

Protection of Small and Medium-sized Investors under the Securities Law

A Study on Information Disclosure and Early Payment System of Listed Companies

Siyao Wang^{1,a,*}

¹*School of foreign languages, Northeastern University, Shenyang, Liaoning, 110819, China*
a. wsy18240282584@163.com

**corresponding author*

Abstract: Small and medium-sized investors occupy the vast majority of China's securities market. However, the rights and interests of small and medium investors are not protected due to the disparity of power with companies, lengthy trial periods, high trial costs and lack of professional knowledge. Through comparative legal analysis, the article first examines the natural investors, followed by the analysis of the policies and implementation status in China and the United States based on data and cases, along with the viability of relevant policies in both countries. Finally, it provides suggestions for the existing policies.

Keywords: small and medium-sized investors, new securities law, advance compensation system

1. Introduction

Infringement of small and medium investors' rights and interests by listed companies happens from time to time due to the strength gap between both parties as well as other factors. After infringement occurs, firstly, it is more difficult to identify the direct infringement in the securities market. Next, other than having an extensive trial period in such cases, the parties do not pay sufficient attention to the cases as they are preoccupied with numerous trivial matters in their daily lives, thus resulting in discontinuous cognition. Last but not least, small and medium-sized investors tend to lack expertise in the securities industry, increasing their possibility of failing to discover the company's illegal acts. Based on this, China actively reformed the securities law and implemented the listing registration system and the early compensation system, all with the goal of maximizing the protection of the rights and interests of small and medium-sized investors from infringement and preserving their enthusiasm for investing in the securities market. Nevertheless, some protection measures have yet to be implemented due to the slow onset of the concern for small and medium-sized investors. For example, in contrast with the securities industry, the first-pay system is now mostly employed to protect motor vehicle traffic accidents, insurance claims and consumer rights. To summarize, this article develops the study based on the above background. The exploration of the protection of natural investors in the field of securities law not only has a great effect on the protection of the interests of small and medium investors in this field, but also can warn us to look back at the protection of small and medium

investors in other fields, effectively implement the protection policy, boost the confidence of small and medium investors in investment, and promote the good development of China's securities market.

2. Definition of Important Terms and Typical Cases

Disclosure (also translated as "public") refers to the sharing of information possessed by the dominant to the party with information disadvantage that the latter does not [1]. The advanced compensation system results from the joint action of the private law entity and the public law authority, which converts the first-lien payer's tort debt into a contractual debt at the private law level and functions as an administrative settlement at the public law level [2].

3. Related Policies of the United States and China

Mediation, arbitration, and litigation are the three main channels for small and medium-sized investors to defend their rights in China. On the legal level, the implementation of the new securities law created the investor suitability management system, differentiated regular investors and professional investment institutions, the advanced compensation system, and the representative litigation system.

Conversely, the U.S. primarily uses the FAIR fund system. Through the Federal Account for Investor Restitution Fund (FAIR Fund), the Securities and Exchange Commission ("SEC") collects the proceeds of securities fraud (Disgorgement), civil penalties (Civil Penalties) through administrative proceedings (Administrative Proceedings), or civil litigation from the fraud perpetrator [3].

The China SEC handled 609 cases in 2021, including 163 major cases. With 163 information disclosure cases, 75 of them were financial fraud, which is an 8% year-on-year increase [4]. Following the development of unlawful means and the amount involved, the number has mushroomed, thus negatively influencing the market. Insider trading cases 201 instances, and the leaking of insider information accounted for a relatively high percentage of 110 market manipulation cases, thus indicating manipulation of the market case gang [4]. Since most violators are professionals, the effect and consequences are even worse as cases of intermediary violations increase. The strength of a nation's securities market is closely correlated with the degree of legal protection provided to investors outside of corporations. From the aforementioned evidence, it becomes clear that there have been sporadic instances of fraud, market manipulation, and insider trading with unfair information in recent years. Therefore, it is critical to safeguard the legal rights, financial interests, and excitement of small and medium-sized investors, who comprise most of China's stock market participants.

4. Small and Medium-Sized Investors

As of the end of 2021, A-share investor accounts totaled 197,408,500, of which 196,939,100 belonged to natural person investors and 469,400 to non-natural person investors [5]. Thus, it is evident that the main participants in China's securities market are small and medium-sized investors.

Listed businesses occasionally violate the rights and interests of small and medium investors in the Chinese securities market due to their corporate objective of maximizing profits. Cases involving rights protection are unique in that they involve significant financial outlays, protracted trial periods, and challenges in determining instances of direct infringement in the stock market [2]. Additionally, there is a tremendous power disparity between small and medium-sized investors and publicly traded corporations, minimal understanding of securities, a propensity to follow the crowd, blind listening, blind compliance, etc. Owing to their unsustainable cognition and lack of attention to the cases, small and medium investors frequently experience infringement. As a result, failure of rights defense has become prevalent in such cases.

The deception of small and medium-sized investors is a common occurrence in China. For instance, Xin company fabricated significant financial false content in the prospectus and issued shares by resorting to falsifying financial data and other means in order to achieve the purpose of listing and issuing shares. Consequently, the shareholders' rights and interests were severely harmed. However, only a fine of RMB 8.32 million and an imprisonment term for the defendant firm were ultimately imposed, which was insufficient to compensate for the damage done to small and medium-sized investors [6].

The Kangmei Pharmaceutical case represents the most prominent instance of financial fraud in China to date. From 2016 to 2018, Kangmei Pharmaceuticals inflated and overstated revenue and interest by a total of \$29.966 billion [7]. They generated a total of 80.393 billion yuan by issuing stocks, bonds, and loans between March 2001 and October 2018 [7]. After the financial fraud scandal came to light, Kangmei Pharmaceuticals' stock market valuation dropped to 15.2 billion yuan, leading to a loss of 123.8 billion yuan. According to the shareholding ratio of 67.28% of small and medium shareholders, this translates to a loss of around 83.3 billion yuan for more than 280,000 small and medium shareholders [8].

The first payment system is currently mainly applied for consumer protection and insurance in China. As of 2022, the advanced compensation method was applied in 165,545 cases involving motor vehicle traffic accident liability conflicts. Still, securities legislation has seen far fewer applications, not to mention the difficulties in adapting to the needs of protecting small and medium-sized investors.

Shortcomings in our securities markets are caused by stringent legal requirements and pervasive legal breaking, as listed corporations benefit much from doing so due to the minimal cost of law breaching. Even if they are penalized, the price they pay will be significantly less than what they otherwise earned.

5. Relevant U.S. Laws and Regulations

The Fair Fund System is an institutional framework that collects fines levied by the Securities and Exchange Commission (SEC) against offenders into a fund and distributes them to victims to ensure the priority of the civil liability principle is realized, thereby enhancing investor protection [3].

A number of stunning financial fraud cases, including the Enron trial, aided the United States in understanding the importance of creating an equitable fund system. Over the past 20 years, the standards and limitations for individuals it can protect have been lowered while broadening the extent of Fair Fund coverage. As of 2019, 95 investment advisory firms that voluntarily self-reported to the Division were required to refund affected mutual fund investors a sum of over \$135 million [9].

In the 2019 fiscal year, the Commission filed lawsuits against publicly traded corporations for various alleged wrongdoings, including fraud, inadequate disclosure controls, false risk factor disclosures, and false presentation of non-GAAP measures. For instance, Facebook was penalized with a \$100 million civil fine for ignoring the risk of user data abuse [9]. Moreover, Fiat Chrysler Automobiles N.V. and FCA US LLC were fined \$40 million for exaggerating reported monthly sales results and falsifying sales [9]. After Hertz Global Holdings LLC was found to have materially misstated its pre-tax income in its public filings, a \$16 million fine was imposed [9]. Overall, these incidents highlight the Division's and the Commission's emphasis on the integrity of financial statements, the veracity of issuer disclosures, and their willingness to sanction severe corporate misbehavior.

The following categories best describe the factors that contribute to the creation and growth of the fair fund system in the United States. Due to the number of parties involved and the amount of money at stake, the majority of securities market fraud cases are well-known cases that cause a social sensation. In addition, they are occasionally paired with group lawsuits, which attract professional litigators and raise public attention in this area. Hence, the public pressures the judicial authorities to

expedite the process and ensure fair justice. Subsequently, in addition to the judge's verdict, the U.S. jury system necessitates the consideration of the jurors' opinions, which are based on their knowledge and legal awareness as the criteria for their verdict. As the general public, juries are mostly affiliated with small and medium-sized investor groups. Hence, they can empathize with small and medium-sized investors and render verdicts more fairly from their standpoint.

However, several fundamental problems with the fair fund system exist, such as far smaller awards than the financial losses incurred by small and medium-sized investors in their investments. The publication claims that the Fair Fund only received one-fourth of the settlement money from the securities litigation in the Dell case. Other than that, the Fair Fund covered only 5.5% of the victims' losses in the infamous WorldCom deception case [10].

6. Conclusion

As we reflect on our policy, the characteristics of small and medium-sized investors should be taken into account. The first step is to raise the amount of compensation, which can serve as a deterrent to the offenders and encourage strict law enforcement against the subject of the law violation so that it would not pay; on the other hand, it can motivate small and medium investors whose rights and interests are infringed to firmly pursue a lawsuit against the offenders and defend their rights in court. Secondly, the trial period should also be cut short. Most small and medium-sized investors have jobs, may own shares in several companies concurrently, and may be involved in multiple litigation cases. Based on the nature of their general public, the lack of legal knowledge and awareness of their own rights, the lack of attention to the case itself, the cognitive continuity, and other characteristics. Small and medium-sized investors are likely to find the trial cycle process draining, resulting in their subsequent abandonment or even withdrawal of the case. Therefore, the offenders fail to receive proper punishment and will continue to violate the law.

Finally, we need to minimize the secondary damage and approval process for cases involving small and medium-sized investors. Other than centralizing the establishment of a special approval department for relevant cases, and procedural that approval process. Small and medium-sized investors may assume multiple roles in their daily lives, including those of their jobs, parents of their children, thus having no time to care about the numerous revisions and appeals to court involving legal paperwork. To boot, frequent documents revisions may be of an issue in their daily lives, causing them to give up their rights under the premise of the power disparity with the offenders. Therefore, we should try our best to simplify the process by creating a more professional process and making it accessible online in advance for small and medium-sized investors to check and prepare.

References

- [1] Xing Huiqiang.(2018). *Deficiencies of the Disclosure System in Financial Law and its Reform - A Reflection from the Perspective of Behavioral Economics*. *Securities Market Herald* (03),64-72. doi:.
- [2] Xiao Yu& Huang Hui.(2019). *Early payment of compensation in the securities market: legal analysis and institutional construction*. *Jurisprudence* (08),160-172. doi:.
- [3] Guo Li.(2018). *Public Compensation in Securities Enforcement: An Exploration of and Lessons from the U.S. Fair Fund System*. *Tsinghua Law* (06),59-78. doi:.
- [4] *China Securities Regulatory Commission website, 2022. 《SEC informs about 2021 case handling》* , <http://www.csrc.gov.cn/csrc/c100028/c1921138/content.shtml>.
- [5] *China Securities Depository and Clearing, 2022.2021China Securities Depository and Clearing Corporation Statistical Yearbook*, http://www.chinaclear.cn/zdjs/editor_file/20230202154737107.pdf.
- [6] *Dandong Intermediate People's Court,2019. Xinmou Co., Ltd, Wenmou B, Liu Mousheng fraudulent issuance of shares and disclosure of material information in violation of the law*, <https://www.jufaanli.com/detail/YDhpHfi0/?q>.
- [7] *Securities and futures law database,2020. Announcement on Receipt of Administrative Punishment Decision Letter from China Securities Regulatory Commission by Kangmei Pharmaceutical Co,*

<https://neris.csrc.gov.cn/falvfagui/rdqsHeader/lawWritInfo?navbarId=3&lawWritId=dc11110e4aa8454eb25330cb1ffffd244>

- [8] Huang Shizhong.(2019). *Analysis of Extended Financial Fraud by Kangmei Pharmaceutical*. *Finance and Accounting Monthly* (17),3-6+178. doi:10.19641/j.cnki.42-1290/f.2019.17.001.
- [9] The U.S. Securities and Exchange Commission,2019.Division of Enforcement 2019 Annual Report. <https://www.sec.gov/reports>.
- [10] Verity Winship, *Fair Funds and the SEC's Compensation of Injured Investors*, *Florida Law Review*, 60 *FLO RIDA LAW REVIEW* 1103, at 1114 (2008) .