LIBRARY
Te Tumu Herenga
THE UNIVERSITY OF AUCKLAND

RESEARCHSPACE@AUCKLAND

Copyright Statement

The digital copy of this thesis is protected by the Copyright Act 1994 (New Zealand). This thesis may be consulted by you, provided you comply with the provisions of the Act and the following conditions of use:

- Any use you make of these documents or images must be for research or private study purposes only, and you may not make them available to any other person.
- Authors control the copyright of their thesis. You will recognise the author's right to be identified as the author of this thesis, and due acknowledgement will be made to the author where appropriate.
- You will obtain the author's permission before publishing any material from their thesis.

To request permissions please use the Feedback form on our webpage.
http://researchspace.auckland.ac.nz/feedback

General copyright and disclaimer

In addition to the above conditions, authors give their consent for the digital copy of their work to be used subject to the conditions specified on the Library Thesis Consent Form

CORPORATE GOVERNANCE IN CHINA

JIANG FU

A THESIS SUBMITTED IN FULFILMENT OF
THE REQUIREMENTS FOR THE DEGREE OF
DOCTOR OF PHILOSOPHY
IN ACCOUNTING AND FINANCE
THE UNIVERSITY OF AUCKLAND
2004

THIS THESIS IS FOR EXAMINATION PURPOSE ONLY AND MAY NOT BE CONSULTED OR REFERRED TO BY ANY PERSONS OTHER THAN THE EXAMINER

ACKNOWLEDGEMENT

First and foremost, I would like to acknowledge Associate Professor Henk Berkman, my supervisor. I will always be grateful to him for his guidance, stimulating discussions, encouragement, friendship, and constant support during the completion of this thesis.

Second, I would like to thank Associate Professor Rebel Cole, Professor Jerry Bowman, Dr. Norman Wang, Mr. Robert Wilton, Ms. Herena Newall, (all from the University of Auckland), the faculty of the department of Accounting and Finance, and Professor Boxi Li (DRC). They have all supported me in different ways during the completion of this thesis.

Third, I would like to acknowledge the University of Auckland Doctoral Scholarship that I received from the University of Auckland, and several research grants from the University of Auckland Business School.

Finally, I would like to thank my parents, my wife, and my friends, who are an essential part of my life and who have always supported me in my pursuits. This thesis is dedicated to them.

ABSTRACT

This thesis addresses some important issues in corporate governance using data from Chinese stock markets. The thesis starts with a summary of relevant research in the area of corporate governance. Next, I describe the historic development of corporate governance in China and the corporate governance framework that is currently in place. These two introductory chapters are followed by my empirical research, which comprises three chapters.

First, I analyse share price reactions and top-management turnover around announcements of negotiated block transfers between different State-ownership structures for a sample of State-controlled firms that are publicly traded on Chinese stock exchanges. I find that changes in firm value and CEO turnover are much greater when a government agency (GA) transfers a block of shares of a listed firm to a state-controlled enterprise with a private joint venture partner (LPSOE) rather than to a solely state owned enterprise (SSOE).

Second, using a sample of listed firms that issued debt guarantees to their large shareholders, I analyse the relation between firm- and ownership characteristics and the probability of expropriation of minority shareholders by controlling shareholders. I also analyse and validate the assumed relationship between 'tunnelling' and several financial measures of expropriation suggested in the literature. I find that, in a weak legal environment such as China, the issuance of related guarantees is more likely at firms with large private blockholders than at firms with the State as the largest blockholder, and that related guarantees are more likely at larger firms and firms with a single controlling blockholder. I also find that firms that issued related loan guarantees have significantly lower industry-adjusted measures of Tobin's Q,

profitability, and dividend yields and have significantly higher leverage. This evidence is consistent with the hypothesis that tunnelling by controlling shareholders can be very costly to minority shareholders. I find no evidence of higher bid ask spreads for firms that issued related guarantees.

Finally, I study the monitoring role of blockholders in China as an alternative mechanism of corporate governance that might result in reduced expropriation of firm assets by the controlling blockholder. I find that non-controlling block holders contribute to firm value only when their ultimate owners are different from the controlling blockholder in terms of the public/private distinction. I attribute this result to the potential conflict of interests between controlling and non-controlling block holders in this case, reducing the opportunities to tunnel and improving monitoring of management. I also provide evidence of a substantial valuation discount if there are clear signals that suggest collusion between blockholders.

CONTENTS

Chapter		Page
	ACKNOWLEDGEMENT	**i**
	ABSTRACT	**ii**
	CONTENTS	**iv**
	LIST OF TABLES	**viii**
	LIST OF FIGURES	**ix**
	LIST OF APPENDIXES	**x**
1.	**INTRODUCTION**	**1-6**
2.	**LITERATURE REVIEW**	**7-29**
	2.1. Introduction	7
	2.2. Agency conflict between management and shareholders	8
	2.2.1. Theory	8
	2.2.2. Evidence	9
	2.2.3. Proposed solutions to the agency problem	10
	2.2.3.1. Incentive contracting	10
	2.2.3.2. Debt issuance	12
	2.2.3.3. Board of directors	13
	2.2.3.4. Large shareholders	15
	2.2.3.5. Takeover markets	17
	2.3. Agency conflict between controlling and minority shareholders	18
	2.3.1. Theory and implications	18
	2.3.2. Empirical evidence	20
	2.3.3. Proposed solutions to reduce expropriation by controlling shareholders	22
	2.3.3.1. Legal reform	22
	2.3.3.2. Ownership structure	24

2.4. State ownership 25

2.4.1. Theory and evidence 25

2.4.2. Evidence on privatization 26

2.4.3. Mixed ownership enterprises 27

Appendix 2.1. Corporate governance definitions 29

3. THE DEVELOPMENT OF CORPORATE GOVERNANCE IN CHINA 30-54

3.1. Introduction 30

3.2. SOE-reform from 1978 to 1992 32

3.3. SOE-reform from 1992 to 1997 33

3.4. SOE-reform from 1997 to present 36

3.5. Chinese banking system 39

3.6. Chinese stock markets 42

3.6.1. The emergence of Chinese stock markets 42

3.6.2. Share classifications 44

3.6.3. Corporate governance of Chinese listed firms 49

3.6.4. Empirical evidence 51

4. FROM STATE TO STATE: IMPROVING CORPORATE GOVERNANCE WHERE THE GOVERNMENT IS THE CONTROLLING BLOCKHOLDER 55-84

4.1. Introduction 55

4.2. Government ownership and hypotheses 58

4.2.1 Government ownership structure 58

4.2.2 Additional hypotheses 62

4.3. Data and methodology 63

		4.3.1. Data	63
		4.3.2. Methodology	65
	4.4.	Results	66
		4.4.1. Full-Sample cumulative abnormal returns	67
		4.4.2. Portfolio cumulative abnormal returns	71
		4.4.3. Cross-sectional regressions	73
		4.4.4. Post-transfer changes in top management	78
	4.5.	Summary	80
	Appendix 4.1	Market Model estimation and test statistics Calculation	82
5.	**EXPROPRIATION THROUGH RELATED GUARANTEES: EVIDENCE FROM CHINA**		**85-103**
	5.1.	Introduction	85
	5.2.	Background and hypotheses	89
		5.2.1. Related guarantees	89
		5.2.2. Firm characteristics and the likelihood of expropriation	90
	5.3.	Data	92
	5.4.	Results	93
		5.4.1 Related guarantees and firm characteristics	93
		5.4.2. Related guarantees and financial measures	98
	5.5.	Summary	103
6.	**THE VALUE OF MONITORING: EVIDENCE FROM BLOCKHOLDERS IN CHINA**		**104-120**
	6.1.	Introduction	104
	6.2.	Literature review and hypotheses	106

6.2.1 Hypotheses: Multiple block holders in China 107

6.3. Data 109

6.4. Results 114

6.4.1. Multiple block holders 114

6.4.2. Collusion discount 116

6.5. Summary 119

Appendix 6.1. Variable definitions 120

7. CONCLUSIONS 121-124

REFERENCES 125-136

LIST OF TABLES

Table		Page
Table 3.1.	Market statistics of Chinese stock market from 1993 to 2000	43
Table 3.2.	Classification of firms by share categories for the Chinese stock market from 1993 to 2002	45
Table 3.3.	Share classifications for the Chinese stock market from 1993 to 2002	47
Table 4.1.	Sample descriptive statistics	65
Table 4.2.	Average daily abnormal return and cumulative average abnormal return	70
Table 4.3.	Mean portfolio cumulative abnormal returns	71
Table 4.4.	Cross-sectional regressions to explain cumulative abnormal returns	75
Table 4.5.	Probit regression to explain the determinants of CEO turnover	80
Table 5.1.	Sample descriptive statistics	94
Table 5.2.	Spearman correlations	95
Table 5.3.	Logistic regression to explain the issuance of related guarantees	96
Table 5.4.	Descriptive statistics for Q, ROA, dividend yield, and bid-ask spreads	99
Table 5.5.	Cross-sectional regressions of different expropriation measures	101
Table 6.1.	Sample descriptive statistics	110
Table 6.2.	Descriptive statistics on industry adjusted Q of sub samples	113
Table 6.3.	Cross-sectional regression to explain the valuation effects of block holders	115
Table 6.4.	Cross-sectional regressions of the value discount of collusions	118

LIST OF FIGURES

Figure		Page
Figure 4.1.	Ownership structure of Chinese listed firms	59
Figure 4.2.	Cumulative average abnormal returns	67

LIST OF APPENDIXES

Appendix		Page
Appendix 2.1.	Corporate governance definitions	29
Appendix 4.1.	Market Model estimation and test statistic calculation	82
Appendix 6.1.	Variable definitions	120

CHAPTER 1

INTRODUCTION

"Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (Shleifer and Vishny, 1997, p.737). When suppliers of finance (principals) render their capital to a professional manager (agent) for future returns, a potential conflict of interest will occur between the principals and the agent because the agent might not always make decisions in the principals' interests in some unforeseen scenarios. This potential conflict between the principal and the agent is called the "agency problem". Corporate governance research is aimed at reducing agency costs, improving corporate governance mechanisms, and better protecting the interests of suppliers of finance.

Jensen and Meckling (1976), Fama (1980) and Fama and Jensen (1983a, b) primarily focussed on the agency problem between the managers and shareholders. They argue that in listed firms, which are typically characterized by a dispersed ownership structure, managers hold substantial "residual control" rights, giving them an incentive to expropriate shareholders' wealth. However, La Porta, *et al* (1999) recently report that ownership concentration is common across the world, and that large shareholders (either State or family) typically control management. When the rights of minority shareholders are not well protected, a controlling shareholder is likely to use the firm's resources for his or her own benefit. Therefore, La Porta, *et al* (1999) claim that expropriation by controlling shareholders from minority shareholders is "the most pervasive agency problem" around the world. Furthermore,

La Porta, *et al* (1997, 1998, 2000b) argue that ownership concentration is the consequence of weak investor protection, and that laws, and the quality of their enforcement by regulators and courts, are essential elements of corporate governance. These insights have resulted in a fast-growing 'Law and Finance' literature, which emphasizes that laws and regulation, and the quality of enforcement, determine the quality of corporate governance and are of enormous importance to firms' growth prospects, and to the development of a country's financial markets.[1] Not surprisingly, corporate governance is currently regarded as a fundamental economic issue and has attracted worldwide attention from regulators, academics and practitioners.

This thesis addresses some important issues in corporate governance using data from Chinese stock markets. China has one of the fastest growing economies in the world, and provides a fascinating environment for corporate governance research given the truly dramatic changes that have taken place in the last 2 decades. For example, since the inception of the stock markets in 1990, the total capitalization of the Chinese stock markets has grown to more than 50 percent of its GDP in 2000 (MacNeil, 2002), which places China ahead of all EU members other than the UK in terms of the significance of the stock market to the economy.[2] Furthermore, in the last decade substantial changes in the legal protection of shareholders have taken place. For example, in a recent report the World Bank (2002) concludes that "corporate governance has moved to the center stage of enterprise reform in China" (p.1), and that many of the recent requirements for listed companies are "even stricter

[1] See Claessens and Laeven (2001), Demirguc-Kunk and Maksimovic (1998), Lemmon and Lins (2003), Mitton (2002), La Porta, *et al* (2000b), and Johnson, *et al* (2000a).

[2] For comparable data on the relative size of stock markets, see Maher and Anderson (2000).

than in Hong Kong and other developed markets…and show the authorities' determination to protect minority shareholders."

The main contributions of this thesis are related to several unique characteristics of the Chinese stock markets. Firstly, the State plays a dominant role in the Chinese stock markets. The State participates in the Chinese stock markets either directly through government agencies or indirectly through State-owned-enterprises. These different types of State shareholders differ with regard to the separation of control rights and cash-flow rights, the degree of involvement from private parties, and management incentives. China, therefore, provides an ideal environment for research on the impact of State ownership on firm value, and the level of agency costs of different forms of State ownership.

This thesis contributes to the literature in this area by analysing share price reactions around announcements of negotiated block transfers between different State-ownership structures for a sample of State-controlled firms that are publicly traded on Chinese stock exchanges. I also study top-management turnover following these block transfers. I find that block shares transfers among different government blockholders can create value and have a significant impact on CEO turnover. These results contribute to research on the market for partial corporate control (Bethel, *et al*, 1998), and have important policy implications because of the prevalence of ultimate State control around the world (La Porta, *et al*, 1999).

Secondly, as a result of high ownership concentration and weak investor protection in China, expropriation of minority shareholders in the Chinese stock markets is a common phenomenon. Various means exist for controlling shareholders to expropriate minority shareholders. For example, transfer pricing, the use of related

guarantees, and inter-group borrowing. These 'tunnelling' activities are usually explicitly prohibited in developed markets, however in China regulations to limit controlling shareholders behaviour only came into effect in the year 2000. The weak investor protection in the Chinese stock markets provides a unique opportunity to study and improve our understanding of 'tunnelling' behaviour by controlling shareholders.

Using publicly available information from annual reports, I identify a unique sample of listed firms where minority shareholders are unambiguously expropriated by their largest shareholder. All listed firms in this sample issued guarantees for the debt of their largest shareholder, which is unambiguously to the detriment of minority shareholders of the listed firm. This unique information allows me to analyse determinants of tunnelling, and to validate the assumed relationship between tunnelling and some financial measures suggested in the literature. I find that firms that expropriate wealth from minority shareholders through the issuance of related-party debt guarantees, typically have specific corporate governance characteristics. For example, the controlling blockholder of tunnelled firms is more likely to be a private investor rather than a State shareholder, and large firms are more likely to be tunnelled than small firms. My results also suggest that tunnelled firms have significantly lower industry-adjusted measures of Tobin's Q, profitability, and dividend yield and have significantly higher leverage. This evidence is consistent with the hypothesis that tunnelling by controlling shareholders can be very costly to

minority shareholders. Consequently, this thesis contributes to the literature by validating some proposed measures of tunnelling.[3]

Finally, about 60 percent of the shares outstanding for listed firms in China are not freely tradable, resulting in a very weak market for corporate control for Chinese listed firms and a virtual absence of hostile takeovers. The absence of this important corporate control mechanism allows us to better focus on other means of corporate governance.

The final chapter in this thesis focuses on the role of blockholders in the corporate governance of Chinese firms. I find that firm value increases in the percentage of shares held by the largest shareholder. I also find that non-controlling blockholders contribute to firm value only when their ultimate owners are different from the ultimate owner of the controlling blockholder in terms of the public/private distinction. Finally, I also find a substantial value discount for firms where clear signals exist that suggest collusion between blockholders. My results are consistent with findings of Lins (2003) and Faccio, *et al* (2001b), and provide further evidence on the role of blockholders in a weak legal environment.

The remainder of the thesis is organized as follows. Chapter 2 presents a review of the corporate governance literature in general. A description of the development of corporate governance in China is included in Chapter 3. Chapter 4 investigates the impact of State-share transfers in the Chinese stock markets. Chapter 5 studies the relation between tunnelling and specific firm characteristics, and analyzes the effectiveness of several proposed measures of expropriation. Chapter 6 investigates the effectiveness of the presence of multiple blockholders as mechanism

[3] See La Porta, *et al* (2000a, 2002b), Claessens, *et al* (2002), Joh (2003), and Faccio, *et al* (2001a, b).

of restricting expropriation by controlling shareholders. Chapter 7 concludes and summarizes.

CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

"Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (Shleifer and Vishny, 1997, p.737)[4]. Jensen and Meckling (1976), Fama (1980) and Fama and Jensen (1983a, b) introduced the classic theory of the agency conflict between management and shareholders, strongly influencing the direction of corporate governance research for the next two decades. Subsequent research on the agency conflict between management and shareholders has substantially improved our understanding of the agency conflict, with most empirical research analysing the situation in the United States and, to a lesser extent, the United Kingdom, Japan, and Germany.

New impetus to corporate governance research was provided by the recent work of La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997, 1998, 1999, 2000b). La Porta, *et al* (1999) claim that the agency problem between the controlling shareholder and minority shareholders is the "most pervasive agency problem". They base this claim on their finding that concentrated ownership is common across the world, and that in many countries the rights of minority shareholders are not well protected. Their work resulted in the emergence of the recent 'Law and Finance' literature. One of the main themes in this growing body of research is that corporate governance has a direct impact not only on the value and growth prospects of

[4] See Appendix 2.1.

individual firms, but also on the development of countries' financial markets and real economies.

This chapter starts with a review of the 'classic' agency theory, followed by a discussion of more recent corporate governance research. Finally, given the importance of State ownership across the world and China in particular, I review the literature in the area of privatisation and government ownership.

2.2 Agency conflict between management and shareholders

This section briefly discusses the 'classic' agency theory, reviews the empirical evidence and gives an overview of research on the effectiveness of the main mechanisms to reduce the agency conflict between management and shareholders.

2.2.1 Theory

The separation of ownership and control lies at the core of the agency conflict between management and shareholders (Shleifer and Vishny, 1997). Jensen and Meckling (1976) argue that when shareholders render their capital to professional managers, they need managers' specialized human capital to generate returns on their funds. However, it is difficult for shareholders to be assured that their funds are not wasted by the managers on, for example, unattractive projects. In an ideal world, both shareholders and managers sign a complete contract which specifies exactly what the manager does in all states of the world, and how the profits are allocated. The problem is that complete contracts are not realistic as no one can foresee all future contingencies. Therefore, shareholders have to allocate substantial so-called "residual control" rights to managers to make decisions in circumstances not fully foreseen by

the contract (Grossman and Hart, 1986 and Hart and Moore, 1990). Given the incompleteness of contracts and given that in many circumstances managers have different interests from shareholders; their decisions may not always benefit shareholders. Managers might expropriate shareholders' wealth by, for example, entering into negative NPV projects to increase firm size, or through the consumption of perquisites such as company airplanes (Burrough and Helyar, 1990).

2.2.2 Evidence

The literature provides clear evidence that the agency conflict between management and shareholders is highly relevant and can result in a substantial reduction of shareholder value. I focus on two areas where the evidence is particularly convincing.

First, Shleifer and Vishny (1997) suggest that some of the clearest evidence on agency problems comes from acquisition announcements. They claim that since managers' compensation is highly related to firm size, managers are likely to use a firm's excess cash to pursue a diversification strategy and build their own empires through acquiring other firms. Consistent with this view, Jensen (1986) shows that managers of firms in the US oil industry prefer to invest in negative NPV projects, or consume perks using firm's free cash flow, rather than returning it to shareholders. Morck, *et al* (1990) find that bidder returns tend to be lowest when bidders pursue a diversification strategy. Lang and Stulz (1994) and Comment and Jarrell (1995) report similar negative valuation effects. Lang, *et al* (1991) find that bidder returns are the lowest among firms with low Tobin Q's and high cash flows. Their results

support Jensen's (1986) argument that agency problems tend to be largest for firms with poor investment opportunities and excess cash.

Another area of research that clearly brings out the conflict between management and shareholders relates to the job security of management. Walking and Long (1984) find that managers are less likely to resist value-increasing takeovers when they have golden parachutes, or when they are more likely to keep their jobs. DeAngelo and Rice (1983), Jarrell and Poulsen (1988), Ryngaert (1988), and Malatesta and Walking (1988) provide evidence that shareholders tend to lose out when managers adopt anti-takeover measures.

2.2.3 Proposed solutions to the agency problem

Several mechanisms to reduce the agency conflict between shareholders and managers have received substantial attention in the literature. In this section I discuss the empirical evidence on: incentive contracting, the issuance of debt, monitoring by board of directors, monitoring by large shareholders, and the threat of a takeover.

2.2.3.1 Incentive contracting

Agency problems stem from the conflict of interests between managers and shareholders. Performance-based compensation, the granting of options, and managerial ownership are all aimed at better aligning the interests of managers and shareholders. Jensen and Murphy (1990) argue that the effectiveness of incentive contracting is mainly determined by the sensitivity of management compensation to financial performance. They find that the sensitivity of compensation of American executives to their performance is low, and interpret their findings as evidence of

inefficient compensation arrangements in US corporations. Kaplan (1994a, b) shows that the sensitivity of management compensation to performance is similar in the United States, Germany, and Japan, although average levels of management compensation are the highest in the United States. Overall, the evidence seems to indicate that even though performance contracts may be an efficient way to solve the conflict between management and shareholders, the effectiveness of performance-based compensation in reality seems limited.

Stock options are a particularly popular form of incentive contracting. However, Shleifer and Vishny (1997) argue that "high powered incentive contracts" like stock options may create substantial opportunities for self-dealing for the managers. That is, managers may maximize their own benefits by taking advantage of the information asymmetry between management and shareholders. Supportive evidence is provided by Yermack (1997), who finds that managers tend to receive stock option grants shortly before good news announcements and delay such grants until after bad news announcements. His results, therefore, suggest that stock options may not be an efficient incentive device for managers.

Finally, it has been argued that managerial ownership can serve as a mechanism to better align managers' interests with those of the shareholders. However, managerial ownership is a "double-edged" sword. On the one hand, managerial ownership gives managers incentives to maximize shareholders' wealth ("alignment" effect). On the other hand, higher managerial ownership may allow managers to pursue private benefits ("entrenchment" effect). Hence, the ultimate impact of managerial ownership depends on the trade-off between the "alignment" and "entrenchment" effects.

The evidence regarding the effect of managerial ownership on firm value is mixed. Morck, *et al* (1988) and McConnell and Servaes (1990) find that the "alignment" effect of management ownership dominates the "entrenchment" effect over some ranges of management ownership. As management ownership increases beyond a certain level, the "entrenchment" effect starts to dominate and decreases firm value. Himmelberg, *et al* (1999) point out that there are severe endogeneity problems associated with managerial ownership. When they control for endogeneity they find no evidence of a relation between changes in managerial ownership and firm decisions or firm performance. Demsetz and Villalonga (2001) also address the endogeneity issue. In their analysis, they test the relation between managerial ownership and firm performance (Tobin's Q and accounting profit) in both ordinary and two-stage least squares regressions. Their results indicate that the positive relation between managerial ownership and firm performance in ordinary least squares regression is biased, and conclude that there is no systematic relation between ownership structure and firm performance.

2.2.3.2 Debt issuance

Smith and Warner (1979) argue that the issuance of debt can reduce the conflict of interests between managers and shareholders. In a debt contract, the borrower typically promises not to violate a range of covenants. If a borrower defaults on a payment, the lender gets certain rights, such as the ability to repossess some of the firm's assets or the opportunity to file for bankruptcy. Moreover, Jensen (1986) argues that issuing debt can reduce the free cash flow problem and stop managers from investing in negative NPV projects because the pressure from debt

holders may give managers greater incentive to operate efficiently and strive to meet fixed payments.

Studies on leveraged buy outs (LBO) provide supportive evidence that debt can reduce agency costs. In an LBO, shareholders of a publicly owned firm are bought out by a new group of investors, that usually includes the managers of the firm, a specialized buyout firm, banks and public debt holders (Jensen, 1989a, b). The new group of investors usually restructures the LBO with extremely high leverage. Several studies provide evidence that debt does play an important role in reducing agency costs of LBO organizations (see, for example, Bhagat, *et al,* 1990).

However, Myers (1977) argues that issuance of debt has both costs and benefits to a firm. He points out that the strict debt covenants (eg, the restriction on firm's dividend policy and issuance of senior debt) may significantly limit a firm's refinancing ability, and prevent it from undertaking good projects. Supportive evidence of costs of debt is also extensively documented in the literature.[5] Therefore, debt issuance also involves a trade-off between costs and benefits.

2.2.3.3 Board of directors

Theoretically, the board of directors should look after the interests of the shareholders. They should monitor managers, and take effective actions when shareholders' wealth is not well protected. However, the question of how effective the board is at reducing agency costs in reality is still unresolved. The research in this area mainly provides evidence on the relation between board characteristics (composition and size), firm performance, and the quality of decisions.

---

[5] See Stulz (1990), Harris and Raviv (1990), Diamond (1991), Hart and Moore (1995), and Lang, *et al* (1996).

Hermalin and Weisbach (1991) find that there is little relation between firm performance and board composition, as measured by the portion of outside directors. Using accounting measures and Tobin's Q as performance measures, Mehran (1995) and Klein (1998) also report that board composition has little cross-sectional relation with firm performance. On the other hand, Jensen (1993) argues that when boards get to be too big, agency problems increase and the board becomes more symbolic and less a part of the management process. He argues that large boards are likely to be less effective than small boards. Yermack (1996) provides supportive evidence and reports a negative relation between Tobin's Q and board size for a sample of large US corporations.

A number of studies examine how boards accomplish some of the responsibilities commonly assigned to directors. For example, Weisbach (1988) studies the interaction between board composition and CEO turnover in relation to firm performance. His results indicate that when boards are dominated by outside directors, CEO turnover is more sensitive to firm performance than it is in firms with insider-dominated boards. Borokhovich, *et al* (1996) and Huson, *et al* (2000) also provide evidence consistent with the view that outsider-dominated boards are more likely than insider-dominated boards to replace CEOs.

The evidence from the takeover market shows that boards play an active role in corporate governance. Cotter, *et al* (1997) report that when a target's board contains a majority of outside directors, the target receives a 20 percentage-point higher return than a similar firm without a majority of outside directors on their board. Brickley, *et al* (1994) analyse the impact of board composition on the decision to adopt a poison pill. They find that the stock market reaction to poison pills is positive

when the board has a majority of independent directors and negative when it does not. Overall, Hermalin and Weisbach (2003) conclude that board composition is not related to firm performance, while board size and firm value are negatively correlated. They also conclude that board composition appears to affect the quality of decisions regarding CEO replacement, responses to a hostile takeover, and adoption of poison pills.

Kaplan and Minton (1994) find that for Japanese firms, the probability of appointment of outside directors increases following poor stock performance and earnings losses. Hossain, *et al* (2001) find that a higher fraction of outsider directors leads to better performance for a sample of New Zealand firms, while Eisenberg, *et al* (1998) report that board size is negatively related to firm value for a sample of small and midsize Finnish firms. Suchard, *et al* (2001) find that in Australia the incidence of top management turnover is positively related to the presence of non-executive directors on the board.

2.2.3.4 Large shareholders

Shleifer and Vishny (1986) argue that the existence of large blockholders can reduce agency costs. When a shareholder accumulates enough shares and becomes a significant blockholder, he has both the ability and the incentive to monitor and influence management. The large shareholder might also have the power to oust management through a proxy fight or a takeover.

Even though concentrated shareholding in the United States is believed relatively uncommon (Roe, 1994), Holderness and Sheehan (1988a, b) in fact found several hundred cases of significant large shareholders in public firms in the United

States. In the rest of the world, large shareholding is more frequently observed. Frank and Mayer (2001) report that the majority of listed firms in Germany is dominated by large shareholders (typically banks or family). In Japan, large cross-holdings and share holdings by major banks are the norm (Berglof and Perotti, 1994). In their review of the corporate governance literature, Shleifer and Vishny (1997) conclude that in most of Europe as well as Latin America, East Asia, and Africa, corporations typically have controlling owners.

The evidence on the role of large shareholders in exercising corporate governance is also substantial. In the US, Shivdasani (1993) finds that the presence of a large blockholder increases the likelihood that a firm is taken over. However, based on a survey of existing evidence, Holderness (2003) concludes that the relation between blockholders and firm value in US is sometimes negative, sometimes positive, and never very pronounced. Mehran (1995) finds no significant relation between firm performance and the holdings different types of blockholders, including individuals, institutions, and corporations. However, there is some evidence suggesting that the formation of a new block or the trade of an existing block, is associated with abnormal stock price increases (Mikkelson and Ruback, 1985 and Barclay and Holderness, 1991 and 1992). Bethel, *et al* (1998) investigate the causes and consequences of activist block share purchases in the 1980s. They find that activist investors were most likely to purchase large blocks of shares in highly diversified firms with poor profitability. Block purchases were followed by increases in asset divestitures, decreases in mergers and acquisitions, abnormal positive share price appreciation, and increases in industry-adjusted operating profitability. Their

findings suggest that blockholder identity has an important effect on firm value, consistent with Holderness and Sheehan (1988b).

Frank and Mayer (2001) find that in Germany, large shareholders are associated with higher turnover of directors; while Gorton and Schmid (1996) report that bank blockholders improve the performance of German firms. In Japan, Kaplan and Minton (1994) and Kang and Shivdasani (1995) show that firms with large shareholders are more likely to replace managers in response to poor performance than firms without large shareholders.

Even though the existing evidence points to a positive role of blockholders, there are substantial costs of large shareholdings. The most obvious of these costs is that large shareholders are not diversified, and therefore bear excessive risk (Demsetz and Lehn, 1985 and Bolton and Thadden, 1998). Another significant cost of large shareholdings is that large shareholders can expropriate minority shareholders (Shleifer and Vishny, 1997). This issue has attracted substantial attention in recent years and will be discussed in detail in section 2.3.

2.2.3.5 Takeover markets

A vast literature indicates that takeovers are an important corporate governance mechanism in both the US and the UK (Jensen and Ruback, 1983). The rationale behind takeovers as a mechanism of reducing agency costs is that bidders usually target poorly performing firms (Palepu, 1986 and Morck, *et al,* 1988a, 1989) and replace the incompetent management once a takeover is successful (Martin and McConnell, 1991). Franks and Mayer (1996) report that takeovers are followed by high turnover among members of the board of directors and significant restructuring

in the UK. However, target firms in their sample do not appear to be performing poorly before the acquisition bids.

It has been argued that takeovers can sometimes increase agency costs when bidding managers pay too much for acquisitions that bring them private benefits of control (Shleifer and Vishny, 1988). Holmstrom and Kaplan (2001) review the literature on takeovers in the US markets and conclude that average abnormal returns to acquiring firm shareholders are significantly negative in most studies.

Finally, Shleifer and Vishny (1997, p757) argue that "hostile takeovers are politically an extremely vulnerable mechanism, since they are opposed by the managerial lobbies. In the United States, this political pressure, which manifested itself through state anti-takeover legislation, contributed to ending the 1980s takeovers".

2.3 Agency conflict between controlling and minority shareholders

2.3.1 Theory and implications

Most research in the corporate governance area in the 1980s and early 1990s was focused on the US markets, where investor protection is relatively strong. In an important paper La Porta, *et al* (1999) report on the ownership structure of large corporations in 27 wealthy economies. They find that outside the US, particularly in countries with poor shareholder protection, even the largest firms tend to have controlling shareholders. These controlling shareholders typically have control over firms in excess of their cash flow rights through pyramidal structures.[6] Furthermore,

[6] In a pyramid, firm A could, for example, own 50 percent of firm B, which in turn owns 50 percent of firm C. Through the pyramid, firm A has 50 percent of the control rights of firm C but only with 25 percent of the cash-flow rights of firm C.

they find that firms are frequently not managed by independent professionals but by the controlling shareholders themselves. Building on La Porta, *et al* (1999), Claessens, *et al* (2000) report that in their sample of 2980 corporations in nine East Asian countries, more than two-thirds is controlled by a single shareholder and that managers of these firms tend to belong to the controlling shareholder's family. Faccio and Lang (2002) also report that family control is the most distinguishing characteristic in their sample of 5,232 corporations in 13 Western European countries. Therefore, recent research clearly shows that ownership concentration is common across the world.

The new 'Law and Finance' literature started with La Porta, *et al* (1998). For 49 countries, the article describes the legal rules that provide protection to shareholders and creditors, the origin of these rules, and the quality of their enforcement. They find that common-law countries generally have the strongest legal protection of investors, French civil-law countries the weakest, while the legal protection of investors in German- and Scandinavian civil-law countries are in the middle category. In addition, they report that, compared to the US, ownership concentration is surprisingly high around the world and that ownership concentration is negatively related to investor protection.

La Porta, *et al* (1997, 1998, 2000b) suggest that ownership concentration is the consequence of weak investor protection, as concentrated ownership gives a large shareholder protection from expropriation by managers. However this benefit comes at a cost to the other shareholders, who are now exposed to the risk of expropriation by the controlling shareholder. La Porta, *et al* (1999) claim that this expropriation by controlling shareholders is "the most pervasive agency problem" around the world.

A central theme in the 'Law and Finance' literature is that laws, and the quality of enforcement by regulators and courts, are essential elements of corporate governance and the development of financial markets. Weak investor protection not only decreases individual firm value, but has also been shown to have negative effects on the development of financial markets, and real economy.[7]

2.3.2 Empirical evidence

Johnson, *et al* (2000b) refer to the expropriation by controlling shareholders as "Tunnelling" — the transfer of assets and profits out of firms for the benefit of controlling shareholders. They argue that tunnelling can take a variety of forms, including expropriation of corporate opportunities from a firm by its controlling shareholder, transfer pricing favouring the controlling shareholder, transfer of assets from a firm to its controlling shareholder at non-market prices, loan guarantees to the controlling shareholder using the firm's assets as collateral, and so on. They provide evidence that tunnelling is a worldwide phenomenon, occurring in both developed and developing countries.

More evidence of tunnelling from both developed and developing markets starts to emerge. For a sample of 18,600 Indian firms during the period 1989 to 1999, Bertrand, *et al* (2000) show that resource diversion in corporate pyramids follows the lines of ownership, flowing from firms near the bottom of the pyramid to firms near the top. La Porta, *et al* (2002c) examine related lending in Mexico, where banks tend to lend to firms controlled by the bank's owner. Related loans have terms similar to

[7] See, Claessens and Laeven (2001), Demirguc-Kunk and Maksimovic (1998), Lemmon and Lins (2003), Mitton (2002), Johnson, *et al* (2000a), and La Porta, *et al* (2000b).

unrelated loans, but are 33 percent more likely to default. La Porta, *et al* (2002c) interpret their findings as evidence that related lending is a manifestation of looting, rather than enhanced information sharing. Bae, *et al* (2002) provide suggestive evidence that controlling shareholders in Korean chaebols use intra-group acquisitions to expropriate the wealth of their minority shareholders.

More indirect evidence is provided in La Porta, *et al* (2002b), who, using a sample of firms from 27 wealthy economies, find that firms in countries with better investor protection have higher values as measured by Tobin's Q. For a sample of East Asian firms, Claessens, *et al* (2002) provide evidence that suggests that controlling shareholders have a greater incentive to expropriate when the wedge between their control rights and cash flow rights increases, i.e. they find that Tobin's Q decreases with the separation of cash-flow rights from the control rights of the largest shareholder. For a sample of 5,829 Korean firms, Joh (2003) finds an inverse relationship between profitability as measured by return on assets and the separation of cash-flow rights from the control rights of the largest shareholder. Controlling shareholders are found to expropriate firm resources even when their ownership concentration is small.

La Porta, *et al* (2000a) argue that dividend payment is the result of effective pressure by minority shareholders to protect their interests. Using information from 33 countries, they find that better protection of minority shareholders is associated with higher dividend payments. Faccio, *et al* (2001b) also report that group-affiliated firms in Europe pay higher dividends than group-affiliated firms in Asia, indicating that expropriation is more serious in Asia than in Europe, consistent with the view that protection is generally weaker in Asia than in Europe.

Finally, Brockman and Chung (2003) investigate bid-ask spreads of firms listed on the Hong Kong Stock Exchange. They find that firms from Hong Kong have narrower spreads than firms from mainland China, and argue that this difference in spreads can be attributed to the weaker protection afforded to investors in firms from mainland China.

Overall, the accumulated evidence on the tunnelling shows that for many countries investor protection is far from optimal, and that expropriation of wealth by controlling shareholders is an important and costly problem.

2.3.3 Proposed solutions to reduce expropriation by controlling shareholders

Recognizing the seriousness of expropriation of minority shareholders, several authors address the question how investor protection can be improved. Shleifer and Vishny (1997) argue that a successful corporate governance system combines significant legal protection of at least some investors with an important role for large investors. Following this direction, both legal reform (external approach) and ownership structure (internal approach) have been proposed as mechanisms to improve corporate governance.

2.3.3.1 Legal reform

It has been argued that legal reform aimed at improving investor protection is a fundamental element of improving corporate governance.[8] Glaeser, *et al* (2001) and Xu and Pistor (2003) argue that in many countries government regulation of financial markets and the creation of a powerful regulator is more feasible than legal reform.

[8] See Shleifer and Vishny (1997), La Porta, *et al* (1998, 2000b), and Johnson, *et al* (2002).

They argue that political opposition to legal changes tends to be intense and that in many countries court enforcement of private contracts and laws cannot be relied on. A case in point is Poland where, despite a weak legal system, financial markets had a spectacular growth after the introduction of securities laws that were more protective of minority shareholders and were enforced by a powerful regulator. On the other hand, the Czech government chose neither to introduce tough securities laws nor to create a powerful market regulator at the time of privatization. As a consequence, the Czech markets have been plagued by massive expropriation of minority shareholders.[9]

Both Coffee (1999) and Gilson (2000) argue investor protection can be achieved by either legal or functional convergence. Legal convergence refers to the changes in rules and enforcement mechanisms toward some successful standard, while functional convergence refers to more decentralized, market-based changes, which do not require legal reform, but still increase effective legal protection of investors. La Porta, *et al* (2000b), argue that functional convergence does have limitations and can not fully replace investor protection provided by legal reform. However, functional convergence is important in countries where legal reform is slow and halting. A prominent example of functional convergence are firms from emerging markets that obtain a (cross-) listing on a US stock exchange. Doidge, *et al* (2004) show that cross-listing and the resulting improvement in investor protection, results in substantial value increases and better growth opportunities.

[9] See Coffee (1999), Pistor (1999), and Glaeser, *et al* (2001).

2.3.3.2 Ownership structure

Shleifer and Vishny (1997) and La Porta, *et al* (1998, 1999, 2000b) argue that the observed high ownership concentration in several countries is a consequence of their weak investor protection. Only when an investor becomes large, can he protect himself from being expropriated by others in a weak legal environment. Obviously a large equity stake also resolves the classic free rider problem of having many small shareholders.

La Porta, *et al* (2002b) analyse the ownership structure of 540 large firms from 27 wealthy economies. They find evidence of higher valuations of firms with higher cash flow ownership by the controlling shareholder. Claessens, *et al* (2002) also find that Tobin's Q increases with the cash-flow rights of the largest shareholder using a sample of East Asian firms. However, ownership concentration is often associated with a degree of the separation of cash-flow rights and control rights through, for example, pyramid ownership structures and dual-class shares, which encourage expropriation. As discussed before, Claessens, *et al* (2002) show that Tobin's Q decreases with the separation of cash-flow rights from control rights of the largest shareholder.

The presence of multiple large shareholders is common in Europe and Asia (Faccio and Lang, 2002 and Lins, 2003). Recent theoretical papers show that the presence of multiple large shareholders may be an effective way to reduce expropriation and increase firm value due to the mutual monitoring among the multiple blockholders.[10] For a sample of 1433 firms from 18 emerging markets Lins (2003) reports that large non-management block holding are positively related to firm

[10] See Pagano and Roell (1998), Bennedsen and Wolfenzon (2000), Gomes and Novaes (2001), and Bloch and Hege (2001).

value. He argues that large non-management blockholders can act as a partial substitute for missing institutional governance mechanisms in countries with weak shareholder protection. Faccio, *et al* (2001b) report that firms with multiple blockholders in Asia have a significantly lower dividend-payout than similar firms in Europe. They interpret this finding as evidence that multiple blockholders in weak legal environments are more likely to collude to expropriate minority shareholders. Hence, the findings of Faccio, *et al* (2001b) indicate that the beneficial role of multiple blockholders as monitors is likely to depend on the degree of investor protection.

Summarizing, ownership concentration and the presence of multiple blockholders are effective ways to restrict expropriation of minority shareholders. The effectiveness of these ownership characteristics, however, ultimately depends on the quality of the legal infrastructure.

2.4 State ownership

2.4.1 Theory and evidence

La Porta, *et al* (1999) report that 18 percent of their sample of listed firms from 27 wealthy economies are dominated by State shareholders. Faccio and Lang (2002) also report that State control is important for large listed firms in some western European countries. In China, State ownership is the dominant feature of a large proportion of the firms listed on the stock exchange. The State owns about 59 percent of all shares in the Chinese stock markets, and 75 percent of Chinese listed firms are ultimately controlled by the State (Tong, 2003).

Laffont and Tirole (1993) and Sappington and Stiglitz (1987) argue that, from a social welfare point of view, State ownership might benefit certain industries such as education and health care. However, recent evidence on the State ownership seems to tell a different story. Summarizing recent empirical evidence, Shleifer and Vishny (1997) conclude that State firms do not to serve the public interest better than private firms, while State firms are typically inefficient (Boycko, *et al*, 1995 and Shleifer, 1998). Shleifer and Vishny (1994 and 1997) attribute the inefficiency to the fact that State firms are usually controlled by bureaucrats, who have concentrated control rights but no significant cash flow rights. Moreover, the bureaucrats typically have goals that are dictated by their political interests and can be very different from profit maximization. Therefore, Shleifer and Vishny conclude that State ownership is an example of concentrated control with no cash flow rights and socially harmful objectives.

2.4.2 Evidence on privatization

In recognition of the problems associated with State ownership, the last two decades have seen a wave of privatizations, aimed at changing State-owned firms' ownership structure, and achieving higher efficiency. In the extreme case of "mass privatizations", it involved complete replacement of public ownership and control by private ownership and control. Megginson, *et al* (1994) investigate 61 companies from 18 countries and 32 industries during 1961 to 1990 and find that firm performance improves significantly after privatization. Megginson and Netter (2001) survey empirical studies of privatizations and conclude that privatizations in general improve the efficiency of resource allocation and firm performance. Two important

exceptions are the privatisations in Russia and Czech Republic, which have be described as disasters.[11] Shelifer and Vishny (1997) argue that privatization without creating large outside blockholders, and without protection of minority shareholders, gave Russian managers too much opportunity to expropriate firm assets. The failure of the Czech Republic's mass privatization has also been attributed to weak investor protection.[12]

2.4.3 Mixed ownership enterprises

Given the lessons from Russia and the Czech Republic, several countries choose to maintain State ownership in strategic industries and gradually developed their institutional infrastructure to accommodate further privatization. A specific form of gradual privatization is the Mixed Enterprise (ME), where firms are jointly owned by the State and private investors. Eckel and Vermaelen (1986) argue that these mixed ownership enterprises (MEs), which are common in Europe and Asia, can sometimes benefit private investors due to the "helping" hand of the government.

Even though MEs are frequently observed around the world (La Porta, *et al* (1999) and Claessens, *et al* (2000)), research in this area is limited. Boardman and Vining (1989) compare the performance of private owned companies (PCs), State Owned Enterprises (SOEs) and MEs. They find that large industrial MEs and SOEs perform substantially worse than similar PCs. All profitability measures indicate that MEs perform no better and often worse than SOEs. Therefore, they conclude that partial privatization may be worse, especially in terms of profitability, than complete privatization or continued State ownership.

---

[11] See Boycko, *et al* (1995), Black, *et al* (2000), and Fox and Heller (2000).
[12] See Coffee (1999), Pistor (1999), and Glaeser, *et al* (2001).

A different point of view is put forward in Qian (2000). He argues that the role of state ownership should be studied by considering the overall institutional environment. Given that the institutional environment may be quiet different at different stages of development of a country, the relation between firm performance and government ownership should be examined from a dynamic perspective, rather than from a static angle.

Qian states that economists do generally agree that government ownership does not have any obvious advantages over private ownership in well-functioning markets, whereas there are several obvious disadvantages (for example, the introduction of objectives other than profit maximization, and the potential lack of commitment from governments given their power to change the rules). However, in an imperfect institutional environment, government ownership might have a comparative advantage over private ownership. This might be the case when property rights are unclear, when capital markets do not function, or in case of a weak legal framework. In these situations, according to Qian, some form of government ownership could be more effective than private ownership.[13] In general, the government should introduce changes in the institutional and market environment in order to facilitate an eventual exit. Qian cites China as an example where a gradual approach is taken that seems to be successful.

[13] An example is the success of Township-Village enterprises in China that have outperformed private firms.

APPENDIX 2.1

Corporate governance definitions

Shleifer and Vishny (1997)	Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.
OECD (1999)	Corporate governance is a system by which business corporations are directed and controlled.
Denis (2001)	Corporate governance encompasses the set of institutional and market mechanisms that induce self-interested managers (the controllers) to maximize the value of residual cash flows of the firm on behave of shareholders (the owners).
Denis and McConnell (2002)	Corporate governance research investigates a set of mechanisms that aim to reduce the agency costs within a corporation and protect the suppliers of finance from expropriation by firm insiders.

From the definitions above it is clear the key issue in corporate governance is the agency problems that result from the separation of control and ownership. This separation of ownership and control results in a conflict of interests between principals and agent (where the agent might make decisions in his own interest rather than the interest of the principals). Therefore, the aim of improving corporate governance is to better protect principals from expropriation by the agents. The two main agency problems are 1) the conflicts between managers and shareholders and 2) the conflicts between large shareholders and minority shareholders. In both cases, the suppliers of finance (principals) are exposed to the risk of expropriation by the agents (either the managers or large shareholders). In this thesis, I adopt the corporate governance definition from Shleifer and Vishny (1997) since it presents the key issue of corporate governance in a very direct and transparent manner.

CHAPTER 3

THE DEVELOPMENT OF CORPORATE GOVERNANCE IN CHINA

3.1 Introduction

Before 1978, China had a central plan economy similar to Russia. The whole economy was effectively organized as a single giant company where almost all decisions of production, investment and employment were centrally planned. Revenue and cost budgets were also centralized by the State treasurer. So-called "enterprises" were simply production plants. In making business decisions, the director of the enterprise was like a special employee, whose main task was to coordinate and supervise ordinary workers to implement the production plan made by the government, rather than strategy and marketing. All inside members of the "enterprises" were compensated through a centrally set hierarchical wage system, which was not related to firm performance. Consequently, most SOEs in China suffered greatly due to inefficiencies in resource allocation, and a lack of managerial incentives to improve production efficiency (Zhang, 1998).

Aiming to improve SOE-performance and strengthen its economy, China adopted an "open-door" policy in 1978 and allowed its economy to be exposed to international markets. Given that restructuring SOEs was the key to the success of Chinese economic reform, the reform of SOEs naturally reflects the development of corporate governance in China. Different from the "mass privatization" in Russia and some East European countries, "privatization" with Chinese characteristics emphasizes not the immediate and complete privatization of the State sector, but rather the retention of the State sector with the creation of a parallel non-State sector

designed to supplement the State sector. It has been called a "dual-track" approach. Even though the long-term effects of China's "dual-track" economic reform are seriously questioned by Sachs, *et al* (2000), others such as Li (1997) and Lau, *et al* (2000) argue that the "dual-track" economic reform is beneficial to China. Cao (2000) argues that China has created an economy with one of the highest growth rates in the world through a development strategy of gradual, market-oriented measures.

The Chinese economic reform has three main periods. During the first period from 1978 to 1992, the reform of SOEs was mainly focused on the separation of government from SOEs, and the adoption of management incentive contracts while also encouraging the growth of the non-State sector. However, the reform of SOEs during this period didn't reach its target—improving the efficiency of SOEs, even though the non-State sector stimulated the Chinese economy and showed promising prospects. From 1992 to 1997, the Chinese government promoted economic growth through a model referred to as the "Modern Enterprises System" (MES). The distinguishing characteristic of the MES was to restructure SOEs through corporatisation and integration. During this period, two important improvements were introduced into the Chinese corporate governance landscape: the establishment of the Chinese stock markets, and the accompanying stock market laws and regulations. However, the fundamental problem in the Chinese corporate governance system, the lack of clarity regarding property rights, still remained. In 1997, President Jiang Zemin announced a policy of significant ownership diversification of the State sector through complete or partial divestiture of small and medium-sized SOEs. Even though public ownership would continue to remain dominant in the Chinese economy, both the Chinese stock markets and the legal environment experienced another

significant improvement. Corporate governance, for the first time, was recognized as a top priority issue of Chinese economic reform. For example, the World Bank (2002) concludes that "corporate governance has moved to the center stage of enterprise reform in China" (p.1), and that many of the recent requirements for listed companies are "even stricter than in Hong Kong and other developed markets…and show the authorities' determination to protect minority shareholders."

In this Chapter, I first review the three periods of Chinese economic reform since 1978. Then, I discuss the evolution of the Chinese banking system. Next, given that the establishment of stock markets is an important landmark in the development of the Chinese corporate governance framework, I discuss the characteristics of the Chinese stock markets and the corporate governance of listed firms in more detail. Finally, I briefly review some important empirical research on corporate governance in China, and further clarify the contribution of this thesis to the literature.

3.2 SOE-reform from 1978 to 1992

Lin (2000) argues that there are intrinsic and fundamental problems of corporate governance in State-owned economic entities because of the ambiguity of property rights associated with state ownership. Under State ownership, property rights do not belong to anyone in particular. The controlling authorities of SOEs (central or local government), in reality do not bear any residual risks over the use of an SOE's assets. As a result, there is an almost complete separation of ownership and control rights.

The early stage of the first wave of SOE-reform, was largely focused on the separation of government from management, and improving firm performance by

giving management greater autonomy and incentives to operate SOEs at a profit and on a commercially-oriented basis free from political intervention. Furthermore, the State-owned Industry Enterprises Law of China was introduced in 1988. The purposes of this law were to clarify the property rights of the State, separate government from enterprises, and adopt incentive contracts. Although the SOE-Law was far from perfect from a corporate governance perspective, it provides the first important legal reference to the SOE-reform of this period (Schipani and Liu, 2002).

Groves, *et al* (1995) argue that the incentive contracts did result in increases in the marginal profit retention rates of some SOEs. However, it didn't effectively bond the management with responsibilities. With no ownership at all, managers tended to retain profit for their personal benefits, rather than for profitable investment projects. In addition, managers were still selected and supervised by bureaucrats, while the government did not really separate itself from SOE's operations (Zhang, 1998). Hence, Lin (2000) argues that the Chinese SOE-reform of 1978 to 1992 was not successful: the incentive contracts between government and management resulted in substantial losses of State property, did not give management proper incentives to operate efficiently, and SOEs were still subject to considerable administrative intervention from bureaucrats.

3.3 SOE-reform from 1992 to 1997

The second period of SOE-reform started in 1992 when Deng Xiaoping declared that one of the official goals of SOE-reform was to set up a "Modern Enterprise System". A MES was defined as one characterised by clarified property rights, clearly delineated rights and responsibilities, financial independence and

accountability, separation of government from enterprise management and scientific commercially-oriented management. To establish a MES, former SOEs were restructured through corporatisation and integration. Compared to traditional SOEs, corporatized SOEs had well-defined shareholder rights, based on Western-style corporate entities predominantly in the form of limited liability companies and joint-stock companies. The SOE-integration policy carried out by the government during this period, entailed the formation of enterprise groups which networked together vertically and horizontally. SOEs were connected to promote rationalisation of the production structure, and stimulate technological development and intra-group cross-financing. One of the key objectives of forming enterprise-groups was to create large conglomerates, modelled after the Korean Chaebols, with the scale and critical mass to compete internationally. The government policies laid the foundation of the landmark "Decision on the problems of establishing a socialist market economy", adopted by the 14th Congress of the Communist Party of China in October 1993, which for the first time since reforms began in 1978, stated that the objective of the reforms was to establish a modern "socialist market economy" with "Chinese characteristics". That is, a competitive market system characterized by the predominance of public ownership.

Another important step forwards was the introduction of Corporate Law in 1994. The Corporate Law requires corporations to form three statutory corporate governing bodies: (i) the shareholders, acting as a body at the general meeting; (ii) the board of directors; and (iii) the board of supervisors. The Corporate Law also introduced two new statutory corporate positions: the Chair of the board of directors, and the Chief Executive Officer.

At first glance, the Chinese corporate governance structure may appear similar to the two-tier system of corporate governance in Germany. There are substantial differences, however. For example, there is no hierarchical relationship between the board of directors and the board of supervisors in China. Both directors and supervisors are appointed by, and may be dismissed by shareholder action (Schipani and Liu, 2002). Therefore, the board of supervisors is very weak in Chinese corporations, compared to their counterparts in Germany. Additionally, the Corporate Law recognizes only two types of corporations: closely held corporations and publicly held corporations. With each category of corporation, there are special provisions applicable to subcategories, depending on the corporation's ownership structure. For example, there is no general meeting of shareholders and no board of supervisors in wholly State-owned enterprises. As a consequence, for solely State-owned enterprises, the board of directors and the CEO have more governing powers than their counterparts in other types of corporations on important corporate issues such as mergers and the issuance of corporate bonds.

After the introduction of the Corporate Law in 1994, government agencies have been making greater efforts to push SOE-corporatisation forward. However, the performance of SOEs during this period, again, was disappointing. Losses of SOEs were accelerating and had an adverse impact on macroeconomic stability. Official data (China Statistical Yearbook, 1998) show that the profits of industrial SOEs dropped from 81.7 billion Yuan in 1993 to 42.8 billion Yuan in 1997, and losses of SOEs doubled from 45.3 billion Yuan to 83.1 billion Yuan (1.1 percent of GDP). Lin (2000) argues that the policy of separation of government from management and corporatisation may appear to be sensible solutions to excessive State intervention,

but are in fact logically flawed from the perspective of agency theory. The increasing separation of government from management equates to an increasing separation of principal from agent, which exacerbated informational asymmetries. Moreover, the formation of enterprise groups precluded any substantive change in corporate governance of enterprises within a group. As a result, Lin claims, the corporate governance problem had become more serious than before.

3.4 SOE-reform from 1997 to present

In 1997, at the 15th Congress of the Chinese Communist Party, President Jiang Zemin announced the policy of significant ownership diversification of the State sector through complete or partial divestiture of small and medium-size SOEs. Jiang's speech also reiterated that public ownership would continue to remain dominant in the Chinese economy. Similarly, a decision of the 4th Plenum of the 15th Party Congress in September 1999, and the State Planning and Development Commission's (SPDC) January 2000-statement elaborating on this decision, reaffirmed that while state-ownership would be reduced in a number of sectors, it would remain dominant in industries of strategic importance such as infrastructure and key producer goods.

Cao, *et al* (1999) state that by the end of 1996, in some provinces, about 70 percent of small and medium-size SOEs were already privatized. The decision to divest small and medium-size SOEs policy was therefore not simply an action proposed by the central government. Rather, it was the reflection of initiatives of local governments, illustrating another important feature of Chinese economic reform: the conflict between central and local government (Lin, 2000).

In China, there are two separate worlds in the State sector: one of small and medium-sized SOEs (accounting for about 95 percent of the total number of SOEs in China) under the supervision of local governments, and another one of large SOEs under the supervision of the central government. Local governments are the representatives of the central government and State assets ultimately belong to the central government, as representative of the Chinese people. However, in reality, there exists an intense conflict between the local and central government. The conflict originates from the hard tax and fiscal constraints faced by local governments, and the growing competitive pressure from non-State enterprises on small and medium-sized SOEs supervised by local governments (Cao, *et al* 1999).

Firstly, before China introduced a major tax reform in 1994, local governments were often exempted from taxes which were supposed to be paid to the central government. However, the tax reform introduced a clear distinction between national and local taxes and established a national tax bureau and local tax bureaus, which were each responsible for their own tax collection. The reform also introduced a value- added-tax (VAT), which is supposed to be shared by the central and local government at a fixed ratio of 60:40. Overall, the tax-reform resulted in a hardening of the local tax and revenue budget.

Secondly, the non-State sector experienced a rapid expansion in the early stages of reform (Qian and Xu, 1993). By 1993, the State's share of industrial output in the national economy had declined to 43 percent. After Deng Xiaoping's Southern tour in 1992, expansion of non-State enterprises obtained new momentum, and both foreign and domestic non-State firms became major sources of competition for SOEs. The growing pressure from foreign firms reflected the rapid increase of foreign direct

investment (FDI) to China. The growing pressure from non-State domestic firms came mainly from rural enterprises, which include both Township-Village Enterprises (TVEs)[14] and private enterprises. By the mid-1990s, foreign firms together with TVEs already accounted for more than half of China's industrial output. The increasing competitive pressure from non-State firms affected SOEs supervised by local governments more than SOEs controlled by the central government because most of the former are in competitive industries (Cao, *et al* 1999). As a result, a large number of SOEs supervised by local government were suffering losses, putting pressure on local governments to privatise in order to reduce their impact on the local government's performance record.

Cao, *et al* (1999) argue that the central government's "endorsement' of privatising small and medium-size SOEs turned out to be successful. The privatizations created more employment in local areas. It also diverted the limited resources into efficient enterprises, rather than into the old poorly-performing SOEs. However, the privatization of small and medium-size SOEs at local level was also associated with substantial losses of State assets. Anecdotal evidence indicates that local governments sold off loss-making enterprises, basically giving them away to private entrepreneurs for nothing. By doing this, local governments not only gained support from local entrepreneurs, but could also show better performance on the SOEs they still supervised. As a result, both local government officials and private entrepreneurs were "better off". In 1994, the prevention of this kind of looting of

[14] TVEs are usually jointly owned by local governments and individuals (mixed ownership). Lin (2000) argues that given the direct protection from local government, TVEs usually enjoy benefits such as preferential access to financing and other inputs, clearances over bureaucratic and licensing hurdles, and protection in local markets through non-tariff barriers.

State assets became a key objective of government, and was strongly promoted by Prime Minister Zhu Rongji.

3.5 Chinese banking system

In countries such as Germany and Japan, banks as major creditors play an important role in the corporate governance of firms. Debt covenants clearly specify the rights of creditors, and banks usually have the power to liquidate a firm if it cannot meet its financial obligations. Therefore, when a bank has a substantial claim on a firm, it has an incentive to monitor management while management is also under pressure to meet its financial obligations (Jensen, 1986).

During the SOE-reform, the banking system in China also experienced some substantial changes. However, the banking system in China is still under-developed and banks are generally passive in monitoring their loans.

Before 1978, SOEs were almost completely State-budget-financed with little debt. Since the reform, debt finance has gradually taken over budget finance. To support the gradual reform of SOEs, the government redefined the financial relation between SOEs and SOBs through changes in the banking system that started in the early 1980s. The objective of the SOB-reform was to build a well-functioning two-tier banking system, with the central bank responsible for financial supervision and monetary policy, and commercial banks responsible for the allocation of capital. In 1983, the People's Bank of China (PBC) officially became the Central Bank. The commercial banking system was built around four main banks: the Agricultural Bank of China (ABC), the Industry and Commerce Bank of China (ICBC), the Bank of China (BOC) and the Construction Bank of China (CBC). These four banks account

for about 70 percent of domestic credit and hold over 70 percent of household deposits (Lardy, 1998). The banks remain under State ownership, and are large by international standards when assets are used to measure size. At the end of 1996, the largest of the four SOBs was ranked fifth in the world and all four were among the top fifty. Hence, the big four SOBs dominate the banking sector, which itself is the dominant part of the financial sector in China.

Since the banking-system reform, bank loans replaced budget-grant-allocations as the key source of SOEs' capital. The four SOBs, which are theoretically self-supporting, but are in reality supported by the State, continue to provide credit to state firms on non-market terms, and perform none of the functions associated with commercial lending. They do not seriously screen borrowers for creditworthiness, nor do they monitor and enforce the loans (Cao, 2000). In fact, banks are often instructed by the central government to make non-commercial, policy-based loans to certain state firms, in which case the loans may be supported by credit from the central bank. According to the Institute of Economics (1998) 'policy loans' accounted for about 35 to 40 percent of total bank loans in the 1990s. Bonin and Huang (2000), estimate that bad debt accounts for at least 30 percent of total loans in China.

China introduced a Bankruptcy Law in 1986, which became effective in late 1988. However, bankruptcy in China has been widely used by enterprises and local governments as a way to write off debts instead of disciplining managers (ICBC Bankruptcy Research Group, 1997). For example, when a SOE applies for bankruptcy, local government usually have the power to stop the liquidation process and let managers still run the firm. The typical action taken by SOBs is either to write

off the debt or to swap the debt into equity. Therefore, SOBs as dominant debt holders showed no willingness to force distressed firms to bankruptcy (Zhang, 1998). Typically, when debtor-firms default on their debt, banks passively accommodate by taking such actions as extending the payment period for loans and capitalizing unpaid interest.[15]

Zhang (1998) argues that the failure of the banking system in China is due to several factors. The first is that the debt between SOBs and SOEs is not originally real debt in a legal sense, with clear rights and obligations between debtors and creditors. SOEs usually treat bank loans as a way to get funds from the government and feel little pressure to pay it back. Similarly, SOBs usually grant loans to SOEs on behalf of the government and pay little attention to the risk of default. Secondly, the bankruptcy proceedings are usually blocked by local governments. The Bankruptcy Law (1986) requires that reorganization or liquidation schemes must be discussed and approved in a creditors' meeting with a simple majority of creditors. However, given that most SOEs are owned by local governments, it is hard for local judges and bank branch managers to go against the local government decisions because their careers and welfare are ultimately determined by the local government. Hence, the enforcement of Bankruptcy Law in reality is failing due to local government interference. As a result, the banking system in China is extremely inefficient and SOBs play only a passive role in the corporate governance in China.[16]

[15] According to Asian Pacific Economic Times, only about 1.4 percent of bankruptcy cases in 1995-1996 were filed by banks.

[16] La Porta, *et al* (2002a) report on the inefficiency and losses of State owned banks around world.

3.6 Chinese stock markets

The establishment of stock markets was an important step in the "gradual-reform" process adopted by China. It aimed to provide SOEs with better access to new financing, and improve their efficiency without surrendering State ownership and control. As a result, the Chinese stock market has developed its own characteristics, which are different from stock markets in developed countries.

This section first discusses the remarkable emergence of the Chinese stock markets, which market capitalization grew from nothing in 1990 to more than 50 percent of GDP in 2000 (MacNeil, 2002). Next, I describe, some important laws and regulations pertaining to the stock markets, such as The Provisional Regulations on Administration of Issuing and Trading of Shares (PRAITS, 1993), the Securities Law (1999) and the Corporate Governance Guidelines for Listed Companies (CGGLC, 2001). Finally, I summarize recent empirical research on corporate governance in China.

3.6.1 The emergence of Chinese stock markets

There are two stock exchanges in China: the Shanghai Stock Exchange (SHSE), which was established in December 1990, and Shenzhen Stock Exchange (SZSE), which opened in April 1991. The primary difference between the SHSE and the SZSE is geographic. The reason for establishing two stock exchanges rather than one was to stimulate competition (Xu and Wang, 1999).

Given that the function of stock markets in China was mainly to support the restructuring of SOEs, the decision as to whether a company can go public or not is determined largely by an administrative process rather than a market-based process.

When a firm wants to go public, it must seek permission from the local government and the relevant central government ministries. The China's Securities Regulatory Commission (CSRC)[17] also requires the firm to provide three years of audited accounting data prior to listing, and requires that typically at least 25 percent of all shares must be available for trading on the stock exchanges after listing.

Table 3.1

Market statistics of Chinese stock market from 1993 to 2000

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
SHSE	106	171	188	293	383	438	484	572	644	708
SZSE	77	120	135	237	362	413	465	516	516	516
Total	183	291	323	530	745	851	949	1,088	1,160	1,224
Turnover	44.2	47.9	48.6	257	370.1	283.6	377.3	732.8	461.45	337.2
Market Cap	42.5	44.4	41.8	118.5	211.2	235	318.9	579.4	524.4	462.8

Market capitalization and Turnover are in billions US dollars.
Source: China Securities Regulatory Commission, 2003.

Table 3.1 provides descriptive statistics for the Chinese stock market from 1993 to 2002. Given that the stock market provides an attractive way to raise funds, the Chinese stock markets have had strong growth during the past ten years. At the end of 2002, there were 1,224 listed companies across both stock exchanges, with a

[17] The CSRC is designated as the regulator for stock markets, similar to the SEC in the US. It enjoys wide-ranging powers in respect of authorisation, rule making, investigation and enforcement of all aspects of the stock markets.

total market capitalization of approximately US$ 500 billion. Note that in the period 1993 to 2002, the number of listed firms has increased sixfold and the turnover has increased sevenfold.

3.6.2 Share classifications

Listed firms in China have several different classes of shares. Shares are classified based on the residency of their owner as *domestic* (A shares), or *foreign* (B, H and N shares). The B-shares are traded on the Chinese stock exchanges, with SHSE B-shares denominated in U.S. dollars, and SZSE B-shares denominated in Hong Kong dollars.[18] *Tradable H* shares and *Tradable N* shares are essentially the same as *Tradable B* shares, except that they are issued and traded on the Hong Kong Stock Exchange and the New York Stock Exchange, respectively.

Table 3.2 presents a classification of listed firms by share categories from 1993 to 2002. From Table 3.2, it can be seen that companies with A-shares only are most common, and their numbers are growing at a relatively rapid rate. Companies with A-shares and B-shares represent the second most prevalent category.

[18] In 2001, the Chinese government opened the B-share market to domestic investors. *Tradable B* shares used to be available exclusively to foreign investors and some authorized domestic securities firms.

Table 3.2

Classification of firms by share categories for the Chinese stock market from 1993 to 2002

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
A shares Only	140	227	242	431	627	727	822	955	1,023	1,085
A&H shares	3	6	11	14	17	18	19	19	22	29
A&B shares	34	54	58	69	76	80	82	86	88	87
B shares Only	6	4	12	16	25	26	26	28	24	24
Total A shares	177	287	311	514	720	825	923	1,060	1,133	1,201
Total B shares	40	58	70	85	101	106	108	114	112	111
Total	183	291	323	530	745	851	949	1,088	1,160	1,224

Source: China Securities Regulatory Commission, 2003.

Domestic *A* shares are further divided into *State* shares, *Legal-Person* shares, *Tradable A* shares, and *Employee* shares. All shares of a listed company have the same voting rights and cash-flow rights, i.e., one share is entitled to one vote. Each of the official share classes is described below.

State shares are those held by government agencies (the Bureau of State Property Management and local finance bureaus), and solely State-owned enterprises (SSOEs). The ultimate owner of State shares is the State Council of China. State shares are not publicly traded on either of the two stock exchanges, but can be transferred to domestic corporations if approved by the Ministry of Finance and the CSRC.

Legal-Person (LP) shares are those owned by domestic corporations or other non-individual legal persons. A legal person in China is defined as a non-individual

legal entity or institution, which includes other listed companies and non-bank financial institutions. There is a sub-category called "State-owned legal person shares (LPSOE shares)", which refers to shares held by institutions in which the State is the majority owner but has less than a 100 percent shareholding. On August 16, 2000, the CSRC decreed that LPSOE shares are to be reclassified as State shares. Like State shares, LP shares cannot be traded on the two exchanges, or transferred to foreign investors, but LP-shares can be transferred to domestic corporations when approved by the CSRC.

Tradable A shares are owned by individual Chinese residents and domestic legal persons, but are not allowed to be owned by foreign investors.[19] They are the only type of equity that can be publicly traded among domestic investors. The market price of a listed company refers to the price of Tradable A-shares. Individuals are prohibited from holding more than 0.5 percent of total shares outstanding for any listed company (Provisional Regulations on Administration of Issuing and Trading of Shares (PRAITS, 1993)). In July 1999, the Chinese Securities Law raised the individual shareholding limit to 5 percent. Regulators typically require that *Tradable A* shares account for more than 25 percent of total outstanding shares when a company is listed.

Employee shares are owned by the employees of a listed company. Employee shares are registered under the title of the labour union of the company, which represents the shareholding employees and exercises their rights. After a holding

[19] Since December 2002, the CSRC has allowed foreign investors to purchase tradable A shares.

period of six to twelve months, the company may file with the CSRC to allow its employees to sell their shares in the open market.

Table 3.3 presents an overview of the percentage of total shares in each of the different share classes across Chinese firms from 1993 to 2002. The table shows that *State* shares, *Legal Person* shares, and *Tradable A* shares are the three dominant share categories. The percentage of *Tradable A* shares has grown steadily during the past 10 years.

Table 3.3

Share classifications for the Chinese stock market from 1993 to 2002

The table presents the percentage of different classes of shares in the Chinese stock markets.

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
State shares	0.45	0.44	0.37	0.34	0.31	0.34	0.36	0.39	0.43	0.44
LP shares	0.27	0.22	0.28	0.31	0.33	0.31	0.28	0.25	0.22	0.20
Employee shares	0.02	0.01	0.00	0.01	0.02	0.02	0.01	0.01	0.00	0.00
Tradable A shares	0.15	0.21	0.20	0.21	0.22	0.24	0.26	0.29	0.25	0.28
Tradable B shares	0.06	0.06	0.06	0.06	0.06	0.05	0.05	0.04	0.03	0.03
Tradable H shares	0.05	0.06	0.07	0.07	0.06	0.05	0.04	0.03	0.06	0.05

Source: China Securities Regulatory Commission, 2003.

Besides the differences above, several characteristics of the distribution of shares in China are very different from Western economies:

First of all, State control is a prominent feature in the Chinese stock market. Tong (2003) observes that 75 percent of Chinese listed firms are controlled either by

State or State controlled companies. This is the most distinguishing characteristic of the Chinese stock market.

Second, since it is difficult and costly to transfer State-shares and LP-shares, a freely operating market for corporate control is almost nonexistent. Most Chinese listed firms maintain a relatively stable ownership structure.

Third, shareholding by managers is small and managers are not allowed to transfer their shares during their tenure. According to Tian (2001), average managerial ownership during the period 1994 to 1998, is only 0.005 percent of the total number of shares outstanding. Bai, *et al* (2003) report that in the year 2000, the average top five manager-shareholdings accounted for only 0.02 percent of the total number of shares outstanding.

Fourth, institutional ownership is small. There are only around 55 investment funds. Insurance firms have only recently been allowed to enter the market (Green, 2003a,b).

Fifth, major securities and investment fund management firms are State-controlled, or under direct control by government agencies such as Haitong, Shenyin Wanguo and Guotai Junan. In addition, CICC, the only joint-venture Sino-foreign securities firm, is controlled by the China Construction Bank.

Sixth, foreign ownership is very limited. However, the CSRC recently introduced Qualified Foreign Institutional Investor (QFII) system, which has built a framework for overseas investors to directly invest in Chinese A share markets (Green, 2003b).

Finally, share buybacks are prohibited in the Chinese stock market as well as short sales.

3.6.3 Corporate governance of Chinese listed firms

The Provisional Regulations on Administration of Issuing and Trading of Shares (PRAITS), promulgated by the State Council in 1993, was the first regulation introduced in the stock markets. Given that the original purpose of Chinese stock markets was to help SOEs to obtain private finance, PRAITS gives substantial consideration to safeguard "State property" and protect State shareholders' interests rather than to protecting minority investors. Until the Securities Law took effect in 1999, the CSRC as stock market regulator had little real power due to the strong interference of the central government. The Securities Law finally provided the CSRC with wide-ranging powers with respect to rule making, investigation and enforcement of all aspects of the securities markets. Since then the CSRC, along with the Corporate Law (1993) and the Securities Law (1999) have shaped the legal environment of corporate governance in China.

In the current legal environment, the State is both the regulatory authority and the controlling shareholder in most listed firms. This dual role of the State results in a conflict of interest, where the State might regulate the market so as to favour its own position as controlling shareholder. Similar to other East Asian countries, the controlling shareholders of Chinese listed firms are often able to control the board of directors and management so that the company is run according to their wishes (Chen, *et al*, 2002 and Claessens and Fan, 2003). Even though the two-tier board system in China requires the board of supervisors to monitor the board of directors, both board of directors and board of supervisors are appointed (or dismissed) by shareholders. Hence, the monitoring function of the board of supervisors is largely failing because

the board of supervisors has no power and no incentive to monitor the board of directors and the controlling shareholders.

To improve the functioning of the board of directors, the CSRC recently released the Corporate Governance Guidelines for Listed Companies (CGGLC, 2001). The CGGLC (2001) attempts to strengthen the independence of listed companies from their controlling shareholders. It requires listed firms to establish committees for strategy, audit, and nomination of directors and senior managers. The audit and nomination committees should have a majority of independent directors. MacNeil (2002) argues that the introduction of the CGGLC (2001) represents a limitation on the role of the State as controlling shareholder, and shows willingness on the part of the State to subordinate its own interests as shareholder to the introduction of an effective system of corporate governance.

According to PRAITS (1993), individuals are prohibited from holding more than 0.5 percent of total shares outstanding for any listed company. Although the Securities Law (1999) raised the individual shareholding limits to 5 percent, the absence of cumulative voting rights for minority shareholders still limits their ability to exert any real influence on the board of the firm. The CGGLC (2001) does formally require a controlling shareholder to take account of the interests of other shareholders; however, this is difficult to apply in practice. For example, MacNeil (2002) reports that it is very difficult to enforce minority shareholders' rights in courts due to the lack of proper legal procedures in China. Overall, the weak investor protection along with the failure of supervisory boards, provide controlling shareholders and managers with considerable opportunity to tunnel firm assets.

To summarize, most traditional mechanisms to reduce the agency costs between shareholders and management are not applicable in the Chinese markets. For example, given the lack of tradability of the majority of shares, the market for corporate control is almost non-existent. The weak monitoring of banks and low management ownership do not help to alleviate agency costs. Furthermore, large shareholders have substantial power to control management. Rather than solving the free rider problem, they are more likely to take advantage of their concentrated control rights and expropriate minority shareholders.

Despite recent improvements in the area of corporate governance, there is still a lot of room for improvement. For example, MacNeil (2002) estimates that based on the index of investors' protection developed by La Porta, *et al* (1998), China falls in the investor-unfriendly category and has a total score of two, compared with a world average of three. Furthermore, enforcement of the rules and regulations tends to be much more problematic than in more developed economies.

3.6.4 Empirical evidence

Most of the early research on corporate governance in China discusses the merits of the economic reform process and its social impact.[20] More recently, researchers have started using Chinese stock market data to investigate corporate governance issues. This new research allows for a more quantitative evaluation of the impact of corporate governance on firm value. This section discusses some of the recent research and indicates how this thesis contributes to the growing body of evidence in this area.

[20] See Cao, *et al* (1999), Cao (2000), Lardy (1998), Lau, *et al* (2000), Li (1997), Lin (2000), and Zhang (1998).

Xu and Wang (1999) were the first to investigate corporate governance issues in the Chinese stock markets using stock market data. They study the relation between ownership structure, accounting performance and firm value during the period from 1993 to 1995. They find a positive and significant correlation between ownership concentration and firm profitability, and a negative correlation between profitability and the fraction of shares held by the State. Qi, *et al* (2000) and Sun and Tong (2003) report similar findings.[21] This evidence is consistent with the conventional view that government ownership has a negative impact on firm value (Shleifer and Vishny, 1997). Tian (2001), however, shows a U-shaped relation between firm value and the portion of shares held by State. He interprets the U-shape as evidence that there are two effects of government ownership: State ownership might lead to managerial inefficiency, but State shareholders might also contribute to firm value in a weak legal environment such as China.

Given that State shareholders participate in the stock markets in different ways, the impact of State shareholders on firm value is still unclear. It is important to recognize that the State ownership in Chinese firms can have three different forms: (i) direct control through government agencies (GAs); (ii) indirect control through solely state-owned enterprises (SSOEs); and (iii) indirect control through state-owned enterprises controlled by the government but with private minority shareholders (LPSOEs). LPSOEs are ultimately controlled by State and are a type of State shareholders. However, before 2000, shares held by LPSOE shareholders were classified as LP shares, rather than State shares by the CSRC. Therefore, most early

[21] Gul (1999) investigates the relation between government ownership, growth opportunities and corporate policy decisions of Chinese listed firms. He finds that government ownership is positively associated with debt financing and dividend payout.

research on the role of State shareholders suffers from inappropriate share classifications. An important contribution of this thesis is the recognition that different State-ownership structures have different characteristics regarding the separation of control rights and cash-flow rights, the degree of involvement from private parties, and management incentives. My study of share price responses of stock transfers among different State shareholders provides direct evidence on the impact of different State shareholders on firm value (Chapter 4).

Ownership concentration is a worldwide phenomenon and an important characteristic of Chinese listed firms. Recently, corporate governance research has shifted its focus from the agency costs between shareholders and managers to expropriation by controlling shareholders. Even though expropriation by controlling shareholders is frequently observed in China, there is no existing research on this issue. This thesis contributes to the literature by studying a sample of listed firms that granted guarantees of the debt of their large shareholders. This unique sample of firms, with unambiguous expropriation of minority shareholders, allows me to investigate the relation between expropriation and corporate governance characteristics. It also allows me to provide evidence on several financial measures proposed by literature as proxies for the quality of corporate governance (Chapter 5).

In recognizing the seriousness of expropriation around world, legal reform (external approach) and ownership structure (internal approach) have been proposed as alternative mechanisms to improve corporate governance and reduce expropriation. In China, the government is active in promoting share market regulations and enhancing the power of regulators. Berkman, *et al* (2003) conduct an event study regarding four regulations introduced by CSRS. Their results provide strong evidence

for the claim that better investor protection in the form of share market regulation can create substantial value for minority shareholders. This thesis takes a different perspective and studies the role of ownership concentration and the presence of multiple blockholders on the quality of corporate governance and firm value in the Chinese stock markets. I find firm value increases in the cash-flow rights of the controlling shareholder. Firm value goes up if there are multiple shareholders, however for firms where collusion among major blockholders is likely a substantial discount is found (Chapter 6).

CHAPTER 4

FROM STATE TO STATE: IMPROVING CORPORATE GOVERNANCE WHERE THE GOVERNMENT IS THE CONTROLLING BLOCKHOLDER

4.1 Introduction

Concentrated ownership is an important determinant of the incentives faced by firm managers and the value of the firm. Much of the research in this area has focused on how the level of block holdings influences value and performance.[22] A number of studies focus on block trades that change the blockholder's identity, but typically do not change the concentration of ownership. These studies have highlighted that the identity of a blockholder also is an important determinant of firm value. For example, Barclay and Holderness (1991) find substantial increases in value around the announcements of block trades and a substantial increase in CEO turnover during the year following the block trades.

This study extends the literature on the importance of blockholder identity and focuses on block trades within the public sector. The specific way in which State ownership is organized, and the resulting quality of monitoring, is important because many of the world's largest enterprises, both listed and unlisted, have the State as the controlling blockholder. For example, La Porta, *et al* (1999) report that the State is the ultimate controlling blockholder for 18 percent of the 20 largest traded firms in the 27 wealthy countries that they study. Claessens, *et al* (2000) find a similar percentage of firms controlled by the State in the nine East Asian countries that they analyse.

Given the number and size of firms under State control around the world, an important issue is how to improve corporate governance at firms where the

[22] See Morck, *et al* (1988), Holderness and Sheehan (1988b), McConnell and Servaes (1990), Slovin and Sushka (1993), and Ang, *et al* (2000).

government is the ultimate controlling blockholder. In this study, I find evidence of such improvements in a sample of Chinese listed firms where the State transferred its control from government agencies to corporatized firms where the State is the controlling shareholder.

I choose to analyse Chinese firms because intra-governmental block transfers are relatively common in China and reflect efforts by the Chinese government to improve corporate governance while maintaining ultimate control at the country's largest firms.[23] The Chinese government uses three different structures to participate in the equity of listed companies: (i) direct control through government agencies (GAs); (ii) indirect but ultimate control through solely State-owned enterprises (SSOEs); and (iii) indirect but ultimate control through legal-person State-owned enterprises (LPSOEs), which are joint ventures between the State and private minority blockholders.[24]

I find no share prices response around share transfers from GAs to SSOEs, and a statistically significant excess return of 6 percent around share transfers from GAs to LPSOEs, which introduces private blockholders into the firms' ultimate ownership structures. Furthermore, the CEO is replaced within twelve months after the announcement for 56 percent of the firms that have an LPSOE as the new

---

[23] Official documents and speeches make it clear that the current Chinese power structure intends to maintain ultimate control over a large segment of the Chinese economy. See, for example, President Jiang Zemin's speech at the 15th congress of the Chinese Communist Party in the fall of 1997. According to some observers, Chinese authorities mainly seek to improve the corporate governance of State-controlled firms as a means of avoiding further privatization (Lin, 2000 and Cao, 2000).

[24] This classification relies on the concept of the 'ultimate shareholder' introduced in La Porta, *et al* (1999, pp. 475-476). Without the concept of the ultimate shareholder, I would not be able to identify firms controlled by SSOEs and LPSOEs as being ultimately controlled by the State.

blockholder, but for only 25 percent of the firms that have an SSOE as the new blockholder.

The results suggest that LPSOEs have better incentives and are better equipped than SSOEs and GAs to monitor and discipline firm management. This result might be partially due to the fact that there is a greater degree to which cash flow rights are reattached to control rights when block shares transferred from GAs to LPSOEs than SSOEs, as SSOEs are still fully owned by government. Furthermore, LPSOEs must hold annual shareholder meetings where shareholders can elect members of the board of directors, whereas SSOEs are controlled by boards of directors selected by government officials and hold no annual shareholder meetings.

This study extends the corporate governance literature in at least two different directions. First, it extends the literature on large block transfers.[25] This research provides new evidence from international markets confirming that block transfers are corporate control events, even when the new blockholder does not obtain a majority interest in the firm. This study also provides new evidence that changes in firm value associated with block transfers, and subsequent changes in top management, are functions of the incentives and managerial skills of the new blockholders, rather than the size of the block holdings. I also find that the gains from block trades accrue to minority shareholders, consistent with the findings of Barclay and Holderness (1991) for US firms, but in contrast to the findings of Franks and Mayer (2001) for German firms. Perhaps the most surprising result is my finding that share transfers between different government blockholders can improve corporate governance and increase firm value. Given the prevalence of State ownership around the world, I regard this as

[25] See Holderness and Sheehan (1985, 1988b), Barclay and Holderness (1991), Bethel, *et al* (1998), and Franks and Mayer (2001).

an important extension of current research that has focused exclusively on share transfers between private blockholders.

The second direction this research contributes to the governance literature is empirical support for theories regarding how the separation of ownership and control affects firm value.[26] My results show that a shift from direct government ownership, where cash-flow rights and control rights are completely separated, to indirect government ownership (LPSOEs), where cash-flow rights are partially reattached to control rights, increases firm value. The closer alignment of cash-flow rights and control rights following block transfers from GAs to LPSOEs is due to the fact that LPSOEs introduce private blockholders into the firms' ultimate ownership structures.

The remainder of this study is organized as follows. I discuss the role of the Chinese government and develop hypotheses in Section 4.2. In section 4.3, I describe my data and methodology. Section 4.4 presents the results of my empirical analysis and section 4.5 provides a summary.

4.2 Government ownership and hypotheses

4.2.1 Government ownership structure

Because of differences in incentives and residual cash-flow rights, I expect the three alternative State shareholding regimes (GA, SSOEs, and LPSOEs) to have differential impacts on firm value, even though the State is the ultimate controlling shareholder in each case (see Figure 4.1).

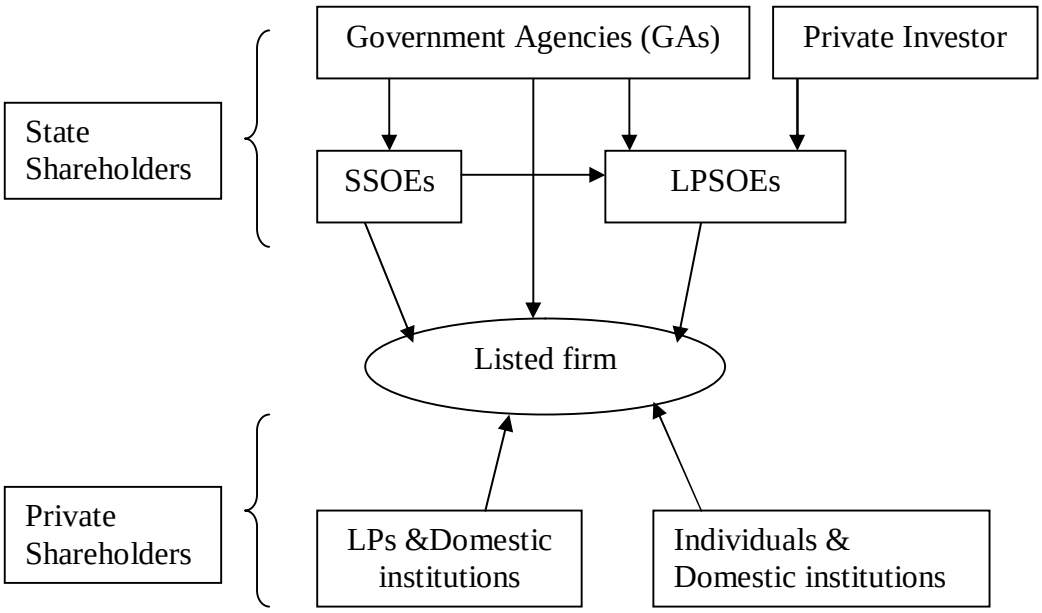
Figure 4.1 shows that GAs, such as the Bureau of State Property Management or local finance bureaus, exercise ownership rights on behalf of the Chinese

[26] See Grossman and Hart (1988), Harris and Raviv (1988), and Shleifer and Vishny (1997).

government. When a GA controls the majority of the shares in a company, officials of the GA have the right to select board members and chief officers and to veto business and investment plans proposed by firm management. As government officials, however, they are prohibited from involvement in the management of State-controlled firms (Cao, 2000).

Figure 4.1

Ownership structure of Chinese listed firms



GA officials have no residual cash-flow rights from the companies they monitor; all dividend revenues from the companies under their control are submitted to the Ministry of Finance or to local governments. Moreover, GA officials are not rewarded based on the performance of the SOEs that they monitor (Xu and Wang, 1999 and Lin, 2000). GA officials typically have little or no management experience and little industry-specific knowledge. Hence, it is difficult for them to evaluate

management decisions. The promotion of GA officials depends largely on how well they execute the instructions of central or local government rather than how much they contribute to creating firm value or dividend revenues. Based on these characteristics, I hypothesize that GA officials are unlikely to have profit maximization as the primary goal for GA-controlled listed firms.

Figure 4.1 shows that SSOEs are enterprises fully owned by government.[27] Managers of SSOEs typically receive explicit monetary rewards based on their firm's performance (Groves, *et al* 1995). This incentive-based compensation represents an indirect and partial reattachment of cash-flow rights to control rights at SSOEs that should mitigate agency problems between the controlling blockholders and minority shareholders. Furthermore, SSOEs are separate legal entities that have a degree of autonomy and are allowed to retain their after-tax profits, which can be used according to their own plans. This provides managers of SSOEs with greater incentive to focus on profitability than GA officials. Hence, the interests of managers are brought into closer alignment with those of the firm's owners. Finally, changes in the identity of the blockholder can increase firm value by improving the quality of management and/or monitoring (Barclay and Holderness, 1991). Because of their managerial experience in industry, I expect that SSOE blockholders are more efficient and professional than GA officials in monitoring the firms under their control.

An alternative view is that SSOEs represent an additional level of bureaucracy that might oppose changes (Broadman, 1997). Given that SSOEs are fully owned and controlled by the State, the appointment of managers is determined by political

[27] According to the Law on State Owned Enterprises (1988), GA officials have the responsibility to appoint and supervise managers of SSOEs, and exercise their rights through the board.

processes rather than markets. Lin (2000) argues that the incentive contracts between government and management result in substantial loss of State property, rather than give management proper incentives to operate efficiently. With no ownership at all, managers of SSOEs are more likely to retain after-tax profit for their personal benefits, rather than for profitable investment projects. Therefore, SSOEs' weak governance structure might simply be mapped onto the listed company. If so, zero or negative returns are to be expected around announcements of block transfers from GAs to SSOEs.

As shown in Figure 4.1, *State-Owned Legal-Person Corporations* (LPSOEs) refer to domestic corporations in which the government is the majority owner but has less than 100 percent ownership. In essence, an LPSOE is a joint venture between the State (usually in the form of a SSOE) and one or more private-sector investors, where the private minority partner contributes capital, technology or management skills to the joint venture.[28] Private investors can exert substantial influence on the selection of managers and other important decisions.

Given that the private joint-venture partner is entitled to receive *pro rata* distributions of the cash flows from firms under control of an LPSOE, there is a greater degree to which cash-flow rights are reattached to control rights at an LPSOE relative to a SSOE and a GA. Furthermore, shareholders of LPSOEs enjoy a distinct advantage over SSOEs and GAs with respect to exercising their control rights. LPSOEs are required to hold annual shareholders' meetings, whereas SSOEs (and, of course, GAs) do not hold shareholders' meetings (Corporate Law, 1993). As a consequence, managers of LPSOEs often have pressure from the board to improve

[28] Given that LPSOEs are usually not listed, I cannot determine the exact ownership structure of LPSOEs.

performance. Therefore, I expect LPSOE blockholders to be more efficient at monitoring the management of firms under their control than either GA or SSOE blockholders. This superior monitoring would be expected to increase the future cash flows of firms under LPSOE control, which should lead to positive abnormal returns following announcements of block share transfers from GAs to LPSOEs.

4.2.2 Additional hypotheses

It is important to distinguish between a transfer that creates a new controlling blockholder and one that does not. According to Barclay and Holderness (1991), block transfers as small as ten percent of outstanding shares can transfer *de facto* control rights. The legal maximum for individual shareholdings and the absence of cumulative voting procedures significantly enhance the control rights of a firm's largest shareholder. In a recent study the World Bank (2002) concludes that, in China, ". . . large shareholders often overstep the bounds of shareholder meetings and boards of directors and exercise direct effective control" (p. xiii). Because of this strong position of the largest shareholder in China, I expect the positive effects of the block transfers to be larger when the new government blockholder becomes the largest shareholder.

Another important characteristic of the post-transfer ownership structure is whether the GA retains a significant ownership position, which is defined as an ownership stake of at least 10 percent after the block trade. Ordinarily, a second large blockholder would be expected to improve firm performance by monitoring the behaviour of the controlling blockholder (Gomes and Novaes, 2001 and Bloch and Hege, 2001). However, this presumes that the second blockholder is interested in

maximizing share value. When the second blockholder is a GA and it has significant control rights but no cash-flow rights, the second blockholder is expected to impair firm performance by promoting the interests of the GA, such as maximizing employment at the expense of profitability. I, therefore, hypothesize that retention of a substantial ownership is perceived as a signal that the GA intends to maintain an active interest in how the firm is managed. According to Shleifer and Vishny (1994), this indicates that profit maximization will not be the primary goal of management. Consequently, I expect that abnormal returns surrounding announcements of block transfers from GAs to SSOEs or LPSOEs will be smaller when the GA retains a significant ownership position.

4.3 Data and methodology

4.3.1 Data

My sample includes all firms from the SHSE and the SZSE that, during 1997-2001, reported share transfers from GAs to SSOEs or LPSOEs that are greater than 5 percent of the total number of shares outstanding. The stock transfer events and firm financial data were obtained from SINOFIN and checked against major financial newspapers in China.[29] Daily share price information is from DataStream.

In total, I identified 79 share transfers from GAs to SSOEs or to LPSOEs for a total of 75 listed companies during the 1997-2001 periods. I exclude one observation with unreliable financial data (a debt-to-asset ratio of 1.4), leaving 78 observations for 74 listed companies.

[29] Sinofin is one of the professional data providers in China. The three leading financial newspapers that I consulted are: the China Securities Daily, Securities Times and Shanghai Securities Daily.

Table 4.1 presents descriptive statistics regarding the pre-transfer ownership structure and firm characteristics of the sample. The State (GAs and SSOEs) is typically the largest shareholder, with an average shareholding of 42.95 percent and a range of 14.62 to 75 percent. Legal Persons hold an average of 16.89 percent of outstanding shares with a range of 0 to 46.7 percent. The average percentage of shares being transferred from GAs to SSOEs or LPSOEs is 33 percent, with a median of 30 percent and a range of 6.5 to 75 percent. Most of the share transfers resulted in the replacement of a GA by an SSOE or a LPSOE as the firm's largest shareholder (85 percent of transfers result in New Control, 15 percent don't). The share transfer was to an SSOE for 79 percent of my sample and to an LPSOE for 21 percent. Government agencies retained more than 10 percent ownership in 15 block transfers (19 percent of the sample).

I calculate the leverage ratio for each firm as the book value of total liabilities divided by the book value of total assets. The average leverage ratio is 51 percent, with a minimum of 14 percent and a maximum of 98 percent.[30] The high leverage ratios in my sample reflect the underperformance of some listed companies and the State-owned-banks' lack of power and incentives to force bankruptcy on poorly performing firms without government approval. Finally, I measure firm size by the natural logarithm of the book value of firm's total assets.[31] Book value ranges from RMB 196 million to RMB 4.88 billion, or US$ 23.7 million to US$ 587.6 million.

[30] There are no finance companies in the sample.

[31] Both leverage ratio and firm size are measured using data from the pre-transfer year.

Table 4.1

Sample descriptive statistics

The table presents sample descriptive statistics. The descriptive statistics of different classes of shares is firstly presented for my sample firms. Shares transferred (%) represents shares being transferred from GAs to SSOEs or LPSOEs. Transfer to LPSOE is a dummy variable that equals one if shares are transferred to LPSOE and zero otherwise. New Control is a dummy variable that equals one if the share transfer results in a new largest blockholder and zero otherwise. GA Retains> 10% is a dummy variable that equals one if a GA holds more than 10 percent of shares after the block transfer and zero otherwise. Leverage ratio for each firm is calculated as the book value of total liabilities divided by the book value of total assets. Firm size (ln(assets)) is calculated by the natural logarithm of the book value of firm's total assets at end of year prior to share transfer.

	Mean	STDEV	Minimum	Q1	Median	Q3	Maximum
State Shares (%)	42.95	12.94	14.62	34.46	42.58	51.56	75.00
LP Shares (%)	16.89	12.70	0.00	6.36	16.50	26.88	46.77
Tradable A Shares (%)	38.56	10.90	24.89	29.09	37.96	45.42	73.02
Employee Shares (%)	1.60	4.35	0.00	0.00	0.00	0.08	21.23
Shares Transferred (%)	33.00	16.00	6.50	21.00	30.00	43.00	75.00
Transfer to LPSOE	0.21	0.41	0.00	0.00	0.00	0.00	1.00
New Control	0.85	0.36	0.00	1.00	1.00	1.00	1.00
GA Retains > 10%	0.19	0.40	0.00	0.00	0.00	0.00	1.00
Leverage Ratio (%)	51.00	18.00	14.00	36.00	51.00	65.00	98.00
ln(assets)	20.38	0.71	19.09	19.88	20.30	20.82	22.31

4.3.2 Methodology

I use standard event-study methodology to analyse the share-price response to announcements of changes in ownership structure where control of a listed company passes from a GA to an SSOE or an LPSOE. This approach contrasts to the cross-sectional regressions of firm value (or performance) against ownership structure

adopted by previous researchers.[32] Rather than regressing firm value or firm performance against ownership variables, I examine the stock market's reaction to announcements of changes in ownership structure at individual companies. The direction of causation is clear: the announcements of ownership changes lead to changes, if any, in firm value. This methodology also enables me to control for firm heterogeneity, another fundamental problem afflicting the cross-sectional analyses, as I am examining the same firms, before and after the announced ownership changes.

I calculate the abnormal return as the difference between the realized return and the risk-adjusted return estimated using the market model. To estimate the market model, I create an index using both the SHSE and the SZSE composite index that gives equal weight to both markets. Both composite indexes are value-weighted and consist of all listed companies on each stock exchange.[33] The estimation period for the market model is from day -160 to -11 relative to the event day (day 0), and the event window is from day -10 to day +5.[34]

4.4 Results

In this section, I test the hypotheses regarding the efficiency of alternative State-ownership structures. First, I analyse the share price response around the block transfer announcement date for the full sample and for several portfolios constructed using the corporate governance characteristics. Next, I estimate cross-sectional

[32] See Xu and Wang (1999), Qi, *et al* (2000) and Tian (2001).
[33] The market capitalizations for the two stock exchanges are similar and market index movements are highly correlated between the two stock exchanges. As Xu and Wang (1999) point out, the formation of two stock exchanges was intended to encourage competition and there is only geographic difference between two stock exchanges.
[34] For some companies, trading is halted on the event day. In these cases, I use the closing price for the next day as the day 0 share price. See appendix 4.1 for market model estimation and test statistics calculation.

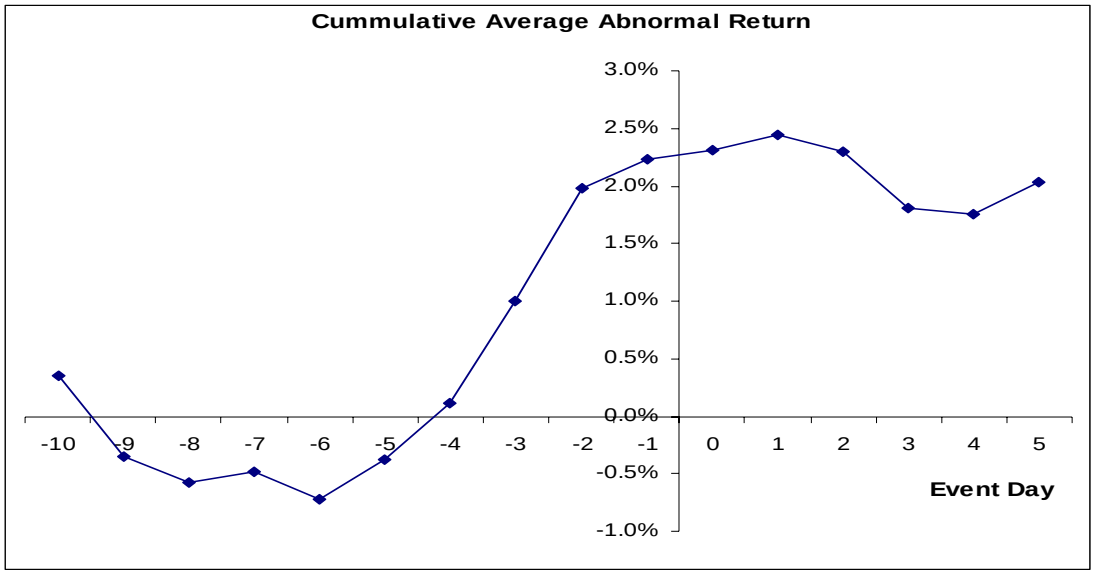
regression models for evidence on the sources of any excess returns. Finally, I examine changes in the top management during the 12 months following the block transfer announcements.

4.4.1 Full-Sample cumulative abnormal returns

Figure 4.2 graphs the cumulative average abnormal returns from day-10 to day+5. It can be seen that share price starts to run up at event day -4 and peaks at event day +1. The cumulative average abnormal return over this period is about 2.5 percent.

Figure 4.2

Cumulative average abnormal returns



Panel A of Table 4.2 presents average daily abnormal returns (AAR) and cumulative average abnormal returns (CAR) for day–10 through day+5. The table

shows that there are positive and statistically significant AARs on day-4 through day-*2*. On the announcement day (day 0), the AAR is positive but not significant. This may indicate information leaking before the event announcement date. The CAR is positive and statistically significant from day-2 through day+5.

Panel B of Table 4.2 reports the CARs for two alternative time periods. First, to capture the full share-price response to the block-transfer announcements, I measure the CAR over the 16-day period from day–10 through day+5 (CAR16). The average CAR measured over this period is only 2 percent. I also report results using the average CAR measured over the six-day interval day–4 through day+1 (CAR6), which encompasses the six days around the announcement day. The average CAR measured over this period is 2.3 percent and is statistically significant at better than the 0.001 level in spite of considerable cross-sectional variation in the firm CARs. Hence, the results in Panel B indicate that, on average, block transfers from GAs to SSOEs and LPSOEs lead to positive abnormal returns.

The following sections test whether the cross-sectional variation in the CARs can provide evidence regarding the other hypotheses. First, I contrast my findings with the results in Franks and Mayer (2001), who analyse a sample of block transfers at German firms. Franks and Mayer (2001) find that the benefits of control transfers do not accrue to minority shareholders and attribute this result to the weak protection of minority shareholders in Germany. My results show a small, but significant value increase for minority shareholders in China, where minority shareholder protection is also considered to be relatively weak.[35] A possible explanation for the difference in

[35] MacNeil (2002) estimates that the LLSV-index of minority shareholder protection for China is only two out of a possible score of six, compared to an average score of

these findings is that privately controlled firms are better at extracting private benefits of control than are State-controlled firms. The value increases resulting from improvement in corporate governance at State-controlled firms are therefore shared with minority shareholders.

four for common-law jurisdictions and an average of three for all countries. He also discusses the difficulties of enforcing minority shareholder rights in China.

Table 4.2

Average daily abnormal return and cumulative average abnormal return

The table presents AAR and CAR along with t-test. I calculate the abnormal return as the difference between the realized return and the risk-adjusted return estimated using the market model. To estimate the market model, I create an index using both the SHSE and the SZSE composite index that gives equal weight to both markets. Both composite indexes are value-weighted and consist of all listed companies on each stock exchange. The estimation period for the market model is from day -160 to -11 relative to the event day (day 0), and the event window is from day -10 to day +5. See appendix 4.1 for details on market model estimation and test statistic calculation.

Panel A

	AAR	*t-test*	CAR	*t-test*
Day-10	0.004	(1.25)	0.004	(1.21)
Day-9	**-0.007**[b]	(-2.34)	-0.004	(-0.84)
Day-8	-0.002	(-0.71)	-0.006	(-1.13)
Day-7	0.001	(0.35)	-0.005	(-0.82)
Day-6	-0.002	(-0.73)	-0.007	(-1.09)
Day-5	0.003	(1.16)	-0.004	(-0.53)
Day-4	**0.005**[c]	(1.67)	0.001	(0.14)
Day-3	**0.009**[a]	(2.98)	0.010	(1.20)
Day-2	**0.009**[a]	(3.20)	**0.020**[b]	(2.22)
Day-1	0.002	(0.08)	**0.022**[b]	(2.36)
Day-0	0.001	(0.26)	**0.023**[b]	(2.33)
Day1	0.001	(0.40)	**0.024**[b]	(2.35)
Day2	-0.001	(-0.44)	**0.023**[b]	(2.12)
Day3	-0.005	(-1.55)	**0.018**[c]	(1.61)
Day4	-0.000	(-0.15)	0.018	(1.50)
Day5	0.002	(0.83)	**0.020**[c]	(1.67)

Panel B

	Mean	*t-test*	Std	Min	Q1	Median	Q3	Max
CAR16	0.02	(0.87)	0.122	-0.322	-0.055	0.014	0.075	0.429
CAR6	**0.023**[a]	(3.51)	0.062	-0.131	-0.010	0.018	0.049	0.263

a, b, and c indicate statistical significance at the 1%, 5%, and 10% levels, respectively[36].

[36] Given the small samples, a non-parametric sign test (Corrado and Zivney, 1992) has also been conducted as robust test. The results are qualitatively similar to the results presented in this thesis.

4.4.2 Portfolio cumulative abnormal returns

Table 4.3 presents average CARs for portfolios of firms based upon corporate governance characteristics introduced in section 4.2. The table provides univariate tests of these hypotheses.

Table 4.3

Mean portfolio cumulative abnormal returns

The table presents mean results of CAR16 and CAR6. CAR16 and CAR6 represent average cumulative abnormal returns from day-10 to day5 and from day-4 to day1, respectively. The sample is partitioned by the transferee's identity (LPSOE or SSOE), GA remaining shareholdings (GA retains > or < 10%), and the controlling status of transferee (new controlling shareholder or not). See appendix 4.1 for details on market model estimation and test statistic calculation.

Panel A	Number of Firms	CAR16	CAR6
Transfer to LPSOE	16	0.06	**0.07**[a]
		(1.48)	(3.76)
Transfer to SSOE	62	-0.00	**0.01**[b]
		(-0.06)	(1.99)
Difference in means		**0.06**[c]	**0.05**[a]
		(1.86)	(3.09)
Panel B	Number of Firms	16-day CAR	6-day CAR
GA retains > 10%	15	-0.03	-0.01
		(-0.82)	(-0.44)
GA retains < 10%	63	0.02	**0.03**[a]
		(1.47)	(4.26)
Difference in means		-0.05	**-0.04**[b]
		(-1.45)	(-2.29)
Panel C	Number of Firms	16-day CAR	6-day CAR
New Controlling Shareholder	66	0.02	**0.03**[a]
		(1.49)	(4.32)
No New Controlling Shareholder	12	-0.05	-0.02
		(-1.53)	(-1.13)
Difference in means		**0.07**[c]	**0.05**[a]
		(1.82)	(2.68)

a, b, and c indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

In Panel A of Table 4.3 are the mean CARs for the two portfolios based upon whether the GA's block was transferred to an SSOE or to an LPSOE. For transfers to LPSOEs, the average 16-day CAR is 6 percent and the average 6-day CAR is 7 percent. CAR6 is highly significant at better than the 0.001 level, while CAR16 is significant at the 15 percent level. For transfers to SSOEs, the average 16-day CAR is zero percent and the average 6-day CAR is 1 percent. CAR16 is statistically insignificant, while the CAR6 is significant at the 0.05 level, however, 1 percent of excess return is not economically significant. The 6 percentage-point difference in mean 16-day CARs between SSOEs and LPSOEs is significant at the 10 percent level; while the 5 percentage point difference in mean 6-day CARs is significant at the 1 percent level. These results strongly support the hypothesis that LPSOEs provide the most efficient monitoring of the three alternative State-ownership structures. Even though LPSOEs are ultimately controlled by the State, the presence of private blockholders in the ultimate ownership structure provides a substantial improvement in monitoring. On the other hand, there is only weak evidence to suggest that SSOEs are better than GAs as blockholder.

In Panel B of Table 4.3 are the mean CARs for two portfolios of firms based upon whether or not the GA retained a significant ownership share of at least 10 percent following the block transfer. When there is no significant share retention, the average CAR16 is 2 percent and the average CAR6 is 3 percent. When the GA did retain a significant ownership share, the average CAR16 is negative 3 percent and the average CAR6 is negative 1 percent. The 5 percentage-point difference in mean

CAR16 is statistically significant at the 15 percent level, and the 4 percentage-point difference in the mean CAR6 is significant at the 5 percent level. Hence, these results provide some support for the hypothesis that retention of a significant ownership stake by the GA reduces the efficiency of the new ownership structure.

Finally, Panel C of Table 4.3 reports the mean CARs for two portfolios based upon whether or not the share transfer created a new controlling (largest) blockholder. When a new controlling blockholder was created, the average 16-day CAR is 2 percent and the average 6-day CAR is 3 percent. When no new controlling blockholder was created, the average 16-day CAR is negative 5 percent and the average CAR6 is negative 2 percent. The 7 percentage point difference in mean CAR16 is significant at the 10 percent level, while the 5 percentage-point difference in the mean CAR6 is significant at the 1 percent level. These results provide evidence that creation of a new controlling blockholder results in an increase in firm value.

4.4.3 Cross-sectional regressions

To provide additional evidence on the sources of abnormal returns, I also perform cross-sectional regressions, where the 6-day or 16-day CAR is the dependent variable and the various governance characteristics the explanatory variables. I estimate the following cross sectional regression model:

$$CAR_i = \alpha + \beta_1 \, Shares\ Transferred_i + \beta_2 \, LPSOE_i + \beta_3 \, New\ Control_i$$
$$+ \beta_4 \, GA\ Retains > 10\%_i + \beta_5 \, Leverage\ Ratio_i + \beta_6 \, ln(asset)_i + \varepsilon_i$$

where CAR_i is either the 6- or 16-day cumulative abnormal return for firm *i*. *Shares Transferred*$_i$ is the percentage of the total shares outstanding of firm *i* being transferred to an SSOE or a LPSOE. I expect that a larger transfer is associated with a larger CAR. $LPSOE_i$ is a dummy variable that equals one when the shares of firm *i* are transferred to an LPSOE, and equal to zero otherwise; *New Control*$_i$ is a dummy variable that equals one when an SSOE or a LPSOE becomes the largest shareholder of company *i*, and equals zero otherwise; and *GA Retains > 10%*$_i$ is a dummy variable that equals one when the GA retains at least a 10 percent ownership share after the transfer, and zero otherwise. As general control variables, I include the ratio of total debt to total assets (*Leverage Ratio*$_i$) and firm size measured as the natural logarithm of the book value of the firm's total assets (*lnassets*$_i$).

Table 4.4

Cross-sectional regressions to explain cumulative abnormal returns

CAR6 is the cumulative average abnormal return for the event window from day -4 to day 1. Shares transferred (%) represents shares being transferred from GAs to SSOEs or LPSOEs. Transfer to LPSOE is a dummy variable that equals one if shares are transferred to LPSOE and zero otherwise. New Control is a dummy variable that equals one if the share transfer results in a new largest blockholder and zero otherwise. GA Retains> 10% is a dummy variable that equals one if GA holds more than 10 percent of shares after block transfer and zero otherwise. Leverage ratio for each firm is calculated as the book value of total liabilities divided by the book value of total assets. Firm size (ln(assets)) is calculated by the natural logarithm of the book value of firm's total assets at end of year prior to share transfer.

Variables	CAR6	CAR6	CAR6	CAR6	CAR6	CAR16
Intercept	0.11	0.15	0.08	0.22	0.20	0.31
	(0.51)	(0.78)	(0.41)	(1.07)	(1.02)	(0.78)
Shares Transferred	0.05				-0.01	-0.13
	(1.02)				(-0.12)	(-1.32)
Transfer to LPSOE		**0.05**[a]			**0.04**[a]	0.05
		(3.11)			(2.59)	(1.39)
New Control			**0.05**[a]		**0.04**[b]	**0.10**[b]
			(2.79)		(2.04)	(2.31)
GA Retains >10%				**-0.04**[b]	**-0.03**[c]	-0.03
				(-2.42)	(-1.68)	(-0.94)
Leverage Ratio	0.01	0.01	0.04	-0.00	0.02	**0.15**[b]
	(0.30)	(0.24)	(0.87)	(-0.08)	(0.57)	(1.96)
Ln (assets)	-0.01	-0.01	-0.01	-0.01	-0.01	-0.02
	(-0.48)	(-0.72)	(-0.59)	(-0.90)	(-1.14)	(-1.05)
Adjusted R^2	-0.02	0.08	0.06	0.04	0.15	0.09

a, b, and c indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

Table 4.4 presents the regression results. In columns two through five, I use the 6-day CAR as the dependent variable and include sequentially as explanatory variables each of the four corporate-governance measures, along with the controls for firm leverage and size. In column six, I include all four of the corporate governance variable along with the two control variables. I concentrate on the results using the 6-day cumulative abnormal return because most of the run-up in the CAR occurs during

days-4 through day+1. In the last column, I show the results using the longer 16-day event window as a robustness check.[37]

In column two of Table 4.4, the coefficient of *Shares Transferred* is positive but not significantly different from zero. I had expected that larger transfers would be associated with greater cumulative abnormal returns, but this does not appear to be the case.

In column three of Table 4.4, the coefficient of *LPSOE*, indicating that shares were transferred to an LPSOE rather than to a SSOE, is positive and statistically significant at the 1 percent level. I interpret this as evidence that LPSOEs are perceived by the market to be more efficient monitors than SSOEs. The coefficient of 0.05 indicates that the 6-day cumulative abnormal return is 5 percentage points higher when a new LPSOE blockholder rather than a new SSOE blockholder is announced.

In column four of Table 4.4, the coefficient of *New Control*, indicating that a new controlling SOE blockholder of either type is announced, is positive and statistically significant at the 1 percent level. The coefficient of 0.05 indicates that the 6-day cumulative abnormal return is 5 percentage points higher when an SSOE or a LPSOE is announced as the largest shareholder of the company. I interpret this as evidence that that the largest shareholder of a company has a considerable power to direct the firm's resources and monitor management.

In column five of table 4.4, the coefficient of *GA Retains > 10%*, which indicates that the transferring GA retained at least a 10 percent ownership interest in

[37] I also tested specifications that include the company's age and dummy variables representing the stock exchange where the company is listed, the year in which the share transfer announcement is made, and the industry to which the company belongs. None of these control variables were significant in any of the specifications I tested. Consequently, Table 4.4 includes only *Leverage Ratio* and *ln (assets)* as control variables.

the firm, is negative and statistically significant at the 5 percent level. I interpret this as evidence that the market regards GAs as inefficient blockholders who are likely to dissipate firm profits.

In column six of Table 4.4, I include all six of explanatory variables to see if my results hold up. I find some evidence of multicollinearity, as the *t*-statistics of each of the three governance variables that were significant in columns three, four, and five, decline modestly in column six. However, all three remain statistically significant. The announcement of a new controlling SOE blockholder is associated with a 6-day CAR that is 4 percentage points higher than when no new controlling blockholder is announced. When this blockholder is an LPSOE, the 6-day CAR is an additional 4 percentage points higher. When the GA retains at least a 10 percent ownership stake, the 6-day CAR is 3 percentage points lower.

In column seven of Table 4.4, I use the same explanatory variables as in column six, but replace the 6-day CAR with the 16-day CAR as a robustness check. *New Control* remains positive and statistically significant at better than the 0.05 level, but both $LPSOE_i$ and *GA Retains > 10%* lose statistical significance.

In summary, the cross-sectional analysis of abnormal returns indicates that different State-shareholding regimes have differential impacts on firm value even though they all represent the State as the controlling owner. Among the three State-shareholding regimes, LPSOEs provide the most effective monitoring while SSOEs do not seem to be a better State shareholder than GAs.

4.4.4 Post-transfer changes in top management

According to Barclay and Holderness (1991), a block transfer is a control event if it is associated with large abnormal stock returns and top management turnover. Block-trade announcements were shown to be associated with large positive and statistically significant abnormal stock returns. In this section, I further examine their association with top management turnover.

Out of 78 announcements, I identified 25 cases, or 32 percent of the sample, where the CEO was replaced within 12 months following the announcement. This compares with a 33 percent CEO turnover within the 12 months following negotiated block trades at US firms, as reported by Barclay and Holderness (1991). I cannot address the frequency with which CEOs are replaced at the typical listed Chinese firm, as these data are not readily available. However, Comment (1985) reports that only about 5 percent of CEOs turn over annually at large US firms. Groves, *et al* (1995) report that Chinese managerial turnover in SOEs in the 1980s is slightly more frequent than that of managers in the US and Japan.

While I cannot make definitive conclusions about whether the CEO turnover in my sample is significantly greater than that at the average listed Chinese firm, I can test whether the identity of the blockholder can explain whether or not the top executive is replaced. I find that the CEO is replaced within twelve months for 56 percent of the firms that have an LPSOE as new blockholder, whereas this number is only 25 percent when a SSOE becomes the new blockholder. This 31 percentage-point difference is significant at the 5 percent level, strongly supportive of the hypothesis that the identity of the block holder is important.

These results support the hypothesis that LPSOEs are significantly more likely to discipline management than are SSOEs. Even though LPSOEs are ultimately controlled by the State, the presence of private blockholders in the ultimate ownership structure seems to provide a substantial improvement in the managerial labor market.

Table 4.5 reports the results from a probit regression where the dependent variable is an indicator variable that is equal to one if the firm's CEO was replaced within 12 months of the block trade announcement and equal to zero otherwise. The explanatory variables are identical to those used to analyse cross-sectional variation in the cumulative abnormal returns shown in Table 4.4. I find that two of the six variables are statistically significant at better than the 10 percent level, and the pseudo-R^2 indicates that this specification explains about 2 percent of the variation in CEO turnover for my sample of firms.

LPSOE, which indicates that the new blockholder is an LPSOE, is positive and significant with a p-value less than 0.01. This indicates that firms where an LPSOE was involved in a block transfer are more likely to experience a management change during the 12 months after the transfer announcement than are firms where an SSOE was involved. This is consistent with the observation that LPSOEs are more independent legal entities, compared to SSOEs which are fully owned by government. Perhaps of more importance from a corporate governance viewpoint, LPSOEs are required to hold annual shareholders' meetings, which provide shareholders with a tool to exercise their control rights and force management to focus on profit maximization by disciplining poorly performing managers. L*n(assets)* is negative and significant with a p-value of 0.09, indicating that the replacement of CEOs is more likely at smaller firms.

Table 4.5

Probit regression to explain the determinants of CEO turnover

CEO equals one if the CEO is replaced within one year following the block share transfer and zero otherwise. Shares transferred (%) represents shares being transferred from GAs to SSOEs or LPSOEs. Transfer to LPSOE is a dummy variable that equals one if shares are transferred to LPSOE and zero otherwise. New Control is a dummy variable that equals one if the share transfer results in a new largest blockholder and zero otherwise. GA Retains> 10% is a dummy variable that equals one if GA holds more than 10 percent of shares after block transfer and zero otherwise. Leverage ratio for each firm is calculated as the book value of total liabilities divided by the book value of total assets. Firm size (ln(assets)) is calculated by the natural logarithm of the book value of firm's total assets at end of year prior to share transfer.

Variables	CEO replacement (p-value)
Intercept	13.49
	(0.13)
Shares Transferred	-3.69
	(0.11)
Transfer to LPSOE	**1.66**[a]
	(0.01)
New Control	1.12
	(0.21)
GA Retains >10%	0.50
	(0.47)
Leverage Ratio	1.30
	(0.42)
Ln (assets)	**-0.74**[c]
	(0.09)
Pseudo-R^2	0.02

a, b, and c indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

4.5 Summary

In this study, I analyse share price reactions around announcements of negotiated block transfers between different State-ownership structures for a sample of State-controlled firms that are publicly traded on Chinese stock exchanges. I also analyse top-management turnover following these block transfers.

I find changes in firm value and CEO turnover are much greater when a government agency (GA) transfers a block of shares to a state-controlled enterprise with a private joint venture partner (LPSOE) rather than to a solely state owned enterprise (SSOE). LPSOEs have stronger incentives and are better equipped than SSOEs and GAs to monitor and discipline firm management. The wedge between cash flow rights and control rights is smaller for LPSOE blockholders than for SSOE or GA blockholders. Furthermore, LPSOEs are required to hold annual shareholder meetings at which the members of Board of directors can be elected.

My results suggest that block transfers between different State owners are true control events, as defined by Barclay and Holderness (1991). First, they result in positive cumulative abnormal returns of two percent in total and more than six percent for block share transfers from GAs to LPSOEs, and the cross-sectional variation in these abnormal returns can be explained by differences in identities of the blockholders. Second, the block transfers are followed by top management changes at more than 30 percent of the sample firms, and, again, these changes can be explained by the characteristics of the new blockholders. Hence, this Chapter contributes evidence from international markets confirming that the identity of the blockholder is an important determinant of firm value.

Finally, my results contribute to evidence on the market for partial corporate control (Bethel, *et al*, 1998). I find that intra-governmental block transfers that reduce the wedge between cash-flow rights and control rights can have important effects on firm value and CEO turnover, even when the State maintains ultimate control. This result has important policy implications because of the prevalence of ultimate State control around the world (La Porta, *et al,* 1999 and Claessens, *et al,* 2000).

APPENDIX 4.1

Market model estimation and test statistic calculation

The market model is as follows:

$$R_{it} = \alpha_i + \beta_i R_{mt} + e_{it} \quad (1)$$

where

R_{it} = Daily return on stock *i* for the period from day -160 to day -11[38].

R_{mt} = Daily return on an index using both the SHSE and the SZSE composite index that gives equal weight to both markets.

α_i, β_i = The market model parameters for firm *i* estimated from day -160 to day -11.

$\boldsymbol{e_{it}}$ = Residual

It is assumed that

$E(e_{it}) = 0$

$\sigma(e_{it}, e_{jt}) = 0 \quad \forall \quad i \neq j$

The abnormal return is calculated as follows:

$$AR_{it} = R_{it} - (\hat{\alpha}_i + \hat{\beta}_i R_{mt}) \quad (2)$$

where

AR_{it} = Daily abnormal return for stock *i* on day *t*.

[38] Both R_{it} and R_{mt} are logarithmic returns.

After calculating the abnormal return for each stock on day *t*, I calculate the cumulative average abnormal return (CAR) using the following formula:

$$CAR_{b,e} = \frac{1}{N}\sum_{i=1}^{N}\sum_{T=b}^{e} AR_{it} \qquad (3)$$

where

N = Number of observations in the sample.

T = T runs from b to e, indicating the period over which the returns are cumulated.

The test statistic is the ratio of the mean daily excess return to its estimated standard deviation (Brown and Warner 1980, 1985); the standard deviation is estimated from the time-series of mean excess returns.

The test statistic for any event day t is:

$$t - statistics = \overline{AR_t} / S(\overline{AR_t}) \qquad (4)$$

Where

$$\overline{AR_t} = \frac{1}{N}\sum_{i=1}^{N} AR_{it} \qquad (6)$$

$$S(\overline{AR_t}) = \sqrt{(\sum_{t=-160}^{t=-11}(\overline{AR_t} - AR^*)^2)/150} \qquad (7)$$

$$AR^* = \frac{1}{150}\sum_{t=-160}^{t=-11}\overline{AR_t} \qquad (8)$$

For tests over the (b, e) interval, the test statistic is the ratio of the cumulative mean excess return to its estimated standard deviation, and is given by

$$\sum_{t=b}^{e} \overline{AR_t} / (\sum_{t=b}^{e} S^2(\overline{AR_t}))^{1/2} \qquad (9)$$

CHAPTER 5

EXPROPRIATION THROUGH RELATED GUARANTEES: EVIDENCE FROM CHINA

5.1 Introduction

In recent years corporate governance researchers have increasingly shifted their focus from the conflict of interests between diffuse shareholders and managers, to the protection of minority shareholders from expropriation by controlling shareholders. This shift in focus reflects the growing awareness that concentrated ownership is common across the world, and that controlling shareholders are likely to use a firm's resources for their own benefit when the rights of minority shareholders are not well protected (La Porta, *et al*, 1999). Johnson, *et al* (2000b) argue that expropriation of minority shareholders, or "tunnelling", is a worldwide phenomenon and can take various forms. For example, controlling shareholders can use asset sales, transfer pricing, dilutive share issues, and loan guarantees to expropriate wealth from minority shareholders.

One of the problems of empirical research in this area is that 'tunnelers' usually cannot be explicitly identified because of the hidden nature of their activities. Despite this difficulty, recent papers try to provide direct evidence on expropriation by controlling shareholders. For example, Bertrand, *et al* (2000) provide evidence of resource diversion in Indian corporate pyramids that disadvantages minority shareholders. La Porta, *et al* (2002c) find that Mexican banks tend to lend to firms controlled by the bank's owner on much more favourable terms than to other clients. Bae, *et al* (2002) show how controlling shareholders in Korean chaebols use intra-group acquisitions to expropriate the wealth from minority shareholders.

More indirect evidence on the relevance of expropriation by controlling shareholders is provided in La Porta, *et al* (2002b). They find that firms in countries with better investor protection have higher values as measured by Tobin's Q. La Porta, *et al* (2000a) show that countries with better protection of minority shareholders tend to have higher dividend payments. Claessens, *et al* (2002) find that Tobin's Q decreases with the separation of cash-flow rights from the control rights of the largest shareholder. Similarly, Joh (2003) finds an inverse relation between return on assets and the separation of cash-flow rights from the control rights of the largest shareholder. Finally, Brockman and Chung (2003) show that weak investor protection results in an increase in bid-ask spreads.

A possible weakness of the indirect approach is that the probability of expropriation is not measured explicitly. However, the hypothesized positive relation between the quality of corporate governance (regulatory framework or ownership structure variables) and a performance measure such as Tobin's Q is based on the assumptions that i) the probability of expropriation is negatively correlated with the quality of corporate governance and ii) the probability of expropriation is negatively correlated with Tobin's Q. This study analyses both of these relations separately, thereby testing the validity of the assumptions that underlie much of the existing empirical literature regarding expropriation by controlling shareholders.

Using 1999 annual reports, I identify a set of 88 Chinese listed firms where the large shareholders engaged in an unambiguous form of tunnelling, by obtaining a debt guarantee from the firm for loan(s) unrelated to the business of the firm. In most

developed markets, regulators prohibit such 'related guarantees,' but they were permissible in China and used by many listed companies during the 1990s.[39]

Observing the issuance of related guarantees, I have a more unambiguous measure of expropriation than the measures used in previous studies.[40] This information is used to contribute to the literature in two ways. As far as I know this paper is the first to analyze the relation between the probability of expropriation and several firm characteristics. Second, I analyze the relation between expropriation and several measures of firm performance used in previous studies such as Tobin's Q, ROA, dividends, leverage and the bid-ask spread.

The first set of results shows that expropriation through related guarantees is less likely when controlling shareholders have more substantial cash-flow rights. I find evidence that the presence of other blockholders reduces the likelihood of a firm issuing a related guarantee. Finally, I find that private controlling shareholders are more likely to use related guarantees to expropriate wealth from minority shareholders than State shareholders. This last finding is consistent with the extensive expropriation by private blockholders after privatisation in Russia and the Czech Republic.[41]

My second set of tests, analysing the association between expropriation and measures of firm performance indicates that firms issuing related guarantees have significantly lower values of Tobin's Q, ROA, and dividend yield than do other firms.

---

[39] Johnson, *et al* (2000b) discuss how related guarantees in some European countries are used to expropriate wealth from minority shareholders. Bae, *et al* (2002) mention loan guarantees issued among members of Korean chaebols, and Bertrand, *et a*l (2000) mention the use of related guarantees by Indian firms.

[40] Bertrand, *et al* (2000), Bae, *et al* (2002) and La Porta, *et al* (2002c) are all cautious to point out that the actions of controlling shareholders might be motivated by reasons other than expropriation.

[41] See Black, *et al* (2000), Fox and Heller (2000), and Coffee (1999).

This evidence validates the use of these measures in previous studies as a proxy for the level expropriation (after inclusion of appropriate controls).[42] In addition, I find that the leverage ratio of firms issuing related guarantees are significantly higher than other firms. This evidence is consistent with the view that Chinese State-owned-banks (SOBs) are accommodating expropriation and are passive monitors of their claims. I do not find significant differences in the bid-ask spreads of firms that issue related guarantees and other firms, suggesting that this variable is a less effective proxy for the level of expropriation.

When both sets of results are combined additional insight is gained into the relation between corporate governance and expropriation of minority shareholders. For example, I find that State shareholders are less likely to expropriate minority shareholders than non-State shareholders, while, at the same time, State ownership is negatively related to firm performance as measured by Tobin's Q. These results can be reconciled by noting that Tobin's Q is likely to be a measure of both the agency costs related to expropriation of minority shareholders and the agency costs related to the conflict of interest between shareholders and management. It is difficult to separate both agency costs and the existing cross-sectional regressions can not unambiguously attribute differences in Tobin's Q to differences in protection of minority shareholders (as opposed to differences in the shareholder-management agency conflict). As argued above, controlling shareholder obtaining loan guarantees do unambiguously expropriate wealth from minority shareholders, so my sample of firms issuing related guarantees enables me to more directly test the impact of tunnelling on measures of financial performance.

---

[42] See La Porta, *et al* (2000a, 2002b), Claessens, *et al* (2002), Joh (2003), Faccio, *et al* (2001b).

The remainder of this study is organized as follows. I discuss related guarantees and develop my hypotheses in Section 5.2. Section 5.3 describes the data. Section 5.4 presents results regarding the likelihood of the issuance of related guarantees and several firm characteristics, and how the issuance of related guarantees impacts five proposed measures of expropriation. Section 5.5 provides a summary.

5.2 Background and hypotheses

5.2.1 Related guarantees

A related guarantee refers to a guarantee issued by one entity that it will ensure repayment of a loan made to a related entity by a third party, usually a bank. In my case, the entity issuing the guarantee is a listed firm and the related entity is the major shareholder of the listed firm. In this research, the listed firm typically pledges its assets as collateral in association with the guarantee.[43] The related guarantee benefits the large shareholder in two ways. First, it enables the large shareholder to obtain financing at a lower interest rate than otherwise would be available. Second, it provides the large shareholder with an option to default on the loan, leaving the burden of repayment to the listed company.

The following example illustrates the extent to which minority shareholders can be expropriated and the extent to which creditors are exposed to expropriation through the issuance of related guarantees. At the end of 2000, the parent company of *Monkey King* (a listed company) was placed in liquidation. Until 1999, *Monkey King* had outstanding loans to the parent company totalling 890 million Yuan, or more than

[43] The importance of related guarantees issued by listed firms can be illustrated with a quote from an officer of a major State-controlled bank: "If listed companies can not be qualified as debt guarantors in China, no other firm would be qualified." *New Fortune,* issue 8 (2001).

US$ 100 million. It had also guaranteed the debt of its parent for a total sum of 244 million Yuan. However, year-end total assets of *Monkey King* amounted to only 934 million Yuan, exposing not only minority shareholders, but also creditors to the risk of default by the parent company (CSRC, 2002).[44]

5.2.2 Firm characteristics and the likelihood of expropriation

I hypothesize that the likelihood of expropriation of minority shareholder wealth by a large shareholder is related to a number of observable firm characteristics.

First, I conjecture that expropriation by non-state shareholders is more likely than expropriation by State shareholders. Non-state shareholders directly benefit from expropriation, whereas State shareholders benefit less directly from expropriation as cash flows accrue to the general population rather than the bureaucrats who control the State shares. Furthermore, private shareholders are more likely to need related guarantees in order to obtain financing from SOBs than are State shareholders. Hence, I hypothesize that listed firms are more likely to issue related guarantees when the major shareholder is a non-government corporate investor.

Second, I expect that firms where the large shareholder has a substantially greater portion of control rights than cash-flow rights are more likely to issue related guarantees. For example, a single large shareholder may only hold 30 percent of

[44] More examples of how related guarantees are used to expropriate minority shareholders in China can be found in *New Fortune* issues 7 and 8 (2001). Note that in an attempt to enhance corporate governance in China, one of the steps taken by the CSRC was to introduce a new regulation in June 2000, prohibiting the issuance of debt guarantees to shareholders of listed firms, or subsidiaries of these shareholders. For more details, see Berkman, *et al* (2003).

shares, but might have full control of the board.[45] In this case, the substantial wedge between control rights and cash-flow rights gives the largest shareholder a strong incentive to expropriate minority shareholders. On the other hand, when the largest shareholder owns, for example, 80 percent of the firm, cash-flow rights and control rights are better aligned, giving the controlling shareholder less incentive to expropriate minority shareholders. La Porta, *et al* (2002b) and Claessens, *et al* (2002) provide evidence that shows an increase in the cash-flow rights of the controlling shareholder is positively related to firm value as measured by Tobin's Q (which they attribute to a lower probability of tunnelling).

Several recent papers argue that multiple blockholders can be an effective mechanism to reduce expropriation.[46] According to the theoretical models, multiple blockholders monitor one another in order to protect their interests, to the benefit of the minority shareholders. Even in case of collusion between the blockholders, minority shareholders are likely to benefit as coordination problems between blockholders potentially increase the costs of tunnelling. Hence, I hypothesize that firms with multiple blockholders are less likely to issue related guarantees.

I also expect that firms issuing related guarantees are larger than firms without related guarantees. Large firms are more likely to be the target of expropriation, simply because there is more value to expropriate. In addition, State-owned-banks (SOBs) are more likely to approve loans guaranteed by large firms because of their

---

[45] Given that most listed firms are controlled by a single large shareholder and limited disclosure on the details of ownership structure of the major shareholder in the Chinese stock market, I simply use the ownership of the largest shareholder to proxy its total cash-flow rights. Therefore, the measure of cash-flow right in this study is upward biased.

[46] See Pagano and Roell (1998), Bennedsen and Wolfenzon (2000), Gomes and Novaes (2001), Bloch and Hege (2001), and Lins (2003).

focus on accounting numbers and lack of expertises in credit analysis and risk management. Hence, I hypothesize that firm size is positively related to the probability of expropriation through the issuance of related guarantees.

5.3 Data

My sample includes 900 listed companies with A-shares outstanding that were listed on either the SHSE or SZSE as of year-end 1999. I exclude firms with shares listed on overseas stock exchanges because these firms have significantly different governance structures than firms issuing only domestic shares.[47] Out of the 900 firms in my sample, I identify 88 firms that, according to their annual reports, had issued related guarantees.[48] For each listed firm, I obtain financial and ownership data from WWW.CNINFO.COM.CN and obtain daily share price information from DataStream.[49]

In the subsequent empirical tests, I use two sets of variables. The first set of variables are firm characteristics that might be related to the issuance of related guarantees. I define a dummy variable, *Non-State*, that is equal to one if a Non-State shareholder is the largest shareholder and zero otherwise.[50] *Blockholder* is a dummy variable that is equal to one when the firm has at least one other blockholder owning 5

[47] Firms with B shares are included in our sample since these firms still abide by the domestic listing rules. Given that B shares account for only a small portion of the outstanding shares of the firms with B-shares, I use only A-share prices in this research.

[48] There are 11 out of 88 firms that issued related guarantees to their non-controlling blockholders. When I exclude these 11 firms, the results are qualitatively similar to the results presented in this study.

[49] WWW.CNINFO.COM.CN is one of the major corporate information providers in China and is sponsored by CSRC.

[50] LPSOE shares used to be classified as LP shares. As of July 2000, the CSRC reclassified LPSOE shares as State shares. In this research, I follow the CSRC's new share classification.

percent of the shares or more. *Firm size* is the natural logarithm of the book value of the firm's total assets as of year-end 1999. Finally, as a measure of the cash flow rights of the controlling shareholder, I use the percentage of shares held by the largest shareholder (*Large Shareholding*).

The second set of variables measures the impact of related guarantees on the financial performance of my sample firms. *Tobin's Q* is calculated as the product of the firm's total number of outstanding shares multiplied by the share price plus the book value of its total debt, divided by the book value of total assets (all measured at the end of 1999). *ROA* is the firm's net income divided by the book value of total assets at the end of year 1999. *Dividend yield* is the total dividend paid by a firm during 1999, divided by the share price as of year-end 1999. *Leverage* is the book value of debt divided by the book value of total assets. The *bid-ask spread* is calculated as the mean bid-ask spread during all 22 trading days in December 1999.[51] After calculating the raw measures of Tobin's Q, ROA, dividend yield and leverage, I calculate the industry-adjusted measures by subtracting the median value for that measure for the firms in the same industry. Industry sectors are defined at the level of two-digit SIC codes. The industry codes are from the CSRC.

5.4 Results

5.4.1 Related guarantees and firm characteristics

Table 5.1 presents descriptive statistics for the full sample, the 88 firms that issued related guarantees and the 812 firms without guarantees, respectively.

[51] There are only 793 firms for which I could obtain closing bid and ask quotes; 87 of these firms issued related guarantees.

Table 5.1

Sample descriptive statistics

The table presents the mean and median (in brackets) for my sample firms. The last column presents the difference in the means for the firms with and without related guarantees (t-statistic in brackets). *Non-State* is a dummy variable that is equal to one if a Non-State shareholder is the largest shareholder and zero otherwise. *Blockholder* is a dummy variable that is equal to one when the firm has at least one other blockholder owning 5 percent of the shares or more and zero otherwise. *Firm size* is the natural logarithm of the book value of the firm's total assets as of year-end 1999. *Large Shareholding* is the percentage of shares held by the largest shareholder.

	Full Sample	Firms with Related Guarantee	Firms without Related Guarantee	Difference
Non-State	0.20 (0.00)	0.27 (0.00)	0.20 (0.00)	**0.08**[c] (1.70)
Largest shareholding	0.45 (0.44)	0.45 (0.43)	0.45 (0.44)	-0.01 (-0.23)
Blockholder	0.51 (1.00)	0.45 (0.00)	0.52 (1.00)	-0.06 (-1.10)
Leverage	0.43 (0.42)	0.52 (0.53)	0.43 (0.41)	**0.09**[a] (4.27)
Firm size	11.52 (11.45)	11.73 (11.67)	11.49 (11.42)	**0.24**[b] (2.43)

a, b, and c indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

The table shows that 27 percent of the firms with related guarantees have a non-State shareholder as largest shareholder, whereas this is 20 percent for firms without related guarantees. The difference is significant at the 10 percent level. The average ownership of the largest blockholder is 45 percent for both the firms with and without related guarantees. About 45 percent of the firms that issued related guarantees have at least one other large blockholder compared to 52 percent for the other firms. This difference is not statistically significant. The average leverage ratio for firms that issued related guarantees is 52 percent and 43 percent for the other firms. This difference is significant at the 1 percent level. The sample firms range in

size from RMB 58.72 million to RMB 45.87 billion (US$ 7.12 million to US$ 5.56 billion). The average size of firms with related guarantees is significantly larger than for firms without related guarantees.

Table 5.2

Spearman correlations

Related Guarantee is a dummy variable that equals one if a firm issued a related guarantee and zero otherwise. *Non-State* is a dummy variable that is equal to one if a Non-State shareholder is the largest shareholder and zero otherwise. *Blockholder* is a dummy variable that is equal to one when the firm has at least one other blockholder owning 5 percent of the shares or more and zero otherwise. *Firm size* is the natural logarithm of the book value of the firm's total assets as of year-end 1999. *Large Shareholding* is the percentage of shares held by the largest shareholder.

	Related Guarantee	Non-State	Largest Shareholding	Blockholder	Leverage	Firm Size
Related Guarantee	1.00 (0.00)					
Non-State	**0.06**[c] (0.09)	1.00 (0.00)				
Largest Shareholding	0.01 (0.77)	**-0.28**[a] (0.00)	1.00 (0.00)			
Blockholder	-0.04 (0.27)	**0.24**[a] (0.00)	**-0.57**[a] (0.00)	1.00 (0.00)		
Leverage	**0.14**[a] (0.00)	0.01 (0.81)	**-0.14**[a] (0.00)	0.04 (0.21)	1.00 (0.00)	
Firm Size	**0.10**[a] (0.00)	**-0.80**[a] (0.01)	**0.20**[a] (0.00)	**-0.19**[a] (0.00)	**0.16**[a] (0.00)	1.00 (0.00)

a, b, and c indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

Table 5.2 presents the spearman correlations among the firm characteristics for all my sample firms. *Related Guarantee* is a dummy variable that equals one if a firm issued related guarantees and zero otherwise.

Concentrating on the significant correlations, it can be seen that firm size is positively correlated with leverage, the ownership of the largest shareholder and the related guarantee dummy. There is a negative relation between firm size and the

presence of a non-state controlling shareholder and the presence of multiple blockholders. The ownership of the largest shareholder tends to be lower for non-state owned firms, tends to be lower when there are other blockholders and decreases in leverage. The results also indicate that firms dominated by non-State shareholders are likely to be smaller and tend to have other large blockholders.

Table 5.3

Logistic regression to explain the issuance of related guarantees

Related Guarantee equals one if a firm issued a related guarantee and zero otherwise. *Non-State* is a dummy variable that is equal to one if a Non-State shareholder is the largest shareholder and zero otherwise. *Blockholder* is a dummy variable that is equal to one when the firm has at least one other blockholder owning 5 percent of the shares or more and zero otherwise. *Firm size* is the natural logarithm of the book value of the firm's total assets as of year-end 1999. *Large Shareholding* is the percentage of shares held by the largest shareholder. Industry sectors are defined at the level of two-digit SIC codes. The industry codes are from the CSRC.

Variable	Related Guarantee
Intercept	-15.09
	(0.90)
Non-State	**0.71**[a]
	(0.01)
Largest Shareholding	**-1.55**[c]
	(0.07)
Blockholder	**-0.57**[b]
	(0.05)
Firm Size	**0.60**[a]
	(0.00)
Industry	Yes
Pseudo-R^2	0.14

a, b, and c indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

In order to control for the simultaneous influence of the explanatory variables, I use exact logistic regression to test the hypotheses with regard to firm characteristics

and the likelihood of expropriation through the issuance of related guarantees. [52] In the logistic regression, the dependent variable is a dummy variable that is equal to one for firms with related guarantees and is equal to zero otherwise. Table 5.3 presents the results from this analysis.

It can be seen that the coefficient of *Non-State* is positive and significant at better than the 1 percent level, supporting my hypothesis that private controlling shareholders are more likely to use related guarantees than is the State. This result appears to contradict the general finding that State ownership has a negative effect on firm value.[53] However, evidence that private parties are more likely to expropriate minority shareholders' wealth is consistent with the evidence of extensive expropriation from minority shareholders following the mass privatizations in Russia and the Czech Republic.[54]

The shareholding of the largest shareholder is negative and significant at better than the 10 percent level, supporting the hypothesis that the probability of tunnelling through the issuance of loan guarantees decreases as the cash flow rights of the largest shareholder increase.[55]

The coefficient of *Blockholder* has the expected negative sign indicating that a firm with multiple blockholders is less likely to issue a related guarantee, and is statistically significant at the 5 percent level. It is interesting to note that several firms issued a related guarantee to the major shareholder despite the presence of multiple

[52] Mehta and Patel (1995) recommend that exact logistic regression be used when data are unbalanced, i.e. a relatively large number of the response variables are either 0 or 1.
[53] See Megginson, *et al* (1994), Shleifer and Vishny (1994), and Xu and Wang (1999).
[54] See Black, *et al* (2000), Fox and Heller (2000), and Coffee (1999).
[55] See La Porta, *et al* (2002b), Claessens, *et al* (2002) and Joh (2003).

blockholders. This observation suggests collusion among major blockholders, which is consistent with Faccio, *et al* (2001b).

Finally, I find that firm size is positive and significant at better than the 1 percent level. This supports the hypothesis that larger firms are more likely to be targets of the expropriation simply because they have more value to expropriate.

5.4.2 Related guarantees and financial measures

Recent studies examining expropriation of minority shareholder wealth implicitly assume that lower quality of corporate governance increases the probability of tunnelling, which, in turn, negatively impacts financial variables. For example, a higher ratio of control to cash-flow rights leads to a higher probability of tunnelling, which, in turn, leads to lower Q.[56]

This study tests the validity of both underlying assumptions. The previous section showed that the presence of multiple blockholders and a lower wedge between control rights and cash flow rights reduces the probability of expropriation. If the underlying assumption that the probability of tunnelling adversely impacts the financial variables is correct, then I expect to find negative relations between the issuance of related guarantees and Q, ROA, and dividend yield and positive relations between the issuance of related guarantees and bid-ask spreads and leverage.

Two caveats are in order when interpreting the results in this section. First, I expect that the issuance of a related guarantee proxies for the likelihood and extent of expropriation in general (supportive evidence is presented later). Second, expropriation of minority shareholders is a general problem in the Chinese stock

[56] See La Porta, *et al* (2000a, 2002b), Faccio, *et al* (2001a, b), Claessens, *et al* (2002), Joh (2003), and Brockman and Chung (2003).

market, and is not limited to the firms that issued related guarantees; hence, estimates of the difference in financial variables between the firms that issued related guarantees and other firms are biased downward from the true value impact of expropriation.

Table 5.4

Descriptive statistics for Q, ROA, dividend yield, and bid-ask spreads

The table presents the mean and median (in brackets) for my sample firms. The last column presents the difference in the means for firms with and without related guarantees (t-statistic in brackets). *Tobin's Q* is calculated as the product of the firm's total number of outstanding shares multiplied by the share price plus the book value of its total debt, divided by the book value of total assets (all measured at the end of 1999). *ROA* is the firm's net income divided by the book value of total assets at the end of year 1999. *Dividend yield* is the total dividend paid by a firm during 1999, divided by the share price as of year-end 1999. *Leverage* is the book value of debt divided by the book value of total assets. The *bid-ask spread* is calculated as the mean bid-ask spread during all 22 trading days in December 1999. After calculating the raw measures of Tobin's Q, ROA, dividend yield and leverage, I calculate the industry-adjusted measures by subtracting the median value for that measure for the firms in the same industry. Industry sectors are defined at the level of two-digit SIC codes. The industry codes are from the CSRC.

	Full Sample	Firms with Related Guarantee	Firms without Related Guarantee	Difference
Q (adj)	0.42 (0.00)	-0.28 (-0.38)	0.50 (0.02)	**-0.77**[a] (-3.66)
ROA (adj)	-0.01 (0.00)	-0.03 (-0.01)	-0.01 (0.00)	**-0.02**[a] (-3.18)
DIV (adj)	0.01 (0.00)	0.00 (0.00)	0.01 (0.00)	-0.01 (-0.95)
BAS	0.02 (0.02)	0.02 (0.02)	0.03 (-0.02)	**-0.01**[c] (-1.77)
LEV (adj)	0.01 (0.00)	0.10 (0.09)	0.01 (0.00)	**0.09**[a] (4.45)

a, b, and c indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

Table 5.4 presents descriptive statistics for the five expropriation measures: industry-adjusted Q, industry-adjusted ROA, industry-adjusted dividend yield (DIV)

and industry-adjusted leverage (LEV), and the bid-ask spread (BAS) for all sample firms and firms with and without related guarantees, respectively. The last column reports the difference in the means of firms that did and did not issue related guarantees.

Consistent with expectations, these results show that industry-adjusted Tobin's Q and ROA are both significantly lower for firms that issued related guarantees, and industry-adjusted leverage is significantly higher for these firms. Dividend yield and the bid-ask spread for firms with related guarantees are smaller, on average, than for firms without related guarantees. However, the differences for dividend yield is not significant, whereas the difference in the bid ask spread is only significant at the 10 percent level.

Table 5.5 presents the results of cross-sectional regressions for each of the five different financial measures of expropriation. To test the impact of related guarantees on the Tobin's Q, ROA, leverage and Dividend yield, I include the natural log of total firm assets, the non-state dummy and industry dummies as control variables in the regression model.[57] In the bid-ask spread regression, price, volume and standard deviation of returns are included as control variables (McInish and Wood, 1992).[58]

[57] See La Porta, *et al* (2000a, 2002b), Claessens, *et al* (2002), Joh (2003), and Faccio, *et al* (2001a, b).

[58] Price and volume are the average daily price and average daily volume for each stock in December 1999. The standard deviation for each stock is the standard deviation of the daily returns of that stock in December 1999.

Table 5.5

Cross-sectional regressions of different expropriation measures

Tobin's Q is calculated as the product of the firm's total number of outstanding shares multiplied by the share price plus the book value of its total debt, divided by the book value of total assets (all measured at the end of 1999). *ROA* is the firm's net income divided by the book value of total assets at the end of year 1999. *Dividend yield* is the total dividend paid by a firm during 1999, divided by the share price as of year-end 1999. *Leverage* is the book value of debt divided by the book value of total assets. The *bid-ask spread* is calculated as the mean bid-ask spread during all 22 trading days in December 1999. After calculating the raw measures of Tobin's Q, ROA, dividend yield and leverage, I calculate the industry-adjusted measures by subtracting the median value for that measure for the firms in the same industry. . Industry sectors are defined at the level of two-digit SIC codes. The industry codes are from the CSRC. Related Guarantee is a dummy variable equals to one if a firm issued related guarantee and zero otherwise. *Non-State* is a dummy variable that is equal to one if a Non-State shareholder is the largest shareholder and zero otherwise. *Firm size* is the natural logarithm of the book value of the firm's total assets as of year-end 1999.

Variables	Q (adj)	ROA (adj)	DIV (adj)	LEV (adj)	BAS
Intercept	**12.42**[a]	**-0.14**[a]	**-0.03a**	**-0.41**[a]	**-2.72**[a]
	(13.58)	(-4.12)	(-5.85)	(-4.05)	(-8.25)
Related	**-0.57**[a]	**-0.03**[a]	**-0.002**[c]	**0.08**[a]	-0.04
Guarantee	(-2.87)	(-3.64)	(-1.84)	(3.82)	(-1.00)
Firm Size	**-1.08**[a]	**0.01**[a]	**0.003**[a]	**0.04**[a]	**-0.09**[a]
	(-14.42)	(2.85)	(7.49)	(4.55)	(-4.71)
Non-State	**0.26**[c]	**-0.01**[c]	0.003	-0.00	0.00
	(1.77)	(-2.14)	(1.57)	(-0.12)	(0.85)
Price					**0.83**[a]
					(22.48)
Volume					**-0.15**[a]
					(-8.61)
STDEV					**0.25**[a]
					(4.61)
Industry	Yes	Yes	Yes	Yes	Yes
Adjusted R^2	0.20	0.02	0.10	0.02	0.52

a, b, and c indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

As shown in Table 5.5, Related Guarantee has the expected sign in each of the five regression models, except for the Bid-Ask Spread. Firms issuing related guarantees have significantly lower industry-adjusted Tobin's Qs, ROAs, and dividend yields; and have significantly higher leverage. The adjusted Tobin's Q for

firms with related guarantees is lower by 0.57, which indicates a substantial value discount for firms that are tunnelled using related guarantees. As argued previously, it is likely that the discount reflects more than just the presence of a related guarantee, but the difference is still remarkably large, given that it is likely that there is some degree of wealth expropriation in firms without related guarantees. The difference in ROA is 3 percentage points per annum, also indicative of substantial expropriation. Adjusted dividend is 0.2 percentage points lower for firms with related guarantees and leverage is 8 percentage points higher. The bid ask spread regression shows the expected signs on each of the control variables, but there is no evidence that firms with related guarantees have a higher bid ask spread.

Perhaps the most important result in Table 5.5 is the validation of the effectiveness of Tobin's Q, ROA, leverage[59] and dividend yield as measures of the expropriation, supporting the use of these measures as proxies for the level of expropriation from minority shareholders (after inclusion of appropriate controls).[60] However, the bid ask spread is much less effective as measure of expropriation than the other financial variables. I conjecture that the relation between the issuance of related guarantees and information asymmetry for firms operating within the same regulatory environment is simply too weak to be detected.

---

[59] Faccio, *et al* (2001a) find that Asian banks appear to be ineffective to stop controlling shareholders of a corporation lower down a pyramid to increase leverage to acquire more resources to expropriate. This finding implies that high leverage of a firm at lower pyramid level of a controlling group might be a proxy of expropriation by the controlling shareholder in a weak legal environment like China.

[60] See La Porta, *et al* (2000a, 2002b); Claessens, *et al* (2002), Joh, (2003), and Faccio, *et al* (2001a, b).

5.5 Summary

In this study, I identify a sample of listed firms that issued debt guarantees to their large shareholders, thereby expropriating or "tunnelling" wealth from their minority shareholders, or even creditors. I use this sample of firms to analyse determinants of tunnelling and to validate the assumed relationship between tunnelling and financial measures including Tobin's Q, dividend yield, leverage, and profitability. My results show that the issuance of related guarantees is more likely at firms with large private blockholders than at firms with the State as a large blockholder, and is more likely at larger firms, and firms with a single controlling blockholder with substantial separation of cash-flow rights and control rights.

I also find that firms that were tunnelled, as evidenced by the issuance of related loan guarantees, have significantly lower industry-adjusted measures of Tobin's Q, profitability, and dividend yield and have significantly higher leverage. There is no evidence of higher bid ask spreads for firms that issued related guarantees. Hence, this research contributes to the literature by providing validating evidence on some measures of tunnelling such as Tobin's Q, dividend yield, leverage, and profitability.

CHAPTER 6

THE VALUE OF MONITORING: EVIDENCE FROM BLOCKHOLDERS IN CHINA

6.1 Introduction

Concentration of ownership is often suggested as solution to the agency conflict between managers and dispersed shareholders, since large blockholders have an incentive to monitor management and the power to implement changes. However, in countries with weak legal protection, concentrated ownership might come at the cost of expropriation of minority shareholders by controlling shareholders. For example, Claessens, *et al* (2002) and Joh (2003) show that expropriation of minority shareholders increases, the larger the wedge between cash flow rights and control rights of the controlling shareholder.

Several recent papers argue that the presence of multiple blockholders is an ownership structure characteristic that might help to reduce the ability of controlling shareholders to expropriate minority shareholders because of "mutual monitoring" among blockholders.[61] Consistent with these theories, Lins (2003) reports that large non-management block holdings are positively related to firm value for a sample of 1433 firms from 18 emerging markets. According to Lins, large non-management blockholders act as a partial substitute for missing institutional governance mechanisms in countries with weak shareholder protection. Also consistent with monitoring by blockholders are the findings in Faccio, *et al* (2001b) that in Europe the presence of multiple block holders tends to result in higher dividend payout. For Asian countries, however, they report a negative relation between dividend payout

[61] See Bennedsen and Wolfenzon (2000), Gomes and Novaes (2001), and Bloch and Hege (2001).

and the presence of multiple blockholders, which they attribute to the lower level of investor protection in Asian countries.

The focus in this study is on the monitoring role of blockholders in China. Listed firms in China are characterised by relatively concentrated ownership, and controlling shareholders that typically control management. This study extends the literature by proposing measures to proxy for the level of monitoring by non-controlling blockholders, and by estimating the value discount for firms where collusion among major blockholders is likely.

This study uses two proxies for the likelihood of collusion among blockholders. The first proxy is based on the identity of the ultimate owner for each of the top-3 blockholders and distinguishes between private and public blockholders. I argue that given the conflicting objectives of the private blockholders and State blockholders, minority shareholders might gain from the presence of a State (private) non-controlling blockholder if the controlling blockholder is a private (State) blockholder in a weak legal environment.[62] My second proxy for collusion between blockholders is the issuance of guarantees by the listed firm for the debt of its major shareholders. In my sample of 854 firms there are 84 firms that issued these so-called 'related guarantees' to their major shareholders. Forty of these firms have substantial non-controlling blockholders that were apparently unwilling or unable to prevent the issuance of the related guarantees.

Consistent with the hypotheses, I find that the presence of non-controlling blockholders contributes to firm value only when the ultimate owner is different from

[62] Lins (2003) finds that non-controlling blockholders play a positive role when the ultimate owner differs from the ultimate owner of the controlling blockholder, but does not focus on the distinction between State and private owners.

the ultimate owner of the controlling blockholder in terms of the public/private distinction.[63] The closer alignment of interests if the ultimate owners of the blockholders are all public or all private, apparently eliminates the positive impact on firm value of the presence of multiple blockholders.

I also find that firms that issued related guarantees and have no other blockholders, or blockholders that are all public or all private, show no significant value discount. However, I do find a significant value discount for the 22 firms that issued related guarantees and have major blockholders with different (public/private) ultimate owners. I interpret these results as further evidence that non-controlling blockholders are only perceived to be efficient monitors in China if the identity of the ultimate owner is different from the identity of the ultimate owner of controlling shareholder in terms of the public/private distinction. Furthermore, the results suggest that collusion between major blockholders is not uncommon in a weak legal environment such as China.

The remainder of the study is organized as follows. Section 6.2 presents the literature review and hypotheses. I describe the data in Section 6.3. In Section 6.4, I present the analysis and empirical results. Section 6.5 provides a summary.

6.2 Literature review and hypotheses

This section first discuses the role of non-controlling blockholders as monitors as suggested in recent theoretical models. Next, I argue that collusion between blockholders might be a more accurate description of reality in China.

[63] I use a 5 percent cut-off for my definition of blockholder. This definition is consistent with the definition used by the China's Securities Regulatory Commission (CSRC) to classify influential blockholders in the Chinese stock markets.

Bennedsen and Wolfenzon (2000) show that expropriation is minimised if there is either a single large shareholder, or multiple shareholders of roughly the same size. Similarly, Gomes and Novaes (2000) show how ex-post bargaining problems among multiple controlling shareholders may prevent business decisions that are in the collective interest of the controlling group, but harm minority shareholders. Pagano and Roell (1998) focus on the monitoring activities of a large external shareholder and how this reduces the ability of the controlling shareholder to expropriate. They extend their model to an environment with weak legal protection of minority shareholders and argue that, in this situation, it is likely that the controlling shareholder will pay off the other large shareholders to limit their monitoring activity (for example, in the form of favourable supply contracts, loans, or other transactions). Note that even in this situation the presence of multiple blockholders might make expropriation more costly and could benefit minority shareholders.

6.2.1. Hypotheses: Multiple block holders in China

There is ample anecdotal evidence of collusion among major blockholders in listed Chinese firms. For example, according to Shanghai Securities times (July, 2003), the two largest shareholders of SDG Information, 'Shenzhen Economic Zone Development Group' and 'Shenzhen Telecommunication Industry Co', transferred RMB 200 millions from SDG Information, during the years 2000 and 2001, for their own investment projects without paying back. Another example relates to Hubai

Biocause Pharm, where the large blockholders cooperated to manipulate secondary market share prices of two listed firms.[64]

Since State shares and LP shares are not freely tradable in the share market, non-controlling blockholders (State or Private) face the choice to be passive holders of their block, to monitor the controlling blockholder, or to collude with the controlling blockholder. If the non-controlling blockholders choose to be passive, they are likely to become the victim of expropriation as the option to 'vote with their feet' does not exist given the lack of liquidity of their blockholding. I conjecture that the choice to monitor or collude with the controlling shareholder depends on the objectives of the blockholder, which in turn is likely to be related to the identity of the ultimate owner.[65]

The main distinction in type of blockholder in China is between blockholders that are ultimately owned by the State, and blockholders that are ultimately owned by private parties. I conjecture that expropriation in the form of 'tunnelling' is more likely to occur if the controlling blockholder is a private party since they directly benefit from expropriation. State shareholders on the other hand, are ultimately owned by 'the people', and benefit less directly from expropriation.[66] However, this relative advantage of the State as controlling shareholder comes at a cost to the minority shareholders. Since the bureaucrats in control of State assets have full

---

[64] See www.stock2000.com.cn for more cases of tunnelling and stock market manipulation in the Chinese stock markets.

[65] Holderness and Sheehan (1988b) argue that the identity of large blockholders is an important characteristic to understand the influence of ownership concentration on firm value. Different types of owners face different trade-offs with regard to maximization of firm value and the private benefit of control.

[66] Consistent with this conjecture, evidence from Russia and the Czech Republic shows large scale expropriation following privatisation (Black, *et al*, 2000 and Fox and Heller, 2000 and Coffee, 1999).

control rights and limited cash flow rights, they have limited incentive to monitor management, increasing the (traditional) agency costs. Furthermore, the State shareholder might try to gain political benefits and use resources to pursue goals other than profit maximization (Shleifer and Vishny, 1994 and Xu and Wang, 1999).

I conjecture that the conflicting interests of private and state owners are potentially beneficial to minority shareholders as both diversion of assets by management and diversion of assets by the controlling blockholder might be reduced under a mixed ownership. Note that this conjecture is in sharp contrast with empirical evidence from Western economies where mixed enterprises are found to underperform both purely private and purely state owned firms (Boardman and Vining, 1989) and partially supports the argument by Qian (2000) that State ownership can be beneficial to investors in a weak legal environment.

6.3 Data

My initial sample includes 872 listed companies from both the SHSE and the SZSE at the end of the year 1999.[67] I obtain information on firm characteristics and ownership structure from WWW.CNINFO.COM.CN, which is the official stock information website sponsored by the CSRC. Share price information is from DataStream.

I use industry-adjusted Tobin's Q (*Q (adj)*) as measure of firm value (La Porta, *et al*, 2002b and Claessens, *et al*, 2002). Tobin's Q is defined as the product of the total number of outstanding shares at the end of year 1999 multiplied by the share price at year end plus the book value of total debt, divided by the book value of total

[67] I exclude firms with overseas listing because different corporate governance rules apply to these firms.

assets at the end of year 1999. I control for differences in Q across industries by calculating the median Q for each industry and then by subtracting the appropriate industry median from each firm's Q. Industry sectors are defined at the level of two-digit SIC codes, which were obtained from the CSRC.

Table 6.1

Sample descriptive statistics

	Sample firms	Mean	Std	Median	Min	Max
Q (adj)	872	0.02	1.90	-0.36	-3.76	15.51
Q (adj)	854	-0.07	1.51	-0.36	-2.58	7.99
S1	854	0.45	0.18	0.44	0.06	0.89
S2	854	0.08	0.08	0.05	0.00	0.37
S3	854	0.03	0.04	0.02	0.00	0.25
Block	854	0.52	0.50	1.00	0.00	1.00
BlockDiff	854	0.29	0.45	0.00	0.00	1.00
BlockSame	854	0.23	0.42	0.00	0.00	1.00
Relgar	854	0.10	0.30	0.10	0.00	1.00
RelgarNoBlock	854	0.05	0.22	0.00	0.00	1.00
RelgarDiffBlock	854	0.02	0.15	0.20	0.00	1.00
RelgarSameBlock	854	0.03	0.15	0.20	0.00	1.00
State	854	0.80	0.40	1.00	0.00	1.00
Top3	854	0.56	0.15	0.56	0.07	0.96
Leverage	854	0.43	0.19	0.42	0.02	1.00
Lnassets	854	11.53	0.80	11.45	9.41	15.34

The variable definitions are in Appendix 6.1.

Table 6.1 presents descriptive statistics for my sample firms and appendix 6.1 gives variable definitions. Table 6.1 shows that the industry-adjusted Q has a mean of 0.02 with minimum of –3.76 and maximum of 15.51. After excluding firms with an

industry-adjusted Q in the top and bottom 1 percent, I have 854 firms in my final sample and industry adjusted Q ranges from -2.58 to 7.99.

Table 6.1 shows substantial ownership concentration in Chinese companies. The percentage shareholding by the largest shareholder (*S1*) is 45 percent on average, with a minimum of 6 percent and a maximum of 89 percent. The second largest blockholder (*S2*) holds on average 8 percent of the shares outstanding, with a median of 5 percent, while the average shareholding for the third largest blockholder (*S3*) is 3 percent (median is 2 percent).

Using a 5 percent shareholding cut off, 52 percent of my sample firms have substantial non-controlling blockholders (*Block*).[68] For 29 percent of the firms, the non-controlling blockholder has an ultimate owner that differs from the controlling blockholders (*BlockDiff*) in terms of the public/private classification. Given the difference in incentives between state shareholders and private shareholders, I expect more extensive mutual monitoring and a higher firm value if the major blockholders are from different ownership categories (i.e. *BlockDiff* equals one). For 23 percent of the sample the non-controlling blockholders and the controlling blockholders are both private or public (*BlockSame*).

My second proxy variable for collusion among the major blockholders is the issuance of guarantees for the debt of one of the blockholders. The issuance of a guarantee for the debt of one of the blockholders is clearly not in the interest of the minority shareholders of a listed firm (Johnson, *et al,* 2000b, and Chapter 5 of this thesis). If a related guarantee is issued by a firm with multiple blockholders, this indicates collusion between the major blockholders. In my sample, 84 firms issued

[68] I also repeat my tests using a 10 percent cut off. The results are qualitatively similar to the results presented in this study.

related guarantees to their major blockholders (*Relgar*).[69] 44 of these firms have only one large shareholder (*RelgarNoBlock*), while 22 have multiple blockholders with different identities (*RelgarBlockDiff*), and 18 have multiple blockholders with the same ultimate owner (*RelgarBlockSame*).

I also introduce several control variables. *State* is a dummy variable that is equal to one if the State is the largest shareholder, zero otherwise. It is clear from Table 6.1 that State ownership is a distinguishing characteristic of Chinese companies. In the year 1999, State shareholders dominated 80 percent of my sample firms. *Top3* represents the total percentage of shares held by the top three largest shareholders. The average leverage ratio (*Leverage*) is 43 percent and ranges from 2 percent to one.[70] Finally, I measure firm size (*Lnassets*) as the natural logarithm of the book value of the firm's total assets as of year-end 1999.

Table 6.2 gives the average industry-adjusted Q for several sub-samples. In panel A, the sample is partitioned based on the number of blockholders. There are 414 firms with only one large shareholder. They have an average industry-adjusted Q of –0.26. The 440 firms with multiple blockholders, have an average industry-adjusted Q of 0.11. The difference in industry-adjusted Q between two sub samples is 0.38, which is statistically significant at the 1 percent level. Of the 440 firms with multiple blockholders, 247 firms have ultimate owners of the major blockholder that are different in terms of the public/private distinction. For 193 firms the major

[69] Nine firms out of these 84 listed firms issued related guarantees to non-controlling blockholders. I repeat all my tests excluding these 9 firms. The results are qualitatively similar to the results presented in this chapter.

[70] The extremely high leverage ratio of some firms is most likely due to their continuous underperformance and the lack of monitoring by State banks. Given the strong involvement of the Chinese government in listed companies, State banks do not exert any real monitoring over firms.

blockholders are all public or all private. The average industry-adjusted Q's for these samples are not significantly different (0.08 and 0.16 respectively).

Table 6.2

Descriptive statistics on industry adjusted Q of sub samples

Panel A				
	One large Shareholder	Multiple Block		Difference
No. Firms	414	440		
Mean	-0.26	0.11		**0.38**[a]
Median	-0.46	-0.24		
		BlockDiff	BlockSame	
No. Firms		247	193	
Mean		0.08	0.16	0.08
Median		-0.28	-0.23	
Panel B				
	The rest of market	Relgar		Difference
No. Firms	770	84		
Mean	0.00	-0.65		**-0.66**[a]
Median	-0.30	-0.71		
		RelgarNoBlock	RelgarBlock	
No. Firms		44	40	
Mean		-0.64	-0.66	-0.01
Median		-0.68	-0.75	

The variable definitions are in Appendix 6.1. a, b, and c indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

Panel B of Table 6.2 shows that the 84 firms that issued related guarantees to their major shareholder have an industry-adjusted Q of –0.65, while the remaining 770 firms have an industry-adjusted Q of 0. The difference is statistically significant

at the 1 percent level. Furthermore, 40 of the firms that issued related guarantees have multiple blockholders (*RelgarBlock*). The difference in industry-adjusted Q between this group and the firms that issued related guarantees and have no other blockholders (*RelgarNoBlock*) is not significant.

Overall, Table 6.1 and 6.2 indicate that the ownership structure of Chinese listed firms is highly concentrated, and that the State controls the majority of listed firms. About half of the sample firms have significant non-controlling blockholders and these firms have a higher industry-adjusted Q. In addition, firms that issued related guarantees display a substantial valuation discount.

6.4 Results

This section first analyses the impact on firm value of the presence of multiple blockholders. Next, I analyse the impact on firm value of variables that proxy for (the absence of) monitoring among major blockholders.

6.4.1 Multiple block holders

Table 6.3 presents cross-sectional regression results showing the impact of ownership structure on firm value. Model (1) in Table 6.3 shows that the percentage shareholding of each of the three largest shareholders is positively related to firm value, suggesting that ownership concentration increases firm value and that the presence of non-controlling blockholders has a positive effect on firm value. Having the State as largest shareholder has a negative impact on firm value, and both firm size and leverage are negatively related to industry-adjusted Q, consistent with Lins (2003) and Mitton (2002).

Table 6.3

Cross-sectional regression to explain the valuation effects of block holders

Model	(1)	(2)	(3)
Variables	Q (adj)	Q (adj)	Q (adj)
Intercept	**9.93**[a]	**10.06**[a]	**10.12**[a]
	(12.78)	(12.97)	(12.98)
S1	**1.00**[a]		
	(2.93)		
S2	**1.38**[c]		
	(1.84)		
S3	**4.40**[a]		
	(2.96)		
Block		**0.21**[b]	
		(2.19)	
BlockDiff			**0.25**[b]
			(2.26)
BlockSame			0.16
			(1.21)
Top3		**1.06**[a]	**1.06**[a]
		(3.13)	(3.13)
State	-0.18	**-0.21**[c]	**-0.24**[c]
	(-1.51)	(-1.75)	(-1.87)
Leverage	**-1.29**[a]	**-1.28**[a]	**-1.27**[a]
	(-5.15)	(-5.08)	(-5.03)
Lnassets	**-0.88**[a]	**-0.89**[a]	**-0.89**[a]
	(-13.86)	(-14.11)	(-14.12)
Industry	Yes	Yes	Yes
Adjusted R^2	0.25	0.25	0.24

The variable definitions are in Appendix 6.1. a, b, and c indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

The second model in Table 6.3, more directly analyses the impact on firm value of the presence of a non-controlling blockholders. This model includes the total cash flow rights of top three large shareholders and a dummy variable that indicates

the presence or absence of a non-controlling blockholder. I find that firm value increases in the ownership rights of the controlling shareholders and increases in the presence of other non-controlling blockholders. This result is consistent with Bennedsen and Wolfenzon (2000), Gomes and Novaes (2001) and Bloch and Hege (2001).

Given the differences in incentives for state blockholders and private blockholders, I expect more extensive mutual monitoring and a higher firm value if the major blockholders are from different ownership categories. When the major blockholders have similar identities (i.e., they are all State blockholders, or they are all private blockholders), I expect the benefits of mutual monitoring to be marginal. Consistent with this hypothesis, the last column in Table 6.3 shows that the presence of major blockholders with different identities results in significantly higher firm value. The presence of non-controlling blockholders that are the same as the controlling blockholder in terms of the public/private distinction have a positive impact on firm value, but the coefficient is not significant.[71]

6.4.2 Collusion discount

Most of the theoretical literature assumes a competitive environment in which block holders compete for control of the firm, or where external blockholders act as effective monitors of the controlling blockholder. However, in an environment with weak legal protection, blockholders might collude to expropriate minority shareholders; alternatively they might be unwilling or unable to effectively monitor

[71] As robustness test, I also partition my sample into a sample of firms where a State blockholder is the controlling shareholder and a sample where a private blockholder is the controlling shareholder. For both samples, I find similar results showing that multiple blockholders with different identities contribute to firm value.

the controlling shareholder. In Table 6.2, I identified 84 firms that issued related guarantees to their major blockholders. 40 of these firms have significant non-controlling blockholders, which I interpret as a signal of ineffective monitoring by the non-controlling blockholder.

Model (1) in Table 6.4 indicates that after inclusion of control variables, the adjusted Q of firms that issued related guarantees is 0.35 lower relative to other firms.

Model (2) in Table 6.4, introduces three dummy variables. *RelgarNoBlock* equals one when a firm issues related guarantees and has no multiple blockholders, zero otherwise. *RelgarBlockDiff* is equal to one if a firm issues related guarantees and has multiple blockholders whose owners differ in terms of the public/private classification, zero otherwise. *RelgarBlockSame* is equal to one if a firm issues related guarantees and has multiple blockholders whose ultimate owners are all private or State, zero otherwise.

Firms with multiple blockholders that differ in terms of the public /private classification are expected to be valued down by the markets if they issue related guarantees, because more extensive mutual monitoring and a higher firm value for those firms is expected (Table 6.3).

The second model in Table 6.4 indicates that firms that issued related guarantees and have multiple blockholders that differ in terms of the public/private classification, have an industry-adjusted Q that is 0.85 lower (significant at the 1 percent level). The value reduction for firms that issue related guarantees and have no other blockholders, or multiple blockholders whose ultimate owners are all private or all public, are -0.11 and –0.41 respectively. However, these coefficients are not significant. Overall, the results suggest that collusion among blockholders in China is

not uncommon. In cases where the market has strong signals that expropriation by blockholders does exist, substantial value discounts result.

Table 6.4

Cross-sectional regressions of the value discount of collusions

Model	(1)	(2)
Variables	Q (adj)	Q (adj)
Intercept	**9.97**[a]	**9.98**[a]
	(12.77)	(12.79)
BlockDiff	**0.24**[b]	**0.31**[a]
	(2.20)	(2.67)
BlockSame	0.16	0.18
	(1.23)	(1.35)
Relgar	**-0.35**[b]	
	(-2.24)	
RelgarNoBlock		-0.11
		(-0.49)
RelgarBlockSame		-0.41
		(-1.32)
RelgarBlockDiff		**-0.85**[a]
		(-2.63)
State	**-0.26**[b]	**-0.28**[b]
	(-2.02)	(-2.20)
Top3	**1.08**[a]	**1.12**[a]
	(3.20)	(3.30)
Leverage	**-1.19**[a]	**-1.17**[a]
	(-4.72)	(-4.62)
Lnassets	**-0.88**[a]	**-0.88**[a]
	(-13.93)	(-14.00)
Industry	Yes	Yes
Adjusted R^2	0.25	0.25

The variable definitions are in Appendix 6.1. a, b, and c indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

6.5 Summary

This study investigates several important issues regarding the impact of ownership structure on firm value from the perspective of minority shareholders. My sample includes 854 listed firms from China, the largest emerging market in the world. China provides an interesting laboratory for research on valuation effects of ownership structure, since listed firms in China are characterized by concentrated ownership, weak investor protections, and a relatively stable ownership structure. I use the price of traded shares to measure Tobin's Q, allowing me to analyse how minority shareholders incorporate ownership information.

I find that non-controlling blockholders contribute to firm value only when their ultimate owners are different from the controlling blockholder in terms of the public/private distinction. I attribute this result to the potential conflicts of interests between controlling and non-controlling blockholders in this case, reducing the opportunities to expropriate wealth from the firm and improving the monitoring of management. I also provide evidence that if there are clear signals that suggest collusion between blockholders, a substantial value discount can result.

APPENDIX 6.1

Variable definitions

Q (adj)	Industry adjusted Q. It equals the difference of firm's Q minus the median Q of the industry the firm belongs to. Q is calculated as the product of firm's total outstanding shares at the end of year 1999 multiplied its market share price at year end of 1999 plus book value of its total debt, divided by the book value of its total assets at the end of year 1999.
S1	The total shareholding percentage of firm's largest shareholder.
S2	The total shareholding percentage of firm's second large shareholder.
S3	The total shareholding percentage of firm's third large shareholder.
Block	A dummy variable equal one if the second large shareholder's shareholding is more than 5% of total share outstanding.
BlockDiff	A dummy variable equal one if there are multiple block holders and the ultimate owner of these blockholders has different identities (public/private), zero otherwise.
BlockSame	A dummy variable equal one if there are multiple block holders and the ultimate owner of these blockholders has same identities (public/private), zero otherwise.
Relgar	A dummy variable equals one if the firm issued related guarantee to its major shareholder.
RelgarNoBlock	A dummy variable equals one if the firm issued related guarantee to its major shareholder while there is no other shareholders having more than 5% of total shares outstanding, zero otherwise.
RelgarBlock	A dummy variable equals one if the firm issued related guarantee to its major shareholder while there are other shareholders having more than 5% of total shares outstanding, zero otherwise.
RelgarBlockDiff	A dummy variable equals one if the firm issued related guarantee to its major shareholder while there are other shareholders having more than 5% of total shares outstanding and the ultimate owner of these block holders having different identities (public/private) each other, zero otherwise.
RelgarBlockSame	A dummy variable equals one if the firm issued related guarantee to its major shareholder while there are other shareholders having more than 5% of total shares outstanding and the ultimate owner of these block holders having same identities (public/private) each other, zero otherwise.
Top3	The total shareholding percentage of firm's top 3 large shareholders.
State	A dummy variable equal one if the largest shareholder in the firm is State shareholder, zero otherwise.
Leverage	Book value of the firm's total liabilities divided by book value of its total assets at end of 1999.
Lnassets	Natural logarithm of the firm's book value of total assets at end of year 1999.
Industry	47 industries have been identified according to the 2 digit industry classification from CSRC.

CHAPTER 7

CONCLUSIONS

"Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (Shleifer and Vishny, 1997, p.737). In recent years corporate governance researchers have increasingly shift their focus from the conflict of interest between diffuse shareholders and managers, to the protection of minority shareholders from expropriation by controlling shareholders. This shift in focus reflects the growing awareness that concentrated ownership is common across the world, and that controlling shareholders are likely to use a firm's resources for their own benefit when the rights of minority shareholders are not well protected (La Porta, *et al*, 1999).

This thesis addresses some important issues in corporate governance, using data from Chinese stock markets. China is one of the fastest growing economies in the world, and has recently gone through a period of dramatic change in corporate governance. For example, during the 1990s, as part of the Chinese strategy towards the creation of a "modern-enterprise system.", the Chinese government corporatized and privatized more than a thousand State-owned enterprises (SOEs) through share-issuance privatizations on the Chinese stock exchanges. Under pressure from the World Trade Organization (WTO) to fasten the economic reform process and to improve its legal protection of investors, important changes were also made in the regulatory environment. The Company and Securities Law in China used to reflect the attempt of lawmakers to protect State control over listed firms, however recent improvements in minority-shareholder protection reflect an increased willingness by

the Chinese leadership to subordinate State interests to the interests of other shareholders (MacNeil, 2002 and World Bank, 2002).

This thesis contributes to literature in several ways. First, I analyse share price reactions around the announcements of negotiated block transfers between different State-ownership structures for a sample of State-controlled firms that are publicly traded on Chinese stock exchanges. I also analyse top-management turnover following these block transfers. I find that changes in firm value and CEO turnover are much greater when a government agency (GA) transfers a block of shares of a listed firm to a state-controlled enterprise with a private joint venture partner (LPSOE) rather than to a solely state owned enterprise (SSOE). I attribute these findings to the fact that the wedge between cash-flow rights and control rights is smaller for LPSOE blockholders than for SSOE or GA blockholders. Furthermore, LPSOEs are required to hold annual shareholder meetings at which the members of Board of directors can be elected while SSOEs do not hold annual shareholder meetings and are still under significant political influence. These results contribute to evidence on the market for partial corporate control (Bethel, *et al*, 1998) and have important policy implications because of the prevalence of ultimate State control around the world (La Porta, *et al*, 1999).

Second, using a sample of listed firms that issued guarantees for the debt of their controlling shareholders, I analyse the determinants of tunnelling and the relationship between tunnelling and financial measures suggested in literature. I find that the issuance of related guarantees (tunnelling) is more likely at firms with large private blockholders than at firms with the State as a large blockholder, is more likely at larger firms, and at firms with a single controlling blockholder with substantial

separation of cash-flow rights and control rights. I also find that firms that issued related loan guarantees have significantly lower industry-adjusted measures of Tobin's Q, profitability, and dividend yield, and have significantly higher leverage. I find no evidence of higher bid ask spreads for firms that issued related guarantees.

Thirdly, I study the monitoring role of blockholders in China as an alternative mechanism of corporate governance to reduce expropriation. I find that the presence of non-controlling blockholders contributes to firm value only when their ultimate owners are different from the controlling blockholder in terms of the public/private distinction. I attribute this result to the potential conflict of interests between controlling and non-controlling blockholders in this case, reducing the opportunities to tunnel and improving the monitoring of management. I also provide evidence that if there are clear signals that suggest collusion between blockholders, the valuation discount can be substantial. These results are consistent with findings of Lins (2003) and Faccio, *et al* (2001b) and provide further evidence on the role of blockholders in a weak legal environment.

This thesis suffers from several potential limitations. First, market efficiency is a key assumption underlying the event study methodology used in chapter 4 of this thesis. However, there is a lot of anecdotal evidence in the Chinese stock market of both share price manipulation and poor information disclosure. Since price manipulation and poor disclosure are not expected to be systematically related to the events I study, I regard these phenomena as only adding random noise. Second, the price of freely tradable shares is used in this thesis even though tradable shares only account for about 25 percent of the total shares outstanding for most listed firms. Questions naturally arise as to whether the price of freely tradable shares is

appropriate for the calculation of valuation effects for the Chinese listed firms. Note however, that the focus in this thesis is on valuation effects for minority shareholders. Finally, because of the substantial dominance of State ownership in the Chinese share markets and the dynamic legal environment, one has to be cautious in generalizing the results in this thesis.

With one of the largest and fastest growing economies in the world, China plays an important role in the global economy. A better understanding and further improvement in China's corporate governance environment are important to promote sustainable future economic growth. In addition, the developments in the area of corporate governance are of immense importance to the large number of minority shareholders in China, and the many foreign investors who are keen to facilitate and participate in future economic growth. It is my hope that this thesis contributes to an improved understanding of corporate governance in China and will stimulate researchers to conduct more research on this fascinating topic.

REFERENCES

Allen, F., Qian, J., and Qian, M., 2002, Law, finance, and economic growth in China, *Working Paper*, University of Pennsylvania.

Ang, J., Cole, R., and Lin, J., 2000, Agency costs and ownership structure, *The Journal of Finance* 55, 81-106.

Bae, K., Kang, J., and Kim, J., 2002, Tunnelling or value added? Evidence from mergers by Korean business groups, *The Journal of Finance* 57, 2695-2740.

Bai, C., Liu, Q., Lu, J., Song, F., and Zhang, J., 2003, Corporate governance and market valuation in China, *Working Paper*, The William Davidson Institute.

Barclay, M. and Holderness, C., 1991, Negotiated block trades and corporate control, *The Journal of Finance* 46, 861-878.

Barclay, M. and Holderness, C., 1992, The law and large-block trades, *Journal of Law and Economics* 35, 265-294.

Bennedsen, M. and Wolfenzon, D., 2000, The balance of power in closely held corporations, *Journal of Financial Economics* 58, 113-139.

Berglof, E. and Perotti, E, 1994, The governance structure of the Japanese financial keiretsu, *Journal of Financial Economics* 36, 259-284.

Berkman, H., Cole, R., and Fu, J., 2003, Expropriation, regulation and firm value: Evidence from events in China, *Working Paper*, The University of Auckland.

Bertrand, M., Mehta, P., and Mullainathan, S., 2000, Ferreting out tunnelling: An application to Indian business Groups, *Quarterly Journal of Economics* 117, 121-148.

Bethel, J., Leibeskind, J., and Opler, T., 1998, Block share purchases and corporate performance, *The Journal of Finance* 53, 605-634.

Bhagat, S., Shleifer, A., and Vishny, R., 1990, Hostile takeovers in the 1980s: The return to corporate specialization, *Brookings Papers on Economic Activity: Microeconomics*, Special issue, 1-72.

Black, B., Kraakman, R., and Tarassova, A., 2000, Russian privatization and corporate governance: What went wrong? *Stanford Law Review* 52, 1731-1808.

Bloch, F. and Hege, U., 2001, Multiple shareholders and control contests, *Working Paper*, University of Aix-Marseille and GREQAM, France.

Boardman, A. and Vining, A., 1989, Ownership and performance in competitive environments: A comparison of the performance of private, mixed, and state-owned enterprises, *Journal of Law and Economics* 32, 1-33.

Bolton, P. and Thadden, V., 1998, Blocks, liquidity, and corporate control, *The Journal of Finance* 53, 1-25.

Bonin, J. and Huang, Y., 2000, Dealing with the bad loans of the Chinese banks, *Journal of Asian Economics* 12, 197-214.

Borokhovich, K., Parrino, R., and Trapani, T., 1996, Outside directors and CEO selection, *Journal of Financial and Quantitative Analysis* 31, 337-355.

Boycko, M., Shleifer, A., and Vishny, R., 1995, Privatizing Russia, *MIT Press*, Cambridge, MIT.

Boycko, M., Shleifer, A., and Vishny, R., 1996, A theory of privatization, *Economic Journal* 106, 309-319.

Brickley, J., Coles, J., and Terry, R., 1994, Outside directors and the adoption of poison pills, *Journal of Financial Economics* 35, 371-390.

Broadman, H., 1997, China's management of enterprise assets: The State as shareholder, *World Bank Report No. 16265-CHA*.

Brockman, P. and Chung, Y., 2003, Investor protection and firm liquidity, *The Journal of Finance* 58, 921-938.

Brown, J. and Warner, J., 1980, Using daily stock returns: The case of event studies, *Journal of Financial Economics* 14, 3-31.

Brown, J. and Warner, J., 1985, Measuring security price performance, *Journal of Financial Economics* 8, 205-258.

Burrough, B. and Helyar, J., 1990, Barbarians at the gate: The fall of RJR Nabisco, (Harper & Row, New York).

Cao, L., 2000, Chinese privatization: Between plan and market, *Law and Contemporary Problems* 63, 13-62.

Cao, Y., Qian, Y., and Weingast, B., 1999, From federalism, Chinese style, to privatization, Chinese style, *Economics of Transition* 7, 103-131.

Chen, D., Fan, P., and Wong, T., 2002, Do politicians jeopardize professionalism? Decentralization and the structure of Chinese corporate boards, *Working Paper*, Shanghai University of Finance and Economics, China.

Claessens, S., Djankov, S., Fan, J., and Lang, L., 2002, Disentangling the incentive and entrenchment effects of large shareholdings, *The Journal of Finance* 57, 2741-2772.

Claessens, S., Djankov, S., and Lang, L., 2000, The separation of ownership and control in East Asian corporations, *Journal of Financial Economics* 58, 81-112.

Claessens, S. and Fan, P., 2003, Corporate governance in Asia: A survey, *Working Paper,* University of Amsterdam.

Claessens, S. and Laeven, L., 2001, Law, property rights, and growth, *Working Paper*, University of Amsterdam.

Coffee, J., 1999, The future as history: The prospects for global convergence in corporate governance and its implications, *Northwestern Law Review* 93, 631-707.

Comment, R., 1985, The effects of firm-specific human capital on management equity investment and turnover, *Working Paper*, University of Michigan.

Comment, R. and Jarrell, G., 1995, Corporate focus and stock returns, *Journal of Financial Economics* 37, 67-87.

Corrado, C. and Zivney, T., 1992, The sepecification and power of the sign test in event study hypothesis tests using daily stock returns, *Journal of Financial and Quantitative analysis* 27, 465-478.

Cotter, J., Shivdasani, A., and Zenner, M., 1997, Do independent directors enhance targe shareholder wealth during tender offers? *Journal of Financial Economics* 43, 195-218.

DeAngelo, H. and Rice, E., 1983, Antitakeover amendments and stockholder wealth, *Journal of Financial Economics* 11, 329-360.

Demirguc-kunt, A. and Maksimovic, V., 1998, Law, finance and firm growth, *The Journal of Finance* 53, 2107-2137.

Demsetz, H. and Lehn, K., 1985, The structure of corporate ownership: Causes and consequences, *Journal of Political Economy* 93, 1155-1177.

Demsetz, H. and Villalonga, B., 2001, Ownership structure and corporate performance, *Working Paper*, University of California, Los Angeles.

Denis, D., 2001, Twenty-five years of corporate governance research…and counting, *Review of Financial Economics* 10, 191-212.

Denis, D. and McConnell, J., 2002, International corporate governance, *Working Paper,* Purdue University, West Lafayette.

Denis, D. and Sarin, A., 1999, Ownership and board structures in publicly traded corporations, *Journal of Financial Economics* 52, 187-224.

Diamond, D., 1991, Debt maturity structure and liquidity risk, *Quarterly Journal of Economics* 106, 1027-1054.

Doidge, C., Karolyi, A., and Stulz, R., 2004, "Why are foreign firms listed in U.S. worth more? *Journal of Financial Economics* 71, 205-238.

Eckel, C. and Vermaelen, T., 1986, Internal regulation: The effects of government ownership on the value of the firm, *Journal of Law and Economics* 29, 381-403.

Eisenberg, T., Sundgren, S., and Wells, M., 1998, Larger board size and decreasing firm value in small firms, *Journal of Financial Economics* 48, 35-54.

Faccio, M., Lang, L., and Young, L., 2001a, Debt and corporate governance, *Working Paper*, University of Cattollca del Sacro Cuore, Italy.

Faccio, M., Lang, L., and Young, L., 2001b, Dividends and expropriations, *American Economic Review* 91, 54-79.

Faccio, M. and Lang, L., 2002, The ultimate ownership of western European companies, *Journal of Financial Economics* 65, 365-395.

Fama, E, 1980, Agency problems and the theory of the firm, *Journal of Political Economy* 88, 288-307.

Fama, E. and Jensen, M., 1983a, Separation of ownership and control, *Journal of Law and Economics* 26, 301-325.

Fama, E. and Jensen, M., 1983b, Agency problems and residuals claims, *Journal of Law and Economics* 26, 327-349.

Fox, M. and Heller, M., 2000, Corporate governance lessons from the Russian enterprise fiascos, *New York University Law Review* 75, 1720-1780.

Franks, J. and Mayer, C., 1996, Hostile takeovers and the correction of managerial failure, *Journal of Financial Economics* 40, 163-181.

Franks, J. and Mayer, C., 2001, Ownership and control of German corporations, *Review of Financial Studies* 14, 943-977.

Gilson, R., 2000, Globalizing corporate governance: Convergence of form or function, *Working Paper*, Stanford University, Stanford, MA.

Glaeser, E., Johnson, S., and Shleifer, A., 2001, Coase versus the coasians, *Quarterly Journal of Economics* 116, 853-899.

Gomes, A. and Novaes, W., 2001, Sharing of control as a corporate governance mechanism, *PIER Working Paper 01-029*, University of Pennsylvania Law School.

Gorton, G. and Schmid, F., 1996, Universal banking and the performance of German firms, *Working Paper* 5453, NBER, Cambridge, MA.

Green, S., 2003a, Reforming China's economy: A rough guild, *A report from the China project*, University of Cambridge.

Green, S., 2003b, Better than a casino: Some good news from the frontline of China's capital market reforms, *Asia Program Working Paper* No 6, Royal Institute of International Affairs.

Grossman, S. and Hart, O., 1986, The costs and benefits of ownership: A theory of vertical and lateral integration, *Journal of Political Economy* 94, 691-719.

Grossman, S. and Hart, O., 1988, One-share, one-vote, and the market for corporate control, *Journal of Financial Economics* 20, 175–202.

Groves, T., Hong, Y., McMillan, J., and Naughton, B., 1995, China's evolving managerial labour market, *Journal of Political Economy* 103, 873-892.

Gul, F., 1999, Government share ownership, investment opportunity set and corporate policy choices in China, *Pacific Basin Finance Journal* 7, 157-172.

Harris, M. and Raviv, A., 1988, Corporate control contests and capital structure, *Journal of Financial Economics* 20, 321-349.

Harris, M. and Raviv, A., 1990, Capital structure and the informational role of debt, *The Journal of Finance* 45, 321-350.

Hart, O. and Moore, J., 1990, Property rights and the nature of the firm, *Journal of Political Economy* 98, 1119-1158.

Hart, O. and Moore, J., 1995, Debt and seniority: An analysis of the role of hard claims in constraining management, *American Economic Review* 85, 567-585.

Henry, P., 2000, Do stock market liberalizations cause investment booms? *Journal of Financial Economics* 58, 301-334.

Hermalin, B. and Weisbach, M., 1988, The determinants of board composition, *The RAND Journal of Economics* 19, 589-606.

Hermalin, B. and Weisbach, M., 1991, The effects of board composition and direct incentives on firm performance, *Financial Management* 20, 101-112.

Hermalin, B. and Weisbach, M., 2003, Board of directors as an endogenously determined institution: A survey of the economic literature, *Economic Policy Review* 9, 7-26.

Himmelberg, C., Hubbard, R., and Palia, D., 1999, Understanding the determinants of managerial ownership and the link between ownership and performance, *Journal of Financial Economics* 53, 353-384.

Holderness, C., 2003, A survey of blockholders and corporate control, *Economic Policy Review* Apr, 51-64.

Holderness, C. and Sheehan, D., 1985, Raiders or saviors? The evidence on six controversial investors, *Journal of Financial Economics* 14, 555-579.

Holderness, C. and Sheehan, D., 1988a, What constrains managers who own large blocks of stock? *Working Paper* 88-07, Managerial Economics Research Centre, University of Rochester.

Holderness, C. and Sheehan, D., 1988b, The role of majority shareholders in publicly held corporations: An exploratory analysis, *Journal of Financial Economics* 20, 317-346.

Holmstrom, B. and Kaplan, S., 2001, Corporate governance and merger activity in the U.S.: Making sense of the 1980's and 1990's, *Working Paper*, National Bureau of Economic Research, Cambridge, MA.

Hossain, M., Prevost, A., and Rao, R., 2001, Corporate governance in New Zealand: The effect of the 1993 Companies Act on the relation between board composition an firm performance, *Pacific Basin Finance Journal* 9, 119-145.

Huson, M., Parrino, R., and Starks, L., 2000, Internal monitoring and CEO turnover: A long-term perspective, *Working Paper*, University of Texas.

Institute of Economics, Chinese Academy of Social Sciences, 1998, Aggregate trend, financial risk and external shocks: Analyses of the current Chinese macroeconomic situation, *Economic Research Journal (Jingji Yanjiu)* 3, 3-14.

Jarrell, G. and Poulsen, A., 1988, Shark repellents and stock prices: The effects of antitakeover amendments since 1980, *Journal of Financial Economics* 19, 127-168.

Jensen, M., 1986, Agency costs of free cash flow, corporate finance, and takeovers, *American Economic Review* 76, 323-329.

Jensen, M., 1988, Takeovers: Their causes and consequences, *Journal of Economic Perspectives* 2, 21-48.

Jensen, M., 1989a, Eclipse of the public corporation, *Harvard Business Review* 67, 60-70.

Jensen, M., 1989b, Active investors, LBOs and the privatization of bankruptcy, *Journal of Applied Corporate Finance* 2, 35-44.

Jensen, M., 1993, The modern industrial revolution, exit, and the failure of internal control systems, *The Journal of Finance* 48, 831-880.

Jensen, M. and Meckling, W., 1976, Theory of the firm: Managerial behaviour, agency costs, and ownership structure, *Journal of Financial Economics* 3, 305-360.

Jensen, M. and Murphy, K., 1990, Performance pay and top management incentives, *Journal of Political Economy* 98, 225-263.

Jensen, M. and Ruback, R., 1983, The market for corporate control: The scientific evidence, *Journal of Financial Economics* 11, 5-50.

Joh, S., 2003, Corporate governance and firm profitability: Evidence from Korea before the crisis, *Journal of Financial Economics* 68, 287-322.

Johnson, S., Boone, P., Breach, A., and Friedman, E., 2000a, Corporate governance in the Asian financial crisis, *Journal of Financial Economics* 58, 141-186.

Johnson, S., La Porta, R., Lopez-de-Silanes, F., and Shleifer, A., 2000b, Tunnelling, *American Economic Review* 90, 22-27.

Johnson, S., McMillan, J., and Woodruff, C., 2002, Property rights and finance, *Working Paper*, Stanford Law School.

Kang, J. and Shivdasani, A., 1995, Firm performance, corporate governance, and top executive turnover in Japan, *Journal of Financial Economics* 38, 29-58.

Kaplan, S., 1994a, Top executives, turnover, and firm performance in Germany, *Journal of Law, Economics, and Organization* 10, 142-159.

Kaplan, S., 1994b, Top executive rewards and firm performance: A comparison of Japan and the United States, *Journal of Political Economy* 102, 510-546.

Kaplan, S. and Minton, B., 1994, Appointments of outsiders to Japanese boards: Determinants and implications for managers, *Journal of Financial Economics* 36, 225-257.

Klein, A., 1998, Firm performance and board committee structure, *Journal of Law and Economics* 41, 275-299.

Kole, S. and Mulherin, J., 1997, The government as a shareholder: A case from the United States, *Journal of Law and Economics* 40, 1-22.

Laffont, J. and Tirole, J., 1993, A theory of incentives in regulation and procurement, *MIT Press*, Cambridge, Mass.

Lang, L., Ofek, E., and Stulz, R.,1996, Leverage, investment, and firm growth, *Journal of Financial Economics* 40, 3-30.

Lang, L. and Stulz, R., 1994, Tobin's Q, corporate diversification, and firm performance, *Journal of Political Economy* 102, 1248-1280.

Lang, L., Stulz, R., and Walking, R., 1991, A test of the free cash flow hypothesis: The case of bidder returns, *Journal of Financial Economics* 29, 315-336.

La Porta, R., Lopez-De-Silanes, F., and Shleifer, A., 1999, Corporate ownership around the world, *The Journal of Finance* 54, 471-517.

La Porta, R., Lopez-de-Silanes, F., and Shleifer, A., 2002a, Government ownership of banks, *The Journal of Finance* 57, 265-301.

La Porta, R., Lopez-De-Silanes, F., Shleifer, A., and Vishny, R., 1997, Legal determinants of external finance, *The Journal of Finance* 54, 471-517.

La Porta, R., Lopez-De-Silanes, F., Shleifer, A., and Vishny, R., 1998, Law and finance, *Journal of Political Economy* 106, 1113-1155.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A., and Vishny, R., 2000a, Agency problems and dividend policies around the world, *The Journal of Finance*, 55, 1-33.

La Porta, R., Lopez-De-Silanes, F., Shleifer, A., and Vishny, R., 2000b, Investor protection and corporate governance, *Journal of Financial Economics* 58, 3-27.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A., and Vishny, R., 2002b, Investor protection and corporate valuation, *The Journal of Finance* 57, 1147-1170.

La Porta, R., Lopez-De-Silanes, F., and Zamarripa, G., 2002c, Related lending, *Quarterly Journal of Economics* 57, 265-302.

Lardy, R., 1998, China's unfinished economic revolution, *Working Paper*, Brookings Institution and Institute for International Economics, Washington D.C.

Lau, J., Qian, Y., and Roland, G., 2000, Reform without losers: An interpretation of China's dual-track approach to transition, *The Journal of Political Economy* 108, 120-143.

Lemmon, M. and Lins, K., 2003, Ownership structure, corporate governance, and firm value: Evidence from the East Asian financial crisis, *The Journal of Finance* 58, 1445-1468.

Lewellen, W., Loderer, C., and Rosenfeld, A., 1985, Merger decisions and executive stock ownership in acquiring firms, *Journal of Accounting and Economics* 7, 209-231.

Li, W., 1997, The impact of economic reform on the performance of Chinese state enterprises, 1980-1989, *Journal of Political Economy* 105, 1080-1106.

Lin, C., 2000, Corporatisation and corporate governance in China's economic transition, *Economics of Planning* 34, 5-35.

Lins, K., 2003, Equity ownership and firm value in emerging markets, *Journal of Financial and Quantitative Analysis* 38,159-184.

Liu, L., 2001, Chinese characteristics compared: A legal and policy perspective of corporate finance, and governance in Taiwan and China, *Working Paper*, National Taiwan University.

MacNeil, L., 2002, Adaptation and convergence in corporate governance: The case of Chinese listed companies, *Working Paper*, University of Aberdeen.

Maher, M. and Anderson, T., 2000, Corporate governance: Effects on firm performance and economic growth, *Oxford University Press*.

Malatesta, P. and Walking, R., 1988, Poison pill securities: Stockholder wealth, profitability, and ownership structure, *Journal of Financial Economics* 20, 347-376.

Martin, K. and McConnell, J., 1991, Corporate performance, corporate takeovers, and management turnover, *The Journal of Finance* 46, 671-688.

McConnell, J. and Servaes, H., 1990, Additional evidence on equity ownership and corporate value, *Journal of Financial Economics* 27, 595-612.

Mclnish, T. and Wood, R., 1992, An analysis of intraday patterns in bid/ask spreads for NYSE stocks, *The Journal of Finance* 47, 753-64.

Megginson, W., Nash, R., and Randenborgh, M., 1994, The financial and operating performance of newly privatized firms, *The Journal of Finance* 49, 403-452.

Megginson, W. and Netter, J., 2001, From state to market: A survey of empirical studies on privatisation, *Journal of Economic Literature* 39, 321-389.

Mehran, H., 1995, Executive compensation structure, ownership, and firm performance, *Journal of Financial Economics* 38, 163-184.

Mehta, C. and Patel, N., 1995, Exact logistic regression: Theory and examples, *Statistics in Medicine*, 14, 2143-2160.

Mikkelson, W. and Ruback, R., 1985, An empirical analysis of the interfirm equity investment process, *Journal of Financial Economics* 14, 523-553.

Mitton, T., 2002, A cross-firm analysis of the impact of corporate governance on the East Asian crisis, *Journal of Financial Economics* 64, 215-241.

Morck, R., Shleifer, A., and Vishny, R., 1988, Management ownership and market valuation: An empirical analysis, *Journal of Financial Economics* 20, 293-315.

Morck, R., Shleifer, A., and Vishny, R., 1989, Alternative mechanisms of corporate control, *American Economic Review* 79, 842-852.

Morck, R., Shleifer, A., and Vishny, R., 1990, Do managerial objectives drive bad acquisitions? *The Journal of Finance* 45, 31-48.

Myers, S., 1977, Determinants of corporate borrowing, *Journal of Financial Economics* 5, 147-175.

Pagano, M. and Roell, A., 1998, The choice of stock ownership structure: Agency costs, monitoring, and the decision to go public, *Quarterly Journal of Economics* 20, 293-315.

Palepu, K., 1986, Predicting takeover targets: A methodological and empirical analysis, *Journal of Accounting and Economics* 8, 3-35.

Pistor, K., 1999, Law as a determinant of equity market development, *Working Paper*, Harvard University, Cambridge, MA.

Qi, D., Wu, W., and Zhang, H., 2000, Shareholding structure and corporate performance of partially privatised firms: Evidence from listed Chinese companies, *Pacific-Basin Finance Journal* 8, 587-610.

Qian, Y., 2000, Government control in corporate governance as a transitional institution: Lessons from China, *Working Paper*, University of Maryland.

Qian, Y. and Xu, C., 1993, Why China's economic reforms differ: The M-form hierarchy and entry/expansion of the non-state sector, *Economics of Transition*, 1(2), 135-170.

Roe, M., 1994, Strong managers weak owners: The political roots of American corporate finance, *University Press*, Princeton, N.J.

Ryngaert, M., 1988, The effect of poison pill securities on shareholder wealth, *Journal of Financial Economics* 20, 377-417.

Sachs, J., Woo, W., and Yang, X., 2000, Economic reforms and constitutional transition, *Working Paper*, NBER.

Sappington, D. and Stiglitz, J., 1987, Privatization, information, and incentives, *Journal of Policy Analysis and Management* 6, 567-582.

Schipani, C. and Liu, J., 2002, Corporate governance in China: Then and now, *Columbia Business Law Review* 2002, 1-69.

Shivdasani, A., 1993, Board composition, ownership structure, and hostile takeovers, *Journal of Accounting and Economics* 16, 167-198.

Shivdasani, A. and Yermack, D., 1999, CEO involvement in the selection of new board members: An empirical analysis, *The Journal of Finance* 54, 1829-1854.

Shleifer, A., 1998, State versus private ownership, *Working Paper*, NBER.

Shleifer, A. and Vishny, R., 1986, Large shareholders and corporate control, *Journal of Political Economy* 94, 461-488.

Shleifer, A. and Vishny, R., 1988, Value maximization and the acquisition process, *Journal of Economic Perspectives* 2, 7-20.

Shleifer, A. and Vishny, R., 1994, Politicians and firms, *Quarterly Journal of Economics* 109, 995-1025.

Shleifer, A. and Vishny, R., 1997, A survey of corporate governance, *The Journal of Finance* 52, 737-783.

Slovin, M. and Sushka, M., 1993, Ownership concentration, corporate control activity, and firm value: Evidence from the death of inside blockholders, *The Journal of Finance* 48, 1293-1321.

Smith, C. and Warner, J., 1979, On financing contracting: An analysis of bond covenants, *Journal of Financial Economics* 7, 117-161.

Stulz, R., 1988, Managerial control of voting rights: Financial policies and the market for corporate control, *Journal of Financial Economics* 20, 25-54.

Stulz, R., 1990, Managerial discretion and optimal financing policies, *Journal of Financial Economics* 26, 3-27.

Stulz, R., 1999, International portfolio flows and securities markets, *Working Paper 99-3,* Fisher College of Business, The Ohio State University, Columbus, OH.

Suchard, J., Singh, M., and Barr, R., 2001, The market effects of CEO turnover in Australian firms, *Pacific Basin Finance Journal* 9, 1-27.

Sun, Q. and Tong, W., 2003, China share issue privatization: The extent of its success, *Journal of Financial Economics* 70, 183-222.

Tenev, S., and Zhang, C.L., 2002, Corporate governance and enterprise reform in China: Building the institutions of modern markets, *World Bank.*

Tian, L., 2001, State shareholding and the value of China's firms, *Working Paper*, London Business School.

Tong, D., 2003, Capital market reform in China: The role of corporate governance, *CSRC*, P.R. China.

Walking, R. and Long, M., 1984, Agency theory, managerial welfare, and takeover bid resistance, *Rand Journal of Economics* 15, 54-68.

Wang, X., Xu, L., and Zhu, T., 2001, State-owned enterprises going public: The case of China, *Working Paper*, City University of Hong Kong.

Weisbach, M., 1988, Outside directors and CEO turnover, *Journal of Financial Economics* 20, 431-460.

Xu, C. and Pistor, K., 2003, Law enforcement under incomplete law: Theory and evidence from financial market regulation, *Working Paper*, Columbia Law School.

Xu, X. and Wang, Y., 1999, Ownership structure and corporate governance in Chinese stock companies, *China Economic Review* 10, 75-98.

Yermack, D., 1996, Higer valuation of companies with a small board of directors, *Journal of Financial Economics* 40, 185-212.

Yermack, D., 1997, Good timing: CEO stock option awards and company news announcements, *The Journal of Finance* 52, 449-476.

Zhang, W., 1998, China's SOEs reform: A corporate governance perspective, *Working Paper*, Institute of Business Research, Beijing University.