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Reforming private securities litigation in China: The stock market has already cast its vote

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ABSTRACT

This paper employs a natural experiment research design to analyze the differences in the effects of the 2002 notice concerning private securities litigation issued by the Supreme People's Court on stock price performance in A/B-share markets. Using a sample of 162 twin A/B-shares issued by 81 listed firms, we find that the portfolio of B-shares, which are treated and held in large volumes, obtains a significant positive treatment effect of 2.08% relative to that of A-shares over a 3-day event window. The treatment effect indicates that the collective action problem undermines the compensatory function of the private enforcement system, which is the primary goal it was designed to achieve. In addition, we look into the determinants of the abnormal return between A/B-shares issued by the same firm and find that the efficiency of the regional court system is positively correlated with the magnitude of the abnormal return. Rational investors expect that the compensation from private litigation is determined by the costs of using the judiciary system.

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1. Introduction

Cross-country empirical studies have shown that both public and private enforcement of securities laws contribute to stock market development (La Porta et al., 2006; Jackson and Roe, 2009).[1] With better enforcement, outside investors are willing to pay more for equity assets, as a result of which more firms are able to finance their investments externally. Private enforcement through securities class litigation has already become an important external governance mechanism and has helped to regulate corporate officials (Thompson and Sale, 2003). Although there is much empirical evidence on private enforcement of securities laws in developed countries, such as the "Private Securities Litigation Reform Act of 1995 (PSLRA)", which was enacted to curb the widespread frivolous suits and agency problems of plaintiffs' attorneys, which significantly undermined the confidence in American securities markets (Choi, 2004),[2] much less is known about reforms conducted in transitional countries.

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[1] The enforcement of laws determines the probability that an offense is caught, which transfers the "law on the book" to *de facto* deterrence. An improvement in enforcement will raise the expected costs of crimes and, hence, decrease the number of offenses committed when other factors are held constant (Becker, 1968). In addition to enforcement, the "law and finance" scholarship also identifies that the "on the book" investor protection laws facilitate stock market development, see two survey articles, La Porta et al., 2008 and Xu (2011). However, Helland and Klick (2011) comment that the statistical identification is overlooked in this strand of literature. Licht et al. (2005) show that cross-cultural psychology could be an alternative explanation for both investors' and creditors' rights. Xu and Xu (2014) further apply the Bayesian model averaging algorithm to empirical macro-law-and-finance studies, and find that the empirical conclusion that "law matters" for stock market development is fragile.

[2] The Congressional override of President Clinton's veto of the PSLRA has brought about significant positive abnormal returns for those stocks of firms in high-litigation-risk industries (Spiess and Tkac, 1997; Johnson et al., 2000). Johnson et al. (2007) report that lawsuits against forward-looking statements are significantly reduced and there is a higher correlation between merit-related factors and securities class actions post-PSLRA. However, the reform is not entirely satisfactory in achieving its goals. First, Choi (2007) shows a side effect of the PSLRA in reducing potentially meritorious suits against smaller firms and those without pre-filing "hard evidence". Second, Choi et al. (2009) find that the PSLRA succeeds in discouraging the file of nonnuisance suits, but not nuisance ones. Finally, Choi et al. (2011) reveal that law firms actively make campaign contributions to officials with influence over state pension funds, which now serve as lead plaintiffs in a

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This paper adopts a natural experiment research design and investigates the differences in the effects of the Supreme People's Court of the People's Republic of China (SPC)'s *2002 Notice Regarding Accepting Tort Cases Arising from Stock Market False Disclosure* (henceforth, *SPC's 2002 Notice*),[3] which, for the first time, explicitly allowed private securities litigations[4] to be accepted, on stock price performance in A/B-share markets. Before *SPC's 2002 Notice* was enacted, listed companies in China faced no *de facto* threats of private litigation (Hutchens, 2003; Liebman and Milhaupt, 2008),[5] although the "law on the book" generally forbade misrepresentations and provided grounds for civil compensation.[6]

The securities litigation system designed by *SPC's 2002 Notice* is compensation-oriented and differs significantly from its American counterpart, which combines the functions of both deterrence and compensation (Cox, 1997; Coffee, 2006). First, an administrative prerequisite requires that private suits should be based on sanctions of public agencies, mainly the China Securities Regulatory Committee (CSRC), or courts' criminal judgments (Hutchens, 2003; Guo and Ong, 2009).[7] In addition, *SPC's 2002 Notice* aggravates the collective action problem in shareholder litigations and requires that they should be brought as individual or joint actions, instead of US-style class actions. Furthermore, the intermediate-level courts at the place where the defendant firms are located have territorial jurisdiction (Lu, 2003), which significantly increases plaintiffs' burdens to pursue such suits. Finally, although the culpable could be listed as the defendants, they rarely pay compensations out of their own pockets, leading to the problem of circularity.

A unique feature of Chinese stock markets is that a proportion of listed firms issue legally identical "twin A/B-shares", which offers an opportunity to examine the market responses to the private enforcement system in different institutional settings. The two types of shares are ordinary shares with the same voting rights and dividends (Chan et al., 2008). However, the transactions, dividend payments, trades, and quotes of B-shares are conducted in foreign currencies: Shanghai B-shares are traded in US dollars, and Shenzhen B-shares are traded in Hong Kong dollars, which leads to different investor structures in these two markets.[8] The majority of investors in the A-share market are "scattered households" (*San Hu*), who generally hold trivial interests in listed firms and adopt a speculative strategy (Hutchens, 2003; Mei et al., 2009). These retail investors suffer from the collective action problem and are "rationally apathetic" to the right to seek compensation. In contrast, investors in B-share markets comprise mainly foreign and domestic institutional shareholders, especially privately managed investment funds raising money from the wealthy in the grey market (Bohl et al., 2010), who would have enough incentives to overcome collective action problems and file private suits.[9] With litigation rights, institutional shareholders could also employ alternative strategies, such as striking settlement agreements with potential defendant firms, if the costs of going to trial are high enough.[10]

We therefore collect a sample of 162 A/B-shares issued by 81 listed firms that undertook their IPOs on the Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE) before January 1, 2002, and employ regression adjustments, which are shown to significantly reduce potential biases (Cochran and Rubin, 1973; Rubin, 1973; Ho et al., 2007). A significant positive abnormal return for B-shares relative to A-shares is documented, which is approximately 2.08% over the 3-day event window after controlling for market liquidity proxy, firm-specific characteristics and industrial dummies. We further find that the magnitude of the abnormal return between B-shares relative to A-shares issued by the same firms is determined by the level of regional judiciary efficiency where listed firms are located.[11]

Our research is closely related to two recent studies on the private enforcement system of Chinese stock markets. First, Humphery-Jenner (2013) conducted an event study on the promulgation of *SPC's 2003 Provisions* and argues that given the same regulatory regime, good laws aimed at curbing misrepresentations could cause negative impacts on the information environment of the stock market in China because the negative externality of a new law outweighs its positive externality.[12] Our results provide

substantial number of cases. These contributions tend to undermine the PSLRA's efforts to mitigate the agency problems of plaintiffs' attorneys.

[3] See *Zuigao Renmin Fayuan Guanyu Shouli Zhengquan Shichang Yin Xujia Chenshu Yingfa de Minshi Qinquan Jiufen Anjian Youguan Wenti de Tongzhi* (promulgated by the SPC, January 15, 2002, effective January 15, 2002) (P.R.C.). *SPC's 2002 Notice* only set out general features of the private litigation system, a subsequent provision, *2003 Provisions Concerning the Adjudication of Civil Compensation Securities Cases Based upon Misrepresentation* (henceforth, *SPC's 2003 Provisions*), was issued to provide detailed guidance to private securities litigation, see *Guanyu Shenli Zhengquan Shichang Yin Xujia Chenshu Yinfade Minshi Peichang Anjian de Ruogan Guiding* (promulgated by the SPC, January 9, 2003, effective February 1, 2003) (P.R.C.).

[4] The private suits governed by *SPC's 2002 Notice* include those against misrepresentations in the stock market and exclude those due to insider trading and market manipulation.

[5] Li Guoguang, the deputy president of the SPC, commented that none of the civil claims brought and filed in the people's courts between 1991 and 2002 due to misrepresentations, market manipulation, or insider trading was continued to the state of substantial hearings. See *Gaofa Fuyuanzhang Li Guoguang Xishuo Guojia Jinrong Anquan de Sifa Baozhang* [*Deputy President of the Supreme People's Court Li Guoguang Talks in Detail about Judicial Protection for the State Financial Safety*], NEWS WEEKLY, July 23, 2002, available at http://www.people.com.cn/GB/shizheng/19/20020723/782456.html (last access on 23/12/2014, in Chinese).

[6] See Gupiao Faxing yu Jiaoyi Guanli Zanxing Tiaoli [Tentative Regulations on Administration of the Issuing and Trading of Shares] (promulgated by the State Council, April 22, 1993, effective April 22, 1993) (P.R.C.).

[7] CSRC made a small number of enforcement actions. Chen et al. (2005) report that CSRC performed 169 regulatory actions against listed companies in 4 years post the *1999 Securities Law*, i.e., approximately 42 cases per year, which is confirmed by the study carried out by Liebman and Milhaupt (2008) on cases from 2001 to 2006. In addition, Huang (2013) shows that CSRC made 253 sanctions for misrepresentation from 2002 to 2011, amounting to approximately 25 cases annually. The limited outputs generate concerns that while such procedural hurdles may exclude frivolous suits, they may also screen out potential meritorious ones for compensation (Hutchens, 2003; Guo and Ong, 2009; Lu, 2003). However, Layton (2008) argues that the administrative prerequisites should bring value to listed firms, considering the capability of the judiciary system and the long history of public-oriented regulation.

[8] To be specific, we mean investors of tradable shares, which consist of "new shares issued in IPOs and seasoned cash offerings and those derived from tradable shares in rights offerings and stock splits" (Liao et al., 2014: 502). The tradable shares were held mainly by outside investors before the *Reform of the Split-Share Structure* beginning in 2005. Non-tradable shares were held mainly by the State and legal persons, who are also the controlling shareholders of listed firms.

[9] Institutional investors in American markets also leave money on the table, due to the failures in the notification process and monitoring of the custodian to file the claims (Cox and Thomas, 2002, 2005). However, the problem indentified may not matter in China, because the information for administrative sanctions and criminal judgments is available to the general public. Institutional investors are able to identify those cases satisfying administrative prerequisites.

[10] Firth et al. (2011b) survey the lawsuits involving listed firms and report that plaintiff firms suffer from negative abnormal return on the event date, which they ascribe to the daunting litigation costs offsetting the expected return from judgments.

[11] Regional judiciary efficiency also matters for the expected compensation of settlements because it relates to the comparative bargaining power of the two parties. The minimum benefits of injured investors are the expected compensation of going to trial, which equals the actual loss minus the costs of using the court system. If the regional court system is inefficient, going to trial could be expected to generate negative return for investors with small stakes. Anticipating this, rational defendant firms are unlikely to reach an agreement with aggrieved investors.

[12] The identification assumptions employed by Humphery-Jenner (2013) should be taken cautiously. First, Polinsky and Shavell (2000) conclude that public enforcement of the law is better than private enforcement when victims are not aware of who injured them. Following their thinking, Bhattacharya and Daouk (2009) acknowledge that public enforcement has advantages in protection against insider trading and private enforcement in securities fraud when infringers are known. Hence, *SPC's 2003 Provisions*, which aim at improving private enforcement against

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