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Shame fills a vacuum in China’s financial law enforcement

The vast gaps in the regulations governing China’s financial markets are no secret. The risks are spelled out in mind-numbing detail in every Chinese share prospectus issued to Western investors: They run the gamut from the possibility of full-blown Communist expropriation to bad accounting, insider trading, market manipulation and fraud.

There are enough prosecutions to indicate that mischief-making goes on, but not enough to make enforcement appear credible. Even when there are rules, the line between acceptable and unacceptable conduct is often unclear, and some actions are patently unfair. There is, for example, no “full” disclosure law, no match of regulation in America. Companies frequently meet investors selectively. The information that emerges can include changes in senior management—and hence strategy—and be of extraordinary value. In more developed markets, aggrieved shareholders kept in the dark could sue for private lawsuits; but private litigation in China is allowed only after the state has determined malfeasance.

Given these shortcomings, China might well be shunned by investors, but it is not. Its Shanghai and Shenzhen stockmarkets—though falling sharply this year—were together capitalised at $3.9 trillion at the end of January, more than in any country in the world except America and Japan. Despite their size, the markets are not efficient, however. Share-price movements, according to several studies, do not fit as closely with financial results as in other large markets. That is not only bad for investors; it also undermines the stockmarket’s broader economic job of channelling capital to where it can best be used.

Name and shame

Plenty of studies demonstrate the role of a good legal environment to financial markets. But Benjamin Liebman and Curtis Milhaupt, two professors at Columbia Law School, argue in a forthcoming paper that, whatever the limitations of the scope and enforcement of China’s laws, another form of regulation has quietly emerged. Drawing on China’s traditions, the authorities now also discipline wrongdoers using public criticism.

Financial markets are usually regulated through well enforced securities laws, like the ones America introduced during the Depression; or through self-regulation, as in America before the Depression and in London’s Alternative Investment Market today. For many years academics focused more on laws, believing that exchanges pursued members’ interests rather than those of investors. But a landmark study by Paul Mahoney, of the University of Virginia, a decade ago began to shift support towards self-regulation. Privately run markets have an interest in safeguarding investors, because that is the best means of increasing listing and trading volumes and thus of generating more fees. When exchanges were run by the state, it was not clear whether the self-interest worked in that way.

When China’s two stock exchanges were created in 1990, the chief goal was to use private savings to restructure state-owned firms. Investors received only minority stakes and limited sway over corporate governance. Equally important, both exchanges were run by bureaucrats, so there were fewer incentives to increase their value by attracting companies and punters. There was little effective competition between them.

Over the past 18 years, China has introduced rules against market manipulation, fraud and insider dealing, but enforcement remains patchy. The China Securities Regulatory Commission seems competent but overwhelmed. Sometimes it takes years to issue penalties after lengthy investigations—and along the way cases lose relevance.

In the meantime, the exchanges have quietly begun to acquire authority. The power that they wield seems flimsy—the most serious penalty they can levy is a rebuke to firms and individuals through public notices. But it is remarkably effective in a country with a long history of punishment by humiliation—think of the caigne, a rectangular slab around the neck, in pre-Communist times and duce caps in the Cultural Revolution.

Messrs Liebman and Milhaupt write that between 2001 and 2006 the exchanges publicly criticised 205 companies and almost 1,700 people. They looked at the share prices of the targeted firms both when they disclosed the conduct for which they were being criticised and when the criticism was published. The admissions typically preceded the rebukes, and in the few weeks that followed the firms’ share prices underperformed the Shanghai stockmarket by an average of up to 6% (see left-hand chart). After the criticism, there was a further lag of up to 3% on average (see right-hand chart).

Using evidence from extensive interviews, Messrs Liebman and Milhaupt point to other damage too. Raising money through equity markets and banks became more costly, and sometimes impossible, for companies that had been criticised. Suppliers and customers also took a tougher line. Some people lost the right to be a director or senior manager, and suffered from pariah status in a country where there is little pity for failure. The criticisms were sometimes even a prelude to formal investigations by the regulatory authorities.

Criticism may count for a couple of reasons, the authors suggest. Amid the vacuum of information in China, any hint of bad news is likely to be seized upon. And, in a state-run economy, it’s never good to be unpopular with the authorities.

From an academic point of view, more intriguing is that the exchanges have begun to regulate themselves even though they are not private. This suggests that there is room, even in countries with authoritarian governments, for new forms of governance to emerge when laws fail. It is quite conceivable that the exchanges may become better regulators than the official ones.

* "Reputational Sanctions in China’s Securities Market", to be published in the Columbia Law Review.