Public Enforcement of Securities Laws in Weak Institutional Environments: Evidence from China

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ABFER Annual Conference, May 29, 2019

Motivation

- It is common practice to borrow laws from advanced countries instead of reinventing the wheels (David and Brierley 1985; Hay and Shleifer 1998).

- European setting
  - Disclosure reform in Europe since the late 1990s has been patterned on the legislative framework of U.S. securities laws (Karmel 2005).
  - European Union's initiative in the early 2000s regarding the Market Abuse Directive (MAD) was launched to mimic the best practice in the U.K. on insider dealing and market manipulation (Hansen 2002).
  - Evidence from European countries suggests that securities laws imported from the U.S./U.K. have achieved their intended objectives (see, for example, Christensen, Hail, and Leuz 2016).

❖ However, there is a lack of academic research on how developing and emerging economies fare when importing laws from advanced economies.

Summary

- **What?**
- Examine the effectiveness of a public enforcement measure implemented in a weak institutional environment.

- **How?**
- U.S. style public enforcement implemented in China
  - The largest emerging economy in the world
  - On December 19, 1990 and July 3, 1991, the Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE) were launched, respectively.

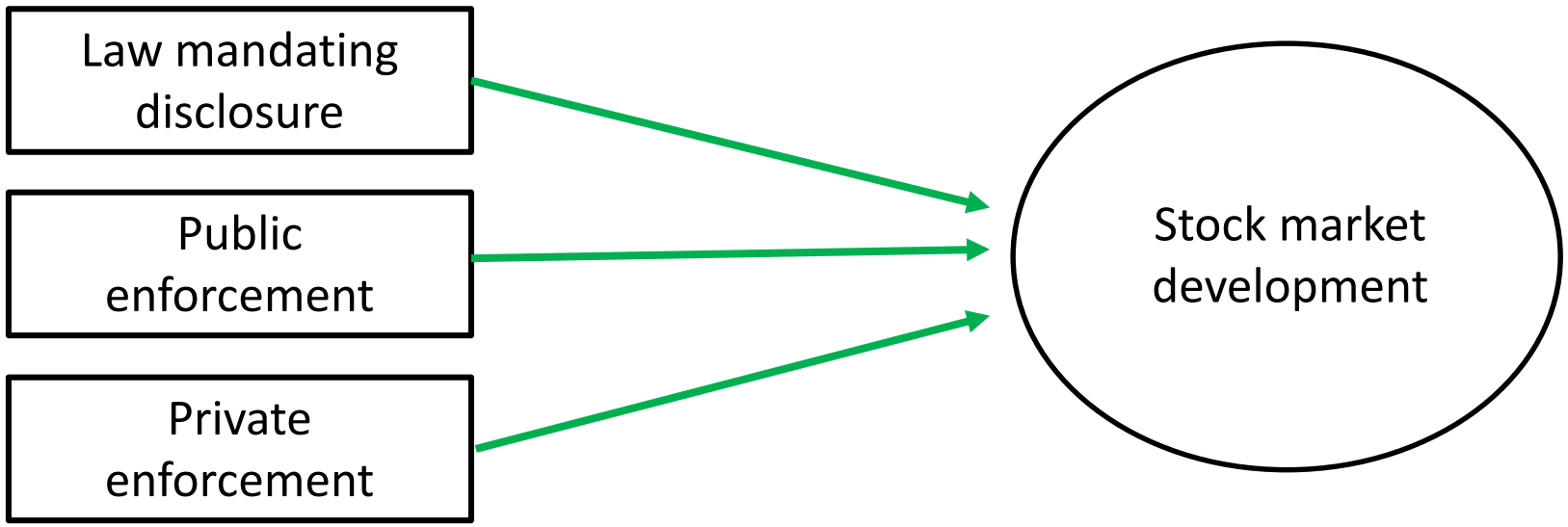
上海證券交易所
SHANGHAI STOCK EXCHANGE

深圳证券交易所
SHENZHEN
STOCK EXCHANGE

  - China's securities regulatory framework **largely followed** that of the U.S.

Summary

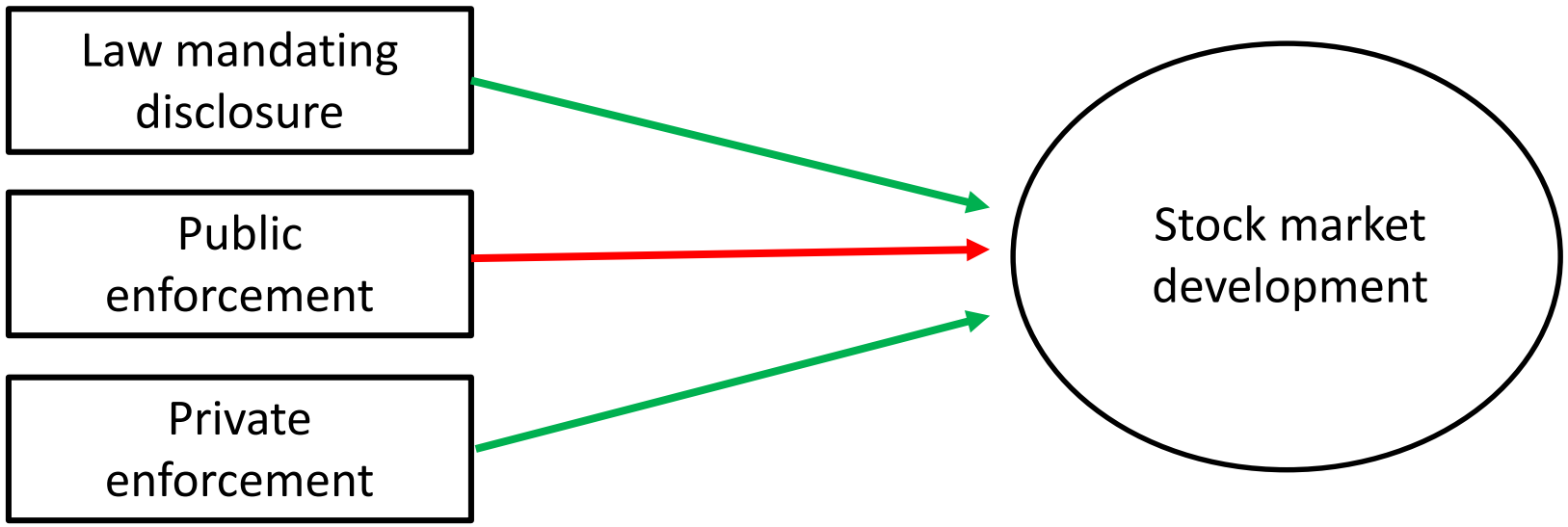
- **Prior literature**



Summary

- **Prior literature**

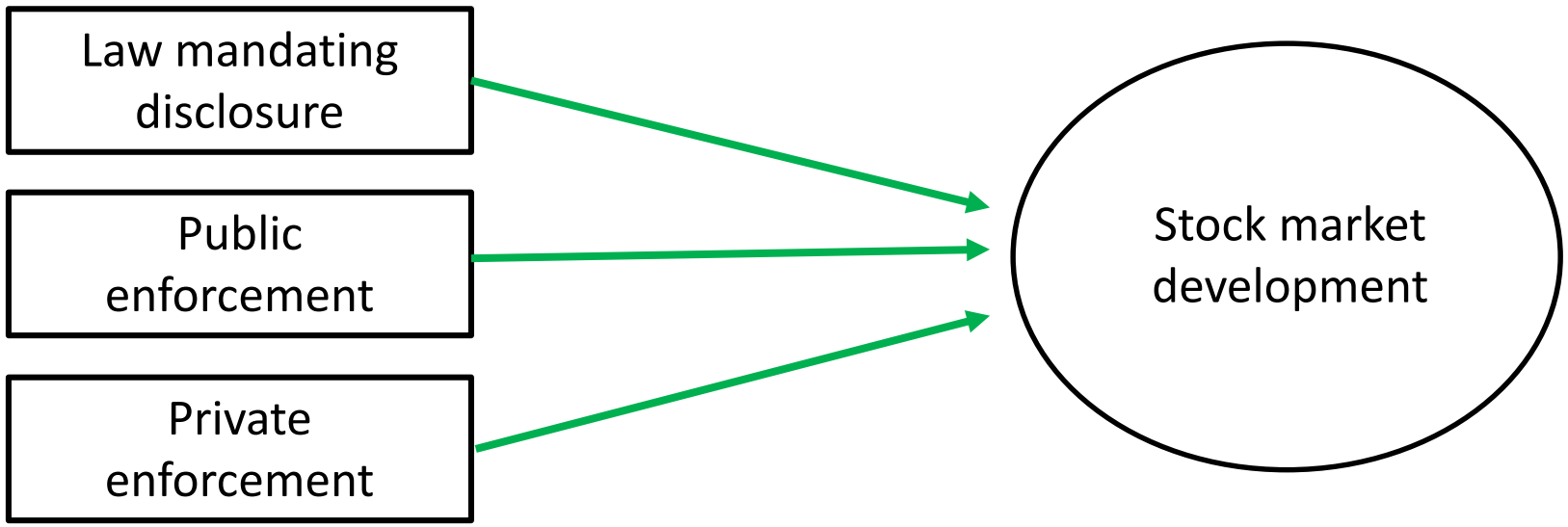
La Porta et al 2006



Summary

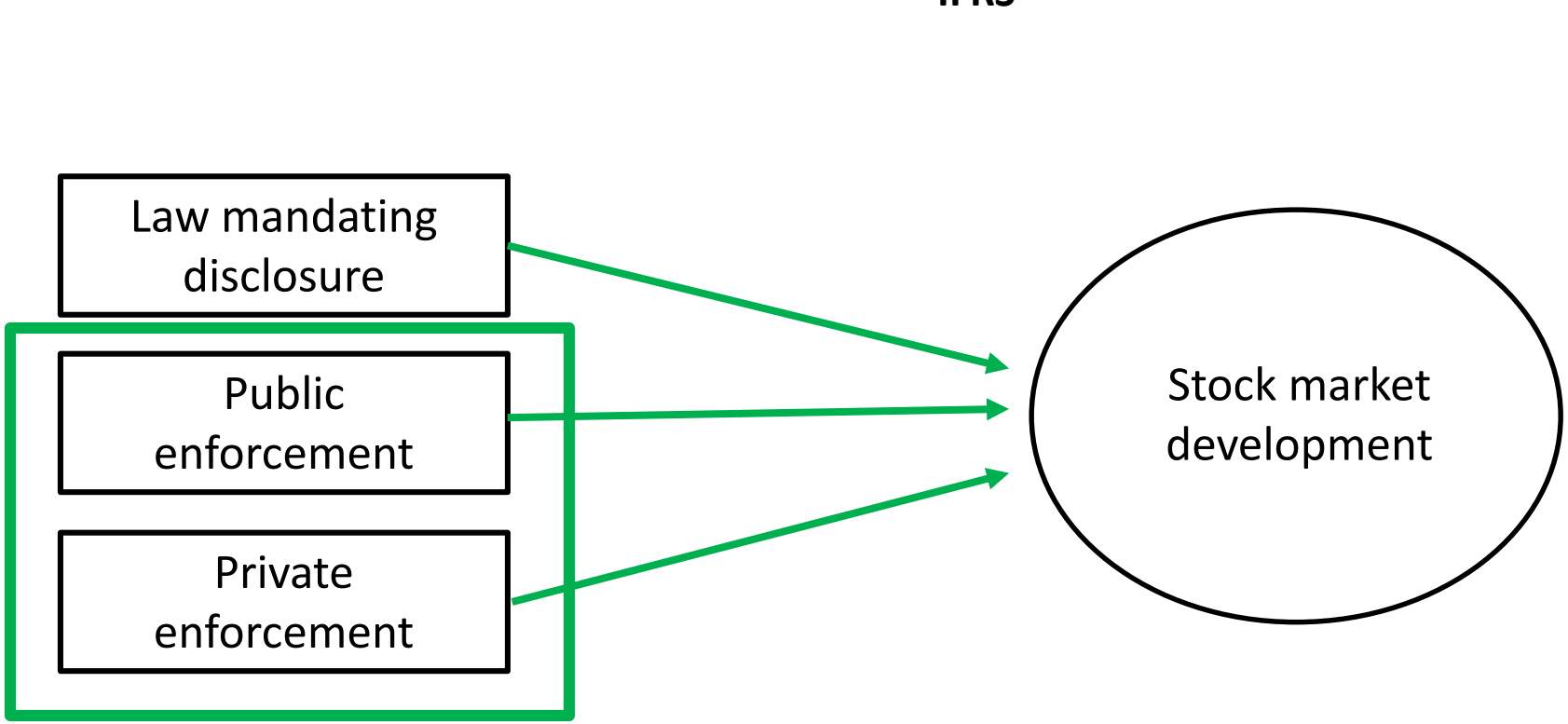
- **Prior literature**

Jackson and Role 2009



Summary

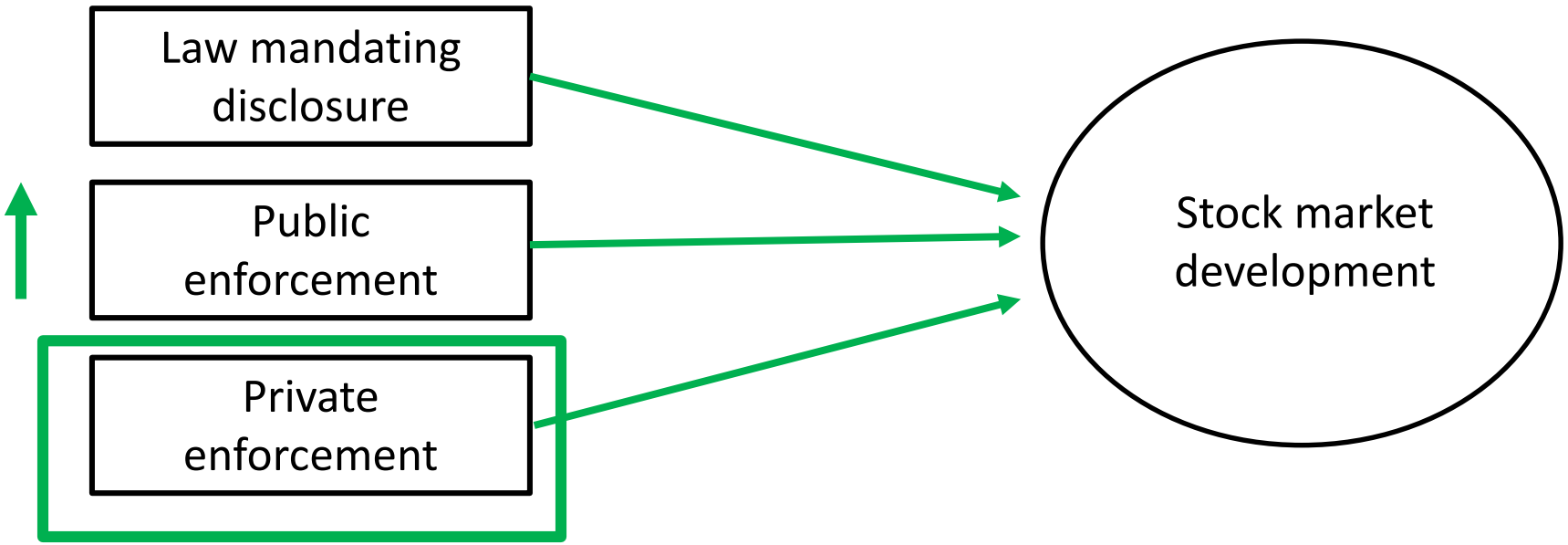
- **Prior literature**



Summary

- **Prior literature**

Our paper



Summary

- **Why?**

- By focusing on the largest emerging economy – China, our study highlights the challenge of importing best practices from elsewhere.

- By examining the determinants and consequence of public enforcement of mandatory disclosure using data outside the U.S., our paper provides a richer understanding of the important interaction between disclosure regulation/enforcement and a country's institutional framework (see Leuz and Wysocki 2016 for a review).

- Dynamic environment: regulator's actions, firms' response, and market and regulator response to firms' behavior.

The setting

- In 2014, China launched a major reform on regulatory oversight.

- One important means of regulatory oversight is the **comment letter review process** whereby stock exchanges review regulatory filings of listed firms and issue comments. The targeted firms are expected to reply and amend behavior promptly. (Shanghai Securities News 2014)

"*…necessary to strengthen the monitoring of firms' information disclosure, …, to ensure the proper functioning of stock markets*"

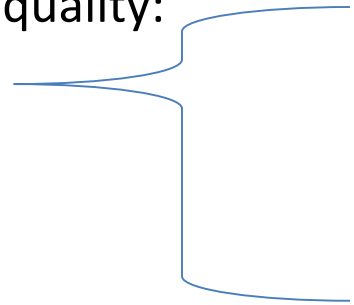
- Xiao Gang

U.S. Comment Letters - Benchmark

- U.S. CL review process leads to material improvement in firms' disclosure and information environment (e.g. Bozanic, Dietrich, and Johnson 2017; Johnston and Petacchi 2017; Cunningham, Johnson, Johnson, and Lisic 2018).

- Observe the dynamic of the regulatory action

- Determinants of regulatory quality:
  - Implementation level
  - Institutional fit



- Resource constraints
- Regulatory capture
- inefficient bureaucracies
- political pressures

China vs. U.S.

	China	U.S.
Regulatory body	China Securities Regulatory Commission (CSRC), Shanghai Stock Exchange (SSE), Shenzhen Stock Exchange (SZSE)	U.S. Securities and Exchange Commission (SEC)
Regulatory mandate	to promote stock market development; to protect investors; to prevent securities fraud; to support economic development	to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation
Regulatory mandate specific to CLs	to strengthening the protection of minority shareholders	to enhance compliance with "the applicable disclosure and accounting requirements" On its website, the SEC (2018b) describes the objective of CL reviews as follows: "Much of the Division's review involves evaluating the disclosure from a potential investor's perspective and asking questions that an investor might ask when reading the document. When the staff identifies instances when it believes a company can improve its disclosure or enhance its compliance with the applicable disclosure requirements, it provides the company with comments."
Staffing	The SSE assigns the review process to seven different industry groups. Each group has about ten professionals and each staff member is responsible to review about 25 companies. In addition, there is the annual report review support team that assist the industry groups to review the annual filings of public companies. (https://dedicated.wallstreetcn.com/qq/articles/3330880).	The DCF performs its primary review responsibilities through 11 offices/industry groups. The members of these 11 offices have specialized industry, accounting, and disclosure expertise. Generally, the Division has staffed the offices with 25 to 35 professionals, primarily accountants and lawyers. (https://www.sec.gov/divisions/corpfin/cffilingreview.htm).

China vs. U.S.

	China	U.S.
Frequency of CLs	at least once every three years, done by the two exchanges (SSE, SZSE); the response is typically required within seven days	Section 408 of the SOX requires the DCF to review U.S. listed-firm filings at least once every three years; the response is typically required within ten days
Factors affecting scrutiny	not applicable	(1) issuers that have issued material restatements of financial results; (2) issuers that experience significant volatility in their stock price as compared to other issuers; (3) issuers with the largest market capitalization; (4) emerging companies with disparities in price-to-earnings ratios; (5) issuers whose operations significantly affect any material sector of the economy; and (6) any other factors that the Commission may consider relevant.
First CL	2000	1998
Major regulatory changes	On January 21, 2014, Xiao Gang, the CSRC Chairman, made a speech at the Annual Futures Market Conference calling on major reforms of regulatory oversight (people.cn, assessed on June 8, 2018). The principle of oversight should be shifted from ex ante approval to ex post oversight.	On June 24, 2004, the SEC announced the public release of comment and responses related to 10-Ks filed after August 1, 2004. The SEC began to publish CLs on EDGAR on May 12, 2005 with a delay between the end of a review and dissemination of 20 business days.

Hypothesis development

On the one hand,

- the securities laws and regulations often change in China, the CL review process could be one of many "fads" pursued by the regulators and hence has no real consequences.

On the other hand,

- The review process is part of a reform on regulatory oversight of mandatory disclosure in 2014 with a focus on disclosure quality and standards that is different from previous regulatory effort.

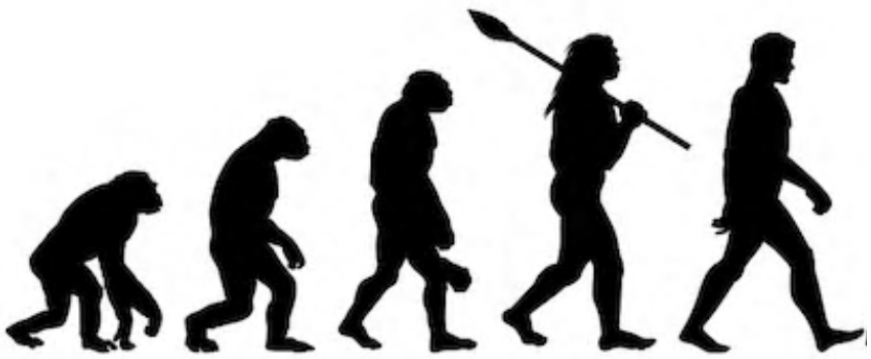
H1: *There is a significantly negative price reaction to CLs.*

- Determinant analysis
- Likelihood of amendments

U.S. Comment Letters - Benchmark

- U.S. CL review process leads to material improvement in firms' disclosure and information environment (e.g. Bozanic, Dietrich, and Johnson 2017; Johnston and Petacchi 2017; Cunningham, Johnson, Johnson, and Lisic 2018).

- Determinants of regulatory quality:
  - ~~Implementation level~~
  - Institutional fit



The institutional environment in China

1) Most Chinese investors are individuals, not institutions;
2) Most listed companies are reformed SOEs, not private firms;
3) Government approval requirements are ubiquitous, including initial public offerings or secondary offerings;
4) Courts are weak and judges are constrained;
5) There is no history of private securities litigation in China.

- China's legal and institutional environments preclude private enforcement from playing a significant role (see a similar argument made by Hay and Shleifer (1998) in the case of Russia and some general arguments by Segal and Whinston (2006)).

The institutional environment in China

- **On the other hand,**

In the absence of a culture of class action lawsuits or other market mechanisms in China (see, for example, Layton 2008; Jiang and Kim 2015), the CSRC and two stock exchanges institutionally are the last line of defense in policing financial reporting practices, and have the potential to make up for the lack of market discipline.

H2: *There is no real effect of CLs on corporate financial reporting practices.*

Sample formation

- There is no disclosure requirement of CLs/responses, we take a two-pronged approach to form our sample of CLs issued by the SSE:
  - For the period 2015-2017, we download CLs from the SSE's website, and supplement it with a search on the website of Shanghai Securities News (www.cnstock.com).
  - For the period 2013-2017, we download all corporate announcements from the website www.cnstock.com so we could conduct keyword search for CLs and/or their responses.
    - There are 600,081 announcements over the period.
    - We first impose the filter that the title of an announcement contains the word "annual report" (年报 or 年度报告), resulting in 23,949 announcements.
    - We then read each title of an announcement to determine whether a CL or a response to a CL is issued.
    - Finally, we also read the opening paragraph of "supplemental announcement related to a firm's annual report" (年报补充公告) to determine that a CL is issued if the beginning of the announcement says, "This supplemental announcement is made in response of receiving a comment letter…."

Our CL sample

Year	SSE	Corporate announcements			CLs (Yes or No)	No. of SSE firms	% of SSE firms receiving CLs
	(1) CLs	(2) CLs	(3) Responses	(4) Supplemental announcements	(5)	(6)	(7)
2013	0	3	76	25	104	950	10.95%
2014	0	1	119	14	134	1,005	13.33%
2015	76	49	9	3	137	1,077	12.72%
2016	124	31	0	3	158	1,217	12.98%
2017	126	72	0	0	198	1,404	14.10%
Total	326	156	204	45	731	5,653	12.93%

- The average frequency of Chinese firms receiving a CL each year is about **13** percent.
- The sample consists of 731 CLs issued to 483 unique firms: 306 firms only receive one CL, 126 firms receive two CLs in different fiscal years, and 51 firms receive three or more CLs in different fiscal years.

CL characteristics

Variable	N	Mean	Median	Std. Dev.	Min	Max
No. of pages	410	4.544	4.000	1.563	2.000	9.000
No. of questions	686	10.131	10.000	4.445	2.000	24.000
Revenue recognition	686	0.746	1.000	0.435	0.000	1.000

The probability of receiving CLs

Variable	Comment letter = 1	
	Logit	OLS
Internal control weakness	0.065	0.006
	(0.097)	(0.011)
High volatility	0.139	0.020
	(0.105)	(0.013)
Prior year stock return	-0.045	-0.007
	(0.107)	(0.012)
Log (market cap)	-0.168**	-0.016**
	(0.067)	(0.006)
Modified audit opinion	0.876***	0.172***
	(0.182)	(0.035)
Big4	-0.374	-0.020
	(0.251)	(0.018)
Auditor tenure	-0.016	-0.002
	(0.016)	(0.002)
Auditor turnover	0.241*	0.028
	(0.142)	(0.017)
CEO/COB duality	0.168	0.022
	(0.122)	(0.015)
Board independence	0.731	0.109
	(1.112)	(0.116)
Board size	-0.037	-0.003
	(0.032)	(0.003)
Institutional ownership	-0.655	-0.062
	(0.612)	(0.051)
Management ownership	-0.777	-0.105
	(0.759)	(0.085)
SOE	-0.321***	-0.039***
	(0.105)	(0.012)
Firm age	0.042***	0.005***
	(0.011)	(0.001)
Loss	0.809***	0.124***
	(0.134)	(0.023)
Special treatment	-0.448*	-0.057*
	(0.249)	(0.034)
Sales growth	0.128**	0.019*
	(0.058)	(0.010)
M&A	0.419***	0.046**
	(0.162)	(0.022)
Related party transaction	7.144***	1.055***
	(1.353)	(0.230)
Loan guarantee	0.326**	0.047**
	(0.139)	(0.022)
Foreign listing	-0.058	-0.002
	(0.203)	(0.018)
Constant	0.187	0.294**
	(1.217)	(0.119)
Industry fixed effects	YES	YES
Year fixed effects	YES	YES
Pseudo R^2 / Adj. R^2	0.092	0.074
N	5062	5084

Variable	Comment letter = 1	
	Logit	OLS
Log (market cap)	-0.168**	-0.016**
	(0.067)	(0.006)
Modified audit opinion	0.876***	0.172***
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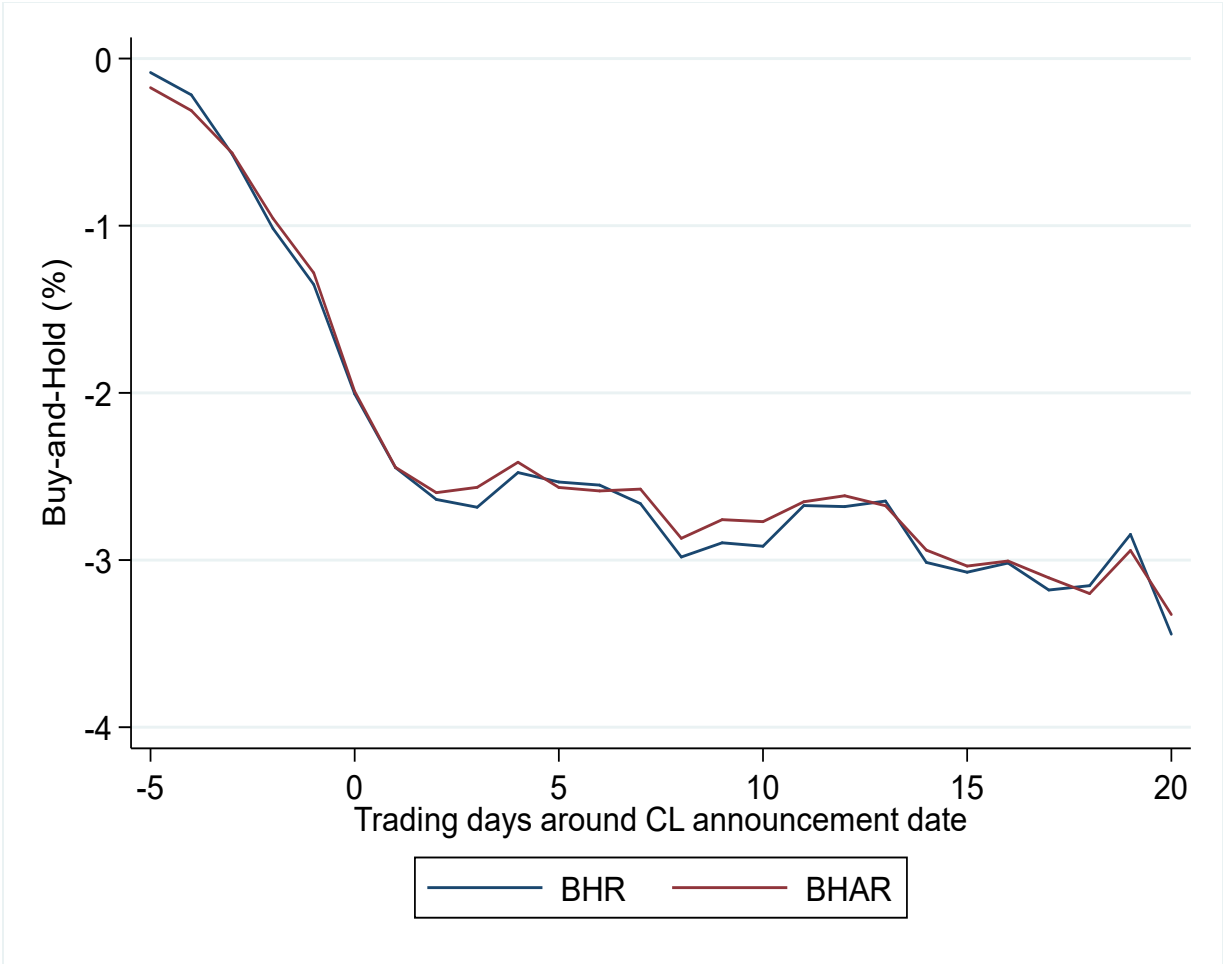
Loan guarantee	0.326**	0.047**
	(0.139)	(0.022)

- Fast-growing firms, and firms doing M&As, and firms engaged in related party transactions and/or providing loan guarantees to related parties are more likely to receive CLs.
- None of the corporate governance characteristics is significantly associated with the likelihood of a firm receiving CLs.

Buy-and-hold returns



CAR (-3, +1)	389	-0.022***	125 : 264

- Given that the average market capitalization of firms receiving CLs is 11.4 billion RMB, the average drop in market capitalization is 250.8 million RMB.

The empirical specification

- We estimate the following model to examine whether targeted firms are more likely to amend their annual reports in receipt of a CL:

$$Amendment_{it} = \beta_0 + \beta_1 CL_{it} + \beta_2 lnMarketCap_{it} + \beta_3 M/B_{it} + \beta_4 Leverage_{it} + \beta_5 CFO_{it} + \beta_6 InstitutionalOwnership_{it} + \beta_7 SOE_{it} + \beta_8 Loss_{it} + \beta_9 ForeignListing_{it} + \beta_{10} Big4_{it} + Firm\ and\ Year\ fixed\ effects + \varepsilon_{it},$$

Variable	Amendment		
	Logit	OLS	
CL	1.676***	0.205***	0.212***
	(0.126)	(0.027)	(0.020)
Controls	YES	YES	YES
Industry fixed effects	YES	NO	YES
Firm fixed effects	NO	YES	NO
Year fixed effects	YES	YES	YES
Pseudo R^2 / Adj. R^2	0.109	0.099	0.086
N	4,171	4,176	4,176

A quick summary

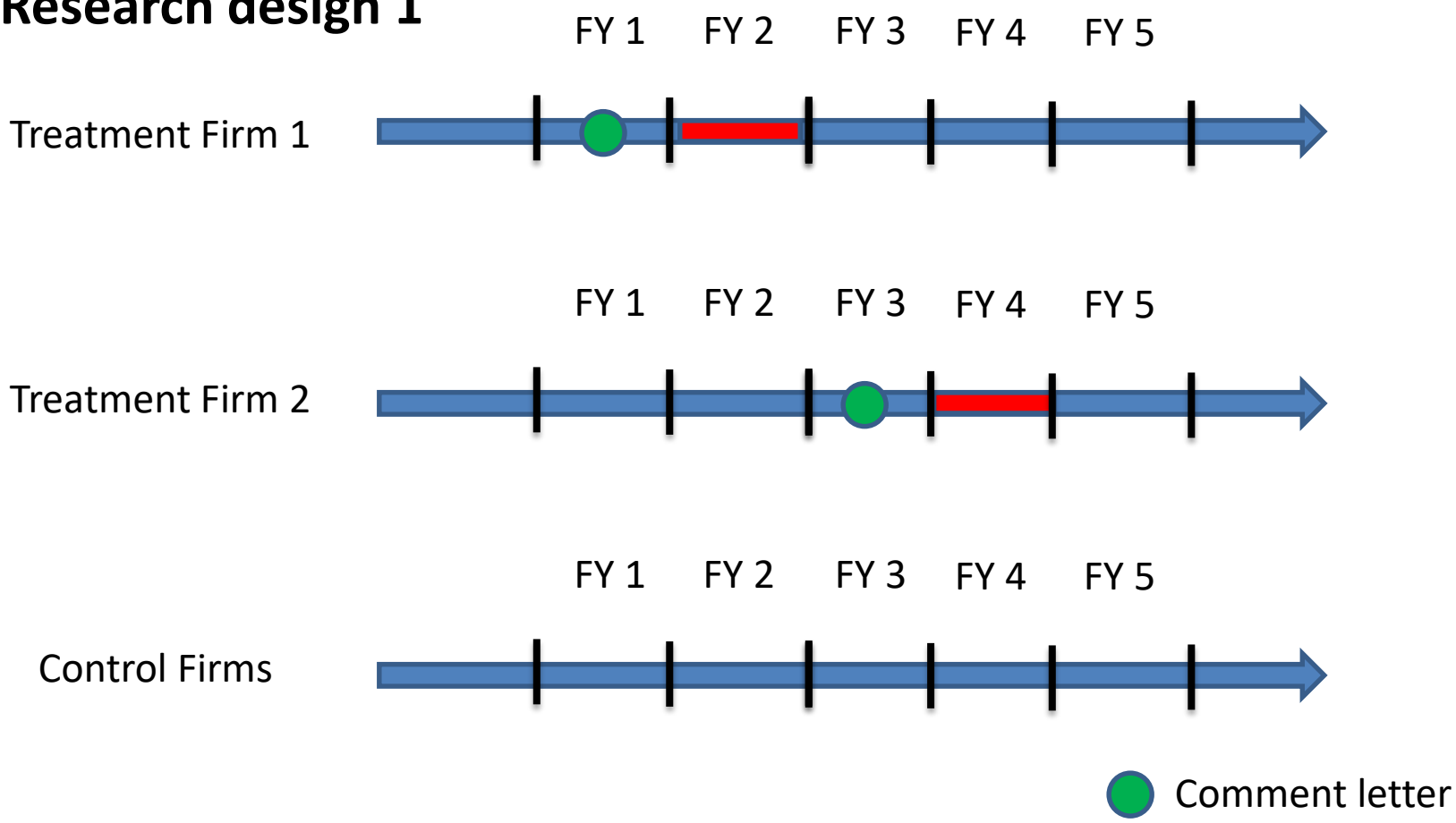
- We interpret this finding as evidence consistent with the notion that the Chinese CL review process is more than a side show like some past reforms, but has significant information content.

- we next examine targeted firms' financial reporting quality subsequent to their receipt of CLs.
  - Earnings management.
  - Disclosure quality.
  - Information asymmetry.

The empirical specification

$$Outcome_{it} = \beta_0 + \beta_1 CL_{it-1} + \beta_2 lnMarketCap_{it-1} + \beta_3 M/B_{it-1} + \beta_4 Leverage_{it-1} + \beta_5 CFO_{it-1} + \beta_6 InstitutionalOwnership_{it-1} + \beta_7 SOE_{it-1} + \beta_8 Loss_{it-1} + \beta_9 ForeignListing_{it-1} + \beta_{10} Big4_{it-1} + Firm\ and\ Year\ fixed\ effects + \varepsilon_{it},$$

Research design 1



CLs and outcomes

Panel B: CLs and earnings management

Variable	DA		AWCA		Small positive earnings	
CL	-0.002	0.003	-0.007	-0.003	-0.001	0.003
	(0.005)	(0.004)	(0.012)	(0.008)	(0.012)	(0.009)

Panel C: CLs and disclosure quality

Variable	Number of numbers		Length of disclosure	
CL	0.020	0.006	0.027	0.020
	(0.019)	(0.023)	(0.017)	(0.015)

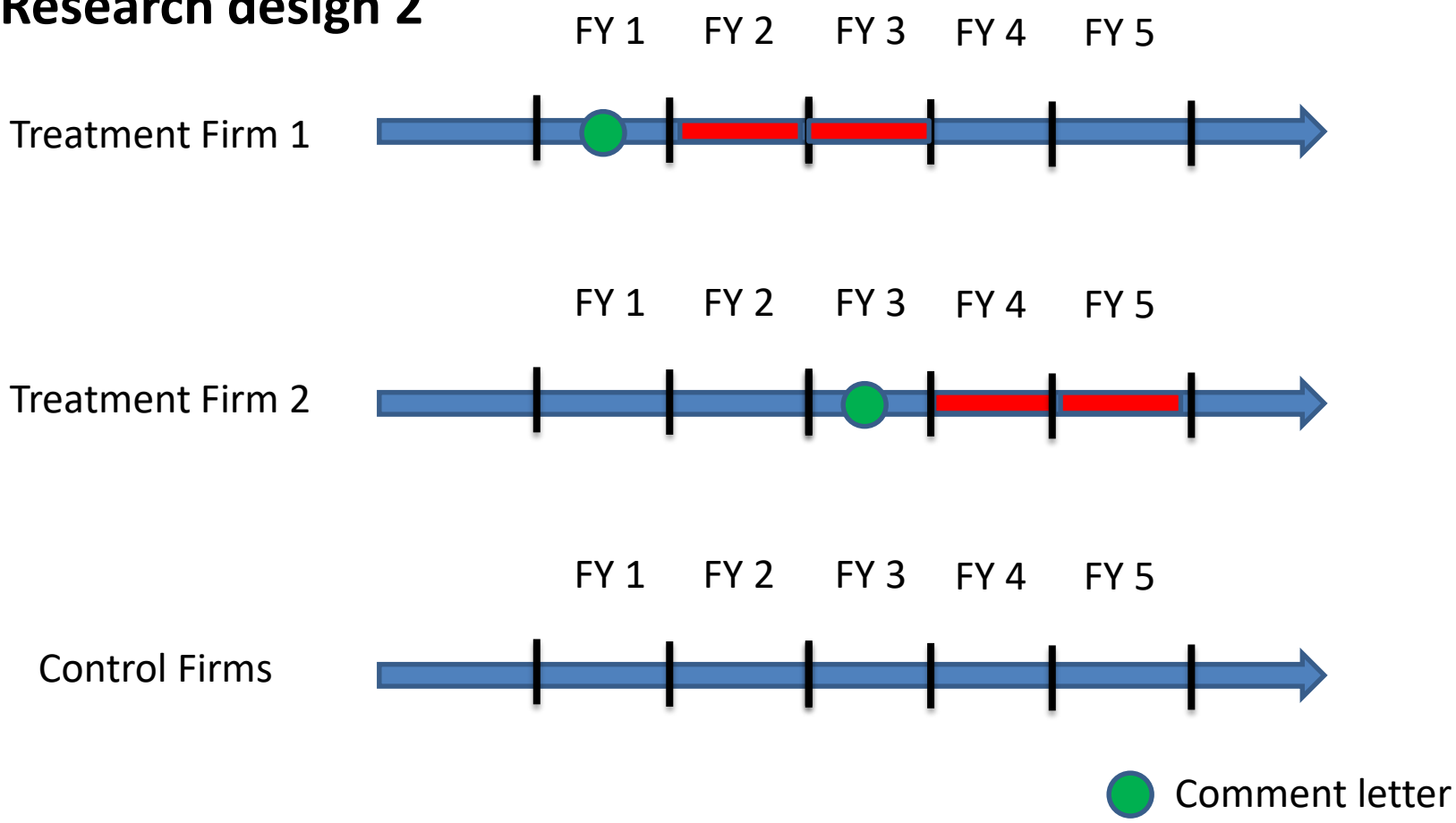
Panel D: CLs and information asymmetry

Variable	Bid-ask spread_CS		Bid-ask spread_AB	
CL	0.018	0.023**	-0.007	0.019
	(0.013)	(0.010)	(0.017)	(0.013)
Industry fixed effects	NO	YES	NO	YES
Firm fixed effects	YES	NO	YES	NO
Year fixed effects	YES	YES	YES	YES
Adj. R^2	0.398	0.342	0.420	0.369
N	5,452	5,452	5,452	5,452

The empirical specification

$$Outcome_{it} = \beta_0 + \beta_1 CL_{it-1} + \beta_2 lnMarketCap_{it-1} + \beta_3 M/B_{it-1} + \beta_4 Leverage_{it-1} + \beta_5 CFO_{it-1} + \beta_6 InstitutionalOwnership_{it-1} + \beta_7 SOE_{it-1} + \beta_8 Loss_{it-1} + \beta_9 ForeignListing_{it-1} + \beta_{10} Big4_{it-1} + Firm\ and\ Year\ fixed\ effects + \varepsilon_{it},$$

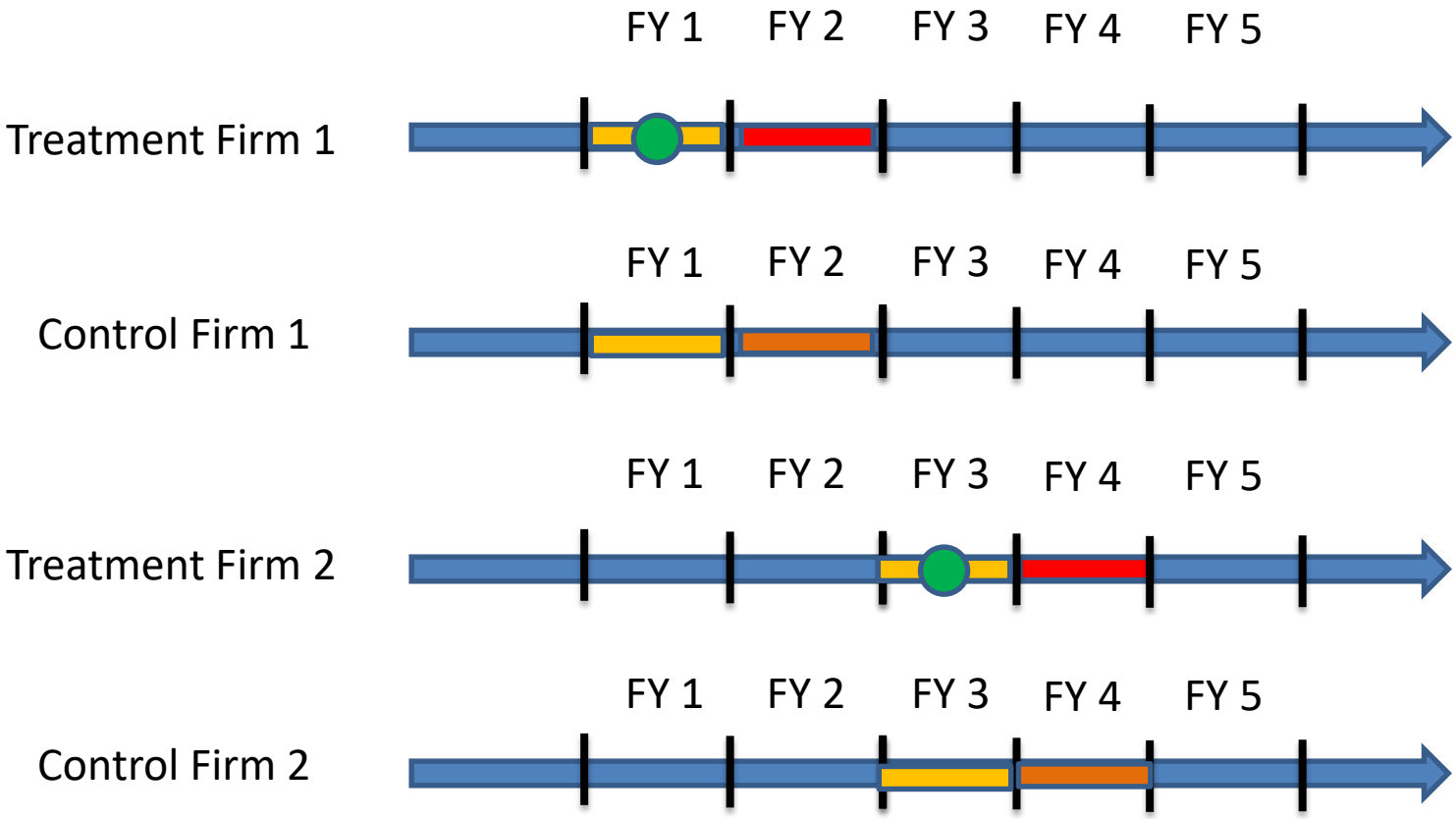
Research design 2



The empirical specification

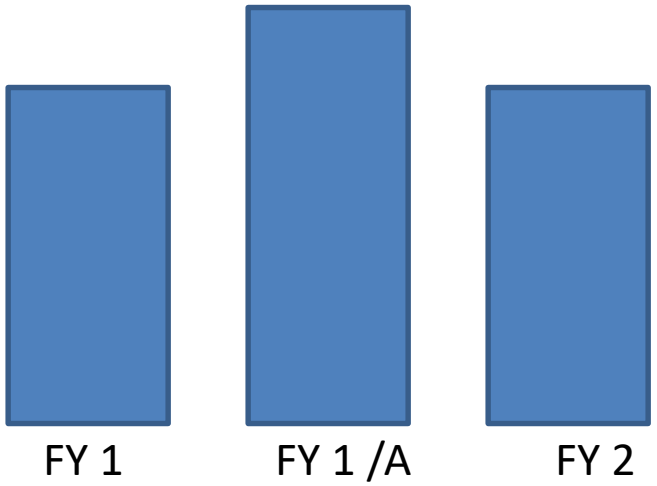
$$Outcome_{it} = \beta_0 + \beta_1 POST_{it-1} + \beta_1 POST\_CL_{it-1} + \beta_2 lnMarketCap_{it-1} + \beta_3 M/B_{it-1} + \beta_4 Leverage_{it-1} + \beta_5 CFO_{it-1} + \beta_6 InstitutionalOwnership_{it-1} + \beta_7 SOE_{it-1} + \beta_8 Loss_{it-1} + \beta_9 ForeignListing_{it-1} + \beta_{10} Big4_{it-1} + Firm\ and\ Year\ fixed\ effects + \varepsilon_{it},$$

Research design 3 – PS-matched DiD



Additional investigation

- **Conversations with Independent directors:**
  - firms are typically “panicking” and want to “make the comment letter go away” instead of changing their reporting practices.
- **Persistence of changes**
  - Comparison of sections of the annual report reviewed by the Exchange with the same sections in the next year’s annual report.
  - In the following year, transactions of similar nature and significance took place with a different set of firms, but no detailed explanation.
- **CL-driven amendments**
  - 49 observations



What is next?

- **Investors?**
  - No increase in cost of capital

- **Regulator?**
  - CLs lead to more CLs and sanctions

Conclusions

- We studied a U.S. style public enforcement measure implemented in a very important emerging country with weak institutional environment.
- Although our results suggest that the implementation level is **somewhat strong**, we find **no evidence** of improvement in targeted firms' financial reporting quality – the main intended objective of the reform

➢ **We provide some evidence that public enforcement in and of itself is limited in scope and efficacy.**

➢ Highlights the challenges in skipping steps in the development of financial markets by borrowing laws from advanced countries.

- Thank you!

Conclusions

- Our findings suggest that firms take a passive role and waiting for requests from the Exchange for more information, given that investors are unlikely to act on the lack of disclosure (as shown earlier).
- However, we find **no evidence** of improvement in targeted firms' financial reporting quality.
- Instead, we show that CL firms **are more likely** to be subject to another CL or sanctioned by regulators in the near future.

- ➢ We provide clean evidence that public enforcement in and of itself is limited in scope and efficacy.

- ➢ The policy and regulatory implication of our findings is that when importing laws from advanced economies, developing and emerging economies need to foster their own institutions such as government regulation, legal

Explaining price reaction to CLs

Variable	CAR (-3, +1)	CAR (-3, +1)	CAR (-3, +1)
No. of pages	-0.006**		
	(0.002)		
No. of questions		-0.001*	
		(0.001)	
Revenue recognition			-0.010**
			(0.005)
Log (market cap)	0.008*	0.008**	0.006
	(0.004)	(0.004)	(0.004)
M/B	-0.000	-0.000	-0.000
	(0.000)	(0.000)	(0.000)
Leverage	-0.017	-0.013	-0.016
	(0.013)	(0.011)	(0.011)
CFO	-0.021	-0.010	-0.007
	(0.037)	(0.032)	(0.032)
Institutional ownership	0.024	0.026	0.025
	(0.035)	(0.034)	(0.035)
SOE	-0.002	-0.006	-0.007
	(0.006)	(0.006)	(0.006)
Loss	0.024***	0.020***	0.018***
	(0.007)	(0.006)	(0.006)
Big4	-0.004	-0.002	0.000
	(0.012)	(0.010)	(0.010)
Foreign listing	-0.011	-0.010	-0.009
	(0.008)	(0.007)	(0.007)
Constant	-0.085	-0.067	-0.055
	(0.087)	(0.071)	(0.072)
Industry fixed effects	YES	YES	YES
Year fixed effects	YES	YES	YES
Adj. R^2	0.061	0.043	0.041
N	348	408	408

- All three measures of CL severity are negatively and significantly associated with CAR (-3, +1), suggesting that the market perceives more severe letters as significantly more negative news.

Regulatory oversight and sanctions after CLs

Variable	Sanction					
	Logit			OLS		
CL_lag1	0.595***		0.542***	0.095***		0.088***
	(0.120)		(0.137)	(0.021)		(0.024)
CL_lag2		0.324**	0.260*		0.047**	0.037*
		(0.145)	(0.143)		(0.023)	(0.022)
Log (market cap)	-0.191***	-0.154**	-0.145*	-0.021***	-0.018**	-0.016**
	(0.065)	(0.074)	(0.074)	(0.007)	(0.008)	(0.008)
M/B	0.009*	0.014**	0.013**	0.002**	0.003**	0.003**
	(0.005)	(0.006)	(0.006)	(0.001)	(0.001)	(0.001)
Leverage	0.614**	0.608**	0.559*	0.073**	0.073*	0.067*
	(0.249)	(0.301)	(0.300)	(0.034)	(0.040)	(0.040)
CFO	-1.408**	-1.261**	-1.024	-0.202***	-0.180*	-0.148
	(0.553)	(0.636)	(0.636)	(0.078)	(0.092)	(0.092)
…						
Industry fixed effects	YES	YES	YES	YES	YES	YES
Year fixed effects	YES	YES	YES	YES	YES	YES
Pseudo R^2 / Adj. R^2	0.068	0.077	0.083	0.052	0.057	0.063
N	4151	3005	3005	4168	3018	3018

- We show that targeted firms are more likely to be sanctioned in the near future.

➢ The CL review process is not effectively in changing firms' reporting practices, leading to follow-up regulatory scrutiny and sanctions.

Relating CL characteristics to future oversight and sanctions

- One concern of the above analysis is that the first CL received by a firm simply puts that firm on the radar screen of the regulators, and there is no systematic association between the first CL and subsequent enforcement.

- To assuage this concern, within our CL firm sample, we relate CL characteristics to subsequent receipt of CL and CL-triggered sanction.

- Our conjecture is that, when public enforcement acts in isolation, the regulators have to follow up with further enforcements based on the severity of prior review outcome.

Within the CL sample

Variable	Comment letter = 1					
	Logit			OLS		
No. of pages	0.254**			0.051**		
	(0.103)			(0.022)		
No. of questions		0.052**			0.011**	
		(0.025)			(0.005)	
Revenue recognition			0.348			0.064
			(0.241)			(0.046)
Log (market cap)	-0.329*	-0.258	-0.253	-0.055	-0.045	-0.044
	(0.188)	(0.163)	(0.158)	(0.038)	(0.029)	(0.029)
M/B	-0.013	-0.008	-0.008	-0.003	-0.001	-0.001
	(0.013)	(0.008)	(0.008)	(0.003)	(0.002)	(0.002)
Leverage	0.349	0.590	0.827	0.053	0.099	0.144
	(0.719)	(0.547)	(0.529)	(0.146)	(0.107)	(0.105)
CFO	-3.894***	-2.090*	-2.383**	-0.766**	-0.431*	-0.489**
	(1.463)	(1.155)	(1.155)	(0.305)	(0.239)	(0.240)
…						
Industry fixed effects	YES	YES	YES	YES	YES	YES
Year fixed effects	YES	YES	YES	YES	YES	YES
Pseudo R^2 / Adj. R^2	0.084	0.059	0.055	0.011	0.017	0.011
N	274	469	469	278	479	479

- We show that No. of pages and No. of questions are positively and significantly associated with the likelihood of receiving a CL in the following year, suggesting that firms receiving more severe letters are more likely to receive another CL in the near future.

Within the CL sample

Variable	CL-triggered sanction					
	Logit			OLS		
No. of pages	0.341***			0.045***		
	(0.103)			(0.014)		
No. of questions		0.092***			0.010***	
		(0.029)			(0.003)	
Revenue recognition			-0.246			-0.027
			(0.309)			(0.033)
Log (market cap)	0.079	-0.093	-0.052	0.008	-0.007	-0.004
	(0.206)	(0.166)	(0.160)	(0.023)	(0.016)	(0.016)
M/B	-0.032	-0.006	-0.009	-0.003*	-0.001	-0.001
	(0.024)	(0.011)	(0.012)	(0.001)	(0.001)	(0.001)
Leverage	-0.452	-0.069	0.368	-0.031	0.006	0.041
	(0.756)	(0.599)	(0.576)	(0.086)	(0.063)	(0.063)
CFO	0.158	0.671	0.309	0.053	0.072	0.028
	(1.446)	(1.199)	(1.211)	(0.176)	(0.136)	(0.136)
...						
Industry fixed effects	YES	YES	YES	YES	YES	YES
Year fixed effects	YES	YES	YES	YES	YES	YES
Pseudo R^2 / Adj. R^2	0.143	0.108	0.093	0.032	0.027	0.017
N	370	635	635	404	676	676

- We show that No. of pages and No. of questions are positively and significantly associated with the likelihood of CL-triggered sanction, suggesting that the regulators are more likely to launch enforcement actions when firms receiving more severe CLs.

Our contribution

- By focusing on the largest developing economy – China, our study highlights the challenge of importing best practices elsewhere that might not achieve its intended objective.

- By examining the determinants and consequence of public enforcement of mandatory disclosure using data outside the U.S., our paper provides a richer understanding of the important interaction between disclosure regulation/enforcement and a country's institutional framework (see Leuz and Wysocki 2016 for a review).

- Our paper contributes to a long strand of the literature examining the pros and cons of public versus private enforcement (Stigler 1964, 1971; Becker and Stigler 1974; Landes and Posner 1975; Shleifer 2005; Segal and Whinston 2006).
  - Our paper has an unambiguous message, at least from the perspective of enforcing securities laws, both forms complement each other to achieve efficacy.

Robustness checks

- We also employ an alternative specification that allows us to examine the impact of CLs for a two-year window (instead of only for the year after receiving a CL).

- One concern of our findings is that there may be systematic differences between firms that receive a CL and firms that do not.

❖ We construct a propensity-score-matched control sample and employ a difference-in-differences (DID) specification.

  - A firm's propensity score is the probability of it receiving a CL conditional on its observable characteristics.
  - We estimate each firm's propensity score based on the specification in Table 3.
  - The treatment group is the sample of firms that are in receipt of their first CL over the sample period.
  - The control firms are chosen from those that have never received a CL over the sample period. We select a control firm that has the closest propensity score to each CL firm without replacement.

Over two-year window

Panel C1: CLs and earnings management

Variable	DA		AWCA		Small positive earnings	
CL2	0.001	0.005	0.000	0.005	0.005	0.008
	(0.005)	(0.004)	(0.012)	(0.006)	(0.012)	(0.007)

Panel C2: CLs and disclosure quality

Variable	Number of numbers		Length of disclosure	
CL2	0.017	-0.009	0.030*	0.002
	(0.020)	(0.022)	(0.018)	(0.021)

Panel C3: CLs and information asymmetry

Variable	Bid-ask spread_CS		Bid-ask spread_AB	
CL2	0.021	0.022**	0.026	0.027**
	(0.014)	(0.010)	(0.018)	(0.012)
Other controls	YES	YES	YES	YES
Industry fixed effects	NO	YES	NO	YES
Firm fixed effects	YES	NO	YES	NO
Year fixed effects	YES	YES	YES	YES
Adj. R^2	0.398	0.342	0.420	0.370
N	5452	5452	5452	5452

- We show that for a longer window, there is no significant improvement in accounting reporting quality for targeted firms.

Using PS-matched control firms

Panel C4: CLs and earnings management

Variable	DA		AWCA		Small positive earnings	
Post	0.030	-0.003	-0.034	-0.022*	0.021	0.009
	(0.019)	(0.007)	(0.043)	(0.013)	(0.032)	(0.014)
Post_CL	0.014	0.005	0.001	0.013	-0.013	-0.001
	(0.012)	(0.007)	(0.027)	(0.013)	(0.027)	(0.015)

Panel C5: CLs and disclosure quality

Variable	Number of numbers		Length of disclosure	
Post	0.106	0.052*	0.008	0.040
	(0.065)	(0.030)	(0.054)	(0.027)
Post_CL	-0.020	-0.025	-0.007	-0.035
	(0.042)	(0.037)	(0.037)	(0.033)

Panel C6: CLs and information asymmetry

Variable	Bid-ask spread _CS		Bid-ask spread_AB	
Post	0.115***	-0.020	0.354***	-0.029
	(0.036)	(0.018)	(0.046)	(0.024)
Post_CL	0.009	0.033*	-0.028	0.032
	(0.036)	(0.019)	(0.045)	(0.023)
Other controls	YES	YES	YES	YES
Industry fixed effects	NO	YES	NO	YES
Firm fixed effects	YES	NO	YES	NO
Year fixed effects	YES	YES	YES	YES
Adj. R^2	0.457	0.399	0.473	0.432
N	1184	1184	1184	1184

- The coefficient on CL_Post captures the change in reporting practices of CL firms relative to those of the matched control firms.
- We show that our main findings remain unchanged.

Price reaction to CLs

Trading day	N	Mean abnormal return	Number of positive : negative
-5	389	-0.002	172 : 217
-4	389	-0.001	172 : 217
-3	389	-0.003*	168 : 221
-2	389	-0.004***	160 : 229
-1	389	-0.003**	155 : 234
0	389	-0.007***	143 : 246
+1	389	-0.005**	147 : 242
+2	389	-0.002	174 : 215
+3	389	0.000	193 : 196
+4	389	0.001	199 : 190
+5	388	-0.001	171 : 217
CAR (-3, +1)	389	-0.022***	125 : 264

- Given that the average market capitalization of firms receiving CLs is 11.4 billion RMB, the average drop in market capitalization is 250.8 million RMB.

➢ We conclude that the Chinese market seems to take the CL review process seriously and perceives firms receiving CLs as significantly bad news.

CLs and amendments

Variable	Amendment		
	Logit	OLS	
CL	1.676***	0.205***	0.212***
	(0.126)	(0.027)	(0.020)
Log (market cap)	-0.044	0.014	-0.004
	(0.077)	(0.023)	(0.006)
M/B	0.004	-0.002	0.001
	(0.007)	(0.002)	(0.001)
Leverage	0.514*	-0.020	0.040
	(0.310)	(0.083)	(0.027)
CFO	-0.298	0.119	-0.017
	(0.669)	(0.106)	(0.061)
Institutional ownership	-0.601	-0.156	-0.052
	(0.800)	(0.099)	(0.055)
SOE	-0.063	0.039	-0.006
	(0.128)	(0.082)	(0.011)
Loss	0.157	0.001	0.016
	(0.173)	(0.027)	(0.019)
Big4	-0.247	0.012	-0.018
	(0.261)	(0.083)	(0.019)
Foreign listing	0.183	0.146	0.016
	(0.215)	(0.114)	(0.019)
Constant	-0.683	-0.126	0.270**
	(1.376)	(0.408)	(0.118)
Industry fixed effects	YES	NO	YES
Firm fixed effects	NO	YES	NO
Year fixed effects	YES	YES	YES
Pseudo R^2 / Adj. R^2	0.109	0.099	0.086
N	4,171	4,176	4,176

- We show that across all specifications, the coefficient on CL is positive and significant, suggesting that CL firms are indeed more likely to amend their annual reports compared to firm-years not in receipt of a CL.

CLs and earnings management

Variable	DA		AWCA		Small positive earnings	
CL	-0.002	0.003	-0.007	-0.003	-0.001	0.003
	(0.005)	(0.004)	(0.012)	(0.008)	(0.012)	(0.009)
Log (market cap)	0.014**	0.004***	0.009	-0.001	-0.018	-0.005
	(0.006)	(0.002)	(0.017)	(0.002)	(0.012)	(0.003)
M/B	0.001*	0.001***	0.001	0.001**	0.001	0.002***
	(0.000)	(0.000)	(0.002)	(0.001)	(0.001)	(0.001)
Leverage	-0.041*	-0.035***	0.091	-0.007	-0.052	-0.043**
	(0.024)	(0.007)	(0.067)	(0.014)	(0.042)	(0.017)
CFO	0.099***	-0.153***	0.277***	0.077**	-0.006	-0.088***
	(0.030)	(0.022)	(0.075)	(0.036)	(0.048)	(0.033)
…						
Industry fixed effects	NO	YES	NO	YES	NO	YES
Firm fixed effects	YES	NO	YES	NO	YES	NO
Year fixed effects	YES	YES	YES	YES	YES	YES
Adj. R^2	0.175	0.042	-0.087	0.015	0.141	0.030
N	3,415	3,415	3,196	3,196	4,168	4,168

- We show that there is no significant change in the level of earnings management in the year following a CL receipt for targeted firms.

CLs and disclosure quality

Variable	Number of numbers		Length of disclosure	
CL	0.020	0.006	0.027	0.020
	(0.019)	(0.023)	(0.017)	(0.015)
Log (market cap)	0.069***	0.164***	0.058***	0.069***
	(0.023)	(0.015)	(0.020)	(0.019)
M/B	-0.003**	-0.013***	-0.004***	-0.003**
	(0.002)	(0.001)	(0.001)	(0.001)
Leverage	0.034	0.386***	-0.010	0.034
	(0.080)	(0.058)	(0.071)	(0.067)
CFO	-0.064	-0.037	-0.034	-0.064
	(0.079)	(0.106)	(0.074)	(0.066)
...				
Industry fixed effects	NO	YES	NO	YES
Firm fixed effects	YES	NO	YES	NO
Year fixed effects	YES	YES	YES	YES
Adj. R2	0.762	0.241	0.746	0.762
N	3,803	3,803	3,803	3,803

- We show that there is no significant change in the amount of numerical (textual) content in annual reports in the year following a CL receipt for targeted firms.

CLs and bid-ask spreads

Variable	Bid-ask spread_CS		Bid-ask spread_AB	
CL	0.018	0.023**	-0.007	0.019
	(0.013)	(0.010)	(0.017)	(0.013)
Log (market cap)	-0.056***	-0.038***	-0.118***	-0.055***
	(0.013)	(0.004)	(0.017)	(0.005)
M/B	-0.000	0.003***	-0.000	0.002***
	(0.001)	(0.001)	(0.001)	(0.001)
Leverage	-0.051	-0.012	-0.076	-0.032
	(0.052)	(0.020)	(0.067)	(0.025)
CFO	-0.030	-0.064	-0.005	-0.081*
	(0.062)	(0.040)	(0.074)	(0.046)
…				
Industry fixed effects	NO	YES	NO	YES
Firm fixed effects	YES	NO	YES	NO
Year fixed effects	YES	YES	YES	YES
Adj. R^2	0.398	0.342	0.420	0.369
N	5,452	5,452	5,452	5,452

- We show that there is no significant change in the degree of information asymmetry between insiders and outsiders in the year following a CL receipt for targeted firms.

Public vs. private enforcement: the debate

- Scholars including Coase (1960), Stigler (1964), and La Porta, Lopez-de-Silanes, and Shleifer (2006) argue that enforcement of securities laws should be delegated to market participants.

- However, China's legal and institutional environments as reviewed above preclude private enforcement from playing a significant role (see a similar argument made by Hay and Shleifer (1998) in the case of Russia and some general arguments by Segal and Whinston (2006)).

- Therefore, a more viable strategy for China would be to strengthen public enforcement.

Hypothesis development

- Given that there is no effective securities litigation system (Hutchens 2003; Layton 2008), or effective shareholder voting given that most of the listed firms in China have controlling shareholders, and institutional ownership is low (Huang and Zhu 2015; Jiang and Kim 2015), we expect limited real effects of CLs on Chinese firms' reporting practices.
- Our second null hypothesis is thus as follows:

H2: *There is no real effect of CLs on corporate financial reporting practices.*

- If CLs do not change firms' financial reporting practices, we expect that CL firms are more likely to be scrutinized and sanctioned when poor practices continue.
- A corollary to the above null hypothesis is as follows:

Corollary: There will be CLs and sanctions following firms receiving CLs.

Hypothesis development

On the other hand,

- In the absence of a culture of class action lawsuits or other market mechanisms in China (see, for example, Layton 2008; Jiang and Kim 2015), the CSRC and two stock exchanges institutionally are the last line of defense in policing financial reporting practices, and have the potential to make up for the lack of market discipline.

- Chen, Firth, Gao, and Rui (2005) examine the impact of the CSRC's enforcement actions and find that enforcement actions have a negative impact on stock prices and that targeted firms experience greater rates of auditor turnover and CEO turnover.

- Our second alternative hypothesis is thus as follows:

H2a: *There is a real effect of CLs on corporate financial reporting practices.*

Summary

What? How effective is public enforcement of mandatory disclosure in weak institutional environments?

- It is common practice to borrow laws from advanced countries instead of reinventing the wheels (David and Brierley 1985; Hay and Shleifer 1998).

- Securities law-making is no exception.
  - Disclosure reform in Europe since the late 1990s has been patterned on the legislative framework of U.S. securities laws (Karmel 2005).
  - European Union's initiative in the early 2000s regarding the Market Abuse Directive (MAD) was launched to mimic the best practice in the U.K. on insider dealing and market manipulation (Hansen 2002).
  - Evidence from EU countries suggests that securities laws imported from the U.S./U.K. have achieved their intended objectives (see, for example, Christensen, Hail, and Leuz 2016).

Summary

What? How effective is public enforcement of mandatory disclosure in weak institutional environments?

Why? Understanding the impact of private enforcement on the effectiveness of public enforcement adds nuance to our knowledge of what works in securities laws

How? We study the implementation of a U.S. style public enforcement measure in a very important emerging market, China.

The institutional environment in China

- On December 19, 1990 and July 3, 1991, the Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE) were launched, respectively.

上海證券交易所
SHANGHAI STOCK EXCHANGE

深圳证券交易所
SHENZHEN
STOCK EXCHANGE

- The China Securities Regulatory Committee (CSRC), akin to the SEC, was formed in October 1992.

中国证监会
CSRC

❖ China's securities regulatory framework **largely followed** that of the U.S.