Securities Law

China’s Regulatory Crackdown Is Increasing Securities Litigation Risk

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April 1, 2022, 4:00 AM

China’s recent regulatory initiatives involving the technology, data privacy, and education industries have resulted in shareholder securities fraud class actions against China-based companies listed on U.S. exchanges, according to Alston & Bird attorneys. They look at some of the cases and offer suggestions on what U.S. companies can do to mitigate risk.

Over the past year, the People’s Republic of China (PRC) has gained global attention by undertaking multiple regulatory initiatives cracking down on the technology, data privacy, and education industries. These initiatives have been blamed, at least in part, for a slowing Chinese economy. Even so, commentators following China are split on whether the coming year will bring further regulatory tightening.

The implications of the PRC’s regulatory policy initiatives extend far beyond its borders. Following the announcement of significant regulatory crackdowns by the PRC, shareholder plaintiffs have begun filing securities fraud class actions against China-based companies listed on U.S. exchanges. So far, these suits have been filed against companies in the wake of PRC education, cybersecurity, and privacy regulations.

While it remains to be seen whether and how the PRC will continue its regulatory push into 2022, these securities class actions demonstrate that shareholder plaintiffs will likely continue to focus on China-based companies’ regulatory-related disclosures, particularly following the issuance of significant regulations or the announcement of new enforcement actions.

PRC Regulatory Initiatives and Cases That Followed

Most recently, in February, shareholder plaintiffs filed a pair of securities class actions against two NYSE-listed private educational and tutoring companies—TAL Education Group and New Oriental Education & Technology Group—following the PRC’s July 2021 announcement banning education companies from raising money through public securities offerings or from foreign investors.

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In both lawsuits, shareholder plaintiffs alleged defendants issued false and misleading statements that they operated in compliance with PRC regulations and would benefit from future regulations.The education companies allegedly suffered stock price declines of greater than 90% following the announcement of the July 2021 PRC regulations, among other things.

Similarly, in July 2021, shareholder plaintiffs filed securities class actions against three newly public technology companies—DiDi Global, Full Truck Alliance, and Kanzhun Limited—in the wake of significant data privacy rules announced by the PRC.

The suits followed purported PRC cybersecurity regulatory investigation revelations about the companies that came to light weeks after each conducted initial public offerings on a U.S. stock exchange.

The complaints focused on each company's alleged failure to disclose they were subject to a cybersecurity regulatory review that could hinder business prospects, including by suspending new user registrations on their platforms or by removing their apps from app stores. The technology companies allegedly suffered stock price declines of approximately 5% to 15% following the announcement of the PRC cybersecurity agency's investigations.

How to Manage Securities Litigation Risk

As these cases demonstrate, shareholder plaintiffs have pursued new theories in the wake of stock price declines following the issuance of significant regulation by the PRC.

In light of these recent developments, companies should consider and take steps to manage the emerging securities litigation risk related to regulation by China.

Consider shareholder focus on China-based companies. As seen in the recent suits against education and technology companies based in China and listed on U.S. exchanges, companies based in China and operating in any heavily regulated industry, but subject to U.S. securities laws, should remain mindful of their regulatory-related disclosures.

Evaluate the potential for heightened risks to technology companies. Companies in the technology sector may face heightened securities litigation risk because the Chinese government has recently signaled a continued interest in regulating technology companies operating there.

For instance, Chinese rules came into force earlier this month governing the way technology companies use recommendation algorithms, which may impact the algorithms that power some of China's most notable homegrown tech giants. Technology companies should consider whether to strengthen their regulatory-related disclosures in light of the emerging risks for the industry.

Stay up-to-date on the evolving regulatory landscape. Companies with significant operations in China that are subject to Chinese law should remain keenly aware of the quickly changing regulatory landscape there, including regulations that could significantly impact their business operations or prospects.

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Companies holding data that the PRC may consider sensitive from an intelligence perspective should be particularly mindful of their regulatory risk. Many analysts believe that the PRC’s regulatory actions against DiDi in the wake of its initial offering on the New York Stock Exchange was driven, at least in part, by the PRC’s concern about a company with sensitive data on Chinese citizens developing close relations with Western investors and Western regulators. Companies that may face similar actions should consider how to appropriately disclose that risk to investors.

Review regulatory-related disclosures about future regulation: These recent securities class actions suggest that companies impacted by the PRC’s regulatory crackdown may remain subject to shareholder litigation based in part on their disclosures about the potential impact of future PRC regulation.

Companies should continue to pay close attention not only to their disclosures related to current regulatory compliance but also keep in mind the breadth of potential future PRC regulation and their related disclosures.

Analyze potential impacts outside China. While the focus has been on China thus far, U.S. exchange listed companies based abroad in countries other than China should be mindful of the heightened securities litigation risk in the U.S.

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