Selective enforcement of regulation ☆

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ABSTRACT

Regulatory agencies may, whether outside of set rules or within their discretion, depart from the original goals or principles set for enforcing the rules, which we term selective enforcement. Taking China, a country in transition, as an example, and using cases and large-sample tests, we present empirical evidence of selective enforcement. The results show that the China Securities Regulatory Commission (CSRC) takes into account whether companies violating the rules have a state-owned background and the strength of that background when investigating and punishing non-compliance. After controlling for the degree of violation, state-owned-enterprises (SOEs) are punished less severely than private companies; and the higher the hierarchy of the SOE in question, the less severe the punishment. It also takes longer for SOEs to be punished. We also find that companies that violate the rules less seriously have a greater tendency to apply for refinancing than those that violate the rules more seriously. This may be because the severity of the violation can affect listed companies' expectations of obtaining refinancing. The analysis and conclusions of this study prove useful in understanding the causes and consequences of selective enforcement in transition economies.

彼窃钩者诛,窃国者为诸侯,诸侯之门而仁义存焉"。

——庄子·胠箧

1. Introduction

Selective enforcement occurs when law enforcers derail the course of regulation or deviate from the established objective or principle of regulation and instead execute the law and enforce regulations by discretion. An example is law enforcers selecting the rules that they enforce according to their own preference, rather than the law. Further, as laws and regulations have gray areas that are not defined clearly or are discretionary, law enforcers may abuse their power or fail to do their duty by deliberately making unjust decisions, rather than making judgments based on the principles of justice and reason.[1] They may also deal with some issues but turn a blind eye to others, deal with matters ahead of time or postpone others, and treat the same kinds of issues with different attitudes.

This study examines the selective enforcement of regulations for the following reasons. First, the quality of law enforcement has become a very important field of study. The role of the law in economic development has been repeatedly stated, yet the law was excluded from the framework of economic analysis for a long time and regarded as a fixed exogenous variable. Researchers started to test the role of the law in the process of economic development empirically in the 1960s. Since La Porta et al. (1997, 1998) linked the law and the financial markets with economic development, economists have paid greater attention to the role of law in capital markets. Beck et al. (2005) found that the efficiency of the legal system could influence the sources of economic development, such as industry growth, capital allocation efficiency and corporate financing from outside markets. However, the effects may not be the same in a transitional economy transplanting a development model rooted in developed economies. One important reason for this is that the enforcement of the law cannot be achieved in a short period of time. Pistor et al. (2000) found that the key factor restricting the development of financial markets is poor law enforcement. In transitional countries, it is thus more important to improve the quality of law enforcement than to complete the legal system. Bhattacharya and Daouk (2009) point out that a good legal system that cannot be enforced is no better than having no system of law at all. That is to say, failure to abide by the law is equal to no law. One of the most important reasons is that selective enforcement results in unfairness and harms economic efficiency. Selective enforcement of the law is an important determinant of the quality and consequences of law enforcement and the relationship between the economy and the law, and thus merits theoretical and empirical analysis.

Second, the quality of regulatory enforcement in transitional and emerging economies deserves academic attention, as regulations play a more important role in these countries because the legal system is not perfect (Glaeser and Shleifer, 2001). Coase (1988) suggested that government regulation may improve economic efficiency under some conditions. Pistor and Xu (2003) stated that it is the reallocation of residual legislative power and law enforcement power, rather than the development of a perfect legal system, that improves the efficiency of law enforcement, because when the law is incomplete it does not clearly set out all potential encroachments. In countries in which the law is imperfect, allocating legislative power to a regulatory organization that positively enforces the law may be better than allocating that power to courts that passively enforce the law. This is especially so in transitional countries in which law enforcement is usually based on administrative regulations rather than the legal system (Pistor and Xu, 2005). The Chinese economy was originally a planned economy and the influence of the planned economy has never completely disappeared. Hence, it will require much effort to perfect the legal system and government regulation is likely to prevail for some time. The Chinese economy is thus perhaps the best setting for testing the aforementioned theories about the role of selective enforcement. Chen et al. (2008) found that the China Securities Regulatory Commission (CSRC) allocated resources based on hidden contracts. Jiang et al. (2009) used the split share structure reform to investigate the influence of information costs on the efficiency of government regulations and found that the enforcement of government regulations could be effective when information costs are low. Besides constraints such as public objections and information costs, a difference in motivation between the administration and the public may influence regulation enforcement and may encourage selective enforcement. Researching the relationship between selective enforcement and economic development is thus important in transitional and emerging economies. As the largest emerging economy in the world, China provides an excellent laboratory to examine this problem.

Third, the selective enforcement of regulations may be the norm rather than the exception, especially in China. If this is the case, then the importance of research on selective enforcement is even greater. For example, the idea that a prince who violates the law must be punished the same way as an ordinary person was a dream that many intellectuals expected the law and law enforcement to realize. However, in reality, it is an unattainable ideal. According to Mencius, "when the prince regards his ministers as his hands and feet, his ministers regard their prince as their belly and heart; when he regards them as his dogs and horses, they regard him as another man; when he regards them as the ground or as grass, they regard him as a robber and an enemy." However, these words were deleted from the book of Mencius compiled by the Ming Dynasty founder Zhu Yuanzhang, according to whom the real rules of the game were that if "a person stole a hook, he could be punished, while a person usurping a throne became governor," or that "punishment cannot be brought to bear

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[1] The translation is either "enforcement" or "implementation." The former stresses initiative and intention, whereas the latter emphasizes extent. In the past, research has translated the word as "implementation" in English, but in this study we use the word "enforcement." This is partly because intention influences extent, and partly because in this way the study will correspond more closely to the literature in Chinese. There are three levels from which to study enforcement: the enforcement of laws, the enforcement of rules, and the enforcement of individual contracts. This study mainly studies the enforcement of law and enforcement of rules, and "enforcement" refers to these two kinds unless stated otherwise. Similarly, the term "regulation" includes both laws and rules.

on high-tier officials, and courtesy cannot be applied to common people."[2] It is difficult to put the idea that all persons are equal before the law into practice.[3] This study takes the current situation in China as an example to study the selective enforcement of regulations.

Finally, studying the selective enforcement of regulations in transitional and emerging economies has far-reaching implications for accounting research. Developed market economies generally follow the "small government, large government" principle, and thus accounting research related to regulations focuses on the political cost of accounting information (Watts and Zimmerman, 1986). However, in transitional and emerging economies, the scope of regulation is larger and the power of officials is stronger, and thus the power of regulation matches and may occasionally surpass the power of the market. The role of accounting information in regulation needs to be researched more deeply, rather than relying on existing research based on developed economies. For example, the influence of selective enforcement on accounting information is a field that merits further study. The market is a client and accounting information must both meet its requirements and adhere to the regulations. Like the market, regulatory officials control many resources and formulate rules to allocate these resources. Research on accounting information in response to regulations in transitional and emerging economies is scarce, but if we do not explore this problem, then it will be difficult for us to understand the reasons for and effects of accounting information in transitional and emerging economies.

Motivated by these four reasons, this study uses listed companies punished by the CSRC for illegal corporate actions as the research sample to observe, analyze and test the empirical existence and consequences of selective enforcement.[4] Note that we use the term "selective enforcement" rather than "discriminatory enforcement" or "flexible enforcement," in accordance with the literature (Smith and Visher, 1981), and because discriminatory enforcement is negative and flexible enforcement positive, whereas selective enforcement is neutral and corresponds better to the idea of value-neutral empirical research.

2. Literature review, theoretical analysis and background

2.1. Causes of selective enforcement

Generally speaking, the legislation and enforcement process itself is the main cause of selective enforcement.[5] From the legislative point of view, LLSV (1998) found that laws, rules and enforcement vary widely across different countries and legal systems, and that legal rules in emerging markets are usually less strict. Allen et al. (2005) held that legal systems in emerging markets (such as China), including those that cover investor protection, corporate governance and government quality, are not well developed.

The accurate enforcement of the law is becoming objectively harder as social and economic activity flourishes. Pistor and Xu (2003) held that because of the high cost of information, it is impossible to regulate every tiny aspect of behavior that is potentially harmful, which inevitably means that there will be gaps in the legislation (and the law cannot deal with certain harmful behavior). In other words, legal provisions are open, which means that there is no clear definition that limits the margins of the law. The law fails to make detailed regulations on certain violations due to its own imperfection, and this large discretionary space provides an incentive for selective enforcement.[6]

The scale of authority and cost-benefit principle of enforcement subjectively affect the quality of law enforcement. Information asymmetry and imperfect contracts mean that enforcement can lack authority and is consequently affected by different interest groups. Zingales (2009) held that regulations (enforcement) are affected by several factors, such as the risk of market failure, system control risks and financial crises. Hutchinson and Kennedy (2008) used state-level punishment for pollution as an example and found that the federal government used stricter standards toward companies

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[2] In the Chinese classical book Journey to The West, only one of 18 monsters who have a patron finally dies: the other 17 are recalled by their patron. In contrast, of the 26 monsters who have no patron, 20 die. Even the monkey king selectively enforces his power.

[3] An example is when Cao Cao held the post of a local official and passed down the death sentence to the uncle of a eunuch favored by the then emperor. This case has become legendary.

[4] Selective enforcement is practiced by the CSRC in their decisions to seriously punish or downplay the illegal action of listed companies. The issue is between punishing and not punishing, rather than in the degree of punishment. Many violations are solved in private. Although we intended to collect data on corporations that engaged in illegal actions but were not punished by the CSRC through an Internet search and disclosures in the media, we were unable to collect a complete sample that fit our criteria. Thus, selective enforcement in this study refers to whether or not the punishment that the CSRC meted out using its own discretionary power matched the illegal activities in character, execution and damage to investors, and the sample includes only corporations that engaged in illegal action and were punished.

[5] Selective implementation is widespread. Caretto (2005) found that the selectivity of legal proceedings is unavoidable given the limitations on time and resources, and that law enforcement agencies give up on some cases. An example is a 2008 sex photo incident in China. Members of the public circulate obscene and indecent articles on the Internet every day and the police do not enforce the law, yet when popular artists were suspected of generating indecent images, the police arrested a number of people.

[6] Selective enforcement is related to but distinct from the concept of random execution. Becker (1968) and Stigler (1970) suggested that not all violators are punished due to the high cost of law enforcement. Enforcement costs (such as those arising from the process of investigating violations and collecting evidence, arrest, prosecution, and punishment) mean that the probability of being punished for non-compliance follows a certain randomness, that is, the randomness of alleged execution. Selective enforcement and random penalties are similar in some ways, but there are also differences between them. The level of penalty for violations may be different in the two cases. Further, selective law enforcement emphasizes a subjective view and is often systemic, such as the CRSC systematically giving SOEs lighter penalties, whereas the results of random law enforcement are random, and there is no subjective choice.

than local governments, and that the stricter standards reduced selective enforcement. Jiang et al. (2009) found that the cost of regulation enforcement affects the enforcement of political promises by the CSRC. Cost-benefit-based selective enforcement exists even in sectors such as traffic regulation and immigration regulation in countries or areas with relatively perfect legal systems.[7] For example, Smith and Visher (1981) found that policemen enforcing traffic regulations take both legal and non-legal factors into account, such as gender, profession and race. Bond and Chen (1987) found that not all illegal immigration is forbidden and that governments permit some illegal immigration after weighing up the economic benefits and costs.

2.2. Effects of selective enforcement on economic and financial development

LLSV (1998) found that the legal system of a country is related to its institutions, finance and economic output. Compared with countries with civil law systems, countries applying the British legal system better protect investors and creditors, and also have better institutions, less corruption and more effective courts. In addition, a better system of legal protection and institutions results in better developed financial systems. Allen et al. (2005) found that countries with weaker protection of small shareholders and outsider investors have weaker financial markets, accompanied by slow growth or even a decline in corporate performance.

It would thus appear that selective enforcement has a large influence on financial markets. However, LLSV (1998) suggests that powerful enforcement can make up for weak legal regulations. In countries with imperfect legal systems or weak enforcement, selective enforcement can be a substitute mechanism or a supplement. In the existing framework of law and economics, Ehrlich and Posner (1974) and Rubin (1977) focused on the efficiency of law enforcement, and Stigler (1970) and Bebchuk and Kaplow (1992, 1993) discussed optimal enforcement. Other scholars have studied topics such as personal enforcement, public enforcement and the costs and benefits of enforcement (Lands and Posner, 1975; Shavell, 1993; Polinsky and Shavell, 2000).

2.3. Selective enforcement of regulations in China

As stated, although there are many studies on the relationships among law, economics and finance, and the impact of selective enforcement has also been studied to some extent, research on the relationship between law and economics in countries with a weak legal environment and selective enforcement, and the impact of the selective allocation of resources, is still relatively rare.[8] The design of the regulatory system for the Chinese capital market, especially in terms of penalties for non-complying companies, provides a very good experimental environment for empirical research for several reasons.

First, the power of the regulatory agencies to punish is less direct. As the stock market regulator, the CSRC has established the Administrative Punishment Committee and other departments that investigate securities violations. However, these have relatively limited powers of punishment compared with the regulatory authorities in developed countries (such as the US Securities and Exchange Commission, or SEC),[9] and punishments cannot be directly implemented for separate penalty violations. The effectiveness of the CSRC's limited battery of disciplinary measures to prevent further violations by listed companies is not obvious (Luo, 2005). The CSRC certainly lacks effectiveness in implementing the rules and its reputation for strict implementation is thereby affected. When securities regulatory authorities cannot maintain their authority and efficiency of punishment, selective enforcement may occur.

Second, the power source and administrative arrangements of the CSRC mean that it lacks independence. In determining the allocation of resources to the stock market, and in the investigation and handling of violations, the CSRC is influenced by its parent body, which is the State Council at the ministerial level. Further, in addition to the CSRC, the Ministry of Finance also has the power to punish non-complying companies listed on the Shanghai and Shenzhen Stock Exchanges and the right to investigate internal issues, which may reduce the independence of the CSRC. In investigating irregularities in a company, whether the CSRC can remain neutral and give fair and objective treatment is open to question. In addition, the rules do not easily lead to more stringent selective implementation. For example, an important basis for enforcement by the CSRC is the "Company Law," which provides that if the information disclosed by a listed company is false and misleading, then the

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[7] Other examples are the fight against idle money by the Hong Kong government during the financial crisis, and stricter enforcement during the election season in the United States, which are both forms of selective enforcement.

[8] Jayakar (2003) found that the major developing countries have promulgated certain acts on the protection of intellectual property rights, but that the enforcement authorities tend to better protect industries that are state related.

[9] Harvey et al. (1993) held that the Securities Enforcement Remedies and Penny Stock Reform Act 1990 granted more rights to the SEC that not only allow it to hand out fines and special bail outs via the federal government, but also to enforce the payment of fines and directly make Cease-and-Desist Orders for existing and potential violations. Moreover, the act grants the SEC the right to impose civil sanctions through an administrative process. Before that, the enforcement rights of the SEC, which were conducted via the courts, were confined to issuing cease-and-correct orders for violations, rather than punishment. Mclucas found that after the Enron scandal, the Sarbanes-Oxley Act 2002 further broadened the enforcement rights of the SEC, granting it powers to expropriate the illegal earnings of CEOs and CFOs.

severity of the punishment is limited by the amount of fines that can be handed out.[10] Law enforcement agencies such as the SFC can also choose between several penalties and fines for the same violation. Nourayi (1994) examined the effectiveness of enforcement in the United States and found that the reaction of securities prices to violations is directly related to the severity of the punishment meted out by the SEC. Meng et al. noted that violations make investors lose confidence in a company, and that punishment for violations makes stock prices fall sharply. The China Journal (2002) studied fraud and public punishment by the CSRC from 1999 to 2000 and found that the punishments meted out to fraudulently listed companies and their executives were small compared with the amounts involved in the fraud, and that this raises questions about the fairness of such punishments. The CSRC is likely to adopt a different strength of enforcement under different market conditions, such as state-owned enterprise (SOE) financing, restructuring projects and stock market fluctuations, as these affect the stability of the national economy and a larger number of investors, thereby influencing social stability. Dai found through case studies that the processing speed and size of punishment handed out by the SFC differed at different times and for different cases.

Third, the tradeoff between costs and benefits must be considered. On the one hand, punishments given to SOEs may affect the vested interest of the local government. In China, securities businesses are generally stripped down versions of SOEs or have priority state financing (Luo, 2005; Zhu et al., 2006). As enterprises that are owned by the government and the people, it is difficult for the CSRC to supervise SOEs. This crude connection may have the effect of "squeezing out" the supervisory rule of the CSRC, and means that SOEs may not be punished for their violations. At the same time, obtaining qualification for listing, as a rare "shell resource," is costly. The financing of an SOE may require the cooperation of local government and the enterprise to obtain listing (Shan, 2002; Yang, 2004). If the company then gets out of line, the CSRC may not apply the law strictly to avoid colliding with the government's goals.

On the other hand, the cost of investigating and punishing a company that fails to comply may be high. The supervisory institutions need to trade off cost and income in developing punishment policies, and need to pin down the goal of the punishment. Given the cost of executing the law, it is not optimal to seek to eliminate every violation. Instead, the supervisory bodies need to make use of their limited resources correctly and strive to achieve the overall goal at a minimal cost. The supervisory institutions and SOEs are also kept in close contact due to the personnel flow between them. Under the dominant pattern of Chinese society and the "people capital connection" (Fei, 1985), supervisory institutions may have a tendency in dealing with misfeasance by SOEs to take the circumstances into consideration in meting out punishments.

The local and central government may not be affected when non-SOEs are punished severely, as tax revenue is the only real bridge that connects the two. However, SOEs may help the local government to achieve many goals beyond tax revenue, such as employment (Zeng and Chen, 2006) and officer promotion (Li and Zhou, 2005). For the central government, the task of stripping down SOEs requires the punishments handed out to miscreant SOEs to be lenient. The central government does not require the same for non-SOEs, as they do not significantly increase local and central government revenue. Further, as they are more market-oriented than SOEs, it is difficult for the government to use them to implement their pluralistic goals. They do not increase revenue, but they do bring higher supervision costs. In supervising SOEs, the CSRC may have the choice of communication or CEO replacement. In supervising non-SOEs, punishment may be the only approach. If the only punishment approach is selectively gentle, then other non-SOEs may disobey rules and laws much more once they observe the signal. This will then increase the CSRC's investigation and punishment costs. The CSRC is reluctant to let this happen, and thus under the constraint of costs and revenue, it is more likely to punish non-SOEs.

Lenient punishment of insubordinate SOEs may have three main side effects. The first is an efficiency cost. For example, a poorly maintained capital market leads to poor efficiency, which in turn damages welfare. The second is an action mechanism correction cost. If the actions of an insubordinate company do not match the accepted punishment, then the predicted cost of insubordination is diminished, and other companies may imitate such actions. This can bring about an incentive to disobey. When analyzed from the perspective of cost and revenue, the revenue from disobeying or violation pertains to government, rather than to the company or personnel. Although the cost of disobeying is low for SOEs, their incentive to disobey is weaker than that of non-SOEs, as the revenue that non-SOEs accrue from disobeying is much greater than that for SOEs. Although China has introduced taxes, foreign trade initiatives and a number of other financial support measures for the development of the non-public economy, their actual implementation has been less than ideal. Non-state enterprises (such as private enterprises) are subject to much more stringent financing constraints (such as bank loans, allotments, or issuances) (Sun et al., 2006; Lu et al., 2009), and sometimes resort to illegal means to gain more benefits. Increased demand

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[10] Under the Security Law of the People's Republic of China, provision No. 193: issuer, listed companies or other entities obliged to disclose information that fail to disclose information or disclose false records and misleading statements, or make major omissions will be ordered to make corrections, given a warning, and handed out a fine of more than 300,000 yuan but less than 600,000 yuan. The personnel directly in charge and others directly responsible are given a warning and a fine of more than 30,000 yuan but less than 300,000 yuan. The issuer, listed companies, and other entities obliged to disclose information that fail to submit a report or submit reports containing false records, misleading statements, or material omissions will be ordered to make corrections, and given a warning and a fine of more than 300,000 yuan but less than 600,000 yuan. Again, the personnel directly in charge and others directly responsible are given a warning and a fine of more than 30,000 yuan but less than 300,000 yuan. Under Provision No. 194, the issuer and listed companies changing the use of publicly raised funds without permission shall be ordered to make corrections, and the personnel directly in charge and others directly responsible given a warning and a fine of more than 30,000 yuan but less than 300,000 yuan. The issuer, the listed company's controlling shareholders, and actual controllers shall be given a warning and a fine of more than 300,000 yuan but less than 600,000 yuan. Under provision No. 203, behavior including the violation of this Law and stock market manipulation will be dealt with by the seizing of illegally held securities, the expropriation of illegal income, and the imposition of a fine not less than five times the illegal income or of more than 300,000 yuan but less than 3,000,000 if the illegal income is less than 300,000 yuan. The personnel directly in charge and others directly responsible shall be given a warning and a fine of more than 100,000 yuan but less than 600,000 yuan.

within the financing system cannot meet the needs of non-SOEs, which may thus be more motivated to bypass the current system of restrictions. Weak law enforcement inevitably leads to bad behavior by companies, and the resulting cost to correct the market cannot be ignored. Selective enforcement allows market players to choose relationships of trust, rather than relying on the law enforcement body (Luo, 2005). In a sense, the nature of violations by different companies and the attendant punishments should not be treated as purely legal or technical problems, but should be regarded as a political issue. In fact, the CSRC's "campaign-style" of law enforcement for violating companies is difficult to avoid in China and is closely related to China's current political system. Bribery is also an issue. The regulatory agencies have great discretion over non-complying companies (especially private enterprises) and thus to reduce possible sanctions, bribes may be paid to such agencies with the resources used costed into the transaction.

If the CSRC does engage in selective enforcement, then it should be possible to identify some of the economic consequences. The CSRC is limited in its power to directly punish violations, but it can directly affect the allocation of resources, and in this way replaces market power. The framework for the CSRC gives it the right to approve refinancing, and thus a violating company may in the future be at a disadvantage in terms of refinancing quotas (Jiang et al., 2009). At the same time, the poor level of resource allocation also affects the CSRC (Chen et al., 2008). Serious violations generally have a greater social impact and investors also need to take on more risk when a company's credibility is seriously damaged. In assessing applications for refinancing from non-compliant companies, the CSRC is likely to consider the seriousness of the violation, and companies whose violations are more minor may be more likely to be successful. Companies that have engaged in serious violations may thus expect to be rejected, and are less likely to apply.

Based on the foregoing theoretical and institutional background analysis, we predict that in punishing, the CSRC takes into account the nature of a company's violations, that SOEs suffer lighter punishments and that the higher the level of state involvement, the more severe the penalty. In making decisions about punishment, the CSRC considers several factors. The first is investor losses: the CSRC decides on the punishment by observing the market reaction to the losses that a company's non-compliance has created for investors and practices a form of "calm man's angry," where the greater the loss, the greater the possibility of being subject to heavy penalties. The second consideration is sector, with protected industries being less likely to receive heavy penalties for violations. The third is the stock market environment: during stock market downturns, the CSRC will hand out fewer heavy penalties for fear of damaging market confidence, but in a more buoyant securities market may choose to increase the intensity of punishments to avoid market speculation. The fourth is the level of violation, with serious breaches being more likely to be heavily punished. The final consideration is the law enforcement environment. In 2001, the National People's Congress audited the CSRC's enforcement and found it to be lax, since which time the CSRC has made efforts to strengthen its law enforcement and is more likely to heavily punish violating companies. To test these predictions, this study provides two descriptive cases and large sample empirical tests.

3. Case-based evidence

3.1. The Kaili case

The CSRC is defined as an administrative institution, but this definition is inconsistent with its nature and its legal status. According to the Securities Act, "it has the equivalent authority of the state council administrative authority." The CSRC has a high status and independent enforcement power. However, its legal status is not consistent with the nature of its business and its responsibilities do not stand up to close scrutiny from the legal perspective, which may affect its authority over the securities market. The Hainan Kaili case is an example of a direct challenge by a private enterprise to the right of the CSRC to enforce the law. On July 5, 2001, in the Beijing Municipal Higher People's Court, in a landmark case in the Chinese stock market the administrative tribunal Vice-President gave an order to "appeal and maintain the verdict," thus marking the failure of the CSRC (Li, 2001).

Kaili was established from Six Enterprises Co. Ltd. in December 1994. The company's goal was to build the central line of the Hainan Expressway, a planned road running from Haikou to Tongshi with a length of 172 km. The project required dynamic investment of about 54 billion yuan, and thus financing became the company's core work after its establishment. In March 1997, the Hainan Securities Management Office sent a letter to the State Ethnic Affairs Commission recommending Kaili's public offering on the stock market. In February 1998, the CSRC notified the Securities Management Office that they had agreed to accept Kaili's application materials for stock issuance, and required the inclusion of this in the Province Plan for 1997. In June 1998, Kaili submitted its application materials for A-share issuance to the CSRC. In June 1999, Kaili received a report from the CSRC transferred from the relevant State Council departments (China Securities Regulatory Commission (1999), No. 39). According to the report, 97% of Kaili's profits did not exist, which was a serious violation of the Company Law, and thus the company did not meet the standard for initial public offering (IPO). The CSRC decided to rescind its approval for IPO. The application materials submitted more than a year previously were eventually returned by the CSRC. Kaili sued the CSRC.

On December 18, 2000, the Beijing No. 1 Intermediate People's Court made the following first-instance ruling: (1) the defendant (CSRC), in returning the company's materials, had broken the law; (2) the defendant was ordered to reissue its authorization for Kaili's application for IPO, and to make a decision within two months of the judgment; (3) Kaili's other claims were dismissed. In the second instance, the CSRC strongly emphasized their legal status. The CSRC agent reviewed

the eight-year history of the stock market, and introduced the concept of "pre-selection procedure." The CSRC claimed that the material submitted by Kaili was in the "pre-selection" stage. The pre-selection process is a historical issue. In 1998, the State Council authorized the CSRC to examine stock issuance, which was a compulsory approval process under the planned economic system. To facilitate communication with local governments and enterprises, the CSRC developed rules for the pre-selection process that were compatible with the mandatory plan. After the promulgation of the "Securities Act," the CSRC issued stock issuance procedures in 2000 and abandoned the quota and limit system. The essential difference between the 2000 and 1998 review procedure was that the former aimed to give guidance for listing by underwriters, whereas the latter provided guidance for local governments or ministries on recommending companies for listing. Although a new approval process for stock issuance was generated, it arrived after the Kaili case. According to the CSRC, Kaili's application for listing was historical, and was not subject to the approval process developed in 2000. Hence, the CSRC could not enforce the judgment in the first-instance verdict and was unable to restore Kaili's listing application according to the procedures approved in 2000.

Lawyers from the Beijing Zhongzhao law office, Kaili's agents, submitted that neither the "Provisional Regulations on Stock Issuance and Transaction Management" nor the "Securities Act" provide for pre-selection procedures. The pre-selection process developed by the CSRC was beyond its mandate, and the CSRC had formulated its own rules of conduct, which was not appropriate: such rules should be developed by higher authorities or legislative bodies. In addition, the CSRC interpretation of the 2000 approval process was wrong. The 2000 approval process made it clear how historical problems were to be solved, and companies making applications in 1997 were placed under the procedural changes approved in 2000. Kaili asked the court to confirm that the CSRC's returning of the pre-selection materials to Kaili was illegal, and to order the CSRC to restore Kaili's listing application according to the procedures approved in 2000. On July 5, 2001, the Beijing Higher People's Court made the final judgment on the case, ordering the CSRC to restore Kaili's listing application and to make an administrative decision on approval within two months of the re-initiation of the process.

The "pre-selection procedure" was one of the most important disputes in the Kaili case. The procedure involves first being recommended by the province, autonomous region, or municipality directly to the central government or ministry, and then being reviewed by the CSRC. The procedure includes reporting pre-qualification material; verification; a formal recommendation, approval, review, and other procedures; and the formal declaration of application materials. The procedure is rather complicated. The judge asked the CSRC, "in the State Council promulgated the "Provisional Regulations on Stock Issuance and Transaction Management" (collectively known as the "Ordinance") No. 12 on the application processing procedures for the public offering of shares, is there a pre-selection process?" The CSRC answered "no." There is also no article in the Company Law regarding a pre-selection procedure. The CSRC takes several years to execute the pre-selection procedure, but there appears to be no legislative basis for this. Securities regulators need to regulate the market behavior of listed companies and investors, but must also regulate themselves, but who will supervise and inspect the enforcement powers of the CSRC, which are granted by the State Council?

In 1993, the State Council promulgated the "Ordinance" to regulate the formal declaration and response time for applications for IPO. The Ordinance contains clear rules: the issuance must occur on a national scale, the local government authorities and the central department in charge must examine and approve the issuing application within 30 days of receipt and must send a copy to the CSRC, and the approved application must be sent to the CSRC for review. The CSRC must generate guidelines within 20 working days from the date of receipt of the review, and then issue guidelines. Why, then, did Kaili have to wait more than a year?

Although Kaili had their legal claim satisfied, there was great difficulty in implementing the judgment. Ultimately, Kaili was not the winner, as the judgment was not carried out. Kaili was unable to continue with the public review process, and although in 1999 the State Planning Commission approved Kaili to issue 1 billion yuan of corporate bonds, no broker was willing to underwrite the company to transfer the stocks to bonds, and Kaili's financing attempt failed. The judgment seemed unfavorable to the CSRC, but in fact it may actually have improved its social image. Although the judgment terminated many years of implementation of the "pre-selection procedure" and "audit procedures," it did not change the logic that allowed the CSRC to formulate its own rules for listed companies and to decide the fate of their listing applications. Companies and the CSRC cannot be equal in the main market economy. In transitional economies, the securities regulatory system is usually not as effective nor as strict as it should be, but still the CSRC should strive to make the securities regulatory system more market friendly. However, under the premise of a poor regulatory environment and lack of effective means of supervision, abandoning the delegation of authority or regulatory power is impractical.

Due to "indicators" and "quota" restrictions, private enterprises often switch to overseas capital markets for financing. Before the main case against the CSRC, Kaili attempted to go public by buying a shell in the United States, because there were no relevant provisions at that time regarding the issuance of B shares. A Chinese consulting firm suggested Kaili consider going public by buying a shell in the NASDAQ system. Kaili accepted the proposal, and in November 1995 the two signed a "consulting contract," with the Chinese consulting firm committing itself to supporting Kaili in its dealings with foreign investment banks, lawyers and other intermediaries to buy a shell. However, this time Kaili suffered commercial fraud, committed by the deputy general manager of the Chinese consulting firm Ren Zhonghua × ×, who undertook the Kaili contract in person. In 1998, × × was promoted to the CSRC as deputy director of the inspection bureau. He was also put in charge of harmonizing the CRSC's business relations and was responsible for auditing listed companies. In April 2000, the CSRC judged Kaili's reported performance to be false and returned its market material. Kaili reported that there were connections between the decision of the CSRC and the Chinese consulting firm, and suspected × × to be the key figure in the matter. In

May 1998, the Ministry of Public Security asked Zhu (the leader of the CSRC) if Kaili had engaged in fraud. In June of the same year, Kaili submitted the application materials for the issuance of A-shares to the CSRC, and the CSRC investigated the company twice after receiving the materials. The CSRC is obliged to routinely publicize its review procedures to minimize or eliminate the possibility of rent-seeking, yet legal standards have been replaced by individual will. Whether CSRC officials are using their power to put up barriers to share issuance applications is unknown.

3.2. The Lukang case

As China's main securities market regulatory body, the CSRC performs the various functions of supervision, development of regulations, pre-market approval investigations and punishment. This raises the question of whether, when companies are suspected of violating the law, the CSRC can investigate in a timely, effective and public fashion. Regulatory policy for the securities market once emphasized a disequilibrium service, with SOEs mainly relying on government and administrative authority to enter the capital market to obtain resources. In the new transition economy, the CSRC faces the important problem of how to give up the role of state ownership. In fact, the CSRC is tainted by its association with state ownership, and thus whether it can treat enterprises with different ownership types impartially is questionable.

The Shandong Lukang Pharmaceutical Co., Ltd. (hereinafter referred to as "Lukang") was established based on the Shandong State Commission for Economic Restructuring document [1992] No. 142, "Official Document Regarding the Establishment of the Shandong Lukang Pharmaceutical Co., Ltd." The Shandong Lu Pharmaceutical Group Co., Ltd. (an antibiotic manufacturer from Jinan) was first established by raising funds from targeted sources. Lukang Pharmaceutical A shares were listed on the Shanghai Stock Exchange in February 1997. Lukang is now a large first-class SOE, and one of the 512 key state enterprises. On December 11, 2002 Lukang published a letter of intent to issue not more than 4700 million yuan worth of shares, with subscription to begin on December 17. On December 14, Lukang held a road show in Beijing. However, based on a report from a Lukang insider to the CSRC citing instances of fraud in its declarations of main business revenue and net profit in several years of Lukang's financial reports, the CSRC issued an emergency halt to the subscription. The application materials provided included details of Lukang's client list and sales to each customer. From January to September 2002, Lukang accumulated drug sales of 3.58 billion yuan, yet Lukang's main business income as disclosed in the third quarter of 2002 was 7.8194 billion yuan. The whistleblower reported that to increase the book profit for the three years from 2000 to 2002, Lukang had refused to accrue depreciation expenses of about 300 million yuan. In addition, Lukang had issued a false financial statement for 2001. Lukang reported revenue from main operations of 7.71 billion yuan and a net profit of 70.46 million yuan. However, the whistleblower stated that Lukang's real main income in 2001 was only 5 billion yuan, and that it actually earned either a small profit or even suffered a slight loss. On August 16, 2002, Lukang's chairman, who doubled as the secretary of the party committee, prepared an internal report entitled "Overcoming Inertia and Advancing with the Times to Ensure Lukang Even Greater Prosperity and Development" (Pang, 2003). To some extent, the report showed the true state of operations within the enterprise. The report mentioned that with the continuous adjustment of national policy, Lukang was facing increasing risk. By the first half of 2002, Lukang was running at a loss. Lukang's financial statements reported a net profit of 5.13 billion yuan in the third quarter of 2002. This study could not obtain access to the specific content of the internal report, but if the whistleblower had disclosed a fabricated or inaccurate internal report, then Lukang should have come out and clarified matters. However, we could find no such clarification after the announcement of fraud hit the newspapers. If the internal report was true, then Lukang reduced its losses and increased profits by more than 50 million yuan in three months.

On January 8, 2003, the CSRC agency in Jinan formed an investigation panel composed of four members to investigate Lukang. However, no timely disclosure of relevant information was made, again revealing the CSRC's attitude to regulation of the securities market. As the largest shareholder of Lukang is the Shandong Province SASAC, the CSRC had a duty to investigate properly, as its remit is to investigate the illegal behavior of listed companies, especially state-owned listed companies that are directly related to the construction and long-term development of China's stock market. Close study shows that although the CSRC sent an investigation team to Lukang, it made no announcement of its findings. On March 6, 2003, Lukang clarified that it had learned from the relevant department of the CSRC that material reported by the company in 2001 was suspected of being fraudulent, and that data reported for the period January to September 2002 lacked sufficient evidence. However, these findings should have been issued publicly by the CSRC, not by Lukang. In addition, whether the conclusion of "insufficient evidence" was based on the material reporting the fraud or the conclusions of the investigation of the CSRC agency is unknown. Regardless of whether the material fraud was true or whether the whistleblower deliberately fabricated it to create trouble, the CSRC should not have kept silent, and can be accused of a dereliction of duty in not disclosing the findings. The whistleblower closely watched the development of the matter, and liaised with the relevant CSRC officers on the day that Lukang released the clarification. The whistleblower asked for a written reply from the official investigation, but was refused.

On May 23, 2003, several major newspapers announced that Lukang would restart its share offering, despite being ordered to suspend it by the CSRC the previous December. Lukang announced on the date of the original issuance of the A-shares that the offering was expected to be completed in early June. However, without the approval of the CSRC, Lukang could not legally restart the offering. Did the CSRC make a definite conclusion as to whether Lukang was involved in financial fraud? On May 28, 2003, the CSRC issued a "Refusal to accept document" that made it clear that it refused the whistleblower' challenge to the company's application for listing due to fraud in 2001 and between January and September 2002. The

whistleblower challenged the CSRC and asked it to reconsider. After review, the CSRC decided that the reporting of unlawful acts on the part of corporations, social organizations and individuals by citizens was beyond the scope of administrative reconsideration. Note that there are specific requirements for administrative reconsideration. In accordance with the PRC Administrative Reconsideration Law Article XVII and CSRC Administrative Reconsideration Act Article XVII, the CSRC declined to reconsider. Lukang successfully restarted its offering, and the CSRC issued a written decision not to accept the application for administrative reconsideration from the whistleblower. It is unclear whether this means that Lukang was cleared of financial fraud. On February 10, 2004, the whistleblower again approached the CSRC to report financial fraud by Lukang, stating that important financial data had not been reported to the CSRC. There were also several work safety accidents at Lukang in 2003, but Lukang never officially disclosed them. On February 11, 2004, the relevant departments of the CSRC heard an oral report from the whistleblower, and decided that it would investigate and deal with the matter according to the law. This was a full six months after Lukang's successful issuance and the debate over Lukang's financial fraud had apparently been settled. The CSRC may have lacked an incentive to thoroughly investigate Lukang's financial problems. The CSRC also did not publish the findings of its investigation of the second whistleblower report.

4. Empirical results

4.1. Sample and data description

This study measures the selective enforcement of the CSRC in two respects: the severity of punishment and the efficiency of punishment. The sample mainly consists of announcements by the CSRC of decisions to punish, augmented by a manual search for cases of violations. We collected a total of 201 instances of violations that were punished by the CSRC, of which 116 were companies receiving penalties as announced by the CSRC between 2002 and 2008, and the other 85 were companies committing violations between 1994 and 2001 that were collected manually.[11]

We use two criteria to classify the severity of the violation. The first criterion values severity according to the type of violation and considers differences in motives and consequences. Violations including the non-disclosure of material matters, the disclosure of false or seriously misleading statements, price manipulation and insider trading are defined as more serious violations, for which the corresponding variable OFFEND takes the value of 1, and the remainder are defined as less serious violations, for which the variable OFFEND equals 0.[12] The other criterion values the amount lost by investors (LOSS). If the losses sustained by investors are above the median, then the corresponding variable LOSS takes the value of 1, and 0 otherwise.[13] To a certain extent, the amount lost by investors is a more objective proxy for the severity of the violation, but it is very difficult to accurately determine the window of loss and exclude noise arising from other events. We thus adopt both criteria for a more comprehensive measure. We define the severity of punishment (PUNISH) as equaling 0 when the penalty is in the less serious form of public criticism, and 1 when the penalty is in the more serious form of public punishment.

Table 1 reports the distribution of the different types of violations of the listed companies in the sample. Panel A shows the severity of violation by type of violation (OFFEND). Of the 201 miscreant companies, 40 (about 70.18%) of the 57 companies committing less serious violations received lighter penalties, and only 17 (about 29.82%) were subject to heavy penalties. Of the 144 companies committing serious violations, 113 (about 78.47%) received heavy penalties and only 31 (about 21.53%) were subject to lighter penalties.[14] Panel B shows the severity of violation by the amount lost by investors (LOSS). Of the 201 violations, 57 of the 98 companies causing less serious losses (about 58.16%) received lighter penalties and 41 (about 41.84%) were subject to heavy penalties. Of the 103 companies causing serious losses, 89 (about 86.41%14) received heavy penalties and only 14 (about 13.59%) were subject to lighter penalties.

Clearly, the severity of punishment meted out by the CSRC is closely related to the severity of violation, with more serious violations usually being subject to heavy penalties and less serious violations being subject to lighter penalties. The results are similar for the two classifications of severity of violations. In terms of the nature of the violating companies, Panel A,

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[11] We mainly reviewed the China Securities News and Shanghai Securities News. The remaining data came from the CCER and Wind databases.

[12] The severity of violation is defined as follows. Violation type 1 is a failure to perform other duties according to the law; type 2 is a failure to disclose periodic reports on time; type 3 is an incorrect performance prediction; type 4 is a failure to disclose material matters on time; type 5 is a disclosure of false information or seriously misleading statement, changing the use of funds without permission, violation of investment rules, material omission, or the illegal provision of assurance; and type 6 is price manipulation or insider trading. When the violation is one or a combination of any of types 1, 2, and 3, the violation is defined as light. When the violation is one or a combination of any of types 4, 5, and 6, then it is defined as serious. The numbers of violation cases corresponding to the six types of violation are 49, 22, 9, 57, 129, and 5, respectively. For the same level of violation (light or serious), we hold that the violation behavior of SOEs and non-SOEs is the same. For example, in the group of light violators, the behavior of being late in disclosing an annual report or failing to perform other duties is the same for SOEs and non-SOEs.

[13] Investor losses refer to the rate of loss that violations by listed companies bring to their investors. Basically, there are two ways of estimating investor losses. One is the incident response method, which calculates the market reaction during the short window around the punishment for violations. This method has less noise but may omit large quantities of information. The other is the causal law, which calculates the market reaction within a long window from the start of the violation behavior to the time of punishment. This approach has more noise, but suffers less from the omission of information. To better describe the impact of violations by listed companies on investors, we adopt the causal law method to calculate investor losses. To reduce the noise to a minimum, we use the method of deducting the effects of the market system to reduce the impact of systemic factors (Chen et al., 2008). Investor loss (LOSS) is calculated as follows: ($AR_{i,t}$ = violating company I's rate of return on day t − the rate of return of the market on day t, T = the day the violation behavior started until one day before the violation was punished. $LOSS_i = (-1) \cdot CAR_{i,t} = -\sum_{t=1}^{T} AR_{it}$.

[14] The severity of penalties is defined as light when the punishment is public criticism, and serious when the punishment is a public penalty.

Table 1
Distribution of violating companies and their punishment.

Type	Severity of violation	Severity of punishment				Total
		Light	Proportion (%)	Serious	Proportion (%)	
Panel A violation = OFFEND						
Whole sample	Light	40	70.18	17	29.82	57
	Serious	31	21.53	113	78.47	144
Nature of company						
SOEs	Light	28	77.78	8	22.22	36
	Serious	24	30.38	55	69.62	79
Non-SOEs	Light	12	57.14	9	42.86	21
	Serious	7	10.77	58	89.23	65
Panel B violation = LOSS						
Whole sample	Light	57	58.16	41	41.84	98
	Serious	14	13.59	89	86.41	103
Nature of company						
SOEs	Light	41	69.49	18	30.51	59
	Serious	11	19.64	45	80.36	56
Non-SOEs	Light	16	41.03	23	58.97	39
	Serious	3	6.38	44	93.62	47
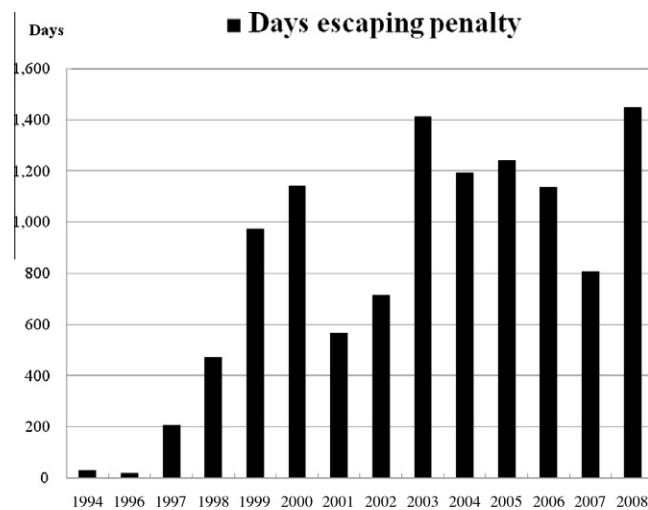
Fig. 1. Days escaping penalty.

which uses type of violation to value the severity of violation, shows that 22.22% of SOEs committing light violations received heavy penalties, whereas the corresponding figure for private companies is 42.86%, some 20% higher than that for SOEs. This indicates that companies with a state-owned background are subject to less severe penalties than companies without this background. Further, only 69.62% of SOEs committing serious violations received heavy penalties, whereas the figure for private companies is 89.23%, again some 20% higher than that for SOEs. Panel B, which uses the amount lost by investors to value the severity of violation, provides consistent evidence. Together, these results show that in cases of severe violation, companies with a state-owned background tend to receive lighter penalties, and that "princes" that break the law do not receive the same punishment as "common people." For the same level of violation, the CSRC engages in selective enforcement, under which listed companies with a state-owned background receive lighter penalties than listed companies with no state-owned background.[15]

[15] It is necessary to add that, by the end of 2008, there were 1575 companies listed on the Shanghai and Shenzhen stock markets, of which 953 were SOEs and 622 non-SOEs. The proportion of companies committing violations was 12% (115/953) among SOEs and 14% (86/622) among non-SOEs, indicating that non-SOEs are more likely to violate the regulations. However, the difference is not very large. Due to the limited sources of information, we cannot observe the exact number of enterprises committing violations, and what is available is only a sample of companies that were punished for their violations. Companies that committed violations but were not punished are excluded, and thus the basic level of selective enforcement (to punish or not) is not known. That we can only test companies that violated the regulations and were punished is a defect of this study. We thus believe that the proportions mentioned in the main text contain noise and may not accurately measure the general prevalence of violation among SOEs and non-SOEs.

Table 2
Days companies escaped punishment by the CSRC.

Type	Severity of violation	Sample size	Escape days	T-stat
Whole sample	Light	57	298.46	11.52***
Panel A violation = OFFEND				
Whole sample	Light	57	298.46	11.52***
	Serious	144	1142.85	
Nature of company				
SOEs	Light	36	308.47	6.38***
	Serious	79	1169.47	
Non-SOEs	Light	21	281.29	9.10***
	Serious	65	1110.51	

Severity of violation	Type	Sample size	Escape days	T-stat
Panel B violation = OFFEND				
Whole sample	SOEs	115	899.94	0.08
	Non-SOEs	86	908.02	
Light	SOEs	36	308.47	0.34
	Non-SOEs	21	281.29	
Serious	SOEs	79	1169.41	0.51
	Non-SOEs	65	1110.51	

Type	Severity of violation	Sample size	Escape days	T-stat
Panel C violation = LOSS				
Whole sample	Light	98	453.04	10.81***
	Serious	103	1331.89	
Nature of company				
SOEs	Light	59	365.03	10.47***
	Serious	56	1463.50	
Non-SOEs	Light	39	586.18	4.58***
	Serious	47	1175.09	

Severity of violation	Type	Sample size	Escape days	T-stat
Panel D violation = LOSS				
Whole sample	SOEs	115	899.94	0.08
	Non-SOEs	86	908.02	
Light	SOEs	59	365.03	−2.30**
	Non-SOEs	39	586.18	
Serious	SOEs	56	1463.50	2.15**
	Non-SOEs	47	1175.09	

** Statistical significance at the 5% levels.
*** Statistical significance at the 10% levels.

The severity of enforcement by the CSRC is reflected both by whether the penalty matches the violation and by the efficiency with which the penalties are enforced, or whether companies can "escape" their penalty. The efficiency of penalty enforcement may of course be constrained by the capacity of the regulator.

Fig. 1 shows that the ability of violating companies to escape their penalty varies with time. In the early stages of the securities market, violators were promptly punished because there were fewer listed companies and thus they were easier to supervise. As the capital market developed, the number of listed companies grew and economic activities became increasingly complex and diversified, which made supervision more difficult and allowed companies to "escape" penalties for a certain period before being punished. Following a National People's Congress's review of law enforcement in 2001, the CSRC significantly enhanced its law enforcement efforts, which resulted in a significant improvement in enforcement efficiency in 2001 and 2002. However, after 2003, the period for which violators escaped their penalties increased rather than decreased. This is probably related to the CSRC's "campaign-style" law enforcement.

Table 2 lists the distribution of the number of days that different types of companies escaped their penalties.[16] Panel A and Panel B use type of violation to as a proxy for the severity of the violation, and Panel C and Panel D use the amount lost by investors as a proxy for the severity of the violation.

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[16] "Escape" is defined as the interval from the point at which a listed company initially committed the violation to the day that the violation was punished, measured in days. A perfect measurement would run from the day the CSRC started to investigate the violation until the day the violation was punished, but the CSRC Administrative Punishment Committee only partially discloses when the violation behavior of a company was documented. Most publically available reports use general terms such as "the recent identification of," "identified," or "under investigation." We are thus unable to deduce the exact time at which the CSRC started its investigation of company violations for the entire sample, and so instead use the aforementioned measure.

Table 3
Distribution of refinancing applications and approvals of violating companies.

Type	Severity of violation	Number of events	Number of companies applying for refinancing	Proportion (%)
Panel A violation = OFFEND				
Whole sample	Light	31	16	51.61
	Serious	81	29	35.80
			Refinancing	
Panel B violation = OFFEND				
Companies applying for refinancing	Light	16	12	75.00
	Serious	29	24	82.76
			Number of companies applying for refinancing	
Panel C violation = LOSS				
Whole sample	Light	76	25	32.89
	Serious	36	20	55.56
			Refinancing	
Panel D violation = LOSS				
Companies applying for refinancing	Light	25	20	80.00
	Serious	20	16	75.00

Panel A shows that of the 201 violating companies, the escape time for the 57 light violators is 386 days and for the 144 heavy violators is 1258 days. These statistics indicate that companies committing serious violations had a significantly longer escape time than companies committing light violations. In terms of the ownership type of the companies, there is a significant difference in the escape time of companies committing serious violations and light violations. Among the SOEs, the average number of escape days of those committing light violations is 438 days, whereas the number for companies committing heavy violations is 1341 days. In contrast, among the non-SOEs, the average number of escape days of companies committing light violations is 80 days, whereas the corresponding number for companies committing heavy violations is 1265 days. To further investigate the effects of state ownership on the escape time of violating companies, we also examined the average escape time of SOEs and non-SOEs. Panel B shows that the average number of escape days of SOEs is 1044 and that of non-SOEs is 1049 days. The difference between the two numbers is not significant. The sub-samples of severity of violation types show that among the light violators, there is no significant difference in the number of escape days between SOEs and non-SOEs, and the same is true of the sub-sample of serious violators. However, Panel C and Panel D show that among the sub-sample of light violators, the number of escape days of SOEs is significantly smaller than that of non-SOEs, whereas among the sub-sample of serious violators, the escape time is significantly longer among SOEs than among non-SOEs.

The descriptive statistics show that no uniform and definite conclusions can be drawn on the relation between the escape time of a company and whether it has a state-owned background. Of course, this does not take into account the different degree of supervision and enforcement of the CSRC of violating companies in different periods. After controlling for the variable *YEAR*, we examine whether SOEs still escape for a longer time than non-SOEs. We also do not take into account the level of the SOEs in the descriptive statistics, and thus have no idea whether SOEs directly under the central government have a longer escaped time. This is addressed later in the empirical results.

The economic consequences of the handing out of penalties to listed companies may include an effect on the allocation of resources in the securities markets, as the CSRC takes into account the "documented record" of violations, including severity of violation, in assessing the refinancing applications of listed companies.

Table 3 shows data on the refinancing applications of the 112 violating companies that met the refinancing criteria.[17] Panels A and B use violation type as a proxy for the severity of the violation and shows that the proportion of companies applying for refinancing of the 31 light violators and the 81 serious violators is 51.61% and 35.80%, respectively. The proportion of light violators applying for refinancing is significantly higher than that of serious violators. Of the 16 light violators and the 29 serious violators that applied for refinancing, 12 and 24 obtained a quota, respectively, indicating that companies committing light violations had a slightly lower success in obtaining a quota than companies committing heavy violations. Panels C and D use the amount lost by investors as a proxy for the severity of the violation and shows that the proportion of companies applying for refinancing among the 76 light violators and 36 serious violators is 32.89% and 55.56%, respectively. Of the 25 light violators and

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[17] The overall sample includes two groups of companies: companies that obtained SEOs and companies that met the refinancing conditions. The criteria for companies meeting the refinancing conditions are rougher, and mainly focus on the profitability requirements, which are continuous profitability for the previous three years and an average ROE of 10% or more for the previous three years. The number of listed companies applying for refinancing can be gleaned from announcements at the shareholders' meetings of listed companies. If a company has re-financing needs, then the refinancing proposal must be approved at the shareholders' meeting. Our data thus come from materials from shareholders' meetings available in the "major issues" section of the Sina Finance website (http://finance.sina.com.cn/stock/). Because such information was first disclosed in 2000 only, the refinancing sample is confined to companies committing violations during or after 2000. A total of 112 companies meet the filtering conditions, of which 46 either secured refinancing or had their refinancing proposal approved at the shareholders' meeting.

Table 4
Refinancing applications and time taken to secure approval for violating companies.

Time	Type of violation	Sample size	Mean	Median	T	Z
Panel A violation = OFFEND						
Refinancing application	Light	16	293.75	239.00	−4.06***	−2.97***
	Serious	29	947.38	801.00		
Refinancing approval	Light	12	326.50	270.50	−3.86***	−2.64***
	Serious	24	1050.54	977.00		
Panel B violation = LOSS						
Refinancing application	Light	25	394.24	267.00	−3.87***	−15.00***
	Serious	20	1115.90	1124.50		
Refinancing approval	Light	20	445.60	287.00	−3.86***	−2.65***
	Serious	16	1263.69	1348.50		

*** Statistical significance at the 10% levels.

Table 5
Variable definitions.

Variable name	Symbol	Definition
Severity of punishment	PUNISH	Dummy variable that takes the value of 1 when companies committing violations are punished, and 0 otherwise
Escape days	ESCAPE	Dummy variable that takes the value of 1 when the number of escape days is larger than the median for the year, and 0 otherwise
Severity of violation	OFFEND	Dummy variable that takes the value of 1 when a violation is serious, and 0 otherwise
Investors losses	LOSS	Dummy variable that takes the value of 1 if investor losses are larger than the median, and 0 otherwise
Nature of companies	SOE	Dummy variable that takes the value of 1 when the company is state owned, and 0 otherwise
Characteristics of industry	PROTECT	Dummy variable that takes the value of 1 when the industry is protected, and 0 otherwise
Market environment	SOAR	Dummy variable that takes the value of 1 when punishment occurred in a bull market, and 0 otherwise
Rate of return on net assets	ROE	Rate of return on net assets in the year before the listed company was punished
Asset-liability ratio	LEV	Asset-liability ratio in the year before the listed company was punished
Company size	SIZE	Natural logarithm of total assets for the year before the listed company was punished
Region	REGION	Dummy variable that takes the value of 1 when the company is located in a more developed eastern area, and 0 otherwise

20 heavy violators that applied for refinancing, 20 and 16 obtained a quota, respectively, indicating that a slightly higher proportion of light violators were successful in obtaining a quota than heavy violators.

The CSRC may be aware that companies that have committed serious violations may selectively avoid applying for refinancing, and because the potential market value for seasoned equity offering (SEO) qualification is large, the cost of policy enforcement is quite high. However, giving companies committing light violations more refinancing opportunities may undermine the CSRC's reputation for enforcement. The CSRC may not take into account the severity of violations when deciding whether to grant a refinancing quota, and may instead classify all tainted companies as having an equally poor credit record. Moreover, the rights to enforce punishment and issue permissions belong to different departments of the CSRC, which need to communicate and coordinate.

Table 4 shows the statistics on the time taken to process a refinancing application and receive approval for violating companies.[18] Panel A uses violation type as a proxy for the severity of the violation, and shows that the average time taken to secure approval for the 16 light violators is 293.75 days, whereas the average time for the 29 serious violators is 947.38 days. Companies committing light violations thus wait for a significantly shorter time. In addition, of the 36 companies that obtained a quota, the severity of violation had a significant impact on the time taken to secure approval. Panel B uses the amount lost by investors and provides similar evidence.

Table 5 lists the definitions of the main variables used in this study.

Table 6 lists the descriptive statistics for the main variables. It shows that SOEs (SOE) are the majority in the sample, accounting for 57.21% of the companies. Companies in protected industries (PROTECT) account for only 5.47% of the sample. Companies that committed violations in a bull market (SOAR) account for 45.77% of the sample. Companies from the eastern region (REGION) account for 47.76% of the sample.

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[18] The time taken to apply for refinancing is measured as the interval from the day that the company was punished for violation to the day that the proposal for refinancing was approved at the shareholders' meetings. Because we cannot determine the time when Xinhuajin (600735) had its refinancing proposal approved, the sample size is 45. In terms of defining refinancing audits, the point at which listed companies applied to the CSRC is not available, and we thus use the interval between the approval of the refinancing proposal at the shareholders' meeting and the point at which the refinancing quota was granted.

Table 6
Descriptive statistics.

Variable	Sample size	Mean	Lower quartile	Median	Upper quartile	Standard deviation
PUNISH	201	0.6468	0.0000	1.0000	1.0000	0.4792
ESCAPE	201	0.5423	0.0000	1.0000	1.0000	0.4995
OFFEND	201	0.7164	0.0000	1.0000	1.0000	0.4519
LOSS	201	0.5124	0.0000	1.0000	1.0000	0.5011
SOE	201	0.5721	0.0000	1.0000	1.0000	0.4960
PROTECT	201	0.0547	0.0000	0.0000	0.0000	0.2280
SOAR	201	0.4577	0.0000	0.0000	1.0000	0.4995
ROE	201	0.0467	−0.0958	0.0260	0.1152	0.9641
LEV	210	0.7996	0.3705	0.6020	0.8245	0.7253
SIZE	201	20.3732	19.8679	20.3354	20.9155	0.9819
REGION	201	0.4776	0.0000	0.0000	1.0000	0.5007

Table 7
Correlation matrix.

	PUNISH	ESCAPE	OFFEND	LOSS	SOE	PROTECT	SOAR	ROE	LEV	SIZE	REGION
PUNISH	1.0000	0.1359	0.4588	0.4661	−0.2394	−0.0052	0.0731	−0.1102	0.2580	0.1095	0.0190
		0.0545	<0.0001	<0.0001	0.0006	0.9412	0.3026	0.1195	0.0002	0.1217	0.7892
ESCAPE	0.1359	1.0000	0.1974	0.2626	0.1541	0.0893	0.0222	0.0411	−0.0351	0.0627	−0.0812
	0.0545		0.0050	0.0002	0.0289	0.2072	0.7540	0.5629	0.6207	0.3770	0.2521
OFFEND	0.4588	0.1974	1.0000	0.4242	−0.0756	0.0058	−0.0645	−0.0856	0.0186	0.1219	−0.1497
	<0.0001	0.0050		<0.0001	0.2862	0.9349	0.3631	0.2269	0.7928	0.0846	0.0339
LOSS	0.4661	0.2626	0.4242	1.0000	−0.0590	0.0159	0.1370	−0.1435	0.3648	−0.0021	−0.0238
	<0.0001	0.0002	<0.0001		0.4058	0.8228	0.0525	0.0421	<0.0001	0.9759	0.7374
SOE	−0.2394	0.1541	−0.0756	−0.0590	1.0000	0.1197	−0.1743	−0.0511	−0.1474	0.1263	0.0015
	0.0006	0.0289	0.2862	0.4058		0.0907	0.0133	0.4710	0.0368	0.0739	0.9831
PROTECT	−0.0052	0.0893	0.0058	0.0159	0.1197	1.0000	0.0863	−0.0475	−0.1644	0.1418	−0.0987
	0.9412	0.2072	0.9349	0.8228	0.0907		0.2233	0.5031	0.0197	0.0447	0.1633
SOAR	0.0731	0.0222	−0.0645	0.1370	−0.1743	0.0863	1.0000	−0.0414	0.1044	−0.0997	0.0412
	0.3026	0.7540	0.3631	0.0525	0.0133	0.2233		0.5596	0.1403	0.1593	0.5616
ROE	0.0108	0.0592	0.0071	0.0466	−0.0704	−0.0822	0.0183	1.0000	−0.0558	0.0688	0.0580
	0.8793	0.4043	0.9198	0.5110	0.3207	0.2459	0.7964		0.4312	0.3319	0.4132
LEV	0.2138	−0.0593	−0.0370	0.2680	−0.1715	−0.1281	0.1178	0.1747	1.0000	−0.0572	0.0938
	0.0023	0.4032	0.6025	0.0001	0.0150	0.0701	0.0959	0.0131		0.4203	0.1853
SIZE	0.0506	0.0619	0.0833	−0.0368	0.1687	0.1316	−0.0574	0.0642	−0.3439	1.0000	0.0604
	0.4756	0.3824	0.2398	0.6041	0.0167	0.0625	0.4186	0.3653	<0.0001		0.3942
REGION	0.0190	−0.0812	−0.1497	−0.0238	0.0015	−0.0987	0.0412	0.0295	0.0891	0.0578	1.0000
	0.7892	0.2521	0.0339	0.7374	0.9831	0.1633	0.5616	0.6774	0.2085	0.4151	

Note: The lower triangular matrix shows Pearson correlation coefficients; the upper triangular matrix shows Spearman correlation coefficients.

4.2. Tests of selective enforcement by the CSRC

We now examine the enforcement efforts of the CSRC in terms of severity of punishment and efficiency of punishment. We first run a correlation analysis of all of the relevant variables, as shown in Table 7. Table 7 shows that severity of punishment (PUNISH) is significantly positively correlated with non-compliance level (OFFEND) and investor losses (LOSS), but significantly negatively correlated with whether a company is an SOE (SOE), which are consistent with our theoretical predictions. The correlation matrix also shows that the correlation between non-compliance level (OFFEND) and investor losses (LOSS) is 42.42%, suggesting that both may reflect the severity of company violations to some extent. There is no serious multi-collinearity between the other explanatory variables.

4.2.1. Test of severity of punishment by the CSRC

To analyze the tendency of the CSRC to engage in selective enforcement when punishing companies committing violations, we use the following logistic regression model.[19]

$$PUNISH = a_0 + a_1 OFFEND + a_2 LOSS + a_3 SOE + a_4 PROTECT + a_5 SOAR + a_6 ROE + a_7 LEV + a_8 SIZE + a_9 REGION$$
$$+ a_{10} Y1 + a_{11} Y2 + a_{12} Y3 + a_{13} Y4 + \varepsilon \tag{1}$$

The regression test results are shown in Table 8. Column (1) shows that, when the other variables are not included, the coefficient for SOEs (SOE) is significantly negative, indicating that SOEs are likely to receive a lighter punishment. Columns (2) and (3) show that when control variables are added, the higher the level of non-compliance (OFFEND) and investor losses

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[19] To control for the influence of years (1994–2008, except 1995, a total of 14 years) and due to the small sample size, we take every three years as a period, and the last two years as a period to obtain five periods in total, where Y1 (1997–2000), Y2 (2001–2003), Y3 (2004–2006) and Y4 (2007–2008).

Table 8
Test results for severity of punishment.

Variable	(1)	(2)	(3)	(4)	(5)
OFFEND		2.3979***		2.4326***	
		(4.358)		(4.337)	
LOSS			1.9840***		2.1322***
			(4.128)		(4.246)
SOE	−1.0684***	−1.1610**	−1.3250***		
	(−3.334)	(−2.492)	(−2.859)		
D1				−1.5899**	−2.2463***
				(−1.977)	(−2.691)
D2				−1.0936**	−1.1993**
				(−2.289)	(−2.517)
PROTECT		0.6695	0.4691	0.7719	0.6730
		(0.683)	(0.490)	(0.762)	(0.710)
SOAR		−0.5299	−1.1350**	−0.4889	−1.1180**
		(−0.943)	(−2.155)	(−0.856)	(−2.124)
ROE		−0.1825	−0.1073	−0.1959	−0.1402
		(−0.746)	(−0.416)	(−0.801)	(−0.539)
LEV		0.1752	−0.4141	0.1832	−0.4279
		(0.436)	(−1.069)	(0.458)	(−1.109)
SIZE		0.1197	0.1641	0.1531	0.2317
		(0.482)	(0.670)	(0.602)	(0.922)
REGION		0.5169	0.2805	0.5363	0.3308
		(1.172)	(0.660)	(1.213)	(0.769)
Y1		0.9094	1.2210	0.9259	1.2390
		(0.993)	(1.384)	(1.004)	(1.398)
Y2		0.3038	0.5186	0.3648	0.6153
		(0.377)	(0.682)	(0.449)	(0.797)
Y3		3.7550***	3.9081***	3.7741***	3.9571***
		(3.820)	(4.055)	(3.838)	(4.074)
Y4		4.0828***	4.6628***	4.1552***	4.8493***
		(2.863)	(3.305)	(2.904)	(3.377)
Constant	1.2603***	−4.4291	−3.7865	−5.2082	−5.2886
	(4.849)	(−0.871)	(−0.770)	(−0.994)	(−1.043)
Observations	201	201	201	201	201
Pseudo R^2	0.0455	0.4415	0.4250	0.4432	0.4322

Note: The upper values are coefficients and the lower values in parentheses are Wald values. For the Chi values in Column (4) where D1 = D2 equals 0.43, the P value is 0.5108. For the Chi values in Column (5) where D1 = D2 equals 1.83, the P value is 0.1759.
** Statistical significance at the 5% levels.
*** Statistical significance at the 10% levels.

(LOSS), the more severe the punishment that companies receive. Similar results are found for the two measures of the severity of the violation. Having a state-owned background can significantly reduce a company's risk of suffering severe penalties from the CSRC, and companies with no state-owned background receive more severe penalties. The market environment (SOAR), the nature of the industry to which a company belongs (PROTECT), company performance (ROE), capital structure (LEV), company size (SIZE) and the level of regional development (REGION) have no significant affect on the severity of the punishment. After 2001, the CSRC significantly strengthened its law enforcement efforts. The test results indicate that non-compliance after 2004 (Y3, Y4) was more likely to attract serious penalties, indicating time-based selective enforcement by the CSRC.

To consider the effect of the level of SOEs on the severity of punishment, we further divide the SOEs into two groups comprising enterprises directly under the central government (D1) and enterprises under the control of local government (D2). The test results are shown in Column (4) and Column (5) of Table 8, and suggest that the central SOEs are more likely to escape severe penalties than private enterprises, and that the penalties that central SOEs receive are lighter.

4.2.2. Test of efficiency of punishment by the CSRC

To study the efficiency of punishment for non-compliance by the CSRC, we use the following logistic regression model.

$$ESCAPE = a_0 + a_1 OFFEND + a_2 LOSS + a_3 SOE + a_4 PROTECT + a_5 SOAR + a_6 ROE + a_7 LEV + a_8 SIZE + a_9 REGION$$
$$+ a_{10}Y1 + a_{11}Y2 + a_{12}Y3 + a_{13}Y4 + \varepsilon. \tag{2}$$

The regression test results are shown in Table 9. Column (1) shows that when the other variables are not included, the coefficient of SOE is significantly positive, indicating that SOEs escape punishment for longer. When the control variables are added, the coefficient for SOEs is still significantly positive, again indicating that SOEs are more likely to escape penalties. Column (2) and Column (3) show that under the same conditions, SOEs escape for longer. Even in a bull market (SOAR), the

Table 9
Test results for efficiency of punishment.

Variable	(1)	(2)	(3)	(4)	(5)
OFFEND		1.4217***		1.4612***	
		(3.518)		(3.502)	
LOSS			1.8490***		1.7402***
			(4.628)		(4.329)
SOE	0.6284**	0.6985**	0.6149*		
	(2.176)	(2.165)	(1.847)		
D1				2.4646***	1.9996**
				(2.966)	(2.449)
D2				0.4706	0.4323
				(1.413)	(1.267)
PROTECT		0.5524	0.2565	0.3378	0.1447
		(0.730)	(0.349)	(0.448)	(0.191)
SOAR		0.6311*	0.4328	0.6792*	0.4509
		(1.811)	(1.234)	(1.887)	(1.257)
ROE		0.1597	0.1865	0.1469	0.1733
		(0.962)	(1.063)	(0.873)	(0.985)
LEV		0.0515	−0.3157	0.0267	−0.3218
		(0.197)	(−1.144)	(0.101)	(−1.169)
SIZE		0.0860	0.1281	0.0391	0.0824
		(0.485)	(0.692)	(0.214)	(0.434)
REGION		−0.2210	−0.3705	−0.2513	−0.3925
		(−0.716)	(−1.165)	(−0.798)	(−1.218)
Y1		−1.3245*	−1.4421**	−1.5554**	−1.5015**
		(−1.806)	(−1.995)	(−2.078)	(−2.059)
Y2		−0.3068	−0.1618	−0.5372	−0.3135
		(−0.511)	(−0.281)	(−0.882)	(−0.542)
Y3		−1.1381*	−1.4039**	−1.3201*	−1.4420**
		(−1.683)	(−2.099)	(−1.918)	(−2.153)
Y4		−1.1348	−1.1016	−1.3981*	−1.2149
		(−1.466)	(−1.462)	(−1.761)	(−1.603)
Constant	−0.1866	−2.4382	−2.6643	−1.2983	−1.5852
	(−0.861)	(−0.683)	(−0.716)	(−0.352)	(−0.414)
Observations	201	201	201	201	201
Pseudo R^2	0.0173	0.0861	0.1287	0.1162	0.1465

Note: For the Chi values in Column (4) where $D1 = D2$ equals 5.96, the P value is 0.0146. For the Chi values in Column (5) where $D1 = D2$ equals 3.78, the P value is 0.0517.
* Statistical significance at the 1% levels.
** Statistical significance at the 5% levels.
*** Statistical significance at the 10% levels.

Table 10
Correlation matrix for the variables on the consequences of selective enforcement by the CSRC.

	APP	OFFEND	LOSS	SOE	PROTECT	ROE	LEV	CR	SIZE
APP	1.0000	−0.1443	0.2159	0.0562	−0.1000	−0.3625	0.1546	−0.0127	−0.2070
		0.1291	0.0223	0.5562	0.2944	<0.0001	0.1036	0.8945	0.0285
OFFEND	−0.1443	1.0000	0.2549	−0.0920	0.1597	0.0256	0.1429	−0.2262	−0.0818
	0.1291		0.0067	0.3347	0.0926	0.7886	0.1328	0.0165	0.3913
LOSS	0.2159	0.2549	1.0000	0.0472	0.1297	0.0077	0.2691	−0.2708	−0.0485
	0.0223	0.0067		0.6213	0.1728	0.9359	0.0041	0.0039	0.6117
SOE	0.0562	−0.0920	0.0472	1.0000	−0.0703	0.1533	−0.0488	0.1471	0.3688
	0.5562	0.3347	0.6213		0.4616	0.1067	0.6091	0.1218	<0.0001
PROTECT	−0.1000	0.1597	0.1297	−0.0703	1.0000	0.2515	0.1639	−0.2596	0.2861
	0.2944	0.0926	0.1728	0.4616		0.0075	0.0842	0.0057	0.0022
ROE	−0.2493	0.0490	0.0348	−0.0378	−0.0574	1.0000	0.0480	−0.0078	0.2950
	0.0080	0.6076	0.7156	0.6920	0.5478		0.6153	0.9347	0.0016
LEV	0.2316	0.1482	0.3052	−0.1388	0.0169	−0.0884	1.0000	−0.7111	−0.0698
	0.0140	0.1189	0.0011	0.1444	0.8594	0.3541		<0.0001	0.4644
CR	0.0833	−0.0197	−0.1625	−0.0503	−0.1590	−0.0630	−0.2965	1.0000	0.1467
	0.3828	0.8367	0.0869	0.5985	0.0941	0.5096	0.0015		0.1228
SIZE	−0.1906	−0.0920	−0.0303	0.4013	0.2980	−0.0748	−0.2413	−0.0851	1.0000
	0.0441	0.3345	0.7510	<0.0001	0.0014	0.4334	0.0104	0.3725	

Note: The lower triangular matrix shows Pearson correlation coefficients; the upper triangular matrix shows Spearman correlation coefficients.

efficiency of enforcement by the CSRC does not improve, with violating companies escaping penalties for a longer period of time. The addition of the year variables show that after 2001, violating companies escaped for a shorter period of time, which

Table 11
Test results for refinancing applications of violating companies.

Variable	(1)	(2)	(3)
OFFEND		−1.1436**	
		(−2.065)	
LOSS			0.5841
			(1.109)
SOE	0.2323	0.6292	0.6257
	(0.594)	(1.182)	(1.183)
PROTECT		0.1768	−0.1014
		(0.272)	(−0.165)
ROE		−0.0647*	−0.0610*
		(−1.888)	(−1.800)
LEV		0.0379**	0.0342*
		(2.126)	(1.907)
CR		0.3685	0.4334
		(1.097)	(1.162)
SIZE		−0.3369	−0.2328
		(−1.339)	(−0.978)
Constant	−0.4947*	7.7208	4.7995
	(−1.950)	(1.436)	(0.952)
YEAR	No	Yes	Yes
Observations	112	112	112
Pseudo R^2	0.0023	0.2977	0.2768

* Statistical significance at the 1% levels.
** Statistical significance at the 5% levels.

Table 12
Test of approval for refinancing of violating companies.

Variable	(1)	(2)	(3)
OFFEND		−1.0527	
		(−0.876)	
LOSS			0.1320
			(0.114)
SOE	−0.5596	−0.8397	−0.9559
	(−0.745)	(−0.694)	(−0.769)
PROTECT		−0.1999	−0.7886
		(−0.113)	(−0.439)
ROE		−0.1491**	−0.1406*
		(−1.964)	(−1.923)
LEV		0.0128	0.0261
		(0.237)	(0.443)
CR		−0.2493	−0.2086
		(−0.901)	(−0.771)
SIZE		−1.4199**	−1.1779**
		(−2.040)	(−1.954)
Constant	1.6582***	35.4848**	29.1047**
	(3.040)	(2.147)	(2.118)
YEAR	No	Yes	Yes
Observations	45	45	45
Pseudo R^2	0.0124	0.3791	0.3613

* Statistical significance at the 1% levels.
** Statistical significance at the 5% levels.
*** Statistical significance at the 10% levels.

suggests that at least after the investigation in 2001 of the National People's Congress, the CSRC strengthened its enforcement efforts and improved its enforcement efficiency.

We again divided the SOEs into enterprises directly under the central government (D1) and enterprises under local government (D2). The test results are shown in Column (4) and Column (5) of Table 9. The results show that the SOEs, and especially the central SOEs, escaped penalties for a longer period of time. The relatively high status of central SOEs may create obstacles to their supervision and punishment by the CSRC, and may result in a more negative attitude toward dealing with their violations. This in turn could mean that a considerably longer time elapses before penalties are enforced. Of course, this phenomenon may also be related to the generally lower quality of SOEs when they go public.

4.3. Test of the consequences of selective enforcement by the CSRC

The CSRC's requirements for approval for refinancing may give violating companies certain expectations. To test whether companies committing light violations are more likely to apply for refinancing, we use the following logistic regression model.

$$APP = a_0 + a_1 OFFEND + a_2 LOSS + a_3 SOE + a_4 PROTECT + a_5 ROE + a_6 LEV + a_7 CR + a_8 SIZE + \sum YEAR + \varepsilon. \qquad (3)$$

Here, *APP* is a dummy variable that takes the value of 1 if the company applied for refinancing, and 0 otherwise. *CR* is the current liquidity ratio of the company. Table 10 shows the correlation matrix for the variables, which indicates that whether a company applied for refinancing (*APP*) is negatively correlated with the non-compliance level (*OFFEND*), but positively correlated with investor losses (*LOSS*). The results require further regression analysis, which is shown in Table 11.

As Table 11 shows, the non-compliance level of listed companies (*OFFEND*) is significantly negative, indicating a small possibility of refinancing for companies committing serious violations. The coefficient for investor loss (*LOSS*) is insignificant. In addition, the coefficient for company performance (*ROE*) is significantly negative,[20] and companies with higher leverage (*LEV*) are more inclined to apply for refinancing. There are no significant differences in the other control variables.

We further examine the effects of the possibility of obtaining a quota for companies applying for refinancing, and present the results in Table 12. The results indicate that the level of non-compliance does not significantly influence the likelihood of obtaining refinancing approval.

5. Conclusion

The selective enforcement of laws and regulations has become a hot topic in academia. This study uses instances of companies being punished for violation behavior during the period 1994–2008 to analyze the characteristics of regulatory enforcement by the CSRC, and in particular the selective enforcement of laws and regulations. The results show that the CSRC pays special attention to the ownership of violating companies in its law enforcement. Companies with a state-owned background are more likely to escape serious punishment, and the higher the level of SOE, the lighter the punishment. However, the larger the loss to investors caused by violations, the more serious the punishment meted out by the CSRC, as the CSRC needs to reassure investors. We also find that SOEs, and especially those directly under central government control, can escape penalties imposed for violations for a longer period of time, which may be due to a lack of supervision of such companies by the CSRC. We also find that selective enforcement may influence resource allocation in the securities market, with companies committing light violations being more inclined to apply for refinancing. We provide details of the two cases of "Hainan Kaili" and "Lukang Pharmaceutical" in an effort to understand the status, ability to control financing resources and investigative efficiency of the CSRC in enforcing the law. We find that there is little doubt about the CSRC's ability to control financing resources, but that although it has certain authority in enforcement, it lacks efficiency in investigating and punishing companies suspected of violations, especially when the suspected companies have a state-owned background. It also fails to be open and transparent, which may affect its ability to deter companies from committing violations. This study thus provides empirical evidence on and discusses the possible consequences of the nature of law enforcement in countries in economic transition.

Its merits notwithstanding, this study has several limitations. First, the classifications for the severity of the violation and the severity of the punishment are somewhat rough. Second, selective enforcement of the law may work as a possible alternative mechanism for law enforcement in transition economies, but we do not test its effectiveness in this sense. Third, the sample of violating companies may be endogenous to some extent, which may have some impact on the conclusions. These limitations should be addressed and resolved in future research.

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[20] This is because companies meeting the application criteria are placed into two categories: companies that obtained an SEO and companies that met the refinancing conditions. The criteria for companies meeting the refinancing conditions are rougher, and mainly focus on profitability requirements, specifically, a continuous profitability for the previous three years and an average ROE of 10% or more in the previous three years. Because of the share reform (2005.9–2005.6), some companies that obtained an SEO had it postponed, which means that they used the ROE before the share reform to apply for refinancing but obtained approval after the share reform when the ROE had changed. If we eliminate this portion of sample, the sample size would be so small that it might reduce the reliability of the results. Thus, we decided to retain these companies.

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