Institutional Predicaments and Optimization Paths in the Causality Determination of Liability for False Statement of Securities

Jiangyu Deng

College of Law and Humanities, Zhejiang Sci-Tech University, Hangzhou, China

Abstract. In recent years, with the deepening implementation of China's registration system, the number of disputes related to liability for false statement of securities has increased significantly. In practice, problems such as the overly mechanical application of causality determination in liability for false statement of securities and the lack of uniform standards for determining the day of disclosure of false statement remain unresolved. This paper, through empirical analysis and comparative law study, proposes optimization paths that include clarifying the boundaries of the application of the fraud on the market theory, expanding the scope of application for causality presumption and unifying the standards for determining the day of disclosure of false statement. The aim is to establish a regulatory paradigm for the causality determination in liability for false statement of securities with Chinese characteristics, assisting regulatory agencies in improving laws and regulations, thereby strengthening constraint of information disclosure, enhancing market transparency, and promoting the sound development of the capital market.

Keywords: False statement, Causality determination.

1. Introduction

In recent years, with the full transition from the approval system to the registration system for securities issuance review, information disclosure has become more comprehensive and in-depth. The accountability framework of the securities market has undergone a transformation, with increasing emphasis on the application of civil liability. The number of cases concerning false statement of securities in China has rapidly increased, particularly following the Kangmei Pharmaceutical case [1], where intermediary institutions began to bear joint liability, leading to frequent disputes over the accountability of intermediaries. The implementation of the new Securities Law of the People's Republic of China (hereinafter referred to as the new Securities Law) in 2020 further standardized securities issuance and securities trading. On December 30, 2021, China’s Supreme People’s Court (SPC) issued the “Several Provisions on the Trial of Cases of Civil Damages for False Statement Infringement in the Securities Market” (hereinafter referred to as the Provisions), which improved the causality determination in liability for false statement of securities and responded to previous criticisms regarding “it’s overly stringent to exclude causality determination for investors who sold securities before the disclosure day of false statement or the correction day of false statement (hereinafter referred to as the disclosure day) [2]. “Causality” serves as an important logical link between illegal behavior and the damage, making it a core issue in tort damages, and a long-standing challenge for both theoretical and practical fields. In securities civil damages cases, due to the unique nature of securities transactions and the difficulties investors face in adducing evidence, the causality determining between the defendant’s tort and the plaintiff’s damage remains a key difficulty in achieving judicial remedy. This study, based on empirical analysis of the judicial predicaments in causality determination in liability for false statement of securities in China, critically incorporates foreign practical experience in light of the domestic capital market’s heterogeneity and proposes optimization paths for the causality determination in liability for false statement of securities. By combining legislation and practical application, this study aims to establish a regulatory framework for the causality determination in liability for false statement of securities with Chinese characteristics, to support regulatory agencies in improving laws and regulations, further strengthening the supervision of information disclosure, enhancing market transparency, and promoting the sound development of the capital market.

2. Judicial predicaments in causality determination of liability for the false statement of securities

2.1. Mechanical application of causality determination

Although there are many deficiencies in the application of causality presumption, it plays an important role in improving judicial efficiency and safeguarding investors' rights. One of the most contentious issues in securities false statement liability disputes in recent years has been the causality as well as the responsibility distribution between multiple acts of false statements by issuers and intermediary institutions and investors' failed investment decisions. Professional intermediaries play a critical role in the preparation of public documents, and as a result, investors place reasonable trust in these intermediaries [3]. In most cases, the issuer makes false statements, and intermediary institutions also have "false" content in the documents they issue, which easily leads to a "multiple causes, one effect" situation. In cases of "causes co-opetition", directly presuming the establishment of causality is detrimental to balancing the interests of all parties involved.

Overall, proving the causality between the actions of each party and the losses suffered by investors is quite difficult since the investment motives of investors are objectively difficult to define. Applying a presumption of causality could ensure judicial efficiency and protect the interests of minority investors, however, the Provisions and related interpretations do not provide clear answers on whether causality presumption can be applied to intermediary institutions. Court rulings tend to presume causality entirely, essentially avoiding discussions on the causality between actions and outcomes. The focus shifts to investigating the causes and faults of each party to determine the scope of their responsibilities. Intermediary agencies primarily rely on information from directors, supervisors, controlling shareholders, and actual controllers. However, because of the interests between directors, et al. and the company, the information provided by the company often requires third-party verification by the intermediaries. Given the limitations of investigative methods, it is possible that intermediaries have exhausted all means but still cannot obtain authentic and accurate information. If the presumption of fault is applied, a hasty ruling imposing joint liabilities on both the issuers and the intermediary agencies would violate substantive fairness [4]. The determination of liability for false statements of securities has relatively high requirements for marketability and technicality, and different types of securities have various technical requirements [5]. Taking underwriters as an example, in an initial public offering (IPO), the securities company acting as the main underwriter differs significantly from a commercial bank that acts as the main underwriter in the issuance of non-financial corporate debt financing instruments. While both types of underwriters are involved in document preparation, due diligence, and pricing, securities companies in IPOs bear broader responsibilities for information disclosure, and their promotional and price stabilization mechanisms are more complex. While commercial banks in bond underwriting focus on financial prudence, market-driven pricing, and compliance confidentiality, with a more institutionalized process [6]. Therefore, in handling cases, it is essential to conduct a detailed, case-specific analysis and judge the professional duties of each intermediary agency carefully.

2.2. Fragmentation of standards for determining the day of disclosure of false statements

Through the review and analysis of practical cases, it was found that the day of disclosure of false statements in judicial practice mainly manifests in six forms: (1) the day the listed company announces the receipt of an administrative penalty decision; (2) the day the China Securities Regulatory Commission (CSRC) announces the investigation notice; (3) the day the listed company self-discloses the information; (4) the day the administrative penalty pre-notice is issued; (5) the day the media reports release; and (6) the day the listed company receives the administrative regulatory measures notice. Current legislation lacks clear provisions on the day of disclosure, and judicial interpretations of this concept are also vague. Moreover, in the application of law, the constitutional principle of equality is specifically reflected in the idea of "equal treatment under equal circumstances" [7]. As a result, courts have considerable discretion in determining the day of disclosure of false statements, and it is generally difficult to definitively determine whether a statement is false or misleading based solely on the form in which the disclosure occurs [8]. This can lead to the "same cases, different judgments" dilemmas, which damages judicial credibility. Some courts consider the day on which information related to the false statement is disclosed through media outlets that are widely accessible to investors across the country as the first disclosure day [9]. Other courts, however, in addition to this requirement, emphasize that the disclosed content must align with the criminal judgments issued by courts or the administrative penalty decisions issued by the CSRC. Additionally, some courts consider the day of the announcement of the investigation notice as the disclosure day due to significant stock price fluctuations that occur following the announcement, raising debates over whether these fluctuations are related to the determination of the disclosure day [10].

3. Comparative study on causality determination in liability for false statement of securities

3.1. United States: reliance-based causality theory and the maturation of standards for materiality determination

The concept of securities false statements was first systematically and comprehensively interpreted in the United States in the Securities Act of 1933. Section 11 of the Act defines securities false statement behavior as "false record" "major omissions" and "misleading statements". [11] In the Basic Inc. v. Levinson case, the U.S. Supreme Court recognized fraud on the market theory [12], introducing the rebuttable "presumption of reliance" in securities civil litigation [13]. The establishment of the presumption of reliance provided a basis for determining the causality between false statements and damages, significantly alleviating the plaintiff's burden of proof. The U.S. Supreme Court considered reliance to be an essential condition for establishing causality in transactions [14]. In securities civil damages cases, the U.S. gradually developed a "dual causality theory". First, the causality of the transaction, establishes that a transaction would not have occurred without the defendant's unlawful conduct, emphasizing the connection between false statements and investment decisions. Second, the causality of the loss, where loss is directly caused by the unlawful act, focuses on the relationship between false statements and the resulting damages. The fraud on the market theory has made the "presumption of reliance" nearly a general rule in the U.S. securities civil relief system. However, the presumption of reliance addresses the causality of the transaction, while the loss causality largely depends on judicial discretion. Since judges' decisions are highly subjective, there are differences in U.S. judicial practice regarding the recognition and judgment of causality between false statements and investors' losses, which in turn affects the predictability of rulings. For example, in the case of loss causality presumption, some judges believe that once the plaintiff demonstrates the materiality of the false statement, the loss causality is presumed to exist, as seen in the Control Data case [15]. However, other judges adhere to a strict causality standard, denying the connection between the fraud on the market theory and loss causality presumption, as in the Robbins case [16].

Regarding the standard of materiality determination for securities false statement cases, in the early development stages of the U.S. securities market, courts predominantly applied a subjective standard. As the U.S. securities market further developed and the number of securities false statement cases increased, some courts began to require plaintiffs to bear duty of care based on a comprehensive assessment of their own knowledge background, cognitive level, and other factors. Subsequently, the U.S. Supreme Court in the TSC Industries case introduced three standards of materiality determination, all focused on movements of stock prices [17]. Therefore, the evolution of the standards of materiality determination for securities false statement cases in the U.S. includes three stages: the subjective standard stage during the early development of the securities market, the relative objective standard stage before the TSC case, and the fully objective standard stage after the TSC case. The maturation of standards for materiality determination in the U.S. provides important reference for other countries in developing their securities false statement liability systems.

3.2. Japan: differentiated provisions of fraud liability and rigorous determination of the day of disclosure

The Financial Instruments and Exchange Act of Japan (hereinafter referred to as the Japanese FIEA) came into effect on September 30, 2007, with the aim of protecting investors’ rights, promoting the transformation of market functions from savings to investment, and supporting the nationalization of financial capital markets. The Japanese FIEA is divided into four main parts: (1) the establishment of laws for investment services, which includes expanding the scope of derivative trading and defining collective investment plans; (2) improvements to the information disclosure system, which includes the legalization of quarterly reports and the public acquisition system; (3) regulation of exchanges and intermediary agencies; and (4) strengthening penalties for unfair trading [18]. The Japanese FIEA establishes different regulations for securities false statements in the securities issuance market and the securities circulation market. On one hand, in the Japanese securities issuance market, if the securities offering documents such as the prospectus, contain false statements, it is presumed that there is a causality between the false statements and the investor's losses. If the person responsible for the false statements wishes to avoid liability, they must prove that the investors purchased the securities despite they already knew the false statements. However, the Japanese FIEA does not provide a clear stipulation for calculating damages when investors pursue liability from the issuers, nor does it define the responsibility distribution of proof for causality [19]. On the other hand, in the securities circulation market, Article 18 of the Japanese FIEA stipulates that if false statements are found in publicly disclosed documents during the ongoing information disclosure process, the person providing the false information shall bear damages liability.

The timing of the day of disclosure of false statements is a key factor in causality determining. In 2007, the Japanese government issued the Order for Enforcement of the Financial Instruments and Exchange Act, which clearly defines the term “disclosure” in Article 30, Paragraph 1: “The representatives of a listed company, such as directors, controlling shareholders, and CEOs, must publicly correct the information that has been disclosed to the public through more than two national media outlets, such as news agencies and newspapers.” While Japan adopts a similar presumption of reliance and fraud on the market theory as the United States, its approach to determining the day of disclosure of false statements is more rigorous, which is worth noting and learning from. Additionally, Article 166 of the Japanese FIEA clearly defines “material facts” as “important facts related to the operation, business, or assets of the listed company that significantly affect the investment decisions of investors.” This article further specifies four types of “material facts”: (1) decided facts, referring to matters for which the company has made a clear decision, such as resolutions passed by the board of directors; (2) occurred facts, referring to events that have already occurred, such as significant losses or debt defaults by the company; (3) financial reports, referring to significant changes in the company's financial status, such as large fluctuations in profit; (4) supplementary terms, referring to clauses in contracts signed by the company with third parties that have a significant impact on the company. The general provisions regarding “material facts” provide valuable insights into the development of China's Securities Law.

4. Optimization paths for causality determination in liability for false statement of securities

4.1. Clarifying the boundaries of the application of fraud on the market theory

There are significant differences between the judicial practices of China's securities market and those of the United States, and the application of fraud on the market theory varies across different markets, such as the A-share market and China's National Equities Exchange and Quotations (NEEQ). Therefore, it should not be applied uniformly across the entire securities market. In the A-share market, the fraud on the market theory has a strong foundation for application. Investors' trust in false statements has led to increased trust in market information and prices, making it appropriate to directly apply the fraud on the market theory in securities false statement cases in this market. In contrast, the NEEQ, which operates under a market maker system, is not a fully developed and efficient market and thus lacks the foundational conditions for the application of fraud on the market theory. The NEEQ has higher requirements for investors [20], thus the reliance relationship can be proven through documents such as research and analysis records from the time of investment. In securities trading, the protection of investors in the securities market should have certain boundaries. A balance of legal interests among economic efficiency, judicial fairness, and the development of the securities market can be sought by defining different presumptions of causality for securities false statement damages, as well as the grounds for defenses and other related factors.

4.2. Expanding the scope of application of causality presumption

The application of causality presumption inevitably leads to an all-or-nothing result in terms of liability, simplifying the determination process but making it prone to discrepancies in the scope of damages. In judicial practice, it's common for both the first and second-instance courts to affirm the establishment of liability, yet make different rulings on the specific amount of damages. Objectively, the factual causality is difficult to prove. Although it can be roughly established that there is a connection between the act and the loss result, it is uncertain whether such a highly generalized proportion can accurately determine that the responsible party should bear full liability for all the damages, when inferred from the outcome. Section 11(f) of the Securities Act of 1933 in the United States establishes the right of recourse between joint tortfeasors, stating that "any person liable under this section, upon performing their obligation, may seek reimbursement from another party who would have been liable if sued separately." This provision implies that parties other than the issuer must bear the actual compensation liability based on their degree of fault, rather than assuming risk-based liability. By drawing on relevant U.S. legal provisions, while applying causality presumption, it is possible to refine the determination of intermediary agencies' responsibility and require them to bear actual compensation liability based on their degree of fault.

To design an appropriate framework for defining the tort liability of intermediary agencies and accurately determining their responsibility in individual cases, while balancing the interests of all parties, it is essential to distinguish and understand the nature of the legal relationships involving intermediary agencies, as well as the scope of responsibility and duties of intermediary agencies, which will maximize the protection of investors' reliance interests while balancing the interests of securities service institutions [21]. China is currently exploring a model that distinguishes the responsibilities of professional institutions under the sponsor-led liability system. This model requires a distinction between the statutory duties and professional duties of intermediary agencies. For example, when a company issues new shares, intermediary agencies need to focus on reviewing information regarding the controlling shareholders of companies with highly concentrated equity; conversely, for companies with relatively dispersed equity, intermediary agencies need to focus on reviewing information concerning the company's directors, supervisors, and senior management [22]. Only by clarifying rights and liabilities can we support the professional division of labor among intermediary agencies under the securities registration system, jointly protect investors' rights, and ultimately realize the vision of "caveat emptor".

4.3. Unifying the standards for determining the day of disclosure of false statements

In foreign cases of disputes over liability for false statements, the determination of the day of disclosure is generally divided into single disclosure and multiple disclosures [23]. In cases involving multiple partial disclosures of false statements [24], damages are calculated in segments, and the multiple disclosures are determined with greater precision. Some scholars suggest that “two or more disclosure days should be recognized.” However, whether multiple disclosure days should be established must be analyzed in the context of China’s laws and regulations, and consideration of the characteristics of the domestic securities market.

After the false statement is revealed, the securities market typically deteriorates rapidly until the "bubble economy" bursts and the market stabilizes [25]. In practice, however, the disclosure of securities false statements is often not a one-time event; it typically occurs in stages, with the truth revealed incrementally over time. The question of whether there are multiple disclosure days under the above-mentioned disclosure method or what time should be considered the day of disclosure has become a challenging issue for judicial decisions. Limiting the determination of the day of disclosure to a specific single period may be overly rigid. Therefore, to more effectively protect investor rights, restore and repair the disrupted price mechanism, return securities prices to their true value [26], and more practically expand and improve ideas for China's judicial practice, reference can be made to the provisions concerning “disclosure” of the Order for Enforcement of the Financial Instruments and Exchange Act of Japan. According to this regulation, if the disclosed content reaches a substantial level and the media outlets involved have national coverage, the day should be recognized as the day of disclosure. In this case, both the necessity and the possibility of multiple disclosure days are absent.

5. Conclusion

The core and cornerstone of modern finance is the capital market, and the sustained development of the capital market is of significant importance for enhancing China’s ability to allocate global resources. By combining the specific provisions of relevant laws, efforts should be made to form a mechanism where each party fulfills its duties, with mutual checks and balances, to effectively resolve the legal risks accumulated in the implementation of China’s registration system reform. The development of a well-structured and nuanced framework for determining the day of disclosure of false statements, alongside a more adaptable standard for causality determination, presents a viable solution to resolving securities false statement liability disputes within the existing legal structure. By improving relevant laws and regulations and strengthening the supervision of information disclosure, investors’ rights can be better protected, thereby boosting market confidence and providing legal support for the sound development of the capital market. Additionally, grounded in the realities of China’s securities market, this study is expected to offer insights into the causality determination in securities false statement liability for economies with similar conditions or facing comparable governance challenges. It aims to contribute to the sound development of global capital markets and provide useful directions for future research in this field.

References

[1] In China's first special representative securities class action—the Kangmei Pharmaceutical Securities False Statement Liability Case, a civil judgment for joint and several liability was, for the first time, rendered against an accounting firm and the responsible certified public accountants. Zhengzhong Zhujiang Certified accounting firm, which audited Kangmei Pharmaceutical’s annual reports, was held jointly and severally liable for 100% of the damages, because it “failed to perform fundamental audit procedures and exhibited significant deficiencies in its work, failing to detect severe financial fraud.” See Guangdong Province Guangzhou Intermediate People’s Court, Civil Judgment (2020) Yue 01 Min Chu No. 2171.

[2] Huang Jiazheng. Reflective Interpretation on the Causality Determination of Securities Transaction Fraud under Judicial Interpretation [2003] No. 2 [J]. Enterprise Economy, 2008, 28 (11): 169.

[3] Wang Liming. Improvement of the Civil Liability System in China's Securities Law [J]. Chinese Journal of Law, 2001, 23 (4): 65.

[4] Miao Yinzhi. On the Deficiencies of CSRC's Information Disclosure Rules [J]. Research on Rule of Law, 2016, 33 (2): 141.

[5] Ding Yuxiang. Analysis of the Liability of a Securities Issuing Intermediary Agency for False Statement-From the Perspective of Causality and Fault [J]. Global Law Review, 2021, 60 (6):166.

[6] Article 28-31 of Measures for the Administration of the Offering and Underwriting of Securities (2025 Revision). Articles 5 -10 of the Rules on Intermediary Services for Debt Financing Instruments of Non-financial Enterprises in the Interbank Bond Market (2020 Edition).

[7] Bai Jianjun. The Constitutional Significance of Adjudicative Consistency: An Empirical Study [J]. China Legal Science, 2003, 20 (3): 133.

[8] Rapp R N. Plausible Clause: Exploring the Limits of Loss Causation in Pleading and Proving Market Fraud Claims under Securities Exchange Act Sec. 10 (b) and SEC Rule 10b-5 [J]. Ohio NUL Rev., 2014, 41: 389.

[9] In the case of Qin v. Hebei Jinniu Chemical Co., Ltd. concerning liability for false statement in securities, the court clarified the standard for determining the day of disclosure of false statements, holding that it shall be the date on which the suspected false statement is first publicly disclosed by a national media outlet. The announcement of a CSRC investigation, once disclosed through national media, carries legal effect and may serve as the basis for determining the day of disclosure. Furthermore, the court held that losses incurred by investors who purchased shares after the day of disclosure are not legally causally linked to the false statement. See Hebei High People’s Court, Civil Judgment (2014) Ji Min Er Zhong Zi No. 56.

[10] Cao Mingzhe. The Justification of the Date of Regulatory Investigation Announcements as the Date of Exposure in the Securities Misrepresentation [J]. Securities Law Review, 2019, 26:341-358.

[11] Securities Act of 1993&SEC.11 (a).

[12] The core idea of the “fraud on the market theory” is that the occurrence of false statements constitutes fraud against the entire securities market. Investors make investments based on the belief that the securities market is truthful and that securities prices are fair, without needing to prove that they relied on false statements to make their investment. It is sufficient to demonstrate that the price of the securities in which they invested was affected by the false statements and was thus unfair, to establish a causal link between the investor's loss and the false statements.

[13] In this case, the U.S. Supreme Court established the principle of “presumption of reliance” in securities fraud. This theory holds that when investors trade in the open market, they rely on all publicly available information reflected in the market price, including false statements. The judge in this case ruled that “reliance indicates that there is a causal link between the defendant's false statement and the plaintiff's investment loss”. See Basic Inc. v. Levinson, 485 U.S. 224 (1988).

[14] Ma Qijia. The Determination of Causality in Civil Compensation for False Statements under U.S. Securities Law and Its Implications [J]. Journal of Law Application, 2006, 21 (3): 50.

[15] In re Control Data Corp. Securities Litigation, 933 F. 2d 616(8th Cir 1991).

[16] Robbins v. Koger Properties. Inc. 116 F.3d 1441 (11th Cir. 1997).

[17] On November 12, 1969, TSC Corporation and National Corporation issued a joint proxy statement to their shareholders, advising them to support the liquidation and merger transaction. The statement received shareholder approval, leading to the liquidation and dissolution of TSC Corporation, which affected the price of its stock. One of TSC's shareholders, Beilu Corporation, believed that TSC and National had failed to disclose the extent to which National had gained control over TSC in the joint proxy statement and that this information would have influenced shareholders' decisions. As a result, Beilu Corporation filed lawsuits in 1969 and 1972.

[18] Zhu Daming. Japanese Financial Instruments and Exchange Act [M], Law Press, 2015:133.

[19] Fan Jiwei. The Civil Liability System for Securities Fraud under the Japanese Financial Instruments and Exchange Act and Its Implications [J]. Economic Law Review, 2013, 16 (2): 299.

[20] Article 4 of the Measures for the Appropriateness Management of Investors in the National Equities Exchange and Quotations System: "Investors participating in the trading of stocks in the Innovation Layer must meet the following conditions: (1) Legal entities with a registered capital or paid-in capital exceeding RMB 1 million; (2) Partnership enterprises with a total capital contribution exceeding RMB 1 million; (3) Before the opening of the trading authority, the average daily asset balance in the securities and fund accounts under the investor's name must exceed RMB 1 million for the previous 10 trading days."

[21] Chen Jie. Clarification and Amendment of Joint and Several Liability of the Verification Institution in the Misrepresentation of Securities [J]. China Legal Science, 2021, 38 (6):221.

[22] Coffee, John C. Gatekeepers: The Professions and Corporate Governance [M], translated by Huang Hui, Wang Changhe, et al., Peking University Press, 2011:93.

[23] A single disclosure refers to a situation in the securities market where the market price changes due to the disclosure of a specific event or information, and the investor's loss can be attributed to the disclosure of that single event or piece of information. See Fumerton R A. Market overreaction and loss causation[J]. The Business Lawyer, 2006: 89-101.

[24] Multiple or partial corrective disclosures refer to multiple or partial disclosures made to correct or clarify previously false or misleading information. Unlike a single disclosure, this situation involves the release of information on several occasions to gradually rectify or clarify the prior misinformation. In such cases, the investor's loss may be caused by multiple corrective disclosures rather than a single disclosure event.

[25] Li, Guoguang. Understanding and Application of the Supreme People's Court's Judicial Interpretation on Securities Market False Statement Cases [M]. People's Court Press, 2015:78.

[26] Shu Guoying. Meditations on Legal Philosophy [M]. Peking University Press, 2010:83.