

The Internal Recovery Dilemma of Intermediaries in Securities Misrepresentation

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Abstract. In judgments of securities fraud cases, intermediary institutions are often sentenced to bear joint liability, but their internal compensation procedures face numerous difficulties in practice, such as ambiguous standards for liability allocation and complex internal compensation procedures, which may lead to a mismatch between fault and responsibility. Currently, China's legislation does not have clear and unified provisions regarding the assumption of joint liability and subsequent recourse, resulting in inconsistencies in judgments for similar cases. It is also evident that such a situation is unfavorable for achieving judicial fairness and justice. This article aims to propose a hybrid model that is more suitable for the current judicial situation in China, in order to address existing shortcomings, which based on the theory of causality and supplemented by the semi-additive theory. Additionally, it suggests improving the internal recourse process by referencing successful experiences from other countries, as well as establishing a whitelist for relevant online platforms and service organizations.

Keywords: False statements in securities, Intermediary agency, Internal recovery.

1. Introduction

In recent years, cases of false statements have become frequent, and the issue of the responsibility of intermediary agencies has become a focal point of legal attention. In securities false statement cases, although intermediary agencies mostly apply joint liability, the actual effectiveness of internal recourse remains unsatisfactory. Internal recourse among intermediary agencies still faces many obstacles, such as difficulties in allocating responsibility ratios, challenges in quantifying causality, and inadequacies in internal recourse procedures.

Taking the Wuyang bond case as an example, in this case, the intermediary institution was judged to bear joint liability, with Debang Securities initially compensating and then pursuing internal reimbursement from the other three parties. However, in this case, the division of responsibilities and the disputes over compensation amounts among the parties are ongoing. Essentially, the legal provisions and judicial interpretations are quite vague and lack a clear discretion standard. For instance, Article 163 of the Securities Law states that securities service institutions and their clients bear joint liability; Article 23 of the Supreme People's Court's provisions on the trial of civil compensation cases for false statements in the securities market stipulates the allocation and recourse of responsibility among parties bearing joint liability, which are handled according to Article 178 of the Civil Code. Ultimately, it relies on the discretionary power of judges in the judiciary to make decisions. The further subdivision of joint liability is divided into full joint liability and proportional joint liability. The current mainstream standard is proportional joint liability, which is categorized into the theory of causation and the semi-accumulative theory.

This article aims to explain the reasons for using the theory of causation as the basis for the division of proportional joint liability, while further clarifying its quantification standards through legislation or judicial interpretation, supplemented by other means to ensure market order and industry regulation.

2. Sorting out Disputes Regarding Norms, Theories, and Practices

2.1. Joint Liability

Article 163 of the Securities Law states that if a securities service institution produces or issues documents with false records, misleading statements, or significant omissions that cause losses to others, it shall bear joint and several liability with the client, unless it can prove that it was not at fault. The joint liability mentioned here does not specify whether the securities service institution bears full joint liability or proportional joint liability, which may lead to inconsistent judgments in similar cases, adversely affecting the development of judicial practice.

If joint and several liability is regarded as full joint and several liability, securities service institutions may be held jointly and severally liable for full compensation due to mere negligence, which could lead to abuse of lawsuits in the securities market and the chilling effect on intermediaries as well as the deep pockets phenomenon [1]. Taking the 'deep pockets' phenomenon as an example, when the first defendant subject to compensation is the issuer or actual controller responsible for false statements and they declare bankruptcy or have limited assets, liability is not prioritized based on fault, but instead, the financially strongest defendant is required to compensate first and then seeks internal indemnification. However, since internal indemnification may not succeed, the intermediary institution ultimately bears all the responsibility [2]. Referring to the situation in the Wuyang Bond case, Wuyang Construction and Chen Zhizhang, as the issuer and actual controller in this case, had virtually no ability to pay compensation, leaving the majority of the compensation responsibility to Debang Securities and Da Xin Accounting. Although their liability is based on gross negligence rather than ordinary negligence, they effectively replaced the 'culprits' of the case in assuming full joint and several liability, which is evidently detrimental to industry development and the business environment [3]. In judicial practice, full joint and several liability might also result in intermediaries bearing compensation liability that exceeds their proportion of fault, leading to a mismatch between fault and liability. Thus, many scholars and practitioners interpret 'joint and several liability' as proportional joint and several liability. Compared to full joint and several liability, proportional joint and several liability means that intermediaries are not required to bear total compensation for their partial responsibility, but only to compensate according to their proportion of responsibility. This aligns better with the principle of fairness and better balances risk and efficiency.

Similarly, proportional joint liability requires a relatively clear judgment standard, and the mainstream academic views are divided into cases where causation is primary and fault is secondary, and cases of semi-aggregation of separate torts.

First, the method of determining responsibility mainly based on causation, with fault as a supplementary factor, is to analyze the degree of contribution of various behaviors to the final damage outcome to determine the proportion of responsibility to be borne. The method of determining fault primarily based on causation allows intermediaries to bear responsibilities commensurate with their fault. However, the judgment of causation is both complex and professional, making it still difficult to establish a uniform standard of judgment, which relies more on the discretion of judges. However, excessive discretion may lead to inconsistent rulings in similar cases, posing significant challenges at the practical level [4]. Comparing the Wuyang Bond case with the Zhong'an Ke case, both cases utilized the theory of causation for adjudication, but the judgment outcomes were different: in the Wuyang Bond case, the court held that Debang Securities did not include significant risks that would affect Wuyang Construction's issuance conditions and repayment capability in its verification opinion; Daxin Accounting, as the auditing firm, made substantial errors by issuing a false audit report regarding the bond's issuance and trading, thus bearing joint liability for damages. Daguang International in this case was also found at fault for not further verifying and reasonably assessing the project's credit rating, ultimately bearing joint liability within 10%. In contrast, in the Zhong'an Ke case, the court determined that China Merchants Securities did not conduct due diligence and failed to fulfill its duty of care, bearing joint liability within 25%; Ruida Accounting Firm similarly failed to act diligently in the audit report process and bore joint liability within 15%, while Jincheng Tongda

Law Firm was ultimately exempt from liability. Comparing the two cases, this study find that there is no unified quantitative standard for judging causation in judicial practice; one case follows a result-oriented approach while the other observes a process-oriented approach, leading to differing judgments in similar cases, and the issue of internal recovery also remains a topic for discussion.

In addition, some scholars have proposed the theory of semi-accumulation of separate torts, which is based on Article 1172 of the Civil Code: When two or more persons individually commit tortious acts causing the same damage, and the degree of responsibility can be determined, each shall bear the corresponding liability; if it is difficult to ascertain the degree of responsibility, the liability shall be shared equally. Compared to the causality-based determination method, the semi-accumulation theory suggests that in cases where overlapping causality exists, all parties should bear joint liability for the portion of the loss they collectively caused [1]. This is similar to the issues reflected in the legal responsibilities undertaken by the accounting firm Da Xin in the Wuyang bond case: in practical work, the responsibilities of intermediary organizations are not as isolated from each other as the law stipulates, but have many overlaps, making their responsibilities even more difficult to delineate [5].

2.2. Internal Recovery Issues

Article 93 of the Securities Law states that if an issuer causes losses to investors due to fraudulent issuance, false statements, or other serious violations, the issuer's controlling shareholders, actual controllers, and related securities companies can entrust investor protection organizations to reach an agreement with the affected investors regarding compensation matters, providing advance compensation. After providing advance compensation, they can legally seek recourse from the issuer and other jointly liable persons. From the provisions of the law and some cases, such as the Zhong'an Ke case and the Wuyang Bond case, the final judgments only delineated the general scope of responsibility for intermediaries, without specifically detailing it. Hence, it is evident that neither the legislation nor its implementation clearly defines the portions of responsibility that each party should bear. This makes it difficult to pursue recourse after one party has provided advance compensation, and the allocation of liability remains indeterminate. Additionally, referring to the aforementioned 'deep pockets' effect, the actual party facing penalties may not necessarily be the 'primary offender,' which, while protecting the rights of investors, evidently does not benefit the healthy development of the industry. Therefore, the author believes that in case judgments, the allocation of responsibility among parties should be specifically determined in conjunction with theories such as causation to facilitate subsequent recourse.

At the same time, internal compensation requires a separate legal procedure, which is time-consuming, labor-intensive, and costly for the party that takes on compensation responsibilities first. However, this method remains the main model in today's judiciary. I believe that the approach in the Kangmei Pharmaceuticals case, which includes all parties and specifies their respective responsibilities in the judgment, is more in line with the future judicial trends in China and can more effectively address the difficulties of internal compensation.

3. The Direction for Improving the Division of Responsibilities and Internal Recovery Procedures

3.1. The Direction for Improving the Division of Responsibilities and Internal Recovery Procedures

The author believes that the standard of division based on causation should be combined with the semi-accumulative theory to better assign responsibility and facilitate internal recourse. Both have their advantages and disadvantages; for instance, purely dividing based on causation can lead to overlapping responsibilities, resulting in a mismatch between the distribution of responsibility and actual impact. In securities fraud cases, responsibility is distributed quite flexibly, and combining causation with the semi-accumulative theory can effectively address the inflexibility of causation.

Referring to the judgment on page 239 of the LeTV case regarding the distribution of responsibility, adding liability based on causation exemplifies the practical integration of the semi-accumulative theory with causal theory in real cases. This mixed model aligns better with the judicial trend in China. Additionally, it is necessary to improve internal recourse procedures and support them with other measures to ultimately achieve the dual goals of promoting industry development and protecting investors' rights.

The responsibility allocation related to joint liability among various securities service agencies currently lacks a clear standard. According to the author's earlier views, the allocation of responsibilities should adopt a mixed model based on causation, supplemented by semi-additive theory.

For a better application based on causal power, a mixed model with semi-additive theory as a supplement should first refer to Article 18 of the 'Several Provisions of the Supreme People's Court on Hearing Civil Compensation Cases for False Statements in the Securities Market': If the documents produced and issued by securities service institutions such as accounting firms, law firms, credit rating agencies, asset appraisal agencies, and financial advisors contain false statements, the people's court should determine whether there is fault based on laws, administrative regulations, rules formulated by regulatory authorities, and normative documents, referencing the industry's professional standards regarding the scope of work and procedural requirements, and combining relevant evidence such as their verification and check work papers, to make a preliminary determination of their scope of responsibility and fault. The preliminary determination of fault refers to the views of scholar Xing Huiqiang: since the issuer and relevant intermediary institutions benefit greatly, they should bear heavier responsibilities and obligations; the benefits and responsibilities are proportional; intermediary institutions should conduct in-depth investigations, thus the probability of errors should be low; the funds raised should limit the extent of responsibility, which is low compared to the market capitalization after listing, and the joint liability can be controlled. Subjectively, intentional joint liability will be undertaken; for negligence, proportional liability will be borne [2].

Secondly, the semi-additive theory should also be used as a supplement to comprehensively consider the objective extent of the impact of behavior on the occurrence or expansion of the damage, thereby attributing the damage to a specific subject, that is, determining the causal relationship between behavior and result [6].

This mixed model of causal power and semi-additive theory can effectively avoid excessive accountability caused by purely analyzing causal power, making the responsibilities of all parties involved clearer.

3.2. Optimize the Internal Recovery Process

Article 93 of the Securities Law states that if an issuer causes losses to investors due to fraud, false statements, or other significant illegal activities, the controlling shareholders, actual controllers, and related securities companies of the issuer can appoint an investor protection organization to reach an agreement with the affected investors regarding compensation, allowing for advance compensation. After the advance compensation is made, they can legally seek recourse from the issuer and other liable parties. Although this provision establishes a procedure for internal recourse after advance compensation at the legal level, it lacks regulations or judicial interpretations at the execution level, making it still face challenges in actual operations. Indeed, the principle of internal recourse allows investors to receive compensation first, with over 95% of investors receiving compensation, and the specific compensation amount reaching 98%, which strongly protects investors' rights and prevents issues where investors are left without means to claim due to complicated procedures [7]. However, current laws do not specify the proportion of responsibility that each party needs to bear, which creates significant difficulties for subsequent internal recovery. At the same time, the internal recovery requires institutions that make prior compensations to undergo separate legal proceedings; the recovery process is complicated, and the proportion of responsibility is unclear, making subsequent recovery challenging. Therefore, the author believes that improvements should be made,

namely, during the judgment, the responsibility shares that each party should bear should be allocated based on the mixed liability method mentioned earlier. Furthermore, the realization of internal recovery should be ensured through legal enforcement in the subsequent recovery process [8].

3.3. Improve Industry Regulatory standards

The securities market innovatively proposed the system of advance compensation and the investor compensation fund, by entrusting the insurance fund company to establish the investor compensation fund [9]. Compensation will be provided by the compensation fund when investors' rights are infringed, in order to achieve the goal of quickly and effectively compensating investors [10]. Although this form has the issue of lower capital utilization efficiency, it is undeniable that it is a very effective means of solving internal recovery problems. However, the current system is indeed a voluntary unilateral commitment rather than a legal compulsion. Therefore, the author believes that the U.S. Fair Fund system should be referenced for improvement, moving towards public compensation. The U.S. fund system allocates relevant funds to harmed investors through administrative penalties and other means, effectively ensuring fairness and justice in the securities market through public relief [8]. Therefore, the author believes that measures to transform willingness into mandatory guarantees based on the existing system will more effectively address the issues of internal recourse and investor compensation.

In addition, regarding the regulation of the entire industry, the author believes that the Securities Regulatory Commission can leverage technology to build an open and shared information platform. The Commission's "Regulatory Technology 3.0" also proposes that its core is to establish a highly efficient regulatory big data platform that monitors and assesses the overall market situation in real-time, thus fulfilling its regulatory duties and maintaining market order. At the same time, a whitelist of securities service organizations can be established, and mechanisms such as reward systems can be used to encourage institutions to adhere to industry norms and actively fulfill their responsibilities.

4. Conclusion

With the development of the times, cases of false statements in securities continue to emerge, making the internal compensation dilemma an unresolved issue. The root of the problem lies in the unclear provisions of Chinese legislation regarding joint liability and internal compensation, lacking a clear demarcation standard. As a result, the judges' discretionary powers lead to inconsistent judgments in similar cases. This article proposes three optimization paths for institutional improvement: first, based on a comparative study of causal power and semi-additive theory, a hybrid model combining both should be adopted for liability division. Second, optimize the internal compensation procedures after advance payment. Third, based on the current situation in China, establish an industry regulatory system.

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