs bring a class action alleging a fraud violation under Section 10(b) by a foreign defendant regarding securities the plaintiffs purchased on a foreign exchange. One defendant, National Australia Bank Ltd. (NAB), had issued securities that traded on the Australian Stock Exchange Limited and a variety of other exchanges, and its American Depository Receipts (ADRs) traded on the New York Stock Exchange (NYSE) in the United States.[21] After the sole U.S. lead plaintiff dropped out early in the litigation, the remaining class members were all Australian investors who had purchased their NAB stock on an Australian exchange.[22] They alleged that NAB had committed fraud in violation of Section 10(b) by misstating the financial results of a U.S. subsidiary.[23]

The Second Circuit had applied the widely accepted conduct and effects test, which permitted a securities fraud case to be brought in the United States if it alleged that either "'the wrongful conduct had a substantial effect in the United States or upon U.S. citizens'" or "'the wrongful conduct occurred in the United States.'"[24] The Supreme Court reversed, concluding that Congress did not evidence an intent that Section 10(b) should have extraterritorial application.[25] The majority did not believe that fraud actions in cases involving transnational factors are necessary to protect U.S. markets, stating: "While there is no reason to believe that the United States has become the Barbary Coast for those perpetrating frauds on foreign securities markets, some fear that it has become the Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets."[26]

(holding that plaintiffs must prove materiality before class certification in order to rely on the fraud-on-the-market presumption), Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 264 (5th Cir. 2007) (same), *and In re* PolyMedica Corp. Sec. Litig., 432 F.3d 1, 7 & n.11 (1st Cir. 2005) (stating in dictum that plaintiffs must prove materiality to gain class certification). The Supreme Court decided in *Amgen, Inc. v. Connecticut Retirement Plans and Trust Funds* that plaintiffs are not required to prove materiality as a prerequisite to the certification of a § 10(b) claim. 133 S. Ct. 1184, 1199 (2013).

20. Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869 (2010).

21. *Id.* at 2875.

22. *Id.* at 2876.

23. *Id.*

24. *Id.* at 2879 (quoting SEC v. Burger, 322 F.3d 187, 192–93 (2d Cir. 2003)).

25. *Id.* at 2883.

26. *Id.* at 2886.

Under the Court's formulation, the only transactions to which Section 10(b) can be applied are those that are "in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States."[27]

The key to the Supreme Court majority's analysis, and the portion on which two concurring Justices disagreed, was its definition of what constitutes an extraterritorial application of Section 10(b). First, the majority focused on the language of Section 10(b), which extends only to fraud that is connected with "the purchase or sale of" a security.[28] Using that as a limiting principle, it focused on securities traded on U.S. exchanges and other purchases or sales within the United States.[29] After referring to other sections of federal securities law, the Court turned to consideration of the potential effects of F-cubed Section 10(b) cases on international comity. The Court recognized that significant differences exist between the availability and process of class action litigation and the definition of securities fraud in the United States as compared to other countries.[30] In response to the comity concerns, the Solicitor General advocated a test that would require "significant and material conduct" in the United States to support a right of action under Section 10(b).[31] The Court acknowledged the Solicitor General's opinion that its recommended formulation would be harmonious with "prevailing notions of international comity" but rejected the approach as inconsistent with the Court's view that Congress had failed to express an intent in favor of transnational application of Section 10(b).[32]

The scholarship that has analyzed *Morrison* consistently recognizes that the decision significantly narrowed the application of Section 10(b) as compared to the conduct and effects test used for many years by the circuits.[33] In the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress responded to the *Morrison* decision by granting the SEC jurisdiction to pursue 10(b) actions

27. *Id.* at 2888.
28. 15 U.S.C. § 78j(b) (2006).
29. Morrison, 130 S. Ct. at 2884–85.
30. *Id.* at 2885–86.
31. *Id.* at 2887.
32. *Id.* at 2887–88.
33. *See, e.g.*, Genevieve Beyea, Morrison v. National Australia Bank *and the Future of Extraterritorial Application of the U.S. Securities Laws,* 72 OHIO ST. L.J. 537, 568 (2011) ("*Morrison* clearly narrowed the extraterritorial application of the securities laws from the previous state of affairs under the old conduct and effects tests."); Pritchard, *supra* note 17, at 139 ("The second area where the Roberts Court has confined securities class actions is the extraterritorial reach of the federal securities laws.").

where an actor engages in "(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States."[34] Congress also required the SEC to study the extent to which legislative action should be taken to reestablish private rights of action where those claims would be prohibited by *Morrison*.[35]

Not surprisingly, given the short time that has elapsed since *Morrison* and its departure from years of lower court jurisprudence, neither scholars nor courts agree on the precise boundaries of securities class actions in the post-*Morrison* era.[36] One important category of issues involves cases brought by classes of U.S. investors to enforce Section 10(b) for securities transactions they made on a non-U.S. exchange. To date, the lower courts have uniformly dismissed claims associated with those transactions, holding that the

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34. Dodd-Frank Act § 929P(b)(2)(B), 15 U.S.C.A. § 78aa(b) (West 2012). *But see* Richard Painter, Douglas Dunham & Ellen Quackenbos, *When Courts and Congress Don't Say What They Mean: Initial Reactions to* Morrison v. National Australia Bank *and to the Extraterritorial Jurisdiction Provisions of the Dodd-Frank Act*, 20 Minn. J. Int'l L. 1, 2–3 (2011) (arguing that Congress failed to extend the scope of the SEC's extraterritorial powers because the statutory language grants the SEC subject matter jurisdiction whereas the Supreme Court's decision was based on the scope of Section10(b)). A parallel may be drawn here between the Congress' grant of power to the SEC and its similar response to the Supreme Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), that Section 10(b) does not provide a cause of action for aiding and abetting securities fraud. Although after the *Central Bank* decision the SEC Chairman argued in favor of an amendment providing for private causes of actions, Congress passed legislation granting the SEC, but not investors, the power to bring aiding and abetting actions. *See* Shuenn (Patrick) Ho, Recent Development, *A Missed Opportunity for "Wall Street Reform": Secondary Liability for Securities Fraud After the Dodd-Frank Act,* 49 Harv. J. on Legis. 175, 187–88 (2012). Many have argued that the SEC has been ineffective in addressing the problem of aiding and abetting securities fraud, whether through a lack of resources or insufficient interest in the issue, and legislation has been proposed to permit private civil actions. *See, e.g.*, U.S. Gov't Accountability Office, GAO-11-664, Securities Fraud Liability of Secondary Actors (2011) (reviewing the controversy regarding private actions to address aiding and abetting of securities fraud); Ho, *supra*, at 183–90; Melissa C. Nunziato, Comment, *Aiding and Abetting, a Madoff Family Affair: Why Secondary Actors Should be Held Accountable for Securities Fraud Through the Restoration of the Private Right of Action for Aiding and Abetting Liability Under the Federal Securities Laws*, 73 Alb. L. Rev. 603 (2010); *cf.* Joseph A. Franco, *Of Complicity and Compliance: A Rules-Based Anti-Complicity Strategy Under Federal Securities Law*, 14 U. Pa. J. Bus. L. 1 (2011) (arguing for anti-complicity policies as a way of targeting those who provide assistance to securities fraud violators).

35. Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, § 929Y(a) (2010). The study evaluated a variety of options but did not make a final recommendation. SEC Study, *supra* note 8.

36. *See* SEC Study, *supra* note 8, at 28–38 (discussing post-*Morrison* litigation in the lower courts).

Morrison test precludes them.[37] As discussed below in Part IV.B, our reform proposal is targeted at that category of cases.

The commentary on *Morrison* has been extensive, but there is no clear path forward on the appropriate scope of class action securities fraud lawsuits in situations with transnational factors. At one end of the spectrum are proposals that would protect non-U.S. companies from all or most class action fraud lawsuits. The most thoroughly argued of those proposals is offered by Professor Fox who, after engaging in a detailed analysis based largely on inefficiencies associated with other approaches, argues that non-U.S. companies should only be subject to U.S. securities fraud actions if they explicitly choose to be subject to those actions (Fox Proposal).[38] The opposite perspective, from those who argue that the class actions claiming U.S. securities fraud should be widely available to non-U.S. investors and against non-U.S. companies, tends to advocate a return to some version of the conduct and effects standard developed by the lower courts (Conduct and Effects Proposals).[39] After the next Part analyzes the development and availability of class action securities fraud litigation in China, Part III will consider how the differing regulatory approaches of the United States and China result in more significant differences in the rights of action for shareholders than is superficially apparent based on the comparative regulatory regimes.

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37. *See, e.g.*, *In re* BP P.L.C. Sec. Litig., 843 F. Supp. 2d 712, 793–97 (S.D. Tex. 2012); *In re* Vivendi Universal, S.A. Sec. Litig., 842 F. Supp. 2d 522, 528 (S.D.N.Y. 2012); *In re* Royal Bank of Scot. Grp. PLC Sec. Litig., 765 F. Supp. 2d 327, 337 (S.D.N.Y. 2011). Other even more complex questions are beyond the scope of this Article, including the extent to which transactions involving ADRs, derivatives, or swaps may serve as the basis for a private right of action. *See, e.g.*, SEC STUDY, *supra* note 8, at 30–31, 36–38.

38. Fox, *supra* note 7, at 1272–73. For a more detailed discussion of Professor Fox's argument see *infra* Part IV.A.

39. *See, e.g.*, SEC STUDY, *supra* note 8, at 49 n.179 (citing thirty-nine comment letters supporting statutory adoption of the conduct and effects test). A variety of proposals advocate adopting a test that would permit a greater range of class actions than allowed by the *Morrison* test but less than a return to the full conduct and effects test. *See, e.g.*, *id.* at 55–58 (outlining various alternative approaches proposed by commenters); Cosenza, *supra* note 17, at 343 (proposing a test permitting private actions where those actions meet both a conduct and effects requirement); Marco Ventoruzzo, *Like Moths to A Flame? International Securities Litigation After* Morrison*: Correcting the Supreme Court's "Transactional Test,"* 52 VA. J. INT'L L. 405 (2012) (proposing a revised effects test); E-mail from Forty-Two Law Professors to Elizabeth M. Murphy, Sec'y, Sec. and Exch. Comm'n (Feb. 18, 2011), *available at* http://www.sec.gov/comments/4-617/4617-28.pdf (proposing a fraud-in-the inducement test).

II. Development of Class Action Securities Fraud Litigation in China

This Part begins by providing an overview of China's securities markets and regulation. In the next section, it discusses the current status of class action securities fraud litigation. It then analyzes early cases of class action securities fraud litigation in China in some detail. Finally, it considers the 2012 amendments to China's Civil Procedure Law (CPL),[40] which are intended to expand access to class actions.

A. *China's Securities Exchanges and Securities Law*

The first modern stock exchanges were established in China in the early 1990s,[41] and the initial national securities legislation followed in 1998.[42] As of the end of 2009, 870 companies were listed on the Shanghai Stock Exchange, China's largest exchange, with a market capitalization of $2.78 trillion.[43] The other major exchange, the Shenzhen Stock Exchange, consists of three boards with 830 listed companies and a total market capitalization of $1.4 trillion. In roughly comparable data, the U.S.-based NYSE had the world's largest domestic equity market capitalization at the end of 2011 at almost $12 trillion. The NASDAQ, also a U.S. exchange, was second at approximately $3.8 trillion. The Shanghai Stock Exchange was the sixth largest in the world.[44]

The growth of the Chinese exchanges, even during the global financial crisis, has been substantial. Between 2007 and 2009, the

40. Zhonghua Renmin Gongheguo Minshi Susong Fa (中华人民共和国民事诉讼法) [Civil Procedure Law of the People's Republic of China (CPL)] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 28, 2007, effective Apr. 1, 2008).

41. *See* Wallace Wen-Yeu Wang & Chen Jian-Lin, *Reforming China's Securities Civil Actions: Lessons from PSLRA Reform in the U.S. and Government-Sanctioned Non-Profit Enforcement in Taiwan*, 21 Colum. J. Asian L. 115, 121 (2008).

42. *See* Guo Li & Allan V.Y. Ong, *The Fledgling Securities Fraud Litigation in China*, 39 H.K. L.J. 697, 697–98 (2009).

43. *See* Int'l Monetary Fund [IMF] & The World Bank, *IOSCO Objectives and Principles for Securities Regulation: Detailed Assessment of Observance*, at 4, IMF Country Report No.12/80 (Mar. 2012), *available at* http://www.imf.org/external/pubs/ft/scr/2012/cr1280.pdf.

44. *See* World Fed'n of Exchs. [WFE], *2011 WFE Market Highlights*, at 6 (Jan. 19 2012), *available at* http://www.world-exchanges.org/files/file/stats%20and%20charts/2011%20WFE%20Market%20Highlights.pdf. Tokyo and the London Stock Exchange were third and fourth respectively. *Id.*

total market capitalization of public companies approximately tripled. During the same period, the number of securities accounts in China more than doubled to over 170 million individual accounts.[45]

Although foreigners may purchase certain types of securities on China's exchanges, only Chinese companies may list their securities on those exchanges.[46] Chinese companies may issue a variety of classes of stock, which are conventionally labeled as A shares or B shares.[47] If a company lists its A Shares (the basic type of shares) on a Chinese exchange, then it also is permitted to list B shares. Typically, the only types of shares that foreign investors are permitted to purchase are B shares and, in turn, B shares are held only by foreign investors.[48]

The China Securities Regulatory Commission (CSRC) has engaged in some preliminary planning in the event that listings by non-Chinese companies are permitted in the future.[49] It appears reasonably probable that China will launch an International Board at the Shanghai Stock Exchange on which the securities of non-Chinese companies could be listed during the next few years.[50]

The current version of the Securities Law of China became effective in 2006.[51] The stated goals of the Chinese securities law are to "standardize the issuing and trading of securities, protect the lawful rights and interests of investors, safeguard the economic order and

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45. *See* IMF & The World Bank, *supra* note 43, at 6. In addition, China has multiple futures exchanges. *Id.* at 4–6.

46. *See* Zhang Yong, *China's International Board a Step Closer,* ECON. OBSERVER, Sep. 20, 2010, at 23, *available at* http://www.eeo.com.cn/ens/finance_investment/2010/09/23/181547.shtml. *But see* Amy Li, *Shanghai Bourse: No "Material Plan" for International Board,* DOW JONES VENTURE WIRE (June 4, 2012), http://pevc.dowjones.com/article?an=DJFVW00020120604e864qe57q&from=alert&pid=32&ReturnUrl=http%3a%2f%2fpevc.dowjones.com%3a80%2farticle%3fan%3dDJFVW00020120604e864qe57q%26from%3dalert%26pid%3d32 ("The Shanghai Stock Exchange said Monday it has no 'material plan' for launching an international board on which foreign companies can list . . . ").

47. *See* Wei Shen, *Face Off: Is China a Preferred Regime for International Private Equity Investments? Decoding a "China Myth" from the Chinese Company Law Perspective*, 26 CONN. J. INT'L L. 89, 99 (2010). A discussion of the differences between the various categories of shares is beyond the scope of this Article. Foreigners are permitted to purchase A shares in China only if they are approved as Qualified Foreign Institutional Investors (QFII). Jiangyu Wang, *Dancing with Wolves: Regulation and Deregulation of Foreign Investment in China's Stock Market,* 5 ASIAN-PAC. L. & POL'Y J. 1, 22–24 (2004). Changes in late 2011 created an expectation that the typical time period to gain approval as a QFII would shrink from one to two years to about six months. *See* Rocky T. Lee, *Opportunity to Invest in China's Securities Market: The Accelerated Approval Process for Foreign Financial Institutions*, CADWALADER (Mar. 16, 2012), http://www.cadwalader.com/assets/client_friend/031612AccelaratedApprovalProcessForeignFinInst.pdf.

48. *See* Shen, *supra* note 47, at 99.

49. *See* IMF & The World Bank, *supra* note 43, at 54.

50. *See* Yong, *supra* note 46.

51. *See* Li & Ong, *supra* note 42, at 698.

public interests of society and promote the development of the socialist market economy."[52] Thus, although investor protection is a concern of the statute, that concern must be balanced with considerations of the regulatory effects on the Chinese economy.

Primary regulatory responsibility is held by the CSRC, and private rights of action have not been used extensively in securities fraud.[53] One significant limitation on private rights of action is that there are only two circumstances in which courts are permitted to hear lawsuits brought by investors alleging false statements: either the CSRC must have made a prior decision on an administrative penalty or the People's Court (as the lower courts are designated) must have issued a finding of a false statement in a criminal case brought by the People's Procuratorate, the entity with prosecutorial power.[54] The net effect is that the right of securities investors to bring misrepresentation claims is dependent on the government's willingness to bring a prior action based on the same facts. Both the CSRC and the People's Procuratorate have limited resources to pursue actions.[55] Further, the administrative processes of the CSRC and the People's Procuratorate have been criticized for lack of transparency, and questions of bribery and political or social influences have been raised.[56] Other limitations on private rights of action to pursue misstatement claims are based in the regulation of suits brought by more than one party, which is discussed in the next section. Finally, private securities fraud claims may be brought only in cases involving publicly traded securities.[57]

The revisions to China's securities laws that became effective in 2006 resulted from the growth and changes in China's securities markets in the late 1990s and early 2000s. Professors Baoshu Wang and Hui Huang identify four factors as the basis for the 2006 reforms: (1) development of various corporate ownership structures, including entities with primarily state ownership and others with solely private ownership; (2) a decrease in government influence and increase in market forces; (3) a need to liberalize certain aspects of the 1999 Securities Law; and (4) the existence of corporate fraud, resulting in decreased investor confidence and falling values

52. Roman Tomasic & Jian Fu, *The Securities Law of the People's Republic of China: An Overview*, 10 Austl. J. Corp. L. 268, 271 (1999).

53. *See* Li & Ong, *supra* note 42, at 698.

54. *See id.* at 705–06; *see also infra* note 127 (discussing the limited rights of individuals to initiate government actions).

55. *See* Li & Ong, *supra* note 42, at 706.

56. *See id.* at 707.

57. *See id.* at 701.

on the stock exchanges.[58] One example of changes included in the 2006 revisions is that, similar to the Gramm-Leach-Bliley Act of 1999 in the United States,[59] the structural segmentation of banking, securities, and insurance entities was decreased.[60] This responded to the concern identified by Wang & Huang that portions of the 1999 Act needed to be liberalized in order to decrease regulatory boundaries among institutions and increase the synergies in financial sector firms.

Professor Wang JiangYu has argued that since 1998 China has shifted its securities regulatory approach from one based on government control to a more disclosure-based system.[61] He cites numerous requirements of full and accurate disclosure that are specific to initial public offerings.[62] However, China's securities law does not contain provisions permitting groups of investors to bring lawsuits to enforce the requirement that companies issue the required disclosure. Instead, their rights are limited to pursuing cases of inaccurate disclosure.[63] Recent reports of government-backed interference with attempts by investors to investigate Chinese companies may indicate a retrenchment of the trend toward increased corporate disclosure.[64]

In sum, China's securities markets have developed rapidly since the opening of the first modern exchange in the early nineties. Regulatory reform has followed but, even apart from the restrictive class action procedures discussed in the next section, protections for shareholders remain substantially less robust than in the United States. A recent report coauthored by the IMF and The World Bank concluded that:

> [T]he legal system (in particular, the commercial courts) and the effect of market discipline provided by institutional investors and other participants on corporate governance is not as

58. *See* Baoshu Wang & Hui Huang, *China's New Company Law and Securities Law: An Overview and Assessment*, 19 AUSTL. J. CORP. L. 229, 229–31 (2006).

59. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of 12 and 15 U.S.C.).

60. *See* Wang & Huang, *supra* note 58, at 237.

61. *See* Wang JiangYu, *Regulation of Initial Public Offering of Shares in China*, 76 CHINA L. 54, 63 (2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1382577.

62. *Id.* at 63–74; *see also* Xiao Huang, *Modernising the Chinese Capital Market: Old Problems and New Legal Responses*, 21 INT'L COMPANY & COM. L. REV. 26, 37 (2010) (discussing the information requirements for initial public offerings).

63. *See* Walter Hutchens, *Private Securities Litigation in China: Material Disclosure About China's Legal System?* 24 U. PA. J. INT'L ECON. L. 599, 629 (2003).

64. *See* Dinny McMahon & Kathy Chu, *Clampdown in China on Corporate Sleuthing*, WALL ST. J. (July 19, 2012, 6:45 PM), http://online.wsj.com/article/SB10000872396390444097904577536483359775436.html.

> significant in China as in other jurisdictions . . . In combination, these factors undermine the capacity of private legal action to have a meaningful practical impact on compliance.[65]

B. The Current Legal System of Class Action Litigation in China

The closest Chinese parallel to the United States' Federal Rule of Civil Procedure 23's class action provisions can be found in the CPL, China's general civil procedure law. In addition to traditional litigation involving one plaintiff against one defendant, three provisions in China's current CPL appear on their face to permit litigation to be brought by or against more than one person or entity. The first possibility is joint litigation. The second is representative litigation where each party is known when the suit is filed. The third is representative litigation where some parties remain unidentified at the time of filing. Each of these types of litigation is explained below.

CPL Article 53 sets forth the rules for joint litigation, also called "non-representative group litigation."[66] If there are two or more persons as either plaintiff or defendant and the subject matter of the action is the same or of the same category, the litigation is referred to as joint litigation.[67] If the number of plaintiffs or defendants reaches ten, the litigation typically would be brought as one of the two types of representative litigation discussed next, not joint litigation.[68] A lower court, known as a People's Court, may, at its discretion, adjudicate the claims together as a joint action if all parties consent. If the joint parties have common rights and obligations with respect to the subject matter of the lawsuit and an action by any of them that is related to the lawsuit, such as a decision on

65. IMF & The World Bank, *supra* note 43, at 9.

66. Michael Palmer & Chao Xi, *Collective & Representative Actions in China*, Global Class Actions Exchange 2–3 (2007), http://globalclassactions.stanford.edu/sites/default/files/documents/China_National_Report.pdf.

67. CPL art. 53 (1991). Technically, Article 53 applies to all categories of class action litigation, but it typically is viewed as primarily governing joint litigation. *See* Palmer & Xi, *supra* note 66, at 2.

68. "The circumstance [sic] 'one party has numerous litigants' as prescribed in Articles 54 and 55 of the Civil Procedure Law generally refers to ten persons or more." Zuigao Renmin Fayuan Guanyu Shiyong Zhonghua Renmin Gongheguo Minshi Susong Fa Ruogan Wenti De Yijian (最高人民法院关于适用《中华人民共和国民事诉讼法》若干问题的意见) [Opinions of the Supreme People's Court on Some Issues Concerning the Application of the Civil Procedure Law of the People's Republic of China] (promulgated by Sup. People's Ct., July 14, 1992), *available at* http://www.cietac.org/index/references/Laws/47607cb9b0f4987f001.cms; *see also* Palmer & Xi, *supra* note 66, at 4.

counsel, is recognized by the others, that act is legally binding on the other members. If the joint parties do not have any common rights or obligations regarding the claims, any acts taken by any member will not be legally binding on the other members.[69]

Alternatively, CPL Article 54 provides for representative litigation involving ten or more plaintiffs or defendants where all of the parties to the suit are identified at the time the suit is filed. The representatives elected by all of the litigants—who collectively are known as principals—are permitted to bring the litigation. Many of the actions taken by the representatives are binding on all principals. Certain actions, however, including claims modifications or waivers and negotiated settlements, must be approved by all of the principals.[70]

Finally, CPL Article 55 permits representative litigation with unidentified multiple parties. If the number of plaintiffs or defendants is not known at the time the lawsuit is filed but the subject matter of the action is of the same category, then the People's Court may accept the filing. In such a case, the People's Court may, at its discretion, issue a public notice to explain the claims. Interested parties then have a fixed period of time to register their rights with the court.[71] The registration period must be a minimum of thirty days. Once the registration process has ended, the principals elect representatives to proceed with the litigation. If the election does not determine the representatives, the People's Court may appoint the representatives through consultation with all of the registered parties. As with the representative litigation where the parties are known at the time the suit is filed, many actions taken by the representatives are binding on the principals while others require approval. All court judgments and orders are binding on all registered parties and on anyone who has not registered his or her rights but brought legal actions during a specified period, typically two years.[72]

In sum, the CPL provides for multiple types of class action litigation, including representative litigation with large numbers of plaintiffs who are not yet identified when a suit is filed. The next section, however, explains that the Supreme People's Court of the People's Republic of China (Supreme People's Court) has, in effect, limited suits that allege securities fraud to the use of joint

69. CPL art. 53 (1991); *see also* Li & Ong, *supra* note 42, at 709–12 (discussing the use of joint actions in securities fraud cases).

70. *See* CPL art. 54 (1991).

71. *See* CPL art. 55 (1991).

72. *See* Palmer & Xi, *supra* note 66, at 5.

litigation. Part III analyzes a variety of factors that discourage the use of even joint litigation.

C. Early Class Action Securities Fraud Litigation in China

Depending on one's definition, two cases vie for designation as the "first" Chinese class action securities fraud lawsuit. In 2001, 363 investors filed a class action suit against Yorkpoint Science & Technology Co.[73] However, the following day, the Supreme People's Court promulgated a notice temporarily prohibiting lower courts from accepting securities lawsuits from private parties.[74] That resulted in the dismissal of the action. Based on statements by one of the justices of the Supreme People's Court, the rationales for the temporary prohibition were that courts lacked the experience and resources to try and decide securities lawsuits and that the securities markets were too immature to risk the potential costs of legal actions brought by investors.[75]

In early 2002, the Supreme People's Court issued a notice entitled "Acceptance of Cases of Disputes over Civil Tort Arising from False Statements in the Securities Market" ("2002 Securities Notice").[76] Although it permitted courts to accept securities fraud suits, the 2002 Securities Notice prohibited plaintiffs from bringing "group action[s]."[77] Commentators have different views regarding the meaning of this language.[78] Professors Liu and Xu, however, agree with the commentators who believe that it has been applied in Chinese securities litigation to mean that those cases must, in effect, be brought as either individual actions or joint actions.[79]

Within days of the 2002 Securities Notice, investors filed *Chen v. Daqing Lianyi Co.*, the first class action case to be permitted to state

73. *See id.* at 6.

74. *See* Jun Xie & Lijuan Sun, *Access to Collective Litigations in China: A Tough Work*, 3 J. Pol. & L. 45, 47 (2010).

75. *See* Palmer & Xi, *supra* note 66, at 6; Xie & Sun, *supra* note 74, at 47.

76. *See* Li & Ong, *supra* note 42, at 704 & n.17.

77. *See* Palmer & Xi, *supra* note 66, at 6.

78. *See* Donald C. Clarke, *The Private Attorney-General in China: Potential and Pitfalls*, 8 Wash. U. Global Stud. L. Rev. 241, 249 (2009) (stating that securities litigation cannot be brought as "representative actions under article 54 . . . "); Palmer & Xi, *supra* note 66, at 6 (stating a belief that securities litigation cannot be brought under Article 55).

79. Because of the relative scarcity of English-language published material on securities fraud claims involving more than one plaintiff or defendant, this Article relies in part on the expertise of Professors Liu and Xu, both of whom are law professors at well-respected law schools in China. *See also infra* text accompanying notes 83–89 (discussing the decision of a Chinese court to break a securities fraud action into small groups of plaintiffs).

a claim of securities fraud.[80] The case did not proceed, however, until the Supreme People's Court issued a type of statement known as a Provision, which outlines the civil procedure to be used in cases of securities misrepresentations (2003 Securities Provisions).[81] In Provisions, the Supreme People's Court states its view, outside the context of particular litigation, on legal issues of import. Sources are divided as to whether Provisions have the legal effect of legislation or of judicial review, but there is agreement that they do have legal force.[82]

In 1999, the CSRC had begun an investigation into Daqing Lianyi Co.'s (Daqing) revenue statements in its 1997 prospectus and annual report.[83] Daqing's board of directors publicly acknowledged the investigation.[84] The CSRC subsequently determined that Daqing had made untruthful statements in the 1997 prospectus and annual report.[85] The CSRC's administrative penalty against Daqing provided the necessary government action to enable a suit to be brought by Daqing's investors based on the untruthful revenue representations.[86] The defendants were Daqing and Shenyin Wanguao Securities Corporation, the entity that was the listing recommender and main underwriter of the securities during the public offering.[87] The court required the 381 original plaintiffs to divide into groups of ten to twenty, presumably either to come within the general parameters of Section 53 joint litigation[88] or to receive a favorable judicial evaluation as a result of hearing more cases.[89]

The case involved a number of issues—allocation of liability, whether causation existed, determination of economic damages,

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80. Chen Lihua Deng 23 Ming Touziren Su Daqing Lianyi Gongsi, Shenyin Zhengquan Gongsi (陈丽华等23名投资人诉大庆联谊公司、申银证券公司虚假陈述侵权赔偿纠纷案) [Chen v. Daqing Lianyi Co.] (Heilongjiang Province Interm. People's Ct. Aug. 19, 2004). For the convenience of the reader, whenever possible this Article cites secondary resources in its discussion of the case involving Daqing Lianyi. *See* Li & Ong, *supra* note 42, at 704. A questionably translated version of the appellate court's decision is available at http://www.eastlaw.net/cases/corp/Daqinglianyi.htm.

81. Xi Chao, *Private Enforcement of Securities Law in China:* Daqing Lianyi Co. v. Zhong Weida and Others *(2004) Heilongjian High Court*, 1 J. COMP. L. 492, 493 (2006).

82. *See* M. Ulric Killion, *Quest for Legal Safeguards for Foreign Exporters Under China's Anti-Dumping Regime*, 29 N.C. J. INT'L L. & COM. REG. 417, 446 (2004); Palmer & Xi, *supra* note 66, at 1 (calling the explanations "binding on all courts").

83. *See* Ling Dai, Comment, *The Judicial Application of the Causation Test of the False Statement Doctrine in Securities Litigation in China*, 15 PAC. RIM L. & POL'Y J. 733, 755 (2006).

84. *See id.*

85. *See id.*; Charles Zhen Qu, *An Outsider's View on China's Insider Trading Law*, 10 PAC. RIM L. & POL'Y J. 327, 330 n.12 (2001).

86. *See* Dai, *supra* note 83, at 755–56.

87. *See* Li & Ong, *supra* note 42, at 699.

88. *See supra* text accompanying notes 66–69.

89. *See infra* text accompanying notes 114–17.

and application of the statute of limitations—that are not relevant for purposes of this Article. It did not evaluate whether the revenue statements were false since the 1999 announcement of the investigation by Daqing's board of directors admitted the inaccurate nature of the reported revenues. The Chinese appellate court partially upheld an award in favor of twenty-three investors on claims that false statements had been made about Daqing.[90] The plaintiff investors were therefore successful in that they were awarded part of the damages they sought.[91]

D. Proposed Extensions of Rights of Action on Behalf of Multiple Investors

China recently amended the CPL to extend rights of action on behalf of multiple parties. The initial legislation proposing the addition of a new class-action-like provision to the CPL was introduced in October 2011. We refer here to that proposed legislation as the 2011 CPL Draft. The legislation proposed using public interest litigation, which has been used by some other countries to permit governmental authorities or social organizations to act as intermediaries on behalf of harmed individuals.[92] Specifically, the 2011 CPL Draft proposed to add the following article as Article 55: "Relevant authorities and social organizations may take litigations against the infringements of the public interest especially those involving environmental pollution or damaging mass consumers' legal rights and interests."[93] Professors Liu, Xu, and others believe that the increasing problem of environmental pollution, food safety scandals in China, and the difficulties of pursuing class actions under the existing CPL provisions were the motivating forces that led some members of the National People's Congress (NPC)[94] and related interest groups to support the mechanism of public interest

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90. *See* Dai, *supra* note 83, at 755–57.

91. *See id.* at 757.

92. *See, e.g.*, Wang & Jian-Lin, *supra* note 41, at 143–44 (discussing Taiwan's use of intermediary plaintiffs).

93. Minshi Susong Fa Xiu Zheng An (Cao An) Tiaowen Ji Cao An Shuoming (民事诉讼法修正案（草案）条文及草案说明) [The Provisions of the Amendment Draft of Civil Procedure Law and the Explanation of the Draft] (promulgated Oct. 29, 2011), *available at* http://www.npc.gov.cn/npc/xinwen/syxw/2011-10/29/content_1678367.htm.

94. Palmer & Xi, *supra* note 66, at 1; *see also* IMF & The World Bank, *supra* note 43, at 7.

litigation.[95] Early indications were that the provision would be available to address a wide variety of issues,[96] including, in the view of Professors Liu and Xu, violations of China's securities laws.

When the NPC Standing Committee returned to the proposal in April 2012, the approach became more conservative by limiting the entities that can bring suits to relevant authorities and "related organizations."[97] Deputy Director Li of the NPC Law Committee has stated that the more limited proposal is meant "to ensure a sound practice" and prevent class actions from being overused.[98] He also analogized the proposed public interest provision to existing legislation that empowers the State Oceanic Administration (SOA) to file a claim if "severe damage" is done to the oceanic environment.[99] The SOA power that Deputy Director Li refers to derives from a specialized procedural provision in the Marine Environment Protection Law, which enables the SOA to seek, on behalf of the state, to hold polluters liable for severe damage suffered by the state arising from infringements of marine ecosystems, marine fishery resources, and marine protected areas.[100]

In late August 2012, the NPC Standing Committee passed amendments to the CPL that were then approved by President Hu Jintao and became effective on January 1, 2013.[101] Under Article 55 of the new CPL, relevant authorities and "related organizations" will have standing to bring suits where "the public health and/or public safety is at risk."[102] As security frauds damage the legal rights and interests of large numbers of investors, Professors Liu and Xu believe that the amendments to the CPL may become a legal weapon that Chinese investors injured by securities fraud can wield.

95. *See, e.g.*, Zhou Tao, *Lawsuits in the Public Interest*, CHINA.ORG.CN (Oct. 26, 2011), http://www.china.org.cn/opinion/2011-10/26/content_23728183.htm.

96. Some members of the NPC Standing Committee proposed that the class action law should be applied to destruction of cultural relics. *See* Li Xiao, *What Makes a Public Interest Plaintiff?*, CHINA.ORG.CN (Nov. 8, 2011), http://www.china.org.cn/opinion/2011-11/08/content_23845547.htm.

97. *See* Richard W. Wigley, *China's Civil Procedure Law Reported to be Amended to Broaden Definition of Types of Litigants Allowed to File Class-Action Lawsuits*, CHINA L. INSIGHT (Sept. 13, 2012), http://www.chinalawinsight.com/tags/related-organizations/ (follow "Continue Reading" hyperlink).

98. Zhao Yinan, *Draft Limits Scale of Class-Action Lawsuits*, CHINA DAILY (Apr. 25, 2012, 7:39 AM), http://usa.chinadaily.com.cn/china/2012-04/25/content_15131945.htm.

99. *See id.*

100. *See* Xiao, *supra* note 96.

101. *See China Amends Civil Procedure Law Following Third Reading*, GOV.CN (Aug. 31, 2012), http://english.gov.cn/2012-08/31/content_2214483.htm.

102. *See* Richard W. Wigley, *China's Civil Procedure Law Reported to be Amended to Broaden Definition of Types of Litigants Allowed to File Class-Action Lawsuits*, CHINA L. INSIGHT (Sept. 13, 2012), http://www.chinalawinsight.com/tags/related-organizations/ (follow "Continue Reading" hyperlink).

As explained by Wang Shengming of the NPC Standing Committee, including "related organizations" in the CPL will allow more organizations to bring actions than the prior version of the amendments, which would have extended only to "social groups."[103] The term "social group" in China is a technical term that is restricted to groups that meet particular procedures regarding their registration and management.[104] Most importantly, social groups must register with a government office and typically must be affiliated with a government agency,[105] which is not required of "related organizations." The expansiveness of the final amendment as compared to the prior proposal is evidenced by the number of entities that meet each definition. In 2011, a total of 460,000 social organizations existed, but only 55 percent of them qualified as social groups.[106] Regulation and court practice will likely be necessary to shape the definition of "related organization," which is not precisely defined under China's laws.[107]

III. Comparison of Class Action Securities Fraud Actions in the United States and in China

In order to consider the comity concerns implicated by the potential extension of U.S. securities fraud class actions to include those against foreign companies, this Part compares the actual barriers to the use of those actions in the United States and China. It finds that the obstacles to such actions in China are much higher than a comparison of China's CPL provisions to the applicable U.S. standard, Rule 23, would indicate. The first subsection below bases its analysis on the law in China as it has applied in securities fraud suits. The next subsection considers how that analysis may be affected by China's 2012 revision of its CPL.

103. *See* Zhao Yinan, *More Groups Can Litigate in Public Interest*, China Daily, Sept. 1, 2012, at 3, *available at* http://www.chinadaily.com.cn/cndy/2012-09/01/content_15725847.htm.

104. *See id.*

105. *See id.*

106. *See id.*

107. *See id.* ("[V]arious government agencies may later publish more specific regulations to help guide the organizations in their related fields."); Wigley, *supra* note 102 ("[T]he term 'related organization' is still rather vague in nature and, as such, allow[s] the Courts certain discretion in determining whether the organization at issue is indeed representing the public interest . . . ").

A. Evaluation of the Extent of Class Action Securities Fraud Litigation in the United States and China

As discussed above, China's CPL explicitly provides for multiple party actions.[108] However, numerous barriers exist to the actual use of those provisions in securities fraud cases.[109] This subsection begins by comparing the prevalence of class actions in securities fraud litigation in the United States and China. It next compares the scope of barriers imposed in each country through judicial and administrative factors and then turns to the relevant procedural considerations.

1. Prevalence of Class Actions Alleging Securities Fraud

Substantial numbers of securities fraud class actions are brought under federal law in the United States. However, the lack of official data makes it more difficult to ascertain the prevalence of collective securities fraud actions in China. One major research entity reported that 188 securities law class actions were filed in the United States in 2011, as compared to 176 filings in 2010.[110] Suits against Chinese companies listed on U.S. exchanges increased considerably, from just one case in 2009 to ten cases in 2010 and thirty-nine cases last year.[111] The increase in class actions filed against Chinese companies resulted from a spate of frauds by Chinese reverse merger companies that gained public attention.[112] In contrast, it does not appear that the annual numbers of class actions filed alleging securities fraud in China is reported. The result of the 2002 Securities Notice and 2003 Securities Provisions issued by the Supreme People's Court is that it appears that only individual and

108. *See supra* Part II.B.

109. *See supra* Part II.C.

110. CORNERSTONE RESEARCH, ACCOUNTING CLASS ACTION FILINGS AND SETTLEMENTS—2011 REVIEW AND ANALYSIS 1 (2012), *available at* http://www.cornerstone.com/pubs/xprPubResultsCornerstone.aspx?xpST=PubRecent (follow "Accounting Class Action Filings and Settlements—2011 Review and Analysis" hyperlink).

111. These numbers define Chinese companies broadly to include those either legally domiciled in China or having their primary executive offices in China. *See* JORDAN MILEV ET AL., NERA ECON. CONSULTING, RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION: 2011 YEAR-END REVIEW 8–9 (2011), *available at* http://www.nera.com/nera-files/PUB_Trends_Year-End_1211_final.pdf.

112. *See* David M. Katz, *Chinese Reverse Mergers Spawned U.S. Class Actions, Report Says*, CFO (May 22, 2012), http://www3.cfo.com/article/2012/5/m-a_reverse-mergers-china-firms-class-action-cornerstone-research-heli-electronics. For a discussion of Chinese reverse mergers, see Benjamin A. Templin, *Chinese Reverse Mergers, Accounting Regimes, and the Rule of Law in China*, 34 T. JEFFERSON L. REV. 119, 123–28 (2011).

joint actions, and perhaps CPL Article 54 representative actions, are permitted when the allegations involve misrepresentations by a publicly traded company.[113] As discussed below, there are a number of disincentives for Chinese courts to accept or to consolidate joint actions even to the extent permitted by the Supreme People's Court.

2. Judicial and Administrative Barriers to Class Actions

Unlike in the United States, the funding and assessment of the Chinese court system and the role of the state as a substantial owner in many business enterprises discourage securities fraud class actions in China. One factor is that case acceptance fees are used to fund the lower courts,[114] and smaller claims are charged a higher percentage case acceptance fee than larger claims. For example, at the time of the *Daqing* case, smaller claims were required to pay one percent of the total remedy sought by all of the plaintiffs, but larger claims were required to pay one-half of one percent.[115] As a result of the fee differential between large and small claims, the lower courts have an economic incentive to break class actions into smaller cases and not to consolidate actions.

China's method of evaluating judicial performance also provides an incentive for courts to prefer multiple actions over a single, consolidated action. One factor on which judges are evaluated is the number of cases they decide. Although they may combine the cases when it comes to their decision on the merits, if the cases remain separate for purposes of legal representation or other metrics, the judge that hears the case receives more credit for his or her work.[116] This evaluation system ignores the fact that class litigation requires a significant time commitment by judges to ensure the rules for collective actions are met.[117]

The political relationship of the lower courts with local governments is another contributing factor to the lack of willingness of Chinese courts to hear class action cases with large numbers of plaintiffs. One concern is that social upheaval might result from

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113. *See supra* text accompanying notes 76–82; *see also* Liang Tao, *Where's the Real Beef?*, China's Foreign Trade, Jan. 2012, at 56, *available at* http://works.bepress.com/cgi/viewcontent.cgi?article=1020&context=tim_liang.

114. *See* Xin He, *Court Finance and Court Responses to Judicial Reforms: A Tale of Two Chinese Courts*, 31 Law & Pol'y 463, 465 (2009).

115. *See* Li & Ong, *supra* note 42, at 711.

116. *See* Tao, *supra* note 113, at 57.

117. *See* Clarke, *supra* note 78, at 249; Xie & Sun, *supra* note 74, at 49.

consolidated actions. Commentators have noted this concern that social unrest might result from class action litigation.[118]

Similarly, the state's role as a significant shareholder in many business enterprises and the social and economic power of prominent business executives appears to affect the use of joint actions. The lower courts are heavily dependent on local governments for financial resources.[119] As a result, they may be reluctant to accept cases where the state is at least implicitly a defendant. Where claims are brought by significant numbers of investors against the state as an implied defendant, the government might view the situation as having elements of social unrest. And an award against an enterprise with state ownership is to some extent an award in favor of citizens against the government. In addition to these political tensions between the courts and the governing political party, the economic result of imposing liability on an enterprise with long-term government ownership may be to transfer some of the costs of the securities fraud to the broader Chinese society.[120] Although wages in China have been improving, the average worker there still earns less than half the world average.[121] Thus, the potential use of securities fraud class actions to transfer wealth from the general populace to shareholders as a class implicates a variety of societal concerns.

Another political implication observed in the use of securities fraud class actions in China relates to political power and individual ownership of defendant corporations. Scholars have noted that individuals with social or economic power in China have sometimes been able to avoid civil lawsuits by exerting pressure to avoid or affect the administrative proceedings that are a necessary prerequisite to civil suits, including those brought by groups of shareholders.[122] In fact, the potential influence of politically powerful defendants to avoid lawsuits through behind-the-scenes

118. *See* Clarke, *supra* note 78, at 248–49; Li & Ong, *supra* note 42, at 714 ("[T]he government may also be restricting access of investors to courts in order to prevent any situations of social unrest."); Wang & Jian-Lin, *supra* note 41, at 154 (discussing "the political risk entailed in a group becoming an interest group, which status may pose a threat to China's political regime"). It is possible, though, that permitting class actions would promote, rather than decrease, social stability by providing injured citizens with compensation, deterring wrongful acts and increasing confidence in the rule of law.

119. *See* He, *supra* note 114, at 465.

120. *See* Wang & Jian-Lin, *supra* note 41, at 155.

121. Kenneth Rapoza, *U.N. Shocker: Chinese Workers Underpaid*, FORBES (Apr. 4, 2012, 5:00 PM), http://www.forbes.com/sites/kenrapoza/2012/04/04/u-n-shocker-chinese-workers-underpaid/.

122. *See* Li & Ong, *supra* note 42, at 707–08.

intervention in administrative proceedings is particularly interesting in the context of avoiding group actions because one of the generally recognized advantages of group actions is to permit claims to be brought by small shareholders for whom individual claims typically would not be cost-effective. In China, the increased power of individual shareholders that is achieved through a class action may be undermined by the ability of a politically-connected individual business owner to avoid the action through intervention by a government authority.

Comparatively, unlike China, the United States does not categorically bar the use of class actions in securities fraud suits[123] in the way that the Supreme People's Court precluded at least some representative actions. Nor are U.S. courts able to avoid hearing class actions by refusing to certify classes that meet the minimum certification standards simply because the litigation may be time consuming for the court. That is not to say, however, that courts are entirely agnostic when it comes to class actions. Some scholars have argued that U.S. courts not only are hostile to class actions but particularly hostile to class actions brought to allege violations of the securities laws.[124] Even if this is true, institutional barriers are substantially lower in the United States.

3. Procedural and Related Barriers to Class Actions

Across the world, procedural rules governing class actions differ on such factors as designation of attorneys and representative parties; when comparing the approaches of China and the United States, such differences become apparent since practices governing the designation of a lead plaintiff and selection of lead attorneys

123. *See* Stephen B. Burbank, *International Civil Litigation in U.S. Courts: Becoming a Paper Tiger?*, 33 U. Pa. J. Int'l L. 663, 666 (2012) ("One of the foundational assumptions of the Federal Rules of Civil Procedure is that the same rules apply in every type of case—they are trans-substantive.").

124. *See id.* ("A majority of the [*Morrison*] Court was . . . signaling hostility to class actions that is not confined to securities laws."); Roslyn Falk, *May a Shareholder Who Objects to a Proposed Settlement of a Derivative Action Appeal an Adverse Decision? A Report on* California Public Employees' Retirement System v. Felzen, 25 Del. J. Corp. L. 235, 246 (2000) ("[F]ederal courts have seemed extremely hostile to class actions generally, and to securities class actions especially."); Mark Klock, *What Will It Take to Label Participation in a Deceptive Scheme to Defraud Buyers of Securities a Violation of Section 10(b)? The Disastrous Result and Reasoning of* Stoneridge, 58 U. Kan. L. Rev. 309, 323 (2010) ("[T]he securities bar knew in advance of the Court's hostility towards investor class actions against corporations."). *But see* Pritchard, *supra* note 17, at 140 ("The SEC's efforts to throw the plaintiffs under the bus were to no avail. The Court rejected not only the plaintiffs' claim, but also the government's argument that private actions should be held to a higher standard.").

vary between the United States and China. As discussed above, in China, the representative plaintiffs and lawyers are selected by the victim investors as a group. In the United States, courts designate lead plaintiffs in securities law class actions, typically the willing plaintiff with the largest alleged financial loss. The lead plaintiff then selects counsel for the class.[125] Another difference is that attorneys in China now are prohibited from receiving contingency fees in any class actions, which also raises the barriers to such suits because fewer attorneys will be willing to pursue them.[126]

A procedural barrier to securities fraud class actions in China is the requirement that there be an administrative or criminal ruling of liability before the filing of a misrepresentation claim involving securities.[127] As a result, the CSRC plays a gatekeeping role to private litigation not played by the U.S. SEC. In the United States, no private right of action exists for a few types of securities cases, such as those alleging an aiding and abetting violation of Section 10(b), even though the SEC does have the power to bring those cases.[128] That is very different, however, from leaving private plaintiffs dependent on the SEC to bring an enforcement action in all cases of securities fraud, as would be the equivalent of the regulatory approach in China. It has long been argued that one of the benefits of private rights of action in the United States that extends particularly to class actions is the additional deterrent effect that results when issuers face potential fraud claims by investors since resource constraints and, arguably, political constraints, limit the enforcement abilities of regulators.[129]

In sum, although the CPL's provisions for joint and representative actions facially extend to securities fraud suits, numerous formal and informal mechanisms severely circumscribe the rights of investors to bring class action claims alleging securities fraud in

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125. *See* James L. Tuxbury, Note, *A Case for Competitive Bidding for Lead Counsel in Securities Class Actions*, 2003 COLUM. BUS. L. REV. 285, 293. Although this sounds like a simple process, that is far from the case. *See, e.g.*, John C. Coffee, Jr., *Litigation Governance: Taking Accountability Seriously*, 110 COLUM. L. REV. 288, 310–11 (2010) (discussing the pattern of institutional investors opting out of securities class actions on the advice of their attorneys). The patterns in and incentives associated with the selection and payment of legal counsel is largely beyond the scope of this Article.

126. *See* HARVARD LAW SCH., THE LEGAL PROFESSION OF THE PEOPLE'S REPUBLIC OF CHINA 5 (2011), *available at* http://www.law.harvard.edu/programs/plp/pdf/Chinese_Legal_Profession.pdf.

127. *See supra* text accompanying note 54. Investors have limited abilities to pursue criminal cases where the government refuses to do so, but there is no similar right if the CSRC refuses to pursue a complaint. *See* Li & Ong, *supra* note 42, at 707–08.

128. *See* Franco, *supra* note 34, at 50.

129. *See, e.g.*, Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 552–53 (1997).

China. It appears that representative actions were not available before the 2012 CPL amendments. Furthermore, even where otherwise permitted, acceptance of class actions is at the discretion of the courts, which have powerful incentives to limit such suits. In contrast, securities fraud class actions are widely used in the United States, though those rights were limited by the Supreme Court's decision in *Morrison* in cases involving transnational factors.

B. Effects of the Recent CPL Amendments on Comparative Barriers to Securities Class Actions

As explained above, the recent amendments to the CPL that provide for a public interest model of class actions were motivated by concern that the current procedural mechanisms do not deter and/or compensate for harms where the effects of the harms are spread over large numbers of people.[130] Rather than rely on injured individuals to bring claims, as in the U.S. class action system, the revised CPL also permits related organizations to act as intermediary plaintiffs.[131] This representational model is not unique. Taiwan's securities law, for example, designates a statutorily created not-for-profit organization, The Securities and Futures Investors Protection Center (IPC), as the entity with authority to bring civil actions on behalf of investors.[132] Investors must opt in to cases brought by the IPC, each case must consist of a minimum of twenty investors who opted-in, and any damages collected in the litigation are dispersed to those investors.[133]

Also as noted above, one Chinese official, when supporting an earlier version of the public interest amendments to the CPL, cited the powers of China's SOA as being similar to those proposed in the amendments and as evidence that such an approach is effective. The SOA, however, provides a poor blueprint for public interest legislation intended to fulfill a role similar to that of U.S.-style class actions. The authority vested in the SOA has even less of a compensatory effect than enforcement actions brought by the U.S. SEC, where provisions may be made for investor compensation.[134] When the SOA sues for environmental damage, the plaintiff in the litigation is the state instead of the individual victims of the ocean

130. *See supra* Part II.D.
131. *See supra* text accompanying notes 101–02.
132. Wang & Jian-Lin, *supra* note 41, at 143–45.
133. *Id.* at 146–47.
134. *See* Rose, *supra* note 17, at 1360 (noting the ability of the SEC to recover on behalf of investors through the Fair Funds program).

pollution, for example.[135] Thus, public interest legislation as configured in countries like Taiwan differs from the SOA powers on two dimensions. In the authors' view, first, unlike what would occur in the public interest model of class actions, even if the SOA brings suit, individual victims retain the right to engage a law firm to bring a class action against the polluters as tortfeasors.[136] The grant of authority to the SOA does not deprive individuals of any legal rights. The grant merely authorizes the SOA to take action to protect the state without speaking to the rights of individuals who suffer damages as a result of the pollution. Second, the purpose of the grant of authority to the SOA is to address damage suffered by the state. As such, it is not an ideal model for legislation designed to effectuate the rights of classes of individuals who have suffered harm in situations such as those resulting from pollution, unsafe food, or securities fraud. Thus, the litigation rights of the SOA in no sense substitute for the compensatory elements of class actions since there is no individual beneficiary except for the state, and the state will not distribute the compensation it receives to members of the public.[137]

The litigation that resulted from the oil leaks of ConocoPhillips in North China's Bohai Bay in 2011 illustrates the shortcomings of the authority held by the SOA. Oil slicks from the ongoing leaks by ConocoPhillips eventually covered about 1,200 square kilometers of Bohai Bay.[138] ConocoPhillips settled for approximately 1.8 billion yuan ($297 million), 1 billion of which appears to have been designated to improve fishery resources in the bay.[139] However, some of the affected fishermen were not satisfied with that settlement.[140] In

135. *See, e.g.*, Xiao, *supra* note 96 (noting that the "SOA declared that it would sue ConocoPhillips China for ecological compensation").

136. *See* Yinan, *supra* note 98.

137. This is not to say, however, that the state should not have a cause of action in circumstances where there was harm to the state. Instead, it is simply important to note that the interests of the state may not entirely coincide with the interests of harmed individuals, meaning redress of the harms to the state frequently will not result in redress to those individuals. This remains true when moving away from pollution and comparing interests and damages to the state from securities fraud with the interests of and losses suffered by shareholders.

138. *See* Jonathan Watts, *ConocoPhillips Slow to Clear Up Oil Spill in China's Bohai Sea*, THE GUARDIAN (Aug. 9, 2011, 12:37 PM), http://www.guardian.co.uk/environment/2011/aug/09/conocophillips-oil-spill-china.

139. *See* Kenneth Rapoza, *ConocoPhillips Pays Up $297 Mln for China Oil Spill*, FORBES (Apr. 30, 2012, 10:24 PM), http://www.forbes.com/sites/kenrapoza/2012/04/30/conocophillips-pays-up-297-mln-for-china-oil-spill/.

140. *See* Yinan, *supra* note 98 (citing the fishermen's lawyer as saying "some of his clients do not agree with the compensation").

commenting on the 2012 CPL Draft, Zhao Jingwei, a lawyer representing some of the fishermen, stated that the effect of only permitting those authorized by law to bring class actions would be to make "the possibility of filing a public-interest case small."[141] Similarly, Professor Tang Weijian criticized the proposed section as being "short on details and fail[ing] to consider academic research and legal practice in class-action suits."[142] Although the legislation as enacted permits a broader range of entities to bring representative litigation, details remain subject to interpretation and development.[143]

The use of intermediaries in class action litigation, as is done by Taiwan and as authorized by China in the 2012 CPL revision, is more restrictive than the entrepreneurial approach of the United States that permits investors to be represented in class litigation by private-sector counsel whom they had a voice in choosing. One topic of the academic debate over the U.S. approach to class actions, particularly in the securities law context, is the extent to which permitting plaintiffs' attorneys to compete increases agency costs at the expense of shareholder compensation and fails to result in optimal levels of fraud deterrence.[144] Here, we compare the U.S. system of allowing shareholders a role in the selection of private sector class attorneys with the decision in China to rely on intermediaries to represent shareholders in securities law class actions.

One concern with the intermediary approach is that the intermediaries necessarily have some interests that diverge from those of the investors, and the litigation may be affected by that self-interest.[145] The concerns are heightened when the number of intermediaries qualified to bring actions is limited in a significant way. The 2012 amendments to the CPL restrict those who can bring

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141. *Id.*

142. *Id.*

143. *See supra* text accompanying notes 101–07.

144. *See supra* text accompany notes 14–15 (noting the debate about the compensatory and deterrent effect of U.S. class actions). *Compare* Myriam Gilles & Gary B. Friedman, *Exploding the Class Action Agency Costs Myth: The Social Utility of Entrepreneurial Lawyers*, 155 U. Pa. L. Rev. 103, 147–51, 155–62 (2006) (discussing the allocation of responsibility among lawyers in class action cases and arguing the approach provides substantial deterrence), *with* John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. Chi. L. Rev. 877, 896–917 (1987) (arguing that the conflicts of interest between class attorneys and their clients result in substantial agency costs).

145. *See, e.g.*, Wang & Jian-Lin, *supra* note 41, at 148 ("[B]ureaucratic members are driven by their own self-interest and may fail to produce the optimal amount of public goods.").

representative litigation to "related organizations."[146] This limitation on the potential intermediaries increases the monopoly power of allowed intermediaries.

Such monopoly power does have some virtues. One of the major advantages is that, as Professors Liu and Xu argue, it is likely that some of the social organizations empowered to act as intermediaries in China would be organizations that are financially and politically supported by the government. As a result, their profit maximization motivation would be moderated, thereby addressing a frequent criticism of plaintiffs' attorneys in the U.S. entrepreneurial system. In addition, the financial resources that authorities and social organizations could potentially bring to the actions may be greater than those of some U.S. class action attorneys. And, if the authorities and social organizations are funded in ways other than through fees charged to clients, 100 percent of any recoveries could be used to compensate injured investors.

As noted above, it is expected that regulation and court practice will be necessary to define which related organizations will be permitted to bring representative actions under the revised CPL.[147] One entity that may become important in representative actions is the China Securities Investor Protection Fund Corporation (SIPF), which was established in 2005 by the CSRC.[148] Originally, the SIPF, which was funded with substantial capital, was to serve as a sort of insurance fund for investors to provide protection from failures of securities companies.[149] However, given the revisions to the CPL, the SIPF could assume a role similar to that played by the IPC in Taiwan.[150]

From the opposite perspective, the approach taken in the revised CPL that restricts the right to bring representative actions to entities that meet the definition of related organizations results in some potential disadvantages due to the monopoly power of those intermediaries. At least in theory, the entrepreneurial nature of U.S. class actions should benefit from competition in the legal services market such that firms are forced to render quality legal services at competitive contingency fees. This would be a greater disadvantage

146. *See supra* text accompanying notes 101–05.

147. *See supra* text accompanying notes 101–07.

148. *Corporate Profile*, CHINA SEC. INVESTOR PROTECTION FUND CORP. LIMITED (Mar. 29, 2011, 9:55:48 AM), http://www.sipf.com.cn/NewEN/aboutsipf/corporateprofile/03/40081.shtml.

149. *See* Chenxia Shi, *Protecting Investors in China Through Multiple Regulatory Mechanisms and Effective Enforcement*, 24 ARIZ. J. INT'L & COMP. L. 451, 484 (2007).

150. *See supra* text accompanying note 132–33 (discussing the IPC).

of the use of intermediaries if there were not such substantial evidence of serious dysfunctions in the U.S. system of class counsel.[151] Regardless of one's views on the inefficiencies of the U.S. approach, an issue remains regarding the source of compensation for whoever litigates a class action. If, as seems likely after the recent Chinese reform, some of the intermediaries rely on government resources to finance litigation on behalf of injured investors, it arguably is unfair for taxpayers to subsidize litigation from which only a limited subset of them directly benefit. Where the state is a long-term owner in the defendant securities issuer, not only do the taxpayers bear the cost of the litigation process, they also may bear a portion of the cost of any damages award. On the other hand, if the injured investors compensate the intermediaries, either the investors will not be made whole for their losses or the judgments will have to be calculated to include both losses and litigation costs. Either way, the monopoly power of the authorities and social organizations may result in agency costs that are then borne by some combination of injured investors, issuers, a subset of their shareholders, and society.

In sum, large-scale representative securities fraud actions effectively are not available in China because of judicial and administrative barriers in addition to the procedural barriers imposed by the CPL. The 2012 amendments to the CPL will permit representative actions by a somewhat vaguely defined set of related organizations, but the extent to which representative actions will be effective in clearing the judicial and administrative barriers in situations of securities fraud is yet to be tested. Comparatively, the judicial, administrative, and procedural barriers to such actions in the United States by U.S. investors against U.S. companies are low. Jurisprudence continues to develop on the extent to which securities fraud plaintiffs must prove various elements of a Section 10(b) case at the class certification stage.[152] However, the continued robustness of securities fraud class actions is evidenced by the substantial annual settlements and judgments that result from those suits.[153]

151. *See, e.g.*, John C. Coffee, Jr., *Accountability and Competition in Securities Class Actions: Why "Exit" Works Better than "Voice,"* 30 Cardozo L. Rev. 407, 407–08 (2008) (arguing opt-outs can increase competition and decrease agency costs in class action litigation); Howard M. Erichson, *CAFA's Impact on Class Action Lawyers*, 156 U. Pa. L. Rev. 1593, 1596–602 (2008) (discussing mistrust of class action lawyers); Hillary A. Sale, *Judges Who Settle*, 89 Wash. U. L. Rev. 377, 384–89 (2011) (discussing agency costs associated with defense of class actions).

152. *See supra* notes 18–19 and accompanying text.

153. *See* Milev et al., *supra* note 111, at 3, 15, 17–18.

IV. TRANSNATIONAL APPLICATION OF SECTION 10(B) IN PRIVATE RIGHTS OF ACTION—A MODEST PROPOSAL

As the United States considers the extent to which private actions alleging violations of Section 10(b) should be permitted in contexts that involve non-U.S. plaintiffs, defendants, securities transactions, or activities, one of the oft-referenced policy considerations is international comity.[154] This Article has delved into the use of class actions in China and the United States in order to facilitate this Part's recommendation for an amendment to the '34 Act. The Part begins, however, by considering how the comparative analysis of securities fraud actions in the United States and China would change if either the Fox Proposal or one of the Conduct and Effects Proposals are adopted. It then outlines our proposal for statutory change. The Part concludes by framing the application of our proposal through discussion of a post-*Morrison* case.

A. Comparative Effects of Adoption of the Fox Proposal or Conduct and Effects Proposals

The Fox Proposal is elegant in its simplicity.[155] Elimination of all U.S. securities fraud class actions against non-U.S. companies, as Professor Fox advocates, would avoid the ambiguities associated with the *Morrison* test. For example, defining when a transaction occurs in the United States is challenging.[156] The sole exception under Professor Fox's approach would permit Section 10(b) claims against those non-U.S. companies that choose to be subject to Section 10(b).[157] That standard would be administratively convenient and make the outcomes predictable.

From the perspective of international comity, the Fox Proposal defers entirely to a company's home country to provide any access to securities class actions unless a particular company elects to be subject to the U.S. regime. There is no involuntary intrusion of U.S. law into a foreign jurisdiction. If one accepts Professor Fox's assumptions that securities markets are efficient, class actions fail to provide substantial compensation to anyone other than attorneys

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154. *See, e.g.*, Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2887 (2010) ("The Solicitor General points out that the 'significant and material conduct' test is in accord with prevailing notions of international comity.").

155. *See* Fox, *supra* note 7, at 1176–82 (setting forth a reform proposal to address post-*Morrison* issues).

156. *See* SEC STUDY, *supra* note 8, at 33–35.

157. *See* Fox, *supra* note 7, at 1179.

for the class, and unsophisticated investors should be protected through means other than securities fraud class actions, then there is much to be said for this proposal.

The Fox Proposal, though, requires careful evaluation. The most significant concerns are associated either with the Fox Proposal's economic efficiency assumptions or with its reliance on alternate mechanisms to address efficiency lapses. One thread running through the Fox Proposal is the argument that U.S. markets will not be internationally competitive if non-U.S. companies are involuntarily subjected to U.S. securities fraud class action suits. However, though non-U.S. companies may articulate concerns with the potential liability associated with those suits,[158] data indicate that the U.S. financial markets do not reflect such a negative view of the liability. For example, one study found that the securities prices of foreign companies listed in the United States did not change significantly in reaction to either the *Morrison* decision or the oral arguments to the Supreme Court, when the Court's skepticism of the conduct and effects test was apparent.[159] If, in fact, markets are efficient and the potential liability effect of U.S. securities fraud class actions was significant, one would have expected securities prices of non-U.S. issuers to increase in reaction to the decision or oral arguments.

Further, if the efficiency assumptions underlying the Fox Proposal accurately predict firm behavior, then one result may be for U.S. companies to move outside the United States. Consider the proposal's argument that permitting foreign companies to register in the United States without being automatically subject to U.S. securities fraud class actions would increase the attractiveness of the U.S. capital markets to those companies.[160] Application of the same analysis and assumptions to U.S. public companies, which would remain subject to securities fraud class actions, means they would have a higher cost of capital, making them less competitive.[161] The resulting incentive would be for U.S. public companies to establish their primary locus outside of the United States in order to avoid being subject to U.S. securities fraud class actions, making this a troubling

158. *See id.* at 1178 & n.9.

159. *See* SEC Study, *supra* note 8, app. B, at B8.

160. *Cf.* Fox, *supra* note 7, at 1269 (discussing concern that U.S. capital markets are uncompetitive in part because of the costs associated with class action fraud lawsuits).

161. Professor Fox acknowledges the potential costs on U.S. issuers but suggests revisiting the issues with the liability framework another day. *See id.* at 1270.

course for U.S. policymakers to take in the current economic climate.[162]

The Fox Proposal also takes minimal account of the SEC's investor protection mandate and only marginally recognizes the fact that a robust anti-fraud regime is important to unsophisticated, undiversified investors. Professor Fox suggests that investor education, enhanced broker disclosures, and reductions in the proportion of employer stock that individuals are permitted to hold in their retirement accounts would provide sufficient protection to those investors.[163] The suggestion ignores the literature showing that many people are uninterested in making financial decisions and that investor education is ineffective.[164] Research studies show that increasing the disclosure obligations associated with financial advice may result in investors receiving even worse advice.[165] Finally, the problem of lack of diversification in retirement accounts goes far beyond the overinvestment in employer stock that Professor Fox acknowledges but argues should be dealt with through other regulation.[166] In sum, it is unlikely that the issues faced by unsophisticated investors can be sufficiently addressed through education, disclosure, and direct regulation of investment allocations in retirement accounts.

The Conduct and Effects Proposals are more complex than the Fox Proposal, relying on fact-intensive evaluations of when sufficient conduct occurs in the United States and the types of effects that establish adequate U.S. interests. The Supreme Court discussed the extensive critiques of the prior test by scholars, which predated *Morrison* and continue.[167] The criticisms include the intrusion of U.S. securities law into the markets of other countries, the

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162. For a company to move its locus outside the United States could be less difficult than some might guess; some U.S. companies have established "co-headquarters" outside the United States. *See* Tom Kucharvy, *The Payoffs of Cisco's Globalization Odyssey*, BEYOND IT (Jan. 31, 2010), http://beyond-it-inc.com/GKEblog/the-payoffs-of-cisco%E2%80%99s-globalization-odyssey.html.

163. *See* Fox, *supra* note 7, at 1198.

164. *See, e.g.*, RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE 111–12 (2008) (describing the net effect of investor education as increasing performance on a true/false test from 54 percent to 55 percent).

165. *See, e.g.*, Robert A. Prentice, *Moral Equilibrium: Stock Brokers and the Limits of Disclosure*, 2011 WIS. L. REV. 1059, 1100–02 (2011).

166. *See* JACK VANDERHEI, EMP. BENEFIT RESEARCH INST., THE IMPACT OF THE RECENT FINANCIAL CRISIS ON 401(K) ACCOUNT BALANCES (2009) at 3, 11, *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_2-2009_Crisis-Impct.pdf (highlighting the danger during the financial crisis to employees' with investment allocations concentrated in high risk assets).

167. Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2880–81 (2010).

unpredictability of the tests, and the burden on U.S. judicial resources.[168]

B. Proposal for Legislative Reform

We propose a modest and clear expansion of the right of private plaintiffs to bring Section 10(b) suits in cases involving transnational factors. The proposal is a simple one—that U.S. investors be permitted to bring securities law class actions against companies whose securities, including ADRs, trade on U.S. exchanges regardless of where those investors entered into the relevant securities transactions. Our proposal would not modify any other rights of action that arise from the application of the *Morrison* test.

We recognize that our proposal draws two clear lines that have not in the past existed in the Section 10(b) jurisprudence. First, it would provide additional rights of action for certain shareholders of public companies that trade on a U.S. exchange, thus explicitly distinguishing between the rights of shareholders in public companies as compared to nonpublic companies. Second, our proposal focuses the protective aspects of Section 10(b) on U.S. investors, thus distinguishing among a company's shareholders.

Our decision not to recommend extension of rights of action regarding the securities of companies that do not trade on a U.S. exchange both recognizes the policy judgment reflected in the Jumpstart Our Business Startups Act (JOBS Act)[169] legislation and addresses the effect of the JOBS Act on the access of non-U.S. companies to U.S. exchanges. The JOBS Act increases the ability of non-public companies to raise capital from wealthy individuals without being subject to the disclosure obligations imposed on public companies.[170] This provides flexibility for small businesses in accessing capital. Under our proposal, small foreign companies, or even large foreign companies that choose to forgo the benefits of trading on a U.S. exchange, would be protected from securities fraud claims brought by investors, though the SEC would retain authority to enforce Section 10(b) against those entities.

Our recommendation, however, responds to the increased threat after the JOBS Act of fraud by foreign companies that list on U.S.

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168. *See, e.g.*, SEC Study, *supra* note 8, at 53–55.

169. JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

170. *Cf.* Jennifer J. Johnson, *Fleecing Grandma: A Regulatory Ponzi Scheme,* 16 Lewis & Clark L. Rev. 993, 1011–12 (2012) (discussing the removal of the ban on general solicitation in private placements directed at accredited investors).

exchanges and obtain capital from U.S. investors via U.S. and foreign transactions. Consider, for example, the potential future effects if Chinese companies rely on a JOBS Act provision that has become known as the IPO on-ramp. The IPO on-ramp permits companies, including non-U.S. companies, that become public in the United States after December 9, 2012 to elect lower levels, as compared to established public companies, of auditor engagement and reporting for up to five years.[171] A technique that pre-dated the JOBS Act and was used by more than 150 Chinese companies to access the U.S. capital markets between January 2007 and March 2010 is known as a reverse merger.[172] The structure of a reverse merger is somewhat complex, but the point is that the technique permits companies to avoid the typical lengthy IPO process. That process includes scrutiny of the company by underwriters and review by the SEC of the company's registration statement including audited financial statements.[173] Recently, significant numbers of the Chinese companies that had utilized the reverse merger technique have faced securities fraud class actions, typically for inaccurate disclosures related to financial results.[174] As discussed above, this constituted an increase in U.S. class actions filed against Chinese companies.[175]

Chinese companies' use of techniques to access the U.S. public capital markets, while reducing to the extent possible scrutiny and reporting, may become an increased threat to U.S. investors as China's internal securities markets grow and become more open to foreign investors. Under the rule established in *Morrison,* U.S. investors who buy securities of Chinese companies on a U.S. exchange or in a U.S. transaction are permitted to bring class actions under Section 10(b). However, if those shareholders purchase shares in the same companies on a Chinese exchange, they are precluded by *Morrison* from bringing an action in the United States regarding those shares. We have seen that it is also unlikely they will be able to bring a representative action in China.[176] We discuss below the extent to which certain investment strategies by U.S. investors may result in purchases on foreign exchanges.[177]

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171. *See* JOBS Act §§ 101–04.

172. Jan Jindra et al., *Reverse Mergers: The Chinese Experience* 8 (Fisher Coll. of Bus., Working Paper No. 2012-03-018, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2105814. By comparison, fifty-six Chinese companies conducted traditional IPOs during the time period. *Id.*

173. *See id.* at 7.

174. *See id.* at 10–11.

175. *See supra* text accompanying notes 110–12.

176. *See supra* Part III.

177. *See infra* text accompanying notes 189–92.

Although our proposal reflects deep concern with the need to protect the integrity of the U.S. exchanges, it aligns with the principle long reflected in the securities acts, and which continues in the JOBS Act, that certain categories of investors, such as accredited investors, require less regulatory protection. Thus, we limit our suggested extension of rights of action to shareholders in companies that trade on the U.S. public markets. Similarly, that limitation permits non-U.S. companies to decide whether to be subject to securities fraud class actions because companies must take explicit actions for their securities to trade on a U.S. exchange.

At least two other commentators recommended, prior to *Morrison,* that U.S. securities class actions be limited to plaintiffs who purchased their shares in U.S. transactions.[178] Our proposal is both more and less inclusive than those proposals. Acknowledging the many reasons why transactions may be executed on various exchanges, as discussed in the next two sections, our proposal would permit U.S. investors to bring securities fraud class actions that relate to all securities of a company with shares traded on a U.S. exchange. Our proposal is intentionally more limited than those proposals that focus primarily on the locus of a transaction in order to extend securities fraud protections to any investor who trades in a U.S.-based transaction. In addition to the increasing difficulties in determining when a non-exchange based transaction is located in the United States, we are concerned, as discussed below, with respect for international comity. Thus, we do not advocate extending any additional rights beyond those that exist under *Morrison* to non-U.S. investors.

C. Application of Proposed Reform

One post-*Morrison* case involving U.S. investors that would have come out differently under our proposal is *Stackhouse v. Toyota Motor Co.*[179] The *Stackhouse* order at issue addressed the appointment of a lead plaintiff and, thus, required consideration of the scope of the

178. Hannah L. Buxbaum, *Multinational Class Actions Under Federal Securities Law: Managing Jurisdictional Conflict*, 46 Colum. J. Transnat'l L. 14, 68 (2007) (advocating limitation of claims to those "arising out of transactions on U.S. markets"); John C. Coffee, Jr., *Global Class Actions*, Nat'l. L.J., June 11, 2007, at 12 ("U.S. courts should certify only a class of individuals, both foreign and domestic, who purchased on U.S. markets.").

179. Stackhouse v. Toyota Motor Co., No. CV 10-0922 DSF (AJWx), 2010 U.S. Dist. LEXIS 79837 (C.D. Cal. July 16, 2010).

losses a plaintiff could assert in a Section 10(b) claim.[180] Toyota Motor Company's common stock trades in its home country of Japan on the Tokyo stock exchange, and its American Depository Shares (ADS)[181] trade in the United States on the NYSE.[182] In January 2010, Toyota announced a recall of over three million vehicles due to problems involving throttle malfunctions that arguably led to unintended acceleration. Prior to that date, Toyota had publicly stated that thousands of reports of unintended acceleration were attributable to either driver error or incorrectly installed floor mats. After the recall and related announcements, Toyota's stock price lost at least 11 percent of its value, and shareholders brought Section 10(b) claims alleging Toyota's earlier statements constituted material misstatements.[183] The Maryland State Retirement and Pension System (MSRPS), the claimant holding the largest value in Toyota ADSs, was appointed lead plaintiff. It, along with other plaintiffs, was permitted to assert claims based on its purchases of the ADSs, but, under the principles established in *Morrison,* the court indicated they would be precluded from including in their claims any shares purchased on the Tokyo exchange.[184]

In their opinion concurring in the judgment in *Morrison v. National Australia Bank Ltd.*, Justices Stevens and Ginsburg anticipated cases similar to *Stackhouse*.[185] They posited the situation where a company listed overseas defrauded a U.S. investor, but "it was in New York City that the executives masterminded and implemented a massive deception which artificially inflated the [company's] stock price."[186] They argued that it would be an "oddity" not to protect U.S. investors in such a case and that the majority's ruling narrowed the interpretation of Section 10(b) to an extent "that would surprise and alarm generations of [U.S.] investors."[187] In the view of Justices Stevens and Ginsburg, the conduct and effects test would better serve U.S. interests by "strik[ing] a reasonable balance

180. *See id.* at *4–5.

181. American Depository Shares (ADS) are the trading shares of American Depository Receipt (ADR) programs, which enable the shares of foreign companies to trade on U.S. exchanges. *See* Peter M. Friedman, Note, *Risky Business: Can Faulty Country Risk Factors in the Prospectuses of U.S. Listed Chinese Companies Raise Violations of U.S. Securities Law?*, 44 COLUM. J. TRANSNAT'L L. 241, 245 n.15 (2005).

182. *See* Hannah L. Buxbaum, *Remedies for Foreign Investors Under U.S. Federal Securities Law,* 75 LAW & CONTEMP. PROBS. 161, 178 (2012).

183. *See In re* Toyota Motor Corp. Sec. Litig., No. CV 10-922 DSF (AJWx), 2011 U.S. Dist. LEXIS 75732, at *2 (C.D. Cal. July 7, 2011).

184. *See* Buxbaum, *supra* note 182, at 178.

185. *See* Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2888–95 (2010) (Stevens, J., concurring in the judgment).

186. *Id.* at 2895.

187. *Id.*

between the goals of 'preventing the export of fraud from America,' protecting shareholders, enhancing investor confidence, and deterring corporate misconduct, on the one hand, and conserving United States resources and limiting conflict with foreign law, on the other."[188]

We do not go as far as Justices Stevens and Ginsburg would have because of the legitimate concerns with the unpredictability of the conducts and effects test and the scope of its potential application to both private and public foreign companies that engage in activities in the United States or whose activities have effects in the United States. However, under the approach we advocate, those plaintiffs such as the MSRPS in *Stackhouse*, who were U.S. investors, could have included in their claim all of the Toyota securities that they had purchased during the class period.

In the absence of adoption of our proposal, sophisticated U.S. investors, including pension funds such as MSRPS, whose investment strategies require large purchases of securities in transnational companies, may find it costly, difficult, or impossible to make all of their purchases in such a company on a U.S. exchange due to trading volume or limited numbers of ADSs. In that situation, the U.S. investor is left with an unwelcome choice. One possibility is for it to modify its preferred investment strategy and restrict its purchases to the U.S. exchange, with the result that it buys fewer shares. Alternatively, it could forego the protections of Section 10(b) for some part of its portfolio and implement its investment strategy by making some purchases on a non-U.S. exchange. If, as an example, the investor purchased shares of a Chinese company on an exchange in China, it would face all of the barriers discussed above to a class action securities fraud lawsuit.[189] These alternatives force the investor to compromise either its investment strategy or its ability to efficiently seek redress through a single class action if a portfolio company engages in securities fraud.

The question of where securities transactions will be executed occurs in a variety of circumstances that are not necessarily obvious. For example, sophisticated investors that wish to trade outside the operating hours of the U.S. exchanges may face the quandary of whether to trade on a foreign exchange and forego Section 10(b) protections or to wait for the U.S. markets to open. And, even where it is convenient for a U.S. investor to engage in transactions

188. *Id.* at 2893–94 (quoting Morrison v. Nat'l Austl. Bank Ltd., 547 F.3d 167, 175 (2d Cir. 2008), *rev'd*, 130 S. Ct. 2869 (2010)).

189. *See supra* Part III.

on a U.S. exchange using ADSs, that strategy may be more expensive, due to the fees assessed by ADS issuers, than if the investor had conducted some of the transactions on a non-U.S. exchange.[190] In those circumstances, the investor must add the comparison of transaction costs to the risk calculus of how best to pursue its strategy of investing in non-U.S. companies.

Another problem with *Morrison*'s exclusion of all securities not purchased in the United States is that investors, particularly unsophisticated investors, may not discover until the time they are denied the right to bring a Section 10(b) claim that a particular transaction was executed on a foreign exchange. This may occur, for example, because a broker-dealer, in accordance with its obligation of best execution, automatically executed a transaction on a non-U.S. exchange.[191] Even if asked about any execution preferences, a retail customer may not express a preference for a U.S. exchange simply because he or she did not know about or understand the implications of *Morrison* for his or her future claims. We are less sanguine than Professor Fox about the likelihood that increased investor education would remedy this lack of understanding.

Somewhat similarly, sophisticated investors may find that they have no choice but to pursue costly individual securities litigation in a foreign country. One commentator has noted that if an institutional investor that owes fiduciary duties to its clients chooses to purchase on foreign exchanges, then the investor could be left with an obligation to pursue costly foreign litigation in order to vindicate its client's interests.[192] For example, if an investment manager for a pension fund to which it is a fiduciary purchases shares of a Chinese company on a Chinese exchange for the account of the pension fund, that investment manager may have an obligation to pursue litigation on behalf of its client in China.

Our proposed amendment clarifies the application of Section 10(b) and its protections in these circumstances. It supports the ability of U.S. investors to pursue their preferred trading strategies in companies that choose to list on U.S. exchanges without losing the protections of U.S. anti-fraud law. It avoids the trading costs that would result from the alternative of using enhanced disclosures to explain where each securities transaction is to be executed and the necessary calculations of whether an additional cost of execution on a U.S. exchange is offset by the increased legal protections.

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190. *See* SEC STUDY, *supra* note 8, at 45–47.
191. *See id.* at 43.
192. *See id.* at 47.

The discussion above of the limited availability of representative securities fraud actions in China provides an example of the complexity of these calculations. In order to assess the potential costs of securities fraud attached to shares purchased in China, an investor not only would need to become familiar with the statutory provisions in the CPL but also would have to understand the implicit barriers associated with judicial incentives, political concerns, and other hurdles discussed above.[193] Furthermore, these assessments would have to be undertaken on a continuing basis.

D. General Considerations Regarding Proposed Reform

We recognize that expanding the rights of U.S. investors to bring Section 10(b) actions in cases involving non-U.S. companies will not be universally acclaimed. We expect non-U.S. companies that would be subject to increased liability to U.S. investors as a result of a decision to list on a U.S. exchange to object, arguing that our proposal will cause U.S. markets to be uncompetitive. They also may contend that U.S. law would be unreasonably intrusive into securities transactions executed outside the United States, with the result being a lack of respect for international comity. In contrast, foreign investors might object that our proposal would provide them with too little protection because they would have fewer rights of action than U.S. investors. This section addresses those objections.

1. Competitiveness of U.S. Capital Markets

Concerns may be raised about the effect of our proposal on the U.S. securities markets through its expansion of liability for companies listed in the United States. The world securities markets have undergone rapid change in recent years, and exchanges must now compete for listings. Thus, it is important to consider whether a liability standard predicated in part on whether a foreign company has publicly traded securities in the United States would decrease the competitive position of U.S. exchanges. In addition to the negative impact on the U.S. markets, our proposal could result in costs to U.S. investors. If fewer foreign firms listed in the United States, our proposal would decrease, to some extent, the ability of U.S. investors to invest in those firms.

193. *See supra* Part III.

Chinese companies provide a particularly good example of these potential issues because, as noted above, there are currently still limitations on the ability of both individual and institutional investors to purchase shares on China's exchanges. However, the history of substantial numbers of foreign companies choosing to list on U.S. exchanges undermines the argument that the threat of securities fraud class actions makes U.S. exchanges uncompetitive. The conduct and effects test that was in effect prior to the *Morrison* decision permitted private rights of action to far more investors in far more circumstances than we propose. We cannot know what the U.S. public markets would have looked like in the absence of that pre-*Morrison* liability, but, clearly, significant numbers of foreign firms, including Chinese firms, determined that the additional liquidity and prestige of a U.S. listing more than offset the potential Section 10(b) liability.[194] As discussed above, for example, significant numbers of Chinese companies have accessed the U.S. capital markets in recent years.[195] The lack of any significant pricing effect resulting from either the *Morrison* decision or the oral arguments to the Supreme Court—when the Court's skepticism of the conduct and effects test was apparent—also calls into question whether participants in the U.S. capital markets view the liability risk associated with securities fraud class actions as substantial.[196]

As also noted above, Congress and the courts have imposed substantial limitations, in addition to those that resulted from *Morrison,* on class actions and in particular on securities fraud class actions.[197] One commentator encapsulated his viewpoint on those changes in his statement that "the need of foreign companies for protection against litigation in U.S. courts is less today than it has been in decades, in both absolute and comparative dimensions."[198] Our proposal does not affect any of the limitations other than granting U.S. investors the right to bring class action securities fraud cases against non-U.S. companies that choose to list on U.S. exchanges regardless of where the U.S. investors purchase or sell the companies' securities. At the same time, it would retain a more level competitive playing field between non-U.S. and U.S. firms than the Fox Proposal, which would competitively disadvantage U.S. firms.[199]

194. *See* SEC STUDY, *supra* note 8, at 66.
195. *See supra* text accompanying note 172.
196. *See supra* text accompanying note 159.
197. *See supra* text accompanying notes 12–17.
198. Burbank, *supra* note 123, at 664.
199. *See supra* text accompanying notes 160–161.

2. Comity and Differentiation Between U.S. and Non-U.S. Investors

The concerns of foreign companies and governments about the implications of our proposal for international comity, and the objection by non-U.S. investors that U.S. law would provide them with fewer rights than received by U.S. investors, are dealt with together in this subsection. One of the mechanisms used by our proposal to moderate the effect of U.S. class actions on international comity is to differentiate between U.S. and non-U.S. investors. Thus, our rationale for the differentiation addresses the comity concerns.

The potential strain on international comity if a U.S. law is too broad in its authorization of causes of action for class action securities law claims in transnational situations is widely recognized. The Supreme Court in *Morrison* acknowledged the issue of comity, citing amicus briefs from some countries that argued for limited application of Section 10(b).[200] The Solicitor General also was sensitive to the issue, noting that its preferred test, which was narrower than the conduct and effects test but broader than the test ultimately adopted by the *Morrison* Court, was "in accord with prevailing notions of international comity."[201]

International comity does not have a single definition. One oft-cited early statement by the Supreme Court supplies two basic considerations for comity: "having due regard . . . to international duty and convenience"[202] on the one hand and "to the rights of its own citizens or of other persons who are under the protection of its laws" on the other.[203] The second consideration accords with the argument made against use of U.S. class actions in securities fraud suits with transnational implications by some foreign governments, namely that their legal systems permit appropriate actions by investors in cases of securities fraud.[204]

Our study of China's class action securities fraud regime permits us to test the argument that U.S. investors who buy securities of Chinese companies in China have sufficient remedies under Chinese law if they are defrauded. We certainly do not make the claim that China provides no protection to U.S. investors against securities fraud.[205] Our focus here is limited to the availability of class

200. *See* Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2885–86 (2010).
201. See *id.* at 2887.
202. Hilton v. Guyot, 159 U.S. 113, 164 (1895).
203. *Id.*
204. *See* SEC Study, *supra* note 8, at 55–56.
205. *But see supra* text accompanying notes 53–57 (discussing limitations of China's system of securities regulation).

actions. Our finding on that point, as discussed above, is that numerous barriers, imposed explicitly by proclamations of the Supreme People's Court[206] or implicitly through incentives to the lower courts and potential political considerations by government enforcement bodies,[207] limit the ability of investors to use class actions in instances of securities fraud. The 2012 amendments to the CPL permit entities that qualify as related organizations to bring representative actions.[208] Professors Liu and Xu believe this may increase the use of securities fraud class actions but will not address many of the impediments to those actions discussed above. Although our study is of only one country, China, it is a country that is important in considering the protection of U.S. investors both because of the recent pattern of securities fraud among a number of Chinese companies that have accessed the U.S. capital markets in recent years and because it is not a question of if, but at what pace, China's economic development and world economic influence will continue to expand.

The second factor at issue in weighing international comity concerns is "having due regard . . . to international duty and convenience."[209] In summary, in the authors' view, our study of China's securities law regime for class actions provides a rich set of explanations for why China has chosen to limit those actions.[210] When carefully considered from the perspective of comity, however, we find that the primary concerns with securities fraud actions in China flow from the potential use of class actions by Chinese citizens and have limited application to the rights of non-Chinese citizens in actions brought outside China.[211] Our proposal, which does not extend the rule from *Morrison* with respect to the right of non-U.S. investors to bring class actions, is sensitive to China's concerns regarding the rights of its domestic investors, just as our proposal is sensitive to the obligation of the United States to ensure its laws appropriately protect U.S. investors.

One issue discussed in China regarding the use of collective actions in securities fraud cases is the potential of social unrest. By limiting the extension of rights to U.S. investors, our proposal does not risk empowering foreign investors in ways that their home countries might find challenging. Our proposal does not grant foreign investors additional rights of action in the United States that

206. *See supra* text accompanying notes 76–79.
207. *See supra* Part III.A.2.
208. *See supra* text accompanying notes 101–02.
209. Hilton v. Guyot, 159 U.S. 113, 164 (1895).
210. *See supra* Parts III.A.2–3.
211. *Id.*

might lead them to seek similar rights in their home jurisdiction, nor does it risk providing them with any new source of action against companies from their home country that they would not have under local law. Our proposal also does not interfere with the judicial administrative incentives established abroad. If anything, our proposal should reduce the external pressure on countries where investors have limited or no access to class actions to deviate from their policy choices because U.S. shareholders would be permitted to assert legal claims in the United States rather than having to attempt to seek vindication of those claims either in the place where they engage in securities transactions or in the home country of the foreign company.

Another set of issues with the internal use of class actions in China results from the Chinese government's ownership interest in Chinese companies and includes the potential for wealth transfers from the general populace to investors[212] and the possibility of political considerations infiltrating the decision making of the judiciary and government enforcement bodies.[213] Our proposal mitigates these concerns by giving U.S. investors, and only U.S. investors, a mechanism in the United States to pursue securities fraud actions against non-U.S. companies, including Chinese companies. Because those lawsuits would occur within the United States, they entirely avoid China's concern about the potential for political considerations to affect the proceedings of its domestic courts and government enforcement bodies.

Our proposal admittedly permits U.S. fraud class actions to be brought in the United States against Chinese companies with government ownership. The result of fraud awards or settlements may result in some transfer of wealth from the Chinese state to U.S. investors. But, to the extent a company with government ownership chooses to list on a U.S. exchange, the company, and impliedly its shareholders, would be willingly assuming the risk of securities fraud suits brought by U.S. investors based on securities transactions by those investors anywhere in the world in exchange for the possibility of direct access to the U.S. public capital markets. In balancing the comity concern of intrusion of U.S. fraud law into China's domestic affairs with the obligation of the United States to protect U.S. investors, this compromise holds the state equally responsible for securities fraud from a financial standpoint as it holds any other shareholder. But, because it does not expand the rights

212. *See supra* text accompanying notes 119–20.

213. *See supra* text accompanying notes 117–18, 122.

of non-U.S. investors, our proposal does not increase the risk of intra-country transfers of wealth between shareholders and society.

A final Chinese concern regarding class actions generally, and securities fraud class actions specifically, is whether the judicial system and securities markets are sufficiently mature for large, complex class actions.[214] Our proposal does not implicate this concern at all because we advocate only an extension of rights under U.S. law involving lawsuits within the United States. In fact, it arguably would reduce the burden on Chinese courts because, if given a choice, one would expect U.S. shareholders to choose to litigate securities fraud claims against Chinese companies in the United States rather than in China.

Conclusion

The use of class action lawsuits continues to be the subject of much debate in the academic and policy communities throughout the world. Although the debates about class actions are to some extent agnostic across doctrinal boundaries, this Article focuses on the use of class actions in cases involving transnational securities fraud. In light of the globalization of the securities markets and China's increasing economic power, the Article investigates China's approach to class actions. It finds that administrative incentives and authoritative statements by the Supreme People's Court more heavily circumscribe the use of securities fraud class actions than would be apparent from comparing Rule 23 with the equivalent provisions in the Chinese civil procedure code.

The rejection of U.S.-style class actions by a burgeoning economic power with a rapidly developing system of securities markets arguably affirms the validity of the Supreme Court majority's concern, expressed in its decision in *Morrison,* with international comity. However, the balance of interests between the United States and China, or between the United States and any other country, depends on a complex set of considerations that in the case of U.S. securities law should include the protection of U.S. investors and trading markets and deterrence of those who might cause the United States to "become the Barbary Coast for those perpetrating frauds on foreign securities markets."[215] After analyzing the effects of the *Morrison* decision and considering various proposals intended to address those effects, we make the simple, limited

214. *See supra* text accompanying notes 75–79.
215. Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2886 (2010).

proposal that the '34 Act be amended to authorize U.S. investors to bring Section 10(b) class actions against non-U.S. companies whose securities are traded on a U.S. exchange regardless of where those investors entered into the relevant securities transactions.