Chinese Regulation of Issuer Earnings Forecasts: Recommendations for an Ex Ante Legal Framework

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We would not think much of a military general staff or intelligence staff which told the field commander they were not going to give him their estimates as to the enemy’s strength and dispositions for fear they might not be accurate or complete, but would prefer to give him something that they were sure was reliable, like information about the enemy’s dispositions in World War II.

—Homer Kripke (1972)

"The securities laws typically do not act as a Monday Morning Quarterback."

—Stransky v. Cummins Eng. Co., Inc. 1

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1 Sidney Davidson, The Study Group on Objectives of Financial Statements: A Progress Report, 1973 STANFORD LECTURES IN ACCOUNTING 5, 8–9 (June 1, 1973) (quoting Homer Kripke, Proceedings, New York State Bar Association Meeting (Jan. 27, 1972)).

2 51 F.3d 1329, 1332 (7th Cir. 1995).
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INTRODUCTION

Economic theory suggests that corporate disclosures and enhanced information quality reduce information asymmetries between firms and investors, and between informed and uninformed traders. Reduction in information asymmetry in turn mitigates adverse selection, thereby increasing the firm’s stock liquidity in the secondary market and lowering the firm’s cost of capital in the primary market. Empirical studies of the Chinese markets and of the U.S. markets both find that management earnings forecasts—one of the most informative corporate disclosures—affect stock prices. In the United States, to encourage issuer disclosure of...
projections and other forward-looking information, the Securities and Exchange Commission (SEC) in 1979 adopted a safe harbor rule under the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act) respectively.\(^7\) Noting that the SEC safe harbor rules had “not provided companies meaningful protection from litigation,” Congress enacted the Private Securities Litigation Reform Act of 1995 (PSLRA) to both “discourage” frivolous litigation and “encourage” issuer dissemination of forward-looking statements.\(^8\)

Under the dichotomy of the mandatory/voluntary forward-looking disclosure regime in the United States, reporting issuers are required to make the forward-looking disclosures specified in Item 303 of Regulation S-K, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” (MD&A).\(^9\) The MD&A must be included in the issuers’ registration statements filed under the Securities Act; the registration statements, etc.
periodic reports, and proxy statements filed under the Exchange Act; and in annual reports to security holders.\textsuperscript{10} Item 303 requires,\textsuperscript{11} inter alia, a public company to discuss, with respect to liquidity, capital resources, and results of operations:

- any known trends or known uncertainties that are reasonably likely to result in the issuer's liquidity increasing or decreasing in any material way;\textsuperscript{12}
- any known material trends in the issuer's capital resources, and any expected material changes in the mix and relative cost of such resources;\textsuperscript{13} and
- any known trends or uncertainties that the issuer reasonably expects will have a material impact on net sales, revenues, or income from continuing operations.\textsuperscript{14}

Literature has studied context-based standards of materiality,\textsuperscript{15} the distinction between materiality and affirmative

\textsuperscript{10} See, \textit{e.g.}, SEC, FORM S-1, PART I ITEM 11(b); SEC, FORM S-3, PART I ITEM 12; SEC, FORM 10, ITEM 2; SEC, FORM 10-K, PART II ITEM 7; SEC, FORM 10-Q, PART I ITEM 2; 17 C.F.R. \S 240.14a-101 (2016); 17 C.F.R. \S 240.14a-3(b)(5)(ii) (2016).

\textsuperscript{11} See Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release 6835, Exchange Act Release 26,831, 54 Fed. Reg. 22,427, 22,430 n.27 (May 24, 1989) ("MD&A ... specifies its own standard for disclosure—i.e., reasonably likely to have a material effect .... The probability/magnitude test for materiality approved ... in Basic ... is inapposite to Item 303 disclosure."). As the SEC further explained in 2002, the MD&A disclosure under Item 303 is governed by a "reasonably likely to occur" and "reasonably likely to have a material impact" test. Specifically, disclosure would be required if the known trend or uncertainty is reasonably likely to occur and is reasonably likely to have a material impact on the issuer's financial condition or results of operations. Disclosure would not be required if management could affirmatively conclude that the trend or uncertainty is not reasonably likely to come to fruition or that a material effect is not reasonably likely to occur. \textit{See} Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting Policies, Securities Act Release No. 8098, Exchange Act Release No. 45,907, 67 Fed. Reg. 35,620, 35,622 n.16, 35,627 (May 20, 2002).

\textsuperscript{12} 17 C.F.R. \S 229.303(a)(1) (2016).

\textsuperscript{13} \textit{Id.} \S 229.303(a)(2)(ii) (2016).

\textsuperscript{14} \textit{Id.} \S 229.303(a)(3)(ii) (2016).

\textsuperscript{15} \textit{See, e.g.}, Edmund W. Kitch, \textit{The Theory and Practice of Securities Disclosure}, 61 BROOK. L. REV. 763, 819–26 (1995) (arguing that the standard of
duty to disclose,\textsuperscript{16} and the contrast between fraud prohibition and mandatory disclosure.\textsuperscript{17} Analyzing the relationship between nondisclosure-based Item 303 violations and antifraud violations, the literature views some case law as rejecting an automatic finding of an antifraud violation based on an Item 303 violation and other case law as holding that Item 303 violations can be, could be, or might be the basis for an antifraud violation.\textsuperscript{18} Two recent decisions, \textit{Stratte-McClure v. Morgan Stanley} and \textit{In re NVIDIA Corporate Securities Litigation}, however, do not appear to demonstrate any substantive conflicts among the circuits on the issue than a facial linguistic divergence.\textsuperscript{19}

Materiality should vary with context: in a disclosure context, materiality simply prohibits lying and half-truths; in an insider trading context, materiality bars insider's secret trading profits and thus should be of a more exacting standard; in a 10b-5 implied right of action context, materiality functions similar to the common law tort action for misrepresentation; in contrast, in \textit{Basic}, the Court defined materiality in a free-standing context).\textsuperscript{16}See Donald C. Langevoort & G. Mitu Gulati, \textit{The Muddled Duty to Disclose Under Rule 10b-5}, 57 VAND. L. REV. 1639, 1644–45 (2004). Materiality refers to whether a piece of information would likely be important to the reasonable investor, whereas duty refers to whether there is a duty to disclose the information. \textit{Id.} at 1644. Not all material information must be disclosed; on the other hand, immaterial information may be required to be disclosed. \textit{Id.} at 1645. For example, not every piece of information required in an issuer's periodic reporting is going to be important to investors in every instance. \textit{Id.} at 1645 n.18. See also Brian Neach, \textit{Note, Item 303's Role in Private Causes of Action Under the Federal Securities Laws}, 76 NOTRE DAME L. REV. 741, 752–53 (2001) (arguing that Item 303's two-pronged disclosure standard does not purport to determine whether or not particular information is material; it only imposes on management a duty to disclose specified information that may or may not be material).

\textsuperscript{17}See, e.g., Joseph Franco, \textit{Why Antifraud Prohibitions Are Not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure}, 2002 COLUM. BUS. L. REV. 223, 230–32 (2002). Disclosure regulation can be divided into fraud prohibitions and mandatory disclosures: fraud prohibitions are designed to eliminate deception in disclosure and mandate accuracy; mandatory disclosures impose affirmative content-based disclosure obligations. \textit{Id.}


\textsuperscript{19}Compare \textit{Stratte-McClure v. Morgan Stanley}, 776 F.3d 94, 100–01 (2d Cir. 2015) (concluding that a failure to make a required Item 303 disclosure in a 10-Q filing can serve as the basis for a Section 10(b) securities fraud claim only if (i) the omission satisfies \textit{Basic}'s probability/magnitude test for materiality, and (ii) all of the other requirements to sustain a Section 10(b) action, including
In contrast to the mandatory disclosure regime under Item 303, Item 10(b) of Regulation S-K “encourages”\textsuperscript{20} public companies to disclose in their SEC filings, with respect to their future economic performance:

- projections that are made in good faith and have reasonable basis; such projections need not be limited to revenues, net income (loss), and earnings (loss) per share, but should be presented in an appropriate format so as not to be misleading;\textsuperscript{21} and

- other information accompanying the projections to facilitate investor understanding, such as key assumptions to the projections and variances between actual and projected results.\textsuperscript{22}

Once an issuer starts the voluntary disclosure path, Item 10(b) “reminds” the issuer of “[i]ts responsibility” to make full and prompt disclosure of material facts causing its previous projections to “no longer have a reasonable basis”; and discourages the issuer from discontinuing or resuming projections “without a reasonable basis.”\textsuperscript{23}

Ambiguity abounds concerning whether an issuer has a duty\textsuperscript{24} to update a voluntary earnings projection. While the SEC’s


\textsuperscript{21} See 17 C.F.R. § 229.10(b)(1)–(2) (2016).

\textsuperscript{22} See id. § 229.10(b)(3)(i)–(ii) (2016).


\textsuperscript{24} Case law suggests that a corporation has no affirmative duty to disclose all material information in its possession. See, e.g., Basic v. Levinson, 485 U.S. 224, 239 n.17 (1988) (“Silence, absent a duty to disclose, is not misleading under Rule 10b-5.”); Chiarella v. United States, 445 U.S. 222, 235 (1980) (“[A] duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information.”); Roeder v. Alpha Indus., 814 F.2d 22, 26–27 (1st Cir. 1987) (recognizing three sources to trigger a corporation’s affirmative duty to disclose:
safe harbor rules do not expressly impose a "duty to update" condition, its interpretation of the "reasonable basis" requirement for earnings projections effectively incorporates such a duty. While the statutory safe harbor rule expressly declares that "[n]othing in this section shall impose upon any person a duty to update a forward-looking statement," it stops short of providing an exemption from antifraud liability for failure to update a forward-looking statement that was accurate when

insider trading; statute or regulation requiring disclosure; and inaccurate, incomplete, or misleading prior disclosures); Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1321–22 (2011):

"It bears emphasis that § 10(b) and Rule 10b-5(b) do not create an affirmative duty to disclose any and all material information. Disclosure is required under these provisions only when necessary 'to make ... statements made, in the light of the circumstances under which they were made, not misleading.' ... Even with respect to information that a reasonable investor might consider material, companies can control what they have to disclose under these provisions by controlling what they say to the market.


made but has become inaccurate due to subsequent events.\textsuperscript{28} Judicial decisions stay divided on the existence and scope of such a duty\textsuperscript{29}—divisive enough to have caused concern over whether a snapshot act would trigger a motion picture production obligation.\textsuperscript{30} Academic literature relies upon the corporate "half-truth" doctrine\textsuperscript{31} as the foundation for "a narrow and limited duty to update" theory.\textsuperscript{32}

\textsuperscript{28} See, e.g., John Coffee, The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung, 51 BUS. LAW. 975, 992 (1996); Robert Prentice, The Future of Corporate Disclosure: The Internet, Securities Fraud, and Rule 10b-5, 47 EMORY L.J. 1, 28 (1998); Brown, supra note 18, at 1–60.

\textsuperscript{29} See, e.g., Dale Arthur Oesterle, The Inexorable March Toward a Continuous Disclosure Requirement for Publicly Traded Corporations: "Are We There Yet?", 20 CARDOZO L. REV. 135, 148–49 (1999) (noting that disagreement exists among the federal circuit courts as to whether the duty exists at all: the Seventh Circuit says no; the First, Second, and Third Circuits say yes, and among those circuits that say yes, there is disagreement as to the breadth and limits of the duty); Steven Bochner & Samir Bukhari, The Duty to Update and Disclosure Reform: The Impact of Regulation FD and Current Disclosure Initiatives, 7 STAN. J.L. BUS. & FIN. 225, 232 (2002) (observing that the other circuits, specifically the Fourth, Fifth, Sixth, Eighth, Ninth, Tenth and Eleventh, have opted not to directly confront the question of whether a duty to update exists). See also Stuart Cohn & Erin Swick, The Sitting Ducks of Securities Class Action Litigation: Bio-Pharms and the Need for Improved Evaluation of Scientific Data, 35 DEL. J. CORP. L. 911, 940 n.151 (2010) (pointing out that the statutory safe harbor for forward-looking statements post-dates much of the litigation in this area and that the safe harbor's lack of reference to updating projections suggests that projections initially protected under the safe harbor provisions would not lose their protection by virtue of subsequent events. However, this issue has not been judicially resolved.).

\textsuperscript{30} See Carl Schneider, Duty to Update: Does a Snapshot Disclosure Require the Commencement of a Motion Picture?, 3 INSIGHTS 3 (Feb. 1989) (commenting on frequently cited duty-to-update cases); Oesterle, supra note 29, at 143 (stating that a robustly applied duty to update doctrine can in effect approximate a continuous disclosure obligation).

\textsuperscript{31} See Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1098 (1991) (describing a corporate disclosure that is literally true but misleading due to a material omission as nothing more than "a half-truth"); see also 17 C.F.R. § 230.408 (2016), 17 C.F.R. §§ 240.12b-20, 240.10b-5(b) (2016).

\textsuperscript{32} Compare Donald C. Langevoort, Half-Truths: Protecting Mistaken Inferences by Investors and Others, 52 STAN. L. REV. 87, 118–20 (2000) (applying the half-truth doctrine to the prior forward-looking statement), with Gregory
In contrast to the voluntary earnings projection regime in the United States, as the first study published in a U.S. law journal comprehensively examining the Chinese projection regulatory policies and the Shanghai and Shenzhen stock exchange listed issuers' projection practices, in light of disclosure theories in U.S. accounting, economics, and legal literatures, this Article contributes to the extant literature on regulation of issuer projections and more broadly of issuer forward-looking information. Following this introduction of motivating disclosure theme and a review of U.S. legal literature on mandatory and voluntary disclosure, Part I of the Article explores the origins and characteristics of issuer mandatory/voluntary earnings projection practices in China against the historical evolutions of the Chinese stock market. Part II discusses the Chinese disclosure and enforcement policies governing issuer earnings projections, benchmarked to disclosure theories in accounting and economics.

Extending SEC Regulation S-K Item 10(b) to the Chinese setting, Subpart II.A critiques the current disparate and fragmented projection regulation among the stock exchanges and China Securities Regulatory Commission (CSRC). It recommends integrating issuer public projections into a CSRC centrally administered public disclosure system that provides a transparent and level playing field for state-controlled and private entrepreneur-controlled issuers. Departing from Item 10(b)'s controversial "duty to update" concept, however, Subpart II.A recommends an economic efficiency-based voluntary disclosure policy. To fill a critical void in the Chinese legal and disclosure systems, Subpart II.B imports two key features from the U.S. systems for being equally important and relevant to the Chinese issuers and investors under an institutional setting of predominant state-ownership of capital markets: issuer safe harbor protection versus investor private right of action; and fact versus opinion distinction in determining fraud liability. It recommends an ex ante legal framework with balanced public-private enforcement, to improve upon the current ex post, Fidelity regulation-based, solely public enforcement. In conclusion, disclosure recommendations based on U.S. legal and economic theories are highlighted in two dimensions: those uniquely applicable to the Chinese market, and those of potential common interest to Chinese and U.S. disclosure systems.

I. TRIGGERS OF ISSUER EARNINGS FORECAST DISCLOSURES

A. IPO and Earnings Projection Disclosure

Following the establishment of the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE) in 1990, consistent with its planned economy philosophy transplanted to
the capital markets, China's central planners adopted an Annual IPO Offering Allowance in 1993, which was superimposed with an Annual IPO Issuer Quota in 1996. The Offering Allowance fixed the total face value of stock shares to be floated for the year, regardless of the actual offering proceeds. The Issuer Quota set the number of issuers to go IPO in a year.

A regime of mandatory earnings projections by IPO issuers was instituted in 1993, when China's first Company Law (1994) and the State Council's Provisional Regulation of Securities Offerings and Trading (1993) mandated that IPO issuers make and disclose their earnings projections for the forthcoming year in the IPO prospectus. The IPO offering price was set by a formula supplied by the CSRC along the following form; issuers were to project earnings within the confines of given regulatory formulations;


and penalties for threshold over-projections ex post were fixed ex ante by the CSRC\textsuperscript{39}:

$$P_{\text{IPO}} = \text{projected earnings per share} \times \frac{P}{E} \text{ ratio}$$

Under the joint effect of the Offering Allowance, Issuer Quota, and earnings projection-based IPO pricing formula (as well as the lack of an investor protection-focused enforcement regime), issuers resorted to overly optimistic or even unfounded earnings projections to boost their IPO offering price as the only way to increase their offering proceeds.\textsuperscript{40} Such over-projection priced IPOs were able to be sold in the primary market and were traded in the secondary market at huge premiums, fueled by the scarcity of Issuer Quota, which had made the primary market "a seller’s market."\textsuperscript{41}


\textsuperscript{40} For empirical literature investigating the earnings projection-based IPO pricing rules in effect during the 1993–1999 period, see, for example, Jennifer Kao, Donghui Wu & Zhifeng Yang, Regulations, Earnings Management, and Post-IPO Performance: The Chinese Evidence, 33 J. BANK. & FIN. 63 (2009) (finding that 40 percent of sampled Chinese IPO firms in 1996 and 46 percent during the 1998–1999 period did not meet their EPS projections; concluding that accounting performance-based IPO pricing rules might have induced firms’ opportunistic over-projections and income-increasing earnings management).

China's first Securities Law (1999) introduced a legal Verification and Approval System, replacing the administrative Offering Allowance and Issuer Quota System. The evolving Verification and Approval System has incorporated increased market elements since 2004: (1) it allows greater roles for the managing underwriter to select, sponsor, and recommend IPO candidates to the CSRC, replacing the government's direct selection of issuers under the Offering Allowance and Issuer Quota Systems; and (2) it authorizes a book-building process to determine the IPO price, which no longer is set or need be approved by the CSRC.


As a threshold matter, however, firms' access to the IPO market fundamentally remains a central planning model, from China's first Securities Law (1999) to its current Securities Law (2014). Before a firm is eligible to file a "preliminary prospectus," it must file an "application prospectus," which is "examined and verified" by CSRC's functional offices and an Offering Examination and Verification Committee (Offering E&V Committee), composed of the CSRC-designated outside technical advisors and CSRC staff liaison.45 The application prospectus procedure is a means for the government to determine, importantly, the applicant firm's "ability for achieving sustained profitability." Such ability is to be assessed based on criteria including "whether material changes have occurred, or will likely occur, to the business model of the applicant or to the business environment of the industry sector of the applicant, with material adverse effects on the applicant's ability for achieving sustained profitability."46 The CSRC approves or disapproves the firm's IPO application considering the Examination and Verification Opinion rendered by a panel of the Offering E&V Committee,47 and giving deference to the decisions


46 See Securities Law 2014, supra note 45, art. 13(2); CSRC 2015-122, supra note 45, art. 30.

47 See Securities Law 1999, supra note 42, art. 10; Securities Law 2014, supra note 45, art. 10; Offering E&V Committee Charter, supra note 45, arts. 3, 29.
of the National Development and Reform Commission, the provincial government of the issuer's principal place of business, and "other relevant government departments," to "ensure compliance with national industrial policies and other national policies." At the end of 2013, China's Communist Party Central Committee announced China's plan of a grand offering reform to move from the current Verification and Approval System to a disclosure-based Registration System, and to accomplish key reform targets by 2020.

As IPO pricing evolved from a government-determinants model in 1993, to a government approval model in 1999, and to a government filing model since 2004, mandatory earnings projections as the basis for IPO pricing lost their raison d'être. In 2001, the CSRC gave issuers the option of disclosing in the IPO prospectus either earnings projections or additional line items related to the use of offering proceeds, offering price, and dividend policy. The CSRC also introduced a line item in the prospectus mandating "a brief discussion by management of ... any known or uncertain factors that have caused or may cause serious difficulties to the issuer"—an MD&A idea that has, since 2006, developed into a full-fledged, mandatory "Management Discussion and Analysis" section in IPO and following-on offering prospectuses and in issuer

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48 CSRC 2015-122, supra note 45, arts. 11, 33, 36-37.
50 See supra notes 38-39 and accompanying text.
54 Id. § 10 art. 141.
periodic reports. In 2005, the Company Law was amended: the mandatory earnings projection clause was eliminated and replaced by the term “Verification and Approval System” introduced by the first Securities Law (1999).

The current bifurcated mandatory/voluntary policy on earnings projections in connection with an IPO was adopted by the CSRC in 2006, when it adopted the Regulation of Initial Public Offering and Listing. An IPO issuer must make earnings projections if

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the offering proceeds are applied to make any “Significant Asset Purchase,”\(^{58}\) defined to mean a purchase by the issuer when (1) the ratio of the gross asset value (or net asset value) of the asset to be purchased to the gross assets (or net assets) of the issuer as reported in its consolidated financial statements of the most recent year is at least 50 percent; or (2) the ratio of the business income generated in the immediately preceding year by the asset to be purchased to the business income of the issuer in the same period is at least 50 percent.\(^{59}\) An IPO issuer may make earnings projections if “it believes that such earnings projections are useful to informed investment decisionmaking by investors, and it is confident of its forecasting ability.”\(^{60}\)

Regardless of whether the disclosure is mandatory or voluntary, an IPO issuer’s earnings projections must be made in the form of an Issuer Earnings Projection Report, consisting of:

- a projected earnings table, which must be in the same format as the issuer’s income statement;
- notes, disclosing key underlying assumptions and forecasting methodology; and
- a uniform cautionary legend, alerting investors to “use projections with caution due to uncertainties associated with assumptions.”\(^{61}\)

An Auditor’s Report of Attestation of Management Earnings Projections must be appended to the Issuer Earnings Projection Report.\(^{62}\) Both reports must be made exhibits to the IPO prospectus.\(^{63}\)

Regardless of whether the disclosure is mandatory or voluntary and subject to an undefined force majeure exoneration, in the event of an over-projection by 20 percent or more determined ex post, both the legal representative of the issuer and the attesting auditor must make public apologies at the shareholder meeting and in CSRC-designated media. The issuer representative may

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\(^{58}\) CSRC 2006-5, \textit{supra} note 55, art. 84.

\(^{59}\) See CSRC 2006-2, \textit{supra} note 55, art. 39.

\(^{60}\) See CSRC 2006-5, \textit{supra} note 55, art. 84.

\(^{61}\) \textit{Id.} arts. 85–86.

\(^{62}\) \textit{Id.} arts. 8, 124.

\(^{63}\) \textit{Id.} art. 128.
additionally receive a CSRC warning.\textsuperscript{64} If the over-projection reaches 50 percent, the issuer shall be suspended from access to the public offering market for a period of three years.\textsuperscript{65} Earnings projections in connection with follow-on offerings (public or private) by listed issuers are governed by a mandatory/voluntary disclosure policy similar to that for an IPO issuer.\textsuperscript{66}

\textbf{B. Listed Issuer Significant Assets Restructuring and Earnings Projection Disclosure}

Historically, a typical Chinese state-owned enterprise ("SOE") was composed of profitable business units, unprofitable business units, and not-for-profit units. SOE-controlled listed issuers were generally IPO carveouts of SOEs' profitable units, with the unprofitable and not-for-profit units being kept by the parent SOEs.\textsuperscript{67} Most of the central and local government-controlled listed issuers adopt a form of pyramidal structure which does not create a divergence between voting rights and cash flow rights but which credibly transfers rights in respect of day-to-day operations to the SOE managers.\textsuperscript{68} In comparison, private

\begin{itemize}
\item \textsuperscript{64} CSRC 2015-122, supra note 45, art. 56.
\item \textsuperscript{66} Id.
\item \textsuperscript{67} See Joseph Aharony, Chi-wen J. Lee & T. J. Wong, \textit{Financial Packaging of IPO Firms in China}, 38 J. ACCT. RES. 103 (2000).
\item \textsuperscript{68} See, e.g., Joseph Fan, T. J. Wong & Tianyu Zhang, \textit{Institutions and Organizational Structure: The Case of State-Owned Corporate Pyramids}, 29
entrepreneur-controlled Chinese listed issuers generally come from one of three backgrounds: IPOs (close to 50 percent); reverse mergers, generally with poor performing listed issuers (close to 50 percent); and management buyouts or MBOs (a limited few). The Shanghai Stock Exchange runs a main board; the Shenzhen Stock Exchange runs a main board, a Small-and-Medium-Sized Enterprise ("SME") board, and a ChiNext Market for micro issuers. Less than 40 percent of the issuers on the two main boards, the vast majority of the SME issuers, and nearly all of the ChiNext issuers are private entrepreneur-controlled. All of the private entrepreneur-controlled issuers on the SHSE and SZSE's main boards, some on the SME board, and few on the ChiNext Market adopt pyramiding or cross-holdings ownership structures, which enhance the ultimate controlling person's share of control (or


voting rights) given its share of ownership (or cash flow rights) in the listed issuer.\(^{73}\)

Categorized based on the person ultimately controlling the issuer,\(^{74}\) the largest stockholders of the Chinese listed issuers fall among the following six types: central SOE (or central government-controlled SOE); local SOE (or local government-controlled SOE); private entrepreneur; foreign investor; township, university, etc.; and hybrid (where the largest stockholder is controlled by two or more types of persons).\(^{75}\) Based on issuers’ filings as of Q3 2014,\(^{76}\) Table 1 below provides summarized statistics of share concentrations of the largest stockholders of SHSE and SZSE listed issuers; Table 2 provides a summary view of such issuers’ market capitalizations and industry sector distributions.\(^{77}\)

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\(^{73}\) See Stijn Claessens, Simeon Djankov, Joseph Fan & Larry Lang, *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. Fin. 2741, 2742–43, 2758 (2002). *Cf.* supra text accompanying note 68.

\(^{74}\) For definitions of “controlling shareholder” and “the ultimate controlling person of the issuer,” see NAT’L PEOPLES’ CONG., PRC 2013-8: COMPANY LAW OF THE PEOPLE’S REPUBLIC OF CHINA, arts. 216(2)–(3) (2014) (Westlaw China 万律 (Westlaw China)).


\(^{77}\) Issuer data, including ownership, market capitalization, and industry sector, were retrieved from the WIND Financial Terminal and processed by the Author. Full data are available from the Author. The WIND system is the premier financial database in China. *See* WIND INFO. CO., LTD., http://www.wind.com.cn [https://perma.cc/LMP4-R3SX].
Table 1

<table>
<thead>
<tr>
<th>Shareholding Brackets$^{(1)}$ of the Largest Shareholders</th>
<th>sh ≤ 5%</th>
<th>5% &lt; sh ≤ 30%</th>
<th>30% &lt; sh &lt; 50%</th>
<th>sh ≥ 50%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central SOE: 338</td>
<td>0</td>
<td>99</td>
<td>130</td>
<td>106</td>
</tr>
<tr>
<td>Local SOE: 649</td>
<td>0.0401%</td>
<td>192</td>
<td>274</td>
<td>182</td>
</tr>
<tr>
<td>Private Entrepreneur: 1,355</td>
<td>0.1603%</td>
<td>533</td>
<td>547</td>
<td>171</td>
</tr>
<tr>
<td>Foreign Investor: 85</td>
<td>0.0401%</td>
<td>28</td>
<td>28</td>
<td>39</td>
</tr>
<tr>
<td>Township, Univ., etc.: 46</td>
<td>0.1603%</td>
<td>10</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Hybrid: 22</td>
<td>0.0401%</td>
<td>13</td>
<td>9</td>
<td>3</td>
</tr>
</tbody>
</table>

| Total: 2,495 Issuers$^{(2)}$: 100%                         | 0.2004%| 39.8798%       | 40.1603%       | 19.7595%|


2. Based on issuer filings as of Q3 2014, there were a total of 2,603 issuers on the SHSE and SZSE, out of which 108 issuers did not have information available concerning the types of their largest shareholders. This Table thus covers 2,495 issuers.
<table>
<thead>
<tr>
<th>Issuer Type; No. of Issuers; b %;</th>
<th>INDUSTRY SECTOR(^{d}) DISTRIBUTIONS OF SHSE AND SZSE LISTED ISSUERS (Q3 2014)</th>
</tr>
</thead>
<tbody>
<tr>
<td>SOE-Controlled: 984; 40.6% 32,076.6 bn RMB; 66%</td>
<td>16 42 506 72 31 74 71 6 23 20 63 13 3 14 1 0 17 12</td>
</tr>
<tr>
<td>Private-Controlled: 1,355; 55.9% 9,855.7 bn RMB; 32%</td>
<td>22 28 988 7 33 68 8 5 97 8 55 10 11 13 0 4 9 6</td>
</tr>
<tr>
<td>Foreign-Controlled: 85; 3.5% 582.5 bn RMB; 2%</td>
<td>0 1 64 0 1 6 0 0 2 0 9 0 0 1 0 0 0 1</td>
</tr>
</tbody>
</table>

1. Of the 2,495 issuers identified in Table 1, seventy-one issuers are not controlled by SOE, Private, or Foreign. This Table thus covers 2,424 issuers.

A: Agriculture, Forestry, Animal Husbandry & Fishery
B: Mining
C: Manufacturing
D: Electric, Thermal, Gas & Water Production & Supply
E: Construction
F: Wholesale & Retail
G: Transportation, Storage & Postal Service
H: Accommodation & Catering
I: Information Transmission, Software & Information Technology Service
J: Finance
K: Real Estate
L: Leasing & Business Service
M: Science Research & Technology Service
N: Water Conservatory, Environmental & Public Facilities Management
P: Education
Q: Health & Social Work
R: Culture, Sports & Entertainment
S: Miscellaneous
Under the Company Law and the Securities Law from their initial enactments to their present forms, Chinese regulatory policy uses the accounting yardsticks of "three consecutive years' operating losses" to institute a stock trading suspension and delisting in the fourth consecutive loss year, and "three consecutive years' operating profits" to grant listed issuers access to the public offering markets. As evidenced by empirical literature studying the Chinese markets, such accounting number-based policy has motivated the use of asset exchanges with listed issuers for strategic "propping," i.e., provision of financial support by the controlling shareholder to the listed firm today in order to preserve its option to expropriate minority shareholders tomorrow (also referred to as "negative tunneling"). The policy has also motivated the predatory practice of "tunneling," i.e., siphoning off resources from the listed firm by the controlling shareholder through self-dealing real or financial transactions.

Asset exchanges with listed issuers are regulated under the rubric of "Significant Assets Restructuring" ("SAR") by a listed

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81 Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, Tunneling, 90 AM. ECON. REV. 22, 22-23 (2000). An example of tunneling via real transaction is where an asset is transferred from the firm to the controlling shareholder at nonmarket prices. An example of tunneling via financial transaction is where the controlling shareholder increases its share of the firm through dilutive share issues. Id. at 26.
An SAR is defined to mean asset purchase(s), sale(s), and/or other exchange(s) by a listed issuer (including firms controlled by such issuer) when, computed based on the issuer's audited consolidated financial statements of the most recent fiscal year, such transactions meet any one of the following three benchmarks and cause significant changes to the main business, assets, and income of the listed issuer:

(1) the ratio of the gross asset value of the assets purchased and sold by the issuer to the gross assets of the issuer is at least 50 percent;\textsuperscript{83}
(2) the ratio of the business income generated in the most recent fiscal year by the assets purchased and sold by the issuer to the business income of the issuer during the same period is at least 50 percent;\textsuperscript{84}
or
(3) the ratio of the net asset value of the assets purchased and sold by the issuer to the net assets of the issuer is at least 50 percent and such net asset value exceeds CN¥50 million.\textsuperscript{85}

For the purpose of the SAR definition, “assets” include both “equity assets” and “non-equity assets” (such as non-equity financial assets and real, or physical, assets).\textsuperscript{86}

From the perspective of issuer earnings projections, the characteristics and regulation of SARs have evolved in three stages: from the 1990s to the end of 2001 (no earnings projection requirement); from 2002 to November 2014 (across-the-board mandatory earnings projection requirement); and from November 2014 onward (across-the-board mandatory MD&A discussion requirement and related-party SAR mandatory earnings projection requirement). As of the end of 2001, the combination of the IPO

\textsuperscript{83} Id. art. 12(1).
\textsuperscript{84} Id. art. 12(2).
\textsuperscript{85} Id. art. 12(3).
\textsuperscript{86} Id. art. 14.
quotas and allowance system and accounting earnings-based delisting and offering access system led to SARs primarily to gain listing (of the assets of an unlisted entity which became the controlling shareholder post-transaction, or the unlisted assets of the existing controlling shareholder of the listed issuer) via reverse merger; to avoid delisting; or to qualify for a follow-on offering. The SAR activities during this period were regulated in a stop-go approach, being perceived by the regulators ambivalently as a means to avoid listing standards, or as a means to improve listed issuers' assets quality. No earnings projections were required in connection with listed issuer SAR activities.

During the second stage beginning in 2002, in response to the "related party transactions" ("RPTs"), "controlling shareholder-issuer business competition," and "restructuring for accounting

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87 See supra Part I.A and accompanying notes.
88 See supra text accompanying note 78.
92 See supra notes 90–91.
93 "Related party transactions" or RPTs are defined by the Ministry of Finance (MOF) to mean transfers of resources, services, and/or obligations between related parties. "Related parties of a firm" include, inter alia, the firm's parent, subsidiaries, and companies under the common control with the firm. See Ministry of Finance, MOF 2006-3: Enterprise Accounting Principle No. 36: Related Party Disclosure (2006) (Westlaw China万律 (Westlaw China)). Not all RPTs are adverse to the firm interest: RPTs may be means for the controlling shareholder (as well as other corporate insiders) to expropriate outside shareholders; RPTs may also be a means of efficient contracting. See Michael Ryngaert & Shawn Thomas, Not All Related Party Transactions (RPTs) Are the Same: Ex Ante Versus Ex Post RPTs, 50 J. ACCT. RES. 845 (2012). In this Article, RPTs generally refer to the expropriation type. See supra note 79.
94 "Controlling shareholder-issuer business competition" refers to the phenomenon where the controlling shareholder (or its subsidiaries other than
cosmetics" or sham restructuring prevalent among SARs, the CSRC issued an administrative notice mandating earnings projections by all listed issuers effecting SARs. The notice contemplated public enforcement for over-projections. The penalties for ex post over-projections made in connection with an SAR paralleled those in connection with stock offerings.

The year 2008 saw CSRC's first official rulemaking regulating listed issuers' SAR activities: the Regulation of Significant Assets Restructuring by Listed Issuers. The regulation set forth an earnings projection policy combining public enforcement with private compensation, and designed to prevent overpricing of assets sold to listed issuers and underpricing of listed issuers' stocks issued to fund the SARs. The policy contained three main components:

- a mandatory earnings projection requirement;
- mandatory disclosure of realization-projection comparison, and a mandatory private compensation scheme; and
- public enforcement against ex post inaccurate—and regulatory reward for ex post accurate—projections.

First, the listed issuer must make earnings projections with respect to the assets to be purchased, and to its own firm if it issued stock to fund the SAR or if the SAR reached scales requiring approval by the Listed Issuer M&A and Restructuring Examination

\[ \text{the listed subsidiary) engage(s) in the same or similar lines of business as, and} \]
\[ \text{act(s) in competition with, the listed issuer. See China Sec. Reg. Comm'n & State Econ. & Trade Comm'n, CSRC 2002-1: Governance Principles of Listed Issuers, art. 27 (2002) (Westlaw China 万律 (Westlaw China)).} \]


\[ \text{Id. art. 15.} \]

\[ \text{Id. See also CSRC 2001-1, supra note 78, art. 32; see supra text accompanying notes 64–66.} \]

and Verification Committee ("SAR E&V Committee"). All earnings projections must be attested by a qualified accounting firm. If the issuer was unable to make the required projections, it must show the reason thereof, release a Special Risk Factor Statement, and provide an MD&A discussion in the SAR Report in lieu of earnings projections.

Second, in its annual reports for three years following an SAR, the issuer must provide computations of any disparities between projected earnings and realized earnings, pertaining to the purchased assets and to its own firm separately. All such computations must be attested by a qualified accounting firm. For the SAR completion year and the following year, the independent financial advisor retained by the issuer for the SAR transaction must publish a Post-SAR Continuous Supervision and Guidance Annual Opinion comparing projected earnings with realized earnings, and comparing the issuer's MD&A discussion in the SAR Report with its actual results of operations. To the extent that realized earnings fell short of the projected earnings pertaining to the purchased assets, the SAR counterpart must compensate the listed issuer.

Third, in the case of an over-projection by 20 percent or more, or if actual results of operations were substantially inferior to the MD&A discussion, the chairman and the general manager of the issuer, as well as the intermediaries participating in the SAR (such as the accounting firm, the independent financial advisor and the assets appraisal firm, and their staff involved in the SAR

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101 Id. 2008-53, supra note 99, art. 17.

102 Id.

103 Id. art. 33.

104 Id.

105 Id. art. 15, 36.

106 Id. art. 33.
transaction) must all make apologies to investors in the CSRC-designated media.\textsuperscript{107} If the over-projection reached 50 percent, all the preceding parties could additionally be subject to CSRC's "regulatory measures."\textsuperscript{108} Actual meting out of the penalties was subject to an undefined force majeure exception.\textsuperscript{109} On the other hand, if the realized earnings post-SAR pertaining to the issuer and the purchased assets met their respective projected earnings, the CSRC would allow the issuer to use pro forma\textsuperscript{110} accounting earnings for the issuer's pre-SAR period in qualifying for a post-SAR public offering.\textsuperscript{111}

\textsuperscript{107} Id. art. 54.
\textsuperscript{108} Id.
\textsuperscript{109} Id. art. 8, 54. A sample study of twenty-seven group companies listed via merging the unlisted parent with the listed subsidiary as of June 2009 found that fifteen out of the twenty-seven listed group companies did not meet their earnings projections made in connection with the SARs. See FUDAN UNIV. & SHANGHAI STOCK EXCH., SHJR 2009-20: GROUP COMPANY LISTINGS AND ISSUER PERFORMANCES §§ 2.4, 6.1 (2009), http://www.sse.com.cn/researchpublications/jointresearch/c/plan20100311a.pdf [https://perma.cc/N9CL-6LRF].
\textsuperscript{110} Neither the CSRC, nor the Chinese Institute of Certified Public Accountants (CICPA), nor the latter's regulator the Ministry of Finance has adopted any rule or standard governing pro forma financial information. Cf. Pro Forma Financial Information, 17 C.F.R. § 210.11 (2016); AICPA, REPORTING ON PRO FORMA FINANCIAL INFORMATION, SSAE No. 10 (2001), http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AT-00401.pdf [https://perma.cc/F63D-6U6Q]. "Pro forma financial information" in Regulation S-X is to be distinguished from "non-GAAP financial measures" targeted by Section 401(b) of the Sarbanes-Oxley Act. The former is intended to depict the continuing impact of an actual or proposed transaction on the historical GAAP financial statements, and shows the specific adjustments that would have been required by GAAP had the transaction occurred at an earlier time, and ending with the pro forma statements. The latter refers to financial information calculated and presented on the basis of methodologies other than in accordance with GAAP, and the Sarbanes-Oxley Act sought to eliminate manipulative or misleading use of non-GAAP financial measures. See Conditions for Use of Non-GAAP Financial Measures, Financial Reporting Release No. 65, 68 Fed. Reg. 4820, 4820–21 n.12 (2003); Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 8145, Exchange Act Release No. 46,788, 67 Fed. Reg. 68,790, 68,791 n.12 (2002).
\textsuperscript{111} CSRC 2008-53, supra note 99, art. 47. See also supra text accompanying note 78. The CSRC's 2011 and 2013 amendments to the SAR Regulation have retained the 2008 earnings projection policy, except that where an SAR results in a "back-door listing," the independent financial advisor must publish its
The third stage is preceded by China's Twelfth Five-Year Plan (2011–2015) for National Economic and Social Developments, which envisions group listings of large SOEs as opposed to IPO carveout listings. This stage of SAR characteristics and regulation is guided by the State Council's emphasis on SARs as important means of resource allocation by the capital markets, and on the increased role of the market in SAR regulation. In 2014, the CSRC reoriented its SAR regulation. It set the primacy of issuer MD&A discussion over issuer earnings projections, noting "the inherent unreliability of earnings projections." It
differentiated between an issuer SAR with its controlling shareholder and an arm's-length SAR, noting "the inherent market forces in play" in the latter.\textsuperscript{116} Compared with the SAR Regulation (2008),\textsuperscript{117} the current SAR Regulation (2014) has these three features:

- mandatory MD&A discussion for all SARs, and voluntary earnings projections permitted;
- mandatory projection disclosure and mandatory compensation scheme for related-party SARs; and
- public enforcement against ex post inaccurate—and regulatory reward for ex post accurate—projections.\textsuperscript{118}

First, a listed issuer effecting an SAR \textit{must} provide an MD&A in the SAR Report, discussing the impact of the SAR on its continued operating ability, its future prospects, its earnings per share in the SAR year, and other financial and non-financial benchmarks.\textsuperscript{119} The issuer \textit{may} make earnings projections which, if made, must be attested by a qualified accounting firm.\textsuperscript{120}

Second, if an issuer effects an SAR with its controlling shareholder (or a related party of the latter) or with a party who becomes the controlling shareholder post-SAR, and the SAR pricing is based on earnings projections, then for three years post-SAR the issuer must disclose an annual computation of any disparities between projected earnings and realized earnings pertaining to the assets purchased.\textsuperscript{121} Such computation must be attested by a qualified accounting firm and published in the issuer's annual report.\textsuperscript{122} To the extent that realized earnings fall short of the projected earnings, the related-party SAR counterpart must

\footnotesize


\textsuperscript{116} Id. § 2.6.

\textsuperscript{117} See supra text accompanying note 99.

\textsuperscript{118} See CSRC 2014-109, supra note 82.

\textsuperscript{119} Id. art. 19.

\textsuperscript{120} Id. art. 22.

\textsuperscript{121} Id. art. 35.

\textsuperscript{122} Id.
compensate the listed issuer.\textsuperscript{123} To the extent that the SAR transaction dilutes the earnings per share of the issuer in the SAR year, the SAR counterpart must undertake to make the issuer whole.\textsuperscript{124}

In contrast, if the issuer effects an SAR with a non-related party and the SAR does not result in a change in control of the issuer, the ex post comparison and compensation requirements do not apply. The exemption is based on the rationale that the negotiation process of a non-related party SAR is subject to market forces, and that the assets purchased by the listed issuer in the SAR have since been operated by it and are no longer under the control of the non-related SAR counterpart.\textsuperscript{125}

Regardless of related party or non-related party SAR, the independent financial advisor to the listed issuer SAR transaction must, for four years in the case of an SAR resulting in a "back-door listing"\textsuperscript{126} and two years otherwise, publish a Post-SAR Continuous Supervision and Guidance Annual Opinion, comparing projected earnings with realized earnings, and the issuer's MD&A discussion with actual results of operations.\textsuperscript{127}

Third, the SAR Regulation (2014) has left intact the SAR Regulation (2008)'s carrot and stick policies for accurate projections and over-projections.\textsuperscript{128}

\section*{C. Issuer Periodic and Current Reporting and Earnings (Forecast) Disclosure}

Listed issuers began to be subject to annual, semi-annual, and current reporting requirements in 1993.\textsuperscript{129} In 2001, motivated by

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{123}] Id.
\item[\textsuperscript{124}] Id.
\item[\textsuperscript{125}] \textit{Id.} See also CSRC Q&A's with Press Regarding SAR Regulation Amendment, Q&A No. 6, CHINA SEC. REG. COMM'N (July 11, 2014), http://www.csirc.gov.cn/pub/newsite/qghxwfb/xwdd/201407/t20140711_257663.html [https://perma.cc/M475-JCV4].
\item[\textsuperscript{126}] For the definition of an SAR resulting in a "back-door listing," see \textit{supra} note 111.
\item[\textsuperscript{127}] CSRC 2014-109, \textit{supra} note 82, art. 38.
\item[\textsuperscript{128}] \textit{Id.} arts. 51, 59. \textit{See also} \textit{supra} text accompanying notes 107–11.
\item[\textsuperscript{129}] \textit{See} State Council, SC 1993-112, \textit{supra} note 36, art. 57; China Sec. Reg.
the need for enhanced market transparency with respect to issuers facing delisting risks, the CSRC added a quarterly reporting requirement across the board for all listed issuers. To complement the periodic and current reporting system for historical information, the CSRC and the stock exchanges set a bifurcated mandatory/voluntary disclosure regime for earnings forecasts, which evolved from annual earnings projections in 1994 to semi-annual and quarterly earnings forecasts beginning in 2002. The current mandatory/voluntary bifurcated periodic earnings forecast system is administered by the CSRC and the stock exchanges according to their respective jurisdictions, and regulates the following three types of information:

- annual earnings projections: voluntary disclosure subject to a duty to update;
- periodic earnings projections: mandatory for exchange-designated issuers; and
- earnings preannouncements: voluntary, generally.

Comm'n, CSRC 1993-43: Listed Company Disclosure Rules (Provisional), art. 4 (1993) (Westlaw China (Westlaw China)).


In connection with the filing of its annual report, an issuer may make annual earnings projections for the forthcoming year, and disclose them in the current year’s annual report. If an issuer chooses to do so, it must have its earnings projections attested by a qualified public accounting firm. The issuer becomes under a duty to “timely” (undefined by rule) disclose any “material update” (undefined by rule) to its earlier earnings projections, by filing a current report with the listing stock exchange. The issuer triggers a further duty to analyze any “material disparity” (defined by rule to mean a threshold 20 percent ex post forecast error in either direction) between its projected earnings and realized earnings, and to disclose such material disparity and its analysis in the following year’s annual report.

In connection with the filing of a periodic report, an issuer must disclose its projected cumulative earnings from the beginning of the year through the end of the next reporting period (“Projection Period”) if it hits any of the following three benchmarks (“Benchmark Issuer”):


134 See SHANGHAI STOCK EXCH., SHSE 2014-65: SHANGHAI STOCK EXCHANGE STOCK LISTING RULES, art. 11.3.7 (2014), http://www.sse.com.cn/lawandrules/sserules/listing/stock/a/20141019/0c66952a92b51b909f3d75165f2f9778.doc [https://perma.cc/LW77-5CDJ]; SHENZHEN STOCK EXCH., SZSE 2014-378: SHENZHEN STOCK EXCHANGE STOCK LISTING RULES, art. 11.3.8 (2014), http://www.szse.cn/main/files/2014/11/28/%E6%B7%B1%E5%9C%B3%E8%AF%81%E5%88%8B%E4%BA%A4%E6%98%93%E6%89%80%E8%82%A1%E7%A5%88%E4%B8%8A%E5%B8%82%E8%A7%84%E5%88%99%EF%BC%8912014%E5%B9%B4%E4%BF%AE%E8%AE%A2%EF%BC%89.pdf [https://perma.cc/H96A-QW6N]; SHENZHEN STOCK EXCH., SZSE 2014-378-C: SHENZHEN STOCK EXCHANGE STOCK LISTING RULES FOR CHINEXT MARKET, art. 11.3.9 (2014), http://www.szse.cn/main/files/2014/12/25/%E6%B7%B1%E5%9C%B3%E8%AF%81%E5%88%8B%E4%BA%A4%E6%98%93%E6%89%80%E5%88%9B%E4%B8%8A%E6%88%99%E5%88%99%E7%8E%A6%E4%BF%AE%E8%AE%A2%EF%BC%89.pdf [https://perma.cc/YEM9-2XHV].


136 Different treatments between the SHSE and the SZSE are discussed in Part II.A, infra.

137 Where the periodic report is the annual report, the Projection Period shall be the first quarter of the year following the year covered by the annual report.
(1) the issuer projects an earnings loss for the projection period;
(2) the issuer projects an earnings turnaround from the year-to-date loss reported in the periodic report, or from the earnings loss reported for the same period the previous year; or
(3) the issuer’s projected earnings represent a threshold 50 percent increase or decrease compared to the earnings reported for the same period the previous year.  

The mandatory forecast must be concurrently disclosed in the periodic report filed with the CSRC and repeated in a current report filed with the issuer’s stock listing exchange.  

Ex ante, issuers must assure and expressly represent that their earnings forecasts are “accurate” and “objective,” or caution to the contrary.  

Issuers shall have a duty to “timely” disclose any “substantial update” to their previous forecast, and offer a public apology for the revision.  


See CSRC 2014-22, supra note 55, art. 20; CSRC 2014-23, supra note 76, art. 12; CSRC 2013-29, supra note 55, art. 26; CSRC 2013-21, supra note 55, art. 17. The SHSE only requires the Benchmark Issuers to make annual earnings projections, whereas the SZSE requires the Benchmark Issuers to make quarterly, as well as annual, earnings projections. Compare SHSE 2014-65, supra note 134, art. 11.3.1, with SZSE 2014-378, supra note 134, art. 11.3.1, and SZSE 2014-378-C, supra note 134, art. 11.3.1.  

Id.  

SHSE 2014-65, supra note 134, arts. 2.1–2.2, 2.6; SZSE 2014-378, supra note 134, arts. 2.1–2.2, 2.5; SZSE 2014-378-C, supra note 134, arts. 2.1–2.2, 2.4. A sample review of issuer earnings forecast releases for FY 2013 shows that issuers generally provided the standard affirmative representations.  

SHSE 2014-65, supra note 134, art. 13.3.3; SZSE 2014-378, supra note 134, arts. 11.3.3–11.3.5; SZSE 2014-378-C, supra note 134, arts. 11.3.4–11.3.6. The Shanghai and Shenzhen stock exchanges’ rules appear to fail to
earnings loss after having suffered two consecutive years’ losses must repeat its negative predictions together with a “Trading Suspension Risk Warning” at least three times before its third-year annual report filing date. An issuer predicting a fourth-year earnings loss after having suffered three consecutive years’ losses must disclose its negative predictions together with a “Stock Delisting Risk Warning” prior to the tenth day after the end of the fourth year. Loss issuers on SZSE’s ChiNext Market are required to disclose their earnings forecasts and suspension and delisting risk warnings much earlier and with greater frequency than their main board and SME board counterparts.

Different from the mandatory forecasting regime for Benchmark Issuers, any issuer may release a preliminary earnings announcement after the end of a reporting period but before the filing of the periodic report. Such an earnings preannouncement must include at a minimum all of the following nine items for both the reporting period and the same period the year before, presented in a comparative format: (1) business income; (2) business profits; (3) gross profits; (4) net profits; (5) gross assets; (6) net assets; (7) earnings per share; (8) net assets per share; and (9) return on equity. The voluntary discloser must assure that there is no material disparity between its preliminary earnings announcement and the final periodic report. In the event of a threshold 20 percent disparity in either direction, the issuer must issue a public apology simultaneously with its filing of the periodic report.

The idea for a preliminary earnings announcement originated in 2000, when the stock exchanges informally required issuers to release an advance, unaudited version of their annual financial statements if the information had been leaked pending the filing

distinguish between a “correction” and an “update.” See Stransky v. Cummins Engine Co., 51 F.3d 1329, 1331–32 (7th Cir. 1995).


144 SHSE 2014-65, supra note 134, art. 11.3.5; SZSE 2014-378, supra note 134, art. 11.3.6; SZSE 2014-378-C, supra note 134, art. 11.3.7.

145 SHSE 2014-65, supra note 134, art. 11.3.6; SZSE 2014-378, supra note 134, art. 11.3.7; SZSE 2014-378-C, supra note 134, art. 11.3.8.
of the audited annual report. In 2004, the stock exchanges' listing rules imposed such a leak-triggered disclosure obligation in connection with all periodic reports. Since 2006, the stock exchanges started using the term "preliminary earnings announcement" (kuai bao) as a mandatory mechanism where the financial information has been leaked, and voluntary otherwise.

Tables 3 through 5 below provide a summary view of the timing, reliability, and complementarity of issuer earnings forecasts made under the mandatory regime and issuer earnings preannouncements made under the voluntary regime for FY 2013 earnings. The list of 2,489 issuers included in the analysis represents all issuers listed on the SHSE and SZSE at the end of Q4 2013, based on the CSRC published data ("Sample Issuers"). Financial data are based on issuer filings retrieved from the WIND Financial Terminal and processed by the Author. "Reliability"

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147 SHSE 2004-X, supra note 132, art. 6.7; SZSE 2004-107, supra note 132, art. 6.8.


150 Mandatory annual earnings forecasts for FY 2013 are based on Sample Issuers' Q3 2013 periodic reports and current reports filed in or after October 2013. Some of the sample forecasts may not strictly have triggered the Benchmarks (see supra note 138 and accompanying text), but were nevertheless issued under the mandatory regime. Only quantitative (i.e., point, range, and a few open-ended) forecasts were included in the analysis; qualitative forecasts were excluded. See Yongtai Kim, Michael Lacina & Myung Seok Park, Positive and Negative Information Transfers from Management Forecasts, 46 J. ACCT. RES. 885, 889 n.3, 892 (2008). Voluntary annual earnings preannouncements are those filed by Sample Issuers preceding their audited 2013 annual reports. Actual, reported 2013 annual earnings are from Sample Issuers' audited 2013 annual reports. Full data are available from the Author.
is measured by “forecast error” and “preannouncement error” respectively, expressed by the following formulae\textsuperscript{151}:

\[
\text{Forecast Error} = \frac{\text{Actual Earnings} - \text{Forecasted Earnings}}{|\text{Forecasted Earnings}|} \times 100\%
\]

\[
\text{Preannouncement Error} = \frac{\text{Reported Earnings} - \text{Preannounced Earnings}}{|\text{Preannounced Earnings}|} \times 100\%
\]

Four salient features stand out from the empirical data:

- \textit{Mandatory forecaster percentage}. Of the 2,489 Sample Issuers, 1,722 (approximately 69 percent) issued earnings forecasts for FY 2013 in connection with their Q3 2013 reports and current reporting thereafter under the mandatory regime.

- \textit{Timing of forecasts}. Of the total 1,960 quantitative forecasts made by the 1,722 issuers for their FY 2013 earnings, 869 forecasts (approximately 44 percent) were made during Q4 2013, and 1,091 forecasts (approximately 56 percent) were made in 2014, when all Chinese listed issuers by law have the calendar year as their fiscal year.\textsuperscript{152}

- \textit{Accuracy and bias of forecasts}. There were consistently more over-forecasts than under-forecasts across all forecast error brackets. Forecasts with shorter forecasting horizons were not necessarily more accurate than those with longer forecasting horizons.

- \textit{Mandatory-voluntary disclosure complementarity}. Of the 2,489 Sample Issuers, 1,202 (approximately 48 percent) made voluntary earnings preannouncements. Of the 1,202 voluntary preannouncers, 1,058 (approximately 88 percent) were concurrently under the mandatory earnings forecasting regime.


<table>
<thead>
<tr>
<th>Timing of Forecasts</th>
<th>( FE^* &lt; 0 ) (Over-Forecast: Optimism)</th>
<th>( FE^* = 0 )</th>
<th>( FE^* &gt; 0 ) (Under-Forecast: Pessimism)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(</td>
<td>FE</td>
<td>\geq 50% )</td>
</tr>
<tr>
<td>Oct 2013</td>
<td>2.9892%</td>
<td>5.0000%</td>
<td>6.2755%</td>
</tr>
<tr>
<td>Nov 2013</td>
<td>0.2551%</td>
<td>0</td>
<td>0.1920%</td>
</tr>
<tr>
<td>Dec 2013</td>
<td>0.0510%</td>
<td>0.0610%</td>
<td>0.1310%</td>
</tr>
<tr>
<td>2013 Sub-Total:</td>
<td>64</td>
<td>99</td>
<td>128</td>
</tr>
<tr>
<td>Jan 2014</td>
<td>3.3653%</td>
<td>5.0516%</td>
<td>6.5300%</td>
</tr>
<tr>
<td>Feb 2014</td>
<td>1.8878%</td>
<td>3.6738%</td>
<td>6.2601%</td>
</tr>
<tr>
<td>Mar 2014</td>
<td>0</td>
<td>0.1510%</td>
<td>0.0510%</td>
</tr>
<tr>
<td>Apr 2014</td>
<td>0.0510%</td>
<td>0.0510%</td>
<td>0.1620%</td>
</tr>
<tr>
<td>May 2014</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2014 Sub-Total:</td>
<td>37</td>
<td>77</td>
<td>107</td>
</tr>
<tr>
<td>Total</td>
<td>1.0912%</td>
<td>3.9268%</td>
<td>5.4592%</td>
</tr>
<tr>
<td>Total: 1,960; 100%</td>
<td>5.1531%</td>
<td>8.9796%</td>
<td>11.9898%</td>
</tr>
</tbody>
</table>

*FE*: Forecast Error

**NOTES:**
1. Total number of issuers: 2,489. Number of issuers disclosing mandatory forecasts: 1,722.
2. Total number of forecasts: 2,139. Number of quantitative forecasts: 1,960.
Table 4

**Voluntary Annual Earnings Preannouncements by SHSE and SZSE Listed Issuers for FY 2013 Based on Issuer Preannouncements Released Prior to Their Audited 2013 Annual Report Filings**

<table>
<thead>
<tr>
<th>No. of PA's*</th>
<th>PE* &lt; 0 (Audited earnings are less than preannounced earnings)</th>
<th>PE* &gt; 0 (Audited earnings are greater than preannounced earnings)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>PE</td>
<td>&lt; 50%</td>
</tr>
<tr>
<td>Timing of PA's</td>
<td>Jan 2014</td>
<td>0.0801%</td>
</tr>
<tr>
<td></td>
<td>Feb 2014</td>
<td>1.3611%</td>
</tr>
<tr>
<td></td>
<td>Mar 2014</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>Apr 2014</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>1,249</td>
<td>18</td>
</tr>
</tbody>
</table>

*PA: Preannouncement. *PE: Preannouncement Error

**NOTES:**
2. Total number of preannouncements: 1,249.

<table>
<thead>
<tr>
<th>No. of PA's*</th>
<th>PE* &lt; 0 (Audited earnings are less than preannounced earnings)</th>
<th>PE* &gt; 0 (Audited earnings are greater than preannounced earnings)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>PE</td>
<td>&lt; 50%</td>
</tr>
<tr>
<td>Timing of PA's</td>
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<td>1.3611%</td>
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<tr>
<td></td>
<td>Mar 2014</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>Apr 2014</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>1,249</td>
<td>18</td>
</tr>
</tbody>
</table>


Table 5

**Numbers and Percentages of Issuers Disclosing 2013 Annual Mandatory Earnings Forecasts and/or Voluntary Earnings Preannouncements**

<table>
<thead>
<tr>
<th>Mandatory Forecast Only: 664; 26.68%</th>
<th>Mandatory Forecast and Voluntary Preannounces: 1,658; 42.51%</th>
<th>Voluntary Preannouncements Only: 144; 5.70%</th>
<th>Neither Mandatory Forecast Nor Voluntary Preannounces: 623; 25.03%</th>
</tr>
</thead>
</table>

A. Constructing an Integrated Issuer Historical and Forward-Looking Disclosure System

Fragmented, incoherent, and sometimes contradictory regulatory rubrics currently govern issuer periodic and current reports (including mandatory earnings projections and voluntary earnings preannouncements), while the Listed Issuer Disclosure Regulation adopted by the CSRC in 2007 provides principles governing listed issuers’ offering and listing documentation, and periodic and current reporting.153 “Annual reports” and “semi-annual reports” have been mandated since 1993 by the State Council’s Provisional Regulation of Securities Offerings and Trading, and since 1999 by the Securities Law. Their forms and contents have been standardized since 1994 by the CSRC Disclosure Guide for Annual Report and CSRC Disclosure Guide for Semi-Annual Report.154 “Quarterly reports” have been required since 2001 by the CSRC Disclosure Guide for Quarterly Reports, but they are neither contemplated by the State Council’s Provisional Regulation nor mandated by the Securities Law.155 The concept of “current reports” originated in the 1993 State Council’s Provisional Regulation. The term “current reports” first appeared in 1998 in the stock exchanges’ listing rules, and since 1999 has also appeared in the Securities Law.156 The list of “material events” within the scope of current reports has been set in the Securities Law since 1999

153 CSRC 2007-40, supra note 76, art. 5.
155 CSRC 2001-55, supra note 130; cf. SECURITIES LAW 2014, supra note 45, § 3.3; SC 1993-112, supra note 36, ch. 6.
with little change over the years.\textsuperscript{157} The forms and contents of current reports are specified by each of the stock exchanges according to their respective standards,\textsuperscript{158} and there is no CSRC disclosure guide for current reports.\textsuperscript{159}

Issuer earnings projections are governed, separately, by the CSRC's disclosure guides for periodic reports, and by the stock exchanges' listing rules and disclosure guides for current reports. Under the rubric of periodic reporting regulation, the CSRC mandates that Benchmark Issuers project their earnings ex ante for the projection period.\textsuperscript{160} Conversely, under the rubric of current reporting regulation, the stock exchanges allow Benchmark Issuers to "project" earnings ex post, i.e., after the end of the relevant accounting period.\textsuperscript{161} The CSRC requires that earnings forecasts by Benchmark Issuers be made progressively for six-month, three-quarter, and one-year forecasting periods, to which the Shenzhen Stock Exchange rules adhere. In contrast, the Shanghai Stock Exchange rules cut down the three mandatory progressive forecasting periods to a one-year forecasting period, and leave the semi-annual and quarterly earnings forecasts to the discretion of the Benchmark Issuers.\textsuperscript{162} Under both stock exchanges' rules,

\begin{flushleft}
157 See, e.g., SECURITIES LAW 1999, supra note 42, art. 62 (listing eleven "material events"); SECURITIES LAW 2014, supra note 45, art. 67 (adding one more "material event" to the 1999 list); cf. CSRC 2007-40, supra note 76, art. 30 (exercising authority delegated by the Securities Law and expanding the list into twenty-one "material events").


159 See CSRC 2007-40, supra note 76, ch. 4; cf. id. ch. 3, art. 29.

160 See CSRC 2014-22, supra note 55, art. 20; CSRC 2014-23, supra note 76, art. 12; CSRC 2013-29, supra note 55, art. 26; CSRC 2013-21, supra note 55, art. 17.

161 See SHSE 2014-65, supra note 134, art. 11.3.1; SZSE 2010-X, supra note 137, art. 2.

162 See CSRC 2014-22, supra note 55, art. 20; CSRC 2014-23, supra note 76, art. 12; CSRC 2013-29, supra note 55, art. 26; CSRC 2013-21, supra note 55, art. 17. Compare SZSE 2014-378, supra note 134, art. 11.3.1, and SZSE 2014-378-C, supra note 134, art. 11.3.1, with SHSE 2014-65, supra note 134, art. 11.3.1. This Article does not engage in the current debate in the United States concerning the advisability of management quarterly earnings guidance. Compare Leo E. Strine, Jr., Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational
Benchmark Issuers, whose risk of negative earnings or earnings volatility underlies the mandatory disclosure regime, need only disclose "earnings," whereas non-Benchmark Issuers must disclose, once they voluntarily undertake to preannounce, a whole range of balance sheet and income statement items.163

This Article recommends an integrated issuer disclosure and reporting system for Chinese issuers under the Securities Law,164 by expanding and reconstructing the CSRC's Listed Issuer Disclosure Regulation into a central disclosure repository and operational mechanism and benefiting from the philosophy of SEC Regulation S-K.165 Whereas Regulation S-K streamlined the two distinct disclosure systems (under the Securities Act and the Exchange Act respectively) to achieve disclosure efficiency, this Article recommends streamlining the two bifurcated jurisdictions (over periodic reports by the CSRC and over current reports by the stock exchanges respectively) to achieve efficient and equitable regulation.166 Specifically, all periodic and current reports should

163 See supra text accompanying notes 136–38, 144.
166 Cf. supra text accompanying notes 139, 161–62.
be authorized by the Securities Law of the People’s Republic of China, with rulemaking authority related thereto granted to the CSRC.167 The CSRC should prescribe uniform forms and line items for all periodic and current reports.168 Such a CSRC-administered mandatory disclosure system should facilitate a level playing field—with respect to mandatory projections169—for issuers listed on the SZSE, which features private entrepreneur-controlled issuers, and issuers listed on the SHSE, which features state-controlled issuers.170

It further recommends integrating issuer earnings projections into such a CSRC-administered public disclosure system. Three disclosure policies should be addressed. First, “projection” (and similar terms) should be rigorously defined. Academic literature, as well as the accounting profession and securities regulators in the United States,171 does not treat as “projections” management’s earnings disclosure issued after the end of the fiscal period and before the filing of a formal periodic report. A bright line must be drawn between the mandatory “earnings forecast” by a Benchmark Issuer (yu gao),172 and the voluntary “earnings preannouncement” by any issuer (kuai bao).173 An earnings “forecast” is a

167 Cf. 15 U.S.C. §§ 78m(a)–(b)(1) (2012) (requiring listed issuers to file periodic and other reports with the Commission, and authorizing the Commission to prescribe forms and line items for such reports).


170 See supra text accompanying notes 71, 162.


172 See supra text accompanying notes 136–39.

173 See supra text accompanying notes 144–48.
prediction of "future" earnings, and thus must have a "forecast horizon" or the number of calendar days between the forecasting date and the end of the forecast period. A "forecast period" in turn refers to the time period covered by a forecast and may be partially expired by the forecasting date.\footnote{See, e.g., Atiase et al., supra note 171, at 522 n.12; Grace Pownall, Charles Wasley & Gregory Waymire, The Stock Price Effects of Alternative Types of Management Earnings Forecasts, 68 ACCT. REV. 896, 899 (1993); AICPA, FINANCIAL FORECASTS AND PROJECTIONS, supra note 4, § 301.08(a). Cf. Sugata Roychowdhury, Earnings Management Through Real Activities Manipulation, 42 J. ACCT. & ECON. 335, 363 (2006) (stating that, unlike management forecasts, analyst forecasts can continue beyond the year-end until shortly before the earnings announcement date, and that, during the year, management can form expectations of the analysts' final consensus forecast outstanding prior to the management's earnings announcement).}

An earnings "preannouncement" is an early announcement of "historical" earnings, i.e., a tentative report made after the end of an accounting period but shortly before the release of the formal report.\footnote{See, e.g., Atiase et al., supra note 171, at 522 n.12; Leonard Soffer, S. Ramu Thiagarajan & Beverly R. Walther, Earnings Preannouncement Strategies, 5 REV. ACCT. STU. 5, 5 (2000).}

Second, a fair and transparent presentation format should be prescribed for mandatory earnings projections. In particular, any government subsidy should be separately disclosed, both in forecasted and reported earnings.\footnote{In 2013, the CSRC began to require IPO and listed issuers to disclose their government subsidy-related information in notes to annual financial statements. See CHINA SEC. REG. COMM'N, CSRC 2013-38: IPO AND LISTED ISSUER DISCLOSURE INTERPRETIVE GUIDE NO. 2—GOVERNMENT SUBSIDY DISCLOSURE IN NOTES TO ANNUAL FINANCIAL STATEMENTS (2013), http://www.csirc.gov.cn/pub/ejhpublic/q00306201/201309/P020130927528247963554.doc [https://perma.cc/EH9K-UJGH].}

Economic models and empirical literature demonstrate that investors rely on management earnings forecasts and reported earnings to draw inferences about the level and riskiness of the firm value; managers thus have incentives to manage reported earnings upward toward their forecasts so as to influence investors' perceptions and to avoid reputation loss or legal exposure due to missing their own forecasts.\footnote{See Anne Beyer, Capital Markets Prices, Management Forecasts, and Earnings Management, 84 ACCT. REV. 1713, 1723–25 (2009); Ron Kasznik, On the Association Between Voluntary Disclosure and Earnings Management, 37 J. ACCT. RES. 57, 61–62, 79–80 (1999).} Empirical literature studying the Chinese markets has found that...
government's strategic, selective subsidies to listed firms are "pervasive," with the government pursuing its socio-political agenda via the listed issuers, and issuers managing earnings using the government subsidies to meet regulatory requirements or market expectations.\textsuperscript{178} Separate tabulations of government subsidies in both forecasted and reported earnings will ensure a comparable basis for measuring forecast errors, bringing greater transparency to issuer forecasting ability and enhancing fairness of the forecast accuracy-based public enforcement.\textsuperscript{179} Furthermore, since operating income and non-core earnings are shown to have different implications for firm valuation,\textsuperscript{180} separate disclosure of the government subsidy component in earnings forecasts and earnings reports may help avoid any misleading inferences about firm value or its risk.\textsuperscript{181}

Third, with respect to discretionary or voluntary disclosure, literature has told "a compelling economic story"\textsuperscript{182} that, in the presence of firm proprietary costs or investor uncertainty about firm information, and consistent with efficient disclosure choices—such as by comparing the information asymmetry component of the cost of capital with the disclosure-related proprietary costs—firms will neither fully disclose nor totally withhold information about firm value, despite the fact that the market rationally

\textsuperscript{179} See supra text accompanying notes 64–66, 107–11, 128; infra text accompanying notes 206–11; see also Hanwen Chen, Securities Markets and Accounting Regulation 228 (Beijing, China Fin. & Econ. Pub. House 2001) (suggesting that, in computing forecast errors for enforcement purposes, "recurring earnings" should be separated from "nonrecurring earnings" in order to have a consistent and comparable basis).
\textsuperscript{181} See 17 C.F.R. § 229.10(b)(2) (2016); Guides for Disclosure of Projections of Future Economic Performance, supra note 26, 43 Fed. Reg. at 53,248; see also supra note 177.
\textsuperscript{182} See Verrecchia, supra note 3, at 160.
interprets the withheld information.\textsuperscript{183} Economic literature has also stated that it is inefficient for firms to precommit to a policy of full disclosure.\textsuperscript{184} The Chinese regulatory policy imposing obligations on voluntary disclosers to timely update their earnings projections and to follow up disclosing variances\textsuperscript{185} in effect presents firms with an inefficient "precommitment mechanism of full disclosure" akin to "getting on a treadmill that one cannot get off,"\textsuperscript{186} which will discourage voluntary disclosure. To encourage voluntary projections, the voluntary regime should create an economically efficient disclosure environment, allowing issuers to append a forewarning to a projection that the projection is not intended to be updated, to postpone updating with a timely cautionary explanation, or to suspend an issued projection against any continued use.\textsuperscript{187} This could be accomplished via a current

\textsuperscript{183} Id. at 141–47, §§ 3.5, 4.2 (expounding efficiency-based voluntary disclosure theory); Ronald Dye, Disclosure of Nonproprietary Information, 23 J. ACCT. RES. 123, §§ 1, 3 (1985) (extending the Grossman-Milgrom unraveling idea in stating that investor uncertainty about management's information endowment induces partial disclosure); Robert Verrecchia, Discretionary Disclosure, 5 J. ACCT. & ECON. 179, §§ 1, 5 (1983) (extending the Grossman-Milgrom unraveling idea in stating that proprietary costs raise the equilibrium threshold level of disclosure and introduce noise to possible interpretations of withheld information). For the original Grossman-Milgrom unraveling idea, see Sanford J. Grossman, The Informational Role of Warranties and Private Disclosure about Product Quality, 24 J.L. & ECON. 461, 462–63, 465 (1981) (stating that rational expectations of the buyer propel full disclosure by the seller to maximize profit); Paul R. Milgrom, Good News and Bad News: Representation Theorems and Applications, 12 Bell J. Econ. 380, § 5 (1981) (stating that, at a sequential equilibrium, the buyer's attitude is one of extreme skepticism and the salesman's best strategy is one of full disclosure).

\textsuperscript{184} See Verrecchia, supra note 3, at 146–47, 155.

\textsuperscript{185} See supra text accompanying notes 134–35, 145. The SEC adopts a similar policy on duty to update and variance disclosure. See 17 C.F.R. § 229.10(b)(3)(ii)–(iii) (2016); supra text accompanying notes 22–23.

\textsuperscript{186} See Verrecchia, supra note 3; John R. Graham, Campbell R. Harvey & Shiva Rajgopal, The Economic Implications of Corporate Financial Reporting, 40 J. ACCT. & ECON. 3, § 6.2.1 (2005); see also Oesterle, supra note 29.

\textsuperscript{187} See AICPA, GUIDE: PROSPECTIVE FINANCIAL INFORMATION §§ 8.48–8.51 (2013); see also Backman v. Polaroid Corp., 910 F.2d 10, 17 (1st Cir. 1990) ("[A] statement, correct at the time, may have a forward intent and connotation upon which parties may be expected to rely. If this is a clear meaning, and there is a change, correction, more exactly, further disclosure, may be called for.").
report,\textsuperscript{188} based on the disclosure cost-benefit determination made by the issuer, and absent any manipulative intent on the part of the issuer to inflate or deflate its stock price.\textsuperscript{189}

**B. Some Building Blocks for Ex Ante Regulation of Issuer Projections**

1. **Issuer Safe Harbor Conditional on Audit Review**

The requirement of audit review of issuer earnings projections currently depends on three circumstances. Transaction-triggered issuer earnings projections, such as those made in connection with


\textsuperscript{189} See, e.g., Stephen Baginski, John Hassell & Michael Kimbrough, Why Do Managers Explain Their Earnings Forecasts?, 42 J. ACCT. RES. 1, 5 (2004) (stating that demand for forward-looking information may vary across firms and through time while costs of disclosure remain potentially high, and that managers are likely to disclose only when the benefits of meeting the demand exceed the costs of supplying the disclosure); D. Eric Hirst, Lisa Koonce & Shankar Venkataraman, Management Earnings Forecasts: A Review and Framework, 22 ACCT. HORIZONS 315, 324 (2008) (citing studies documenting that managers' forecasting behaviors can be influenced by their own self-interest, such as different managerial incentives in connection with equity-based compensation, around equity offerings, during stock option award periods, or when engaging in insider trading). The issuer's "disclosure cost-benefit" determination and absence of "manipulative intent" standard proposed by this Article stands in contrast to the SEC's "reasonable basis" standard, for updating, discontinuing, and resuming voluntary projections. Cf. 17 C.F.R. § 229.10(b)(3)(iii)—(iv) (2016); see supra text accompanying notes 23, 31—32.
a public offering or a related party SAR transaction, are required to be attested by a qualified accounting firm regardless of whether such projections are mandatory or voluntary.190 Listed issuers' voluntary earnings projections with a full-year projection horizon are also required to be attested by a qualified accounting firm.191 Benchmark Issuers' mandatory earnings forecasts made in connection with their periodic and current reporting are not subject to any audit review at all.192

To encourage issuer voluntary forecast disclosure,193 and for the market to benefit from informational intermediaries' monitoring role over issuer forecasting process,194 this Article recommends a safe harbor for issuer projections conditioned on an advance audit review of the projections. Such an audit review could be performed by a qualified public accounting firm195 or by

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190 See supra Parts I.A–I.B.
191 See supra Part I.C.
192 Id.
194 See, e.g., Frank H. Easterbrook & Daniel R. Fischel, Mandatory Disclosure and the Protection of Investors, 70 VA. L. REV. 669, 687–89 (1984) (commenting on the role of accountants as informational intermediaries); George Blazenko & William Scott, A Model of Standard Setting in Auditing, 3 CONTEMP. ACCT. RES. 68, 69 (1986) (commenting on auditing as a monitoring device); AICPA, FINANCIAL FORECASTS AND PROJECTIONS, supra note 4, § 301.29–30 (describing the attestation process as involving the following: evaluating the preparation of the prospective financial statements, the support underlying their assumptions, and their presentation; and, on the basis of such examination, rendering an opinion on whether the prospective financial statements are presented in conformity with AICPA Guide Prospective Financial Information and whether the assumptions provide a reasonable basis for management's forecast or for management's projection given the hypothetical assumptions).
195 For a registered public accounting firm in China to engage in "securities and futures-related business," it must be jointly qualified by and subject to the
the issuer's board of directors' audit committee. An ex ante audit review of the support for management's material assumptions, coupled with an ex ante management disclosure of probability distributions or other probabilistic statements relating to its projections, is superior to management's ex ante disclosure of material assumptions and its ex post analysis of historical variances as are currently required. The ex ante assumption disclosure may harm the firm's competitive interests, while the ex post variance analysis may be of limited utility to users of projections in a significantly changing business environment. A foundation for joint supervision of the Ministry of Finance and the CSRC. "Securities and futures-related business" is defined to mean auditing, verification, examination, and attestation engagements (e.g., auditing of financial statements and attestation of earnings projections) performed for "securities and futures firms." "Securities and futures firms" refer to issuers, securities trading, clearing, and settlement intermediaries, stock and futures exchanges, investment funds, and investment management companies. See Ministry of Finance & China Sec. Reg. Comm'n, MOF 2012-2: Notice Concerning Securities and Futures-Related Business Qualification of Public Accounting Firms, arts. 1, 6-7 (2012) (Westlaw China). As of December 31, 2013, there were forty such qualified firms. See MINISTRY OF FINANCE & CHINA SEC. REG. COMM'N, MOF-CSRC 2014-13: LIST OF SECURITIES-QUALIFIED PUBLIC ACCOUNTING FIRMS (Mar. 10, 2014), http://www.csrc.gov.cn/pub/zh/public/G00306213/201403/W020140310620717659135.pdf [https://perma.cc/C9WW-Z382].

See, e.g., Bruce J. McConomy, Bias and Accuracy of Management Earnings Forecasts: An Evaluation of the Impact of Auditing, 15 CONTEMP. ACCT. RES. 167, 189-90 (1998) (documenting that, in the Canadian market, auditing of management forecasts reduced forecasting bias but not forecast errors); Irene Karamanou & Nikos Vafeas, The Association between Corporate Boards, Audit Committees, and Management Earnings Forecasts: An Empirical Analysis, 43 J. ACCT. RES. 463, 481 (2005) (finding that, in the U.S. market, effective board audit committees were related to greater forecast accuracy in both good news and bad news samples); see also HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 281-82 (1979) (emphasizing the importance of independent judgmental opinions on soft information, and recommending that the accounting profession act as ombudsman in the public interest and participate in attestation functions on disclosures that are judgmental and nonobjective).


For literature supporting this view, see, for example, AICPA, GUIDE FOR A REVIEW OF A FINANCIAL FORECAST 47-48 (2nd ed. 1982) (encouraging forecast preparers to develop ranges, probabilistic statements, or estimates of
the safe harbor thus is for the Chinese issuers and the accounting profession to develop adequate standards and presentation guidelines for the preparation and attestation of issuer projections. 199

2. Open and Transparent Legal Framework a Necessary Complement to Safe Harbor

A "Fidelity-based capital markets legal and regulatory system" was espoused by the State Council in 2004. 200 In 2006, the CSRC adopted a confidential "Program of Action for Fidelity Building in Securities and Futures Markets"; in 2008, the CSRC launched a confidential "Central Fidelity File System for Securities and Futures Markets." Both actions by the CSRC were designed to record legal, regulatory, and administrative violations by capital
markets participants, and to provide for the use of such data by
the CSRC in its future administrative, regulatory, and enforce-
ment actions relating to such parties.\textsuperscript{201} In 2012, the CSRC pub-
lished the Securities and Futures Markets Fidelity Regulation
(Provisional),\textsuperscript{202} which, as amended in 2014, specifies eight
categories of persons whose Fidelity files are collected in the Central
Fidelity File System.\textsuperscript{203} In 2014, the Central Fidelity File System
was expanded to become an inter-governmental information
sharing platform, so that “any capital markets Fidelity violator
will be punished and dealt with not only by the CSRC but also
similarly by other governmental agencies.”\textsuperscript{204}

\textsuperscript{201} See, e.g., \textit{Instilling a Fidelity Culture in the Securities Industry}, CHINA SEC.
.com/dybyg/201403/t20140311_9445940.htm; CHINA SEC. REG. COMM’N, TWENTY
YEARS OF CHINA’S CAPITAl MARKETS ch. 25 (2010) (BEIJING: CHINA CITIC PRESS
2010); CHINA SEC. REG. COMM’N, CSRC BULLETIN 2008-11: CENTRAL FIDELITY
FILE SYSTEM FOR SECURITIES AND FUTURES MARKETS LAUNCHED (Nov. 24,
[https://perma.cc/9J69-6DZK].

\textsuperscript{202} China Sec. Reg. Comm’n, CSRC 2012-80: Securities and Futures Markets
Fidelity Regulation (Provisional) (2012) (Westlaw China 万律 (Westlaw China)).

\textsuperscript{203} China Sec. Reg. Comm’n, CSRC 2014-106: Securities and Futures
zjhpiblic/G00306201/201409/P02014091948923759622.pdf [https://perma.cc
/XC66-P1J4] [hereinafter Fidelity Regulation]. Persons covered by the Central
Fidelity File System include:

- issuers and their officers, directors, major stockholders, and
- controlling persons;
- securities and futures firms and their associated persons;
- investment management firms and their associated persons;
- investment research firms and their associated persons;
- professional services organizations serving the securities
and futures industries, such as accounting firms, asset
appraisal firms, credit rating agencies, law firms, public rela-
tions firms, investor relations firms, and computer software
and hardware providers, and employees of such professional
services organizations; domestic and foreign institutional
investors and their fund managers; representative offices of foreign
securities-type firms in China; and any person with securities
and futures markets-related Fidelity regulation violations.

\textit{Id.} art. 7.

\textsuperscript{204} See Capital Markets Fidelity File System Launched, CHINA SEC. REG.
08/t20140808_258971.html [https://perma.cc/5N54-K7WG].
Among others, the following earnings disclosure-related events are recorded in the Central Fidelity File System:

(1) An issuer fails to disclose a mandatory earnings forecast, or fails to timely disclose a material update to its previous earnings disclosure whether mandatory or voluntary, or a material disparity exists between the issuer's forecasted or preannounced earnings and actual reported earnings.

(2) Under a stock exchange's disclosure rating scale declining from A to D, an issuer is given a Disclosure Rating D due to the sign error of its annual earnings projection or preannouncement, such as a projected or preannounced profit versus an actual loss, or vice versa; is given a Disclosure Rating C due to its over-projection or over-preannouncement of annual earnings by a threshold 50 percent; or is denied a Disclosure Rating A (regardless of its other disclosure performance) due to its over-projection or over-preannouncement of annual earnings by a threshold 20 percent.

(3) An SAR counterpart did not live up to its undertakings made in connection with an SAR transaction.

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205 The Fidelity Regulation lists twelve categories of Fidelity Information. See CSRC 2014-106, supra note 203, art. 8.


208 CSRC 2014-106, supra note 203, art. 8(4).
(4) An underwriter sponsored the offering of an issuer who over-projected earnings by a threshold 20 percent during the underwriter's post-offering continuing sponsorship period (which lasts between two to four years depending on the listing board of the issuer and IPO or follow-on offering). An accountant signed the attestation report on an issuer's earnings projections made in connection with a public offering, where the issuer over-projected earnings by a threshold 20 percent. A financial advisor advised the issuer with respect to an SAR transaction, an assets appraiser signed the SAR assets appraisal report, and an accountant signed the SAR earnings projection attestation report, where earnings attributable to the issuer or the purchased assets were over-projected by a threshold 20 percent.

In stark contrast to the confidential public enforcement, the Chinese Securities Law has never expressly authorized any private rights of action for materially false or misleading statements, whether in forward-looking disclosure or otherwise. To fill the legislative void, the Adjudication Committee of the Chinese

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209 CSRC 2009-63, supra note 43, arts. 11, 36, 72(6).
210 CSRC 2015-122, supra note 45, arts. 55-56; CSRC 2006-30, supra note 66, art. 67.
213 Under the Chinese Law of Legislation in effect as of 2000, national legislative power resided exclusively in the National People's Congress (NPC) and the Standing Committee of the NPC: the NPC was to legislate in the areas of “fundamental laws” and the Standing Committee in other areas as well as when the NPC was in recess. The power to interpret law resided exclusively in the Standing Committee, and its legal interpretations had the same force and effect as law. See NAT'L PEOPLE'S CONG., PRC 2000-31: LAW OF LEGISLATION OF
Supreme People's Court (SPC), the highest court in China,\textsuperscript{214} has released four judicial interpretations since 2001 addressing securities-related private causes of action:

(1)\textit{ Notice of Non-Acceptance of Securities-Related Private Damage Actions} ("SPC 2001"), citing "legislative and judicial constraints";\textsuperscript{215}

(2)\textit{ Notice of Acceptance of Private Tort Actions on Account of Securities-Related False Statement} ("SPC 2002"), acknowledging China's WTO member obligation to provide judicial relief;\textsuperscript{216}

\textit{The People's Republic of China, arts. 7, 42, 47 (2000)} (Westlaw China 万律 (Westlaw China)).

In a puzzling twist, the Organizational Law of the People's Courts, which took effect in 2007, grants the Chinese Supreme People's Court the "power to interpret laws" without any case or controversy before it. See \textit{Stand. Comm. of the NPC, PRC 2006-59: Organizational Law of the People's Courts of the People's Republic of China, art. 32 (2007)} (Westlaw China 万律 (Westlaw China)); cf. \textit{U.S. Const. art. III, § 2.}

Perhaps aware of the inconsistency between the Law of Legislation and the Organizational Law of the People's Courts, in August of 2014, the Legislative Sub-Committee of the NPC Standing Committee proposed amending the Law of Legislation to, inter alia, add an article to recognize the Supreme People's Court's power to interpret law without any case adjudication—a power to be shared with the NPC Standing Committee—provided that any such judicial interpretation by the Supreme People's Court be filed with the NPC Standing Committee within 30 days of its pronouncement. See \textit{Legislative Sub-Commit. of NPC Standing Comm., NPC 2014-00: Proposed Amendment to the Law of Legislation} ¶ 28 (2014) (Westlaw China 万律 (Westlaw China)). The amendment was enacted on March 15, 2015. See \textit{Nat'l People's Cong., PRC 2015-20: Law of Legislation of the People's Republic of China, art. 104 (2015)} (Westlaw China 万律 (Westlaw China)).

\textsuperscript{214} See \textit{PRC 2006-59, supra} note 213, art. 29. The "Adjudication Committee" is the management body of the Supreme People's Court, whose meetings may be attended by the prosecutorial branch of the government. \textit{Id.} art. 10; cf. \textit{U.S. Const. art. III, § 1.}

\textsuperscript{215} Sup. People's Ct., SPC 2001-406: Notice of Non-Acceptance of Securities-Related Private Damage Actions (2001) (Westlaw China 万律 (Westlaw China)).

(3) Certain Substantive and Procedural Requirements Governing Adjudication of Private Damage Actions on Account of Securities-Related False Statement ("SPC 2003"), hailed by its drafter as "the first comprehensive judicial interpretation of law governing securities-related private action adjudication," "supplementing criminal and administrative enforcement with an indispensable private enforcement conditional on the former"; and

(4) Pronouncement Concerning Adjudication of Private Tort and Damage Actions on Account of Untrue Audit Report ("SPC 2007").

In essence, under SPC 2003, if an administrative penalty by the CSRC or another governmental agency or a criminal sanction by a court has been imposed on a defendant for a securities-related false statement, a private party may bring a civil damage action against the defendant for that false statement. Potential defendants under the SPC 2003 are the following: (1) the issuer, its controlling shareholder and de facto controlling person, members of the board of directors, board of supervision, and management;

219 For a detailed analysis of the SPC Judicial Interpretation 2003-2 by its drafter, see Li & Jia, supra note 216.
220 The suit must be brought as an “individual action” or a “joint action” where there are multiple plaintiffs. In a joint action, the plaintiffs shall elect (or the court shall appoint where the plaintiffs fail to so elect) two to five plaintiff representatives. The court will publish a notice of action and all putative plaintiffs must register with the court in time to be eligible to join the joint action and to elect or be elected as plaintiff representatives. Parties who did not register with the court but subsequently brought a separate action within the statute of limitations will be bound by the judicial decision rendered in the joint action. See SPC 2003-2, supra note 217, § 3; Nat'l People's Cong., PRC 2012-59: Code of Civil Procedure of the People's Republic of China, arts. 52–54 (2013) (Westlaw China 万律 (Westlaw China)).
221 See SPC 2003-2, supra note 217, art. 5.
(2) intermediaries such as underwriters, offering and listing sponsoring firms, accounting firms, law firms, assets appraisal firms, and their employees with direct responsibility for the false statement; and (3) any other person who made the false statement. 222 “Securities-related false statement” is defined to mean “an untrue statement contrary to facts, a misleading statement, a material omission, or a disclosure improper as to timing or method, with respect to any ‘material events’ set forth in the Securities Law.” 223 In addition, 224 under the SPC 2007, a private party who reasonably relied upon or otherwise used an untrue audit report in its transactions with the audited firm, 225 or in trading the audited firm’s securities, may sue the auditor for damages caused thereby without government action, prerequisite but conditional on the audited firm and its fraudulent stockholders being co-defendants. 226 “Untrue audit report” is defined to mean “an audit report containing any untrue statement, misleading statement, or material omission.” 227

This Article contends that neither Fidelity regulation nor the Supreme People’s Court’s judicial interpretations (SPC 2003 and SPC 2007) obviate the need for a private right of action for

222 Id. art. 7.
224 For a detailed analysis of the SPC Judicial Interpretation 2007-12 by its drafter, see Civ. Div. No. 2 of SUP. PEOPLE’S CT. (Xiaoming Xi ed.); TORT AND DAMAGE LIABILITY OF ACCOUNTANTS FOR AUDITS: AN ANALYSIS OF SUPREME PEOPLE’S COURT’S JUDICIAL INTERPRETATION (Beijing: The People’s Court Press 2007).
225 SPC 2007-12, supra note 218, art. 2. According to its drafter, SPC 2007-12 contemplates as plaintiffs both investors trading the audit client firm’s securities and persons who have transactional or contractual relationships with the audit client firm (such as lenders and suppliers of the firm). See Xi, supra note 224, at 71; cf. “In connection with” concept under U.S. securities law. See, e.g., Chadbourne & Parke LLP v. Troice, 134 S. Ct. 1058, 1069 (2014) (citing SEC v. Zandford, 535 U.S. 813, 820 (2002)) (“warning against ‘construing’ the phrase ‘in connection with’ ‘so broadly as to convert any common-law fraud that happens to involve securities into a §10(b) violation’”).
226 SPC 2007-12, supra note 218, arts. 1–3. Any damages shall be paid first by the audited firm and its fraudulent stockholders, and then by the auditor to the extent of any unpaid damage and in proportion to the auditor’s fault. Id. art. 10.
227 Id. art. 2.
fraudulent forward-looking information. First, regulation by Fidelity File per se does not bring injured investors any economic relief although it may result in government allocation of resources. This is achieved by the government denying an inaccurate forecasting issuer and rewarding an accurate forecaster with access to the capital markets, and imposing on the former other immediate and real—not merely future and reputational—penalties.228 Second, "securities-related false statement" is defined by the SPC 2003 by reference to the Securities Law's listing of "material events," which in turn are defined as the occurrences of the specified events.229 "Untrue audit report" is defined by the SPC 2007.

228 See supra text accompanying notes 64-66, 107-11, 128, 204. It is a questionable conclusion that "public criticisms have significant effects on [Chinese] listed companies and their executives." See Benjamin L. Liebman & Curtis J. Milhaupt, Reputational Sanctions in China's Securities Market, 108 COLUM. L. REV. 929, 929–30, Part III (2008). Rather, it is the real benefits the CSRC denies to, or the real costs the CSRC imposes on, an issuer and other related market participants in conjunction with a public criticism that produce the stock price effect or otherwise adversely affect the parties involved. See, e.g., Yunling Song & Xinwei Ji, Enforcement Actions and Their Effectiveness in Securities Regulation: Empirical Evidence from Management Earnings Forecasts, 5 CHINA J. ACCT. RES. 59, 61–62 n.2 (2012) (stating that market reaction in an event study reflects the informational content of the issuer's fraud and not of the regulator's effectiveness); Donghua Chen, Yuyan Guan, Gang Zhao & Feifei Wu, Securities Regulation and Implicit Penalties, 4 CHINA J. ACCT. RES. 47, 48 (2011) (stating that a reduction in the market share of the underwriting business suffered by the underwriters associated with their IPO client issuers' violations was not due to any reputational effect but was due to the CSRC's real penalties imposed on the underwriters for their clients' violations); see also Patricia M. Dechow, Richard G. Sloan & Amy P. Sweeney, Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC, 13 CONTEMP. ACCT. RES. 1, 3, 7 (1996).

229 The Securities Law specifies twelve "material events":

For the purposes of current reporting, occurrence of any of the following shall constitute a "material event": (1) any material change to the business policy and business scope of the company; (2) company decision concerning material investment or material assets acquisition; (3) company entering into a significant contract potentially having significant impact on its assets, liability, equity, and results of operations; (4) company incurring or default on a material debt; (5) company suffering material operating or other losses; (6) material changes to the conditions external to the company business operations; (7) changes to any director of board, one third of board of supervision, or any senior
with respect to "auditing activities prescribed in the Law of the People's Republic of China Governing Certified Public Accountants," which do not include attestation of prospective financial information.230 Thus, private causes of action under the SPC 2003 or the SPC 2007 are based on information of current and historical facts only, to the exclusion of forward-looking information.231 Lastly, while conditioning private actions on successful government action may prevent "frivolous litigation" and "entrepreneurial lawyer" abuses,232 unchecked agency discretion may leave

management of the company; (8) sizable change in ownership or control of any 5 percent shareholders or de facto controlling person(s) of the company; (9) company decision to reduce its share capital, merge, divest, dissolve, or apply for bankruptcy; (10) any major litigation involving the company; a resolution of the shareholder meeting or of the board of directors being nullified or declared invalid by law; (11) company or any members of its board of directors, board of supervision, or management being subject to criminal investigation; and (12) such other events as may be specified by the State Council securities regulatory agency.

See SECURITIES LAW 2014, supra note 45, art. 67. The CSRC's list of twenty-one material events is generally similar to the Securities Law's list of twelve material events, although it contains greater detail. See CSRC 2007-40, supra note 76, art. 30; see also supra text accompanying note 223.

230 See SPC 2007-12, supra note 218, art. 1; NAT'L PEOPLE'S CONG., PRC 2014-14: LAW OF THE PEOPLE'S REPUBLIC OF CHINA GOVERNING CERTIFIED PUBLIC ACCOUNTANTS, art. 14 (2014) (Westlaw China 万律 (Westlaw China)); see also supra text accompanying note 227.

231 Not surprisingly, neither the ten-year (2002–2011) review of private securities litigation in China nor the five-year (2007–2011) assessment of the CSRC's sanctions against listed issuers documented any single case based on an issuer's fraudulent forward-looking statement. See Robin Hui Huang, Private Enforcement of Securities Law in China: A Ten-Year Retrospective and Empirical Assessment, 61 AM. J. COMP. L. 757, 763–64 (2013); Weixia Gu, Securities Arbitration in China: A Better Alternative to Retail Shareholder Protection, 33 NW. J. INT'L L. & BUS. 283, 290–91 n.29 (2013); see also XINMIN LIU, THE ESSENTIALS OF THE CHINESE SECURITIES LAWS 275 n.2 (Beijing, Peking Univ. Press 2013) (stating that the "securities-related false statement" within the meaning of SPC 2003 refers to historical information, and thus does not reach forward-looking statements); BING PENG, CHINESE SECURITIES REGULATION 343 (Beijing, Higher Edu. Press 2007) ("As of current time, there has never been a single case of civil damage action based on material disparity between projected earnings and realized earnings.").

232 Securities Litigation Reform Proposals S.240, S.667, and H.R.1058: Hearings Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and
investors at the mercy of "regulatory capture." More specifically under China's institutional setting, the government is the controlling shareholder of most large issuers in most industry sectors. Both the securities regulators and the judiciary are part of the centralized government system. The confidential Central Fidelity File System creates an informational asymmetry between the regulated firms and the public investors, which, worsened by an undefined "force majeure" exoneration power wielded by the regulators, makes discretionary public enforcement real.


See supra text accompanying notes 204–18; see also Bó, supra note 233, at 210 (expounding a three-tier hierarchical agency model comprising three parties: a political principal (the government), its delegate (the regulator), and an agent (the regulated firm); and stating that asymmetric information between the principal and the agent is the source of regulatory discretion, making regulatory capture, or regulator-firm collusion, possible).

See supra text accompanying notes 64–66, 109, 128.
This Article therefore recommends a model of private action for materially false or misleading historical and forward-looking information, conditioned on either the government's pre-action or a showing by the private party of regulatory capture. Such an alternative avenue for private action should be designed both to compensate for any existing regulatory failure and to deter future captive relations between regulators and those they regulate.\textsuperscript{238} Such a private action without the government action precondition could additionally be subject to a net social positive externality analysis.\textsuperscript{239}

3. Ex Ante Perspective of “Fact” and “Materiality” of Projections Under Safe Harbor

Antifraud provisions in U.S. securities law proscribes any “untrue statement of a material fact,”\textsuperscript{240} not “untrue statements.”\textsuperscript{241} A statement of “fact” and a statement of “opinion” differ most importantly in the degrees of certainty and definiteness, and can be mutually embedded\textsuperscript{242}: an apparent “opinion” may have “fact” cores, and vice versa.\textsuperscript{243} In 1994, the SEC noted an “implied factual
assertions” doctrine to determine “an untrue statement of fact” in predictions and statements of opinion for purposes of fraud liability:

A projection or statement of belief contains at least three implicit factual assertions: (1) that the statement is genuinely believed, (2) that there is a reasonable basis for that belief, and (3) that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement.

If a prediction was not believed when made or did not have a valid basis, it would constitute an untrue statement of fact ....

Under the U.S. Supreme Court opinion in Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund, every statement of opinion “explicitly” affirms one fact: that the speaker actually holds the stated belief. Thus, a false description of one’s own state of mind constitutes an untrue statement of fact;

close context, directors’ statements of reasons or belief “are factual in two senses: as statements that the directors do act for the reasons given or hold the belief stated and as statements about the subject matter of the reason or belief expressed.” Equivalently, the statements of reasons do not misstate the directors’ reasons and do not mislead about the stated subject matter of the reason); AICPA, GUIDE: PROSPECTIVE FINANCIAL INFORMATION § 1.03 (2013) (“Prospective financial statements are based on assumptions regarding future events. The assumptions are in turn based on a combination of available information and judgment, in which both history and plans play a part.”).

244 Safe Harbor Concept Release, supra note 232, 59 Fed. Reg. at 52,727 (citing In re Apple Computer Sec. Litig., 886 F.2d 1109, 1113 (9th Cir. 1989)). See also Brief for SEC as Amicus Curiae 11–13 (No. 08-5442-cv) (Jan. 21, 2010), Slayton v. Am. Express Co., 604 F.3d 756 (2d Cir. 2010) (stating that for purposes of the statutory safe harbor, a forward-looking statement contains at least three implicit factual assertions, citing In re Apple Computer Sec. Litig., 886 F.2d 1109, 1113 (9th Cir. 1989)); Kripke, supra note 5, at 1198–99 ("[T]he sole factual elements of a projection should be that it represents management’s view, that it was reached in a rational fashion and that it is a sincere view. Only these elements can be subject to a statutory liability, not the eventuation of the prophecy.").

conversely, an opinion actually held when made remains true even if later proved to be erroneous.246 A reasonable investor may make inferences about the issuer's basis for its opinion; thus, if material facts conflict with a reasonable investor's expectations about the basis, but are undisclosed, the opinion is misleading.247 However, a reasonable investor does not expect that every fact known to an issuer supports its opinion. Whether an opinion is misleading when the issuer knows, but fails to disclose, facts undermining its opinion depends on a fair reading of the opinion in its full context.248

Thus, the "untrue statement of fact" in an earnings projection is not automatically the ex post discrepancy249 between projected and realized earnings: that provision is not "an invitation to Monday morning quarterback an issuer's opinions."250 Similarly, an objectively based251 projection may nevertheless turn out to be "objectively false" or ex post inaccurate.252 But the U.S. securities

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246 See Omnicare, 135 S. Ct. at 1326-27.
247 See id. at 1328-29.
248 See id. at 1329-30; cf. supra text accompanying note 244. Under the SEC's third "implied factual assertion," the SEC would automatically treat a non-disclosure of certain fact "cutting the other way," or, disconfirming an opinion, as misleading. In contrast, the Omnicare Court takes a holistic "fair reading" of an opinion "in its full context" approach to determine whether such non-disclosure would cause the opinion to be misleading. Omnicare, 135 S. Ct. at 1329-30.
249 See Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 514, 518 (7th Cir. 1989) ("If all estimates are made carefully and honestly, half will turn out too favorable to the firm and the other half too pessimistic. In either case the difference may disappoint investors, who can say later that they bought for too much (if the projection was too optimistic) or sold for too little (if the projection turns out to be too pessimistic) .... The securities acts do not have this ex post perspective.").
250 See Omnicare, 135 S. Ct. at 1327.
251 In evaluating whether an opinion is reasonably based, there is an interesting debate concerning whose perspective should be considered. Compare Omnicare, 135 S. Ct. at 1327-28 n.5, 1330-31 n.11 ("objective" test that looks at the perspective of a reasonable investor, which may include consistency with industry practice or reliance on advice from regulators), with id. at 1336-37 (Scalia, J., concurring in part and concurring in the judgment) ("subjective" test that looks at the perspective of the speaker instead of the listener).
252 Professor Wendy Couture appeared to have erroneously conflated "objectively false" and "objectively unreasonable." See Wendy Gerwick Couture, Opinions Actionable as Securities Fraud, 73 LA. L. REV. 381 passim (2013);
law antifraud provisions do not expose issuers to liability for mere "untrue statements," and thus not for ex post inaccurate projections that were genuinely believed and objectively based when made. Rather, the offense is the ex ante falsehood—be it an untrue statement of one’s truly-held projection (assuming materiality),

id. at 404 ("The falsity of an opinion is established only if it is both objectively and subjectively false."); id. at 414 ("As this Article has argued so far ... an opinion is only false if the speaker both objectively unreasonably and subjectively disbelieved it."). In reality, an issuer’s projection that was genuinely held and objectively based—such as by relying on applicable regulations and following professional guidelines and industry practice—may still turn out to be inaccurate. To equate “objectively false” with “objectively unreasonable” would turn an antifraud-compliant projection into a “guarantee” of realization. "The [Securities] Act does not go that far." See United States, Omnicare Amicus Brief, supra note 245, at 30–31; see also AICPA, GUIDE: PROSPECTIVE FINANCIAL INFORMATION § 7.01 (2013) ("The responsible party should have a reasonably objective basis to present a financial forecast .... The term reasonably objective basis communicates to responsible parties a measure of the quality of information that is necessary to present a financial forecast."); Kripke, supra note 5.

The second error in Professor Couture’s statement (that “[t]he falsity of an opinion is established only if it is both objectively and subjectively false,” see supra, at 404) is that she conflates ex post and ex ante perspectives, and would have the ex post outcome of an opinion partially determine or bear upon the ex ante falsity of the opinion. But the U.S. federal securities laws distinguish between ex ante and ex post perspectives, and do not Monday morning quarterback an issuer’s opinion. See supra note 249; see also Omnicare, 135 S. Ct. at 1327.

Thirdly, Professor Couture’s “both objectively and subjectively false” or “dual-falsity” proposition (see supra, at 404, 407) conflicts with the 1994 and 2010 SEC positions and the 2015 U.S. Supreme Court Omnicare decision. Both the SEC and the Omnicare Court hold that an opinion is false either because it falsely describes one’s own state of mind or because it is not reasonably based. To establish falsehood of an opinion does not require both. See supra text accompanying note 244; Omnicare, 135 S. Ct. at 1326, 1328–29 n.6.

253 See Omnicare, 135 S. Ct. at 1325–26. The Author’s argument here assumes that either there was no duty to update a projection or that such a duty had been satisfied.

254 See Stransky v. Cummins Engine Co., Inc., 51 F.3d 1329 (7th Cir. 1995) 1332 ("The securities laws approach matters from an ex ante perspective: just as a statement true when made does not become fraudulent because things unexpectedly go wrong, so a statement materially false when made does not become acceptable because it happens to come true.").

255 A temporal distinction (i.e., an inadvertent ex post correct result versus an inadvertent ex ante correct assessment) exists between the two scenarios: where an ex ante false projection happens to materialize due to unexpected
or an omission of material facts conflicting with a reasonable investor's fair inferences of the projection's basis. Only such ex ante material misstatement or omission, rather than the ex post non-eventuation of the projection, should be subject to liability. 256

In contrast to such an ex ante perspective of "fact" in an opinion, and consistent with their ex post perspective of "fact" in the definition of "securities-related false statement" as "an untrue statement contrary to facts," 257 Chinese securities regulators adopt a bright-line approach to projection regulation. Ex ante, issuers are required to expressly warrant the "accuracy" and "objectivity" of their earnings projections. 258 Ex post, the regulators penalize issuers for projection inaccuracies exceeding the regulatory thresholds arbitrarily and uniformly set for all industries irrespective of their characteristics or volatilities. 259 Such ex ante accuracy warranty is counterproductive to investor protection, as users of projections would be better served with information concerning uncertainty associated with the projections, such as probability statements 260

intervening events, and where a person thinks he is lying but is accidentally actually telling the truth about the subject matter of his opinion. In the latter "rare" case, courts have not imposed liability under Section 10(b) or Section 14 of the Securities Exchange Act or Section 11 of the Securities Act for such sheer "impurities" of the "unclean heart." See Omnicare, 135 S. Ct. at 1326 n.2 (citing Va. Bankshares v. Sandberg, 501 U.S. 1083, 1095–96 (1991) (quoting Stedman v. Storer, 308 F. Supp. 881, 887 (S.D.N.Y. 1969)). The latter scenario would fail, but the former scenario may meet, the materiality test. See id.; see also supra note 254.

256 See Omnicare, 135 S. Ct. passim; see also Denny v. Barber, 576 F.2d 465, 470 (2d Cir. 1978) (equating the claim to "alleging fraud by hindsight"); DiLeo v. Ernst & Young, 901 F.2d 624, 627–28 (7th Cir. 1990) (stating that there is no "fraud by hindsight").

257 See supra text accompanying note 223.

258 See supra text accompanying note 140. While the stock exchanges mandate "accuracy" representation, the CSRC requires a "uniform" cautionary legend. See supra text accompanying note 61.

259 See supra text accompanying notes 64–66, 128, 206–11; cf. Sudip Datta, Mai Iskandar-Datta & Vivek Sharma, Product market pricing power, industry concentration and analysts’ earnings forecasts, 35 J. BANK & FIN. 1352, 1352–53 (2011) (stating that firms in more concentrated industries are expected to have higher earnings forecastability due to greater pricing power, whereas firms in fragmented, competitive industries are expected to have lower earnings forecastability due to greater information complexity).

260 See supra text accompanying notes 197–98; see also 17 C.F.R. § 229.10(b)(3)(i) (2016) (exhorting forecasting issuers to caution investors against attributing undue certainty to management projections); cf. Beecher
and meaningful cautions. The ex post inaccuracy penalty mechanism motivates issuers' strategic projection behaviors, such as "projecting" ex post facts and earnings management, to achieve greater forecast accuracy. Issuer forecasts distorted by such ex post policy deprive forecasting of its resource allocation role. Public enforcement based solely on ex post variance can result in mistaken liability or "Type I error" for good faith, reasonably made projections that do not materialize, thus discouraging voluntary disclosure. It can also result in mistaken innocence or "Type II error" for fraudulent projections that happen to come true, thus reducing enforcement deterrence. This Article recommends v. Able, 374 F. Supp. 341, 348 (S.D.N.Y. 1974) ("[A] reasonably prudent investor would conclude [from an earnings forecast] that it was highly probable that the forecast would be realized."); Kowal v. IBM (In re IBM Corp. Sec. Litig.), 163 F.3d 102, 107 (2d Cir. 1998) (holding that statements regarding projections of future performance may be actionable under Section 10(b) or Rule 10b-5 if they are worded as guarantees or are supported by specific statements of fact).

An issuer's cautionary language accompanying the public projections may not be "meaningful" within the statutory safe harbor when it did not mention the (or any of the) important sources of variance. Id. at 734. The safe harbor may apply if the issuer can establish that its "cautions did reveal what were, ex ante, the major risks." Id. at 735. The statute "rules out a caution such as: 'This is a forward-looking statement; caveat emptor.'" Id. at 729; cf. supra text accompanying note 61 (discussing the CSRC's "uniform cautionary legend" requirement).

See Asher v. Baxter Int'l, Inc., 377 F.3d 727, 729, 734–35 (7th Cir. 2004). An issuer's cautionary language accompanying the public projections may not be "meaningful" within the statutory safe harbor when it did not mention the (or any of the) important sources of variance. Id. at 734. The safe harbor may apply if the issuer can establish that its "cautions did reveal what were, ex ante, the major risks." Id. at 735. The statute "rules out a caution such as: 'This is a forward-looking statement; caveat emptor.'" Id. at 729; cf. supra text accompanying note 61 (discussing the CSRC's "uniform cautionary legend" requirement).

262 See supra Table 3.

263 See supra text accompanying note 178.


265 See Martin Walker, Forecast Disclosure: An Information Economics Perspective, 12 J. BUS. FIN. & ACCT. 355, 368 (1985) (stating that benefits from the allocation role of forecasts can only arise if the forecasts are made available in time for resource reallocation to take place); Ronald King, Grace Pownall & Gregory Waymire, Expectations Adjustment via Timely Management Forecasts: Review, Synthesis, and Suggestions for Future Research, 9 J. ACCT. LIT. 113, 124 (1990) (arguing that for a disclosure to adjust investor expectations, it must be credible, precise, and timely).

introducing a “fact versus opinion” concept into the Chinese securities laws’ definition of “false statement,” and a reorientation from the ex post variance-based naive enforcement to an ex ante fact-based determination of falsehood in projections.

Where an issuer’s projection contains a misstatement or an omission as determined on an ex ante basis, materiality of the falsehood must be ascertained for fraud liability to attach. Under U.S. case law, “a misrepresentation or omission is ‘material’ if a reasonable investor would have considered the information significant when contemplating a statutorily relevant investment decision.” The Chinese securities laws prescribe no general definition of “materiality” but define, in the context of required current reporting of material events, a “material event” as “the occurrence of an event investors’ knowledge of which may produce a substantial impact on the trading prices of the issuer’s stock and/or its derivatives.”

public enforcement of law); cf. RON LARSON & BETSY FARBER, ELEMENTARY STATISTICS 323–24 (2nd ed. 2004) (defining Type I and Type II errors).

A materiality assessment should be made of the misrepresentation or omission, rather than of any particular categories of information as inherently significant to investors. The latter approach is rightly criticized by a commentator as “adding little discipline to the process” and “going beyond the established legal standard.” Richard C. Sauer, The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws, 62 BUS. LAW. 317, 327–28 (2007).


Chadbourne & Parke v. Troice, 134 S. Ct. 1058, 1066 (citing Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1318–19 (2011). See also Omnicare, 135 S. Ct. at 1327 ("Whether a statement is 'misleading' depends on the perspective of a reasonable investor: The inquiry (like the one into materiality) is objective.").

See SECURITIES LAW 2014, supra note 45, art. 67; CSRC 2007-40, supra note 76, art. 30; see also supra note 229; cf. 17 C.F.R. §§ 230.405, 230.408(a) (2016), 240.12b-2, 240.12b-20 (2016) (requiring “such further material information” to be added to the information expressly required in a Securities Act registration statement or an Exchange Act statement or report, as may be
Whether under a "reasonable investor would consider significant" standard or a "substantial market price impact" standard, materiality of any factual falsehood in an earnings projection should be evaluated on an ex ante basis, i.e., the effect on the reasonable investor or on the market price of the relevant security at the time of the projection, rather than the subsequent time of earnings realization. Disclosure of realized earnings does not

necessary to make the required statements made not misleading; and defining the term "material".

272 For a critical analysis of the reasonable investor-based traditional model versus the market price-based market model of the investment decision, see generally Daniel R. Fischel, Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities, 38 BUS. LAW. 1 (1983). For an argument that Basic and TSC Industries accommodate both definitions of materiality, see generally Richard A. Booth, The Two Faces of Materiality, 38 DEL. J. CORP. L. 517 (2014). See also Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2413–14 (2014) (elaborating on the four prerequisites for invoking the Basic presumption, stating that if a misrepresentation was immaterial, it would not have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available, and could not have distorted the stock's market price).

273 See, e.g., Fischel, supra note 272, at 6–7 n.19 (arguing that information that is stale or not credible would be disregarded by the market); ARNOLD S. JACOBS, DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS § 12:29 n.19 (2014) ("Materiality is measured when the alleged violation occurred."); see also Future Economic Performance Projections, supra note 171, 40 Fed. Reg. at 20,318 (stating that the determination as to compliance with the safe harbor criteria would be based on the facts at the time the projection was disclosed). Both the fraud-on-the-market theory and the truth-on-the-market theory point to the time when the material misstatement or omission occurred. See Donald C. Langevoort, Judgment Day for Fraud-on-the-Market: Reflections on Amgen and the Second Coming of Halliburton, 57 ARIZ. L. REV. 37, 56 (2015) ("If the facts at issue appear to be material, one can fairly presume that their misrepresentation or omission would necessarily distort the market price unless the market somehow already knew the truth."). The term "price distortion" (or price impact) should be differentiated from the term "price reaction" (or price change, price move, price adjustment). Price distortion refers to the market price being different from what it otherwise would have been absent the misrepresentation. Price reaction refers to the visible market price change as may be captured and measured by an event study. A "confirmatory lie," i.e., a misstatement made to meet the existing market expectations, demonstrates the difference. A confirmatory lie at the time of its making may produce a fraudulent price distortion without producing any apparent price move, such as by preventing the prevailing market price from falling. See Lucian Bebchuk & Allen Ferrell, Revisiting Basic, 69 BUS. LAW. 671, §§ III-A, III-D (2014).
equate with the “corrective disclosure” in the event study sense. By definition, corrective disclosure reveals the truth. The “truth” in a management earnings forecast is not, however, the “realized” earnings but is the management’s ex ante genuinely-held and objectively based “expectation” of earnings. Similarly, the concept of “forecast error,” measured as the difference between realized earnings and forecast earnings properly scaled, does not equate with the concept of “economic loss,” measured by the difference between the artificial price paid and the corrected market price when the truth is revealed.

A forecast error reflects both information arriving between the earnings forecast date and the earnings report date and any management bias or deviation from its true expectations. Thus, “forecast error” can be decomposed into a “true” forecast error component and a “bias” component. The “true” forecast error component, reflecting post-forecast macroeconomic shock, industry condition, and firm-specific information, should not expose the

274 For the use of event studies to determine materiality, see, for example, Mark L. Mitchell & Jeffrey M. Netter, The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission, 49 BUS. LAW. 545 (1994).


277 See supra text accompanying note 151.

278 See Robert N. Rapp, Plausible Causes: Exploring the Limits of Loss Causation in Pleading and Proving Market Fraud Claims Under Securities Exchange Act § 10(b) and SEC Rule 10b-5, 41 OHIO N.U. L. REV. 389, 399 (2015); see also Dura Pharma., Inc. v. Broudo, 544 U.S. 336, 345 (2005) (stating that the securities statutes make private securities fraud actions available, not to provide investors with broad insurance against market losses, but to protect investors against economic losses actually caused by the misrepresentations).

279 Maureen McNichols, Evidence of Informational Asymmetries from Management Earnings Forecasts and Stock Returns, 64 ACCT. REV. 1, 6–7 (1989).

280 Id. at 19 n.17, 25. Cf. Dura, 544 U.S. at 342–43 (stating that in the loss causation context, intervening causes such as “changed economic circumstances, changed investor expectations, new industry-specific or firm-specific
forecasting issuer to liability under Omnicare’s “genuinely held” and “objectively based” standards. The “bias” component, be it management’s intentional bias to misrepresent thus conflicting with Omnicare’s “actually held” standard, or management’s cognitive biases thus conflicting with Omnicare’s “objectively based” standard, should be measured for materiality. This may have caused all or part of the later loss).  

281 See supra text accompanying notes 246–47, 250.  

282 See supra text accompanying note 246; see also McNichols, supra note 279, at 17.  

283 See supra text accompanying note 247 (discussing lack of reasonable basis as a disjunctive test for establishing falsehood of an opinion); see also McNichols, supra note 279, at 17 (requiring an expectation of earnings to be both “true” and “unbiased” to qualify for true forecast error); cf. supra note 252 (arguing for a “dual falsity” test for establishing falsehood of an opinion).  

For legal literature commenting on management’s intentional bias and cognitive bias, see, for example, HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES LAW HANDBOOK 256–58 (2015) (stating that a “blinded” or overconfident corporate officer is capable of making misleading forward-looking statements without deliberately intending to defraud investors, but investors may be hurt as much or more by such misleading forward-looking statements than by a deliberate scheme to defraud them).  

For economic and accounting literature studying managerial forecasting biases, see generally Guojin Gong, Laura Y. Li & Jeff J. Wang, Serial Correlation in Management Earnings Forecast Errors, 49 J. ACCT. RES. 677 (2011) (concluding that management earnings forecast errors should not exhibit serial correlation if managers truthfully convey their earnings expectations and efficiently process information, i.e., management has neither intentional bias to misrepresent nor cognitive bias); Gilles Hilary & Charles Hsu, Endogenous Overconfidence in Managerial Forecasts, 51 J. ACCT. & ECON. 300 (2011) (documenting that managers’ self-serving attribution cognitive bias led to less accurate forecasts subsequent to a series of accurate predictions); Paul Hribar & Holly Yang, Does CEO Overconfidence Affect Management Forecasting and Subsequent Earnings Management? (Mar. 2010) (unpublished manuscript), http://web-docs.stern.nyu.edu/old_web/accounting/docs/Summer_Camp/Hribar.Yang.Does.CEO.Overconfidence.Affect.Mgmt...pdf [https://perma.cc/6PU2-VVUH] (concluding that overconfident managers are more likely to issue optimistically biased forecasts); Catherine M. Schrand & Sarah L.C. Zechman, Executive Overconfidence and the Slippery Slope to Financial Misreporting, 53 J. ACCT. & ECON. 311 (2012) (concluding that overconfident executives are more likely to exhibit an optimistic bias and thus are more likely to start down a slippery slope of growing intentional misstatements, possibly to the degree of fraudulent intent within the meaning of SEC Rule 10b-5). See
Article recommends the abandonment of the CSRC's current 20 percent/50 percent forecast error policy (i.e., "public apology" and related penalties for a 20 percent ex post over-projection and a "three-year offering ban" for a 50 percent ex post over-projection—"itself a biased enforcement policy indeed). In lieu thereof, it recommends the adoption of a "random error versus bias" decomposition approach to assess materiality of an ex ante untrue projection.

284 See supra note 267. In 1975, the SEC solicited comments on "whether specific percentage tests of materiality should be adopted for projections and, if so, what percentage would be appropriate." See Future Economic Performance Projections, supra note 171, 40 Fed. Reg. at 20,317–18.

285 See McNichols, supra note 279, at 22; see also Janet Cooper Alexander, Rethinking Damages in Securities Class Actions, 48 STAN. L. REV. 1487, 1498 n.39 (1996) ("[P]rojections or statements about the future can turn out to be wrong through bad luck or bad judgment as well as fraud."); Healy & Palepu, supra note 6, at 423 (commenting that the legal system will be penalizing forecasts made in good faith if it cannot effectively distinguish between unexpected forecast errors due to chance and those due to deliberate management bias); cf. Basic v. Levinson, 485 U.S. 224, 232 n.9, 238–39 (applying a probability/magnitude test of materiality to contingent or speculative information or events such as preliminary merger negotiations, but noting "[w]e do not address here any other kinds of contingent or speculative information, such as earnings forecasts or projections.").

For the use of the "statistically significant" concept to determine "materiality" in the securities fraud context, compare Frederick C. Dunbar & Dana Heller, Fraud on the Market Meets Behavioral Finance, 31 DEL. J. CORP. L. 455, 507–09 (2006) (noting that in an efficient market, if the price impact of a misleading information (or a corrective disclosure) is statistically insignificant, then the information (or the disclosure) is immaterial at that time; in an inefficient market, such a direct link between materiality of the information to the average market participant and the stock price response to the information does not necessarily hold), with Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1321 (2011) (stating that, in assessing the materiality of drug adverse event reports for disclosure purposes under Section 10(b) and Rule 10b-5, the reports' statistical significance or lack thereof is not dispositive of every case; and that a "fact-specific" inquiry into the source, content, and context of the reports is required (quoting Basic v. Levinson, 485 U.S. at 236)). Under the "random error vs. bias" decomposition approach proposed in this Article, only the price impact attributable to the bias component at the time of the earnings projection should be tested for materiality, by statistical significance or otherwise. See supra text accompanying notes 240–41, 246–47, 272–83. Where an earnings
CONCLUSION

Issuer forecasting fares with striking differences under the two regimes. In the United States, issuer earnings forecasts are discretionary. In China, earnings forecasts are mandatory for issuers whose expected earnings meet regulator-set risk or volatility benchmarks, who use offering proceeds for significant asset purchases, or who effect a related party Significant Assets Restructuring (SAR). In the United States, the forecasting issuers are exposed to private litigation risk, but are also shielded by safe harbors and demanding liability standards. In China, projection is found materially false ex ante, proof of any economic loss in a private fraud action should also be subject to such a "random error vs. bias" decomposition test, to wring out any market loss which may be reflected in the realized earnings report. See, e.g., Dura, 544 U.S. at 343, 345; Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179, 2186 (2011) (citing Dura, 544 U.S. at 342-43) ("Loss causation ... requires a plaintiff to show that a misrepresentation that affected the integrity of the market price also caused a subsequent economic loss .... If one of those [intervening] factors were responsible for the loss or part of it, a plaintiff would not be able to prove loss causation to that extent."). For calculation methodologies, see generally Allen Ferrell & Atanu Saha, Forward-Casting 10b-5 Damages: A Comparison to Other Methods, 37 J. CORP. L. 365, 366-67, Part V (2012) (proposing a forward-casting method in place of the back-casting methods for estimating Rule 10b-5 damages, and stating that the analysis is also useful in determining whether the misinformation was "material").

See supra text accompanying note 20.

See supra Parts I.A, I.B, I.C.

There are eight express private rights of action under the Securities Act and the Exchange Act, and four implied private causes of action under the Exchange Act; most relate to material misrepresentations and omissions. See Hillary A. Sale, Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA’s Internal-Information Standard on ’33 and ’34 Act Claims, 76 WASH. U. L. Q. 537, 541 n.7 (1998).

The statutory safe harbor requires a private plaintiff to prove that the defendant acted "with actual knowledge" of the falsity. See 15 U.S.C. §§ 77z-2(c)(1)(B), 78u-5(c)(1)(B) (2012). Even if a defendant fails the safe harbor, for the plaintiff to prevail on a Section 10(b) and Rule 10b-5 general antifraud private action, it must plead and prove six elements, including scienter proven by "a strong inference." See 15 U.S.C. § 78u-4(b)(2) (2012); Chiarella v. United States, 445 U.S. 222, 226 (1980) (stating that Section 10(b) was designed as "a catch-all clause" for fraud); Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 157 (2008) (citing Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341-42 (2005)) (setting forth six elements a plaintiff
the securities laws provide no express or implied private right of action to investors on account of fraudulent forward-looking statements; nor do the securities laws provide any safe harbor to the forecasting issuers.

Instead, issuer forecasts are regulated by the China Securities Regulatory Commission, the Shanghai Stock Exchange, and the Shenzhen Stock Exchange according to their respective jurisdictions and respective standards. Public enforcement of issuer forecasts is effected via a confidential Central Fidelity File System, which scores and records any substantial discrepancies between an issuer's forecasted earnings and realized earnings, and the CSRC and other government agencies mete out regulatory and administrative rewards and penalties based on the ex post accuracy or inaccuracy of an issuer's projections.

Most notable is the CSRC's "20 percent/50 percent" rule: an issuer with a 20 percent ex post over-projection must offer public apologies, and an issuer with a 50 percent ex post over-projection shall be denied access to the public offering market for a period of three years—unless exonerated by the CSRC on an undefined "force majeure" ground. Complementary to the stick is the carrot: an issuer with ex post accurate earnings projections will be granted favorable treatment when it applies for a securities offering. Empirical data sampled by this Article analyzing the must prove in a typical Section 10(b) private action: "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation"; Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976) (defining "scienter" as "a mental state embracing intent to deceive, manipulate, or defraud."); Tellabs v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007) (holding that a "strong" inference of scienter is one that is "more than merely plausible or reasonable" but is "cogent and at least as compelling as any opposing inference of nonfraudulent intent."). Even though Section 11 liability against issuers is "virtually absolute," it is "no small task" for investors to prove an issuer's unfulfilled opinion misleading. See Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983); Omnicare, Inc. v. Laborers Dist. Council Contr. Indus. Pension Fund, 135 S. Ct. 1318, 1332 (2015).

See supra text accompanying notes 212–27.

See supra Part II.B.1.

See supra text accompanying notes 153–63.

See supra text accompanying notes 204–11.

See supra text accompanying notes 64–66, 128.
FY 2013 earnings forecasts by Shanghai and Shenzhen stock exchange listed issuers show that more than 50 percent were issued ex post facto in 2014.\textsuperscript{295} Empirical literature reviewed by this Article has noted issuers' use of government subsidies to meet regulatory requirements or market expectations.\textsuperscript{296} This Article argues that issuers' strategic forecasting behavior and earnings management may have been induced by regulators' accounting number-based ex post accuracy policy.

To regulate the Chinese listed issuers' earnings forecasts and other forward-looking disclosure, this Article recommends the construction of a legal framework that is fair, open, and transparent. Underlying the legal framework could be a centralized, CSRC-administered issuer disclosure and reporting system for both historical and forward-looking information, to ensure a level playing field for issuers listed on the SHSE (which features large, state-controlled issuers) and those on the SZSE (which features private entrepreneur-controlled issuers).\textsuperscript{297} One pillar supporting the legal framework should be an open and independent judicial system, to be recognized by the Constitution of the People's Republic of China, and a meaningful express private right of action to investors on account of fraudulent forward-looking information, to be written into the Securities Law of the People's Republic of China. Not only does public enforcement by the confidential Central Fidelity File System fail to provide economic compensation to investors, but such a confidential system also creates an information asymmetry between investors and regulated entities and increases the risk of regulatory capture.\textsuperscript{298} Equally important is the other pillar of the legal framework: a safe harbor for forward-looking statements conditional on an advance audit review. As the literature demonstrates, the market benefits from informational intermediaries' monitoring role, and investors and issuers alike benefit from increased amounts of quality corporate disclosure in the marketplace.\textsuperscript{299}

\textsuperscript{295} See supra text accompanying note 152; supra Table 3.
\textsuperscript{296} See supra text accompanying note 178.
\textsuperscript{297} See supra text accompanying notes 164-70.
\textsuperscript{298} See supra Part II.B.2.
\textsuperscript{299} See supra text accompanying notes 3-6; supra Part II.B.1.
This Article also recommends an ex ante versus ex post perspective as a theoretical guide to the legal framework and the disclosure system. With respect to voluntary earnings projections or discretionary disclosure in general, economic theory has espoused an economically efficient disclosure regime. This Article argues that, rather than requiring issuer ex ante disclosure of assumptions and ex post disclosure of variances, it is more meaningful to require an ex ante audit review of issuer's material assumptions together with an ex ante issuer's disclosure of probabilistic statements. Similarly, rather than imposing “a duty to update” a voluntary disclosure thus converting a voluntary disclosure act into a mandatory continuous disclosure obligation, it would better encourage voluntary disclosure to have a mechanism that allows issuers to make efficiency-based voluntary disclosure choices, such as a requirement for a timely issued current report to disclose discontinuance of projections.

The Chinese legal system may benefit from the U.S. legal theory enunciating the “untrue statement of ... fact” in an opinion. Under the U.S. Supreme Court’s Omnicare standard, an opinion which ex ante (i.e., at the time of its making) was actually held and reasonably based—as viewed from the perspective of a reasonable investor—precludes liability, even though the opinion was erroneous ex post. An opinion which ex ante was either not genuinely believed or not reasonably based triggers liability (assuming materiality).

In contrast to Basic’s reasonable investor test for materiality of a misrepresentation or omission, the Chinese securities laws adopt a market price test for materiality of certain current events.

300 See supra text accompanying notes 182–87.
301 See supra text accompanying notes 22, 61, 135; supra note 26.
302 See supra text accompanying notes 195–98.
303 See supra text accompanying notes 23–26, 30, 134.
304 See supra text accompanying notes 187–89.
305 See supra text accompanying notes 240–48.
specified by the Securities Law. To assess the materiality of an ex ante false earnings projection (and proof of economic loss attributable to an earnings projection materially false ex ante), this Article proposes a “random error versus bias” decomposition approach, to separate the ex post random error component from the ex ante management bias component. It suggests that, consistent with Omnicare’s fact-opinion dichotomy and fact-opinion possible mutual embedment, only the management bias component of the forecast error—be it management’s intentional bias to misrepresent or cognitive biases—should be subject to the “untrue statement of a material fact” analysis.

Debate in economics and finance literature over the relative virtues of public versus private enforcement has not examined the China phenomenon. In this Article, the Author argues against enforcement solely by the government pursuant to a confidential and discretionary Fidelity regulation regime. The Article recommends a conditional private right of action to supplement public enforcement against materially false or misleading forward-looking statements. Further sophistication of the Chinese issuers and investors, as well as China’s legal system, may provide a new ground to test the public versus private enforcement theories.

308 See supra text accompanying notes 229, 271.
309 See supra text accompanying notes 268-85.
310 Compare R. La Porta, F. Lopez-de-Silanes & A. Shleifer, What Works in Securities Laws?, 61 J. Fin. 1 (2006) (arguing that securities laws matter not because of public regulatory enforcement, but because of extensive disclosure requirements and standards of liability to improve market discipline and private litigation), with Howell E. Jackson & Mark J. Roe, Public and Private Enforcement of Securities Laws: Resource-based Evidence, 93 J. Fin. Econ. 207 (2009) (arguing that resource-based public enforcement is regularly associated with deeper securities markets, as strongly as is disclosure, and that there is no significant evidence that private enforcement liability standards play a role in developing financial markets).
Footnotes: Bibliographical References to Chinese Language Resources*


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