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Key words: Corporate governance, Corporate ownership structure, China stock market, A share, B share, Non-tradable shares, Rights issues, Cross listing, Block trade, Large shareholders, Expropriations, Corporate control transactions, Tobin's Q, Block premia

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Singapore

16.02.2006

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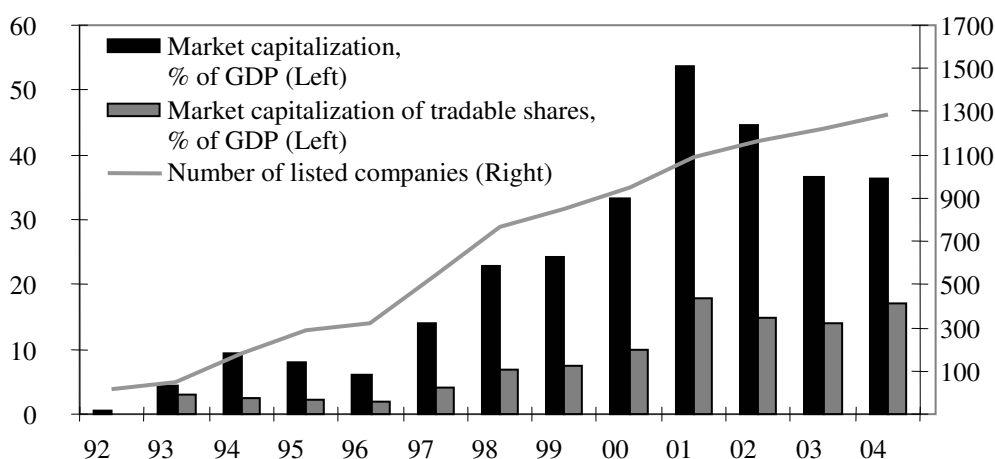
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PART I: OVERVIEW OF THE THESIS

1. INTRODUCTION

By the end of 2004, the total capitalization of the Chinese stock market reached US\$ 400 billion¹ (Table 1), which ranks it among the ten largest stock markets in the world. It is believed that the Chinese stock market will surpass that of Japan and become the largest in Asia by 2010. Moreover, the share of stock market capitalization in GDP has surpassed 50 %² from a starting level of mere one percent in 1990. These numbers without exceptions paint a picture of spectacular developments on the Chinese stock market during the past decade.

Table 1 Market capitalization of total outstanding shares and tradable shares, and the number of listed firms on the Chinese stock market



Meanwhile, more than a decade after the official opening (or reopening³) of stock exchanges in world's most populous and impoverished country⁴, the Chinese stock market appears to convey more historical significance than economic sense. Although the stock indices at both Shanghai and Shenzhen stock exchange grew by 75 % and 20 % respectively from 1992 to 2002 (Graph 1), the Chinese GDP more than doubled

¹ The statistics was compiled by the China Securities Regulatory Commission.

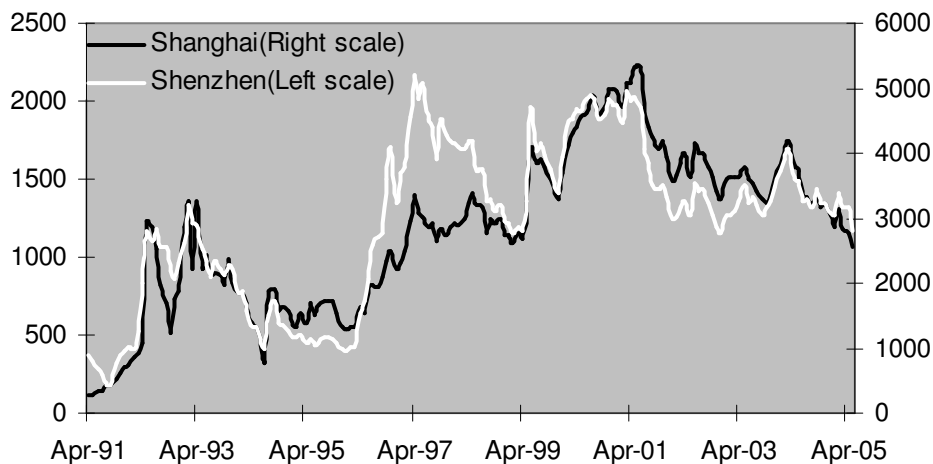
² By the end of 2003, the total market capitalization of the Chinese stock market amounts to CNY 4,246 billion, when GDP at CNY 11,669 billion.

³ Shanghai stock exchange emerged first in 1860, and the Share-brokers Association was established in 1891. By the end of 1930s, Shanghai had become the financial center of the Far East.

⁴ United Nation estimates that, in 1990, China's GDP per capita amounted to \$ 342 with a 1,160 billion populations.

during the same period. Effective annual rates of return are calculated at 5.76 % and 1.84 % for Shanghai and Shenzhen stock exchanges, whereas Chinese GDP has grown at an impressive 9.47 % per year during the time period. Moreover, a total of US\$ 80 billion of loss has been reported by listed firms from 1994 to 2001. When economy continued to perform strongly in past two years⁵, the stock market was heading toward the opposite direction⁶. In May, 2005, the value of stock indices retreated to the level seen last in 1997.

Figure 1 The performances of stock indices on Shanghai and Shenzhen stock market



The waning interests of investors also contribute to the uninspiring performance on the Chinese stock market, and recent events further hardened the resolves of investors' retreats. Almost at the same time of Enron scandal in the U.S, the Chinese stock market responded with its own version of some most spectacular revelations. YGX biotechnology, which lists on the Shenzhen stock exchange, falsified US\$ 100 million out of total sales of US\$ 125 million from 1999 to 2000, which constituted all its reported profit of US\$ 60 million in 2000. YIAN technology Ltd., which lists also on the Shenzhen stock exchange, found that its majority shareholder had manipulated its share price through 630 different individual trading accounts. On the 12th of January 2000, the insider trading represented 85 % of total outstanding shares of the firm. Total

⁵ GDP grew by 9.5% in 2003, and 2004.

⁶ The average returns on the stock indices at Shanghai and Shenzhen exchanges are -7.31% and -18.65% respectively during the most recent two year period from 2003 to 2004.

profits from this scam amounted to more than US\$ 50 million. Both firms are currently undergoing “restructuring” processes and continue to be listed.

The negative correlation between the economic growth and stock returns is not an anomaly per se, as Ritter (2004) gives evidence on the negative relationship for sixteen countries from 1990 to 2002. He argues that future economic growth is largely irrelevant for predicting future equity returns, since long-run equity returns depend on dividend yields and the growth of per share dividends. The economic growth does result into a higher standard of living for consumers, but does not necessarily translate into higher returns for owners of the capital. The divergence of the performance on China’s stock market from the rapid economic growth appears to lend support to this argument. This thesis however strives to offer a different explanation to the apparent divergence within the framework of corporate governance. It argues that the weak corporate governance standards in listed firms and the poor investor protection result into a marginalized capital market. Both factors can be traced back to China’s “prudent” reforming strategy that not only excludes privatization officially but also shuns away from building rule of laws and institutions.

Each of the following three essays addresses one aspect of the corporate governance structure on the Chinese stock market in a sequential way. The first essay questions whether significant agency conflicts do exist on the market. The second essay then turns to the level of agency costs by examining expropriations by the majority shareholders. The third essay looks into the possible avenue through which improvements on the corporate governance standards in listed firms is possible. On the other hand, each of these three essays gathers empirical evidences from one distinctive stock market activity, which is the rights issue, the block trading, and the cross-listing, because it is also hoped to provide detailed information on these very important market activities on the Chinese stock market. Constituting these individual essays, this thesis is able to gather evidences on the agency conflicts between the majority and minority shareholders by documenting significant misalignment of interests between the two in rights offerings. Also, significant benefits of control are documented in block share transactions, which indicate expropriations of minority shareholders by the majority

shareholder. Last but not least, the thesis finds that firms committing to higher disclosure standards through cross-listings are valued more.

Moreover, during more recent years, the Chinese stock market has seen major overhauls in various areas such as the trading platforms, the regulatory regime, and the disclosure standard. For instance, the Chinese accounting standard has been upgraded steadily to be more comparable with the International Accepted Accounting Standard. The regulatory regime has been refined and redefined by which the stock market regulatory body finally became independent from the central bank at the end of 1997. Moreover, many laws and regulations have been drafted in the area of stock market and are expected to expand in lieu of the adoption of private property rights in its constitution early 2005. On the other hand, major obstacles to the reform remain. Given the robust development process on the Chinese stock in the area of corporate governance standard, this thesis is hoped to be able to contribute to a growing cross-section of empirical evidences and to shed some lights on this important emerging capital market that has not been researched adequately.

The thesis is divided into two parts. First part provides an overview of the thesis, and the second part presents the full versions of three individual essays. The rest of the first part is organized as follows. The second section introduces the theoretical background and provides a thorough literature review. Section three describes briefly the development on the Chinese stock market. Section four presents our research questions and summarizes the main results in the essays.

2. THEORETICAL BACKGROUNDS

The original agency problem as formalized by Jensen and Meckling (1976) centered on the contractual relationship between a principal (outside financier) and an agent (entrepreneur, management). The essence of the agency problems is the separation of cash flow and control rights. Agency problems emerge when the interests of an agent who holds control rights diverge from those of the principal who holds the cash flow right. Because a complete contract in which the agent's behavior are specified

in all states of the world is technically infeasible, costs are incurred to ensure the alignment of interests between the principal and the agent. The alignment can be maintained by either internal bonding mechanisms or external monitoring. Monitoring can be improved by employing auditors, analysts and independent board, whereas bonding can be achieved by increasing agent's equity stake, and compensations tied to performances. In the original agency context, 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). More specifically, the agency conflicts in this setting are the ones between the incumbent manager and shareholders in dispersedly held firms.

Large shareholders are believed to be “the most direct way to align cash flow and control rights of outside investors” (Shleifer and Vishny, 1997, p.754). Large shareholders have the incentives and the cost efficiency means of monitoring the management, therefore avoiding the “free rider problem”⁷. Thus, large shareholder is an important internal bonding mechanism, which alleviates problems arising from the separation of control and cash flow rights. However, there are costs of having large shareholders as well, because the large shareholders' interests are not necessarily aligned with those of other shareholders or the management. Large shareholders can extract private benefits of control by expropriation from other shareholders. The expropriation or tunneling behaviors become more severe, when cash flow and control rights are more deviated. Stulz (1988) predicts a concave relationship between managerial ownership and firm value. In his model, as managerial ownership and control increases, the costs associated with the entrenchment of manager-owners start to exceed the incentive benefits of managerial ownership. Empirically, Morck, Shleifer, and Vishny (1998) show a U-shaped relationship between managerial equity ownership and firm valuation for a sample of U.S. firms.

Indeed, concentrated corporate ownership structure is witnessed even on the more developed capital markets. Eisenberg (1976), Demsetz (1983), Demsetz and Lehn

(1985), Shleifer and Vishny (1986), and Morck, Shleifer and Vishny (1988) show that, even among the largest US firms, there are moderate concentrations of ownerships. Holderness and Sheehan (1988) find several hundred publicly traded firms with majority shareholders in the U.S. Studies on other developed economies also discover the significant concentration of the ownership structure. In a study of 27 wealthy economies, La Porta *et al* (1997) investigate the ultimate control instead of cash flow ownerships, and find that the families or the State typically controls the listed firms. A similar study by Classens *et al* (1998) on 3,000 publicly traded firms in nine East Asian countries finds that large families are in control of more than half of the East Asian corporations.

Shleifer and Vishny (1997) conclude that “as ownership gets beyond a certain point, the large owner gains full control of the company and is wealthy enough to prefer to use firms to generate private benefits of control that are not shared by minority shareholders” (p. 759). The separation of control rights from cash flow rights can be achieved through outright violation of one-share-one-vote or/and pyramid holdings that are common in many developing economies. The agency conflicts under a concentrate ownership structure are thus ones between the controlling and minority shareholders. Empirical evidence on agency costs of having large shareholders are documented extensively on both developed and developing capital markets⁸. Johnson *et al* (2000) found that, even in developed countries, the expropriation of minority shareholders by the large shareholder is substantial. The expropriation activities usually take legal forms instead of outright theft and fraud. Dyck and Zingales (2001) conducted an international study of private benefits of control by examining block transactions in different countries and found that the private benefits of control were larger in countries where the capital markets are less developed, the corporate ownership is more concentrated, and the privatization is less likely to take place as public offerings. Classens *et al* (2001) documented that the higher control right is associated with lower market valuation,

⁷ Free rider problem depicts a situation where with dispersed ownership individual investors will have no incentives to engage into monitoring of management but prefer to ride on other investors. See Stiglitz (1985), Grossman and Hart (1980).

⁸ See Dyck and Zingales (2001); Classens *et al* (1998).

especially when cash flow right is low and control right is high in nine East Asian countries.

The costs of having large shareholders suggest that alternative corporate governance mechanisms should be implemented in tackling agency conflicts between large and minority shareholders. The presence of outside directors is regarded as another source of corporate monitoring (Fama, 1980 and Weisbach, 1988). Debt and dividend policies are also possible instruments in reducing this kind of agency costs (Jensen and Meckling, 1976 and Jensen, 1986). External mechanisms proposed include threat of take over (Fama and Jensen, 1983, Jensen and Meckling, 1976, Grossman and Hart, 1980) and product market competition (Hart, 1983). However, all of the above mechanisms are not without limitations, or most of the time costs.

Perhaps the most important external factor that influences corporate governance is the legal environment in which firms operate. Laws can be written to facilitate and safeguard the reduction of above mentioned agency costs. This is especially true under the concentrated ownership structure where large shareholders will resist or even defy external pressure to implement better corporate governance mechanisms. The quality of the legal protection of minority shareholders is thus crucial in providing cost efficient means of monitoring and curbing large shareholders' capacity to expropriate. Consequently, the quality of the legal protection of minority shareholders will directly influence developments on capital markets. La Porta *et al* (1997, 1998) find that the existence of investor protection determines the development on the domestic capital market. Also, widely held firms are more frequently observed when better shareholder protection is guaranteed by the legal system. Bebchuk and Roe (1999) argues that the sources of path dependence are both structure driven and rule driven. Their path dependent theory predicts the coexistence of different corporate ownership structures, despite the pressure to converge during the current time of globalization on financial markets. Coffee (2002) extends the path dependence in corporate ownership structures to question the "racing toward the top" scenario. This scenario predicts that the impact of cross-listings and stock market competition should produce convergence in regulatory regimes among different capital markets. Coffee argues instead that the

competition under path dependence is more likely to result into a variety of regulatory regimes that each caters for the need of a particular corporate ownership structure.

The globalization of financial markets in recent years embraces cross listings as an important instrument. Recent studies that investigate motivations for international cross-listings find evidence in favor of the corporate governance hypothesis, instead of the traditional market segmentation hypothesis⁹. The corporate governance hypothesis stipulates that “the cross listing maybe a bonding mechanism by which firms incorporated in a jurisdiction with weak protection of minority rights or poor enforcement mechanisms can voluntarily subject themselves to higher disclosure standards and stricter enforcement in order to attract investors who would otherwise be reluctant to invest (or who would discount such stocks to reflect the risk of minority expropriation)” (Coffee, 2000, Page 11). This hypothesis is able to offer consistent explanation to why the regulatory regime on one market and one listing facility affects the listing decision and the value of international cross listing, while the market segmentation hypothesis is unable to offer. Therefore, cross-listing can be viewed as an alternative corporate governance mechanism that circumvents weaker legal protection of investors on the local market.

3. THE CHINESE STOCK MARKET

The Chinese stock market was established to facilitate the reform of state owned enterprises, as government found it increasingly difficult to continue policy lending, subsidies, and different preferential treatments through the ailing banking sector. These soft budget constraints which inevitably lead to incentive problems have the state owned sector trailing far behind in productivity and profitability. The huge amount of non-performing loans in the banking sector reveals the legacy of these policies, and the magnitude of the damage inflicted to the China’s economy.

⁹ See Karolyi and Stulz (2001) for a thorough review on the market segmentation hypothesis. See Stulz (1999); Reese and Weisbach (2001); Doidge, Karolyi, and Stulz (2001) for corporate governance explanation of international cross listing.

Therefore, to re-establish the stock market was expected to alleviate government's fiscal burden. At the same time, the high domestic savings that are prevented from leaving the country due to capital controls can expect higher returns than just bank deposits. Moreover, the stock market listing is expected to transfer government's responsibility of monitoring state owned enterprises to more efficient institutions. To convince the wary investors, the government sought to minimize default risk in listed firms. It established a quota-based screening process and many discretionary measures to sanction new listings and stock trading. Contrary to its original wish, the government had to continuously extend soft budget to listed firms to substantiate its promise. Indeed, only 14 out of over 1,300 listed firms have been actually de-listed from the stock market, and all delisting took place after 2001.

The role of government on the stock market remains controversial. Instead of building rules and institutions, the government constantly intervenes by influencing either the demand or the supply on the market. When most interventions are discretionary, those in fact create more risks and distortions in investors' expectation. For instance, in response to the sluggish consumption demand and the waning interests of stock market investors, the government started to levy 20 % of capital income tax at the end of 1999. Individual investors had long sought sanctuary in bank deposit during the volatile time on the stock market, which represents virtually the only financial investment available to individual investors in China. The impact of this policy on individual investors could be grasped clearly from the following statistics. At the end of year 2000, new A-share trading accounts increased from the previous year by an astonishing 264 %, which translates into half a million more individual investors flocking to the two exchanges; the total market capitalization of the Chinese stock market almost doubled¹⁰. Again¹¹, the authority reasserted itself over the market in a less subtle fashion, which reminded the individual investors once again of the peril in

¹⁰ CSRC statistic releases.

¹¹ In 1994, to invigorate the sluggish stock market the government suspended IPOs, restricted rights issues, and permitted more funds into the stock market. These measures induced the biggest gain of all time on the stock market. In 1996, confronting the rising enthusiasm among small individuals to trade with their life savings on the stock market, the government issued a series of warnings on the basis of high P/E ratios of the Chinese listed firms. During the following week, both stock exchanges sustained the biggest loss ever and eventually had to suspend the trading.

investing on a market that is more dependent on policy discretions than market principles.

There are currently 1,233 firms listed on the two stock exchanges in China. A complete survey on both exchanges by Xu and Wang (1997) found that the state owned shares and the legal person owned shares represent around 60 % of the total outstanding shares by the end of 1995. Their estimation of ownership concentration in Chinese listed firms indicated that the largest shareholder in Chinese listed firms on average owned more than 40 % of the total outstanding shares, while the second largest shareholder trailed far behind with only less than 10 % of the total cash flow rights. The second essay of this thesis arrives at the similar finding. For all the sample firms that transacted blocks of shares from 1997 to 2002, the largest shareholder on average owned 39 % of the total outstanding shares, with the second largest shareholder following remotely with 12 %. Although the second largest shareholder has increased their ownership during more recent years, the largest shareholder's ownership has decreased only marginally. Therefore, on average the large shareholder in a Chinese listed firm remains to be uncontested in control and possibly unchecked for its expropriation behaviors. Liu and Sun (2003) try to identify ultimate large shareholders in Chinese listed firms by the definition of ultimate ownership and control proposed in La Porta *et al* (1999). They find that by the end of 2001 approximately 84 % of listed firms had been ultimately controlled by the state. Their study indicates that large shareholders are able to acquire absolute control in Chinese listed firms with less than half of the cash flow rights.

The greater deviation of control rights from cash flow rights on the Chinese stock market implies that large shareholders are able to engage into and profit from expropriation behaviors. However, the important characteristic that pertains only to the Chinese stock market is the fact that large shareholders in most of the listed firms are the state itself ultimately, which differs substantially from perhaps most of the other markets. The objectives of the government are known to depart substantially from those of a private investor. The former maximizes a social welfare function, while the latter its own utility function. The agency conflicts arise consequently due explicitly to the

above divergence in objectives, in addition to the traditional agency problem that is between large and small shareholders.

Diagram 1 Share categories on Chinese stock market by tradability and ownership

Ownership \ Tradability	Traded on exchanges	NOT traded on exchanges
Domestic investor	A-share, Employee-share	State-share, Legal person-share Employee-share ¹²
Foreign investor	B-share ¹³	

The Chinese stock market has a complex ownership structure that is not witnessed on other markets regarding ownership and trading restrictions (Diagram 1). Ownership restrictions on domestic investors are implemented by four different classes of share: the state owned shares, the legal person owned share, the employee share, and the tradable A-share. The state owned share represents ownership by the central government, local governments, and government solely owned enterprises. The legal person owned share represents ownership by domestic institutions, such as share holding firms, government and private jointly owned enterprises, and non-bank financial institutions. The employee share represents a unique feature of the Chinese ownership structure, which deviates substantially from the employee ownership plans or stock options that are commonly seen on other developed markets. Shares are offered to employees and the management prior to the initial public offering, usually at a substantial discount. After a specific lock-up period of 6 to 12 months, the listed firm may file with the Chinese Security Regulatory Commission for allowing shares to be traded. The employee share in China thus resembles more a benefit than an incentive scheme to the employees. Whereas the first three categories are offered to the original shareholders or stakeholders in the firm prior to the initial public offering, the tradable A-share is issued to new investors, usually individual investors, through equity

¹² Employee shares were abolished at the end of 1998.

¹³ B shares were allowed to be owned by domestic investors from 19th February, 2001.

offerings. Although all four categories of shares are classified collectively as A-shares, the tradable A-shares are the only share category that can be traded on the stock exchanges. The latest statistics from the regulatory body indicates that tradable A-shares constitute only one third of the total outstanding A-shares on the market.

The ownership restriction aimed at the foreign investors regulated that foreign citizens can only invest in Chinese listed firms through B-shares. The B-share was issued exclusively towards foreigners, and strictly forbidden from either the domestic institutions or individuals¹⁴. The face value of B-shares is denominated in Chinese yuan, however can be subscribed and traded only in foreign currencies. More specifically, the B-share is denominated in Hong Kong dollar on the Shenzhen stock exchange and in U.S. dollar on the Shanghai stock exchange.

Although the state owned and the legal person owned shares cannot be traded on stock exchanges, these are allowed to be transferred among domestic institutions through negotiated trade. According to regulations, the state owned share is not allowed to be traded at price below its book value in order to prevent the state assets from depreciating in value. The trading of state owned shares based on book value is also the consequence of the rather unique Chinese Initial Public Offering process. When conducting the Initial Public Offerings, the original owner, such as the government or the government owned enterprises convert the book value of their initial ownership into non-tradable shares in the listed firm by the face value of the share (usually one CNY per share). In contrast, individual investors subscribing the tradable A-shares through equity offerings must pay by cash the market price which is often above ten times of the face value.

¹⁴ On February 19th of 2001, domestic investors were allowed to trade B-shares with foreign currency in their bank savings. On December 1st of 2002, Qualified Foreign Institutional Investors (QFII) granted foreign investment access to domestic A-share market. These actions together with a possible QDII (Qualified Domestic Institutional Investor) scheme at the later stage will eventually remove the ownership restrictions for the domestic and the foreign investors.

4. RESEARCH AND RESULTS

Summarizing from above descriptions, the Chinese stock market exhibit the following main characteristics. 1) A large shareholder dominated corporate ownership structure; 2) A majority of outstanding shares are not traded on the stock exchange, and owned by the large shareholders, whereas minority shareholders often hold tradable shares; 3) Control in Chinese listed firms is concentrated not only through large cash flow ownership, but also large shareholder's direct influence on both the management and the board of directors; 4) The market for corporate control exists but functions exclusively through negotiated trade of large share blocks; 5) The open tenders through tradable shares are allowed but practically unfeasible; 6) Last but not least, legal protection of small investors is scarce and poorly developed. The above setting on the Chinese stock market spells out severe problems in the corporate governance standard of listed firms, as all main mechanisms that are found to alleviate agency problems with large shareholder in particular are absent on this market. This unique agency problem of having large shareholders on the Chinese market motivates this research project.

4.1 Essay one

Previous research has found evidences of both benefits and costs of having large shareholders on different capital markets. Moreover, the separation of cash flow and control rights in the corporate ownership structure is found to aggravate the agency problem between large and small investors. On the Chinese stock market, both the large shareholder dominated corporate ownership structure and the separation of control and cash flow rights are prominent features. The agency problem is exacerbated by ability of large shareholders to appoint management and even board members. Moreover, China's stock market is still an emerging capital market, which is reflected in her weaker legal institutions and protection of small investors.

However, the above characteristics do not necessarily result into agency conflicts, if the interests of large shareholders are aligned with those of other investors. Thus, the

first research question in this thesis is to examine whether the interests of large shareholders in Chinese listed firms indeed depart substantially from those of other investors. This essay looks at a particular market transaction, rights issues, for evidences.

The rights issue is by far the dominant method of seasoned equity offerings on the market. It has accounted for more than half of the total equity raised on the market from 1991 to 2001. Nevertheless, the rights issue remains to be a puzzle to many. When the large shareholder initiates rights issues, it often denounces the rights at very early stage. More specifically, the denunciation of rights is announced in conjunction with the publication of the rights issue prospectus. Despite that the denunciation from the large shareholder of the proposed rights issue sends a negative signal to other shareholders, often small shareholders subscribe the rights to the maximum. Why would this pair of seemingly unmatched strategies become an equilibrium outcome? This is the rights issue puzzle on the Chinese stock market that we intend to look upon.

This essay builds a game of rights issues in the framework of corporate governance structure though the unique corporate ownership and the share class structure on the Chinese stock market. More specifically, the large shareholders in Chinese listed firms are in most cases either the government or the government owned enterprises, whereas the small shareholders are mostly individual investors. Furthermore, the large shareholders own shares that are not traded on the exchanges, whereas the shares owned by the small shareholders are tradable shares. This essay argues that the large shareholder when its ownership is not traded acts to maximize the book value. In contrast, small shareholders whose ownership are traded on exchanges act to maximize their wealth based on the market value of their ownership.

This essay continues with two hypothetical games which demonstrate that the optimal strategy for the large shareholder in rights issues is to give up all its rights, in regardless of small shareholders' strategies. By doing so, the large shareholder will gain in book value dilution from small shareholders. On the other hand, when the subscription price is set below the market price, small shareholders will compete in

subscribing more to avoid market value dilution, which eventually forces small shareholders to full subscription. Since the large shareholder decides on all specifics of a rights issue, it could set the subscription price at a level so that small shareholders would be enticed or coerced to into subscribing more rights. Therefore, the seemingly unmatched subscription strategies become the equilibrium outcome in Chinese rights issues.

A sample of 229 rights issues that were conducted at the Shenzhen Stock Exchange is constructed. The data is collected from rights issue prospectus, annual financial reports, as well as firms' disclosures on rights issues to the stock exchange. Share trading prices are gathered from the exchange. The sample constitutes 207 firms out of 501 that are listed on the stock exchange at the beginning of 2002. In our sample, the median take-up ratio of large shareholders is only 5.75 %, comparing with 92.84 % from small investors. Further empirical investigations indeed support our main prediction that small shareholders' take-up ratios are determined by the relative level of market price to the subscription price, but not the take-up ratios of large shareholders.

The purpose of this essay is not only to solve a puzzle on the China's stock market, but also reveal the peril of having the existing corporate ownership structure. This distinctive corporate ownership structure results into distortions in both incentives and monitoring mechanisms in Chinese listed firms.

4.2 Essay two

An efficient market for corporate control transactions is one of the most important mechanisms of reducing agency conflicts and improving the corporate governance standard. The lack of progress is due partly to the reluctance in accelerating the pace of privatization. Also, there has been a lack of development in institutions, laws and regulations that are highly relevant in establishing an efficient market of corporate control. As a result, the current transfer of ownerships is often not transparent and plagued by rampant corruptions. On the stock exchanges where government sanctioned

privatization is taking place, measures were deployed to prevent the control of listed SOEs from being taken over by private individuals or non-state enterprises. For example, non-tradable shares are introduced to exclude a large portion of shares from being publicly traded on the stock exchanges. These shares can be traded only through negotiated transactions among state owned entities and will remain to be non-tradable even after these transactions. Evidently, a transparent and efficient market of corporate control remains elusive in China.

The research question in the second essay extends from that in the previous essay. Given that we observe agency conflicts between large and small investors on the Chinese stock market, this essay tries to quantify these agency costs, one of which being the private benefits of control. The private benefits of control are difficult to detect given their illusive nature. This essay examines the premium in share block trading transactions as a measurement of private benefits of control.

The existence of private benefits of control has been documented on both developed and the developing markets. It is argued that the consumption of private benefits of control is of larger magnitudes on markets with poor corporate governance standards. The Chinese stock market can be certainly characterized as having poor corporate governance standards. The empirical documentation of private benefits of control however proves to be a difficult task. Previous studies have used block premiums to measure private benefits of control. However, the difficulty of implementing such a methodology on the Chinese stock market arises from the fact that non-tradable shares do not have a market value that would reflect their security benefits, because block transactions in China transact exclusively non-tradable shares whose prices are based on the book value. Thus, the security benefits will not be able to be extracted from the block premium as readily, which leads to either over- or under-estimation of private benefits of control.

In remedy to the issue, this essay categorizes block transactions into two groups. The control group includes block transactions that effectively transfer control, and non-control group includes those that do not transfer ultimate control. If the block premium

in the control transactions is found to be higher than that in the non-control transactions, the difference can be interpreted to be the value of control. The real magnitude of private benefits of control however depends crucially on there will be shared benefits or costs of control brought by the new shareholder. The shared benefits will overestimate the magnitude of private benefits of control in our estimation, whereas the shared costs will underestimate the magnitude of private benefits of control. This essay argues however that on the Chinese market the shared costs are more likely due to the weak corporate governance structure, which thus implies that the magnitude of private benefits of control is likely to be underestimated.

The empirical results demonstrate that the block premiums in control transactions are on average more than 10 % of firms' total book value, which is significantly higher than that in non-control block transactions. This corroborates with our prediction that the private benefits of control indeed exist on the Chinese stock market. Further investigations are conducted by including different firm level specifics, and the premium in control transactions remains consistently significant in all specifications. One interesting finding in the essay also shows that the stock market membership constitutes a major part of the block premium.

4.3 Essay three

The protection of minority shareholders is proved to be a major factor behind the different levels of developments on capital markets around the world. Better protection of minority shareholder is believed to facilitate the stock market development, and improve corporate governance standards in listed firms. China has only until recently adopted the private property rights into her constitution. Thus, it should not come as a surprise that China is lagging far behind in developing adequate laws and regulations in above mentioned areas. On the other hand, according to the rule driven path dependent theory, the reluctance in instituting more legal protection of investors can be also explained by the fact that the state is itself the largest shareholder in the public sector. The government would naturally be reluctant to implement changes that could place constraints on its own capacity. Under such circumstances, Chinese firms that intend to

voluntarily commit to better protection of small investors and higher corporate governance standards have to migrate to another legal regime of higher quality.

Cross-listing becomes an important mechanism in achieving such an objective. This essay explores the cross-listing mechanism on China's stock market, where firms choose to cross-list in two share classes. While A-shares are only allowed to be owned by domestic investors, B-shares were designed exclusively for foreign investors. However, issuing B-shares entails more stringent disclosure requirements than for their A-share counterparts, and much higher operational costs as well. This essay thus looks at this particular strategy of cross-listing and tries to understand whether the voluntary endorsement of higher disclosure requirements is qualified as means of migrating to a higher corporate governance standard.

This essay examines the valuation of cross-listed firm. It argues that if the cross-listing is a mechanism of committing to the increased information disclosures and consequently better corporate governance standard, cross-listed firms should command higher valuation than their counterparts. Previous studies have indeed found cross-listing firms to command higher valuations, and both the market segmentation and the corporate governance hypothesis were used to explain the higher valuations for cross-listed firms. This essay attempts however to disentangle the two hypotheses with the unique characteristics on the Chinese stock market.

The cross-listing on the Chinese stock market involves issuing both A- and B-shares. According to the market segmentation hypothesis, B-share that is owned exclusively by the foreign investors should command premium, because foreign investors hold more diversified portfolios which result into lower expected returns. However, on the China's stock market, the opposite B-share price discount has been documented extensively in previous studies. Research on this "anomaly" seems to agree that the domestic investors have even lower expected returns due to very limited investment opportunities. Given the above mentioned B-share discount anomaly contradicts the market segmentation hypothesis, this essay is able to concentrate on the corporate governance explanation in Chinese cross-listed firms.

Tobin's Q is calculated on a sample of firms during the period from 1998 to 2001. A dummy is created to distinguish cross-listed firms from their counterparts. Also, a number of variables are employed to control for firm specific features. Both cross-section and panel regressions are conducted. In cross-section regressions, Heckman's two-stage procedure is used to adjust for possible selection bias. The empirical results confirm our prediction that cross-listed firms indeed command significantly higher valuations, and the higher valuation is in line with the corporate governance hypothesis. The results also show that a general overhaul of the current accounting standard cannot be the substitute of a voluntary commitment mechanism, such as the cross-listing.

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