

Judicial Dilemmas and Improvement Paths of Special Representative Litigation in Securities Disputes

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Abstract

The special representative litigation system for securities disputes is centered on the principle of "implied participation and explicit withdrawal," aiming to resolve the collective action dilemma that hinders small and medium investors from protecting their rights. It represents a milestone in the legal construction of China's capital market. However, in judicial practice, the special representative litigation system faces numerous dilemmas that restrict its full functionality, such as unreasonably set preconditions, a single activation subject mode, and the lack of supervision by insurance institutions. Based on this, it is necessary to gradually relax preconditions, explore multiple activation subjects, and strengthen the supervision of insurance institutions, thereby fully safeguarding investors' rights and interests.

Keywords

Special Representative Litigation; Investor Protection; Insurance Institutions.

1. Introduction

Infringement litigation serves two main functions: remedy and deterrence. Traditional tort litigation in securities disputes primarily focuses on providing remedies for investors[1]. Initiating civil litigation facilitates the enforcement of securities law, serves as a fundamental remedy, and effectively supplements securities regulation, compensating for the shortcomings of public enforcement[2]. However, constrained by high costs, difficulties in evidence provision, and other collective action dilemmas, the traditional litigation model struggles to provide effective relief for affected investors. To address this predicament, the new Securities Law establishes the special representative litigation system for securities disputes. This system, led by investor protection institutions and centered on "implied participation and explicit withdrawal," is hailed as a milestone in the legal construction of China's capital market, possessing profound significance for increasing the costs of violations and maintaining market confidence. Nevertheless, the practical effectiveness of this system is limited due to inherent dilemmas. Judicial practice has revealed issues such as unreasonable precondition settings, a single activation subject model, and gaps in supervision mechanisms by insurance institutions, which affect the system's ability to fully protect investors. In view of this, this paper aims to systematically analyze the operational dilemmas of this system and propose improvement paths. It first reviews its institutional structure and legislative objectives, then focuses on the three aforementioned judicial dilemmas, and finally offers targeted suggestions, including gradually relaxing preconditions, exploring multiple activation modes, and strengthening supervision of insurance institutions, with the aim of providing references for optimizing the system and effectively enhancing judicial protection of investors' rights and interests.

2. Institutional Characteristics and Legislative Objectives of Special Representative Litigation in Securities

2.1. Institutional Characteristics of Special Representative Litigation in Securities

The special representative litigation system in securities is an important innovation in the construction of China's capital market legal system. Compared with ordinary representative litigation, it exhibits several distinct procedural characteristics that profoundly impact the operational logic and practical outcomes of the system.

First, a participation mechanism centered on implied participation. Article 95, Paragraph 3 of the Securities Law states: "An investor protection institution entrusted by more than fifty investors may participate in litigation as a representative and register with the people's court on behalf of the right holders confirmed by the securities registration and clearing institution in accordance with the preceding provisions, unless the investors explicitly indicate that they do not wish to participate." This mechanism has completely transformed the traditional model of civil litigation where parties proactively initiate cases. It effectively addresses the challenge of dispersed victims with insufficient individual incentives to pursue rights in securities infringement cases. It can cover the vast majority of affected investors at once, greatly improving litigation efficiency and creating a scale effect in claims. Xing Huiqiang pointed out in his research that this mechanism uses the expansion of judgment effects to consolidate scattered investors into a powerful litigation collective, effectively overcoming the collective action dilemma[3].

Second, lawsuits are represented by specific insurance institutions. Grant categorizes parties as either one-time participants who are incidentally involved in litigation or repeat litigants engaged in the same type of case over time. Empirical studies demonstrate that repeat litigants are the party with more resources and higher winning rates in litigation[4]. The purpose of having specific insurance institutions serve as representatives in litigation is to leverage their professional expertise, informational advantages, and financial resources to compensate for the ordinary investors' deficiencies in handling complex securities lawsuits. In this process, insurance institutions act as public interest representatives. Their litigation actions are not solely aimed at obtaining remedies in individual cases but also carry the public goal of maintaining the overall health and order of the market. Special representative litigation reflects public-oriented characteristics, protecting investors' rights through the privatization of public enforcement[5].

Third, the initiation of procedures relies on ordinary representative litigation. Special representative litigation cannot be initiated independently; its launch is contingent. The prerequisite is that the People's Court has already accepted a qualifying ordinary representative litigation case. The specific process is that after the court publishes a rights registration notice for the ordinary representative litigation, investor protection agencies may, during this period, accept the entrustment of over fifty investors and apply to the court to convert it into special representative litigation. This design makes special litigation an enhancement and upgrade of ordinary litigation, creating a dual-layer rights protection channel that combines market-driven private initiative with selectively prioritized public interest intervention.

2.2. Legislative Objectives of Special Securities Representative Litigation

The legislature created the special representative litigation system with the aim of achieving multiple strategic objectives, and its legislative pursuit is both layered and systematic.

First, to compensate for the inadequacy of private enforcement and achieve efficient remedies for investors. Historically, China's securities market regulation has primarily relied on

administrative penalties by the China Securities Regulatory Commission, while private civil litigation has proven ineffective due to high costs, difficulty in presenting evidence, and low compensation. The "opt-out" mechanism significantly reduces the cost of defending rights, while the professional involvement of insurance institutions effectively increases the likelihood of success. The legislative intent is to systematically consolidate dispersed and weak individual claims into a strong collective force, thereby creating effective deterrence against illegal activities in the securities market and providing investors with tangible compensation.

Second, to strengthen market deterrence and purify the capital market ecosystem. Beyond individual compensation, special representative litigation is endowed with significant market governance functions. Some scholars argue that U.S. class actions aim primarily to prevent unlawful conduct, with investor compensation being secondary; thus, a lower proportion of compensated investors is acceptable. However, the concept of class action litigation in China differs from that of the United States, and China should strive to maximize the proportion of investors receiving compensation[6]. Legislators hope that by imposing massive civil compensation, they can significantly increase the cost of violations and deter potential wrongdoers. This deterrence is universal, targeting not only already exposed illegal activities but also warning all market participants that they must operate lawfully. For instance, the Kangmei Pharmaceutical Case is a benchmark case featuring multiple crossed types of offenses—criminal, civil, and financial—ranking first in terms of financial fraud data, number of plaintiffs, and compensation amounts. [6] It comprehensively showcases the current levels of legislation, enforcement, and judiciary in China's securities sector, genuinely reflecting the practical operation of representative securities litigation[7]. It also sends a clear signal to the market: any act of fraudulent issuance or financial fraud may face collective lawsuits substantial enough to wipe out personal wealth. This strong deterrent power aims to fundamentally curb securities violations, promote the improvement of governance structures in listed companies, enhance the quality of information disclosure, and thereby optimize the ecosystem of the entire capital market.

Third, improving the securities legal system and enhancing financial judicial capacity. The establishment of representative litigation is an important milestone in the maturity of China's securities legal framework. It signifies that China is aligning with advanced international practices in judicial protection for investors. The operation of this system not only tests the professional abilities of the protection institutions but also imposes unprecedented high demands on the financial adjudication capabilities of the People's Courts. How to handle complex legal and technical issues, balance investor protection with market stability, and coordinate civil compensation with administrative fines, all drive the improvement of judicial competence. Therefore, the deep goal of this system is to continuously enrich and refine securities legal rules through judicial practice, promote the formation of a more complete and forward-looking securities legal framework, and in the process, cultivate a professional team for financial adjudication.

3. Judicial Challenges of Representative Litigation

The representative litigation system introduced in China's securities field is regarded as a significant innovation in the history of protecting investors' rights. This system aims to overcome the collective action dilemma and high litigation costs faced by traditional civil lawsuits when addressing large-scale securities violations through the involvement of legally mandated investor protection institutions. However, in the transition from theory to practice, this system has gradually revealed inherent judicial challenges, mainly concentrated in three aspects.

3.1. Unreasonable Setting of Preconditions

The initiation of representative litigation currently depends on a key procedural prerequisite, namely that the People's Court has already accepted an ordinary representative lawsuit that meets certain conditions. There has been debate over whether the initiation mode should be 'parallel' or 'progressive'[8]. In the 'progressive' initiation model, this procedural design may have been initially intended, for prudential reasons, to filter cases through preliminary court review. However, from both legal theory and practical perspectives, this precondition is clearly unreasonable.

From a theoretical standpoint, this prerequisite essentially constitutes an improper restriction on the direct exercise of litigation rights by investor protection institutions. The basic principles of civil litigation guarantee the equal litigation rights of the parties, whereas investor protection... The fundamental principles of civil litigation safeguard the equal litigation rights of the parties involved. As legally established and professional organizations for the protection of investors' rights, investor protection institutions should possess independent and proactive authority to initiate lawsuits on behalf of investors. Making the initiation of special procedures entirely dependent on the prior establishment of ordinary representative lawsuits renders the litigation rights of these protection institutions derivative and subordinate. To some extent, this undermines their institutional value and functional positioning as special representatives. Such a design contravenes the legal principle of the independent status of litigation subjects and casts doubt on the independent value of the special representative litigation system itself.

From a practical standpoint, this prerequisite significantly raises the threshold for special representative lawsuits, potentially preventing many typical cases from entering the special procedure. The initiation of ordinary representative lawsuits itself requires satisfying complex conditions such as rights registration and the election of representatives, making the process time-consuming and labor-intensive. If the ordinary representative lawsuit fails to be initiated for various reasons, special representative litigation cannot proceed. This may result in cases where the nature of the infringement is clear and a broad group of investors is affected being blocked from special representative procedures due to the difficulties in organizing ordinary lawsuits. Consequently, the deterrent effect and coverage of special representative lawsuits are greatly reduced, making it difficult to establish a routine and predictable check on illegal activities in the securities market.

3.2. Single Initiating Entity Model

Currently, the initiation of special representative lawsuits is strictly limited to specific investor protection institutions, primarily entrusted to the China Securities Investor Services Center Co., Ltd. This single-entity model may be advantageous during the early stages of the system for concentrating resources and standardizing procedures. However, from the perspective of long-term institutional development and performance optimization, its singularity constitutes a potential judicial dilemma. The "many cases, few personnel" issue arising from limited resources in investor protection centers has already begun to manifest in securities disputes in China's mainland [9].

The singularity of the initiating entity may first result in a sharp conflict between limited litigation resources and the enormous market demand. China's capital market is vast, with frequent and diverse violations of securities laws. Relying solely on one national investor protection institution to handle all potential special representative lawsuit cases will inevitably test its capacity limits. These resource constraints may compel the institution to adopt an extremely cautious or conservative approach in case selection, focusing only on a very small number of high-impact, relatively straightforward benchmark cases, while many other representative cases that similarly harm investors' rights may be unable to enter the procedure. Such a situation undoubtedly undermines the fairness and inclusiveness of the system.

Secondly, the single-entity initiating model lacks the necessary competitive mechanism, potentially leading to inefficiencies and insufficient innovation. Investor protection institutions become litigation representatives not because they are institutional investors in the capital market, but due to their status as public welfare organizations and societal organizers[10]. In the absence of other potential qualified entities, the sole investor protection institution, while able to maintain professionalism and prudence in litigation advancement, strategy selection, and settlement negotiations, may also face constraints in maximizing efficiency due to the lack of external pressure. The speed of litigation and the aggressiveness of rights protection strategies largely depend on the internal decision-making processes and risk preferences of a single institution. As the ultimate beneficiaries, investors have little choice or benchmark for comparison in this process. A completely monopolistic service provision model is, in the long run, disadvantageous to the continuous optimization of the system and the enhancement of its dynamic adaptability.

3.3. Lack of Supervision over Insuring Institutions

The special representative litigation system grants investor protection institutions concentrated and substantial litigation powers, including the authority to decide whether to initiate a lawsuit, formulate litigation strategies, and approve settlements with defendants. However, corresponding to this concentration of power, the mechanisms for supervising and balancing the exercising of power by these institutions remain relatively weak, resulting in a clear lack of oversight.

This lack of supervision is first evident in the absence of oversight over an insuring institution's decision not to file a lawsuit. When a securities infringement event occurs, if the insuring institution internally decides not to initiate special representative litigation, the current system lacks effective mechanisms to review or supervise such a decision. Investors are unable to ascertain the specific reasons for inaction and cannot challenge the decision's reasonableness through legal channels. This grants insuring institutions nearly unrestricted discretion in case selection, and the transparency, fairness, and rationality of their decision-making processes lack effective external constraints. This may lead to the improper exclusion of cases that should have received collective redress, undermining investors' substantive rights to judicial remedies. Second, the supervision of insuring institutions during the litigation process is also insufficient. For instance, when deciding whether to accept a settlement proposed by the defendant, although rules require the institution to seek the opinions of plaintiff investors, the final decision rests with the institution. Ensuring that the settlement genuinely maximizes the collective interests of investors, rather than being influenced by litigation costs, duration, or other non-legal factors, requires a more open, transparent decision-making process and supervisory mechanism. Moreover, the use and management of litigation funds also involve potential agency and moral hazard risks. Scholars have noted that in representative litigation, a lack of effective supervision over representatives may create a risk of misalignment between the interests of the representative and those represented, commonly referred to as the "agency cost" issue[11]. Although insuring institutions have a public-interest role, their internal operations must prevent such risks to ensure that their actions consistently align with the collective interests of investors. Relevant studies indicate that in the United States, class actions not only effectively deter and regulate listed companies but also compensate for deficiencies in governmental regulatory efforts[12].

In summary, China's special representative litigation system faces practical judicial dilemmas in three areas: preconditions, initiating subjects, and supervisory mechanisms. These challenges are interconnected and jointly restrict the effective realization of the system's intended functions. A thorough analysis of these dilemmas is a necessary theoretical foundation for facilitating the system's future improvement and development.

4. Pathways for Improving Securities Special Representative Litigation

Since its implementation, the securities special representative litigation system has achieved significant results in enhancing investor protection and deterring illegal activities in the securities market. However, its practical operation has also revealed some institutional limitations. To ensure that this system can maintain long-term stability and exert its intended long-term effect, it is necessary to systematically improve and optimize it from the following three key aspects.

4.1. Gradually Relax Pre-litigation Conditions

Currently, special representative litigation relies excessively on administrative penalties issued by securities regulatory authorities or effective criminal judgments for fact verification. Although this prerequisite can reduce the initial burden of evidence for investors and ensure the stability of the case's foundation, its limitations have become increasingly apparent. Therefore, consideration should be given to gradually relaxing and ultimately removing this pre-litigation requirement. The specific improvement approach can be carried out in stages. Initially, it may be feasible to expand the scope of prerequisites to include self-regulatory measures by stock exchanges, such as public censures and major regulatory actions, as one of the triggers for initiating litigation. Further, drawing on the experience of class actions in the United States, legislation could specify that for certain cases of significant importance and clear indications of misconduct, courts should accept cases even without prior administrative or criminal judgments, provided that investor protection institutions or plaintiffs can submit preliminary evidence demonstrating the existence of false statements or other infringements and a basic causal link to investment losses. Some scholars believe that further reforms could include the advance involvement of insurance institutions in determining the scope of rights holders, thereby enhancing the credibility and fairness of the court in this process[13]. In such circumstances, courts should, either on their own initiative or upon request, fully exercise their role in evidence collection and fact-finding, carrying out independent determinations through specialized financial tribunals. This reform would not only expand the coverage of special representative litigation but also demonstrate the judiciary's proactive and authoritative role in maintaining fairness and justice in the securities market.

4.2. Explore the Introduction of Multiple Initiating Entities

Before the establishment of the Investor Protection Center, securities dispute cases were rare in Taiwan, and the Center effectively promoted the development of securities litigation[14]. However, the single-entity initiation method currently employed in China's mainland is insufficient to meet investors' rights protection needs. To activate the system's potential, it is necessary, when conditions permit, to explore the introduction of diversified initiating entities. One feasible solution is to legally recognize the China Securities Investor Protection Fund Co., Ltd. as another eligible litigation representative. This company also possesses public welfare attributes, professional competence, and financial strength, allowing its involvement to create beneficial complementarity and moderate competition, encouraging both institutions to proactively discover cases and diligently fulfill their duties. Moreover, consideration could be given to establishing a public-private cooperation mechanism that allows experienced and reputable law firms or other market professionals, after completing preliminary evidence collection and investor mobilization, to recommend or assist investor protection institutions in initiating litigation. This pattern of participation by multiple parties can effectively overcome the issues of insufficient motivation or limited perspectives that may exist in a single institution, forming a more responsive, efficient, and comprehensive investor protection network. It ensures that violations, regardless of their scale or form, can be subject to legal action, thereby weaving a more rigorous network of legal accountability.

4.3. Strengthening the Supervision Mechanism over Insurance Institutions

Establishing a systematic supervision mechanism is crucial. Firstly, the judicial supervision by the people's courts should be reinforced. In particular, regarding litigation settlement proposals, the court should not merely conduct a formal review but must carry out a substantive examination. For important litigation matters, such as changes of representative, waiving claims, admitting the opposing party's claims, or deciding to withdraw a case, the court shall issue rulings on whether to approve them in accordance with the law[15]. Courts may establish a mechanism for hearing objections, proactively listening to the opinions of investors who dissent from settlement proposals, and may engage independent financial experts to provide evaluation reports on the fairness and reasonableness of settlement amounts, using these reports as key references for approving the settlement. Secondly, internal governance and information disclosure obligations of insurance institutions should be improved. Insurance institutions should establish and publicly disclose detailed standards and decision-making processes for case selection, regularly publish work reports explaining in detail their litigation activities, use of funds, and outcomes achieved, thereby accepting public supervision. Finally, the establishment of an external advisory committee composed of legal and financial experts as well as investor representatives may be explored, to provide advice and supervision over major decisions of the insurance institutions. By combining judicial supervision, information disclosure, and external assessments, a comprehensive system of checks and balances can be built, ensuring that the power held by insurance institutions is always used to effectively protect the legitimate rights and interests of investors.

5. Conclusion

The 2023 Central Financial Work Conference clearly stated the need to "comprehensively strengthen financial regulation" and to "better leverage the hub function of the capital market," while raising higher demands on the concept of finance for the people. Under this significant strategic deployment, improving the judicial enforcement system for securities, particularly optimizing the system of special representative litigation for securities disputes, has become a key component of implementing the political and people-oriented aspects of financial work. However, although this system, with its focus on "implied joining and explicit withdrawal," has achieved a historic breakthrough in overcoming the collective action dilemma of investors, its judicial practice remains constrained by preconditions, initiation modes, and supervision mechanisms. Therefore, gradually relaxing preconditions, exploring multiple initiating parties, and strengthening supervision over insurance institutions are essential for systematically addressing these challenges and unlocking the full potential of the system. Promoting the deepening and improvement of the special representative litigation system is a necessary step to consolidate the rule of law foundation in the capital market and protect the legitimate rights and interests of a broad base of small and medium-sized investors. Guiding the continuous maturation of this system under the people-centered development philosophy, its core value lies in strengthening the rule of law, effectively deterring illegal activities, maintaining market confidence, and ultimately contributing to the modernization of a China-style capital market.

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