View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by Research Papers in Economics

American Law & Economics Association Annual Meetings

Year 2004 *Paper* 77

Addressing Deterrence and Regulatory Failure in Emerging Stock Markets

Katharina Pistor
Columbia Law School

This working paper site is hosted by The Berkeley Electronic Press (bepress) and may not be commercially reproduced without the publisher's permission.

http://law.bepress.com/alea/14th/art77

Copyright ©2004 by the author.

Addressing Deterrence and Regulatory Failure in Emerging Stock Markets Lessons from China[1]

Katharina Pistor[2]

&

Chenggang Xu

Abstract:
Effective legal governance of stock markets is a difficult task as evidenced by the repeated failure of governance systems. We identify two major sources of enforcement failure: deterrence failure and regulatory failure. These problems are particularly acute in emerging markets and transition economies, where law is underdeveloped and enforcement agents are weak. The prediction that follows from this diagnosis is that emerging markets should be prone to frequent failure, which is in fact what we observe. Yet, Chinese financial markets have performed substantially better than these insights would predict. We identify and analyze governance mechanisms that have substituted standard law enforcement mechanisms as known in the West with mechanisms that are more akin to administrative governance. We also discuss the limits of these governance mechanisms and call attention to the transformation of financial market governance currently under way in China.

JEL classification: G3, K2, K4, N2,

---

[1] Insightful discussions with FANG Liufang, GAO Xiqing, LIANG Zhiping, WU Jinglian and comments from participants of the seminars at Shanghai Institute for Law and Economics and Tsinghua Law School are greatly acknowledged. We would like to thank Daniel Magida for excellent research assistance and Mingxing Liu and Huilian Zhang for help in data.
[2] Financial Support from the Milton Handler Faculty Research Fellow Fund is gratefully acknowledged.

bepress Legal Repository

Hosted by The Berkeley Electronic Press

I. Introduction

This paper analyzes the emergence of institutions governing financial markets in China, and explores the political determinants of institutional choice. We argue that the initial conditions for developing equity markets are quite unfavorable in emerging markets generally and in the former socialist countries in particular. The reason is that law and related governance mechanisms are important determinants for financial market development (La Porta et al., 1997; Pistor, 2001). Yet, initial conditions in emerging markets and in particular in transition economies suggest that they are prone to enforcement failure. Based on earlier work (Pistor and Xu, 2003; Xu and Pistor, 2004) we identify two sources of enforcement failure: deterrence failure and regulatory failure. Deterrence failure results from the ability of courts to effectively enforce the law. The reason may lie in the incentive structure courts face (Glaeser, Johnson, and Shleifer, 2001a); in their corruptibility (Glaeser and Shleifer, 2003); or in the fact that law is highly incomplete and that, therefore, even the best courts may be unable to deter optimally (Pistor and Xu, 2003; Xu and Pistor, 2004). Moreover, the incompleteness of law in emerging markets may get a lot worse due to the political economy of their lawmaking process. Regulatory failure again may be caused by weak or corrupt regulators (Stigler, 1971), but also by the lack of reliable firm specific information without which regulators will either over- or under-enforce the law (Xu and Pistor, 2004). In transition economies deterrence failure is particularly likely, because courts are weak and inexperienced, and law is highly incomplete. Transplanting comprehensive legal codes from abroad is no easy remedy to address the incomplete law problem, because

bepress Legal Repository

these codes have not been put to a test and their meaning and application in the law receiving country therefore remains uncertain (Berkowitz, Pistor, and Richard, 2003b; Ohnesorg, 2003). In addition, transition economies may suffer from regulatory failure, because of the lack of reliable firm specific information. Given the severity of the deterrence and regulatory failure problems in transition economies, we predict that financial markets in these economies will be hard to develop or it will be retarded.

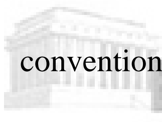
Taking this prediction as a starting point, we selected a country that seems to defy our prediction. This country is China. China had a very weak legal basis when it began to develop financial markets in the early 1990s. Moreover, courts were weak, and – as we will further document below – have in fact not played an important role in enforcing investor rights to this day. Firm specific information has been highly distorted thereby undermining the effectiveness of newly established regulatory agents, the two major stock exchanges in Shanghai and Shenzhen, and the Chinese Securities Regulatory Commission (CSRC). Yet, China has been remarkably successful in developing equity markets over the past decade. There are many problems with this market, including the continuing dominance of state owned enterprises, the limited amount of shares that are held by private investors and are tradable, and mounting problems of market manipulation. Nevertheless, even when adjusting standard measures of market performance to take account of some of these problems, China's equity market performance compares favorably with that of other transition economies. This evidence challenges not only our own theory, but the literature on law and finance (La Porta et al, 1997, 1998, 2003) more generally.

bepress Legal Repository

Hosted by The Berkeley Electronic Press

We suggest that this can be explained by the fact that China has deployed governance institutions that have mitigated the problems of deterrence and regulatory failure at the early stage of market development. The anchor of this governance structure has been the so-called quota system. This system effectively enlisted pre-existing institutions of state governance in the selection of companies for listing on a stock exchange; it utilized competition among regions for access to centrally controlled resources; tapped into the insider knowledge about firms by state bureaucrats at companies and/or local governments which was not accessible by other means; and used political promotion systems as well as the threat of having to bail out companies to impose some checks on the selection process.

China's initial success in building functioning governance institutions does, however, not guarantee the long-term success of the system. Here we depart from a growing literature that suggests that China's remarkable economic development refutes the notion that formal legal institutions are important determinants of economic growth and development (Allen et al., 2002; Ohnesorg, 2003). Instead, we argue that while the governance structures anchored in the quota system may have been successful in initiating financial market development, it is not sustainable in the long term. The system may have worked in selecting companies for listing given the initial conditions China faced at the time. However, there are strong signs that existing governance mechanisms are failing to monitor companies once they are listed on the market. As a result China would be better off, if it strengthened standard law enforcement mechanisms. We find evidence that this is happening and that China may be transiting towards a more convention governance structure of its financial markets



bepress Legal Repository

This paper on the one hand documents deterrence failure and regulatory failure in China. On the other hand it explains why when the legal system fails to function, financial markets can still be jumpstarted rapidly and perform reasonably well.

The paper builds on the growing literature on comparative governance of financial markets. Using newly created data bases of legal indicators, this literature has established the importance of formal legal institutions for financial market development, including minority shareholder rights (La Porta et al., 1997; La Porta et al., 1998) as well as mandatory disclosure rules and their enforcement (La Porta, Lopez-de-Silanes, and Shleifer, 2002). While much of this literature samples OECD countries with well-established equity markets, a number of studies have extended this research to emerging markets and transition economies. Johnson et al. (2000), for example, suggest that formal legal indicators in combination with perception indices on the effectiveness of law and legal institutions have had a strong impact on how countries in Asia weathered the storms of the financial crisis in the region in the late 1990s. Countries with better laws on the books and more effective legal institutions were less affected by the crisis than countries with weaker institutions. Using a broader sample of emerging markets, Claessens, Klingebiel and Schmukler (Claessens et al., 2002) document a positive correlation between the level of formal shareholder protection on the books and stock market development (measured as market capitalization as a share of GDP). An even stronger predictor of financial market development, however, is the level of GDP and the degree of internationalization. Yet, formal legal protections appear to have some benefits for firms seeking cross-listing on markets outside their home jurisdiction.

bepress Legal Repository

Hosted by The Berkeley Electronic Press

By contrast, Pistor et al. (2000) find no evidence that formal legal indicators are correlated with financial market development in 24 transition economies in Eastern Europe and the former Soviet Union. They suggest that a major determinant for equity market development in the region is not primarily the law on the books, but the effectiveness of legal institutions. The latter, they suggest, is influenced by the legacy of legal development in each country (Berkowitz et al., 2003a).

The present paper identifies the sources of weak enforcement commonly observed in transition economies. We use this analytical framework to analyze actual governance structures of financial markets in China. The paper is organized as follows. Part II develops the analytical framework. Part III documents the lack of effective law enforcement by courts and regulators in China. Part IV presents data on China's financial market performance. The surprisingly strong performance in the absence of effective law enforcement raises the question about how markets have in fact been governed during the initial phase. Part V seeks to answer this question by analyzing the quota system, which was the prevailing governance system until now. We argue that the quota system, though problematic in many ways, mitigated the threat of deterrence and regulatory failure during the early phases of market development. Part VI assesses possible market distortions of the quota system and discusses its weaknesses in enforcing continuous disclosure and preventing rampant market abuse. Part VII concludes.

II. Deterrence and Regulatory Failure

bepress Legal Repository

The formal legal framework governing financial markets in most developed economies today combines deterrence and regulation. The law enforcement literature going back to Becker's seminal work (Becker, 1968) based on the idea of Bentham (1830) and further developed by Stigler (1970) and others (Polinsky and Shavell, 2000) has long identified deterrence as the determinant factor for effective law enforcement. In recent work, we have sought to extend this idea to understand law enforcement institutions (Pistor and Xu, 2003; Xu and Pistor, 2004). We argue that law is inherently incomplete, because lawmakers cannot foresee all future contingencies, and also because of political economy of lawmaking process. Even a benevolent lawmaker (court, legislature, etc.) cannot escape the problem that despite best efforts inherent ambiguities of language, socioeconomic or technological change will render law incomplete.

Given that law is incomplete, a key challenge for any legal system is to allocate lawmaking and law enforcement powers (LMLEP) to achieve effective law enforcement. We distinguish two law enforcement mechanisms: reactive law enforcement by courts and proactive law enforcement by regulators. We call courts reactive law enforcers, because they enforce law only after a party other than the court brings an action. This party may be the victim, or it may be a state agent, such as a prosecutor or administrative agency. By contrast, regulators can take the initiative and launch an investigation, enjoin actions, or impose fines, and do not have to wait for others to bring such actions. The power to enforce the law proactively also allows regulators to be more effective preemptive, or ex ante, law enforcers.

Courts and regulators may both suffer from enforcement failures, albeit for different reasons. The failure of courts to effectively deter violations can be attributed

bepress Legal Repository

Hosted by The Berkeley Electronic Press

primarily to incomplete law (Xu and Pistor, 2004). The more incomplete the law, the greater the likelihood that deterrence failure will occur – even when courts are optimally incentivized, or incorruptible. Regulatory failure, by contrast, is primarily associated with the lack of reliable information that both investors and regulators have to avoid harm (Xu and Pistor, 2004).

In transition economies, the incompleteness of law problem and the information problem are both more severe than in developed market economies. Given the scale and scope of economic and legal reforms that are taking place concurrently, both law and actions subject to law enforcement are quickly moving targets. It will therefore take a long time before the meaning of legal rules for particular kinds of cases will be clarified. As a result, court enforcement cannot effectively deter violations. In fact, the level of incompleteness of the law may exacerbate the problem of judicial corruption, as judges may more easily distort the purpose of an untested legal rule than one the meaning and application of which has long been established.

We argue that the problem of incomplete law is even more severe in transition economies today than it was at the outset of financial market development in the West. When England's stock market soared in the nineteenth century during the railway mania, there were no securities laws or regulators that would monitor the amount or type of information companies disclosed when issuing shares to the public. But there was a highly developed contract and tort law at hand (Pistor and Xu, 2003). Although the principles of the law had been developed with different cases in mind, a sufficiently large body of case law was available to determine how these principles should be applied to the newly arising securities fraud and misrepresentation of information cases. Moreover,

bepress Legal Repository

courts had experience with handling matters of a commercial nature and with adapting law over time in response to new fact patterns. Although court enforcement ultimately proved to be insufficient for dealing with the problem of law enforcement in securities matters, courts nevertheless played an important role in advancing legal standards to deal with stock fraud schemes and imposing civil and criminal liability. Moreover, the legislature closely observed case law and readily intervened whenever it saw reasons to fill gaps left by the courts or to correct decisions made by them.

The former socialist countries did not have the benefit of a developed contract or tort law to build on for addressing problems related to misrepresentation of information on securities markets. While some countries had enacted state of the art civil and commercial codes during the inter-war period, others had never developed a comprehensive formal legal framework prior to the establishment of the socialist regime (Pistor, 2000). China was home to a flourishing stock exchange in Shanghai in the 1920s and enacted a basic set of codes based primarily on German models at the time (Kirby, 1995). However, this legal framework was systematically dismantled under the Communist period. Only with the introduction of economic reforms did China embark on the creation of a new formal legal framework for economic transactions. The most important pieces of legislation for dealing with securities fraud include the 1986 Principles of Civil Law, the 1991 Civil Procedure Law, the 1994 Corporate Law, and the 1999 Securities law.

Enacting law on the books is only the very first step in establishing an effective legal system. Because law is incomplete, its meaning and implication for a particular fact pattern cannot be easily derived from statutory law alone. This is certainly the case when

bepress Legal Repository

Hosted by The Berkeley Electronic Press

broad, ambiguous standards are used to define liability (Kaplow, 1992). But even when law is more specifically circumscribed in the form of bright-line rules (Hay, Shleifer, and Vishny, 1996), new fact patterns raise new questions about how the law should be interpreted. It is impossible to stipulate all the possible meanings and applications of the fiduciary duties a director or managers owes to the corporation. Any attempt to do so would leave key aspects unresolved. By using broad, ambiguous terms, lawmakers in essence invite law enforcers to give meaning to this provision when applying it to specific cases, or put differently, they allocate residual lawmaking powers to enforcement agents, i.e. courts and/or regulators. Conversely, attempts to clearly articulate actions that are considered violations of the law invite strategies aimed at circumventing the law. They require future lawmaking to avoid major gaps developing in the law. The greater the pace of socio-economic and/or technological change, the greater the vulnerability of law to deterrence failure that results from incomplete law.

In order to address the deterrence failure problem it may be advisable to introduce regulators. We suggest that regulators combine flexible lawmaking with proactive law enforcement powers, which distinguishes them from courts, which exercise predominantly ex post law making and reactive law enforcement powers. The proactive enforcement powers allow regulators to enforce law ex ante by screening and monitoring companies in order to prevent actions that have the potential of causing harm. The efficacy of these regulatory tools, however, depends crucially on the quality of company specific information (Xu and Pistor, 2004).[3]

[3] Recent literature on financial market development in transition economies has drawn attention to regulators, albeit for somewhat different reasons. Glaeser, Johnson and Shleifer (2001b) suggest that regulators may be superior law enforcers to courts because they can be better incentivized. Similarly, Glaeser and Shleifer argue that the rise of the regulatory state in the US can be explained by apparent

bepress Legal Repository

In transition economies, reliable company specific information is difficult to obtain and standard practices, such as disclosure of financial information may be more misleading than reflecting the true underlying value of a company. State owned enterprises are especially affected, as their accounts were created on the basis of socialist book-keeping with little relation to market principles (Bailey, 1995). The balance sheets of firms listed on China's stock exchanges to this day have double entries: one for the value of company assets according to legal accounting principles, which may be legal, but do not present the intrinsic value of the firm, and another with re-evaluation estimates, which may be closer to the actual market value, but remain guesswork in an environment where markets for many assets remain underdeveloped (Fang, 1995). The information problem is aggravated by the absence of reliable independent sources of information as well as professional intermediaries particularly at the early stages of China's financial market development.

Given the severity of incomplete law problem and the information problem in transition economies, enforcement failure is likely to occur in their financial market development. The result may be either the failure of markets to take off, or the collapse of the market.

III. Law & Law Enforcement in China

In this section we diagnose the existing legal and regulatory framework for financial markets in China. During the Cultural Revolution China had all but dismantled

---

weaknesses of the courts in the preceding period, when judicial corruption was rampant (Glaeser and Shleifer, 2003). Or argument is somewhat different and focuses on structural features law enforcement by regulators.

bepress Legal Repository

the formal legal system it had begun to build in the early 20th century and the parts it had transplanted from the Soviet Union in the 1950s. With the introduction of economic reforms in 1978, China started virtually from scratch. Unlike the former socialist countries, however, China did not embrace the notion of establishing a legal framework for a market based economy, which is clearly reflected in the laws. The corporate law enacted in 1994, for example, is designed for state owned enterprises and sets forth detailed procedures for corporatizing these companies. By contrast, it is mostly silent on newly created companies with different ownership structures (Fang, 1995; Wang, 1994). In fact, China did not recognize the notion of private property in its constitution until this year. Not surprisingly, the formal legal framework governing securities markets was targeted at state owned enterprises (Zhu, 2000).

Many informally established exchanges that had mushroomed in the 1980s were closed down in the early 1990s as government officials focused attention on creating equity markets for the purpose of financing the existing state owned enterprise sector. Initially, the tools used to build equity markets resembled those used in other economies, particularly in the early days of their development. Merit requirements were established as a means to screen companies that applied for access to equity markets. The State Council's Provisional Regulations on the Administration of Issuing and Trading Shares of 1993 and the 1994 Company Law set forth a list of merit requirements companies that wished to be listed on one of the state approved stock exchanges had to meet. These requirements included at least three years of operation; continuous profitability during this period; more than 1,000 shareholders holders; and registered capital of at least RMB

bepress Legal Repository

400 Million (Wang, 1994). This system, however, was never put in action but was de facto over-ruled by the quota system (see Part IV below).

China developed a basic legal framework over the last two decades, including the Principles of Civil Law enacted in 1986, and the 1999 Securities Law. The latter includes a series of provisions that allow the agency that emerged as China's most important regulator, the CSRC, to sanction violators or for investors to seek damages from them. Most of these laws (if not all of them) are highly incomplete as a result of weak lawmaking institution and the highly politicized lawmaking process. As a result, these laws often are poorly drafted and frequently inconsistent with provisions found in other statutes. They are therefore difficult, some times impossible, to enforce. Rather than enumerating the many inconsistencies and the scope of incompleteness of the law, we focus on actual enforcement activities. The main purpose of this analysis is to demonstrate the weakness of formal law enforcement and to set the stage for an analysis of the actual governance of China's financial market beyond law enforcement. Consistent with the general analytical framework we assess reactive and proactive enforcement activities separately.

Reactive Enforcement Activities

In most Western market economies the default enforcement agents are the courts performing the dual functions of resolving disputes among private parties and imposing criminal sanctions. By contrast, hina has a long tradition of using courts primarily as agents for criminal and administrative law enforcement. Since the introduction of economic reforms in China in 1978, the number of civil disputes has increased

bepress Legal Repository

Hosted by The Berkeley Electronic Press

substantially. While in 1983 only 44,080 economic cases were filed at first instance courts, this increased to 1,278,806 in 1995, representing an increase from 43.1 to 1,065.5 cases per million people (Pistor and Wellons, 1999). In comparison, in Taiwan 4,350 cases per million people were filed in 1995, and 9,482 in Malaysia, suggesting that the starting from a very low level although the change is extremely rapid by the mid 1990s China's level of litigiousness lacked far behind other Asian economies.

Even though civil litigation has been increasing in China, private suits have played no role in enforcing investor rights in financial markets so far, mostly because courts refused to hear such cases, rather than because of a lack of demand for them. The greater demand for litigation is evidenced by a rising tide of investor lawsuits (Chen, 2003), which until now has been controlled only by the courts rigorously restricting access to them. To this day, private litigation has not resulted in major liabilities imposed by the courts (see Table 1).

To illustrate the struggle over civil litigation in China, consider the following case. In the summer of 2001, *Caijing*, a leading financial newspaper exposed a fraud at a recently listed company, *Guangxia* (Magida, 2003). The company from Ningxia Hui Autnomous Region, one of the poorer provinces in China, originally engaged in computer software. Prior to seeking listing on the Shenzhen stock exchange it redirected its activities into wine growing and subsequently diversified into real estate, hotels and car dealerships. In 2001 it made plans for listing on the Hong Kong main board, but these plans were undermined when *Caijing* revealed serious fraudulent misrepresentation. At the core of the allegation was misrepresentation of the company's export activities, in particular their claim that they were deeply involved with a German firm with a long

bepress Legal Repository

history, while in fact they had used a small front company to create the impression of substantial export activities. In addition, the company had misstated the financial accounts of its subsidiaries. Only after the press had revealed this fraudulent scheme did the Shenzhen stock exchange and the CSRC become active, suspended trading and began an investigation. Disgruntled investors sought to take the matter into their own hands and brought civil action: 1,000 cases were filed in Wuxi, Jiangus Province against Guangxia alone. In addition, another 360 law suits were filed in Beijing in an unrelated case against Yorkpoint Science and Technology.[4] A trial date for the Guangxia case had been set for 15 October, when the Chinese Supreme Peoples' Court (SPC) intervened with a "Notice" that temporarily banned investor law suits in China.[5]

According to Chinese law, the SPC may issue guidelines about judicial practices even in the absence of a specific case brought before it. This obviously contrasts with our characterization of courts as pure reactive law enforcers. The same practice was common in the Soviet Union and is still the rule in Russia and other former republics of the Soviet Union (Hendley, 1998). The "Notice" stated that "our country's capital markets are in a period of continuous standardization and development and a number of problems have arisen including insider trading, cheating, market manipulation and other behaviors." The court acknowledged that these behaviors "infringe upon investor's legal rights", but

---

[4] Bei Hu, *Call for Trial Guidelines in Civil Actions; Courts Told to Stop Accepting Cases Involving Damage Claims by Investors Pending Internal Consultations*, South China Morning Post, September 26, 2001, LEXIS, News Library, ARCH File.

[5] Zuigao Renmin Fayuan Guanyu She Zhengquan Minshi Peichang Anjian Zhanbu Shouli De Tongshi [Supreme People's Court Notice on the Temporary Ban on Acceptance of Securities Related Civil Compensation Cases], September 21, 2001, (2001) No. 406, *available at* http://www.chinalawnet.com/law/law07_12.asp.

bepress Legal Repository

Hosted by The Berkeley Electronic Press

pointed out that "under current legislative and judicial limits [courts] still don't have the conditions to accept and hear this type of cases."[6]

The Notice was opposed by investors as well as law firms representing them and was equally criticized by the CSRC, which had supported investor litigation. In January 2002 the SPC modified the Notice of September 2001. The court now stated that investors may bring civil action against misrepresentation of information – not however, against insider trading and market manipulation. Courts were now directed to hear cases, but only after the CSRC, the primary proactive law enforcement agents had investigated them and had found wrongdoing. These cases must be brought within two years after CSRC's rulings. Individual or independent action as well as group, or joint, actions (gongtong) were permitted, but class actions were explicitly ruled out.

The difference between joint actions and class actions are of procedural nature with important implications for the cost of litigation. Joint actions are explicitly permitted in China's 1991 Civil Procedure Law. They allow for more than one litigant to join in a single case against a defendant. However, the litigants will have to be identified individually and be named in the action brought and the outcome of the case has no effect on the class members not specifically mentioned and do not participate in the trial. Thus, a defendant may face additional litigation even after a case with a particular group of litigants has been resolved. In January 2003, the SPC issued more extensive rules governing investor law suits, the Private Securities Litigation Rules (hereinafter PSLRs). The rules do not extend investor litigation to issues other than misrepresentation of information, but they relax the rules on joint litigation. Litigants are allowed file jointly and to elect between two and five representatives. The PSLRs do not explicitly state the

bepress Legal Repository

[6] Ibid. Translation by Daniel Magida.

upper limit of litigants who may join in a single action, but a commentary published by one of the judges involved in the case suggested that groups of 10 to 20 plaintiffs was what the court had in mind.[7] The PSLRs also require that law suits are filed in the jurisdiction where the defendant company is registered. This rule is likely to re-enforce the well known "home-bias" of China's courts (Lubman, 1995). It also implies that expertise in securities matters will take a long time to build as they cannot be pooled in courts with the greatest expertise.

In the meantime many investor law suits have been filed anew to comply with these rulings. Most of these cases have either been settled or their resolution is still outstanding. Table 1 summarizes law suits filed after the September 2002 SPC ruling that have been widely reported in the Chinese press and their current state of resolution. So far not a single civil law case has resulted in liability imposed by a court, although some cases have been settled after court mediation. We interpret this evidence to suggest that civil liability has virtually no deterrence effect in the current legal environment.

[INSERT TABLE 1]

In addition to civil litigation, the Chinese Peoples' Courts are in charge of criminal law enforcement. China is known for stiff punishments and little respect for rule of law principles, such as "nulla poena sine crimen" (no punishment without crime), the presumption of innocence, or the proportionality between the committed offense and the

[7] Gu Wei, *Ruhe Lijie <Guanyu Shenli Zhengquan Shichang Xujia Chenshu Minshi Peichang Anjian De Nuogan Guiding>>*, [How to Understand <Several Regulations of the Supreme People's Court Concerning the Hearing of Civil Compensation Cases Caused by Fraudulent Misrepresentation in the Stock Market>, Renmin Fayuan Bao [People's Court Daily].

bepress Legal Repository

Hosted by The Berkeley Electronic Press

punishment. In its recent China report, Amnesty International notes that "the combined effects of repressive and vaguely worded criminal legislation, the use of administrative detention, a weak judiciary and impunity for officials who abuse their power continued to result I widespread abuses of human rights."[8] Data on enforcement of cases involving securities fraud is again largely anecdotal, as systematic statistical data from the lower courts on these specific types of cases is not available. In press reports about criminal cases brought against individuals accused of fraudulent activities, we find some evidence for retroactive or disproportionate punishment, but not to an extent that would suggest that the level of punishment applied by Chinese courts would fully offset the deterrence failure problems we outlined above.

Consider the following examples: In October 1993 investor Li bought shares in Susanshan company only to witness a steep drop in the share price shortly thereafter. Mr. Li took counter measures to protect the value of his shares by fabricating information about "big purchases" of the company's stock that he sent to the Shenzhen Stock Exchange where the company was listed. As a result of his manipulations the stock price recovered, at which point he dumped his shares and recovered his investments. At the time of his action, the Criminal Code did not include a provision stipulating that "producing and spreading false information about securities exchanges" constituted a criminal offense. This provision was included in the code only in 1997. Nevertheless, the court sanctioned Mr. Li citing a provision in the 1979 Criminal Codes that was in effect in 1993, which broadly outlawed speculative activities. Mr. Li was sentenced for 2.5 years imprisonment and fined for 10,000 Yuan. In another case Zhao Zhe was sentence to

bepress Legal Repository

[8] See the China report for 2003 by Amnesty International at www. http://web.amnesty.org/report2003/chn-summary-eng [last visited 28 April 2004].

three years imprisonment for invading the computer system of Zhongya Trust and Investment company and manipulating the price of listed companies helping him and his friends who held shares in some of the companies to make RMB 90,000 while investors allegedly lost a total of 2.95 Mln. He received a three year prison term, was fined for RMG 10,000 and had to pay the company RMB 2.5 Mln in compensation.

Similar attempts of share price manipulation have been rampant in the early stages of financial market development in the West. English courts were reluctant to impose criminal liability mostly because the threshold for establishing evidence is substantially higher for criminal than for civil law (Pistor and Xu, 2003). There is also some evidence that judges were inclined to turn a blind eye to white collar crimes (Robb, 1992). Chinese courts are obviously less constraint. In particular, the enforcement of a law, such as the 1979 Criminal Code, that was obviously designed to punish any kind of market activities which were deemed to be speculative per se, raises the specter of arbitrariness and over-deterrence. Still, the level of punishment as applied in these cases alone is unlikely to deter future violations sufficiently to mitigate the weakening of the deterrence effect resulting from highly incomplete law and a rather low probability of being caught in a volatile, non-transparent market.

There is anecdotal evidence that criminal law enforcement is more extensive than a couple of press reports suggest. Even in cases where evidence is not sufficient to result in conviction under Chinese legal standards, the rounding up of executives or financial analysists and their detention for days if not weeks alone can be a strong deterrent. We can therefore not rule out completely that law has a deterrence effect in China. Yet, the amount of fraudulent activities reported in the press or revealed in surveys of market

bepress Legal Repository

insiders (Xie and Lu, 2003) that go unsanctioned suggest that the overall effect is rather modest.

Proactive Enforcement Activities

Law enforcement by regulators has also been weak in China. As noted above, the defining characteristic of regulators as compared with courts is that regulators are proactive law enforcers. They can initiate law enforcement proceedings without the victim or the police or any other agent brining a case to their attention. This enables them in principle to be better *ex ante* law enforcers, i.e. to stop actions before harm has been done. But it also allows them to be effective *ex post* law enforcers.

Our evidence on the functioning of regulatory agents in China suggests that their role as *ex ante* law enforcers was severely limited by the lack of reliable company level information, the lack of a proper legal regime for disclosure at least at the outset, and the politicization of the listing and public issuance processes. The lack of reliable firm specific information is an inherent problem of the transition process. Both state owned enterprises and recently privatized former state owned enterprises had assets and liabilities, the value of which was difficult to ascertain. The problem of valuing illiquid assets, such as the value of closely held corporations or of assets for which a market does not exist, is difficult enough in developed market economies (Benston et al., 2003). These difficulties are exacerbated in China and other transition economies, where markets for virtually all assets are only emerging and the book value does not even contain meaningful information about historic market value. Even if companies adopt Western style accounting standards, the problems are not easily resolved (Bailey, 1995).

bepress Legal Repository

In addition, a market for financial intermediaries capable of collecting and assessing whatever firm level information is available, is also only developing. Securities firms mushroomed in China in the late 1980s and early 1990s, engaging in activities that ranged from real estate transactions over direct investments to insurance business. Since 1995 registered securities firms have been required to focus on core activities, including underwriting, brokering shares for clients, and proprietary trading (Green, 2003). Most securities firms are state owned companies or were set up by ministries or other government agencies, even if their legal form – i.e. shareholding or limited liability company – disguises the identity of their owners. Their background and knowledge of the workings of government administrations as well as access to insider familiar with the state owned firms listed on stock exchanges gave them access to crucial information. However, this information was frequently used by traders at securities firms to engage in "extensive manipulation and insider trading".[9] In other words, while financial intermediaries are often regarded as at least a partial solution to the information problem (Gilson and Kraakman, 1993), in emerging markets, they are often at least part of the problem (Green, 2003). The implication for law enforcement by regulators is that they have little reliable information to go by and thus are likely to commit substantial errors when enforcing law *ex ante*, i.e. by approving or denying approval for the issuance of shares to the public; or by enjoining other activities that may (or may not) result in harm.

The major central government regulator of the Chinese financial market today is the CSRC. In the early days proactive law enforcement was scattered among various state agents, including the state owned stock exchanges, the People's Bank of China (PBC), the CSRC and the State Council Securities Commission (SCSC). The increasing

bepress Legal Repository

[9] See Green (2003) at p. 89.

Hosted by The Berkeley Electronic Press

centralization of financial market regulation was a response to failures of the system. In particular, a securities scandal in the summer of 1992 which caused rioting by investors resulted in the reallocation of regulatory activities away from the PBC and its local branches. Investor riots broke out after it was discovered that the shares of a company that were to be floated to the public had almost been fully subscribed to by government insiders, including agents of the PBC (Walter and Howie, 2003). Directly in response to these events, the State Council established the State Council Securities Commission (SCSC) as well as the Chinese Securities Regulatory Commission. The SCSC became an important body for developing policies for financial markets, but did not become a full-blown regulator. This task was increasingly taken up by the CSRC. In 1998, the two agencies were merged into a single agency, the CSRC. The chairman of the CSRC is ex officio member of the State Council. Thus, there is no attempt to create an independent regulatory body. The CSRC was given some lawmaking power, and it issued listing requirements as early as 1993. The CSRC assumed ministerial status in 1998 and its formal powers have considerably grown since. In 1999, China's first comprehensive Securities Law was enacted. The law vests the CSRC with the primary power to regulate markets, yet allows it to delegate decisions, including admission to trading, to the stock exchanges. Under the law, the CSRC may issue implementing regulations and it has made extensive use of this authority by issuing a host of rules and regulations for issuing companies and intermediaries alike. One of the most important changes for the CSRC's role as an enforcement agent for financial market regulations came in 2000 with the expansion of its enforcement unit not only in the central office in Beijing, but also in numerous branch offices (Walter and Howie, 2003). Enforcement activities have

bepress Legal Repository

increased since. Nevertheless, available data on enforcement activities suggest that they remain rather timid. Table 2 summarizes enforcement activities by the CSRC from 1998 until the end of March 2004. The numbers stand for enforcement events, not companies against which enforcement actions were taken. Thus, the total number of companies subjected to any enforcement is lower than 224 in total, or 81 for the CSRC.

[INSERT TABLE 2]

Interpreting enforcement activities is no mean task, mostly because there are no good comparative data available that could be used as a benchmark. However, it is worth noting that in 2003, when total enforcement procedures reached 51 for all enforcement agents and 15 by the CSRC, there were 1,278 companies listed in Shanghai and Shenzhen. Ignoring the fact that not each enforcement activity represents enforcement against a different company and that enforcement activities were directed not only against issuing companies, but also against intermediaries, this means that on average only every 25th company was subjected to any kind of enforcement activity, or every 85th company was subject to enforcement proceedings initiated by the CSRC. In the US, the Securities and Exchange Commission has initiated 598 enforcement actions in 2002[10] of which 518 were targeted at an issuing entity.[11] The SEC regulates all companies that are traded on national exchanges, which is larger than the roughly 2,800 companies currently listed on the New York Stock Exchange. Nevertheless, as a rough approximation using the number

[10] See the annual report of the SEC for 2002 (latest report available online) at http://www.sec.gov/about/annrep02.shtml [last visited 28 April 2004].
[11] See the more detailed data in the SEC performance report http://www.sec.gov/about/gpra2004-2002.shtml [last visited 28 April 2004].

bepress Legal Repository

of stocks currently listed on NYSE suggests that every 5th company listed on that exchange has been subject to SEC enforcement proceedings in 2002. The impression of low enforcement activities in China's financial market is re-enforced by the choice of sanctions. Table 3 below summarizes the type of sanctions that were imposed by the CSRC, the stock exchanges or other enforcement agents. Among the public sanctions were 41 cases of fines in the amount of RMB 30,000 to 2,000,000.

[INSERT TABLE 3]

Assessing Formal Law Enforcement

The analysis of enforcement activities against companies or intermediaries that violate investor rights suggests that formal law enforcement in China has not been very effective. Courts are weak and have not plaid a role in civil litigation, although their role as criminal law enforcers may be somewhat stronger. The powers of key regulatory enforcement agents have increased over time, but actual enforcement activities are low and the level of sanctions they have imposed are modest. In part, this is a function of political constraints placed on legal institutions. The decision of the Supreme Peoples' Court in 2001 not to hear investor law suits was most likely dictated by Party concerns about the prospects of organized legal opposition to government activities. Precisely because all listed companies are state owned companies and the majority of their shares is held by legal persons that are themselves government agencies or controlled by them, adversarial litigation raises the specter of opposition (Chen, 2003). The denial of class action status to joint actions and the attempt to keep down the number of law suits that

bepress Legal Repository

are joined in a single action reflect a similar concern. Whatever the causes, the implication is that formal law enforcement has been weak. Courts did not play a role as important law enforcers during the initial phase of China's financial market development. Even in the absence of these political constraints, courts would have had a difficult time to do so. At the time financial market development took off, China did not have a well developed body of contract or tort law. Moreover, the criminal code had not been updated to account for the kind of white collar crimes that arise with the development of financial markets. The broad anti-speculator provisions of the 1979 Criminal Code were highly ambiguous, raising concerns to both over- and under-enforcement of the law.

Equally, proactive law enforcement could not function effectively in an environment where reliable firm specific information processed and analyzed by professional financial intermediaries was absent. In fact, the low number of enforcement activities by the CSRC and other regulators reported above may be taken not only as a sign for political intervention in the enforcement process (although this may very well be the case), but also for the difficulties of enforcing securities fraud in such an environment. It is impossible to weigh the relative impact of the political factors on the one hand, and the structural factors, including incomplete law and information problems, on the other. Whatever their weight, in combination these factors suggest that formal law enforcement in China has been weak. Based on available empirical evidence that strong investor protection and effective enforcement is crucial for financial market development, we would therefore expect to see a highly underdeveloped financial market, or else need to explain the kind of governance mechanisms that have allowed the markets to take off despite the weaknesses of the formal legal framework.

bepress Legal Repository

Hosted by The Berkeley Electronic Press

IV. China's Financial Market Development

Any assessment of China's stock market development must start from the fact that the market was created for the purpose of financing China's state owned enterprise sector. In the 1980s equity markets mushroomed more broadly and many non-state owned companies raised funds by issuing shares [Tam, 1991 #2373]. These markets were cl0osed down and only two stock exchanges remained after 1991, the Shanghai and the Shenzhen stock exchanges. Listing on these exchanges was subject to central state approval, which ensured until very recently the dominance of state owned enterprises, even though this was nowhere explicitly stated. As a result, 80 percent of companies that are currently listed on the exchange are controlled by the state (Chen, 2003). With regards to the state controlled firms, on average less than 40% of shares are freely negotiable, 60% belong to state agents who may trade them among themselves, but may not freely trade them with private investors. Table 4 below presents the average shareholder structure of listed companies in China at the end of 2001. Among the negotiable shares, A shares are shares held by domestic investors, B shares are shares held by foreign investors, and H and S shares are traded on exchanges outside the mainland (i.e. in Hong Kong). Investors of A shares are primarily individual investors as well as securities firms and a growing number of institutional investors (Green, 2003). Their relative stakes tend to be small not only in relation to the various state agents, but also to each other.

bepress Legal Repository

[INSERT TABLE 4]

As of April 2004, a total of 1274 companies were listed on the two main exchanges. The number of listings in each year increased from only 13 in 1991 to 206 in 1997 and leveled off 71 in 2002 (Chen, 2003). The total amount of funds raised through initial public offerings and seasoned equity offerings amounts to 751,159 Mln Yuan (Green and Ming, 2004).

The performance of China's financial markets should be measured not only in absolute, but also in relative terms. The major challenge here is to find the right comparison. Comparing China with the most developed market economies makes little sense in light of its low level of GDP, which is a strong predictor for financial market development (Claessens, Klingebiel, and Schmukler, 2002; Levine and Zervos, 1996). Even a simple comparison with emerging markets may be misleading as not all faced the same adverse initial conditions for market development as did the (former) socialist countries with extensive state ownership, centrally planned economies, and a highly underdeveloped legal system for markets in general. Table 5 below compares China with other transition economies on the basis of market capitalization. The first row gives China's unadjusted market capitalization. The second row adjusts this number by excluding the non-negotiable state-owned shares.

[INSERT TABLE 5]

bepress Legal Repository

Hosted by The Berkeley Electronic Press

The data suggest that China's market capitalization in nominal terms is relatively high when compared with other transition economies even after excluding the state controlled shares (adjusted market capitalization). If one were to adjust for the percentage of stock held by large shareholders in other transition economies, some of which are directly or indirectly controlled by the state, the picture would even be more favorable. According to calculations by Pajuste (2002), on average the largest single shareholder holds 47.3% of voting power in nine Eastern European economies. The percentage of (adjusted) market capitalization to GDP shows that China's financial market is smaller on average than other transition economies. Controlling per capita GNI, however, suggests that China is fairing quite well.[12] China certainly has more firms listed than any other transition economy today, namely roughly 1300 whereas Poland has 230, and Hungary 56. Other indicators that measure the relative transparency of stock markets also suggest that China has come some way in developing financial markets. Morck et al use the co-movement of stock on a given market as a measure for the level of firm-specific information available to investors. They show that emerging markets in general have much higher levels of co-movement than do developed market economies (Morck, Yeung, and Yu, 1999). In the international comparison of the level of co-movement for 1993, China is at the bottom of the scale with a co-movement indicator (R square) of 0.31, as compared to the US, where it is 0.03. By 2001, however this indicator had improved to 0.22 suggesting that investors had substantially more firm specific

[12] Ibid at p. 407.

bepress Legal Repository

information at their disposal by then.[13] By comparison the R-square for Russia was .28 in 1995 and .37 in 2000.[14]

In summary, with appropriate adjustments China's financial market development over the past 10 years remains substantial even though it may be less impressive than is often alleged. These results stand in contrast to the weak formal lega; regime. The next section seeks to explain how China's financial markets have been governed, given that formal law has played such a minor role.

V. Governance Mechanisms Beyond Law Enforcement

At the core of the governance system of financial markets in China during the initial phase is the so-called quota system. The quota system was officially in place from 1993 and 2000. De facto, it governed financial markets until the beginning of 2004, because many companies that were selected under the quota system were placed on a queue and were released to the market only over time. While the system was in operation, China developed a formal legal framework for financial market governance, including merit and disclosure rules. These rules increasingly complemented the quota system. However, it is only now that formal legal governance structures are becoming the primary governance structure of financial markets.

The quota system was not invented for financial markets. It is a basic feature of centralized state planning as practiced in China during the transition period and has been widely used for allocating credit, energy, and other resources among regions. It was

---

[13] We are grateful to Randal Morck and Bernard Yeung for making these additional data available to us.
[14] This may reflect the fact that in Russia primarily oil stocks are traded, and that these stocks move closely together.

bepress Legal Repository

established for financial markets after a growing number of firms had begun to issue shares to the public relying only on approval by provincial governments or the stock exchanges (Fang, 1995).[15] The central government sanctioned local approval only for shares that were issued to employees of the company. For issuing shares to the public, it reserved the exclusive right of final approval. Between 1986 and 1992 the central government regulator for financial markets was the People's Bank of China (PBoC); sine then it has been the CSRC . The first guidelines for the quota system were issued by the PBoC in April of 1992.

The quota system uses central governance and regional competition as its major governance devices. Each year provincial government organs work out with the provincial branches of the central government the size of the quota desired by that region. This request together with information about the relevant companies seeking to issue shares is then submitted to the center. On the basis of similar information received from all provinces, the central government bargains with the governments of the provinces about the size of the quota each one of them will receive. After the quota for a province has been set, individual companies' applications are submitted to the central government regulator. At this stage the applicants are vetted for compliance with the formal merit and disclosure requirements set forth in relevant statutes and regulations.

The quota system was established to ensure central government control over financial markets. However, it also functioned as an important administrative governance device, which is the point we focus on. Specifically, the governance mechanisms the quota system employed consisted of decentralized bargaining and information collection;

bepress Legal Repository

[15] The description on how the quota system worked is based on (Fang, 1995) and information collected from interviews with agents at the CSRC, the Shanghai and Shenzhen stock exchanges, et al.

incentive structures that mitigated against the worst frauds at IPO stage; and central government oversight and control.[16]

The quota system established the framework for a bargaining process that imposed a 'quantity constraint' on the provinces. The quantity constraint required provinces to select specific companies for listing and this selection process in turn generated information collection from insiders with knowledge about these companies. The checks and balances built into the system ensured that this selection process did not result in a race to the bottom.

This virtuous outcome of the bargaining and information revelation process may not have prevailed in all cases. However, we suggest that sufficient checks and balances were built into the system to avoid the worst-case scenario. In the worst case scenario, the described bargaining process allowed the most powerful agents at the provincial level to choose their favorite companies even when these were the worst performing companies in the region. There are good reasons to believe that the provincial government may have wanted to choose the worst performing companies in the hope that the funds raised by issuing shares would keep these companies afloat and reduce the burden on the local budget. Subsequently, financial accounts may have been manipulated to disguise the actual state of the company (Chen, 2003). Although this strategy may well have been followed in some cases, we suggest that this was not the dominant strategy chosen. In particular, available data suggest that the performance of listed companies has been on

[16] The quota system has been widely criticized as intrusive government management of the issuing and listing process fostering corruption and insider dealings (e.g., Chen, 2003; Green, 2003). We do not disagree with them that many of these allegations are true. We submit, however, that they overlook important governance features of the quota system.

bepress Legal Repository

average superior to non-listed companies as measured by the level and variance in profitability [TBA].

The checks and balances built into the system include the following. First, prior to allocating a quota to a province the companies selected for issuing shares are already screened by the central government. The central government has incentives to avoid market crashes and will therefore avoid bringing primarily lemons to the market. Second, a province may lose its prospects of receiving additional quotas in the future, if it systematically brings under-performed companies to the market. Third, a regional government remains in control over its firms even after their shares have been issued to the public. In particular, a province may have to bail out a failing company, which is a drain on its resources, Moreover, performance of listed companies is highly publicized by an increasingly sophisticated financial press (Liebman, 2004), putting additional pressures on its owners. Fourth, successful governors see their next career move in the central government or the Party apparatus (Huang, 1996), and their future will depend on the economic performance of their province. Finally, before finally admitted to issue shares to the public and to listing, the selected company will be screened by the CSRC and the authorities of the relevant stock exchanges. The CSRC itself is monitored by the State Council. However, more decentralized control mechanisms seem to be at work as well. Most importantly, companies backed by their home provinces have taken to the courts when they felt that the CSRC denied their approval without justification. In 2001 the first such case, 'Kaili v CSRC' was decided in favor of the company and against the CSRC.[17] The case has been a landmark case in that it was the first successful case by a

bepress Legal Repository

[17] With support from the Chinese Minority Ethnic Affairs Commission (guo-jia min-zu shi-wu wei-yuan-hui) and Hainan province. Hainan-Kaili company applied to issue A shares using the quota that had been

company against a state agent. However, it also raises important questions about the relation between courts and the regulator in enforcing securities regulations, and as such illustrates the problems of law enforcement in a country where the rule of law is only slowly taking hold.

Our analysis suggests that the governance structure based on the quota system helped mitigate the major challenges of deterrence and regulatory failure transition economies face. We documented in Part III above that China's legal system was seriously underdeveloped at the outset of financial market development. Given these constraints, China could not possible rely on reactive law enforcement to minimize cheating. It was therefore sensible to focus on ex ante screening of companies. This could have been accomplished to some extent by a simple merit system. However, merit requirements are crude indicators for company performance or future prospects. Whether a company has existed for at least three years or has been profitable during that time does not necessarily imply what its future prospects might be. Furthermore, merit criteria were easy to manipulate. The profitability of a company is established in financial accounts, but these were unreliable for reasons stated above. They also give regulators substantial discretionary powers, which make them vulnerable to corruption.

Alternatively, ex ante screening can be accomplished by a disclosure regime. As argued above, the effectiveness of a disclosure regime is contingent on reliable firm

---

assigned to Hainan province in 1998. The application was rejected by the CSRC in 2000 citing fraudulent financial reports. Moreover, the CSRC returned all application materials, which implied that Kaili would not be able to apply again. Kaili sued the CSRC in the Beijing Intermediate Court later in the same year. On Dec 18, 2000, the Court decided that the CSRC's decision to deprive Kaili's qualification to apply for issuing shares has no legal ground. The CSRC appealed to the Beijing Supreme Court. On July 5, 2001 the Beijing Supreme Court decided to maintain the Beijing Intermediate Courts decision against the CSRC (Legal Daily (fa-zhi bao) 25 July 2001, http://www.legaldaily.com.cn/gb/content/2001-07/25/content_21457.htm). This is the first lawsuit against a central government agent in history of PRChina.

bepress Legal Repository

specific information a regulator can easily verify. This was clearly not available in China ten years ago. Instead, the quota system created ex ante screening by fostering decentralized information collection that was subsequently vetted by central agents. Moreover, the checks and balances between central and regional governments help curb abuse of power and corruption to some degree. We do not make a claim that this has resulted in selecting the best performing companies and in preventing corruption, but suggest that this system has worked against selecting lemons on a grand scale. It thereby mitigated the problem of regulatory failure, which we have identified as a major impediment to the development of emerging financial markets.

Our account of how the quota system worked is consistent with other work that highlights the role of government and party structures in governing China's economy. Qian and Xu (1993) and Xu and Zhuang (1998) argue that government can be a transitional institution of firm level governance in the former socialist countries at least during the initial period when markets are not yet developed and market failure therefore is rampant. Absent effective oversight by the central government, however, decentralization may promote the maximization of local interests with adverse consequences for economic performance (Zhuravskaya, 2000). We suggest that for the governance of financial markets effective oversight by central regulators was crucial for avoiding a race to the bottom. It was the CSRC at the central level that screened the final application of companies put forward for public offerings and listing and it was the prospect of future jobs in the central government for local governors that created some checks on their behavior in selecting companies for listing. This, to some extend, is consistent with Blanchard and Shleifer (2000).

bepress Legal Repository

VI. Impact of the Quota System on Market Development

In this section we turn to evidence on how the quota system affected the composition of financial markets. In particular, we are interested in whether or not the system distorted markets by over- or under-representing particular regions and whether law enforcement was biased in favor or against others.

According to statistics available from the CSRC, virtually all provinces in China have companies listed today on one of the two exchanges. If the quota system worked in bringing, on average, better than poorer performing companies to the market, we would expect that regions with higher levels of economic development are better represented than others. By contrast, if all provinces are equally represented, the quota system failed in screening companies on the basis of their (potential) economic value.[18] We use the number of listed firms in each region as a proxy for that regions representation. The firm's capitalization broken down by region would be another useful indicator, but the data is currently not available to us. In addition, we use a province's per capita GDP as a proxy for the region's level of economic development. To control for regions' size, instead of using number of listed firms directly, we use the number of firms per million inhabitants.

The results of this analysis do indeed indicate that economically stronger regions are better represented on the country's stock exchanges. For example, the three largest cities in China, Beijing, Shanghai and Tianjin have per capita GDP levels that are about

bepress Legal Repository

[18] It was reported that in the first year when the quota system was implemented, 900 million out of 1 billion shares were issued by firms from Shanghai and Shenzhen, leaving little for other provinces (Fang, 1995).

Hosted by The Berkeley Electronic Press

200%, 300% and 150% respectively, higher than the national average. The umber of listed firms per million people from these regions was about 450%, 720%, and 130% higher than the national average. Similarly, the number of firms per capita from the two of the best performing provinces Zhejiang and Jiangsu, with GDP per capita about 50% higher than the national average is about 6% to 40% higher than the national average. With regards to provinces with per capita GDP levels close to the national average, the average number of listed is roughly proportional to their per capital GDP levels. A high statistical correlation between average number of listed firms and per capita GDP across all of China's regions (with a correlation coefficient of 0.85) confirms this observation.

Nevertheless, there is little doubt that some regions are over-represented given their poor economic performance. This is the case for regions with a high concentration of ethnic minority groups. For example, the average number of listed firms in Ningxia, Qinghai, Tibet and Xinjiang was 90%, 80%, 200% and 40% higher than the national average respectively in year 2004, whereas the level of capita GDP in those regions is about 30% lower than the national average.

This observation demonstrates an important drawback associated with the quota system, namely that political intervention may skew the distribution of firms in favor of poorer regions to the disadvantage of richer regions, which because of the quantitative constraint imposed by the quota system will get a smaller share. There is, however, a piece of good news, namely that investors have become increasingly capable of distinguishing good from bad companies. This is evidenced by the decreasing trend in the co-movement of stock. Moreover, market analysts have observed that the market is

bepress Legal Repository

becoming more and more segmented into "blue chip", and other companies (Green and Ming, 2004).

Our analysis of the quota system as an alternative governance device to allow ex ante law enforcement does not give an account on how markets were governed in the post-listing stage. To some extent, the checks and balances built into the quota system may have been at work. In fact, in a number of cases, firms had to be bailed out and quotas for regions were not increased [TBA]. In addition, the CSRC has used its enforcement powers to suspend listing, or to place under-performing firms under special surveillance. Nevertheless, it is becoming increasingly clear that the quota system is ill-suited for dealing with problems of continuous disclosure or market manipulation. Moreover, the CSRC is not well placed to use law enforcement mechanisms against companies that have the entire backing from the regional authorities, because even though it is a central government agency, it is not formally superior to provincial governments. In the public offering stage, this was less of a problem, because the CSRC could play regions off against each other and thus get leverage from the fact that regions were competing with each other. Yet, these governance devices are significantly weaker in the post listing world, and violations by firms that have been already listed have become rampant in recent years.

Table 7 illustrates that more than 90% of all violations by firms listed in Shanghai and Shenzhen Stock Exchanges were related to violation of continuous disclosure. Moreover, about 64% of the violations related to continuous disclosure (or about 59% of all violations) were related to violation of ad hoc information disclosure. The reason for

bepress Legal Repository

Hosted by The Berkeley Electronic Press

this may be that companies have much more discretion in determining when an information is sufficiently important for it to be disclosed to the public.

Table 8 illustrates the ineffectiveness of regional competition as a means to induce compliance with disclosure requirements post listing. This table contains information about the regional distribution of post listing disclosure violations on the two stock exchanges. The data show that the best performing regions, Northern China, Eastern China, and Southern China, are on opposite ends of the spectrum. The number of listed firms from Northern and Eastern China counted for more than 56% of all listed firms in the two stock exchanges, whereas their violations amounted to less than 31% of the total violations – far better than the national average. This seems to suggest that better performance is associated with greater compliance or less cheating. By contrast, the data on Southern China suggest the opposite. Only 15% of listed firms are located in the Southern region of China, but they accounted for 28% of all violations – the worst region in the nation.[19]

VII. Conclusion

The relative success of the quota system in China during the early phases of stock market development does not imply that it will be superior to a disclosure system in the long term. Nor does it mean that it should be taken as a simple recipe for developing financial markets elsewhere. The effectiveness of the quota system depended heavily on

[19] The fact that the Northern, Eastern, and Southern China are the best economic performing regions is supported by other sources of data, such as Chinese Statistic Yearbook (all the years since the mid 1990s). The fact that the Northern and Eastern China are among regions followed law best (or least corrupted), and Southern China is among regions that followed law worst (or most corrupted) is also supported by other sources of data, such as Xie and Lu (2003).

bepress Legal Repository

the availability of checks and balances within the existing system of state governance. Competition among regions and ministries for future quotas and the possible bail-out sanction were important parts of this system and have gone some way in ensuring that relevant state agents invested in the selection of more rather than less viable firms. However, the system has not been flawless, nor is it sustainable. There is evidence that once companies have made it to the market, the assets they represent are substituted for different assets in takeover transactions. Green (2003) asserts that by the late 1990s the most common route for private companies to gain access to financial markets was to take over moribund listed companies. This practice resembles similar practices in the early development of stock corporations in Europe, when only companies that had been chartered by the Crown could incorporate. Companies not officially chartered sought access to the market by buying up failing companies. Allegedly, this practice contributed to the major stock scandal of the eighteenth century, the South Sea Bubble (Davies, 1997). The ex post substitution of assets undermines the efficacy of a governance system that relies on pre-screening of firms rather than continuous monitoring. Moreover, the quota system presumed that only state owned enterprises would be listed on exchanges and that therefore mechanisms that made use of existing governance structures over the state owned sector could be used for governing the emerging financial markets. With the growing importance of the non-state sector these assumptions no longer hold. In fact, recent years witnessed not only private companies taking over shells of listed companies, but also the renewed mushrooming of local exchanges.[20] Finally, the quota system may

[20] South China Morning Post reported in April 2003 that representatives of 30 such exchanges met earlier that year to develop strategies aimed at expanding their presence in China's capital markets. Estimates at the time suggested that over 3 million investor had bought shares in more than 1,000 companies outside of

bepress Legal Repository

have gone some way in governing the selection process of companies. However, it is not designed for, nor capable of ensuring effective monitoring of companies once they are listed. Many reported incidences of violations of investor rights take place after a company has been listed.

In response to these challenges, the CSRC has strengthened its enforcement capacity and issued a host of new rules and regulations aimed at continuing and ad hoc disclosure.[21] The enforcement data discussed in Part III suggest that so far this had not had a strong impact. In fact, enforcement actions taken by the CSRC declined from 71 in 2001 to 62 in 2002 and 51 in 2003. The same is true for enforcement activities at the stock exchanges. Whether private litigation may step in and fill the gap remains yet to be seen. So far, not a single case has been decided by the courts. Moreover, reactive ex post law enforcement may not be sufficient for governing financial markets (Pistor and Xu, 2003). The major challenge China is currently facing is whether it can transform its governance structure and whether this transformation will keep pace with the transformation of the market. Unless China successfully manages this transition, her initial success in jumpstarting financial markets may not be worth much. If successful, however, the case of China could serve as an example that financial markets can take off even absent a developed legal system. More generally, our analytical framework suggests what the major problems are that any governance system must address.

---

the two major stock exchanges. The legality of these activities is questionable (Pissler, 2003), but the CSRC has not been very successful in curbing their activities.

[21] In 2001, Laura Cha, the former chairman of the Hong Kong securities regulator became deputy chairwoman of the CSRC and launched a campaign to enhance market transparency and enforce securities regulations. Her actions were criticized, however, as an outright attack on stock markets causing harm rather than benefiting investors. See her interview in *Caijing*, 20 January 2002, where she justifies her measures as benefiting investors in the long term.

bepress Legal Repository

References:

Akerlof, George A. 1970. The Market for "Lemons": Quality Uncertainty and the Market Mechanism. *Quarterly Journal of Economics* 84:488-500.

Allen, Franklin, Jun Qian, and Meijun Qian. 2002. Law, Finance, and Economic Growth in China. *Wharton School, mimeo*.

Bailey, Michael. 1995. Accounting in Transition in the Transitional Economy. *The European Accounting Review* 4 (4):595-623.

Becker, Gary S. 1968. Crime and Punishment: An Economic Approach. *Journal of Political Economy* 76:169-217.

Benston, George, Michael Bromwich, Robert E. Litan, and Alfred Wangehofer. 2003. *Following the Money*. Washington, D.C.: AEI-Brookings Joint Center for Regulatory Studies.

Berkowitz, Dan, Katharina Pistor, and Jean-Francois Richard. 2003a. Econmic Development, Legality, and the Transplant Effect. *European Economic Review* 47:165-195.

Berkowitz, Daniel, Katharina Pistor, and Jean-Francois Richard. 2003b. The Transplant Effect. *American Journal of Comparative Law* 51 (2):163-203.

Blanchard, Olivier, and Andrei Shleifer. 2000. Federalism with and without Political Centralization. China versus Russia. *ssrn.com* id=236127.

Chen, Zhiwu. 2003. Capital Markets and Legal Development: The China Case. *China Economic Review* 14:451-472.

Chinese Securities Regulatory Commission (CSRC), http://www.csrc.gov.cn/en/statinfo.

Claessens, Stijn, Daniela Klingebiel, and Sergio L. Schmukler. 2002. The Future of Stock Exchanges: Determinants and Prospects. *European Business Organization Law Review* 3 (2):403-438.

Coffee, Jack C. Jr. 1999. Privatization and Corporate Governance: The Lessons from Securities Market Failure. *Journal of Corporation Law* 25:1-39.

Davies, Paul L. 1997. *Gower's Principles of Modern Company Law*. 6 ed. London: Sweet & Mawell.

Fang, Liufang. 1995. China's Corporatization Experiment. *Duke Journal of Comparative and International Law* 5:149-269.

Frydman, Roman, Katharina Pistor, and Andrzej Rapaczynski. 1996. Investing in Insider-Dominated Firms: A Study of Russian Voucher Privatization Funds. In *Corporate Governance in Central Europe and Russia*, edited by R. Frydman, C. W. Gray and A. Rapaczynski. Budapest, London, New York: CEU Press.

Gilson, Ronald J., and Reinier Kraakman. 1993. Investment companies as guardian shareholders: the place of the MSIC in the corporate governance debate. (managerial strategic investment company). *Stanford Law Review April* 45:985-1010.

Glaeser, Edward, Simon Johnson, and Andrei Shleifer. 2001a. Coase vs. Coasians. *Quarterly Journal of Econmics* 116 (3):853-899.

Glaeser, Edward, Simon Johnson, and Andrei Shleifer. 2001b. Coase vs. Coasians. *Quarterly Journal of Economics* 116 (3):853-899.

bepress Legal Repository

Glaeser, Edward, and Andrei Shleifer. 2003. The Rise of the Regulatory State. *Journal of Economic Literature* (June):forthcoming.

Green, Stephen. 2003. *China's Stockmarket*. London: The Economist Newspaper Ltd.

Green, Stephen, and He Ming. 2004. China's Stock Market: Outof the Valley in 2004? *The Royal Institute of International Affairs Briefing Paper* February 2004 (1):1-11.

Hay, Jonathan R., Andrei Shleifer, and Robert W. Vishny. 1996. Toward a Theory of Legal Reform. *European Economic Review* 40 (3-5):559-567.

HE Jia et al., *Chinese and Foreign Disclosure Systems Comparison and Their Effectiveness [Zhong-wai Xinxi Pilu Zhidu jiqi Shiji Xiaoguo Bijiao Yanjou],* Shenzhen Stock Exchange Research Institute, 2002.

Hendley, Kathryn. 1998. Remaking an Institution: The Transition in Russia from State Arbitrazh to Arbitrazh Courts. *American Journal of Comparative Law* 46:93-128.

Johnson, Simon, Peter Boone, Alasdair Breach, and Eric Friedman. 2000. Corporate Governance in the Asian Financial Crisis 1997-98. *Journal of Financial Economics* 58:141.

Kaplow, Louis. 1992. Rules versus Standards: An Economic Analysis. *Duke Law Journal* 42:557-629.

Kirby, William. 1995. China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China. *The Journal of Asian Studies* 54 (1):43-63.

La Porta, Rafael, Florencio Lopez-de-Silanes, and Andrei Shleifer. 2002. What Works in Securities Laws? *unpublished mimeo, Harvard University*.

La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny. 1997. Legal Determinants of External Finance. *Journal of Finance* LII (3):1131-1150.

La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny. 1998. Law and Finance. *Journal of Political Economy* 106 (6):1113-1155.

Levine, Ross, and Sara Zervos. 1996. Stock Markets, Banks, and Economic Growth. Washington D.C.: The World Bank.

Lubman, Stanley. 1995. Introduction: The Future of Chinese Law. *The China Quarterly* 141 (March):1-21.

Magida, Daniel. 2003. Establishing an Effective Regulatory Regime: Corporate and Securities Case Studies from Russia and China. *Columbia Law School mimeo*.

Morck, Randall, Bernard Yeung, and Wayne Yu. 1999. The Information Content of Stock Markets: Why Do Emerging Markets Have Synchronous Stock Price Movements? *ssrn.com.*

National Statistical Bureau, *Chinese Statistical Yearbook, 2002*, Beijing: Chinese Statistic Press, 2003.

Ohnesorg, John K.M. 2003. China's Economic Transition and the New legal Origins Literature. *China Economic Review* 14:485-493.

Pajuste, Anete. 2002. Corporate Governance and Stock Market Performance in Central and Eastern Europe. *ssrn.com.*

Pissler, Knut Benjamin. 2003. *Chinesisches Kapitalmarktrecht*. forthcoming.

Pistor, Katharina. 2000. Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies. *European Business Organization Law Review* 1 (1):59-110.

bepress Legal Repository

Pistor, Katharina. 2001. Law as a Determinant for Stockmarket Development in Eastern Europe. In *Assessing the Value of Law in Transition Economies*, edited by P. Murrell. Ann Arbor: University of Michigan Press.

Pistor, Katharina, Martin Raiser, and Stanislav Gelfer. 2000. Law and Finance in Transition Economies. *The Economics of Transition* 8 (2):325-368.

Pistor, Katharina , and Philip Wellons. 1999. *The Role of Law and Legal Institutions in Asian Economic Development*. Hong Kong: Oxford University Press.

Pistor, Katharina, and Chenggang Xu. 2003. Incomplete Law. *Journal of International Law and Politics* (forthcoming).

Polinsky, Mitchell , and Steven Shavell. 2000. The Economic Theory of Public Enforcement of Law. *Journal of Economic Literature* 38 (1):45-76.

Qian, Yingyi, and Chenggang Xu. 1993. "Why China's Economic Reforms Differ: The M-form Hierarchy and Entry/Expansion of the Non-State Sector," with Yingyi Qian, *The Economics of Transition*, **1**(2), 1993.

Robb, George. 1992. *White-Collar Crime in Modern England: Financial Fraud and Business Morality, 1845-1929*. Cambridge: Cambridge University Press.

Stigler, George J. 1970. The Optimal Enforcement of Laws. *Journal of Political Economy* 78 (3):56-536.

Stigler, Joseph. 1971. The Theory of Economic Regulation. *Bell Journal of Economics*.

Walter, Carl E., and Fraster J.T. Howie. 2003. *Privatizing China: The Stock Markets and Their Role in Corporate Reform*. Hoboken, NJ: John Wiley & Sons (Asia) Pte Ltd.

Wang, Guiguo. 1994. China's Company Law: The New Legislation. In *China's Company Law: The New Legislation*.

Xie, Ping, and Lei Lu. 2003. Data on Corruption in Chinese Financial Market Regulation. Beijing: Research Department, People's Bank of China.

Xu, Chenggang, and Katharina Pistor. 2004. Enforcement Failure under Incomplete Law. *mimeo, London School of Economics*.

Xu, Chenggang, and Juzhong Zhuang. 1998. "Why China Grew: the role of decentralisation," in P. Boon, S. Gomulka, and R. Layard (eds.), *Emerging from Communism*, MIT Press, 1998.

Zhu, Sanzhu. 2000. *Securities Regulation in China*. Ardsley, New York: Transnational Publishers Inc.

Zhuravskaya, Ekaterina V. 2000. Incentives to Provide Local Public Goods: Fiscal Federalism, Russian Style. *Journal of Public Economics* 76 (3):337-368.

bepress Legal Repository

Hosted by The Berkeley Electronic Press

Table 1: Civil Actions in Chinese Courts

Date	Defendant	Litigants	Court	Status
9/2001	Yorkpoint Science and Technology	360 Minority Investors	Beijing No. 1 Intermediate People's Court, Guangzhou Intermediate People's Court	Pending
6/2002	ST Jiuzhou	3 Investors	Xiamen Intermediate People's Court	Rejected on procedural grounds
11/2002	Jiabao Industrial	1 investor	Shanghai #2 Intermediate People's Court	Investor receives compensation in settlement
11/2002	Hongguang	11 investors	Chengdu Intermediate People's Court	Investors settle with individual underwriter through mediation; cases against company still pending
12/2002	Jiabao Industrial	24 investors	Shanghai #2 Intermediate People's Court	Pending
09/2003	Daqing Lianyi	381 investors	Harbin Intermediate Court (Heilongjiang Province)	Suit originally brought in 2000 and accepted; re-filed in 2003; pending as of 1/13/2004
2003	Bohai Group	1 Investor	Jinan Intermediate People's Court	
02/2003	Jinzhou Gang	1 investor	Shenyang Intermediate People's Court	Pending
02/2003	ST Tongda	5 investors	Shanghai No. 1 Intermediate People's Court	Pending
03/2003	Shengwan Keji	72 investors	Harbin Intermediate People's Court	Pending
03/2003	Sanjiu Yiyao	3 investors	Shenzhen Intermediate People's Court	Pending
03/2003	ST Tianyi	1 investor	Wuhan Intermediate People's Court	Pending
04/2004	Yinguangxia	Several Investors	Yinchuan Intermediate People's Court	Pending

Table 2: Ex post Regulatory Enforcement Activities 1998-2004

YEAR	Total # of Enforcement Activities	By CSRC	By Shanghai SE	By Shenzhen SE	By Other Enforcement Agencies
1998	3	3	0	0	0
1999	12	10	1	1	0
2000	16	11	2	3	0
2001	71	23	20	27	1
2002	62	11	24	24	4
2003	51	15	19	15	2
2004	9	8	1	0	0
Totals	**224**	**81**	**67**	**70**	**7**

Note: SE = stock exchange.

bepress Legal Repository

Table 3: Types of sanctions imposed by the CSRC, the Stock Exchanges, and Other Enforcement Agencies

YEAR	**Public Punishment**	**Internal Criticism**	**Public Criticism**	**Public Censures**	**Apologies**
1998	3	0	0	0	0
1999	9	1	1	1	0
2000	7	0	1	8	0
2001	9	1	14	46	0
2002	8	6	7	40	1
2003	11	0	6	34	0
2004	8	0	0	1	0
Totals	55	8	29	130	1

Table 4: Shareholder structure in China 2001

<table>
<tr><th colspan="3">ShareHolder Structure</th><th>Shares</th><th>Ratio (%)</th></tr>
<tr><td rowspan="8">Non-negotiable Shares</td><td rowspan="3">Sponsor's Legal Person Shares</td><td>State-owned Shares</td><td>56081639195</td><td>32.56</td></tr>
<tr><td>Domestic Legal Person Shares</td><td>35418125288</td><td>20.56</td></tr>
<tr><td>Foreign Legal Person Shares</td><td>2016610078</td><td>1.17</td></tr>
<tr><td colspan="2">Private Placement of Legal Person Shares</td><td>10129159231</td><td>5.88</td></tr>
<tr><td colspan="2">Staff Shares</td><td>589558249</td><td>0.34</td></tr>
<tr><td colspan="2">Others after Share Reserve and Rights Issue</td><td>38221061</td><td>0.02</td></tr>
<tr><td colspan="2">Rights Issue to Institution</td><td>685483890</td><td>0.40</td></tr>
<tr><td colspan="2">Total Non-negotiable shares</td><td>104958796992</td><td>60.94</td></tr>
<tr><td rowspan="3">Negotiable shares</td><td colspan="2">A Shares</td><td>57027527883</td><td>33.11</td></tr>
<tr><td colspan="2">B Shares</td><td>7356569723</td><td>4.27</td></tr>
<tr><td colspan="2">H and S Shares</td><td>2903117808</td><td>1.69</td></tr>
<tr><td colspan="3">Total Shares</td><td>172246012406</td><td>100.00</td></tr>
</table>

Table 5: Market Capitalization in Transition Economies, end of 2001

Country	Market Capitalization in US$ billion	Market Cap as % of GDP	GNI per capita
China nominal	524		
China adjusted	170	15	900
Russia	76	25	1,800
Poland	26	14*	4,350
Hungary	10	34	4,820
Czech Republic	9	25	5,260

Source: [Green, 2003 #2371] using data from Standard & Poor; Worldbank world development indicators
Note: China nominal refers to total stock market capitalization; China adjusted excludes non-negotiable shares. *Data for 2000 from PAJUSTE.

bepress Legal Repository

Hosted by The Berkeley Electronic Press

Table 6. Regional Distribution of Listed Firms

			Growth rate of	GDP/capita
	Ave # of listed firms	Ave # of listed firm	# of listed firms	1000 RMB
Region	Year 2004	Year 1999	Yr 1999-2004	Year 2001
China	1.04779268	0.69209	0.513953	8.365492
Anhui	0.64406836	0.288136	1.235294	5.220771
Beijing	5.60092221	2.431979	1.30303	25.523
Chongqin	0.91764879	0.655463	0.4	5.654
Fujian	1.26107299	0.997127	0.264706	12.362
Gansu	0.79604265	0.398021	1	4.163357
Guangdon	1.65444398	1.325902	0.247788	13.72993
Guangxi	0.50165846	0.228027	1.2	4.668
Guizhou	0.39718909	0.226965	0.75	2.89529
Hainan	2.91042441	2.64584	0.1	7.135
Hebei	0.47987222	0.29992	0.6	8.362
Heilongj	0.9382526	0.579509	0.619048	9.34891
Henan	0.35073546	0.175368	1	5.923552
Hubei	0.99144884	0.672169	0.475	7.81307
Hunan	0.61636523	0.331889	0.857143	6.054
Inner Mo	0.85750986	0.600257	0.428571	6.462522
Jiangsu	1.10892707	0.547618	1.025	12.922
Jiangxi	0.56934078	0.297047	0.916667	5.221
Jilin	1.56703607	0.93276	0.68	7.640012
Liaoling	1.36284044	1.147655	0.1875	12.04086
Ningxia	2.00496027	1.275884	0.571429	5.34
Qinghai	1.86607279	1.45139	0.285714	5.734566
Shaanxi	0.50897677	0.508977	0	5.024
Shandong	0.76690706	0.489042	0.568182	10.465
Shanghai	8.83729588	7.374571	0.198347	37.382
Shanxi	0.64672611	0.400354	0.615385	5.46
Sichuan	0.76504315	0.631464	0.211538	5.25
Tianjin	2.33532625	1.218431	0.916667	20.15444
Tibet	3.05771942	1.52886	1	5.307
Xinjiang	1.46266063	0.650071	1.25	7.913
Yunnan	0.44853541	0.283286	0.583333	4.866
Zhejiang	1.43694893	0.78379	0.833333	14.655

Sources: For number of firms listed in each region, CSRC http://www.csrc.gov.cn/en/statinfo ; for population and per capita GDP, NSB, Chinese Statistical Yearbook, 2002.

bepress Legal Repository

Table 7 Violations in Shanghai and Shenzhen Stock Exchanges (1993-2001_

	Information Typel	Type of Disclosure Violation	# of violations	Share as % of Total	Share as % of Total
Disclosure Violations During Share Issuance	IPO	False Information Disclosure re listing	9	3.6	4
	Stocks distributed to employees	False Information Disclosure re employee held shares	1	0.4	
Continuous Information Disclosure Violations	Periodic Disclosure (Annual Report)	Non-disclosure in Annual Report	34	13.6	28.80
		False Disclosure in Annual Report	14	5.6	
		Other Annual Report Disclosure Violations	24	9.6	
	Periodic Disclosure (Midyear Report)	Non-disclosure in Midyear Report	3	1.2	4
		False Disclosure in Midyear Report	7	2.8	
	Interim Information Disclosure	M&A Information Disclosure	2	0.8	58.8
		Non-disclosure of Major Investments	3	1.2	
		Non-disclosure of Guarantees	12	4.8	
		Non-disclosure of Major Transactions	13	5.2	

bepress Legal Repository

Hosted by The Berkeley Electronic Press

		Non-Disclosure of Major Litigations	15	6	
		Non-Disclosure of Connected (Related) Transactions	18	7.2	
		Non-disclosure of Predicted Losses	31	12.4	
		Unapproved Interim Disclosures	3	1.2	
		False Interim Information Disclosure	1	0.4	
		Failure to Make Interim Disclosure	49	19.6	
Others	Other Rehaznos	Other Reasons	11	4.4	4.40
	Total		250	100	100

Source: HE Jia et al., *Chinese and Foreign Disclosure Systems Comparison and Their Effectiveness [Zhong-wai Xinxi Pilu Zhidu jiqi Shiji Xiaoguo Bijiao Yanjou], Table 3-5,* Shenzhen Stock Exchange Research Institute, 2002.

bepress Legal Repository

Table 8. Regional Distribution of Listed Companies Penalized For Disclosure Violations

	Region	# Of Firms Fined	% Of All Firms Being Fined	Number of Firms Listed as % of National Total	Violation Indicator
	Northeast	31	14.22	10.51	+35.30
	Northern China	22	10.09	17.98	-43.87
	Eastern China	47	21.56	28.58	-24.56
	Southern China	62	28.44	15.38	+84.92
	Central China	25	11.47	9.99	+14.79
	Northwest	6	2.75	6.69	-58.86
	Southwest	25	11.47	10.86	+5.86
		218	100	100	0

Source: HE Jia et al., *Chinese and Foreign Disclosure Systems Comparison and Their Effectiveness [Zhong-wai Xinxi Pilu Zhidu jiqi Shiji Xiaoguo Bijiao Yanjou], Table 3-11,* Shenzhen Stock Exchange Research Institute, 2002

bepress Legal Repository