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Which Firms went Public in China? A Study of Financial Market Regulation

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Summary. — Plagued by a notoriously weak legal system, China has developed an alternative governance system based on *de facto* regulatory decentralization in its financial market development, in which regional governments are responsible for selecting state-owned enterprises (SOEs) to go public. The effect of this regulatory system has been highly controversial but evidence is very scant in the literature. This paper shows that regional governments tended to choose better-performing SOEs in the pre-listing stage to go public, and thus substantial stock market investment funds were channeled into potentially productive companies. China's experience demonstrates that administrative governance of capital markets may have been instrumental in jump starting capital markets in the absence of adequate market-supporting legal institutions.
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Key words — Asia, China, regulatory decentralization, financial market regulation, IPO firm screening, regional competition

1. INTRODUCTION

Recent cross-country studies demonstrate the central importance of formal legal institutions for financial market development. These legal institutions encompass various dimensions such as formal minority shareholder rights (La Porta, Lopez-de-Silanes, Shleifer, & Vishny,1997, 1998), formal mandatory disclosure rules and their enforcement (La Porta, Lopez-de-Silanes, & Shleifer, 2006), the effectiveness of legal institutions (Pistor, Raiser, & Gelfer, 2000), and the legacy of legal development in countries being studied (Berkowitz, Pistor, & Richard, 2003).

Transition economies, including China, suffer from severe enforcement failures. Thus, any mainstream law and finance wisdom will predict that financial market development in transition economies will be inevitably retarded. However, China seems to have defied the above prediction by jump starting capital markets on the basis of rather weak formal legal institutions, including the absence of a functioning and effective court system, the lack of an independent judicial system and weak law enforcement on the part of the national regulatory authority (Allen, Qian, & Qian, 2005; Pistor & Xu, 2005). [1]

It was only in the early 1990s that China, like other transition economies, re-launched its stock markets. However, standard measures for stock market development suggest that China has been performing better than most other transition economies both when comparing all other transition economies taken together with China and when comparing selected provinces of China with other individual transition economies of similar size. Take what is considered to be the most important aspect of financial market development—the ability of listed firms to raise funds. According to the data shown in Pistor and Xu (2005), the 2002 ratio of market capitalization to GDP was 0.4 in China, double the average for this ratio in all the East European and former Soviet Union transition economies. Only Russia and Estonia were at a similar level as China. Comparatively rich East European countries such as Hungary and the Czech Republic had *per capita* GDPs close to those of China's richer provinces such as Guangdong and Shanghai. Nonetheless, the market capitalization/GDP ratios of Hungary and the Czech Republic were 0.25 and 0.28 respectively, while those of Guangdong and Shanghai amounted to as much as 0.52 and 1.61, respectively.

Taking into account the fact that a substantial proportion of shares in the stock markets of transition economies are non-tradable illiquid ones owing to block shareholding in Central and Eastern Europe and state shareholding or control in China, market capitalization can be discounted by 40% in Central and Eastern Europe and 60% in China to obtain the tradable market capitalization/GDP (Pistor & Xu, 2005). Based on the data presented in Pistor and Xu (2005), we find that China with a ratio of 0.16 still fared better than Central and Eastern European transition economies, which as a whole had a ratio of 0.12. Hungary and the Czech Republics had ratios of 0.15 and 0.17, respectively, which is almost the same as Guangdong (0.16), but their ratios were still far below that of Shanghai (0.41). Even the star Central and Eastern European performers, Estonia and Russia, had tradable market capitalization/GDP ratios of only 0.26 and 0.24, respectively; far below that of Shanghai.

Next, we turn to market liquidity. The 2002 data illustrated in Pistor and Xu (2005) demonstrate that China had the most liquid market of all stock markets in transition economies with a turnover ratio (defined as the ratio of the total stock value traded to the market capitalization of stocks traded) of 67.6, while the average ratio of the Central and Eastern European transition economies was only 24.65. In terms of individual countries, Hungary and the Czech Republic had the most liquid markets in the Eastern European bloc with a turnover

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ratio of 52.2 and 48.7, respectively; figures that were far below the average for China and much lower than those in Guangdong and Shanghai where the ratio were 331.7 and 391.8, respectively.

Finally, the number of initial public offerings (IPOs) also exhibits a great disparity between China and other transition economies. Companies in Central and Eastern Europe have only rarely used IPOs to raise capital, with the exception of Poland which used 47 IPOs during 1994–2001. By contrast, in the same period of time, there were 873 IPOs in China. During 1998–2001 alone China witnessed 414 IPOs with firms raising a total of 508.6 billion RMB (or 61.6 billion US$). No other transition economy came close (Pistor & Xu, 2005).

China's spectacular stock market growth despite its weak legal basis poses a puzzle in the financial development literature. In our view, China has developed an alternative governance system based on *de facto* regulatory decentralization. In this system, regional governments are responsible for screening and selecting quality state-owned enterprises (SOEs) to go public, which promotes public confidence in equity investment and thus has resulted in the rapid development of the stock markets. The main instrument needed/used to implement the decentralized regulation of the capital market is the quota system deployed in the stock share issuance process. The effect of quota-based regulatory decentralization has been highly controversial. Many people have criticized it for spawning rampant rent-seeking activities of China's SOEs. As a result, the majority of firms selected to go public are lemons. For instance, Mr. Cheng Siwei, the vice chairman of the National People's Congress Standing Committee, said in a forum on finance at Peking University in November 2005 that the overall quality of China's listed companies is fairly poor and that among the 1300 or so listed companies, only 30%, that is, about 400 companies, are worth investing in (United Morning Post, 2005). Zhu (2001) argues that the state-administered quota system has led to the quality of listed companies in China being generally low as it has put politically connected SOEs rather than excellent SOEs onto the exchanges. Nonetheless, other experts are more positive. For example, according to a report in Stock Star (www.stockstar.com), Mr. Tong Daochi, the deputy director of the listed company supervision department of the China Securities Regulatory Commission (CSRC), the national security markets regulatory authority, said in 2001 that widespread suspicions about the quality of listed companies mainly stem from the bear stock market and the media coverage of some sensational corporate fraud cases. In fact, the quality of China's listed companies was on average still better than that of non-listed companies, especially that of non-listed SOEs. Though the overall quality of China's listed companies is a heatedly debated topic, evidence in assessing the effect of this regulatory system is scant in the literature. This study is the first attempt at directly addressing the issue of what kinds of SOEs were selected to go public.

Du and Xu (2006) provide systematic econometric evidence to demonstrate that in the quota-based decentralized regulatory system, regional governments that had previously selected better-performing firms for stock share issuance had been rewarded by gaining more stock issuance quotas in subsequent periods, and *vice versa.* By doing so, this regulatory system has mitigated the problems of enforcement failure.

This paper compliments Du and Xu (2006) for shedding light on the impact of regulatory decentralization by examining what SOEs were chosen by regional governments to be IPOs. We provide evidence from 23 provincial level regions that regional governments tended to choose better-performing SOEs under their jurisdiction in the pre-listing stage to go public. This suggests that the administrative governance system based on regulatory decentralization was effective in regulating the financial markets in the absence of strong formal legal institutions.

Our results also demonstrate that the listed companies in each region of China were on average better SOEs prior to making IPOs. In the process of data collection, we carefully controlled for possible earnings management or window dressing practices of the firm managers or government officials in the pre-IPO period. The large majority of the data we collected were published before the quota system was introduced, which helped us greatly to reduce the possibility that the data were manipulated for the purpose of going public.

Our research relates to a growing literature on IPOs in China. The majority of existing studies, among which are Chan, Wei, and Wang (2004), Su and Fleisher (1998, 1999), and Tian and Megginson (2007), focus on the under-pricing of IPO shares and the post-listing performance of IPO shares in China. Our paper addresses a fundamental issue, which has not been addressed in the literature: how the Chinese regulatory regime chooses firms to go public and ensures a reasonably good return for investors. We identify the administrative governance system based on regulatory decentralization and regional competition as an institutional arrangement that ensures the proper operation of the equity markets in China.

We do, however, want to add a caveat on the effectiveness of regulatory decentralization: it works only when it is carefully implemented together with other factors. For example, incentives associated with a quota-based regulatory decentralization regime might not automatically ensure successful selection of good SOEs for public listing, if a quota-based regulatory regime is not incentive compatible with regulating IPOs of non-state-owned firms; or if it does not fit the enforcement of some important laws/rules, such as the post-IPO information disclosure. This may explain the phasing out of the quota-based regulatory regime where these problems have become critically important.

The rest of the paper is organized as follows: Section 2 gives an overview of the administrative governance of financial markets based on regulatory decentralization. Section 3 describes data and methodology. Results of the empirical analysis are displayed in Section 4. Section 5 discusses the empirical findings and concluding remarks are contained in Section 6.

2. DECENTRALIZED REGULATION OF CAPITAL MARKETS IN CHINA

The administrative governance of capital markets based on regulatory decentralization emerged in the Chinese capital markets in response to the absence of formal law enforcement institutions. In transition economies, courts can fail to deter against violations due to incomplete law (Pistor & Xu, 2003). Though law incompleteness exists even in advanced market economies, transition economies, including China, are particularly vulnerable. Given the scale and scope of economic and legal reforms that take place concurrently, legal systems in transition countries are bound to be highly incomplete, that is, its meaning and application to specific cases are largely untested and the scope of liability is, therefore, uncertain. Moreover, the level of incompleteness of the law may exacerbate the problem of judicial corruption, as judges may more easily distort the purpose of an untested legal rule than one the meaning and application of which has long been established.

In the presence of severe deterrence failures, regulations may be introduced to address law enforcement problems (Pistor &

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