

# **An Empirical Analysis of the Public Enforcement of Securities Law in China: Finding the Missing Piece to the Puzzle<sup>\*</sup>**

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## **Abstract**

Public enforcement regime in China has long been blamed for its underdeterrence of securities crimes. We collect data on public enforcement outcomes from the documents disclosed by listed firms, and find that the outputs of law enforcement have increased significantly since 2011, thanks to the efforts made by the China Securities Regulatory Commission's 38 regional offices. However, because of lacking reliable private enforcement regime and the limited monetary penalties, general enforcement of securities law is still regarded as weak. In addition, there exists a salient pattern of selective enforcement. Private-owned listed firms suffer from disproportionately high enforcement intensity, both in terms of the number and severity of sanctions, from the regulators, whereas state-owned, particularly central-government-controlled firms enjoy the most favorably treatment, though the gap being reduced in recent years.

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**JEL Classifications:** G18, G28, G32, G34, G38, K22

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# 1. INTRODUCTION

The literature on law and finance started from an empirical investigation of the cross-country relationship between legal institutions and securities market development and spawns a series of studies on legal determinants of financial market development.<sup>1</sup> However, these studies mainly focused on “law in book” and overlooked “law in action”, which is shown to dominate the effects of the previous one. For example, Bhattacharya and Daouk argue that it was the first enforcement of insider trading laws in 1990s that significantly reduced the costs of equity.<sup>2</sup> Jackson and Roe employ a resource-based method to measure the budget and staff number of securities regulators and also demonstrate that public enforcement is significantly associated with the stock market development.<sup>3</sup>

In addition, those studies looking into the institutional details of the market operation in the US also confirms the importance of securities laws enforcement,<sup>4</sup> which follows a multi-enforcers approach.<sup>5</sup> In the US stock market, law enforcement relies not only on governmental agencies (including the Securities and Exchange

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<sup>1</sup> La Porta et al. in their seminal paper titled as “Law and Finance” first empirically investigates the cross-country relationship between “on-the-book” legal institutions and securities market development, see Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny, “Law and Finance,” *Journal of Political Economy* 106 (1998): 1113-55; Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, “The Law and Economics of Self-Dealing,” *Journal of Financial Economics* 88, no. 3 (2008): 430-65; Rafael La Porta, Florencio Lopez-De-Silanes and Andrei Shleifer, “What Works in Securities Laws,” *Journal of Finance* 61 (2006): 1-32. See also two survey articles on this strand of literature, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, “The Economic Consequences of Legal Origins,” *Journal of Economic Literature* 46 (2008): 285-332 (hereinafter: Economic Consequences); Guangdong Xu, “The Role of Law in Economic Growth: A Literature Review,” *Journal of Economic Surveys* 25 (2011): 833-71.

<sup>2</sup> See Utpal Bhattacharya and Hazem Daouk, “The World Price of Insider Trading,” *Journal of Finance* 57 (2002): 75-108.

<sup>3</sup> See Howell E. Jackson and Mark J. Roe, “Public and Private Enforcement of Securities Laws: Resource-Based Evidence,” *Journal of Financial Economics* 93 (2009): 207-38 (hereinafter: Public and Private Enforcement).

<sup>4</sup> For example, the high enforcement intensity is the key to understand the valuation premium and stock market prosperity, see, John C. Coffee, “Law and the Market: The Impact of Enforcement,” *University of Pennsylvania Law Review* 156 (2007): 229-311.

<sup>5</sup> See Amanda M. Rose, “The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis,” *University of Pennsylvania Law Review* 158 (2010): 2173-231. For discussions on the merits of different approaches, see James J. Park, “Rules, Principles and the Competition to Enforce the Securities Laws,” *California Law Review* 100 (2012): 115-81.

Commission (SEC), state regulators,<sup>6</sup> and the Department of Justice), but also the quasi-governmental agencies (including New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotations (NASDAQ)), as well as the private parties (such as investors who can resort to litigation to protect their interest). Between 2002 and 2004, the average outputs of public regulators were around 3,624 actions per year, while private parties initiated 2,824 actions per year during this time.<sup>7</sup> The enforcement outputs in the US are exceptionally high compared to those in other countries and they frequently overlap with each other.<sup>8</sup> And the concerns on over-deterrence risks, particularly those of the frivolous suits in securities fraud class actions controlled by “entrepreneur attorneys”, result in the passage of the *Private Securities Litigation Reform Act of 1995* (PSLRA), which takes a “narrowing approach” and introduces significant changes to the standards for substantive liabilities and procedural rules to constrain these suits.<sup>9</sup>

However, the current debate lacks of studies on developing nations. This article contributes to the literature by empirically examining the public enforcement regime<sup>10</sup> in China, whose stock markets was the second largest in the world by the end of 2014

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<sup>6</sup> The *Securities Litigation Uniform Standards Act of 1998* (SLUSA) explicitly preserved the authority of state regulators to enforce against securities fraud, see Amanda M. Rose and Larry J. LeBlanc, “Policing Public Companies: An Empirical Examination of the Enforcement Landscape and the Role Played by State Securities Regulators,” *Florida Law Review* 65 (2013): 395-442, at p. 411 (hereinafter: Policing Public Companies).

<sup>7</sup> See Howell E. Jackson, “Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications,” *Yale Journal on Regulation* 24 (2007): 253-91 (hereinafter: Variation in the Intensity).

<sup>8</sup> In a recent study on the enforcement efforts of state securities regulators, Rose and LeBlanc report that around 93% of the enforcement actions of state regulators are overlapped with at least one action of another enforcer during the fiscal year 2004-2006, see Rose and LeBlanc, “Policing Public Companies,” at p.421.

<sup>9</sup> For a general discussion, see Stephen J. Choi, “The Evidence on Securities Cass Actions,” *Vanderbilt Law Review* 57 (2004): 1465-526. But PSLRA also brings about certain side effects, for example, it reduced potentially meritorious suits against smaller firms and those without pre-filing “hard evidence” due to the rising costs, see Stephen J. Choi, “Do the Merits Matter Less after the Private Securities Litigation Reform Act?” *Journal of Law, Economics, and Organization* 23 (2007): 598-626.

<sup>10</sup> In general, legal enforcement can be divided into two categories. The first is private enforcement, which is initiated by private litigation, and the second is public enforcement, which relies on public authorities, such as the SEC or tax collection agents, see Mitchell A. Polinsky and Steven Shavell, “The Economic Theory of Public Enforcement of Law,” *Journal of Economic Literature* 38 (2000): 45-76, at p.45. A new enforcement model mixing both the features of public and private enforcement is the state attorneys general who bring civil actions in American federal courts, which has not yet emerged in China. For more detailed discussion, see Margaret H. Lemos, “State Enforcement of Federal Law,” *New York University Law Review* 86 (2011): 698-765.

in terms of market capitalization.<sup>11</sup> Though the corporate governance of Chinese listed firms is featured with the controlling shareholder system, a large quantity of retail investors actively participates in trading stocks, which leads to a high trading volume.<sup>12</sup> Consequently securities law enforcement is an important instrument to protect minority shareholders from the exploitation of controllers. Public agencies mainly including the China Securities Regulatory Commission (CSRC) and its 38 regional offices (ROs), the Ministry of Finance (MOF),<sup>13</sup> and the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE)<sup>14</sup> are responsible for enforcing securities law. In contrast, the private enforcement is handicapped, because its effectiveness is conditional on administrative sanctions, which therefore fails to serve its theoretical dual functions of deterrence and compensation.<sup>15</sup>

Public enforcement brings about significant costs on sanctioned firms. For example, the enforcement actions of the CSRC are shown to cause decline of stock prices and increase in auditor change and CEO turnover.<sup>16</sup> In addition, the public criticism notices issued by the two stock exchanges also impose reputational costs on listed firms, which lead to significant and negative abnormal returns for their shares.<sup>17</sup> The insufficiency in the current literature is that the public enforcement regime is investigated in a piecemeal manner and the enforcement efforts of the 38 provincial ROs, which account for more than 70% of the CSRC's staff and nearly 50% of enforcement actions, are overlooked. This is probably due to the difficulty in obtaining relevant information about the operation of the CSRC's ROs, which is hard to obtain from public channels, such as websites of or public announcements by these agencies.

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<sup>11</sup> See *CSRC Annual Report 2014*, at p.15 (available at <http://www.csrc.gov.cn/pub/newsite/zjhjs/zjhnb/>, last visited Feb. 5, 2016).

<sup>12</sup> The average daily trading volume of the two Chinese stock exchanges is around 303.6 billion RMB in 2014, only second to the NYSE and NASDAQ, see *CSRC Annual Report 2014*, at p.18 (available at <http://www.csrc.gov.cn/pub/newsite/zjhjs/zjhnb/>, last visited Feb. 5, 2016).

<sup>13</sup> The MOF shares the responsibility of regulating accounting anomalies with the CSRC, but its regulatory output is negligible in our sample.

<sup>14</sup> Unlike the stock exchanges in the US, which operate independently from the federal regulator (SEC), the CSRC has *de facto* authority over these exchanges. See Benjamin L. Liebman and Curtis J. Milhaupt, "Reputational Sanctions in China's Securities Market," *Columbia Law Review* 108 (2008): 929-83 (hereinafter: Reputational Sanctions).

<sup>15</sup> Private enforcement is claimed to be designed to attain both functions, see John C. Coffee, "Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation," *Columbia Law Review* 106 (2006): 1534-86.

<sup>16</sup> Gongmeng Chen, Michael Firth, Daniel N. Gao and Oliver M. Rui, "Is China's Securities Regulatory Agency a Toothless Tiger? Evidence from Enforcement Actions," *Journal of Accounting and Public Policy* 24 (2005): 451-88.

<sup>17</sup> See Liebman and Milhaupt, "Reputational Sanctions," 929-83.

A particular innovation of our paper is to solve this problem by collecting information from the regulated firms, which offers a unique chance to investigate the enforcement outputs of all main public regulators over a relative long period. The listing rules of the two exchanges require that listed firms should report events that may significantly influence their share price.<sup>18</sup> The China Stock Market & Accounting Research (CSMAR), one of the major financial data providers in China, collects such information, based on which we compile our data set covering 3026 recorded sanctions from 2003 to 2015. A caveat is that we may underestimate the enforcement outputs of the ROs and the two stock exchanges, because listed companies are not required to report the sanctions against non-listed firms or individuals.<sup>19</sup>

Our research contributes to the literature in two ways. First, public enforcement in China is usually claimed to fail to meet the requirements of sustaining a healthy stock market,<sup>20</sup> whereas we provide evidence showing that this is probably not the case. The total outputs of public enforcers quadrupled in 2012 as compared to that in 2008 and the standardized output of CSRC and its ROs is around two thirds of that of SEC in 2012. In addition, our findings support Rose's argument that the problem of under-enforcement can be mitigated by properly aligning the incentives of public

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<sup>18</sup> See article 11.11.3 of *2014 Listing Rules of Shenzhen Stock Exchanges* (available at [http://221.181.104.29/cache/www.szse.cn/main/images/2014/11/28/20141128112611307.pdf?ich\\_args=1ac6302d0e714c3e08d0ba6d8a28a458\\_1\\_0\\_0\\_3\\_32455c38fff9b77c381ddb61902b6aff495a2773cb4c7b7528596c3e4ae51f7c\\_091a1ec3e69b117be6b7c62c3a17200b\\_1\\_0&ich\\_ip=](http://221.181.104.29/cache/www.szse.cn/main/images/2014/11/28/20141128112611307.pdf?ich_args=1ac6302d0e714c3e08d0ba6d8a28a458_1_0_0_3_32455c38fff9b77c381ddb61902b6aff495a2773cb4c7b7528596c3e4ae51f7c_091a1ec3e69b117be6b7c62c3a17200b_1_0&ich_ip=), last visited Feb. 5, 2016) and article 11.12.5 of *2014 Listing Rules of Shanghai Stock Exchanges* (available at [http://www.csrc.gov.cn/pub/shenzhen/xxfw/tzzsyd/ssgs/zh/zhxx/201504/t20150430\\_275950.htm](http://www.csrc.gov.cn/pub/shenzhen/xxfw/tzzsyd/ssgs/zh/zhxx/201504/t20150430_275950.htm), last visited Feb. 5, 2016).

<sup>19</sup> Non-listed firms or individuals could also commit misconducts and get sanctioned, while the concerned listed firms are not involved. For example, in insider trading cases concerning mergers and acquisitions, the insiders could be the senior managements of the intermediaries hired for the transactions.

<sup>20</sup> See Franklin Allen, Jun Qian and Meijun Qian, "Law, Finance, and Economic Growth in China," *Journal of Financial Economics* 77 (2005): 57-116 (hereinafter: Law, Finance); Donald C. Clarke, "Law without Order in Chinese Corporate Governance Institutions," *Northwestern Journal of International Law & Business* 30 (2010): 131-99 (hereinafter: Law without Order); Marlon A. Layton, "Is Private Securities Litigation Essential for the Development of China's Stock Markets," *New York University Law Review* 83 (2008): 1948-78, at p.1976 (hereinafter: Is Private Securities Litigation); Katharina Pistor and Chenggang Xu, "Governing Stock Markets in Transition Economies: Lessons from China," *American Law and Economics Review* 7 (2005): 184-210 (hereinafter: Governing Stock Markets).

enforcers.<sup>21</sup>

Second, we provide empirical evidence on the problem of selective enforcement in Chinese markets over the last decade.<sup>22</sup> On average, private listed firms do face the highest probability of being sanctioned during our sample time, while the central-government-controlled firms (CGCF) enjoy obvious favorable treatment, both in terms of the number and severity of sanctions. However, it can be argued that state-owned enterprises (SOEs) comply with the regulations more strictly, a hypothesis that cannot be tested by our study. If we look into the enforcement preferences of specific public regulators, it seems that private listed firms are less discriminated by the CSRC, its 38 ROs and SHSE since 2012, whereas the CSRC and its ROs have been disproportionately enforcing rules against provincial-government-controlled firm (PGCF). The discriminatory attitude against private enterprises can only be found in SZSE's enforcement actions, which could be explained by the fact that it has a high percentage of listed private firms.

The article is organized as follows: Section 2 discusses the allocation of regulatory authorities among different regulators and offers a resource-based measure of the regulatory input of the CSRC. Section 3 presents our data. Section 4 assesses the public enforcement of securities laws in China empirically. Section 5 concludes.

## 2. AN OVERVIEW OF SECURITIES LAW ENFORCEMENT IN CHINA

### 2.1. The allocation of enforcement authorities

This subsection will present a brief overview on the public enforcement mechanisms of China securities law rather than a comprehensive review, which can be found in previous studies.<sup>23</sup> The CSRC plays a key role in the public enforcement of China's

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<sup>21</sup> See Amanda M. Rose, "Reforming Securities Litigation Reform: Restructuring the Relationship between Public and Private Enforcement of Rule 10b-5," *Columbia Law Review* 108 (2008): 1301-1364.

<sup>22</sup> For discussions on selective public enforcement, see William M. Landes and Richard A. Posner, "The Private Enforcement of Law," *Journal of Legal Studies* 4 (1975): 1-46 (hereinafter: Private Enforcement of Law).

<sup>23</sup> See Clarke, "Law without Order," 131-99; Layton, "Is Private Securities Litigation," 1948-78; Liebman and Milhaupt, "Reputational Sanctions," 929-83.

securities law and is granted authority to investigate major illegal activities<sup>24</sup> and issue administrative sanctions<sup>25</sup> or non-administrative sanctions<sup>26</sup>. The power to address minor infractions of listed firms are delegated to CSRS's 38 ROs<sup>27</sup> and two stock exchanges, so that administrative resources can be efficiently used, local conditions can be taken into account, and information can be collected and handled timely. Unlike local courts that are dependent on local governments, the ROs and two stock exchanges are directly subordinated to the CSRC and enjoy high degree of independence from local governments.

ROs are mainly responsible for regulating listed firms that are incorporated in their jurisdictions. More specifically, their duties include day-to-day supervision, preventing and handling market risks, investigation and sanction of illegal activities, and investor protection and education.<sup>28</sup> At the initial stage, ROs only have authorities to investigate and issue non-administrative sanctions.<sup>29</sup> In 2011, the CSRC

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<sup>24</sup> The MOF has the authority to investigate accounting anomalies of listed firms, but its regulatory outputs are limited. Regarding the role of the MOF, see article 42 of *1999 Accounting Law* (available at

[http://www.pkulaw.cn/fulltext\\_form.aspx?Db=chl&Gid=23550&keyword=%E4%BC%9A%E8%AE%A1%E6%B3%95&EncodingName=&Search\\_Mode=accurate](http://www.pkulaw.cn/fulltext_form.aspx?Db=chl&Gid=23550&keyword=%E4%BC%9A%E8%AE%A1%E6%B3%95&EncodingName=&Search_Mode=accurate), last visited Feb. 5, 2016).

<sup>25</sup> The definition, meaning, and scope of administrative versus non-administrative sanctions are stipulated in the article 8 of *2009 Administrative Penalty Law*, according to which administrative sanctions mainly include formal warnings, monetary fines, disgorgement of illegal gains, suspension of production or business, temporary seizure or revocation of license, and administrative detention (available at

[http://www.pkulaw.cn/fulltext\\_form.aspx?Db=chl&Gid=167113&keyword=%E8%A1%8C%E6%94%BF%E5%A4%84%E7%BD%9A%E6%B3%95&EncodingName=&Search\\_Mode=accurate](http://www.pkulaw.cn/fulltext_form.aspx?Db=chl&Gid=167113&keyword=%E8%A1%8C%E6%94%BF%E5%A4%84%E7%BD%9A%E6%B3%95&EncodingName=&Search_Mode=accurate), last visited Feb. 5, 2016).

<sup>26</sup> The non-administrative sanctions mainly include internal criticisms, public criticism, censure and correction order, etc.

<sup>27</sup> There are two ROs in each of Shanghai and Shenzhen where the stock exchanges reside. The RO in City of Qinghai has no regulatory output in our sample.

<sup>28</sup> See article 5 of the *CSRC's 2015 Provisions on the Regulatory Responsibilities of Resident Agencies* (available at

[http://www.pkulaw.cn/fulltext\\_form.aspx?Db=chl&Gid=259260&keyword=%E4%B8%AD%E5%9B%BD%E8%AF%81%E7%9B%91%E4%BC%9A%E6%B4%BE%E5%87%BA%E6%9C%BA%E6%9E%84%E7%9B%91%E7%AE%A1%E8%81%8C%E8%B4%A3%E8%A7%84%E5%AE%9A&EncodingName=&Search\\_Mode=accurate](http://www.pkulaw.cn/fulltext_form.aspx?Db=chl&Gid=259260&keyword=%E4%B8%AD%E5%9B%BD%E8%AF%81%E7%9B%91%E4%BC%9A%E6%B4%BE%E5%87%BA%E6%9C%BA%E6%9E%84%E7%9B%91%E7%AE%A1%E8%81%8C%E8%B4%A3%E8%A7%84%E5%AE%9A&EncodingName=&Search_Mode=accurate), last visited Feb. 5, 2016).

<sup>29</sup> See article 1 of the *CSRC's 2003 Notice on the Regulatory Responsibilities of Resident Agencies* (available at

[http://www.pkulaw.cn/fulltext\\_form.aspx?Db=chl&Gid=124725&keyword=%E6%B4%BE%E5%87%BA%E6%9C%BA%E6%9E%84%E7%9B%91%E7%AE%A1%E5%B7%A5%E4%BD%9C%E8%81%8C%E8%B4%A3&EncodingName=&Search\\_Mode=accurate](http://www.pkulaw.cn/fulltext_form.aspx?Db=chl&Gid=124725&keyword=%E6%B4%BE%E5%87%BA%E6%9C%BA%E6%9E%84%E7%9B%91%E7%AE%A1%E5%B7%A5%E4%BD%9C%E8%81%8C%E8%B4%A3&EncodingName=&Search_Mode=accurate), last visited Feb. 5, 2016).

launched a pilot project granting ROs in Shanghai, Guangdong and Shenzhen with the authorities to issue administrative sanctions against those minor cases.<sup>30</sup> On October 2013, the CSRC issued a notice announcing that all the ROs would be granted the authorities to make administrative sanctions.<sup>31</sup> The delegation of enforcement authorities to regional regulators also exists in the US, where the 11 regional offices of the SEC are responsible for investigating and litigating potential violations of the securities laws.<sup>32</sup>

According to the *2005 Securities Law*, China's stock exchanges are self-regulatory membership organizations<sup>33</sup>, but *de facto* they are under strict control of CSRC.<sup>34</sup> For example, the general managers and senior staffs of the stock exchanges are appointed by the CSRC. Hence, it is highly unlikely that the stock exchanges will enforce the laws against the CSRC's priorities. The two exchanges have no authorities to issue administrative sanctions, but their non-administrative sanctions, such as public criticism, have shown to bring significant reputational costs to listed companies.<sup>35</sup> In addition, the stock exchanges have two other powerful weapons to discipline listed firms, i.e. temporary suspension of trading and delisting.<sup>36</sup>

The administrative sanctions of the CSRC and its ROs also have significant third-party effects for the protection of minority shareholders, because these sanctions are the prerequisites for private securities litigation. Before 2002, the injured investors enjoyed no *de facto* rights of bringing lawsuits for compensation.<sup>37</sup> The situation

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<sup>30</sup> See <http://finance.ifeng.com/roll/20101102/2811349.shtml> (last visited Feb. 5, 2016).

<sup>31</sup> See the CSRC's website, available at [http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201309/t20130927\\_235486.html](http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201309/t20130927_235486.html) (last visited Feb. 5, 2016).

<sup>32</sup> *SEC Agency Financial Report Fiscal Year 2015*, at p.9 (available at <https://www.sec.gov/about/secreports.shtml>, last visited Feb. 5, 2016).

<sup>33</sup> See article 102(1) and article 105(2) of the *2005 Securities Law* (available at [http://www.pkulaw.cn/fulltext\\_form.aspx?Db=chl&Gid=233280&keyword=%E8%AF%81%E5%88%B8%E6%B3%95&EncodingName=&Search\\_Mode=accurate](http://www.pkulaw.cn/fulltext_form.aspx?Db=chl&Gid=233280&keyword=%E8%AF%81%E5%88%B8%E6%B3%95&EncodingName=&Search_Mode=accurate), last visited Feb. 5, 2016).

<sup>34</sup> See Liebman and Milhaupt, "Reputational Sanctions," at p. 931.

<sup>35</sup> *Id.*, at p. 962.

<sup>36</sup> See article 55 and article 56 of the *2005 Securities Law* (available at [http://www.pkulaw.cn/fulltext\\_form.aspx?Db=chl&Gid=233280&keyword=%E8%AF%81%E5%88%B8%E6%B3%95&EncodingName=&Search\\_Mode=accurate](http://www.pkulaw.cn/fulltext_form.aspx?Db=chl&Gid=233280&keyword=%E8%AF%81%E5%88%B8%E6%B3%95&EncodingName=&Search_Mode=accurate), last visited Feb. 5, 2016).

<sup>37</sup> The SPC even promulgated the *Notice Concerning Temporarily Not Accepting Civil Compensation Cases Related to Securities* on September 21, 2001, instructing lower courts to refuse acceptance of civil compensation cases related to securities disputes due to current legislative and judicial limitations (available at [http://www.pkulaw.cn/fulltext\\_form.aspx?Db=chl&Gid=36895&keyword=%E8%AF%81%E5%88%B8%E6%B0%91%E4%BA%8B%E8%B5%94%E5%81%BF&EncodingName=&Search\\_Mode=accurate](http://www.pkulaw.cn/fulltext_form.aspx?Db=chl&Gid=36895&keyword=%E8%AF%81%E5%88%B8%E6%B0%91%E4%BA%8B%E8%B5%94%E5%81%BF&EncodingName=&Search_Mode=accurate), last visited Feb. 5, 2016).

changed after the Supreme People's Court of the People's Republic of China (SPC) issued the *2002 Notice Regarding Accepting Tort Cases Arising from Stock Market False Disclosure* (henceforth, *SPC's 2002 Notice*), which, for the first time, explicitly allowed lower courts to accept civil cases for compensation brought by private parties.<sup>38</sup>

However, the *SPC's 2002 Notice* sets an administrative prerequisite for private actions, i.e., it requires that private litigations should be based on sanction decisions made by public agencies, particularly the CSRC and the MOF, or courts' criminal judgments. The prerequisite is criticized by several commentators because it prevents investors from bringing meritorious suits.<sup>39</sup> A recent empirical study carried out by Hui Huang shows that only around one quarter of eligible cases (65/253), i.e. those cases with administrative sanctions or criminal judgments against misrepresentation, are brought to court.<sup>40</sup> He points out that the inefficient court system imposes significant burdens on aggrieved investors, which compromises the compensatory role of private litigations.<sup>41</sup> As a result, the actions of the CSRC dominate the enforcement of China's securities laws. In the next subsection, we employ two resource-based proxies to measure the inputs of the CSRC and its ROs, which are compared with those of their American counterpart SEC.

## 2.2. A resource-based measure of regulatory inputs

The regulatory outputs are to a large extent determined by the inputs of regulatory agencies. It is hard or impossible to reach the optimal level of deterrence without

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<sup>38</sup> The private suits governed by *SPC's 2002 Notice* include those against misrepresentations in the stock market and exclude those due to insider trading and market manipulation.

<sup>39</sup> For discussions on administrative prerequisites and other features of *SPC's 2002 Notice*, see Li Guo and Allan V.Y. Ong, "The Fledgling Securities Fraud Litigation in China," *Hong Kong Law Journal* 39 (2009): 697-718 (hereinafter: *Fledgling Securities Fraud Litigation*); Walter Hutchens, "Private Securities Litigation in China: Material Disclosure About China's Legal System," *University of Pennsylvania Journal of International Economic Law* 24 (2003): 599-690 (hereinafter: *Private Securities Litigation*). Guiping Lu, "Private Enforcement of Securities Fraud Law in China: A Critique of the Supreme People's Court 2003 Provisions Concerning Private Securities Litigation," *Pacific Rim Law & Policy Journal* 12 (2003): 781-805 (hereinafter: *Securities Fraud Law*).

<sup>40</sup> Hui Huang, "Private Enforcement of Securities Law in China: A Ten-Year Retrospective and Empirical Assessment," *American Journal of Comparative Law* 61 (2013): 757-98 (hereinafter: *Private Enforcement*).

<sup>41</sup> In addition to the significant costs of using Chinese court system, retail investors also suffer from the collective action problem because only individual and joint actions, rather than class actions, are allowed. See Wenming Xu, "Reforming Private Securities Litigation in China: The Stock Market Has Already Cast Its Vote," *International Review of Law and Economics* 45 (2016): 23-32 (hereinafter: *Reforming Private Securities Litigation*).

sufficient resources.<sup>42</sup> In terms of securities law, Jackson and Roe propose a resource-based approach that attempt to gauge the intensity of public enforcement by measuring the regulators’ staffing and budget levels.<sup>43</sup> We follow their approach, collect data on the staffing and budget levels of both the CSRC and the SEC from 2010 to 2014, and compare regulatory inputs between the CSRC and the SEC (and other jurisdictions in Jackson and Roe’s paper). Table 1 presents both the absolute and standardized levels of regulatory inputs of both agencies.

**Table 1: Staffing and budget levels of the CSRC versus that of the SEC**

Year	Panel A. CSRC				Panel B. SEC			
	Budget	Budget (std)	Staff	Staff (std)	Budget	Budget(std)	Staff	Staff(std)
2014	155,512.05	14,912.21	3,167	2.32	1,550,513.00	89,012.74	4,150	13.02
2013	156,080.11	16,456.90	3,183	2.34	1,402,477.00	83,639.82	4,023	12.71
2012	134,528.94	15,867.74	2,891	2.14	1,236,057.00	76,473.73	3,785	12.05
2011	118,760.09	15,945.12	2,745	2.04	1,713,531.00	110,422.68	3,844	12.33
2010	112,080.34	18,638.80	2,589	1.94	1,592,638.00	106,428.66	3,748	12.12

Note: <sup>a</sup> The data on annual budget and staffing levels are standardized by annual GDP and population size respectively. The unit for “Budget” is “thousand US dollars”, for “Budget (std)” is “per billion US dollars of GDP”, for “Staff” is “head count”, and for “Staff (std)” is “per million of population”.

<sup>b</sup> The data on the CSRC’s annual budget is drawn from the website of the State Council of the P.R.C., available at <http://www.gov.cn/>; the data on the SEC’s annual budget is drawn from the account *Total Budgetary Resources* in *SEC Agency Financial Report Fiscal Year 2011-2014*, available at <https://www.sec.gov/about/annrep.shtml>; the data on annual exchange rate between RMB and US dollars, GDP and population of both China and the US are drawn from World Development Indicators, available at <http://data.worldbank.org/data-catalog/world-development-indicators/>.

We report the absolute annual budget of the CSRC and the SEC in column 1 and 5, respectively. Although the CSRC’s budget has been increasing steadily from 2010 to 2014, its absolute budget level is only around one tenth of the SEC by the end of 2014. In contrast, the absolute number of the CSRC’s staffing is quite close to that of the SEC’s, as can be seen in Column 3 and 7. The reason for the coexistence of a small budget and a relatively large staffing base is probably due to the lower average salary paid to staff members in China. After adjusting for the annual GDP, the standardized budget of the CSRC is around 20% of that of the SEC, but the staffing level of the CSRC decreases to less than 20% of the of the SEC when the difference in population size of China and the US is taken into consideration. A significant proportion of the CSRC’s staffing is affiliated to the 38 ROs, which increases from 73.1% in 2010 to

<sup>42</sup> Richard B. Stewart and Cass R. Sunstein, “Public Programs and Private Rights,” *Harvard Law Review* 95 (1982): 1193-322.

<sup>43</sup> See Jackson and Roe, “Public and Private Enforcement,” 207-38.

75.7% in 2014.<sup>44</sup> The SEC also has 11 regional offices mainly comprising of enforcement staff,<sup>45</sup> but we cannot access the information on their staffing levels from the SEC's annual report.

Even worse for China, only a small part of the staff and budget inputs reported here is devoted to enforcement activities. The enforcement function of the CSRC is mainly performed by its examination division, which was founded in 2007. The staffing number of the examination division is around 300,<sup>46</sup> taking less than 10 percent of the total staff member of the CSRC. In contrast, a previous report shows that the staff number of the SEC's enforcement division was 1,117 in 2008, with more than 50% being the investigative attorneys.<sup>47</sup> In addition, the amount of the SEC's 2014 budget used to enforce securities law (under the account of *Enforcement and Compliance Inspections and Examinations*) is 768,785 thousand dollars, which is about 50% of its annual budget.<sup>48</sup>

The staffing and budget levels of the CSRC are also unremarkable when compared with that of public regulators in other countries, as reported by Jackson and Roe.<sup>49</sup> The minimum and median of "Budget per billion US dollars of GDP" reported in their basic sample are 5,576 and 60,675 respectively, and those of "Staff per million of population" are 0.43 and 6.35 respectively. In contrast, the highest standardized annual budget of the CSRC is around 18,638.80 (2010) and the highest standardized annual staffing number of the CSRC is around 2.34 (2013). It is obvious that the resources at the disposal of the CSRC are considerably limited.

It may therefore be reasonable to argue that China is close to civil law countries, such as Japan and Germany, which invest a small amount of resources to enforce their securities laws. This conclusion is consistent with the results of Jackson and Roe, whereas (at least partially) in contradiction with the legal origin theory that claims that civil law countries regulate their market more intensively.<sup>50</sup> It should be noted that

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<sup>44</sup> *CSRC Annual Report 2010-2014* (available at <http://www.csrc.gov.cn/pub/newsite/zjhjs/zjhnb/>, last visited Feb. 5, 2016).

<sup>45</sup> *SEC Agency Financial Report Fiscal Year 2014*, at p. 9 (available at <https://www.sec.gov/about/secreports.shtml>, last visited Feb. 5, 2016).

<sup>46</sup> In 2014 there was rumor on the market that CSRC would double the staffing level of examination division to 600, see [http://finance.ifeng.com/a/20140604/12477301\\_0.shtml](http://finance.ifeng.com/a/20140604/12477301_0.shtml) (In Chinese). But no official news has come out until January 2016.

<sup>47</sup> See United States Government Accountability Office, *Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement* (2009), at p. 17-18 (available at <http://www.gao.gov/assets/290/288156.pdf>, last visited Feb. 5, 2016).

<sup>48</sup> *SEC Agency Financial Report Fiscal Year 2014*, at p.75 (available at <https://www.sec.gov/about/secreports.shtml>, last visited Feb. 5, 2016).

<sup>49</sup> See Jackson and Roe, "Public and Private Enforcement," 207-38.

<sup>50</sup> See La Porta, Lopez-de-Silanes and Shleifer, "Economic Consequences," at p.286.

China has adopted a stringent *ex ante* screening process to ensure the quality of listed firms. For example, the quota system established at the start of the two stock exchanges is proven to provide incentives for regional governments to compete with each other and select high-quality firms to list on the market.<sup>51</sup> It is obvious that the CSRC and its ROs lack sufficient resources to enforce securities laws as stringently as the SEC. However, regulatory outputs are not entirely dependent on regulatory input, and we need more information to understand the pattern and performance of China's public enforcement. In next section, we describe our data set, which is used to empirically assess the outputs of public regulators in China.

### 3. THE DATA

Previous studies usually obtain their data on regulatory outputs from regulators' websites, which is in piecemeal, and sometimes inconsistent, and therefore restrict their abilities to study public enforcement in China comprehensively. We take a different approach by collecting the information on enforcement outcomes from regulated firms, which are required to disclose these sanctions to the public.<sup>52</sup> We employ a sanction-based measure of regulatory output, rather than individual- or firm-based measure.<sup>53</sup> CSMAR's data set has 3558 entries of sanctions, starting from 1994.<sup>54</sup>

Unfortunately, the information on the characteristics of sanctioned listed firms before 2003 is not fully available, and we hence exclude 369 entries, in which sanctions were made before that year. In addition, we exclude other 375 entries of sanctions not made by the CSRC, its ROs, the MOF or two stock exchanges, leaving

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<sup>51</sup> See Pistor and Xu, "Governing Stock Markets," 184-210.

<sup>52</sup> Listed firms are required to disclose major events that may influence the price of their securities and derivatives. The definition of major event is given by the Article 30 (11) of the *Administrative Measures for the Disclosure of Information of Listed Companies* (promulgated by CSRC in Jan. 30<sup>th</sup>, 2007, available at [http://www.pkulaw.cn/fulltext\\_form.aspx?Db=chl&Gid=83590&keyword=%E4%B8%8A%E5%B8%82%E5%85%AC%E5%8F%B8%E4%BF%A1%E6%81%AF%E6%8A%AB%E9%9C%B2&EncodingName=&Search\\_Mode=accurate](http://www.pkulaw.cn/fulltext_form.aspx?Db=chl&Gid=83590&keyword=%E4%B8%8A%E5%B8%82%E5%85%AC%E5%8F%B8%E4%BF%A1%E6%81%AF%E6%8A%AB%E9%9C%B2&EncodingName=&Search_Mode=accurate), last visited Feb. 5, 2016). More specifically, it refers to situations as follows: when listed firms breaking laws and regulations are under public investigations, or receive criminal or major administrative sanctions, and when the directors, supervisors and senior managers of listed firms breaking laws and regulations are under public investigations or coercive measures. Our data is mainly from the CSMAR, one of the largest financial data suppliers in China (available at <http://www.gtarsc.com/>).

<sup>53</sup> A sanction-based measure means that the regulatory output is counted by the sanction decisions made by various regulators, rather than the individuals or firms punished in each decision. It is highly likely that one decision sanctions multiple individuals or firms.

<sup>54</sup> The latest date for us to access the data set is January 8, 2016.

our sample of 2814 entries.<sup>55</sup> We find that 53 sanctions are jointly made by two regulators and double-count these sanctions as regulatory outputs for each of these two regulators. We further exclude 77 repetitive recordings.<sup>56</sup> Finally, we survey the website of the CSRC and supplement our data with additional 237 administrative sanctions, which are mainly made against non-listed firms or individuals. As a result, our data set covers 3026 administrative sanctions made by the CSRC, its ROs, the MOF or two stock exchanges, of which 837 sanctions are against non-listed firms or individuals and 2189 ones are against listed firms.<sup>57</sup>

In our sample, there are in total 1083 listed firms that have received certain type of sanctions, of which 36.57% (396), 54.94% (595) and 8.49% (92) are listed on SHSE, SZSE and Growth Enterprise Market<sup>58</sup>, respectively. Based on the nature of ownership, i.e. the identities of their controllers, listed firms are classified into five groups: Private firm (PF), foreign firm (FF), municipal-government-controlled firm (MGCF), PGCF and CGCF.<sup>59</sup> Table 2 reports the distribution of these firms by their industries and ownership. As shown in Column 3, around 62.3% of sanctioned firms (675/1083) are in the manufacturing industry. Firms in other industries receive far fewer sanctions. This may simply because firms in the manufacturing industry account for a large percentage of total listed firms. In terms of ownership, we find that 56.2% of sanctioned firms are PFs.

CSMAR also provides the information necessary to identify the misconducts leading to public sanctions. Listed firms are most commonly sanctioned for misrepresentations in information disclosure, including misleading statements, delayed disclosure, material omission and false disclosure.<sup>60</sup> In contrast, non-listed firms or individuals are most commonly sanctioned for transactional misconducts (including insider trading and illegal transaction of stocks) and misrepresentation

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<sup>55</sup> The excluded sanctions are made by the firms themselves, or environmental protection agencies, or safety control agencies, etc, which do not fit the classification of public enforcement of securities law.

<sup>56</sup> We find and delete two types of repetitive recordings: First, we delete those entries that are recording exactly the same content; second, for the same illegal activities, the CSRC may sanction the listed firms, its law firms and accounting firms in separate administrative decisions, which are recorded in different entries and therefore deemed as repetitive recordings.

<sup>57</sup> Non-listed firms or individuals received fewer sanctions in our sample is probably due to the fact that a significant proportion of sanctions are not disclosed.

<sup>58</sup> The Growth Enterprise Market is regulated by SZSE.

<sup>59</sup> For listed firms sanctioned in 2015, the information on the identities of their controllers is not available. Hence, we use the data reported at the end of 2014 as substitutes.

<sup>60</sup> A listed firm is usually sanctioned for multiple misconducts in one decision. Our sample covers 4461 sanctioned misconducts of listed firms, of which 2434 are related to misrepresentation. The second largest group is the miscellaneous, which includes 1199 sanctioned misconducts.

(including delayed disclosure and material omission).<sup>61</sup> In the following section, we will use this data to explore several unsettled questions concerning public enforcement regime in China.

#### 4. PUBLIC ENFORCEMENT OF SECURITIES LAWS: AN EMPIRICAL ASSESSMENT

The public enforcement in China is often claimed to suffer from high costs of under-enforcement and selective enforcement.<sup>62</sup> In this section, we use our data set to investigate the enforcement pattern of public regulators from 2003 to 2015, and test the validity of these assertions.

##### 4.1. Under-enforced securities laws?

Looking at the enforcement outputs of the CSRC in early this century, several commentators conclude that the securities laws are weakly enforced.<sup>63</sup> In Figure 1, we report the number of total sanctions (NTS), the number of sanctions against listed firms (NSLF) and the number of sanctions against non-listed firms or individuals (NSNF) each year from 2003 to 2015. Generally speaking, the public enforcement outputs stayed at a considerably low level before 2009, with around 100 cases per year. Hence, the argument that securities law in China was weakly enforced before 2009 is fairly tenable and supported by our data. However, the situation has changed significantly since 2010 and the enforcement output reached its peak of more than 450 sanctions in 2012, which was twice of that two years ago. The number of listed firms increases for around 20% from 2010 to 2012, which indicates that the increase in public enforcement is not driven by the increased base of regulated firms.<sup>64</sup>

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<sup>61</sup> Our sample covers 1104 sanctioned misconducts of non-listed firms or individuals, of which 488 and 275 are related to transactional misconducts and misrepresentation respectively.

<sup>62</sup> See two seminal articles on regulatory capture, George J. Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science* 2 (1971): 3-21; Sam Peltzman, "Toward a More General Theory of Regulation," *Journal of Law & Economics* 19 (1976): 211-40.

<sup>63</sup> See Allen, Qian and Qian, "Law, Finance," 57-116; Clarke, "Law without Order," 131-99; Layton, "Is Private Securities Litigation," 1948-78, at p.1976; Pistor and Xu, "Governing Stock Markets," 184-210.

<sup>64</sup> See *CSRC Annual Report 2014*, at p.14 (available at <http://www.csrc.gov.cn/pub/newsite/zjhjs/zjhnb/>, last visited Feb. 5, 2016).

**Table 2: Distribution of sanctioned listed firms sanctioned by industry and ownership**

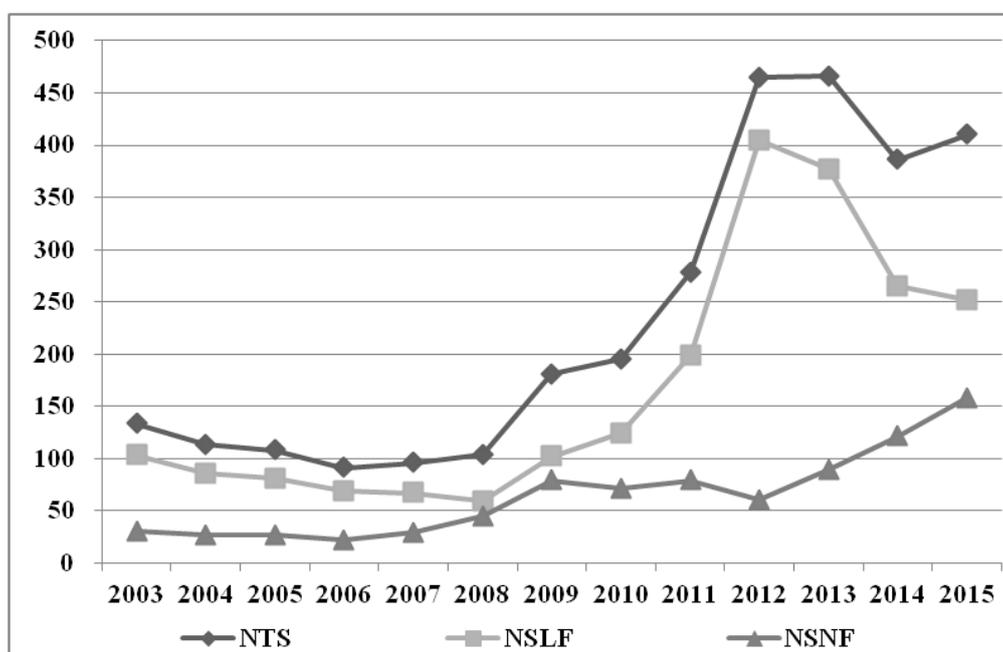
	Agriculture, forestry, animal husbandry and fishery	Mining	Manufacturing	Electricity, heat, gas and water production and supply	Construction	Wholesale and retail	Transportation, storage and postal service	Accommodation and restaurants	Information transmission, information technology and software
PF	17	15	409	4	19	29	8	4	38
FF	0	1	24	0	0	2	0	0	1
MGCF	5	2	91	19	3	21	5	0	1
PGCF	5	6	72	11	8	5	7	1	4
CGCF	3	5	79	8	2	3	3	0	3
Subtotal	30	29	675	42	32	60	23	5	47
	Finance	Real estate	Leasing and business service	Scientific research and technical services	Water conservancy, environmental protection and public facilities	Healthcare and social work	Culture, sports and entertainment	Miscellaneous	Total
PF	6	36	5	2	4	1	4	8	609
FF	1	4	0	0	1	0	0	0	34
MGCF	8	20	1	0	3	0	3	2	184
PGCF	5	3	0	0	1	0	3	2	133
CGCF	4	7	2	0	1	0	1	2	123
Subtotal	24	70	8	2	10	1	11	14	1,083

Note: The 2012 CSRC Guidelines for Industrial Classification is used.

It is obvious to see from Figure 1 that the total regulatory output is boosted up by the sharp increase of the sanctions against listed firms. We therefore further report the number of sanctions against listed firms that are issued by different public agencies to examine the force behind such change (see Table 3). In Panel A of Table 3 where the enforcement outputs of the five main regulators are presented, we can find that SZSE and ROs are the main enforcers of securities law in China, as they account for around 77.16% of total enforcement actions against listed firms. This is particularly the case for ROs, which imposed in total 839 sanctions after 2010, accounting for around 56% of the total regulatory outputs in this period.

ROs started to play a more important role in enforcing securities law in China after 2011, when the CSRC initiated a pilot project to delegate the authority to impose administrative sanctions against minor cases to RO in Shanghai (RO(SH)), RO in Shenzhen (RO(SZ)) and RO in Guangdong (RO(GD)).<sup>66</sup> In Panel B, we report the enforcement outputs of these three ROs. The number of sanctions issued by ROs in these three regions takes around 25% of the total output of 38 ROs. The governance structure of China’s public enforcement in securities law has therefore been similar with China’s authoritarian political regime, which has been termed as a “regionally decentralized authoritarian (RDA) model”<sup>67</sup>, and may share the comparable advantages (or disadvantages) created by such as regime.

**Figure 1: Number of total sanctions, sanctions against listed firms and non-listed firms or individuals**



<sup>66</sup> More details can be found at <http://finance.ifeng.com/roll/20101102/2811349.shtml>. (In Chinese)

<sup>67</sup> Chenggang Xu, “The Fundamental Institutions of China’s Reforms and Development,” *Journal of Economic Literature* 49 (2011): 1076-151.

The RDA model combines the attributes of centralization and decentralization together. On the one hand, the Chinese political and personnel governance structure has been highly centralized. Subnational government officials are appointed and promoted from above,<sup>68</sup> which serves as powerful incentives to induce regional officials to follow the central government's policies. On the other hand, substantial powers are delegated to subnational governments. They have the general responsibility for initiating and coordinating reforms, providing public services, and making and enforcing laws within their jurisdictions. This regime is argued to have decisively contributed to China's miraculous economic growth by encouraging inter-regional competition around certain performance indicators, such as GDP (total or per capita), GDP growth rate, and FDI, and by using regional experiments to initiate and test new reform policies that weaken political resistance and reduce uncertainties.

**Table 3: Year-by-year statistics of sanctions against listed firms issued by different public regulators**

	Panel A													
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total
CSRC	22	26	15	21	22	15	14	17	18	15	17	18	29	249
MOF	0	0	0	1	3	3	1	1	4	1	5	2	2	23
SHSE	16	18	18	17	10	6	5	7	4	23	26	41	37	228
SZSE	60	36	48	30	26	24	29	45	55	134	103	70	55	715
RO	5	6	0	0	6	11	53	54	118	232	226	134	129	974
	Panel B													
RO(SZ)	0	0	0	0	0	2	8	8	13	20	14	11	7	83
RO(GD)	0	0	0	0	0	0	0	4	7	39	23	6	10	89
RO(SH)	0	0	0	0	1	0	2	1	2	14	31	6	15	72

The relationship between the CSRC and its local agencies can be argued to duplicate the relationship between China's central and local governments. On one hand, local agencies are subordinated to the order of the CSRC (particularly its personnel power), which means that the authority is highly centralized. On the other hand, local agencies have been granted considerable power to regulate listed companies, leading to a certain degree of decentralization. With a properly designed incentive mechanism, such as a performance targets system that is prevalent in China's governance system, officials in local agencies can be motivated to devote their attention to particular objectives preferred by their principals, such as an aggressive regulatory strategy. Officials in local agencies may also be incentivized to compete with each other on

<sup>68</sup> More specifically, this personnel control system is a nested network in which the center directly controls the key positions at the provincial level and grants each tier of subnational government the power to appoint key officials at the next level below. Each level of subnational government oversees the appointment, evaluation, promotion, and dismissal of its subordinate-level regional leaders.

certain indicators designed by the CSRC, such as sanctions issued or fines collected each year, and therefore become even more aggressive than that can be implied by the targets system.<sup>69</sup>

Moreover, a RDA-like governance structure may help to improve the performance of China's public enforcement in securities law by taking advantage of the territorial proximity (and hence information accessibility) between local agencies and the targeted listed companies. Local agencies have an informational advantage over the CSRC on the listed companies, and may therefore implement securities law more efficiently and more effectively. Finally, a RDA-like structure may help the CSRC to distance itself from blame-generating situations in which local agencies fail to enforce securities law effectively. In other words, local agencies act as "buffer zones" that protect the CSRC from social dissatisfaction and cushion the CSRC from potential crises.<sup>70</sup>

When the outputs of ROs are taken into consideration, the enforcement intensity of the CSRC is comparable to that of the SEC after 2010. The annual enforcement outputs of the CSRC and its ROs from 2011 to 2014 recorded in our sample are 181, 288, 300, and 235, respectively, whereas during the same time those of the SEC are

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<sup>69</sup> Certainly, there is a possibility that regional competition may lead to a "race for the bottom" rather than a "race for the top". For example, economic goals, such as GDP growth, tax collection, and FDI inflow have long been targets that are tightly correlated with the prospects for promotion of local officials in China and that therefore incentivize them to pursue economic construction projects regardless of local conditions, public opinion, and even national law if they are understood to conflict with economic aims. Certain economic, social and environmental problems have therefore emerged and endangered the stability of China's economy and society. See, for example, Guangdong Xu and Michael Faure, "Explaining the Failure of Environmental Law in China," *Columbia Journal of Asian Law*, forthcoming (2016). For more general discussions on the topics of "race for the bottom" and "race for the top", see William L. Cary, "Federalism and Corporate Law: Reflections upon Delaware," *Yale Law Journal* 83 (1974): 663-705; Ralph K. Winter, "State Law, Shareholder Protection, and the Theory of the Corporation," *Journal of Legal Studies* 6 (1977): 251-292.

<sup>70</sup> As Lü puts it clearly, "the Chinese central government is poised to benefit from social policy initiatives regardless of the success or failure of policy implementation. If a social policy is not well implemented at the local level, residents receive few policy benefits. Then citizens blame the local government because they hold it responsible for providing public goods and service, even though the implementation failure may be caused by insufficient transfers from upper levels of government. Conversely, if the policy is implemented successfully and local residents benefit, they credit the central government more than the local government, because state media tend to favor the central government, which initiated the policy and provides fiscal transfers to the local government". See Lü, Xiaobo, "Social Policy and Regime Legitimacy: The Effects of Education Reform in China," *American Political Science Review* 108 (2014): 423-437, at p.426.

735, 734, 676 and 755, respectively.<sup>71</sup> Considering that the number of listed domestic firms in China is around 60% of that in the US,<sup>72</sup> the intensity of public enforcement of securities laws in China is around one half to two thirds of that in the US in recent four years. Given that the resources at disposal of the CSRC is only around 20% of that of the SEC (see Section 2.2.), the input-output ratio of the CSRC is actually much higher than that of the SEC.

Despite the significant improvements in public enforcement in recent years, securities law is still taken as an ineffective instrument by investors who are injured by misconducts in stock markets for two reasons. First, the private enforcement mechanism still functions poorly and very few suits are brought to court each year. Private parties cannot sue for damages without administrative prerequisites.<sup>73</sup> The problem is aggravated by the inefficient court system and collective action problems among injured investors. On average, only 25.7% of eligible cases that meet the requirement of administrative prerequisites finally result in securities civil suits.<sup>74</sup> Private enforcement therefore fails to compensate harmed investors and deter potential infringements meaningfully.<sup>75</sup>

Second, the monetary penalties imposed by the CSRC are relatively negligible compared to that by its American counterpart. Table 4 presents the annual penalties and disgorgements imposed by the CSRC and the SEC. The monetary sanctions imposed by the CSRC are only around 2% of that imposed by the SEC, which is extremely low considering the fact that the CSRC in theory only investigates the major cases. The most important reason is that there are statutory restrictions on the fines that can be imposed by the CSRC. For example, the fine that the CSRC could impose on listed firms for misrepresentation ranges from 300,000 to 600,000 RMB (48,860-97,720 US dollars), while the fine on individuals ranges from 30,000 to

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<sup>71</sup> See SEC's website, available at <https://www.sec.gov/news/newsroom/images/enfstats.pdf> (last visited Feb. 5, 2016).

<sup>72</sup> From 2011 to 2014, the number of listed firms in China is 2342, 2494, 2489 and 2613 respectively, and that in the US is 4171, 4102, 4180 and 4369 respectively, see the World Bank Indicators, available at <http://data.worldbank.org/indicator/CM.MKT.LDOM.NO> (last visited Feb. 5, 2016).

<sup>73</sup> For discussions on the effects of administrative prerequisites on private enforcement of securities law, see Guo and Ong, "Fledgling Securities Fraud Litigation," 697-718 ; Hutchens, "Private Securities Litigation," 599-690; Lu, "Securities Fraud Law," 781-805.

<sup>74</sup> See Huang, "Private Enforcement," 757-98; Xu, "Reforming Private Securities Litigation," 23-32.

<sup>75</sup> In contrast, the average annual number of private enforcement, including class actions and stock exchanges arbitrations, was around 2824 between 2002 and 2004 in the American markets, see Jackson, "Variation in the Intensity," at p.280.

300,000 RMB (4,886-48,860 US dollars).<sup>76</sup> Hence, except for the potential reputational costs and criminal sanctions, the culpable face extremely limited monetary penalties.

**Table 4: Total penalties and disgorgements obtained by SEC and CSRC  
(million US dollars)**

	2011	2012	2013	2014
Total penalties and disgorgements obtained by SEC	2800	3100	3400	4160
Total penalties and disgorgements obtained by CSRC	54	69	117	77

Note: <sup>a</sup> The data is collected from the *SEC Agency Financial Report Fiscal Year 2011-2014*, and *CSRC Annual Report 2011-2014*.

<sup>b</sup> The average official exchange rate reported by World Bank Indicators is employed to convert RMB to US dollars, which is 6.46, 6.31, 6.20 and 6.14 from 2011 to 2014 respectively, available at <http://data.worldbank.org/>.

#### 4.2. Selective enforcement of securities laws?

One major concern raised by Landes and Posner on a monopolistic public enforcer is the risk of discretionary non-enforcement.<sup>77</sup> Selective enforcement is a salient threat to the development of securities market in China, given that *de facto* the CSRC enjoys the exclusive authority in public enforcement and a high percentage of listed firms are owned or controlled by various levels of governments.<sup>78</sup> To concentrate our discussions, we focus on the enforcement preferences of regulators against listed firms in this subsection.<sup>79</sup> An enforcement intensity index (EII), which is calculated with Equation (1) by dividing the annual number of sanctions received by listed firms with certain ownership with the total number of listed firms with the same ownership

<sup>76</sup> Article 193 of *Securities Law* (available at [http://www.pkulaw.cn/fulltext\\_form.aspx?Db=chl&Gid=233280&keyword=%E8%AF%81%E5%88%B8%E6%B3%95&EncodingName=&Search\\_Mode=accurate](http://www.pkulaw.cn/fulltext_form.aspx?Db=chl&Gid=233280&keyword=%E8%AF%81%E5%88%B8%E6%B3%95&EncodingName=&Search_Mode=accurate), last visited Feb. 5, 2016).

<sup>77</sup> See Landes and Posner, “Private Enforcement of Law,” 1-46.

<sup>78</sup> A previous study using the enforcement data disclosed by CSRC’s annual reports also finds that it provides a relatively “level playing field” for listed firms, except that CGCFs receive favorable treatments, see Tianshu Zhou, “Is the CSRC Protecting a ‘Level Playing Field’ in China’s Capital Markets: Public Enforcement, Fragmented Authoritarianism and Corporatism,” *Journal of Corporate Law Studies* 15 (2015): 377-406. Also the strategy of focusing law enforcement could in certain circumstances generates positive net social gains given the limited resources at the disposal of CSRC, see Henrik Lando and Steven Shavell, “The advantage of focusing law enforcement effort,” *International Review of Law and Economics* 24 (2004): 209–218.

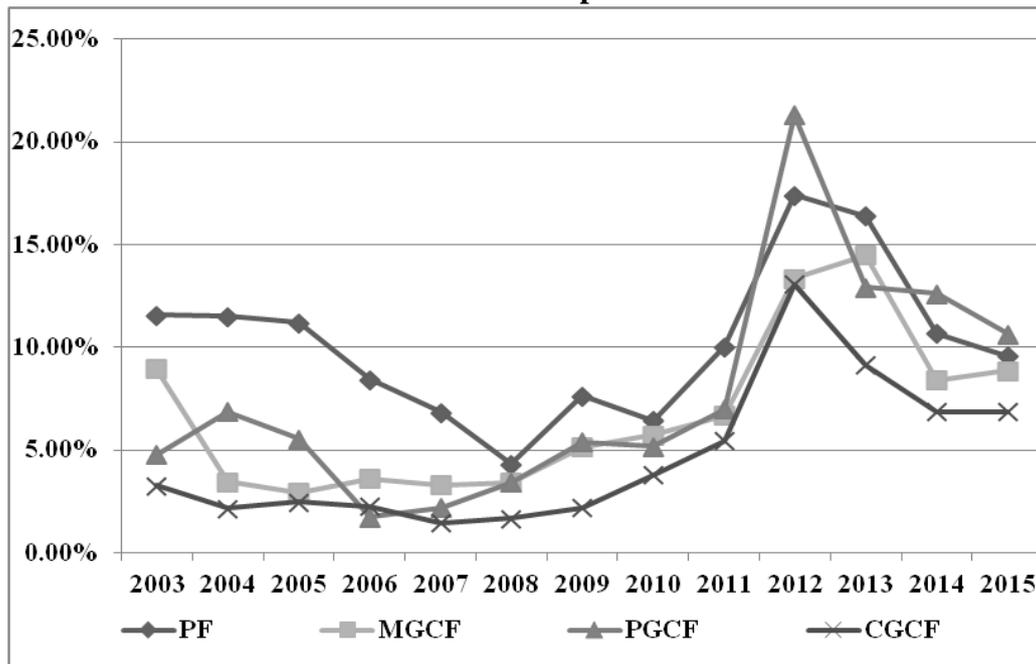
<sup>79</sup> The data set used in this subsection excludes those sanctions issued by MOF and those against FFs because the number is too small to conduct meaningful in-depth analysis. Hence, the sample size is reduced to 2108 sanctions against listed firms.

in that year, is used to measure the probability of receiving public sanctions.

$$\text{EII} = (\text{The annual number of sanctions received by PF/MGCF/PGCF/CGCF}) / (\text{The annual number of PF/MGCF/PGCF/CGCF listed on the market}) \quad \text{Equation (1)}$$

Figure 2 presents the EII for each group of firms. Clearly, PFs suffered from an enforcement bias with the highest EII, MGCFs and PGCFs in the middle, and CGCFs had the lowest. In 2003, the probability of being sanctioned for PFs is around 11.56% and that for CGCFs is only around 3.26%. But the gap started to converge after 2005, which is due to the fact that the number of PFs increased quickly during this time, while the absolute number of sanctions received by each group of firms remained stable. Similar to that shown in Figure 1, EIIs for all groups of firms increase significantly and move in a similar trend after 2010, partially due to the increase in RO's outputs. By the measure of EII, the selective enforcement problem against PFs was a prominent concern in the early years of twenty-first century, but this bias has been mitigated in recent years with only CGCFs still enjoying obvious preferential treatment of public regulators.<sup>80</sup>

**Figure 2: The enforcement intensity index for listed firms with different types of ownership**



We further look into the enforcement preferences of different regulators and construct an enforcement preference index (EPI), which is calculated by using Equation (2). EPI compares the probability of being sanctioned for firms with different types of ownership with the probability of being sanctioned for all firms. The logic behind the

<sup>80</sup> It must be admitted that we cannot rule out the possibility that CGCFs have established a better corporate governance structure that leads to fewer infringements.

ratio is simple. If a regulator has no bias in enforcing the securities laws against a given type of firms, the value of EPI should be close to 1. If a regulator over- or under-enforce the securities laws, the value of EPI should be larger/smaller than 1. Table 5 reports the EPIs for each regulator from 2003 to 2015.

$$\text{EPI} = (\text{Probability of being sanctioned for PF/MGCF/PGCF/CGCF}) / (\text{Probability of being sanctioned for all firms}) = (\text{Number of sanctions against PF/MGCF/PGCF/CGCF} / \text{Number of listed PF/MGCF/PGCF/CGCF}) / (\text{Number of Total sanctions} / \text{Number of listed firms})$$

Equation (2)

The last row of Table 5 reports the average EPI of firms with different types of ownership for each regulator over our sample period, where the EPI against PFs is significantly higher than 1, indicating that PFs receive a disproportionately higher percentage of sanctions. In contrast, CGCFs are sanctioned less often than other groups of firms. If looking into the enforcement outputs of each regulator from a time-series perspective, we can find different enforcement patterns among these regulators. Panel A reports the CSRC's EPI against different groups of firms. Before 2012, MGCFs and PGCFs also enjoyed obvious preferential treatment when compared to PFs, but the situation changed thereafter as they are sanctioned more intensively by CSRC.

In Panel B, RO's EPI is presented. Before 2009, ROs sanctioned listed firms sporadically (accounting for around 3% of the total output), and their outputs significantly increased after 2010, when RO (SZ), RO(GD) and RO(SH) were granted with the authorities to issue administrative sanctions. The EPIs of RO against PFs, MGCFs and PGCFs are similar after 2011 and that against CGCFs is significantly lower. Panel C and Panel D report the EPIs of the two stock exchanges, SHSE and SZSE, which also differ from each other in enforcement patterns. Starting from 2011, SHSE went easy on PFs and enforced regulations more intensively against CGCFs. In contrast, SZSE has a higher EPI against PFs. It is worthy noted that the reason that PFs lived a relatively easy life in recent years is partially due to the fact that the number of total listed PFs increases for around 20%, while the number of other groups of firms remain stable, which dilutes the EPI for PFs.

**Table 5: The enforcement preference index of different regulators for listed firms with different types of ownership**

Year	Panel A. CSRC				Panel B. RO				Panel C. SHSE				Panel D. SZSE			
	PF	MGCF	PGCF	CGCF	PF	MGCF	PGCF	CGCF	PF	MGCF	PGCF	CGCF	PF	MGCF	PGCF	CGCF
2015	0.94	0.97	2.00	0.58	1.06	0.99	1.06	0.71	0.79	1.52	1.11	1.21	1.23	0.50	1.02	0.59
2014	1.12	0.67	1.67	0.40	0.96	1.13	1.39	0.73	0.88	0.91	1.75	1.09	1.39	0.28	0.61	0.44
2013	1.02	1.38	1.06	0.41	1.04	1.19	0.96	0.64	1.20	0.45	0.69	1.07	1.29	0.61	0.74	0.50
2012	1.06	1.13	1.22	0.46	1.06	0.75	1.22	0.91	0.84	1.23	0.80	1.49	1.09	0.81	1.52	0.51
2011	1.21	0.91	0.99	0.36	1.19	0.90	1.00	0.45	0.45	1.37	0.00	3.28	1.27	0.51	0.49	0.97
2010	1.37	1.19	0.00	0.38	0.97	1.30	1.45	0.36	1.42	0.00	2.35	0.00	1.17	0.76	0.37	1.24
2009	1.07	0.94	1.11	0.83	1.25	1.09	0.97	0.31	1.86	0.81	0.00	0.00	1.52	0.56	0.99	0.37
2008	1.19	0.97	1.37	0.36	1.28	1.09	0.69	0.53	0.85	1.21	1.14	0.89	1.39	0.91	0.86	0.44
2007	1.69	0.62	0.31	0.76	2.21	0.00	1.12	0.00	1.59	1.02	0.00	0.55	1.53	1.05	0.78	0.00
2006	1.65	0.93	0.30	0.51	0.00	0.00	0.00	0.00	1.70	0.77	0.37	0.63	1.93	0.65	0.42	0.36
2005	2.33	0.38	0.42	0.37	0.00	0.00	0.00	0.00	2.30	0.32	0.35	0.62	1.62	0.61	1.34	0.36
2004	1.49	0.64	1.69	0.23	2.15	0.46	1.04	0.00	2.50	0.15	0.70	0.33	1.70	0.70	0.87	0.49
2003	1.35	1.36	0.56	0.00	2.97	0.50	0.00	0.00	1.16	1.25	0.38	0.75	1.42	1.04	0.71	0.50
Avg.	1.34	0.93	0.98	0.43	1.24	0.72	0.84	0.36	1.35	0.85	0.74	0.92	1.43	0.69	0.82	0.52

Another proxy that could be used to gauge the enforcement intensity is the severity of issued sanctions. In our sample, the regulators mainly use non-administrative sanctions and four types of administrative sanctions including criticism, warning, censure and fine, which are arranged in the ascending order of severity.<sup>81</sup> We construct an enforcement severity index (ESI) to measure the magnitude of discrimination against firms with different ownership, which is calculated according to Equation (3) by dividing the number of each type of penalties by the number of sanctions received by each group of firms. If firms with certain ownership are given preferential treatment and sanctioned less severe, then ESI for the less severe type of sanction will be larger, indicating that a higher percentage of sanctions are associated with lighter penalties.

$$\text{ESI} = (\text{The number of each type of penalties against PF/MGCF/ PGCF/CGCF}) / (\text{The number of total sanctions received by PF/MGCF/ PGCF/CGCF}) \quad \text{Equation (3)}$$

Table 6 presents the ESIs for listed firms with different types of ownership. Generally speaking, CGCFs receive the lightest penalties. They have the highest ESI for non-administrative sanctions, which suggests that they are most often sanctioned with non-administrative sanctions. In addition, their ESIs for the more severe administrative sanctions, including criticism, warning, censure and fine are the lowest among all groups of firms. In contrast, PFs and MGCFs are sanctioned most severely. Their ESIs for non-administrative sanctions are the lowest and they have much higher chance to receive more severe administrative sanctions.

**Table 6: The enforcement severity index for listed firms with different types of ownership**

	Non-administrative				
	sanctions	Criticism	Warning	Censure	Fine
PF	61.79%	16.43%	8.18%	10.93%	11.24%
MGCF	54.01%	18.09%	6.72%	13.95%	13.70%
PGCF	64.92%	12.90%	5.24%	11.29%	11.29%
CGCF	72.22%	13.64%	4.55%	6.57%	7.07%

It is not difficult to explain the enforcement discrimination faced by private companies in China. This is just a miniature of the big picture of China's economy, particularly its financial system. China's financial system is claimed to conform to the stereotype described by financial repression theory. For example, Huang and Wang argue that "despite more than 30 years' economic reform, the Chinese economy still possesses the typical characteristics of financial repression: heavily regulated interest rates, state-influenced credit allocation, frequently adjusted reserve requirements and

<sup>81</sup> The other two possible administrative sanctions are disgorgement of illegal gains and disqualifications.

tightly controlled capital accounts”.<sup>82</sup> Johansson also claims that “repressive financial policies constitute a central problem in the Chinese economic system”.<sup>83</sup>

Under such a repressed financial environment, scarce financial resources, particularly credit, have been systematically and continually allocated to less profitable but more politically preferable ventures, particularly SOEs, whereas private firms – which have become the driving force behind China’s economic growth – are forced to rely on informal and even underground credit channels to finance their survival. According to the *Report on the Development of Private Economy in China 2008-2009*, the narrow private sector (i.e., domestic privately owned and individual businesses) accounted for only 7.4% to 13.5% of the total bank loans issued from 2002 to 2008.<sup>84</sup> By contrast, SOEs, particularly those under the control of central government, are the main beneficiaries of the financial rents created by distorted financial policies.<sup>85</sup> Brandt and Zhu find that over the 1998–2003 period, the state sector, which is defined to include companies in which governments have significant ownership shares, continued to absorb between one-half and two-thirds of new bank lending.<sup>86</sup>

The discrimination can be attributed to the ideology of the Chinese Communist Party that plays a leading role in China’s political life and enjoys the monopoly of power. The attitude of the Party towards private enterprises is consistently unfriendly. Haggard and Huang report that “despite the well-documented process of economic reform in China, the domestic private sector remains relatively small and subject to a variety of policy and economic constraints”.<sup>87</sup> A plausible explanation for this

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<sup>82</sup> Yiping Huang and Xun Wang, “Does Financial Repression Inhibit or Facilitate Economic Growth? A Case Study of Chinese Reform Experience,” *Oxford Bulletin of Economics and Statistics* 73 (2011): 833-855.

<sup>83</sup> Anders C. Johansson, “Financial Repression and China’s Economic Imbalances,” in *Rebalancing and Sustaining Growth in China*, ed. Huw Mckay and Ligang Song, 45-64 (Canberra: ANUE-Press, 2012).

<sup>84</sup> Available at [http://www.china.com.cn/news/zhuanli/09myjjlps/2009-09/28/content\\_18621412.htm](http://www.china.com.cn/news/zhuanli/09myjjlps/2009-09/28/content_18621412.htm) (last visited Feb. 5, 2016).

<sup>85</sup> See Guangdong Xu and Binwei Gui, “Why Are China’s State-Owned Enterprises so Profitable? A Financial Repression Perspective,” in *Market Integration: The EU Experience and Implications for Regulatory Reform in China*, ed. Niels Philipsen, Stefan Weishaar and Guangdong Xu, 139-163 (Berlin/Heidelberg: Springer, 2015).

<sup>86</sup> Loren Brandt and Xiaodong Zhu, “China’s Banking Sector and Economic Growth,” in *China’s Financial Transition at a Crossroads*, ed. Charles Calomiris, 86-136 (New York: Columbia University Press, 2007).

<sup>87</sup> Stephan Haggard and Yasheng Huang, “The Political Economy of Private-Sector Development in China,” in *China’s Great Economic Transformation*, ed. Loren Brandt and Thomas G. Rawski, 337-374 (Cambridge: Cambridge University Press, 2008).

phenomenon is that the Party might reason that, endowed with economic power and wealth today, private entrepreneurs will gain political power in the future and therefore pose a threat to its ruling.<sup>88</sup> After all, as McGregor clearly states, private entrepreneurs “were more like valued foster-children than part of the family”.<sup>89</sup>

It is also understandable to find that SOEs controlled by the central government are more favoured by regulators in their enforcement than SOEs controlled by local governments. After several rounds of reform and reorganisation, a number of powerful central SOEs have emerged as “national champions” in sectors of strategic importance, with unprecedentedly high levels of remuneration and managerial independence from governmental agencies. A certain number of leaders from these SOEs are represented in important Party fora such as the Central Committee and therefore can exert significant influence over China’s economic policies. As Brødsgaard reports, “once a CEO has been elected member of the Central Committee he/she will try to influence policy-making within his/her field of expertise”, and “leaders with a background in business have an opportunity to advance the interests of the business groups and industrial sectors in which they have worked”.<sup>90</sup> These SOEs have become powerful interest groups and enforcement against them may be a politically unwise decision.

## 5. CONCLUSION

This article empirically investigates the public enforcement regime in China. Using resource-based measure of regulatory inputs, we find that the CSRC has considerably limited resources at disposal compared to its counterparts in the US and other jurisdictions. However, the public enforcers in China have significantly increased their outputs since 2011, when the CSRC delegated the authorities to issue administrative sanctions over minor cases to its 38 ROs. Despite the significant improvements in public enforcement in recent years, securities law is still taken as an ineffective weapon by harmed investors because of the poor private enforcement and the negligible monetary penalties imposed by the CSRC. We also confirm the existence of selective enforcement problem in China’s stock markets. PFs suffer from enforcement discrimination and receive a disproportionately large number of sanctions from public regulators, whereas the CGCFs face the lowest probability of being sanctioned. However, the enforcement discrimination has been reduced in recent years.

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<sup>88</sup> Yasheng Huang, *Selling China: Foreign Direct Investment During the Reform Area* (New York: Cambridge University Press, 2003).

<sup>89</sup> Richard McGregor, *The Party: The Secret World of China’s Communist Rulers* (New York: HarperCollins Publishers, 2010).

<sup>90</sup> Kjeld Erik Brødsgaard, “Politics and Business Group Formation in China: The Party in Control?” *The China Quarterly* 211 (2012): 624-648.