Securities Fraud Compensation: A Legislative Scheme Drawing on China, the US, and the UK

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This article proposes reforms to securities fraud compensation. It draws on the law in China, the US and the UK. A key problem with the current position in the US and the UK is that that it does not fully define fundamental compensatory principles: the date when loss arises, and the rules of causation, remoteness, and mitigation. China has addressed securities fraud compensation and has implicitly defined the operation of compensatory principles. Thus, I use experiences in China, the US and the UK to: (1) show that developed markets can learn from the law in emerging markets, and (2) propose reforms to securities fraud compensation that address the key compensatory principles. These principles provide a basis for a globally harmonized approach to market manipulation by false statements.

1. Introduction

This article (1) proposes reforms to the law on market manipulation that could guide a globally harmonized approach to compensation and (2) demonstrates that legal rules in emerging markets can guide reforms in developed markets. The motivation is threefold. First, the law on market manipulation in the US[1] and the UK[2] has sustained significant criticism. Second, different laws govern compensation in different countries, and this could hinder cross-border investment.[3] Third, prior literature has focused on 'transplanting' Western law, especially United States law, onto emerging markets.[4] In so doing, it

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[1] Merritt B. Fox, 'After Dura: Causation in Fraud-on-the-Market Actions', *Journal of Corporation Law* 31, no. 3 (2006): 829–876; for criticism, see, for example, Merritt B. Fox, 'Demystifying Causation in Fraud-on-the-Market Actions', *Business Lawyer* 60, no. 2 (2005): 507–532; Mark Laurence Humphery, 'When Does Fraud on the Market Induce a Right to Damages?', *Monash University Law Review* 35, no. 2 (2010): 422–445.

[2] For critiques, see, for example, Eilis Ferran, 'Are US-style Investor Suits Coming to the UK?', *Journal of Corporate Law Studies* 9, no. 2 (2009): 315–348; Paul Davies, 'Liability for Misstatements to the Market: Some Reflections', *Journal of Corporate Law Studies* 9, no. 2 (2009): 295–313; John Armour et al., 'Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States', *Journal of Empirical Legal Studies* 6, no. 4 (2009): 687–722.

[3] See, for example, evidence that countries with strong shareholder protection receive greater capital flows: Douglas Cumming, Sofia Johan & Dan Li, 'Exchange Trading Rules and Stock Market Liquidity', *Journal of Financial Economics*, 99, no. 3 (2011): 651–671.

[4] For example, Li-Wen Lin, 'Legal Transplants through Private Contracting: Codes of Vendor Conduct in Global Supply Chains as an Example', *American Journal of Comparative Law* 57, no. 3 (2009): 711–744.

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has ignored the possibility that developed markets could learn from the experience in emerging markets. Importantly, market manipulation is one area in which emerging markets have had substantial experience and have made fundamental reforms.[5] Thus, this article confronts these issues and asks the following joint questions: (1) can China's law on market manipulation guide reforms in the US and the UK and (2) what is a principled approach to compensation for false statements?

Market manipulation is one especially important area of law. One type of market manipulation is manipulation by making a false statement that inflates (or deflates) a stock price. Such false statements can hinder economic and political development. Chen suggests that market manipulation effaces confidence in the integrity of financial markets.[6] North argues that this could deter financial transactions.[7] Supporting this, La Porta, Lopez-de-Silanes, and Shleifer and Cumming, Johan, and Li indicate that poor market regulation reduces stock market liquidity.[8] Cumming, Humphery-Jenner, and Wu show that poor market regulations in a firm's home country depress stock returns and market values even if the firm subsequently lists abroad.[9]

The regulation of market manipulation is problematic. The regulation in the US and the UK has received substantial criticism. Key heads of criticism are, first, the law is vague and fails to define when the wrong (the false statement) causes the loss.[10] This vagueness creates confusion. This confusion creates changing and conflicting judicial statements[11] and can have a 'chilling' effect on commercial activities.[12] Second, the law in the US and the UK does not explicitly or implicitly address the fundamental compensatory principles of date of loss, causation, remoteness, and mitigation.[13] Furthermore, the presence of different compensatory regimes in different countries could create legal uncertainty and deter investment.[14]

China has had substantial experience with market manipulation and has reformed its law in response. Market manipulation by false statement has been common in China.[15] In 2001, the Supreme People's Court (SPC) refused to hear market manipulation cases. In 2003, the SPC promulgated a 'guideline judgment' that reformulated the approach to market manipulation. This approach implicitly covered the date of loss, causation, remoteness, and mitigation. While the impact of the law is unclear because China has

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[5] Katharina Pistor & Chenggang Xu, 'Governing Stock Markets in Transition Economies: Lessons from China', *American Law and Economics Review* 7, no. 1 (2005): 184–210.

[6] Zhiwu Chen, 'Capital Markets and Legal Development: The China Case', *China Economic Review* 14 (2003): 451–472.

[7] Douglass North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990).

[8] Rafael La Porta et al., 'Legal Determinants of External Finance', *Journal of Finance* 52, no. 3 (1997): 1131–1150; Cumming, Johan & Li, 2011.

[9] Douglas Cumming, Mark Humphery-Jenner & Eliza Wu, *Home-Country Governance and Cross-Listing in the US* (University of New South Wales, York University, 2010).

[10] Humphery, 2010.

[11] Highlighted in Fox, 2006.

[12] Follows the analysis of uncertainty in Richard Craswell & John E. Calfee, 'Deterrence and Uncertain Legal Standards', *Journal of Law, Economics & Organization* 2, no. 2 (1986): 279–303.

[13] See Humphery, 2010; Eilis Ferran, 'Are US-style Investor Suits Coming to the UK?'.

[14] On the deterrent effect of legal uncertainty see, Richard Craswell & John E. Calfee, 1986.

[15] Chen, 2003; Gongmeng Chen et al., 'Is China's Securities Regulatory Agency a Toothless Tiger? Evidence from Enforcement Actions', *Journal of Accounting and Public Policy* 24, no. 6 (2005): 451–488.

stringent rules in relation to the formation of a class (for a class action)[16] and has comparatively lax regulation and enforcement at the stock-exchange level,[17] the purpose of this article is to analyse statutory regimes, not to analyse regulators.

This article uses the problems with the US and the UK law as motivation to (1) examine whether China's law on false statements can inform developments in the US and the UK and (2) propose reforms to the law on compensation for false statements. It does this by analyzing the appropriate approach to the compensatory principles of date of loss, causation, remoteness, and mitigation. This article concludes that the law in China, a developing country, can help shape legal developments in the US and the UK, both developed countries.

This article makes a significant contribution to the literature. From a legal perspective, the article proposes a way to re-formulate the approach to market manipulation to clearly indicate when investors can recover damages for false statements. This could form the basis for a harmonized approach to compensation for market manipulation. From a political science perspective, it shows that the law in emerging markets can help develop the law in developed markets. This is important because prior literature has focused on legal transplants from developed countries onto developing countries.[18] The literature has especially focused on transplants from the US[19] and the EU.[20] However, the literature has not examined the use of emerging market law to guide developed-market law.

The balance of this paper proceeds as follows. Section 2 outlines how false statements operate. This provides a structured framework in which to analyse market manipulations. Section 3 then briefly outlines the legislative schemes in the US, the UK, and China. The following sections then analyse the principles of date of loss, causation, remoteness, and mitigation. Specifically, section 4 examines the proper date of loss. Section 5 identifies the appropriate approach to causation. Section 6 determines when loss is too remote. Section 7 assesses the duty to mitigate. Section 8 concludes with proposals to reform market manipulation. It also highlights that China's law can help to guide developments of US and UK laws.

2. How Does Market Manipulation by False Statements Work?

The regulation of market manipulation focuses on two key parties. First, there is a company (the defendant). The company observes both its price and its intrinsic value.

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[16] Marlon A. Layton, 'Is Private Securities Litigation Essential for the Development of China's Stock Markets?', *New York University Law Review* 83 (2008): 1948–1978; Chen, 2003; Walter Hutchens, 'Private Securities Litigation in China: Material Disclosure About China's Legal System?', *University of Pennsylvania Journal of International Economic Law* 24, no. 3 (2003): 599–690.

[17] See Cumming, Johan & Li, 2011.

[18] Gianmaria Ajani, 'By Chance and Prestige: Legal Transplants in Russia and Eastern Europe', *American Journal of Comparative Law* 43 (1995): 93–118.

[19] For example, Hideki Kanda & Curtis J. Milhaupt, 'Re-examining Legal Transplants: The Director's Fiduciary Duty to Japanese Corporate Law', *American Journal of Comparative Law* 51, no. 4 (2003): 887–902; Máximo Langer, 'From Legal Transplants to Legal Translations: The Globalization of Plea Bargaining and the Americanization Thesis in Criminal Procedure', *Harvard International Law Journal* 45, no. 1 (2004): 1–64; Mark B. Baker, 'No Country Left Behind: The Exporting of U.S. Legal Norms under the Guise of Economic Integration', *Emory International Law Review* 19, no. 3 (2005): 1321–1382; Lin, 2009.

[20] Xingzhong Yu, 'The European Constitution and its Implications for China', *Legisprudence* 1, no. 2 (2007): 181–196.

Second, there is a shareholder (the plaintiff). The shareholder observes the share price but does not observe the intrinsic value. Now, if the market is efficient, then the stock price should reflect all publicly available information about the company.[21] Thus, if there is no market manipulation, then the price should equal the intrinsic value.

A typical manipulation situation unfolds as follows. First, before the manipulation, the stock trades at its intrinsic value. Second, on the 'manipulation date', the company makes a falsely positive statement and the stock trades above its intrinsic value. Third, a shareholder buys a bundle of stock at the inflated price. Fourth, the shareholder sells some, but not all, of the holding. Fifth, there is a market-wide event that causes the price to fall (but note that the price is still 'inflated' because the false statement is operational). Sixth, on the 'reveal date', the market realizes that there was a false statement and the stock price falls.

The goal is to determine for which losses, if any, the company is responsible. Live issues include the date of the loss, whether the false statement inflated the price or caused the purchase, whether the defendant should be liable for losses due to the extraneous market-wide event, and whether any losses are to remove or tenuously connected to the false statement. Four key concepts help to determine when a shareholder can recover losses. First, 'date of loss' assesses the threshold issue of when the loss arises. This defines the limits of potentially recoverable losses. Second, 'causation' determines if the loss was due to the company's actions. Third, 'remoteness' assesses whether there are policy reasons to exempt liability even if the defendant 'caused' the loss. Fourth, 'mitigation' stipulates if the plaintiff has a responsibility to avoid some losses and what happens if the plaintiff does avoid some losses.

3. An Outline of the Legislative Schemes in the US, the UK, and China

This section briefly outlines the legislative schemes in the US, the UK, and China. The US regulation of market manipulation is problematic. The main problem is determining when a false statement 'causes' an investor to suffer loss or damage. The key US regulation comes in two parts. First, the SEC prohibits market manipulation through false statements under SEC Rule 10b-5(b), which it promulgated under section 28j(b) Securities Exchange Act. Second, section 78r(a) Securities Exchange Act of 1934 provides the right to damages for loss 'caused by reliance' on a false statement. Neither the legislation nor the SEC has defined when losses are 'caused by reliance' on a false statement.

The United Kingdom law has had little judicial consideration. The relevant rules are in section 90A Financial Services and Markets Act 2000 (UK).[22] Section 90A(3) holds that the defendant is liable for paying compensation if the plaintiff 'suffered loss … as a result of … any untrue or misleading statement'. Section 90A(4) stipulates that the

[21] Charles M. Lee, James Myers & Bhaskaran Swaminathan, 'What Is the Intrinsic Value of the Dow?', *Journal of Finance* 54, no. 5 (1999): 1693–1741.

[22] This comes into force under s. 1270 Companies Act 2006 (UK).

defendant must have known that the statement was false or had been reckless as to its accuracy.[23] Heretofore, there have been few judicial opinions on false statements.[24] Stapledon cites only one derivative suit.[25] The most recent derivative action cited in Cheffins and Black occurred in 1981.[26] Armour cites six privately initiated (as opposed to regulator initiated) allegations of director misconduct between 1998 and 2006.[27] Thus, the precise meaning of these provisions remains unclear.

China has had substantial experience with market manipulation through false statements. Such market manipulation has been prolific in China.[28] Article 69 of China's PRC Securities Law holds a person liable for compensation if he/she makes a false or misleading statement and an investor 'thus incurs' loss or damage. The words 'thus incurs' are vague. China's SPC resolved this ambiguity by promulgating, on 9 January 2003, its interpretation of the law. Articles 18 and 19 of this interpretation dictate when a false statement causes a person to suffer loss or damage.

4. When Does the Loss Occur

The threshold issue is the time that losses occur. The interpretations in China and the US are different, and here, China could benefit from the US approach.

China's SPC appears to have placed the date of loss at the purchase date. The SPC's interpretation does not explicitly state the precise date of loss. However, it does state that (1) the plaintiff must purchase the shares after the misstatement (under Article 18(b)) and (2) the plaintiff must sustain 'a loss on the date of reveal or correction of the false statement or after that' (under Article 18(c)). The combination of these two sections implies that the cause of action accrues from the purchase date and materializes into a monetary loss at the reveal date.

The approach in the United States appears to be internally contradictory. One strand of law suggests that the date of loss is the purchase date. This is because US courts have adopted out-of-pocket damages, which set damages as the purchase price less the price the plaintiff would have paid if there was no misstatement.[29] This implies that the loss arises at the date of purchase. However, another strand of law suggests that the loss arises at some (unspecified) time after the purchase. This is because the plaintiff must

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[23] This is an abbreviated summary.

[24] Armour et al., 2009.

[25] G.P. Stapledon, *Institutional Shareholders and Corporate Governance* (Oxford: Clarendon Press, 1996).

[26] Brian R. Cheffins & Bernard S. Black, 'Outside Director Liability Across Countries', *Texas Law Review* 84, no. 6 (2006): 1407.

[27] John Armour, 'Enforcement Strategies in UK Company Law: A Roadmap and Empirical Assessment', in *Rationality in Company Law: Essays in Honour of D.D. Prentice*, ed. John Armour & Jennifer Payne (Oxford: Hart Publishing, 2009), 71–119.

[28] Chen, 2003; Chen et al., 2005.

[29] Barbara Black, 'Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions', *North Carolina Law Review* 62, no. 3 (1984): 435–474; Bradford Cornell & Gregory R. Morgan, 'Using Finance Theory to Measure Damages in Fraud on the Market Cases', *UCLA Law Review* 37 (1990): 883–924; Donald C. Langevoort, 'Capping Damages for Open-Market Securities Fraud', *Arizona Law Review* 38, no. 2 (1996): 639–664.

show something more than mere price inflation due to the plaintiff's misstatement.[30] This implies that the cause of action does not automatically accrue from the purchase date. However, it is unclear from when the cause of action does accrue.

The appropriate approach is China's approach. The rationale is twofold. First, the plaintiff changed his/her position at time by purchasing the stock. Thus, the false statement operated upon the plaintiff at the time of the purchase. This suggests that the plaintiff 'accumulates' an unrealized loss at the purchase time[31] Thus, the loss arises at the purchase date rather than at the reveal date.

Second, setting the date of loss as the reveal date could yield anomalous results. The legislature is unlikely to expect courts to adopt an anomalous interpretation.[32] Now, consider the following situation. Say at a time when there is an unexpected boom, rather than an unexpected loss, after the plaintiff buys the stock. Now this boom causes the stock price to exceed the purchase price. Here, the plaintiff has not sustained a 'monetary' loss since the plaintiff's stock position has increased in value. Thus, under the SPC's interpretation, the plaintiff would receive no damages. But consider the plaintiff's position. The plaintiff's stock is worth less than it would have been if there was no misstatement. This implies that even though there is no monetary loss, there is still an accrued loss due to the loss of the benefit the plaintiff would have received. Since the US approach dates damage at the time of the purchase, it implicitly recognizes the accrued loss. Thus, the US approach is preferable.

Overall, the date of loss should be the date of the purchase. China's approach, but not the US approach, recognizes this. The UK approach appears to recognize this but is unclear. Thus, principled reform would allow the China's regulation to guide the development of the US and UK regulations.

5. When Does the Defendant 'Cause' the Loss?

The causation requirement determines if the plaintiff's loss is due to the defendant's actions. However, the precise rules used to establish causation depend upon the mechanism through which the false statement connects with the loss.[33] Analytically, it is necessary to determine whether, and if so how, the misstatement must cause (1) the purchase of the stock ('purchase causation'), (2) losses due to the price inflation ('loss causation'), and (3) losses due to extraneous market-wide events ('extra losses'). The analysis reveals that China's approach to all three limbs is optimal and can guide the US and UK approaches.

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[30] *Dura Pharmaceuticals Inc v. Broudo*, 125 S Ct 1627, 1631 [2005], 1631; *Bell Atl Corp v. Trombly*, 550 US 544, 557–558 [2007], 557–558.

[31] Sharon Christensen & Stephen R. Lumb, 'Ascertaining When Loss Is First Suffered by Misleading Conduct: Relevance of Contingencies, Future Predictions and Concealment', *Trade Practices Law Journal* 13 (2005): 149–153.

[32] William N. Eskridge & Philip P. Frickey, 'Statutory Interpretation as Practical Reasoning', *Stanford Law Review* 42, no. 2 (1990): 321–384.

[33] Joachim Dietrich & Thomas Middleton, 'Statutory Remedies and Equitable Remedies', *Australian Bar Review* 28, no. 2 (2006): 136–170.

5.1. What are the approaches in China, the United Kingdom, and the United States?

5.1.1. *The United States*

The United States courts have proceeded as follows. First, the false statement must 'cause' the plaintiff to purchase the stock.[34] However, the plaintiff can show this by claiming that he/she relied on the assumption that market prices are accurate and thus relied on the assumption that all publicly available information was accurate.[35]

Second, the plaintiff must show that the false statement 'caused' his/her loss. Here, it is insufficient to merely prove that the false statement inflated the stock price; instead, the plaintiff must show some additional connection between the false statement and the loss.[36] However, the court did not define this additional connection. Third, the courts have implied that extraneous losses due to factors unrelated to the false statement are not compensable.[37]

5.1.2. *The United Kingdom*

The UK approach is uncertain. There are two presently relevant aspects. First, the plaintiff must have acquired the securities 'in reliance on the information in the [false statement]' (section 90A(5)(a)) and 'at a time when, and in circumstances in which, it was reasonable for him to rely on that information' (section 90A(5)(b)). Second, the plaintiff must have 'suffered loss … as a result of' the misstatement. This explicitly requires the plaintiff to establish both 'purchase causation' and 'loss causation'. There are no cases directly on either point.

Purchase causation likely requires the plaintiff to show explicit reliance on, and awareness of, the statement, which eventually is revealed as false. One argument is that the court should adopt the US presumptive causation approach. The main basis for this is the court's holding in *Brickenden* in relation to breach of fiduciary duty.[38] The *Brickenden* approach stipulates that the court is to assume that the plaintiff relied on the false statement. However, courts are unlikely to adopt this approach for two reasons. First, section 90A(5) explicitly refers to the concept of 'reliance'. An explicit reference to 'reliance' implies that the plaintiff must show that he/she was aware of the statement. The contrast between (1) the explicit reference to reliance and (2) the well-known approach in the US that the court will presume that the plaintiff relied on the statement implies that the legislature does not intend to adopt presumptive causation.[39] Second, the requirement

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[34] See, for example, *Semerenko v. Cendant Corp.*, 216 F 3d 165, 178–183 (3rd Cir. 2000), 178–183.

[35] *Dura Pharmaceuticals Inc v. Broudo*, 125:1631.

[36] *Ibid.*; *Bell Atl Corp v. Trombly*, 550:557–558.

[37] Bradford Cornell & Gregory R. Morgan, 'Using Finance Theory to Measure Damages in Fraud on the Market Cases'; Langevoort, 1996.

[38] *Brickenden v. London Loan & Savings Co.* [1934] 3 DLR 465.

[39] This is analogous to legislative silence in Daniel A. Farber, 'Statutory Interpretation, Legislative Inaction, and Civil Rights', *Michigan Law Review* 87, no. 1 (1988): 2–19.

that it should be 'reasonable' for the plaintiff to rely on the statement appears to contemplate the plaintiff being aware of the statement. This appears to suggest that the plaintiff must prove more than reliance on the accuracy of stock prices.

Loss causation is partially unclear. Overall, it appears that (1) the plaintiff must establish that the false statement caused the initial increase in price but (2) there can be no causation for losses due to general market movements or due to other people's false statements.

The clear part is that the defendant is not liable for losses that are due to another person's false/misleading conduct (see section 90A(6)). The unclear part is whether the defendant is liable for losses due to general market movements. One possibility is that the defendant will be liable for post-purchase general market movements.[40] This follows deceit cases that have allowed post-purchase losses.[41] However, the better position is that the defendant should not be liable for such damages. This is because (1) analogous deceit cases hold that the loss arises at the date of acquisition (unless there is some 'manifest injustice' with using that date)[42] and (2), in a commercial context such as stock trading, where legal certainty is important,[43] it is unlikely that the legislature would intend an uncertain approach to causation. Thus, it is likely that the plaintiff must prove that the false statement inflated the stock price but that there can be no causation vis-à-vis losses that arise due to general market movements or other people's false statements.

5.1.3. *China*

China's approach also has three key parts. First, for purchase causation, the plaintiff must purchase the stock on or after the misstatement date (under Article 18(b)) but before the reveal date (under Article 19(b)). But even if he/she did so, purchase causation cannot arise if the plaintiff knew that the statement was false (under Article 19(c)). This establishes a presumption that the misstatement caused the purchase. The defendant can rebut this only by showing that the plaintiff knew that the statement was false. Second, for loss causation, it is sufficient to show some economic loss on the reveal date (under Article 18(c)). And third, the defendant does not cause losses that are due to extraneous systematic factors or general market movements (Article 19(a)).

5.2. Which is the appropriate approach to purchase causation?

This article finds that the appropriate approach follows China's approach. This comprises a rebuttable presumption that the plaintiff relied on the misrepresentation. The

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[40] Humphery, 2010.

[41] See, for example, *Dadourian Group International Inc v. Simms* [2009] 1 Lloyd's Rep 601.

[42] *Smith New Court Securities Ltd v. Citibank NA* [1997] AC 254 (HL).

[43] Following Joseph A. McCahery & Erik P.M. Vermeulen, 'Does the European Company Prevent the "Delaware Effect"?', *European Law Journal* 11, no. 6 (2005): 785–801; Blanaid Clarke, 'The Takeover Directive: Is a Little Regulation Better than No Regulation?', *European Law Journal* 15, no. 2 (2009): 174–197.

presumption premises itself on the notion that investors rely on market prices as an accurate reflection of the company's intrinsic value; prices reflect all publicly available information; and thus, investors presumptively rely on public statements about the company. However, the defendant can rebut this presumption if he/she shows that the plaintiff knew that the statement was false. There are three good reasons for a rebuttable presumption.

The idea of a presumption of reliance supports the policy of promoting confidence in financial markets. Courts should promote fair and efficient market prices. One way to promote this is to presume that investors should be able to rely on the accuracy of market prices. A presumption of reliance supports this. For example, China's financial markets feature significant uninformed speculation[44] and market manipulation.[45] This is likely to discourage people from relying on the integrity of market prices.[46] Thus, investors may not be able to prove reliance. Thus, if courts require investors to prove reliance, they will create the anomalous situation in which the fear created by market manipulation actually allows manipulators to avoid paying compensation. This would further undermine investors' confidence in the market.

It is important that the presumption is rebuttable. The defendant should be able to rebut the presumption if he/she can prove that the plaintiff knew the statement was false. This is for policy and criminal reasons. The policy reasons are that allowing compensation for an investor who invested despite knowing the falsity of the statement would not promote confidence in the market (since the investor clearly did not have confidence in the accuracy of public information) and would not deter breaches of trust (since the investor did not trust the information). The criminal reason is that if the investor knew that the statement was false, then the investor had information that the rest of the market did not have. And, if such is the case, then the investor committed insider trading. Insider trading is illegal. Thus, if the court allows compensation for investors who know the statement is false, then it facilitates illegal insider trading.

Overall, purchase causation should adopt a rebuttable presumption that the investor relied on the accuracy of the market and thus the accuracy of the statement. The defendant can rebut this if he/she proves that the plaintiff knew that the statement was false.

5.3. Which is the appropriate approach to loss causation?

This article argues that loss causation should obtain if the misstatement inflated the price. There are two approaches in the literature. First, Fox argues that loss causation arises if the misstatement inflated the price.[47] This reflects China's approach. Second, Coffee

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[44] John Fernald & John H. Rogers, 'Puzzles in the Chinese Stock Market', *Review of Economics and Statistics* 84, no. 3 (2002): 416–432.

[45] Chen, 2003; Chen et al., 2005.

[46] Lynn A. Stout, 'Mechanisms of Market Inefficiency: An Introduction to the New Finance', *Journal of Corporation Law* 28, no. 4 (2003): 635–670; Douglas A. Smith, 'Fraud on the Market: Short Sellers' Reliance on Market Price Integrity', *William & Mary Law Review* 47, no. 3 (2005): 1003–1060.

[47] Fox, 2005, 2006.

asserts that loss causation should obtain only if the misstatement inflated the price, and there is a clear price decline on revelation of the falsity of the statement.[48] This appears closer to the current US approach, which demands that the plaintiff should show more than mere price inflation. The following analysis supports China's approach.

The argument that plaintiffs must prove a subsequent price decline has three main limbs; however, they are not persuasive. The first argument is that judges (or juries) are unable to accurately measure the statement's materiality if they cannot measure the dollar loss. And they can do this only if they can measure a price decline on revelation.[49] However, this is unpersuasive for two reasons: (1) if the case involves making a false statement, then it is unclear why judges/juries are better at assessing a price decline than they are at assessing a price increase, (2) and even if the case is one of a false statement by omission, then evidence of a price decline is an evidentiary issue that goes to damages, not a matter that goes to causation.[50]

Second, it is argued that focusing on the initial price inflation may incorrectly conflate inflation that is due to false statements and inflation that is due to extraneous factors, such as speculative bubbles.[51] However, this argument ignores methods in financial econometrics that adjust a stock's price movements for the price movements of the whole market and thus eliminate bias due to speculative bubbles.[52]

The third argument is that focusing on inflation may erroneously award damages for merely temporary price inflation. However, this ignores two factors: (1) if the inflation is only temporary, then the plaintiff may not be able to make out damages, which are a separate issue from causation.[53] (2) This assumes that the market would react irrationally: if the inflation is transitory, then it was due to a false statement that had no long-term implications for the firm's cash flows and thus was not important. Empirical evidence indicates that the market can react efficiently and quickly to uncertain information.[54] And (3) economic models indicate that if the information is more uncertain or transitory in nature, then the market will react less significantly[55] and thus the inflation is less likely to meet materiality standards.

Overall, the approach that loss causation obtains if the misstatement inflated the price best reflects the nature of false statements. Focusing on subsequent losses is both

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[48] John C. Coffee, 'Causation by Presumption? Why the Supreme Court Should Reject Phantom Losses and Reverse Broudo', *Business Lawyer* 60, no. 2 (2005): 547.

[49] *Ibid*.

[50] Fox, 2005.

[51] Coffee, 2005.

[52] Stephen Brown & Jerold Warner, 'Using Daily Stock Returns: The Case of Event Studies', *Journal of Financial Economics* 14 (1985): 3–31; Sara B. Moeller et al., 'Firm Size and the Gains from Acquisitions', *Journal of Financial Economics* 73 (2004): 201–228; Sara B. Moeller, Frederik P. Schlingemann & René M. Stulz, 'Wealth Destruction on a Massive Scale? A Study of Acquiring-Firm Returns in the Recent Merger Wave', *Journal of Finance* 60, no. 2 (2005): 757–782; Ronald W. Masulis et al., 'Corporate Governance and Acquirer Returns', *Journal of Finance* 62, no. 4 (2007): 1851–1889.

[53] Fox, 2005.

[54] Keith C. Brown et al., 'Risk Aversion, Uncertain Information, and Market Efficiency', *Journal of Financial Economics* 22 (1988): 355–385.

[55] K.R. Subrahmanyam, 'Uncertain Precision and Price Reactions to Information', *Accounting Review* 71, no. 2 (1996): 207–219.

problematic and ignores that the loss accrues from the time of the misstatement. The next issue is then whether the defendant should be liable for extra losses.

5.4. What is the appropriate approach to extra losses?

This article argues that causation should not exist in relation to vis-à-vis systematic or extraneous losses. This supports the approach in China, which explicitly disallows damages for extraneous losses.

The investor can suffer two types of losses. First, he/she may incur losses due to the revelation of the falseness of the misstatement. Second, he/she may incur losses due to extraneous events (e.g., the market-wide decline at $t = 5$). These extraneous declines come in two flavours: (1) systematic declines that affect all stocks in the market and (2) stock-specific declines that only affect this stock. These include law suits, earnings announcements, or other corporate events that only affect this firm. The issue is if the defendant caused the purchase, should he/she be deemed to cause losses due to these extraneous factors? This article argues that the defendant should not be liable for these extraneous losses. This is for two key reasons.

First, this approach analytically quadrates with the operation of false statements. Section 5 demonstrates that the loss arises at the time of the misstatement. The loss is the difference between the price that the investor paid and the price he/she would have paid if there was no misstatement. All 'losses' due to market movements arise after this date and thus are not part of the compensable loss.

Second, excluding extraneous losses supports fundamental compensatory principles. The legislature is unlikely to intend a law to have unjust consequences[56] or to violate fundamental compensatory principles.[57] In the present situation, making the defendant an insurer for all the plaintiff's extraneous losses would be unjust and would conflict with fundamental compensatory principles[58] and may encourage plaintiffs to engage in sub-optimal carelessness and rent-seeking.[59] This is especially the case here since the plaintiff could suffer such losses through ordinary investing.[60] Thus, requiring the defendant to compensate the plaintiff for them would be unjust.

Overall, the principled approach to extra losses follows the approach in China, which prohibits compensation for loss suffered due to 'systematic' factors or ordinary market movements. Thus, China's approach could inform the development of principled regulation in the United States and the United Kingdom.

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[56] Paul Caghan, 'The Absolute Right to Refile: A Plain Meaning Interpretation of Section 24a of the Illinois Limitations Act – Franzese v. Trinko', *DePaul Law Review* 27, no. 2 (1978): 533–544; T.R.S. Allan, 'Legislative Supremacy and Legislative Intention: Interpretation, Meaning, and Authority', *Cambridge Law Journal* 63 (2004): 685–711.

[57] James Spigelman, 'Principle of Legality and the Clear Statement Principle', *Australian Bar Review* 79 (2005): 769–782.

[58] Richard Posner, *Economic Analysis of Law*, 2nd edn (Boston: Little Brown, 1977); Michael O'Meara, 'Causation, Remoteness and Equitable Compensation', *Australian Bar Review* 26, no. 1 (2005): 51–69.

[59] Walter Y. Oi, 'Tort Law as a Regulatory Regime: A Comment on Landes and Posner', *Journal of Legal Studies* 13, no. 3 (1984): 435–440.

[60] Baruch Lev & Meiring de Villiers, 'Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis', *Stanford Law Review* 47, no. 1 (1994): 7–37.

6. When Are Losses Too Remote?

Courts have held that the plaintiff must establish 'something more' than mere causation.[61] At a general level, this means that the loss must be within the 'scope of the liability'. Concepts of remoteness determine if the loss is within the 'scope of the liability'.[62] This motivates examination of, first, the available approaches to remoteness, and second, which of these is the appropriate approach.

6.1. What are the approaches in the US, the UK, and China?

The case law presents three key approaches: the 'immediate-consequence' approach, the 'reasonably foreseeable' approach, and the 'direct-consequence' approach.

First is the 'immediate-consequence' approach. This approach holds that (1) extraneous losses are outside the scope of liability since these do not immediately flow from the misstatement. And (2) liability is limited to losses on the shares that were the subject of the misstatement. There is no liability vis-à-vis losses on other shares even if the misstatement indirectly affected them. This is the current approach in China. Article 18(a) of the SPC's interpretation holds that loss is compensable only if the 'investor invests in securities [that are] directly related to the false statement'. And Article 19(d) indicates that losses due to extraneous market-wide factors, or stock-specific factors, are too remote.

The second approach is the 'reasonably-foreseeable-consequence' approach. This holds that losses are within the scope of the liability (not too remote) if they are reasonably foreseeable.[63] This is the general approach at common law for unintentional or negligent torts.[64] The US appears to have taken this approach vis-à-vis losses due to 'unintentional' or 'negligent' false statements.[65] However, this approach is problematic. It (1) appears to allow compensation vis-à-vis securities that were not subject to the misstatement since the misstatement could foreseeably affect rivals or competitors. And (2) it could deem extraneous losses to be within the scope of liability. This is because if the misstatement induced the shareholder to purchase the shares, then it is foreseeable that he/she could sustain loss simply by virtue of owning shares.

The third approach is the 'direct-consequence' approach. This is the widest remoteness test. It allows for all losses that flow from the misstatement; the losses need not be an 'immediate consequence' and need not be 'immediately foreseeable'.[66] Furthermore,

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[61] Fox, 2006.

[62] Jane Stapleton, 'Cause in Fact and Scope of Liability for Consequences', *Law Quarterly Review* 117 (2003): 411.

[63] Fox, 2005; Frederick C. Dunbar & Dana Heller, 'Fraud on the Market Meets Behavioral Finance', *Delaware Journal of Corporate Law* 31, no. 2 (2006): 455–532.

[64] See Leon Green, 'Foreseeability in Negligence Law', *Columbia Law Review* 61, no. 8 (1961): 1401–1424; Katherine A Gehring, 'Ohio's Approach to Prenatal Torts – A Different Strand of DNA: *Schirmer v. Mt. Auburn Obstetrics & (and) Gynecologic Associates, Inc.*, 884 N.E. 2D 1160 (Ohio, 2006)', *University of Cincinnati Law Review* 76, no. 1 (2007): 235–270; Mathew Boyle, 'Employers' Liability at Common Law: Two Competing Paradigms', *Edinburgh Law Review* 12, no. 2 (2008): 231–258.

[65] *RH Johnson & Co v. SEC*, 198 F 2d 690 (2nd Cir. 1952).

[66] Elizabeth M. Sacksteder, 'Securities Regulation for a Changing Market: Option Trader Standing under Rule 10b-5', *Yale Law Journal* 97, no. 4 (1988): 623–643.

it holds the defendant liable for all losses that flow from the misstatement even if they are unforeseeable. These could include unforeseeable losses that arise simply by holding the shares, such as an unforeseeable market crash. This appears to be the US approach vis-à-vis intentional misstatements.[67]

The UK approach is opaque. Arguably, the scope of liability contains any losses that are a direct consequence, including extraneous losses. This is because the defendant is liable only if he/she knew the statement was false or was reckless vis-à-vis its accuracy (section 90A(4)). Thus, by analogy to the approach to intentional misstatements, the defendant should be liable for any losses that are a direct consequence. However, it is important not to adopt mechanically the approach at common law.[68] Here, it seems that the 'immediate-consequence' approach is more appropriate. This is because the structure of section 90A(3)(b) pertains to loss and then details the possible causes of loss in section 90A(3)(b)(i) and section 90A(3)(b)(ii). The structure of detailing the loss in two sub-sections implies that the loss must connect immediately to the matters detailed in these sub-sections. This suggests that an immediate-consequence test might be more likely.

6.2. What is the appropriate approach?

This article argues that China's 'immediate-consequence' approach is optimal. The proof proceeds by contradiction; that is, if the court adopts the foreseeable-consequence test or direct-consequence test, then the court adopts an unprincipled interpretation. This is for two reasons.

First, neither the foreseeable-consequence test nor the direct-consequence test clearly discourages false statements and market manipulation. The argument for a wide remoteness test is that a person is less likely to make a false statement if the ambit of damages is larger.[69] Both the foreseeable-consequence and direct-consequence tests impose a wider ambit than the immediate-consequence test does. However, neither is principled. The foreseeable-consequence test is vague and open to judicial discretion.[70] The direct-consequence test is unclear since it has a notionally unlimited ambit, potentially covering any security affected by the misstatement and any loss flowing from owning the shares. Such vague standards make it impossible to rationally assess the consequences of wrongful conduct and thus cannot deter wrongful behaviour.[71] By contrast, the immediate-consequence test has a limited ambit to the extent of price inflation in the security subject to the misstatement. This is defined and clear.

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[67] Gregory E. van Hoey, 'Liability for "Causing" Violations of the Federal Securities Laws: Defining the SEC's Next Counterattack in the Battle of Central Bank', *Washington & Lee Law Review* 60, no. 1 (2003): 249–308.

[68] Dietrich & Middleton, 2006.

[69] Steven B. Elliott, 'Remoteness Criteria in Equity', *Modern Law Review* 65 (2002): 588–597; Andrew Tettenborn, 'Hadley v Baxendale Foreseeability: A Principle Beyond Its Sell-by Date?', *Journal of Contract Law* 23 (2007): 120–147.

[70] Andrew Burrows, 'We Do This at Common Law but that in Equity', *Oxford Journal of Legal Studies* 10, no. 1 (2002): 1–16; Stapleton, 2003.

[71] Gillian K. Hadfield, 'Weighing the Value of Vagueness: An Economic Perspective on Precision in the Law', *California Law Review* 85 (1994): 541–554.

Second, the immediate-consequence test promotes the compensatory purpose of the false statement provisions. Rules best promote compensation if they are clear and have certain implications.[72] They do this if they clearly define the ambit of compensation. Thus, the legislature is unlikely to institute an approach that has an unclear meaning.[73] The foreseeable-consequence test is unclear since it gives judges broad discretion to determine the ambit of liability. It is additionally unclear in the case of intentional misstatements, since the common law on reasonable foreseeability relates to negligent wrongs and thus is inapplicable to intentional wrongdoing.[74] The direct-consequence test is inappropriate since it imposes wide-reaching liability. However, direct-consequence liability imposes wide-ranging and uncertain liability, potentially rendering the defendant liable to all investors in the market. Such width undermines the policy goal of legal certainty and thus is undesirable.

The overall conclusion is that both the reasonable foreseeability and the direct-consequence are untenable. Instead, China's immediate-consequence test promotes legal certainty and upholds the rationale for forbidding false statements. Thus, the US could learn from China's approach to remoteness.

7. What if the Plaintiff Mitigates the Loss by Selling the Shares?

Loss arises at the date of the inflation or purchase. However, the investor may sell the shares before revelation of the statements falsity. Here, the plaintiff prevents the unrealized loss from crystallizing into a monetary loss. Following McGregor, the common law has two presently relevant rules.[75] First, the defendant is not liable if the plaintiff mitigates his/her loss. Second, the plaintiff has a duty to mitigate avoidable losses. Thus, the defendant is not liable if the plaintiff could have avoided the loss. Here, this would require the plaintiff to sell the shares if he/she becomes aware that the statement is false. This motivates examination of the current approach and of the appropriate approach.

7.1. The approaches in the US, the UK, and China

United States courts impose a duty to mitigate. Thus, if the plaintiff becomes aware of the misstatement, then the plaintiff has a duty to undertake reasonable actions to avoid loss.[76] Subsequently, courts have held that if a short-seller becomes aware of the false statement, then he/she has a duty to mitigate the loss by covering his/her shot position.[77] Similarly, the plaintiff cannot obtain compensation if he/she sells before the revelation.

China's approach does not require mitigation but does deny compensation if the plaintiff mitigates. Articles 18(c) and 19(a) pertain to mitigation. Their effect is twofold. First, since Article 18(c) explicitly contemplates a 'continuing holding of securities', it is

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[72] Stapleton, 2003; Tettenborn, 2007.

[73] William N. Eskridge, 'Dynamic Statutory Interpretation', *University of Pennsylvania Law Review* 135, no. 6 (1987): 1479–1556.

[74] Elliott, 2002.

[75] Harvey McGregor, *McGregor on Damages* (United Kingdom: Sweet & Maxwell, 2009).

[76] See *In Re Fortune Systems Securities Litigation*, 680 F Supp 1360 (ND Cal 1987).

[77] See, for example, *Van Syckle v. CL King and Associates Inc.*, 822 F Supp 98 (1992).

unlikely that the plaintiff has an obligation to sell securities subject to a misstatement. Second, if the plaintiff mitigates his/her loss by selling the shares before the reveal date, then the mitigation reduces the defendant's liability (Article 19(a)). Thus, the issue is whether this approach is valid.

The position in the UK appears to be similar to that in China. Neither section 90A nor the accompanying Schedule 10A refers to mitigation. However, mitigation appears largely irrelevant to the structure of section 90A. Under section 90A(5), the loss arises when the plaintiff acquires the shares. Therefore, there appears to be no opportunity to mitigate. Thus, mitigation does not appear to apply.

7.2. The appropriate approach

China's approach is preferable; this article finds that there should be no duty to mitigate losses, but if the plaintiff does mitigate losses, then the defendant is not liable.

The plaintiff should not have a duty to mitigate losses. If the plaintiff bears a duty to mitigate, then if he/she knows that the statement is false, and he/she should sell the shares before the reveal date. However, this is problematic since if the investor knows that the statement is false and trades on that knowledge, then the investor trades on material non-public information. Such trades constitute insider trading.[78] But forcing investors to commit an illegal act cannot be a reasonable act of mitigation.[79] Thus, the investor cannot bare a duty to mitigate.

The defendant should not be liable if the plaintiff mitigates his/her losses. The plaintiff avoids monetary losses if he/she sells before the reveal date. This holds whether or not the plaintiff knew that the statement was false. Thus, if the investor avoids the loss and receives compensation, then he/she is in a better position than he/she would have been in if there was no breach. But the purpose of compensation is not to improve the plaintiff's position.[80] Thus, awarding compensation even if the plaintiff avoids the loss conflicts with the compensatory purpose of the provisions.

This analysis suggests that there should be no duty to mitigate. But if the plaintiff does mitigate losses by selling the shares, then the defendant is not liable. This quadrates with the approach in China and confirms that China's approach can inform regulation in the United States and the UK.

8. Conclusion

Market manipulation undermines confidence in financial markets. A way to ameliorate this is to allow shareholders to obtain compensation from people who manipulate prices

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[78] Kenneth E. Scott, 'Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy', *Journal of Legal Studies* 9, no. 4 (1980): 801–818; Dennis W. Carlton & Daniel R. Fischel, 'The Regulation of Insider Trading', *Stanford Law Review* 35, no. 5 (1983): 857–896.

[79] This follows cases holding that plaintiff need not harm innocent persons – *Banco de Portugal v. Waterlow and Sons Ltd*, [1932] AC 452 (HL) – or jeopardize commercial reputation – *Finlay v. Kwik Hoo Tong* [1929] 1 KB 400 (KB); *Joseph & Co Pty Ltd v. Harvest Grain Co Pty Ltd*, 39 NSWLR 722, 737–738 (NSWSC 1996).

[80] David Wright, 'Monetary Remedies under the Trade Practices Act', *Australian Bar Review* 22 (2002): 39–62.

by issuing false statements. However, live issues in market manipulation are the existence of different compensator regimes in different countries and the failure of some regimes to cohere with fundamental compensatory principles.

This article aims to address the problems with compensation for false statements. The article does this by using the law in China as a model to guide the development of law in the US and the UK. This allows the article to (1) demonstrate that regulations in emerging markets can guide the development of regulations in developed markets and (2) provide a framework to govern compensation for false statements that could facilitate a harmonized approach to compensation. The analysis demonstrates that China's approach is a justified approach to market manipulation and can indicate how to regulate market manipulation in the United States and the United Kingdom. A summary of the findings is that a principled approach to market manipulation takes the following form:

(1) *Date of loss*: the plaintiff sustains a loss when he/she purchases the securities. The loss is the difference between the price that he/she pays and the price he/she would pay if there was no misstatement.
(2) *Causation*: causation obtains only if the plaintiff proves purchase causation and loss causation. The defendant prima facie does not cause extra causation:
    (a) Purchase causation obtains if the plaintiff relied on the false statement to purchase the stock at that price. There is a rebuttable presumption that the investor relied on the false statement.
    (b) Loss causation obtains if the price inflation (or deflation) is due to the false statement. Proof of this includes, but is not limited to, evidence of market movements around the announcement and analyst reports.
    (c) The defendant does not cause 'extra' losses. These are losses due to market-wide or stock-specific factors that are unrelated to the false statement.
(3) *Remoteness*
    (a) Loss is not compensable if it is too remote.
    (b) Loss is too remote if it is not an immediate consequence of the price inflation (or deflation). Losses that are not an immediate consequence include but are not limited to:
        (i) losses on securities that are not the subject of the misstatement and
        (ii) losses due to extraneous market-wide factors or stock-specific factors.
(4) *Mitigation*
    (a) The defendant is not liable for loss if the plaintiff mitigated his/her loss. He/she mitigates the loss if he/she sells the securities before the reveal date.
    (b) The plaintiff is under no obligation to mitigate the loss by selling the securities.

This analysis contributes to the legal and political science literature. The examination shows that developed markets can benefit from legal rules in developing markets. This contrasts with the established approach of transplanting developed-market laws onto developing markets. This should generate further analysis of the relationship between emerging markets and developed markets in the formation of international law. Furthermore, this article indicates a principled way to reform market manipulation in the United States and the United Kingdom in order to optimize shareholder protection. This could form the basis of a harmonized approach to market manipulation by false statements.

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