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WEALTH CREATION IN MERGERS AND ACQUISITIONS: A STUDY OF CHINESE CORPORATE RESTRUCTURINGS

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Abstract

Research into the wealth effects of M&A activity in the West generally concludes that substantial value is created for target shareholders. Whereas the evidence from the developed markets is overwhelming, fewer studies have been conducted using data from emerging markets. In this thesis, we will study the wealth consequences for Chinese listed companies in domestic corporate restructurings. Using a sample of 160 "legal-person" share transactions involving the companies listed on the Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE) between 1996 and 2000, empirical tests are carried out to examine whether the targets' "A share" shareholders gain in corporate restructurings.

The tests suggest that the Chinese A share market seems able to correctly anticipate new information relating to the announcements of acquisitions of control before they are announced to the public and on average targets' shareholders benefit from such acquisitions. Further analysis, however, reveals certain characteristics of acquisitions that result in more value being created than others, and in some cases targets' shareholders lose wealth as a result of the acquisition.
Declarations

I hereby declare:

1. that the thesis has been composed by myself; and
2. that the work is my own;
3. that the work has not been submitted for any other degree or professional qualification except as specified.

Date: \[Feb-20\]
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Chapter 1 Introduction

1.0 Opening

If you look for information on a ThinkPad notebook on IBM's web site, you will be redirected to Lenovo, a leading PC manufacturer in China. The redirection is the result of a US$1,750 million deal between the two companies in December 2004. That means IBM is now out of the PC business and Lenovo becomes the third biggest PC manufacturer in the world, after Dell and HP. BaoSteel Group, the largest steel company in China, acquired a 46% interest in Rio Tino's (Australia) mining company for US$30 million in June 2002. Earlier 2005, China National Offshore Oil Corporation offered a staggering US$19,600 million, cash, to acquire Unocal, America's ninth-largest oil company, though it later withdrew its offer because of what it called the "political environment" in the US. Indeed, Chinese enterprises have become more and more actively involved in the mergers and acquisitions (M&As) market worldwide.

Chinese domestic M&As have also grown considerably especially in recent years. M&A Asia reported that China and Japan together accounted for around 60% of the total deal value in Asia in 2004. According to data complied by The Times, the value of reported M&As in China was up 85% in 2004 to US$130,000 million compared to 2003, as shown in Table 1.0 below.

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1 Various resources from USA Today, BBC, China Daily.
This growth is expected to continue. In surveys conducted by Price Waterhouse Cooper, an average of over 70% of respondents felt that M&A activities in China would continue to gain momentum.\textsuperscript{3} Transactions will be driven not only by China's booming economy, but also by the Chinese government's desire to privatise many of its state-owned enterprises (SOEs). The level of industry concentration in China is low. Thousands of rapidly expanding business therefore present potential acquisition targets and opportunities for restructuring existing investments.

A society is dependent on its wealth to advance. As enterprises are major contributors to wealth, it is important to understand whether wealth is created or increased through corporate restructurings such as takeover. Compared to the volume of empirical studies published on the M&As in developed markets, few studies have been conducted in emerging markets. This thesis extends the research into the Chinese context and studies the wealth consequences of acquisitions of control in China. The following section presents the aim of this study and the empirical evidence found. The importance of these findings is outlined in section 1.2. Section 1.3 explains the contributions to knowledge and finally the entire structure of this thesis is introduced in section 1.4.

\textsuperscript{3} Asia-Pacific M&A Bulletin, published by Price Waterhouse Cooper in 2003 and 2004, respectively.
1.1 Aim and Empirical Findings

The aim of this research is to critically evaluate the regulatory framework governing corporate restructurings in China and to determine statistically if wealth is created for the shareholders of the target companies in domestic takeovers. Wealth is considered to have been created if there is a positive abnormal return, and likewise wealth is considered to have been destroyed if there is a negative abnormal return. The research also aims to investigate whether the creation or destruction of wealth varies systematically with certain characteristics of the companies, of the acquisitions and of the companies involved.

Using a sample of 160 legal person share transactions involving listed companies in China from 1996 to 2000 and a traditional event study approach, the following empirical findings are reported.

1. It is found that the domestic Chinese A share markets are not inefficient for these markets are able to correctly anticipated new information relating to major corporate restructuring activities before they are announced to the public. There may be signs of information leakage which could ultimately be used to make small positive abnormal returns around the event day, but abnormal returns disappear after the announcement.

2. The shareholders of the targeted firms benefit around, and in particular prior to the announcement of acquisitions of control in China. The cumulative average abnormal returns (CAAR) for all 160 targets over a 121-day event period (day-60 to day+60) is 6.99% when measured by the Market model (the Mean-adjusted return model reports 11.27% and the Market-adjusted return model, 20.27%).
Further tests indicate that the positive CAARs mainly occur prior to the event: for instance, 9.94% for day-60 to day-1 measured by the Market model. This finding is consistent with the evidence from the west that value has been created by those transfers of corporate control, in this case, to the targets' shareholders.

3. More interesting findings are revealed by the detailed explanatory variable analysis of CAARs. It is found that not all targets' shareholders gain from the acquisitions of corporate control in China, and that the market anticipates certain acquisitions to be more "value-adding" than others. For instance, when targets with a poor performance history are acquired, the CAAR is 15.78% for the 121-day event window, whereas when well-performing targets are acquired, the CAAR is negative and significant, -10.25%. Further tests identify no significant CAAR for the well-performing targets prior to the announcement, but a significant -12.21% after the announcement (day+1 to day+60). The market apparently was "surprised" by the announcement and viewed these restructurings as value-destroying upon learning the news. The shareholders of well-performing targets therefore lose when being taken over, which gives support to the hubris hypothesis and inefficient management hypothesis. Out of the seven variables which may potentially explain CAARs are explored, "previous performance" and "voting power" appear to be of more explanatory power than variables such as "location," "size," etc.

1.2 Importance of the Findings

Mergers and acquisitions are subjects of continuing concern to managers who are looking for (or attempting to avoid) potential partners (or hostile acquirers), to
investment bankers who manage the mergers, to governmental officials who are concerned with the operation of securities markets, and last but not least, to financial economists who want to understand acquisitions better.

M&As in the West have a long history. Wasserstein (1998) documents five waves of mergers since the end of the 19th century: the first was triggered by the completion of the railroad network in the US; the second, in the 1920s, was fuelled by the development of stock markets, the revolution in telecommunications and the growth of automobile industry; the third happened during the 1960s and featured the rise of the conglomerate; the fourth occurred with the hostile takeovers of the 1980s; and finally the fifth wave from the early 1990s driven by the globalisation and the high-tech industry.

M&As in China, however, only emerged from the late 1980s. It was not until the government launched its privatisation program, some 100 years later than the first merger wave in the US, that M&As or acquisitions of control in China started to occur.

As commented by a head of M&A for Asia ex-Japan at Morgan Stanley, "...M&A is so new in China ... (that) people still need to get comfortable with the notion of selling their businesses ... (and) the notion of shared control...". Apart from the difficulties brought by cultural differences, M&As in China have certain unique characteristics. They remained heavily influenced and restricted by the government and were not introduced on large scale initially. They do not appear in the same forms as those in the developed economies. There had not been adequate regulations governing them.

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4 "China leads the way in M&A," The Journal of the Hong Kong Society of Accountants, vol. 15, 6, June 2004
for a long time. Nonetheless, the development of M&As in China was further stimulated by the expansion of its stock markets in the late 1990s and restructurings involving listed companies became common.

China's stock market is no less unique: it is small, yet has a great potential. It is immature, yet is developing rapidly; the general public has less comprehension and there lacks institutional investors to provide a stabilising force. Last but not least, it is poorly regulated and not as transparent compared to the developed markets.

These unique characteristics perhaps explain why there have been few studies conducted using the Chinese data. This research therefore contributes to knowledge by testing well established economic and behavioural models, in the Chinese domain.

1.3 Contributions of the Findings

Overall, this study makes four contributions to knowledge.

First, the research provides one of the most comprehensive introductions to M&As in China to date. It reviews how M&A activities developed in close association with the deepening of SOE reform and the expansion of the stock markets. It explains in detail how these activities help to refine the SOE reform schemes, to improve the corporate governance and the regulatory framework, which in turn, help to reshape the corporate restructurings. In particular, this research documents the major changes in legislation concerning M&As or acquisitions of control, from the Bankruptcy Law in 1986 to the most recent regulations, hence it provides an overall picture of the
evolving nature of Chinese legislation in this field. No previous research has examined this evolution so thoroughly.

The second contribution lies in the empirical test of the efficient market hypothesis (EMH) in China's stock markets. Hughes and Singh (1987) note that in theory, the stock exchange has three roles: first, to pool together society's savings from individual savers; second, to channel these savings selectively to companies with the best investment prospects; and third, to encourage the efficient use of assets embodying past savings. However, only an informationally efficient market can fully fulfil the above functions. The test of the EMH in the Chinese stock exchanges is therefore important. Whereas the majority of previous studies have tested the weak form of the EMH in China, this research attempts to test the semi-strong form of EMH using both more up-to-date data and the event study approach, which was not commonly used by the previous tests in the Chinese context.

The third contribution rests in the study of value creation of the M&As or acquisitions of control in China. Empirical tests of the existence of abnormal returns around M&A announcements are important because the results can help investors and shareholders to make rational investment decisions. There has been very limited evidence in this field in China. Compared to previous research, this study contributes to knowledge by using a more recent data set, with a more clearly defined event.

Finally, this study is the first to look at different explanatory variables that may have impacts on abnormal returns in China. Motivations behind such corporate restructuring activities have been explored over many years in the West and many
hypotheses have been developed. The research contributes to knowledge by further exploring the segmentation of wealth gains in China, which has not in the past been explored. As a pilot study, it reveals some very interesting findings as well as practical implications. For example, the shareholders of some targets in China clearly lose upon the announcement of an acquisition deal, indicating the irrational consequences of governmental intervention.

1.4 Structure of the Thesis

The rest of the thesis is organised as follows.

Chapter 2 "SOE Reform, Stock Markets and M&As in China" first briefly reviews the SOE reform schemes introduced in China since the late 1970s. Different types of shares issued by Chinese SOEs are then explained, followed by a presentation of the development and the regulation of the stock markets. It further describes the history, the types and forms of M&A activities in China. Chapter 2 finally documents the evolution of the regulations governing corporate restructurings since the late 1980s.

Chapter 3 "Literature of EMH, Abnormal Returns and Corporate Governance" reviews the development of the EMH and related research. It discusses the methodological issues regarding the measurement of the effects of a takeover, and hence, abnormal returns. Chapter 3 then evaluates the existing empirical evidence on abnormal returns in M&A studies and finally reviews literature regarding corporate governance.
Chapter 4 "EMH and Abnormal Returns for Chinese Acquisitions of Control" proposes a joint hypothesis. It then describes the data and the step-by-step methodology used in the empirical test. Finally the results and the interpretation are presented.

Chapter 5 "Further Analysis of Abnormal Returns" first reviews seven explanatory variables selected on the basis of previous western literature and the theoretical arguments concerning the unique characteristics of the Chinese securities markets. It then describes the data and proposes the statistical hypotheses. Finally, the empirical results and their interpretations are presented.

Chapter 6 "Conclusion" first summarises the study. It then identifies the possible limitations of this research and finally points out potential future research topics in this field.
Chapter 2  SOE Reform, Stock Markets and M&As in China

2.0  Introduction

Significant attention has been given to the state-owned enterprise (SOE) reform program in China for the last 20 years. Compared to the "harsh" reform measures adopted in other transitional economies, the "gradual" approach adopted in China appears to be more successful. The development of Chinese stock markets has also received considerable attention from the international media for not only being the first stock markets in a socialist state\(^5\) but also for their fast expansion.

It is necessary to examine the related macroeconomic as well as microeconomic issues in order to measure the results of corporate restructurings. Chapter 2 intends to address these issues and will provide a descriptive and analytical study of the corporate reforms, the stock markets and the development of mergers and acquisitions and acquisitions of control in China. In particular, this chapter documents the evolvement of the legal framework in China concerning M&A and ownership. Although we will explain in detail later, most M&As in China are in fact acquisitions of minority shareholdings which are sufficient to transfer control of the target. We therefore frequently refer to "M&As or acquisitions of control."

China adopted a step-by-step, trial-and-error approach to its reform, contrary to the "big bang" measures adopted in other transitional economies, especially the former

\(^5\) Hungary operated a market in the shares of state banks, although only state banks participated in trading (Green 2003).
socialist states, such as Russia, Vietnam and Eastern European countries. As anticipated by Allen et al. (2005), this is because the policy makers in China, under the influence of Confucius' views, believed that fundamental changes in society should be gradual and should only be fully implemented after they have been proven correct. Whereas the benefits of mass privatisation schemes in other transitional nations have been small, the gradual reform in China appears to be successful.

The Chinese government opened two stock exchanges – the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE) – in the early 1990s to raise capital and improve the operating performance of SOEs. Fifteen years after the first shares were traded in Shanghai, China's stock market is now recognised as the developing world's most important market and is believed to be the third largest in Asia with a market capitalisation of over US$500 billion.\(^6\) Although the official figure is impressive, it is questionable whether it truly reflects the size of the market. The reason is that it includes non-tradable state-owned shares, which account for roughly two thirds of the total shares issued. Green (2003) used only the tradable shares and estimated that the real market capitalisation should be less than US$200 billion, which ranked the Chinese stock market to be the fifth largest in Asia by 2002, after Japan, Hong Kong, Taiwan and Korea. Nonetheless, this less impressive estimation should not detract from China's achievement. Some 1,300 companies are now listed in the two stock exchanges and they have benefited substantially from both the rapid growth in issuance and the general public's enthusiasm.

\(^6\) According to the China Securities Regulatory Commission (CSRC - the counterpart of the Securities and Exchange Commission (SEC) in the US)
Despite the fast expansion and the great potential, China's market has had to cope with severe capital control, inexperienced investors and regulators, weak rule of law and the lack of institutional investors. These, indeed, are the common problems faced by many emerging markets. Whilst it is not easy to find an instant "cure-all" solution, the China stock market regulations have been evolving to address these issues. Issuance approval, pricing, transaction procedures have been liberalised considerably.

Closely associated with the evolvement of the SOE reform and the stock market are the change in control and merger and acquisition (M&A) activities in China. As an attempt to optimise the allocation of financial resources, the Chinese government encouraged changes in control and M&As between both the listed companies and non-listed companies. These activities helped to refine the SOE reform schemes, to improve the corporate governance and the regulatory framework, which in turn, helped to reshape the corporate restructurings in China.

Two issues need to be addressed before proceeding:

- Although certain detailed descriptions are inevitable, it is not the aim of this chapter to give a complete historic review of the Chinese financial markets – that topic alone is perhaps already beyond the scope of this thesis.

- It is not feasible to cover every single M&A-related factor, therefore only the most influential ones are described. For example, in order to show the evolvement of the Chinese legal structure governing M&As, five key regulations are reviewed in detail and 57 major ones are listed in Section 2.5., out of over 1,000 from within the last 15 years.
The rest of Chapter 2 is organised as follows. Section 2.1 brief reviews the SOE reform schemes introduced in China since the late 1970s. Different types of the shares issued by the Chinese SOEs are explained in Section 2.2. Section 2.3 presents the development and the regulation of the stock markets. Section 2.4 describes the history, the types and forms of M&A activities in China. Section 2.5 contributes to knowledge by documenting the evolvement of the regulations governing corporate restructurings since the late 1980s. Section 2.6 presents a detailed case study to illustrate institutional arrangement involved in the acquisition of control of a listed company. Finally, Section 2.7 summarises the chapter.

2.1 Chinese Enterprise Reform

The development of the stock markets and corporate restructuring in China is closely connected to the evolution of its enterprises reform. Shares were issued initially to solve problems like capital shortages in the enterprises. Stock exchanges were first set up to prevent illegal trading of those shares. The stock markets then expanded to provide direct financing and to support the listing and asset restructuring of state owned enterprises (SOEs). The following sections will give an overview of the enterprise reform schemes since the late 1970s, focusing on the shareholding system scheme and the corporatisation scheme, which is an ongoing process.

2.1.1 Enterprise Reform before the Early 90s

SOEs in China are firms owned by the State and administered either by various ministries in the central government or by their responding departments in the local
(provincial or municipal) governments. SOE executives were appointed and dismissed by the government and usually treated as government officials. Before the enterprise reform, all production and distribution decisions were centrally planned and the SOEs were effectively operated as "cost centres." In the absence of market competition and a proper incentive system, the operations of most SOEs were inefficient.

The enterprise reform began in the late 1970s, shortly after Deng Xiaoping came to power. A number of reform programs have emerged, and the state has adopted a bold trial-and-error approach, described by the Chinese leaders as "crossing a river by groping for stepping stones" (摸着石头过河). During any particular period of time, different schemes may have co存isted with one another, but only the one that proved to be the most politically feasible and the most economically desirable was promoted to the national level. From 1978 to 1993, in an attempt to offer an incentive program to the enterprises and to establish a competitive market for them, four such mainstream programs were introduced.

2) Delivery of contract profit to the state (1981-82).

The reform schemes mainly addressed "incentive contract" issues by assigning enterprises greater autonomy over production decisions and profit retention. Nonetheless, the State was not able to establish an effective monitoring, control, and incentive system to encourage managers to act in the State's best interests. While these schemes were rather successful in boosting the economic growth of the private
and collective sectors, they had variable results in improving the overall performance of the SOEs.

Groves et al. (1994) showed that Chinese SOE productivity improved significantly after 1978 as a result of the introduction of the basic incentives schemes and the incentives of SOE workers were strengthened via bonus payments and differing work contracts. These changes helped raise workers' incomes and firms' investments. Li (1997) documented a significant increase in the marginal and total factor productivities of 272 Chinese SOEs between 1980 and 1989. Li (1997) also showed that over 87% of the growth in productivity was due to improved incentives and greater product market competition.

One the other hand, Huang and Duncan (1997) found that the overall impacts of these reform schemes on SOE productivity have been negligible. Parker and Pan (1996) found evidence of an absolute rise in SOE labour productivity, but a relative decline in competitiveness. In addition, after analysing incentive contracts in 12 SOEs, Shirley and Xu (2001) even came to the conclusion that incentive contracts had a negative impact on SOE performance. They found that such contracts had no effect on profitability and labour productivity but instead had adverse effects on growth in total factor productivity.

The practical disadvantages/difficulties of the incentive contracts should be fully noted. These include 1) the difficulties in implementing the contract mechanism such as those in identifying a correct level of profits; 2) the lack of punishment when SOEs sustain losses and are unable to make payments; 3) no incentives for innovation and
long-run investment; and last but not least, 4) the opportunistic expropriation or corruption by managers and government officials.

Fundamentally, the unsatisfactory results of these reform schemes are perhaps best explained by the classic property rights theory, as discussed by Alchian and Demsetz (1972), Coase (1960), and Demsetz (1967). Whereas the Chinese enterprises gained some "utilisation rights" (the right to utilise an asset) and "return rights" (the right to appropriate the returns from an asset) from the State through these reform schemes, these two rights were however very limited as the state maintained the "residual control rights" (the utilisation rights that have not been contractually defined) and "alienation rights" (the right to transfer rights over an asset to others through gift or sale), for example, that the State could appoint/remove managers at its will. The private and collective sectors were less affected by this, and that is why they benefited more from these reforming schemes.

In summary, these incentive contract oriented enterprise reform measurements have made contributions to SOE performance, but more efficiency gains could only be achieved if further reform were to be introduced, with more fundamental issues addressed and solved properly. It is the introduction of the shareholding system that represents a major departure from the previous reform schemes for it addresses the ownership of the SOEs.
2.1.2 Introducing the Shareholding System

The idea of the shareholding system reform originated in the rural sector in 1979 when the government allowed brigades to withdraw accumulated funds to form joint-stock enterprises in order to solve the problem of capital shortage in villages. This idea was further backed by an official document "A few issues in the current rural economic policy" (当前农村经济政策的若干问题) issued by the Chinese Communist Party (CCP) in 1983, which stated that capital and labour were both legitimate bases for distributing returns in cooperative economic production in the rural sector. In 1984, the World Bank sent two delegations to China and they suggested that Chinese reformers should draw on the experience of foreign shareholding systems and proposed the concept of socialist joint-stock ownership for SOEs, a suggestion that was quickly tested by Chinese policy makers.

In July 1984, the first shareholding company, the Beijing Tianqiao Department Store Company, was established. Then on 18 November 1984, the Shanghai Feile Acoustic became the first firm to issue shares to the public. This was soon followed by a small number of selected small-sized SOEs in Beijing, Shanghai, Wuhan and Guangzhou as experimental units of the shareholding system reform.

In December 1986, Zhao Ziyang, the reformist leader, ordered expansion of the shareholding experiment. Further support was given in the 1988 Report of the 3rd Plenum of the 13th Central Committee of the CCP which stated that the shareholding system was a way to rationalise property rights relations. Although the reform

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7 Regulations of Several Issues Concerning the Development of Commune- or Brigade-owned Enterprises (关于发展社队企业若干问题的规定), issued by the State Council on 3 July 1979.
suffered from a short period of political setback after the fall of Zhao in 1989, it was resumed by 1990 when the State Council issued "Opinions regarding the improvement and rectification of deepening the enterprise reform" (在治理整顿中深化企业改革的意见), which allowed further experimentation of certain shareholding enterprises.

However, due to its experimented nature, the shareholding reform, it was not the mainstream reform scheme. The incentive and contract oriented measurements as mentioned earlier, were still the major reform schemes.

The early development of the shareholding system, prior to 1994, was largely a spontaneous process which took place in the absence of a legal framework. It only involved (officially) a handful of SOEs, which were small-sized. In addition to these, the shares were mainly sold to employees, organisations and other work units which, in theory, were not supposed to trade these stocks. The shares were more like bonds in nature for they guaranteed high interest and dividends and could be redeemed when mature. As pointed out by Kong et al. (1993), the managers of the securities within the company might themselves have a limited knowledge of the difference between stocks and bonds, or of basic concepts of ownership rights, duties and rights of transfer.

What also appeared spontaneously within the same period was the increasing trading of the shares among investors and/or organisation representatives. Not surprisingly, this type of trading was outside any government regulation and without an officially approved exchange floor. A "stock market" was soon set up in Shenyang (North-east
of China) in 1986, although it was really a window listing the prices of a few fixed interest bonds.\(^8\) Approved by the People's Bank of China (PBC) Shanghai Branch, Shanghai set up the first counter for trading shares in 1986 and by 1990, it had 16 counters. Shenzhen set up its first counter in 1988, and had 10 counters by 1990. While trading over the counter (OTC) was acquiesced by the central government, the trading was highly restricted and proved not to be popular. There were only 12 shares available for OTC trading and the price limit restrictions were severe. Street trading continued to be the dominating trading method until two stock exchanges – the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE) were established. A detailed description of the stock exchanges and their functions will be provided in section 2.2

2.1.3 Corporatisation of SOEs via Shareholding

Soon after the CCP promulgated the reform objectives of a "socialist market economy" and made way for further systematic reform measures in November 1993\(^9\), the corporatisation of the SOEs started on a larger scale. The corporatisation was regulated by the Corporate Law, which became effective on 1 July 1994. Based on the experiences accumulated from the previous shareholding system reforms, the Chinese government was attempting to provide a more sophisticated corporate governance and property rights structure for the SOEs.

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\(^8\) Kong et al. (1993)

\(^9\) Decisions on Several Issues Concerning the Establishment of a Socialist Market Economic System (关于建立社会主义市场经济体制若干问题的决定), issued by the Central Committee of CCP in November 1993.
The Corporate Law divided companies into two broad categories according to their type of ownership: A) closely held corporations, including wholly state-owned corporations and foreign invested corporations, and B) publicly held corporations, including listed and non-listed corporations. Wholly state-owned corporations are only required to have two governing bodies: 1) a board of directors, and 2) a chief executive officer (CEO), whereas all other types of corporations are required by law to have two additional governing bodies: 3) shareholders and 4) a board of supervisors. Publicly held corporations were further divided into four organisational forms:

- limited liability companies (LLCs).
- limited stock companies (LSCs).
- employee shareholding cooperatives.
- private enterprises.

In November 1994, 100 large- and medium-sized SOEs were selected to be corporatised within two years as LLCs or LSCs. According to Article 3 of the Corporate Law, the major difference between LLCs and LSCs is that in the case of an LLC, each shareholder is liable toward the company to the extent of his or her respective capital contribution; whereas in the case of a LSC, the company's total capital is divided into equal shares, and each shareholder is liable toward the company to the extent of their respective shareholdings. It is hoped that these transformations will eventually lead to the separation of enterprise and government functions, a goal which was failed to be achieved by previous reform attempts.
Although the corporatisation of SOEs was modelled after western-style public corporations, an important feature in China was that the state maintained a large percentage (in some cases, 100 percent) of the ownership of these corporations. When an existing SOE is corporatised into an LLC, it becomes either a wholly state-owned LLC (if there is only one state-owned investment entity) or an ordinary state-owned LLC (if there is more than one state-owned investment entity or legal person). In both cases the state remains the *de facto* sole owner of the enterprise, though it may invest in the enterprise through different entities. Corporatisation into LLCs therefore only limits the state's liability toward the enterprises but does not change their ownership structures. In practice, the state intends to keep a majority of shares particularly with regard to those large enterprises belonging to the "lifelines" of the national economy.

Corporatisation of a SOE into an LSC is somewhat different. In this case, the Corporate Law dictates that the SOE must be incorporated by issuing shares. As a sponsor, the state is required to subscribe to a minimum of 35% of the total shares issued, and the remainder is to be offered to the general public, hence, a partial share issue privatisation (SIP). The aim of these provisions is to avoid over-concentration of shares in the hands of the state. As ownership of an LSC is defined under Article 4 of the Corporate Law by the proportion of shares each shareholder holds, the 35% minimum requirement implies that the state need not to be the majority (over 51%) owner, though it can still be the largest shareholder if the other shareholders are highly dispersed, which is fairly common in China. After 1997, this corporatisation method became the most widely used by the Chinese SOEs.

10 Zhang (1996)
Employee shareholding cooperatives differ from the above two organisational forms. An employee shareholding cooperative is held among its shareholders, who must, at the same time, be workers in the enterprise. If a worker chooses to leave the enterprise, he or she will cease to be a shareholder. The employee's union thus becomes the highest authority where decisions are made and voted for on a "one worker, one vote" basis. It was urged that this type of corporations would be more suitable for medium to small sized enterprises (SMEs), although it did not prove to be too popular among enterprisers in reality.

No matter what terminology the Chinese government chose to describe the ongoing enterprises reform, corporatisation via shareholding was effectively a form of privatisation for it makes it possible for private individuals to acquire at least partial ownership of previously completely state-owned assets/enterprises.

The performance of SOEs cannot necessarily be improved just by converting them into shareholding corporations alone. The separation of ownership from control, for example, will not necessarily eliminate the existing agency problem if the state remains the controlling shareholder since the state and its representatives are likely to have unparallel resources and expertise in monitoring and disciplining the management and different objectives. Qi et al. (2000) argue that the conflict of interests between the state and the management continues to exist, or even worsened, because the management enjoys more autonomy after corporatisation and effectively controls shares owned by the state. The conflict essentially underlines different objective functions the state and its representatives may have with regard to whether to maximise the shareholder's value. The state may want the SOE-converted
companies to preserve some social functions, even though this could make them less profitable. Nonetheless, the corporatisation of Chinese SOEs represents an important social experiment, as it provides a potential alternative policy for improving the performance of SOEs without complete privatisation.

It is beyond the scope of this chapter to analyse whether privatisation (or even just partial privatisation) is necessary in order to improve SOE efficiency and performance, for this topic is still being widely debated by many economists and the results remain unclear. Chapter 5 of this thesis further addresses this issue.

In summary, the Chinese SOE reform scheme is characterised by the conversion of SOE governance into that of a modern corporate governance structure and the main form of it is share issuing privatisation (SIP) where some, but not all, of the government's stake in these firms is sold to investors (both legal persons and natural persons) through a public share offering. Most of the firms were corporatised before going to SIP.

2.2 Share Structure

In order to maintain the economy's socialist structure and state-ownership, most of the corporatised SOEs permitted to go public have to issue shares to the government, in addition to various categories of shares representing claims from different stakeholders. A unique and complicated share structure has therefore been created. Five different types of shares may be issued by a company on either of the stock exchanges in China. They include state shares, legal-person shares, A shares, B shares and employee shares. In addition to the above, a company may also issue shares in
Hong Kong and overseas stock exchanges. This section will introduce these different types of shares respectively for they would have different impacts on the Chinese transfer or control and M&A activities.

2.2.1 State Shares & Legal-Person Shares

State shares represent the holdings in the company by the central government, local governments, or wholly government-owned organisations. The proportion of state shares is normally substantial, representing over 30% of total shares on average. State shares are not tradable on the stock markets, but are transferable to other domestic institutions, which include other local governments and other wholly government-owned entities, upon approval of the China's Securities Regulatory Commission (CSRC) and further approval from the Ministry of Finance (MOF).¹¹

Legal-person shares are owned by domestic institutions, most of which are business agencies or enterprises partially owned by the central or local governments. These so-called "legal persons" helped a company to go public by allowing resources under their control to be used during the start up and there can be a number of legal person shareholders in a listed firm. The average legal person ownership is over 30% in a listed company. Similarly to the state shares, the legal-person shares cannot be traded on the stock markets either, although they can be transferred or sold to other legal persons if approved by the CSRC.

¹¹ Sun et al. (2002)
State shares and legal-person shares are very similar for they both reflect continued state ownership and they comply with the policies maintaining a necessary dominant position for state ownership. It is for this reason that both types of shares were titled "state-owned" shares. However, they bear some vague differences for certain historical reasons.

While the concept of the state shares is straight forward – the state's investment or capital contribution to a corporation, the concept of legal-person shares is peculiar to the evolution of China's SOE reform. Before the economic restructuring which converted state enterprises into stock corporations, state enterprises were to submit all of their profits to the state and were to be subsidised for all their losses by the state. After the reform, in an attempt to improve production efficiency, the state introduced market incentives including allowing enterprises to keep extra profits above the state-specified profit level ("Delivery of contract profit to the State" scheme (1981-82) and "Substitution of profit with taxes" scheme (1983-86)). This use of market incentives was effective: enterprises soon accumulated extra profits which they have a legal right to retain, instead of surrendering to the state. In a shareholding system, when an enterprise invests in a company limited by shares, using such assets which the enterprise has a legal right to dispose of, as compared to the pure state assets, it receives "legal-person shares", rather than "state shares."

The above differences may be vague, but it is crucial to identify them as they would have a direct impact on Chinese control change and M&A activities. The transfer of state shares is still highly restricted. However, the Chinese government has shown signs to loosen controls over the transfer/trading of legal-person shares. Between 1992
and 2002 inclusive, the CSRC approved over 700 transfers and tradings of legal-person shares. With the dominating percentage of legal-person shares in a listed company, it is not difficult to see that a change of hand of these shares would result in a change of ownership, hence, control. Indeed, transaction of state-owned shares is the main form of "M&A"s of listed companies in China.

Different percentages of state-owned shares also have different implications on the agency problem. Sun et al. (2003) argue that the legal-person ownership (represented by the legal-person shares) is likely to provide more incentives for the managers of listed firms than the state ownership (represented by the state shares). Sun et al. (2003) give four reasons:

1) a local government ownership may limit state "predation" and reduces costly revenue hiding;
2) a legal person can be more effective in monitoring as it is typically a large shareholder from only one or a few companies whereas the state government's monitoring ability is affected by the vast number of firms it attempts to monitor;
3) the board members appointed by the legal-person shareholders are likely to be from various professional (rather than political) backgrounds, hence, they may bring more expertise; and finally
4) many legal persons have close business connections to the listed firm. It would therefore be in their best interest to ensure the profitability of the listed firm and ensure they could benefit directly from good firm performance.

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12 Zhang (2003)
13 Sun et al. (2003)
Whether the percentage of the legal-person shares will have impacts in transfer of control in China will be further addressed in Chapter 5.

2.2.2 A Shares and B Shares

A shares and B shares are domestically listed and traded in either the SHSE or SZSE. They are available to domestic individual or institutional investors.

A shares are similar to ordinary equity shares in other markets except that they are available exclusively to domestic Chinese investors. They bear the same rights compared to state-owned shares. As requested by the Corporate Law, the percentage of A Shares in a listed firm should account for no less than 25% of the total outstanding shares during an enterprise's initial public offering (IPO).\(^\text{14}\) A Shares typically account for around 30% in listed firms.\(^\text{15}\)

It should be pointed out that A share shareholders can hardly be major shareholders in virtually any listed companies. Even if some individual shareholders are among the top ten, their holdings are restricted to be below 0.5%,\(^\text{16}\) much smaller than those of state and legal persons. In addition, the majority of A share shareholders are individual retail investors, hence widely dispersed. The second panel of Table 2.2.2 below for example, reveals the percentage of individual and institutional A share investors on the SZSE from 1993 to 2003. The first panel demonstrates the total number of investors for both A shares and B shares and the third panel lists the relevant figures for B share investors.

\(^{14}\) Section 4, Article 152, The Corporate Law

\(^{15}\) Sun et al. (2002)

\(^{16}\) Chapter 4, The Interim Provisions on the Management of the Issuing and Trading of Stocks (Interim Provisions) issued by the State Council on 22 April 1993. This limitation, however, was waived by The Securities Law (1999).
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Table 2.2.2 SZSE Investors (1993-2003) in 000's

The lack of institutional investors indicated by the table above essentially signifies the dominating controlling power of the state and legal-person shares. For instance, although CEOs should be elected at the shareholders' general meeting, in practice however, the process merely involves the controlling shareholders (typically the state) appointing the board chairman and CEO. Other board members are appointed by other major shareholders but discussed beforehand with the controlling shareholder. Another example would be that any major strategic decisions are agreed outside the formal shareholders' general meeting or the boardroom because of the relatively high voting power enjoyed by these major shareholders. The influence of widely dispersed A share shareholders over the firm's management appears to negligible compared to state share and legal-person share shareholders. Whether the percentage of the A shares have impacts in transfer of control in China will be further addressed in Chapter 5.

About one-eighth of the listed firms meet the more harsh requirements to issue B shares, which are to attract foreign investors. These firms are expected to have an audit performed by international accountants before the IPO and to produce a stable and adequate supply of foreign currency in order to pay dividends. For example, companies that want to list B shares on the SZSE must have a minimum return on capital of 10 percent in the year preceding the listing. For the SHSE, among other rules, B share issuers must have been operating profitably for at least two consecutive years prior to listing. B Shares account for less than 5% of the total tradable shares and they are quoted and traded in US dollars on the SHSE and in HK dollars on the SZSE for the Chinese currency renminbi (RMB) is not yet freely convertible on the

17 Yao (1998)
capital account. B Shares could only be purchased by and traded among foreign investors and the investors from Hong Kong, Macao and Taiwan prior to 2001. At present, however, the domestic Chinese investors who have access to foreign currencies (US or HK dollars) have been allowed to own B-shares.\footnote{In February 2001, the CSRC allowed Chinese residents to open B-stock accounts using legitimate foreign currency.}

The third panel of Table 2.2.2 above showed the number of B share investors on the SZSE from 1993 - 2003. Although the percentage of institutional B share shareholders is much higher compared to the investors of A shares\footnote{Domestic investors who had access to legitimate foreign currency rushed to open B share account after the CSRC's policy change (footnote above) in 2001. This caused a sharp decrease of the percentage of institutional B share investors, as shown in Table 2.2.2.}, however, like local investors, foreign investors are also too insignificant to influence a firm's management. Trading is known to be thin in the B share market, and B shares are deeply discounted compared to their A share counterparts (Bailey, 1994; Sun and Tong, 2000).

### 2.2.3 Other Minority Shares

Other minority shares include employee shares and shares that are listed on Hong Kong and other foreign stock exchanges.

Not all companies issue employee shares, which are offered to workers and managers of a listed company, usually at a substantial discount. However, employee shares are limited in quantity. On average, employee shares account for less than 2% of the total shares and act essentially as an incentive scheme rather than providing ownership control of any kind. Employee shares are a unique feature of the Chinese stockholding

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18 In February 2001, the CSRC allowed Chinese residents to open B-stock accounts using legitimate foreign currency.
19 Domestic investors who had access to legitimate foreign currency rushed to open B share account after the CSRC's policy change (footnote above) in 2001. This caused a sharp decrease of the percentage of institutional B share investors, as shown in Table 2.2.2.
system and different from those in western markets such as the employee stock ownership plan in the US. They represent accumulated profits from previous contract-responsibility enterprise reform schemes, retained by the company prior to IPO and are collectively owned by the employees of the company. They are not tradable at the time of listing and are managed by either an investment management committee or a workers' union. After a holding period of six to 12 months, the company can apply to the CSRC to allow its employees to sell their shares on the secondary market. Once sold on the market, they become A shares.

A few selected "Red Chip" Chinese companies issue H shares on the Hong Kong Stock Exchange and N shares on the New York Stock Exchange. A few companies have issued shares on the stock exchanges in London, Singapore, etc. Again, they account for a very small percentage of the total outstanding shares.

2.2.4 Summary

The unique ownership structure presented by the different types of shares as detailed above has its advantages as well as disadvantages.

In order to preserve the predominant state ownership, the Chinese government has intentionally created a rigid state shareholding ratio. Furthermore, in order to avoid the loss in state assets, the government removes the state-owned shares from the secondary market, i.e. by making them non-tradable. This policy however is a double-edged sword for it limits the economic value of liquidity for these shares, and it may ultimately jeopardise the state ownership's interests.
Dividing shareholders according to their identity, i.e. domestic and foreign shareholders, as argued by Yao (1998), bears no clear rational relationship to any economic fundamentals and contradicts the "open, fair and just" principle claimed by the Corporate Law. Yet, the author admits that such division can be partially justified by the inconvertibility of the RMB on capital account, which is warranted by the macroeconomic conditions in China.

Different policies associated with different shares may also have an adverse effect on the listed companies and cause market fragments and segmentations. Wei (1995), for example, points out that the preferential policy for H shares has resulted in returns on A shares dropping, subsequently producing different market prices for the same underlined firm.

In summary, a typical listed Chinese firm has a mixed ownership structure. The state, legal persons and domestic individual investors are the dominant groups of stockholders, each accounting for about 30% of total shares outstanding. Many listed firms do not have B shares, employee or foreign shares, and even if they do, these shares on average consist of less than 10% of total shares outstanding when combined. This mixed ownership has been graphically illustrated by the Figure 2.2 below.
2.3 Stock Markets

A and B shares mentioned above are quoted and traded in two stock exchanges in China, namely, the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE). Whereas it is not the task of this section to give a comprehensive description of the stock markets, it is desirable to briefly look at their development and characteristics, and in particular, the trading of A and B shares, China's capital control policy in the stock markets, the big players' control and the regulatory aspects, for these issues will have direct impacts on the empirical analysis carried out later in this thesis.

2.3.1 A Brief History and Overview

The Shanghai Stock Exchange was inaugurated on 19 December 1990 with eight stocks (A shares) listed and the Shenzhen Stock Exchange on 11 April 1991 with six stocks (A shares) listed. Both stock exchanges are non-profit making organisations based on membership structures. The types of securities traded on the SHSE and SZSE now include A shares, B shares, T-bills, bonds, rights, and funds.

Due to the lack of strategic planning especially in the initial stage of the development of Chinese stock markets, the growth rate of the inflow of funds was much greater than the growth rate of total capitalisation. This resulted in sharp rise in share prices in the years immediate following the opening of two stock exchanges. The SHSE composite index, for instance, quickly rose from 100 (at 19 December 1990) to

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20 Notice that all together 12 shares were traded over the counter in Shanghai and Shenzhen prior to 1991.
780.39 at the end of 1992, and 834 at the end of 1993. After the initial abnormal development, the market entered a long-term adjustment period. New Laws and Acts have been passed and existing rules and regulations have been enhanced to ensure a healthy growth of the stock markets.

For the last 15 years or so, both exchanges grew dramatically. Figure 2.3.1a below illustrates the number of firms listed and the number of stocks traded in both exchanges from 1993 to 2003. Figure 2.3.1b shows the annual market capitalisation for the two markets (using end-of-year figures) respectively.

By the end of 2004, there were 837 companies listed and 996 securities traded on the SHSE, with a market capitalisation of 2,980,500 million RMB. The equivalent figures for the SZSE are 536, 673 and 1,265,300 million RMB, respectively.\textsuperscript{21}

Figure 2.3.1c and 2.3.1d below present the movements of Shanghai Stock Exchange Composite Index and Shenzhen Stock Exchange Composite Index, respectively.

\footnotesize{\textsuperscript{21}http://www.csrc.gov.cn, accessed May 2005.}
The indices shown above are the widely accepted benchmark indices for the two stock exchanges. It should be noted that these composite indices capture the price movement of both A shares and B shares. They are value-weighted arithmetic indices and are downloaded from bloomberg. In order to better illustrate the growth of Chinese stock markets, Table 2.3.1 below shows the relative performance of these two composite indices.22

As shown in the above figures, both indices grew to their historic high mid-2001 (June 13th, 2001) – Shanghai composite index rose to 2338 (350.11% relative to 668 on January 1st, 1995) and Shenzhen composite index rose to 698 (485.41% relative to 144 on January 1st, 1995). However, the growth was partially offset by the subsequent fall. At the end of 2003, two indices gained 134.98% and 173.76% respectively since 1995.

Table 2.3.1 below provide descriptive statistics for the daily returns on Shanghai and Shenzhen composite indices. In order to make comparison, relevant figures for daily

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22 Rebased to 100% on January 1st, 1995.
returns on Dow Jones Industrial index between 1995 and 2003 (inclusive) are also presented.

Table 2.3.1 Descriptive Statistics of Daily Returns of Shanghai Composite Index, Shenzhen Composite Index and Dow Jones Industrial Index (1995-2003)

<table>
<thead>
<tr>
<th></th>
<th>Shanghai Comp. Index</th>
<th>Shenzhen Comp. Index</th>
<th>Dow Jones Ind. Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>0.0005866</td>
<td>0.0006856</td>
<td>0.0005105</td>
</tr>
<tr>
<td>Standard Error</td>
<td>0.0004309</td>
<td>0.0004525</td>
<td>0.0002434</td>
</tr>
<tr>
<td>Median</td>
<td>0.0001774</td>
<td>0.0007859</td>
<td>0.0006881</td>
</tr>
<tr>
<td>Mode</td>
<td>#N/A</td>
<td>#N/A</td>
<td>#N/A</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>0.0200000</td>
<td>0.0210017</td>
<td>0.0115755</td>
</tr>
<tr>
<td>Sample Variance</td>
<td>36.6830833</td>
<td>24.7744590</td>
<td>3.6039832</td>
</tr>
<tr>
<td>Kurtosis</td>
<td>1.8559143</td>
<td>1.1507578</td>
<td>-0.1605473</td>
</tr>
<tr>
<td>Skewness</td>
<td>0.4894672</td>
<td>0.4744298</td>
<td>0.1353188</td>
</tr>
<tr>
<td>Range</td>
<td>-0.1683005</td>
<td>-0.1782532</td>
<td>-0.0718380</td>
</tr>
<tr>
<td>Minimum</td>
<td>0.3211667</td>
<td>0.2961766</td>
<td>0.0634807</td>
</tr>
<tr>
<td>Maximum</td>
<td>1.2634288</td>
<td>1.4766796</td>
<td>1.1548278</td>
</tr>
<tr>
<td>Sum</td>
<td>2154</td>
<td>2154</td>
<td>2262</td>
</tr>
<tr>
<td>Confidence Level(95.0%)</td>
<td>0.0008451</td>
<td>0.0008874</td>
<td>0.0004773</td>
</tr>
</tbody>
</table>

Source: Bloomberg

The two Chinese indices are more volatile, as measured by the standard deviations of 2.0–2.1%, while the Dow Jones Industrial index is the least volatile at the standard deviation of 1.2%. The higher volatility of Chinese stock markets, when compared with that of Down Jones Industrial index, hence, New York Stock Exchange (NYSE), however, should not be too surprising. After all, NYSE is considered to be one of the most developed markets while SHSE and SZSE have a relatively very short history.

2.3.2 Organisational Structure

Both SHSE and SZSE consist of four main parts: members, a board of directors, a general manager, and a supervisor board. The members are those selected securities firms which have equal rights to attend members' meetings, to vote for or to be voted for as directors and supervisors, and to decide vital issues, etc. Table 2.3.2 below shows the annual number of the members of the two stock exchanges respectively.
The director board is selected by the meeting and is in charge of daily operations. The general manager is the legal representative of the exchange and is appointed by the CSRC. The supervisor board is responsible for supervision of the exchanges' accounting and business operations. All of them must report to the members' meeting annually.

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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>SHSE</td>
<td>481</td>
<td>550</td>
<td>553</td>
<td>523</td>
<td>467</td>
<td>317</td>
<td>309</td>
<td>305</td>
<td>255</td>
<td>199</td>
<td>171</td>
</tr>
<tr>
<td>SZSE</td>
<td>426</td>
<td>496</td>
<td>532</td>
<td>542</td>
<td>373</td>
<td>329</td>
<td>318</td>
<td>326</td>
<td>284</td>
<td>237</td>
<td>205</td>
</tr>
</tbody>
</table>


2.3.3 Stock Issuances

Both SHSE and SZSE have similar requirements that must be fulfilled by companies to be listed on the market. The SHSE requirements are listed below to illustrate these IPO requirements:

1. The total amount of shareholders' capital is no less than 5 million RMB;
2. The number of public traded shares is no less than 25 per cent of the total number of outstanding shares;
3. The number of shareholders is no less than 500;
4. The company must have gained net profits for the most recent two years;
5. The issuer must be recommended by a member of the SHSE; and
6. Company information must be disclosed regularly in at least one publicly published newspaper or periodical.23

23 The SHSE Fact Book 2000, China Financial Publisher
In practice, though, both stock exchanges have applied stricter criteria for IPOs than the requirements listed above, especially during the early years of their operations. The reason was that the stock exchanges had to pay more attention to the companies' quality to protect the confidence of the new market. For example, to list on SHSE, a company had to make profits for at least three consecutive years before its proposed listing date. The rule was later dropped to show the market's support of high-tech companies.

In addition to the above basic requirements, the SHSE has been given the following guidelines for selecting firms to be listed.

1. To give priority to 1000 key SOEs, 120 key private enterprises, and 100 key "modern management system experiment firms" appointed by the central government.

2. To give priority to the listing of firms in the sectors that comply with the state's development policy. These sectors include agriculture, resources, communication, rare materials, and high technology.

3. To support the transformation of regional (in the case of the SHSE, areas around Shanghai) economic structure and the reform of local (Shanghai) well-performing SOEs.

4. To support firms that have good reforming plans.

5. To encourage corporate restructuring.

6. Not to list low-tech firms and firms in "saturated" sectors.24

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24 The SHSE Fact Book 1996, China Financial Publisher
The guidelines were set up according to the macro development policies set by the central government. Since there are numerous firms meeting the basic requirements for listing, the guidelines therefore played an important role in selecting the firms to be listed. In addition, a quota based recommending/selection mechanism was used. To be more specific, each province was allowed to recommend only a specific number (different from province to province) of firms to be considered as "candidates" each year. As a result of these artificial selection measures, the majority of the listed companies are industrial SOEs. Such a selection reflects the priority in the nation's reforming schedule, however, the guidelines also made it difficult for some highly competitive firms, such as some private companies or joint-ventures, to list on the stock market because of less government support.

Stock issuance is subject to further approval by the CSRC that "a public stock issuance shall follow the conditions as stipulated in the Corporate Law and be submitted to the securities regulatory agency under the State Council (hence, CSRC) for verification." 25

Under the primary method of stock issuance, a stock's issuing price is fixed after the registration with the stock trading system. That is, the lead underwriter issues the stock at a pre-fixed issuing price, by using the trading system of the stock exchanges. "In case premium issuance is adopted for a stock issuance, the issuing price shall be negotiated and determined between the issuer and the underwriter, subject to the verification of the securities regulatory agency under the State Council." 26

26 Article 28, The Securities Law
2.3.4 Operating, Trading and Clearing

Operation
With 1,608 exchange seats and 5,700 terminals, the SHSE is now the largest trading hall in the Asia-Pacific region. Its trading system connects with the outside world via a satellite communications network transmitting real-time market intelligence daily to 3,000 satellite-receiving stations around China. As a matter of fact, brokers occupy mainly 'virtual' seats and most member firms conduct transactions online.

Both stock exchanges are open 5 days a week except holidays. The SZSE has more holidays during the Spring Festival (Chinese New Year) than the SHSE each year. Both exchanges open officially at 9:30am and close at 3:00pm with a lunch session from 11:30am to 1:00pm. The total trading hours are therefore four hours each day. In addition, there is a pre-trading session from 9:00am to 9:30am each day. The morning opening prices are generated during the pre-trading session. The tick size is one cent, regardless of the stock price. Both markets are completely order-driven, with no specialists or market makers.

Trading
Both exchanges have adopted a centralized, scripless, computerised order matching system, which uses two trading methods, namely 1) a periodic auction and 2) a discriminating continuous auction.

1. The periodic auction is employed once a day to generate the morning opening prices. All orders cumulated between 9:00am and 9:30am are batched for execution at the end of the pre-trading session at a "balance price", which is
calculated so that the maximum possible number of buy and sell orders in the auction can be matched.

2. The discriminating continuous auction for matching transactions is used during regular trading hours and follows two principles: the price priority and the time priority. In this type of auction, buy and sell orders are submitted and announced continuously. Matched orders are executed and then subsequently removed from the system. Unmatched orders remain in the system until they are executed or cancelled. The prices are generated contingent upon the bid/ask prices and time of submitted orders.

The afternoon session is a continuation of the morning session. Orders accumulated during the lunch break will be instantaneously executed. This operation is different from that of the Tokyo Stock Exchange where the periodic auction is used twice a day and also different from that of the Hong Kong Stock Exchange where the morning and afternoon sessions are opened with a continuous market (Chang et al., 1993; Cheung et al., 1994). All orders are valid only for one day with the smallest trading unit of 100 shares. Floor trading among member brokers and short selling are not allowed in either stock exchange. Therefore, a transaction can only be legally recognised if it is executed through the automated order matching system.

The trading process at the SZSE differs slightly from the SHSE in that there is a dual clearing system with stocks centrally cleared and locally registered.

To examine how a transaction is processed through the stock exchange, it is perhaps easier to look through an example. Suppose Mr A wants to buy 400 shares of a certain
stock. He can either key in the order by himself through a terminal linked to the exchange, or he can fill in an application form and pass it to an operator in his agent company. If he uses a paper application, the operator will inform the company's appointed broker via telephone, the broker will then key in the order for Mr A. This order will be sent to the computer transaction system that matches the buying and selling orders automatically. When a matched deal is found, the system will then send the transaction information back, and Mr A or his broker will see the results through the terminals. The transaction data will also be sent to the central clearing system. Mr A then has to go to his agent company to close the deal and the shares will be transferred to his account automatically by the system while his cash account will be deducted for the amount of total price, the associated tax and transactional fee.

To illustrate the price priority and the time priority, let us look at Mr A's transaction more closely. Suppose at 10:00am Mr A inputs an order to buy 500 shares of a stock at the price of 18.30 yuan per share while at the same time Mr B inputs an order to buy 100 shares of the same stock at 18.00 yuan per share. At 10:01am Mr C wishes to sell 300 shares of the stock for 18.00 yuan per share and at 10:02am Mr D also wishes to sell 300 share of the stock for the same price. The price priority principle means that Mr A's order will be executed first followed by Mr B's order for Mr A is willing to pay a higher price. The time priority means that Mr C will be able to sell all his 300 shares at 18.30 yuan per share to Mr A, whereas Mr D will only be able to sell 200 shares to Mr A at 18.30 yuan per share, with his remaining 100 shares sold to Mr B at 18.00 yuan per share since Mr C's order to sell is entered earlier than Mr D's.
Clearing

Prior to 1 October 2001, The Shanghai Securities Central Clearing and Registration Co., a wholly owned subsidiary of the SHSE was the central clearing house for the SHSE and the Shenzhen Securities Clearing serves as the clearing house for the SZSE. As of 1 October 2001, above two clearing centres were replaced by the China Securities Depository and Clearing Corporation Ltd. (SD&C), China's current sole national securities depository, clearing and registration company, providing services for the two exchanges. All of its services are processed on two separate platforms operated by the Shanghai branch and Shenzhen branch, respectively.

The Industrial and Commercial Bank of China (ICBC) serves as the clearing bank for both stock exchanges. Individual investors keep accounts with their brokers. Consequently, the payment side of a transaction requires two clearance levels: first, among member brokers of security exchanges; second, between individual investors and brokers. B share trades are similar to A share trades except that settlement takes place 3 days after the day of a trade. Citibank acts as the clearing bank for the SHSE, while Standard and Chartered Bank has been appointed as the clearing bank for the SZSE. Investors, however, are free to choose their own banks in dealing with the official clearing bank.

2.3.5 Capital Control

Since December 16, 1996, both exchanges have used a daily price limit of 10% (both upper and lower limits) based on the previous day's closing price. When a stock hits a price limit, there is no special announcement; instead, this information is simply
posted on the exchange's trading screens. Like most price limit systems, trading of the stock is allowed to continue after it hits a price limit, but only orders at or within the price limits are executed.

This capital control and price limit control is common in most transitional economies and particularly necessary for both SHSE and SZSE. The size of the two Chinese stock exchanges, in terms of their market value, is still relatively small compared to their counterparts in developed countries. The market is not mature in terms of the quality of both listed companies and security traded. The entry of too much "hot money" and larger funds may lead to manipulation and/or make the markets riskier. In order to protect the interests of small investors and to stabilise of the market, capital control is imposed to make sure that the market is not "overheated" and not manipulated by hostile international capital. Price limits may also be able to cool down markets during times of panic, excessive volatility and help to identify market manipulation. The advantage of capital control policies as such was clearly demonstrated during the Asian financial crisis, when China became one of the few Asian countries that were able to keep their currencies and stock markets relatively stable. Although faced with severe criticism from foreign investors, such measurement remains necessary for a relatively immature securities market.

Although price limit control is a common practice in stock markets in transitional economies and seemingly effective in reducing speculation, one should be cautious in interpreting the advantages as well as disadvantages brought by this policy. As shown

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27 For example, the Tokyo Stock Exchange believes that price limits provide a cooling down effect (Tokyo Stock Exchange, 1997), while the Taiwan Stock Exchange and the Athens Stock Exchange believe that price limits moderate excessive volatility and destabilize speculation, respectively (Yang and Kim, 2001).
by Kim and Rhee (1997), when security prices are prevented from going beyond their price limit, desired trading activities are postponed. Consequently, equilibrium price discovery is delayed and, at the same time, stock price volatility is merely temporarily contained. Ma (1992) has argued that there is no clear expected relationship between price limits and speculation. Hermes and Lensink (2000) show there is little support for a positive link between speculation and volatility and conclude that introducing price limits to curb speculation for that purpose may be mistaken. Charemza and Majerowska (2000) examined whether trade limits, in the form of upper and lower limits on stock prices, are effective instruments in reducing portfolio risk both at the theoretical and the empirical level and they conclude that price limits are expensive and increase market inefficiency and portfolio risk. Recently, Chen et al. (2005) find that price limits do not improve information asymmetry, delay the arrival of informed traders, and exacerbate order imbalance.

2.3.6 Big Players’ Control

Another important phenomenon in the Chinese stock markets is the big player's (庄家) control, also called as insider control in western markets. The Chinese term for the big players is zhuangjia, – the "banker" in a gambling game, a term used often in a casino environment – which refers not only to illegitimate investment but also to those big official market players such as brokerage houses and investment funds and non-official players who may have a close connection with the insiders. Although insider control has been observed worldwide, the systematic market manipulation caused by these big players is particularly severe in China.
A number of market participants and regulators in China belong to the informational or even operational insiders. It is not uncommon for informational insiders to use their privileged information advantage (whether they spend a fortune or make efforts to discover the information is another issue) for profitable transactions, but in China, some big players not only know more than others, but are also able to vigorously influence price movements with well-coordinated buy and sell activities, on a much larger scale. This phenomenon has been well documented by Chinese as well as overseas scholars (Yao 1998, Ma 2000, Heilmann 2002). Undoubtedly this sort of insider control will harm the majority of small retail investors who are not informationally privileged. The severely affected price movements will almost certainly push the share prices away from their fundamental values and affect the market's judgement, for instance in corporate restructuring activities, hence, undesired outcomes. These effects help to explain some empirical results in Chapter 5 as will be attained.

The securities industry, being one of the most heavily regulated industries in a nation's economy, is subject to much "political lobbying in rule-marking, rule-enforcement and rule-evasion."28 It is strange to find that the Chinese government for a long time "tolerated" such insider control and did not pass relevant regulations to prevent it.29 There are three possible explanations:

1. Inexperienced legislator. It is likely that the Chinese regulators in the early stages of the development of the stock markets may have underestimated the consequences of the insider control and the inexperienced legislators simply took longer to pass an adequate regulation.

28 Heilmann (2002)
29 It was not until 1 July 1999, when The Securities Law became effective, that "inside information" has been defined.
2. Corruption. As analysed by Heilmann (2002), in the initial operating period, the government and the converted SOEs were closely connected. It would be difficult to draw a line between the regulator and the regulated. When a "mutual" benefit becomes possible within a poorly regulated environment, corruption can occur.

3. Market making. This is likely to be the most appropriate interpretation of this phenomenon. The government might have concerns about the stock market in its infant stage, such as concerns about whether it will attract investment, or whether there will be high demand for the stocks, etc. In order to control and support the market, the regulator to some extent relied on the cooperation of these big players to make a market or to generate high turnovers, even if that meant manipulation!

Despite these possible reasons and the fact that the big players' control was serious for some time, such control is much less severe than previously, thanks to better educated investors, experienced regulators, and more comprehensive regulations.

2.3.7 Regulators and Regulations

Prior to and immediately after the establishments of the two stock exchanges, the central bank – People's Bank of China (PBC) (and its branches) – was the main regulator of share issuing and trading in China, along with the Ministry of Finance, the State Planning Committee and the State Economic System Reforming Committee.
Due to the experimental nature of the early securities market development, these regulatory entities played only limited roles and failed to build a national securities regulatory framework. It was not until October 1992, that two official regulatory bodies were set up: the Securities Committee of the State Council and the CSRC. The former was later merged into the CSRC to form a unified governing entity. In its initial stage of establishment, the CSRC's role was more supervisory and monitory than regulatory.

The Interim Provisions on the Management of the Issuing and Trading of Stocks (Interim Provisions) issued by the State Council on 22 April 1993 for a long time served as a nationwide securities regulation, governing two stock exchanges and share tradings. The Interim Provisions were not complex and far from being complete. The Corporate Law, promulgated by the National People's Congress on 29 December 1993 and effective from 1 July 1994, was the first national law governing corporate enterprises.

The Interim Provisions and the Corporate Law mentioned above, along with hundreds of other provisional regulations, form the initial legal framework governing the Chinese securities market. However, their regulatory power was limited due to the lack of a national securities law, which was urgently needed. The market was volatile with heavy manipulations and speculations for the next 3-4 years. It is under these circumstances that a new committee was formed on June 1998: the Central Financial Work Committee of the Chinese Communist Party (中共中央金融工作委员会) led by the then vice-primer minister Wen Jiabao.
Even many of those specialised in the Chinese financial reform did not know that this committee existed. The setup of the Central Financial Work Committee showed the determination of the central government to enhance and perfect financial regulation for the securities markets in China.

Working closely with the CSRC and the Draft Commission of The Securities Law, The Central Financial Work Committee has accelerated the completion of The Securities Law. The Law was passed by the People's Congress on 29 December, 1998 and went into effect on 1 July, 1999. Compared to the Interim Provisions and the Corporate Law, which were drafted and issued in a relatively short time period and subsequently criticised for being not comprehensive and considerate, it took well over 5 years before the final draft of the Securities Law was submitted for approval. As will be revealed in section 2.4, regulatory improvements were brought in by the Law. Chapter 5 will further address this issue.

The CSRC was granted more regulatory power by the end of 1998 and has become more active in regulating the Chinese securities markets. The Central Financial Work Committee co-existed for over 5 years and in 2003 it was finally dissolved into three major regulating entities, China Banking Regulatory Commission (CBRC), China Insurance Regulatory Commission (CIRC) and China Securities Regulatory Commission (CSRC), covering banking and insurance, and securities.

In summary, the Interim Provisions, the Corporate Law and the Securities Law form the basic legal framework and the CSRC is the major regulator in the Chinese securities markets at the present.
It should be pointed out though that the Provisions and the Laws mentioned above have covered M&As, as shall be later revealed, they are not adequate for current M&A activities in China. Section 2.4 will detail the development of corporate restructurings in China and Section 2.5 will explain how they were regulated.

2.4 M&As and Acquisitions of Control in China

Prior to the 1980s, there were very few M&As or acquisitions of control in China due to the highly planned nature of the economy. Any occasional restructuring activities were carried out in the form of an administrative "order." 1984 saw the start of "modern" M&A activities in China. A property rights exchange market was established for the first time and regional regulations concerning M&As emerged. Within the last twenty years, there have been dramatic changes in this field. Firms now seek more effective ways to improve their competitiveness through M&As, with relatively less direct government influence.

This section will give a brief review of the development of corporate restructuring in China since 1984, an introduction to the types and forms of M&As in China.

2.4.1 Development of M&As in China

It is difficult to draw a clear line between different stages of the development of M&A activities in China. Based on the concentration of these activities, major policy changes and the characteristics of merger activity, the history of modern enterprises'
M&As in China can be broadly divided into three stages: the initial stage, when M&As first emerged; the adjustment stage, when the fast expansion of M&As was associated with numerous problems and finally the standardisation stage, when M&As (especially those involving listed firms) were better regulated and guided.

2.4.1.1 The Initial Stage (1984 – 91)
As was explained in section 2.1, despite various schemes that the Chinese government had undertaken to reform the SOEs, the results were not entirely satisfactory. The shareholding system had not been introduced. Whereas some of the SOEs became successful thanks to the reform, their further growth was limited by the lack certain crucial resources, such as land and equipment. On the other hand, some SOEs had these resources but were poorly run and heavily burdened by debt.

The government of Baoding City boldly tried to solve this dilemma without the approval from the central government and its efforts eventually led to the first takeover case in China's modern enterprise history. On 5 July 1987, the local government encouraged the Baoding Textile Machinery Factory, a well-performing SOE, to take over the Baoding Knitting Equipment Factory, a near bankrupt SOE. The intention was that the Textile Machinery would pay all the debts that the target firm had and in return, the buyer would be able to make full use of the target's land and factory facilities.

After its first attempt, the Baoding government guided ten more acquisitions in a similar fashion, because the results were apparently very encouraging. Firstly, the number of poorly-performing SOEs was reduced, hence, they became economic, and
perhaps more importantly, political achievements for the local officials. Secondly, by "ordering" ("guiding" was the official term) these restructurings, the industrial structure was, to some extent, optimised, and the resources (land and equipment, etc.) were re-allocated more efficiently. Finally, more tax income and loans were paid back, so providing the city with extra funds, which could be used elsewhere.

At the mean time, Wuhan City was also facing a situation where a large number of SOEs were near the edge of bankruptcy. However, bankruptcy was not a realistic option because there was not yet a bankruptcy law and because of the lack of an adequate social welfare system for those who would be unemployed if bankruptcy was claimed. Unlike Baoding, where the local government initiated the restructurings, enterprises in Wuhan took their own actions. After a number of meetings between the managers of the Wuhan Milk Co. and the Hankou Restaurant, an almost out-of-business restaurant, the Milk Co. agreed to pay a lump sum of 120,000 RMB (USD15,000) to take over the Restaurant and convert it into a retailing outlet of the Milk Co., while keeping all of the original employees. The benefits were mutual for the buyer obtained a much better located outlet and the managers and employees from the Restaurant were guaranteed a safer future. Their joint application was soon granted by the local government. Many firms followed and by the end of 1984, there were 40 acquisitions in Wuhan.

There were clear differences between the two acquisitions described above: Baoding and Wuhan. If the local government played a more important role in Baoding, then the restructurings in Wuhan were more spontaneous. However, the similarities should be noted. All the acquisitions involved only municipal-level firms, which were
medium- or small-sized with very simple motivation and limited economic gains. The importance of these two cities' cases, nonetheless, are perhaps beyond the economic gains, because this marked the beginning of the modern Chinese M&A history.

Baoding and Wuhan's experience were promoted nationwide and China witnessed the first wave of restructuring activities. By the end of 1989, limited statistics showed that over 2,559 firms were taken over with transactions valued over 2,015 million RMB (over 250 million USD).\(^{30}\)

A few regulations which were issued since the late 1980s form the early legal framework for regulating M&A activities in China.\(^{31}\)

Chinese M&As in this initial developing stage bear some characteristics that are worth noting.

1. The majority of the M&As appear to be within the same city, same industry or between companies that shared the same supervising governmental department. This reduced the difficulties in obtaining approvals of the proposal for restructuring.

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\(^{30}\) Chen (1998)

\(^{31}\) These regulations and Laws include: Law of the Enterprise Bankruptcy (破产法) promulgated on 2 December 1986; Administrative Regulations Governing the Registration of Legal Corporations (中华人民共和国企业法人登记管理条例), issued by the State Council on 13 May 1988; Interim Measures Governing Enterprise Merger (关于企业兼并的暂行办法), issued jointly by the State Commission for Reform of the Economic System, the State Planning Commission, the MOF, and the State Administration of State-Owned Assets on 19 February 1989; Interim Measures regarding the Selling of Property Right of Small-Sized State-owned Enterprises (关于出售国有企业产权的暂行办法), by the State Commission for Reform of the Economic System, the MOF and the State Administration of State-Owned Assets on 19 February 1989; Interim Regulations Concerning the Assignment and Transfer of the Right to the Use of the State-owned Land in the Urban Areas (城镇国有土地使用权出让和转让暂行条例), issued by the State Council on 19 May 1990; Rules on the Evaluation and Management of State-owned Assets (国有资产评估管理办法), issued by the State Council on 16 November 1991.
2. The motivations behind these activities were simple: from the government's point of view, to reduce possible deficits; from the buyers' point of view, to obtain tangible assets under poor management and expand; from the sellers' point of view, to avoid bankruptcy and unemployment.

3. Government, whether it is county, municipal or provincial, remained heavily involved in these activities either by ordering, co-ordinating or just "guiding" – a Chinese characteristic that continues to be seen even today.

4. These activities were very poorly regulated. Although a few "rules" and "notices" were issued within this period, no clear definition of a M&A was yet given and there were, indeed, inadequate regulations.

2.4.1.2 The Adjustment Stage (1992 – 94)
Deng Xiaoping's famous tour around the southern provinces of China in 1992 and his call for a "bolder" reform stimulated further rapid expansion of restructuring activities across the nation. Acquisition was widely used and acquisitions through the stock market also appeared during this period. It was not until mid-1994 that such an overheated restructuring wave was brought to a temporary pause by the central government due to the problems that occurred during the rapid expansion.

Over 20 Property Right Exchange markets were set up in the early 1990s throughout the nation and by the beginning of 1994, the number of such markets had risen to 174. Tangible assets of SOEs were traded over such markets to other SOEs, subject to final approval from the relevant governmental departments. The Shanghai Urban and Rural Property Right Exchange even offered the whole enterprise as an entity to be traded. It is with the help of those exchanges and the enthusiasm from local governments, that
over 10,000 enterprises were taken over by 1993, with transactions valued at 8,225 million RMB (over 1,000 million USD).\(^{32}\)

The "Bao-Yan Event" of 1993 was the first restructuring activity ever in Chinese stock markets. In September 1993, the Shenzhen Bao'an Group acquired 16.8% of the Yanzhong Company's total shares by purchasing Yanzhong's A shares in the SHSE. It subsequently became the largest shareholder and gained control of the Yanzhong.\(^{33}\)

This event, however, should not indicate that the main form of Chinese M&As was purchasing A Shares via the secondary market. As described earlier, A Shares only account for about one third of the total outstanding shares and are widely dispersed, a non-dominating percentage in most cases.

By the end of 1994, the first restructuring in the form of legal-person share transaction took place between an unlisted firm, the Zhuhai Hengtong and the Shanghai Lingguang, the largest shareholder of the Lingguang Industry and Commerce. The former acquired 12 million legal-person shares (35.5% of the total shares) from the latter and replaced it to be the largest shareholder. "Acquisition" by only gaining the controlling percentage of the shares (mostly state shares or legal-person shares) has gradually become the norm for listed companies' restructurings in China for it reduces the overall takeover cost and is easier to carry out, given that governmental approval can be obtained.

\(^{32}\) Various sources from Guo (1998), Chen (1998) and statistics published by the State-owned Assets Supervision and Administration Commission of the State Council (SASAC).

\(^{33}\) The "Bao-Yan Event" remained very controversial and was widely debated for a long time. In short, the buyer used loop-holes in The Interim Provisions regarding information disclosure and the definition of "related trading." The SCRC later recognised the transaction, but warned the Bao'an for violating those rules by wrongly interpreting them. The Interim Provisions were soon enhanced. For more details, please refer to Ma (2003).
The characteristics and indeed the problems of the acquisitions of control in this stage were as follows.

1. The number of acquisitions of control was increasing quickly, although the targets tended to remain medium- or small- sized firms. Larger SOEs, still under the direct control of the state government, were very cautious in these experiments.

2. A greater variety of acquisitions was witnessed. Under the co-operation of different levels of government, there were more cross-industry and cross-province acquisitions than prior to the 1990s.

3. Heavier governmental intervention was associated with the acquisitions in this stage for many governments were eager to achieve their "political goal."

4. The motives behind these activities were still simple. In fact, with heavier governmental involvements and driven by the government's political desire, enterprises were forced to acquire losing targets while not benefiting from the restructurings.

5. Many governments failed to give further support to the newly formed firms and the buyers tended to ignore the importance of post-merger integration.

6. There was a lack of professional intermediary institutions, which would have helped to standardise the takeover procedures.

7. A large number of regulations were issued, addressing M&As or acquisitions of control and the associated issues more closely, however, the need of more adequate and comprehensive regulations was more urgent than ever.

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34 Many regulations were passed within this period, a few important ones are listed below: Provisions of the State-owned Enterprise Unemployment Insurance (国有企业职工失业保险的规定) issued by the State Council on 12 April 1992; Interim Rules on the Management of Property Right Registration of the State-owned Assets of Enterprises (国有资产产权登记管理办法), issued jointly by the State Administration of State-Owned Assets, the MOF and the State Administration of Industry & Commerce (SAIC) on 11 May 1992; Detailed Rules for the Implementation of Rules on the Evaluation
8. The lack of a well-defined assessment of the state assets, tangible or intangible, affected the overall success of acquisitions.

9. The indiscriminately expansion of restructuring raised issues such as the loss of the state assets, tangible or intangible.

10. Problems associated with the laid-off employees after the merger were becoming more and more serious.

It was with the above concerns, that the General Office of the State Council issued an urgent circular in April 1994 to prohibit unauthorised tradings of the state-owned assets among SOEs\(^{35}\) and called the relevant legislators to draft regulations in acquisitions. This circular, cooled down the apparent acquisitions fever.

2.4.1.3 The Standardisation Stage (1995 –-present)

Although the fever had cooled down, takeover activities never completely stopped. The government gradually realised that, as an efficient and effective means of corporate restructuring, acquisitions should be well guided and wisely used to assist the enterprise reform. There was a lack of supporting policy and regulations. From May 1995 onwards, the State Council, the Ministry of Finance (MOF), the China Banking Regulatory Commission (CBRC) and the People's Bank of China (PBC) had issued, independently or jointly, a number of documents and circulars to further

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encourage poorly-performing SOEs to be taken over by well-performing SOEs and appointed 18 cities\textsuperscript{36} (soon expanded to 58, then to 111 cities\textsuperscript{37}) to be the experimental units. Preferential tax and loan policies were granted to the acquirers. For example the regulations required that when acquirers had to repay the loans of the target after the takeover, the interest associated with the loans would be waived. Corporate restructuring and M&As soon re-attracted attention from not only the government officials and enterprises' managers, but also from scholars as well as ordinary investors.

The highlights of this period, however, were undoubtedly the restructuring of the companies listed on the SHSE and SZSE. Table 2.4.1.3 below presents the number of listed firms along with the total number of the listed companies that were involved in restructuring activities from 1993 to 2003.

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<tbody>
<tr>
<td>Firms Listed</td>
<td>183</td>
<td>291</td>
<td>323</td>
<td>530</td>
<td>745</td>
<td>851</td>
<td>947</td>
<td>1086</td>
<td>1154</td>
<td>1223</td>
<td>N/A</td>
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<tr>
<td>Firms in M&amp;A</td>
<td>1</td>
<td>6</td>
<td>0</td>
<td>9</td>
<td>33</td>
<td>71</td>
<td>351</td>
<td>187</td>
<td>389</td>
<td>169</td>
<td>1216</td>
</tr>
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</table>

Acquisitions of control involving listed firms grew rapidly and they had some distinctive features compared to those involving non-listed companies. For example, listed firms abided by different accounting principles. The Basic Accounting Standards for Enterprise went into effect from 1 July 1993, with 13 new accounting regulations for enterprises in different industries. A further nationwide accounting

\textsuperscript{36} Circular on Handling Bank Loans and Interests after Encouraging and Supporting Better-Performing SOEs in the 18 Pilot Cities to Acquire the Distressed State-owned Industrial Enterprises (关于鼓励和支持18个试点城市优势国有企业兼并困难国有工业生产企业后有关银行贷款及利息处理问题的通知), issued by the PBOC, the State Economic and Trade Commission and the MOF on 4 May 1995.  
\textsuperscript{37} Chen (1999)  
\textsuperscript{38} Various statistics from the CSRC, the SHSE and SZSE and Guotai Securities Co. database.
standard similar to the International Accounting Standard (IAS) was promulgated in 1997. By the end of 1998, a total of eight accounting standards had been pronounced. Among these standards, seven are applicable only to listed companies.

The level of information disclosure requirement differs between listed and non-listed companies. The Corporate Law (1993) requires all share capital-based firms to prepare an audited financial report at the end of the year. A LLC should provide the report to its shareholders whereas a LSE is required to display the report at its registered office prior to the annual general meeting so that shareholders can consult it. A listed firm is bound by stricter rules. It must prepare both an interim report and an annual report within 60 days after the first 6 months of the year and within 120 days of the end of the year, respectively. It must submit 10 copies to the CSRC, publish an abstract in at least one national newspaper approved by the CSRC, and deposit the reports and the abstract in the company's registered office and with the relevant stock exchange and securities trading agents for public consultation.

The ownership structure is better defined in a listed firm than in a non-listed firm. Although the ownership structure, as discussed in the previous sections, is perhaps far from being clear, it is much better defined and more transparent compared to those unlisted firms.

The regulatory environment has been improved dramatically. New Laws and regulations were issued\(^{39}\), replacing some of the previous regulations\(^{40}\). In addition, 

\(^{39}\) Circular Concerning Interim Provisions on Several Problems on Mergers and Bankruptcy of SOEs (关于试行国有企业兼并破产中若干问题的通知), issued by the PBOC and the State Economic and Trade Commission on 25 July 1996; Interim Provisions Concerning Several Financial Problems on Mergers of State-owned Enterprises (企业兼并有关财务问题的暂行规定) and Interim Provisions
The Corporate Law was amended in 1999 and further amended in 2004; The Securities Law was promulgated in 1999 and amended in 2004; Regulations on the Takeover of Listed Companies and Measures for the Administration of Disclosure of Shareholder Equity Changes of Listed Companies were issued in 2002. These Laws and administrative regulations all have specifically addressed domestic M&A issues. Furthermore, Interim Provisions for Foreign Investors to Merge Domestic Enterprises were issued in 2003, which attempted to regulate takeovers by foreign investors. Although not without their limitations, these laws and regulations indicate that the industry has now been closely monitored and better regulated. The regulatory aspects of the M&As in China will be further detailed in Section 2.5.

In summary, corporate restructuring has been a relatively new phenomenon in China, with a history of less than 20 years. The legal framework has been continually modified and improved.

Concerning Several Accounting Problems on Mergers of Enterprises (企业兼并有关会计处理问题暂行规定), issued by the MOF in August 1996; Interim Measures for the Management of the Transfer of the State-owned Property Right of Enterprises (国有企业产权转让管理暂行办法), issued by the SASAC and the MOF on 31 December 2003; Interim Rules on the Management of Property Right Registration of the State-owned Assets of Enterprises (国有企业产权登记管理办法) was replaced by Rules on the Management of Property Right Registration of the State-owned Assets of Enterprises (企业国有资产产权登记管理办法) issued by the State Council on 25 January 1996; Provisions of the State-owned Enterprise Unemployment Insurance (国有企业职工待业保险的规定) was replaced by Regulations of the Unemployment Insurance (失业保险条例), issued by the State Council on 26 December 1998; Measures for the Supervision and Administration of the Property of the State-Owned Enterprises (国有企业财产监督管理条例) was replaced by Interim Regulations on the Board of Supervisors in the State-owned Enterprises (国有企业监事会暂行条例), issued by the State Council on 1 February 2000. The Securities Law (证券法), promulgated on 29 December 1998; Regulations on the Takeover of Listed Companies (上市公司收购管理办法) and Measures for the Administration of Disclosure of Shareholder Equity Changes of Listed Companies (上市公司股东持股变动信息披露管理办法), issued by the CSRC on 28 September 2002.

Interim Provisions for Foreign Investors to Merge Domestic Enterprises (外国投资者并购境内企业暂行规定), jointly issued by the Ministry of Foreign Trade & Economic Cooperation (MOFTEC) (which has now been incorporated into a wider ranging Ministry of Commerce (MOC)), the State Administration of Taxation (SAT), the SAIC and the State Administration of Foreign Exchange (SAFE) on 7 March 2003.
2.4.2 Types and Forms of M&As in China

2.4.2.1 Types of M&As
There are many ways to group M&As into different categories. One of the common methods is to classify them as horizontal, vertical or conglomerate, a classification that is based on whether a merger or acquisition has taken place at the same level of economic activity-exploration, production or manufacturing, wholesale distribution, retail distribution to the ultimate consumer, or in other words, the element of relatedness. Indeed, any takeover in China can be classified into these three groups.

1) A horizontal acquisition involves two firms operating and competing in identical or similar fields of business. A larger firm may therefore benefit more from economies of scale and acquire more market shares as results of a horizontal acquisition. The disadvantages of a horizontal acquisition however are well known for it may have a negative social impact due to reduced competition and the firm's industrial risk may increase due to the lack of diversification.

Many of the earlier acquisitions in China fell into this category, not only because the acquirers wanted to gain, say, economics of scale, but also because a horizontal acquisition may face less constraints in terms of obtaining approvals from its superior governmental departments. The SOEs within the same field of business are likely to be supervised by the same governmental officials.

2) A vertical acquisition takes place between firms in different production or operation stages in a particular industry. There are many reasons why firms want to be vertically integrated. Repeated transaction costs, for instance, may be eliminated for
the costs of searching for prices, contracting, payment collecting, and advertising would now decrease. The costs of communicating and coordinating are also likely to be reduced because of a more efficient internal information flow within a single firm. Reduced chances of hold up depending on the degree of asset specifically may also be a benefit. The disadvantages of a vertical acquisition, however, rest primarily on these issues as well, i.e. whether the cost of market exchange and contracting could be substantially reduced after an acquisition. Possible loss of economies of scale and increased agency costs may also result.

Again, many of the earlier M&As in China were vertical mergers, due to very similar reasons to those described above, hence, more easily gained government approvals.

3) Conglomerate acquisitions involve firms engaged in unrelated business activities. Three types of conglomerate acquisitions are further defined.

- Product-extension acquisitions, which broaden the product lines of firms.
- Geographic market extension acquisitions, which integrate two firms operating in non-overlapping geographic areas.
- Other conglomerate acquisitions, which involve unrelated firms.

Compared to horizontal and vertical acquisitions, conglomerate acquisitions have particular advantages: 1) diversification may reduce risks; 2) cost may be reduced to engage in a new industry; 3) new growth opportunities may bring more profit; and finally 4) internal resources could be more efficiently utilised, for example due to economies of scope or the creation of an internal capital "market" rather than the use of an external one. The disadvantages though should be fully noted: 1) administrative
expenses and agency losses could be higher and 2) entering new lines of business increases risks.

An increasing number of acquisitions in China are now under this category, especially those concerning listed firms. Many listed firm's primary business changed after the restructuring because new businesses were brought in by the new owner/controlling shareholders. The majority of the acquisitions in China, however, are still non-conglomerate.

2.4.2.2 Forms of M&As
Four major forms of M&As were initially defined by the Interim Measures Governing Enterprise Merger (关于企业兼并的暂行办法) of 1989. These were 1) Debt liability: When the value of the total assets of the target equals its debt, the acquirer takes over the target by agreeing to repay all the debt. 2) Assets acquisition: As the title indicates, the acquirer purchases the assets of the target, mostly using cash, from its owner – the relevant governmental departments. 3) Absorbing shares: the owner of the target becomes a shareholder in the acquiring firm and the percentage of its shares is decided by the net asset value of the target. Finally 4) Absorbing controlling shares: the acquirer purchases a controlling percentage of the target's shares and gains control.43

The forms of M&As in the current Chinese market are largely derivations of the above four. They evolved along with the development of the stock markets as well as the deepening of enterprise ownership reforms. As a result of the mixed ownership in

43 Article 4, Interim Measures Governing Enterprise Merger (关于企业兼并的暂行办法).
Chinese firms, particularly in the listed firms, the M&As in China are in different forms compared to those in developed western economies. There are at present five basic forms of M&As in China:

1. asset acquisition.
2. investment for controlling shares.
3. stock acquisition by agreement.
4. stock acquisition through the secondary market.
5. asset replacement and restructuring.

1. Asset Acquisition
In an asset acquisition, an acquiring company purchases part or all of the assets of the target. The target may continue to exist legally after the transaction, although it could eventually be liquidated in order to return investment to its shareholders. In practice, the target firm normally becomes a branch or a subsidiary of the acquiring firm. This method is particularly useful when the acquirer has plenty of cash and the size of the target is not too big.

2. Investment for Controlling Shares
The acquiring firm's investment eventually becomes the shares of the target firm, a controlling percentage in most cases. As a result, the target either becomes a subsidiary of the acquirer or the buyer owns the majority or a controlling percentage of the shares of the target. Investment for majority interest therefore can be a very cost-effective M&A strategy. By investing a relatively small amount of funds, the acquiring firm can enjoy a majority interest in the target.

3. Stock Acquisition by Agreement
Stock acquisition by agreement indicates that the acquiring firm purchases part or all of the shares of the target through reaching an agreement with the shareholders. This transaction almost exclusively concerns only state shares, legal-person shares and/or employee shares, hence, a transaction mainly between the state-owned shareholders of a firm and other state-owned entities or state-owned legal-persons. The outcome of this type of M&A is similar to investment for controlling shares. The acquirer can gain control with a relatively small amount of investment. Although this type of transaction is subject to severe regulations, stock acquisition by agreement is the most commonly used method of M&As, especially among listed firms.

4. Stock Acquisition through Secondary Market
Stock acquisition through the Chinese stock markets is not commonly used at all compared to mature Western economy stock markets. Because of the dominant state ownership in the listed firms, only a few companies are eligible for being taken over via the secondary markets. Given the speculative investment behaviour in the current stock markets, the overall cost could be extremely high. It is also very time consuming as the acquirer would have to report every increase of 2% (later increased to 5% by the Securities Law) of the shares obtained after it obtains 5% of the outstanding shares of the target.

5. Asset Replacement and Restructuring
This type of M&A is unique to China due to strict share issuing regulations. A listed firm is not allowed to issue more shares (allotment of shares or additional share issuing) unless it has been continuously profitable or improving its performance for a required period of time. When a listed firm is faced with risks of falling below the

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44 Article 47, the Interim Provisions on the Management of the Issuing and Trading of Stocks.
45 Article 79, the Securities Law.
requirements, it may choose to spin off some of its poorly-performing assets by selling them to an acquirer and to replace them with better-performing assets "injected" by the acquirer. The acquirer, as a result of the restructuring, tends to become a major, or even a controlling shareholder in the target. Benefits associated with this type of merger or acquisition are mutual in that the target is able to keep its "shell" and the buyer will be able to raise more funds from the secondary market. This is due to the fact that the "shell" is an unusually valuable resource itself in China. The quota based selection mechanism in choosing firms to be listed effectively limits the supply of "shell" firms and the demand for "shells" exceeds supply. However, with more and more companies being allowed to list on the stock markets, the value of "shells" will undoubtedly drop and this type of merger or acquisition will eventually disappear.

As seen from the above descriptions, the forms of M&As are slightly different from those of a Western developed market. They are mainly determined by the distinctive ownership structures of Chinese listed firms.

2.5 M&A Regulatory Framework

This section reviews changes in the regulations governing mergers and acquisitions. Over the past 20 years or so, the Chinese government has gradually developed a quite impressive legal framework authorising corporate restructuring activities. According to one of the largest online law reference libraries, ChinaLawInfo.com, run by the Beijing University, over 400 regulations and rules have been issued to address different aspects of M&As from various governing bodies by the end of 2004, and

\[46\] In terms of keep being listed on the stock exchange.
over 1,000 have been made to cover a wider range of associated issues. It would therefore be indeed difficult to provide a "complete" description of each single one of them. This section will look at some of the most crucial Laws and regulations since they best reflect the development in legislation regarding governing corporate restructurings.

2.5.1 The Bankruptcy Law (1986)

The Bankruptcy Law (破产法) is perhaps the first legal foundation of enterprises' restructuring. Chapter 4 in the Bankruptcy Law stipulates the conciliation system which includes two parts – settlement and reorganisation.

- Settlement means that within three months after the People's Court has accepted the case of bankruptcy, which is applied for by the creditors, the debtor's superior department in charge applies to carry out reorganisation of the enterprise. A draft settlement agreement is reached at a meeting of the debtor and creditors. Then the bankruptcy proceedings will be suspended after the recognition from the People's Court.

- Reorganisation means that after the agreement becomes effective, the debtor's superior department will be responsible for managing and taking measures to recover the enterprise and to implement the settlement agreement.

For a long time, the regulatory power of the Bankruptcy Law was insignificant. Article 4 states that "The state through various means shall arrange for the appropriate reemployment of the staff and workers of bankrupt enterprises and shall guarantee their basic living needs prior to reemployment; specific measures shall be
separately stipulated by the State Council." Yet for several years, the State Council had not issued any "specific measures". This, to some extent, limited the early development of restructuring activities in China.

2.5.2 Interim Measures Governing Enterprise Merger (1989)

The Interim Measures Governing Enterprise Merger (关于企业兼并的暂行办法) issued in 1989 is considered the first regulation addressing M&As in China. It sketches the following basic five-step procedure that a merger should follow, a basic procedure that is still being followed in principle today:47

1. To identify the targets and the acquirers via the property exchange markets or direct negotiations;
2. To assess the targets' assets, identify the creditors and debtors, agree on the base price for merger;
3. To determine the purchase price via bidding;
4. To finalise a transaction agreement, subject to further approval where needed;
5. To complete the transaction clearing and legal procedures.

The Interim Measures was far from being comprehensive. Although it defines acquisition as merger by absorption and the target loses legal-person status in Article 1, the following Article 4 stipulates the acquisition as absorbing stocks and absorbing controlling stocks (also see section 2.4.2.2). This contradicts the definition from Article 1 and leads to confusion in practice.

47 Article 5, Interim Measures Governing Enterprise Merger (关于企业兼并的暂行办法).
The Interim Measures was made under a heavy influence from the planned economy. Article 3 states that "troubled" enterprises should be the emphasis of acquisition, i.e. those that are near bankruptcy, or suffer long-term losses, or have no development prospects. It was more like a guide book for government officials than a financial activity regulation.

2.5.3 The Corporate Law (1993)

As the first national law regulating the corporatised enterprises, the Corporate Law (公司法) gives a clear definition of merger in Article 184 – a definition that is similar with that in other countries corporate laws. The definition distinguishes between "merger by absorption" and "merger by consolidation."

Article 184 further determines the information disclosure procedure for a takeover: "In a merger of companies, the companies shall execute a merger agreement, and prepare their respective balance sheets and schedules of assets. The companies shall notify their creditors within 10 days of adoption of merger resolutions, and shall publish a notice at least 3 times in a newspaper within 30 days." This regulation has been further enhanced by the Securities Law (1999).

Additional regulations associated with mergers include Article 185, Article 189, and Article 196. Article 185 states that "Where a company is to undergo division, its assets shall be divided accordingly" and this provides the vital lawful foundation for an enterprise to separate its well-performing assets to sell to other enterprises. Article 189 rules out the possibility of restructuring if the corporation enters the process of
bankruptcy liquidation. Finally, Article 196 complements Article 189 by allowing the possibility of applying for restructuring as long as the enterprise has not yet declared bankruptcy.

2.5.4 The Securities Law (1999)

As the first national securities law, the Securities Law (证券法), promulgated in 1999, is far more comprehensive than its predecessor, The Interim Provisions on the Management of the Issuing and Trading of Stocks (股票发行与管理暂行条例) (1993).

The entire Chapter 4 of the Securities Law is devoted to takeovers and defines how an acquisition can be carried out. Article 78 states that a listed company may be taken over by offer or by agreement (takeover by agreement was not allowed in the Interim Provisions).

**Takeover by Offer**

Article 79 states that when an investor who directly or indirectly increases its ownership to 5% of a listed company's shares, it must make a public announcement within three trading days and continue to make such announcements with every 5% (was 2% in the Interim Provisions) increase or decrease in its ownership. When the takeover threshold of 30% is reached, the investor should make a takeover bid if he wishes to make further purchase of the share, except where exempted by the CSRC. A proportional bid is allowed under Article 82. Article 87 further states that if a bidder possesses more than 90% of the shares when the bid period has expired, the remaining
shareholders are obliged to sell their shares to the bidder under the same conditions stated in the bid.

**Takeover by Agreement**
Article 89 states that an investor, who purchases shares by agreement, can negotiate with other shareholders and within three days of reaching an agreement, the investor must file in written form, to report the agreement to the CSRC and with the stock exchanges. Such a report shall also be publicly published. The agreement shall not be executed before the announcement.

The forms and procedures of M&As regarding listed firms are better defined by the Securities Law. There are other improvements as well. Firstly, all shareholders (state shareholders, legal person shareholders, individual shareholders) are addressed as "investors" to reflect the principle of "equal rights, equal obligations." Secondly, a natural person was not allowed to hold more than 0.5% of the total outstanding shares in a listed company according to the Interim Provisions. Such a rule effectively eliminated the possibilities for any individual Chinese citizen to take over a listed firm by purchasing A shares over the secondary markets. This limitation is removed in the Securities Law, which provided the lawful foundation for eventual total privatisation.

Finally, the Securities Law defines plans of merger or acquisition as being "inside information" and requires such information, as well as any major corporate restructuring activities, to be disclosed to the general public through pointed channels promptly. This information disclosure improvement will be further tested in Chapter 5.
2.5.5 Measures on the Takeover of Listed Companies (2002)

The Securities Law only outlines but does not specify how exactly a takeover should be carried out regarding listed firms, whereas the Measures on the Takeover of Listed Companies issued in 2002 (上市公司收购管理办法) (the Measures) compliments the Securities Law by further detailing the relevant procedures for mergers by offer and mergers by agreement. This section will summarise these procedures and some clauses from the following interpretation are taken straight from the Measures).

Procedures for Takeovers by Offer

1. The acquirer first submits the offer to the CSRC and the stock exchange; it then needs to notify the target and make a suggestive announcement of the summary of the offer. The offer price should be decided by now. (Article 25, 34)

2. If no objection is received from the CSRC within 15 days, the acquirer may make an announcement of the offer documents. If the CSRC objects, the acquirer may not make an announcement and will have to appeal or provide additional documents to support the offer. The effective term of the offer has to be more than 30 days, but less than 60 days, except when there are competing offers (Article 29, 30, 36).

3. Within 10 days of when the offer is made public, the target needs to submit a report of the board of directors and the professional opinion of an independent consultant to the CSRC. The report and the opinion also need to be publicly announced. (Article 32)

4. The acquirer will have to apply to the CSRC in written form and waits for approval if he wishes to modify the conditions for the offer. Such an application should be submitted within 15 days prior to the expiration of the offer. The offer
cannot be modified within 15 days prior to the expiration, unless there are competing offers. If there are competing offers and if it is within less than 15 days prior to the expiration, the initial acquirer shall modify and prolong the offer term. The prolonged term shall have to be at least 15 days, but shall not go beyond the expiration date of the last competing offer. (Article 37, 38)

5. A Competing offer shall have to be submitted to the CSRC, at least 5 days prior to the expiration of the initial offer. (Article 46)

6. Holders of preliminarily accepted shares can withdraw the preliminary acceptance prior to the expiration of the offer. The acquirer shall publicly announce the number of shares preliminarily accepted and revoked daily every day prior to the expiration. (Article 41)

7. Within the expiration, the acquirer can purchase the preliminarily accepted shares, according to the offer. The transaction should be cleared within 3 working days of the expiration of the takeover offer. (Article 42)

8. A written report on the takeover offer should be submitted to the CSRC by the acquirer within 3 working days upon the expiration of the offer. A public announcement should be made. (Article 43)

Article 26 also specifies the contents that should be included in the report on the takeover offer:

- the name and domicile of the purchaser;
- the purchaser's decision on the takeover;
- the name of the listed company under takeover;
- the purpose of the takeover;
• a detailed description of the shares to buy up and the total number of the shares scheduled to buy up;
• the term and price of the takeover;
• the amount and guaranteed availability of the funds required for the takeover;
• the ratio between the total number of the issued shares of the company to be taken over and the number of such shares held at the time the offer takeover report is submitted;
• the follow-up schedule after the completion of the takeover; and
• other matters required by the CSRC.

Procedures for Takeovers by Agreement
1. Where a listed company is taken over by agreement, the acquirer needs to submit to the SCRC a report on the takeover of the listed company the next day after the conclusion of the agreement and at the same time make a suggestive announcement of the summary of the report. (Article 12)
2. The board of directors of the target company shall state an opinion on the potential influence that may be brought in by the takeover. (Article 15)
3. If the SCRC does not object within 15 days from the date of receiving the report, the acquirer may make a public announcement of the report on the takeover of the target and perform the takeover agreement. (Article 12)

Takeovers by offers, as defined by both the Securities Law and the Measures on the Takeover of Listed Companies, are unlikely to be a feasible solution for restructurings of the listed companies in China in the foreseeable future because of the difficulties discussed previously. Nonetheless, a clearly outlined regulation will help to clarify the related issues should they occur in the future. The implementation of the Measures is
in close connection with another important regulation which was issued at the same time: Measures for the Administration of Disclosure of Shareholder Equity Changes of Listed Companies (上市公司股东持股变动信息披露管理办法) – these two regulations were commonly referred to as one.

The improvement that the Measures brought to the regulatory environment of the Chinese M&As is tremendous. Detailed procedures that a merger should follow will make the transaction more transparent, enable a more efficient information flow, and ultimately, improve the stock market's efficiency. What is more, Article 94 "Where a purchaser holds, controls the shares of a listed company by means of administrative distribution or transfer of the state-owned shares...which entitles him to the practical or possible control of a listed company, these regulations shall be applicable." in the Measures justifies that a state-owned shares (state shares and legal-person shares) transaction is a form of merger by agreement whereas previous regulations either failed to address these transactions properly, or avoided to address them by simply referring to other regulations.48

In short, the legal framework in China has been constantly improved over the past 20 years. Table 2.4.3 below lists 57 selected Laws and regulations governing the corporate restructurings in China since 1986. These regulations are listed because of their most direct relevance and vital influence. The table therefore gives an overall

48 For example, Article 148 in The Corporate Law, 1993 states "A state authorised investment institution may assign shares held by it in accordance with the law, and may also purchase shares held by other shareholders. The authority of approval for, and regulatory measures concerning, such assignment or purchase of shares shall be separately prescribed by the relevant national statutes or administrative regulations."; Article 94 in The Securities Law, 1999, states "When purchasing a listed company involves the stocks held by an investment institution authorised by the state, it is necessary to obtain approval from the relevant department in charge in accordance with the stipulations of the State Council."
picture of the evolving nature of Chinese legislation in this field. Recent regulations indicated that M&As in China are likely to involve more foreign investors\(^{49}\) and may take the form of Management Buy-Out (MBO)\(^{50}\).

\(^{49}\) Notice on Relevant Issues concerning Application Procedures for Transfer of State-owned Shares of Listed Companies to Foreign Investors and Enterprises with Foreign Investment (关于上市公司国有

\(^{50}\) Interim Provisions on the Transfer of State-owned Property Rights of Enterprises to the Management
Staff Thereof (企业国有产权向管理层转让暂行规定), issued jointly by the State Council; the MOF
and the SASAC on 11 April 2005.
<table>
<thead>
<tr>
<th>DATE</th>
<th>NAME</th>
<th>ISSUER</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986/12</td>
<td>Law of the Enterprise Bankruptcy*</td>
<td>NPC**</td>
</tr>
<tr>
<td>1988/05</td>
<td>Administrative Regulations Governing the Registration of Legal Corporations (关于企业法人登记管理条例)</td>
<td>State Council</td>
</tr>
<tr>
<td>1989/02</td>
<td>Interim Measures Governing Enterprise Merger* (关于企业兼并的暂行办法)</td>
<td>State Commission for Reform of the Economic System (体改委); State Planning Commission (计划委); MOF; SASOA</td>
</tr>
<tr>
<td>1989/02</td>
<td>Interim Measures regarding the Selling of Property Right of Small-Sized SOEs (关于出售小型企业产权的暂行办法)</td>
<td>State Commission for Reform of the Economic System (体改委); MOF; SASOA</td>
</tr>
<tr>
<td>1990/05</td>
<td>Interim Regulations Concerning the Assignment and Transfer of the Right to the Use of the State-owned Land in the Urban Areas (城镇国有土地使用权出让和转让暂行条例)</td>
<td>State Council</td>
</tr>
<tr>
<td>1992/05</td>
<td>Interim Rules on the Management of Property Right Registration of the State-owned Assets of Enterprises*** (国有企业产权登记管理试行办法)</td>
<td>MOF; SASOA; SAIC</td>
</tr>
<tr>
<td>1993/03</td>
<td>Interim Provisions on the Management of the Issuing and Trading of Stocks (股票发行与交易管理暂行条例)</td>
<td>State Council</td>
</tr>
<tr>
<td>1993/06</td>
<td>Interim Detailed Rules on Information Disclosure of Companies Publicly Issuing Shares (公开发行股票公司信息披露实施细则)</td>
<td>CSRC</td>
</tr>
<tr>
<td>1993/12</td>
<td>The Corporate Law* (公司法)</td>
<td>NPC</td>
</tr>
<tr>
<td>1994/04</td>
<td>Circular on Strengthening the Management of Property Right Trading (关于加强国有企业产权交易管理的通知)</td>
<td>General Office of the State Council</td>
</tr>
<tr>
<td>1994/07</td>
<td>Measures for the Supervision and Administration of the Property of the SOE*** (国有企业财产监督管理办法)</td>
<td>State Council</td>
</tr>
<tr>
<td>1995/05</td>
<td>Circular on Handling Bank Loans and Interests after Encouraging and Supporting Better-Performing SOEs in the 18 Pilot Cities to Acquire the Distressed State-owned Industrial Enterprises (关于鼓励和支持18个试点城市优势国有企业兼并困难国有企业后有关银行贷款及利息处理问题的通知)</td>
<td>PBOC; SETC; MOF</td>
</tr>
<tr>
<td>1995/05</td>
<td>Guiding Opinions on the Administration of the State-owned Assets in Experimental Units for Developing a Modern Enterprise System (关于建立现代企业制度试点国有企业资产管理工作指导意见)</td>
<td>SASOA</td>
</tr>
</tbody>
</table>

* Introduced in this section; ** A complete list of abbreviations is attached at the end of the table; *** No longer effective
<table>
<thead>
<tr>
<th>DATE</th>
<th>NAME</th>
<th>ISSUER</th>
</tr>
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<tbody>
<tr>
<td>1995/07</td>
<td>Regulation of Shenzhen SEZ on Administration of State-owned Assets***</td>
<td>Shenzhen Municipal CCP Committee**, Shenzhen Municipal Government</td>
</tr>
<tr>
<td>1995/09</td>
<td>Circular on Regulating the Existing Joint Stock Limited Company</td>
<td>State Commission for Reform of the Economic System (体改委); SASOA**</td>
</tr>
<tr>
<td>1995/12</td>
<td>Supplementary Notice on Several Issues Regarding the Formation of Listed Companies, Stock Listing and Asset Assessment</td>
<td>SASOA</td>
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<tr>
<td>1995/12</td>
<td>Regulations on Domestic Listing of Foreign-oriented Stocks by Share-holding Companies</td>
<td>State Council</td>
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<tr>
<td>1996/01</td>
<td>Rules on the Management of Property Right Registration of the State-owned Assets of Enterprises</td>
<td>State Council</td>
</tr>
<tr>
<td>1996/03</td>
<td>Circular of Shenzhen SEZ on Adjusting of the Administration System of State-owned Assets</td>
<td>Shenzhen Municipal CCP Committee; Shenzhen Municipal Government</td>
</tr>
<tr>
<td>1996/07</td>
<td>Circular Concerning Interim Provisions on Several Problems on Mergers and Bankruptcy of SOEs</td>
<td>PBOC; SETC</td>
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<tr>
<td>1996/07</td>
<td>Guiding Opinions on the Management of State-owned Assets in Experimental Cities</td>
<td>SASOA</td>
</tr>
<tr>
<td>1996/08</td>
<td>Interim Provisions Concerning Several Financial Problems on Mergers of State-owned Enterprises***</td>
<td>MOF</td>
</tr>
<tr>
<td>1996/08</td>
<td>Interim Provisions Concerning Several Accounting Problems on Mergers of Enterprises</td>
<td>MOF</td>
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<tr>
<td>1996/08</td>
<td>Circular on Regulating the Administration of State-owned Stock Rights in Stock Limited Company</td>
<td>SASOA</td>
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<tr>
<td>1996/09</td>
<td>Opinions on Several Problems in Regulating the Existing Joint Stock Limited Company</td>
<td>State Commission for Reform of the Economic System (体改委); SAIC; SASOA</td>
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<tr>
<td>1996/12</td>
<td>Circular on Strengthening the Examination of Listed Companies’ Provisional Reports</td>
<td>CSRC</td>
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<td>1996/12</td>
<td>Measures of Shanghai Municipality for the Administration of Shareholder Equity Changes of Listed Companies</td>
<td>Shanghai Municipal Government</td>
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<td>1997/03</td>
<td>Opinions on Regulating the Stated-owned Share Shareholder of the Joint Stock Limited Company to Exercise Stock Rights</td>
<td>State Commission for Reform of the Economic System (体改委); SASOA</td>
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<tr>
<td>1997/09</td>
<td>Interim Implementing Rules for Property Rights Transfer for Enterprises Direct Under the MOFTEC</td>
<td>MOTEC (now MOC)</td>
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</tbody>
</table>

* Introduced in this section; ** A complete list of abbreviations is attached at the end of the table; *** No longer effective
**Table 2.4.3  Major Regulations for M&As in China (Cont.)**

<table>
<thead>
<tr>
<th>DATE</th>
<th>NAME</th>
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<tbody>
<tr>
<td>1998/02</td>
<td>Circular on Several Problems Regarding the Change of Core Business Due to Assets Exchange of Listed Company***</td>
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<td>Interim Procedures of Shanghai Municipality on the Demarcation of the Property Right Over Enterprises' State-owned Assets</td>
<td>Shanghai Municipal Government</td>
</tr>
<tr>
<td>1998/12</td>
<td>The Securities Law*</td>
<td>NPC</td>
</tr>
<tr>
<td>1998/12</td>
<td>Procedures of Shanghai Municipality on the Administration of Transactions in Property Rights (上市企业资产产权界定暂行办法)</td>
<td>Shanghai Municipal Government</td>
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<tr>
<td>1998/12</td>
<td>Regulations of the Unemployment Insurance (失业保险条例)</td>
<td>State Council</td>
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<tr>
<td>1999/01</td>
<td>Reply on Several Questions Regarding the Alterations of Shareholder for Listed Company (关于公司股东变更有关问题的答复)</td>
<td>SAIC</td>
</tr>
<tr>
<td>1999/06</td>
<td>Operating Procedures of the Examination and Approval for Temporarily Stop Levying the Stamp Tax of Securities (Stock) Transaction for Free Transfers of the State-owned Shares of Listed Company (上市公司国有资产无偿转让暂不征收证券(股票)交易印花税审批规程)</td>
<td>SAT</td>
</tr>
<tr>
<td>1999/09</td>
<td>Decisions on Major Issues Concerning The Reform and Development of SOEs (关于国有企业改革和发展若干重大问题的决定)</td>
<td>Central Committee of the CCP</td>
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<tr>
<td>2000/02</td>
<td>Interim Regulations on the Board of Supervisors in the State-owned Enterprises (国有企业监事会暂行条例)</td>
<td>State Council</td>
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<tr>
<td>2000/05</td>
<td>Circular on Administration of Stat-owned Stock Rights of Joint Stock Limited Company (关于股份有限公司国有股权管理工作有关问题的通知)</td>
<td>MOF</td>
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<tr>
<td>2000/06</td>
<td>Circular on Regulating Major Purchase or Sale of Assets of Listed Company*** (关于规范上市公司重大购买或出售资产行为的通知)</td>
<td>CSRC</td>
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<tr>
<td>2000/12</td>
<td>Notification of Improving the Procedures for Transactions of Legal-person Share (关于改进法人股转让程序的公告)</td>
<td>SZSE</td>
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<tr>
<td>2001/06</td>
<td>Interim Measures on the Management of Reducing Held State Shares and Raising Social Security Funds (减持股数筹集社会保障资金管理暂行办法)</td>
<td>State Council</td>
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<tr>
<td>2001/10</td>
<td>Circular of Issues Regarding State-owned Share Pledge of Listed Companies (关于上市公司国有资产质押有关问题的通知)</td>
<td>MOF</td>
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<tr>
<td>2002/01</td>
<td>Periodic Achievement of the Scheme of Reducing Held State Shares (国有股减持方案阶段性成果)</td>
<td>CSRC</td>
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<td>2002/09</td>
<td>Regulations on the Takeover of Listed Companies* (上市公司收购管理办法)</td>
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<td>2002/09</td>
<td>Measures for the Administration of Disclosure of Shareholder Equity Changes of Listed Companies (上市公司股东持股变动信息披露管理办法)</td>
<td>CSRC</td>
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</table>

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<table>
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<th>ISSUER</th>
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<tr>
<td>2002/11</td>
<td>Notice on the Relevant Issues concerning the Transfer of State Shares and Legal-person Shares of Listed Companies to Foreign Investors (关于向外国转让上市公司国有股和法人股有关问题的通知)</td>
<td>MOF; SETC; CSRC**</td>
</tr>
<tr>
<td>2003/03</td>
<td>Interim Provisions for Foreign Investors to Merge Domestic Enterprises (外国投资者并购境内企业暂行规定)</td>
<td>MOFTEC (now MOC); SAT; SAIC; SAFE</td>
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<tr>
<td>2003/05</td>
<td>Interim Measures for the Supervision and Administration of State-owned Assets of the Enterprises (企业国有资产监督管理暂行条例)</td>
<td>State Council</td>
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<tr>
<td>2003/12</td>
<td>Interim Measures for the Management of the Transfer of the State-owned Property Right of Enterprises (企业国有资产转让管理暂行办法)</td>
<td>the SASAC and the MOF</td>
</tr>
<tr>
<td>2004/01</td>
<td>Notice on Relevant Issues concerning Application Procedures for Transfer of State-owned Shares of Listed Companies to Foreign Investors and Enterprises with Foreign Investment (关于上市公司国有股向外国投资者及外商投资企业转让申报程序有关问题的通知)</td>
<td>MOC; General Office of the SASAC</td>
</tr>
<tr>
<td>2004/03</td>
<td>Circular on Relevant Issues concerning the Reducing Held State Shares in Financial Asset Management Companies and State-owned Banks (关于金融资产管理公司和国有银行国有股减持有关问题的通知)</td>
<td>MOF</td>
</tr>
<tr>
<td>2004/08</td>
<td>Circular on Relevant Issues of the Transfer of State-owned Property Rights of Enterprises (关于企业国有产权转让有关问题的通知)</td>
<td>State Council; SASAC</td>
</tr>
<tr>
<td>2005/04</td>
<td>Interim Provisions on the Transfer of State-owned Property Rights of Enterprises to the Management Staff Thereof (企业国有资产向管理层转让暂行规定)</td>
<td>State Council; MOF; SASAC</td>
</tr>
</tbody>
</table>

* Introduced in this section; ** A complete list of abbreviations is attached below; *** No longer effective

**Abbreviations**

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>CCP</td>
<td>Chinese Communist Party (中国共产党)</td>
</tr>
<tr>
<td>CSRC</td>
<td>China Securities Regulatory Commission (中国证券监督管理委员会)</td>
</tr>
<tr>
<td>MOC</td>
<td>Ministry of Commerce (商务部)</td>
</tr>
<tr>
<td>MOF</td>
<td>Ministry of Finance (财政部)</td>
</tr>
<tr>
<td>MOFTEC</td>
<td>Ministry of Foreign Trade &amp; Economic Cooperation (对外贸易经济合作部) (now MOC)</td>
</tr>
<tr>
<td>NPC</td>
<td>National People's Congress (全国人民代表大会)</td>
</tr>
<tr>
<td>PBOC</td>
<td>People's Bank of China (中国人民银行)</td>
</tr>
<tr>
<td>SAIC</td>
<td>State Administration of Industry and Commerce (国家工商行政管理总局)</td>
</tr>
<tr>
<td>SAFE</td>
<td>State Administration of Foreign Exchange (国家外汇管理局)</td>
</tr>
<tr>
<td>SASAC</td>
<td>State-owned Assets Supervision and Administration Commission (国有资产管理委员会)</td>
</tr>
<tr>
<td>SASOA</td>
<td>State Administration of State-Owned Assets (现有资产管理局)</td>
</tr>
<tr>
<td>SAT</td>
<td>State Administration of Taxation (国家税务总局)</td>
</tr>
<tr>
<td>SETC</td>
<td>State Economic and Trade Commission (国家经济贸易委员会)</td>
</tr>
<tr>
<td>SEZ</td>
<td>Special Economic Zone (经济特区)</td>
</tr>
<tr>
<td>SZSE</td>
<td>Shenzhen Stock Exchange (深圳证券交易所)</td>
</tr>
</tbody>
</table>

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2.6 Acquisitions of Control of Chinese Listed Companies

2.6.1 Difference between M&As in Western Economies and in China

As discussed in Section 2.5, The Measures on the Takeover of Listed Companies issued in 2002 (上市公司收购管理办法) suggests that a state-owned shares (state shares and legal-person shares) transaction is a form of "merger by agreement". Article 94 states:

"Where a purchaser holds, controls the shares of a listed company by means of administrative distribution or transfer of the state-owned shares...which entitles him to the practical or possible control of a listed company, these regulations shall be applicable."

This brings up a very important issue: M&As in China can assume forms that are not entirely identical to the ones commonly used in market based economies. Many of the "takeovers" in China involve changes in the control of companies as a result of transferring the ownership of state-owned shares, rather than mergers and acquisitions as traditionally defined in the West, where a majority of shares need to be controlled/purchased.

Merger in the West commonly refers to a combination of two separate businesses into a one single business – such a transaction can leave the purchaser in place, in the case of a forward merger; or leave the target in place, in the case of a reverse merger; or involve a subsidiary of the purchaser merging with the target, in the case of a
triangular merger. Mergers differ from acquisitions, which refer to taking ownership of another business. In a true merger, a new corporation is formed that combines the assets of the two companies and grants the shareholders of each original company stock in the new company based on the relative valuations of the two original companies. In an acquisition, however, one company purchases the assets and majority ownership of the other company for a combination of cash, stock, and other consideration.

The underlying idea behind any M&A transaction in China is the same as that in the West, i.e. change of ownership. However, due to the unique share structure of Chinese listed companies and tighter corporate restructuring control in Chinese regulations, M&As in China occur in similar, but by no means identical forms. The most popular form is "stock acquisition by agreement" as reviewed in section 2.4.2: the acquiring firm purchases part or all of the shares of the target through reaching an agreement with the relevant shareholder(s). This transaction almost exclusively concerns only state-owned shares and (occasionally) employee shares. Since in any listed company the majority of shares are state-owned shares, the changing hands of these shares often brings changes in de facto control. This will be further shown in this section.

2.6.2 The Acquisition Process

This section explains how such a transaction is conducted. It provides a more detailed consideration of the institutional arrangements involved in China for the ownership and transfer of company ownership.
Information and data presented in this section were collected mainly from three channels: 1) Interviews (conducted between May to October, 2006) with professional individuals, including Mr. Shi – Vice President of Investment Banking Dept. at Guosen Securities Co., Ltd.; Mr. Zhang – Senior Partner at Shenzhen Win and Sun Law Firm, and Mr. Zheng – Chief Partner at Shenzhen Pan-China Schinda Certified Public Accountants; 2) Internal memos and documents obtained from Guosen Securities Co. Ltd.; and 3) Previous Annual Reports of the involved listed firm and public announcements in Securities Times and Ta Kung Pao on various dates.

2.6.2.1 Background
We gave above a description of state-owned share transactions in general. A specific case is examined here to help gain comprehension of the unique characteristics of M&As in China and the processes. The case is that of Sinopharm Holding Co., Ltd., [SINOP] (the Buyer), that acquired, from Shenzhen Investment Holding Corporation, [SIHC] (the Seller), 43.33% of Shenzhen Accord Pharmaceutical Co., Ltd., [SAPC], which is a listed firm. The shares acquired by SINOP were state-owned shares held by SIHC.

Before proceeding, we provide some brief background information regarding SINOP - the buyer, SIHC - the seller and SAPC - the listed firm involved.

SINOP - Buyer
SINOP was jointly founded by China National Pharmaceutical Group Corp., the largest domestic medicine corporation, and Shanghai Fosun High Technology (Group) Co., Ltd. in January, 2003, with a registered capital of 1.03 billion RMB. It should be
noted that China National Pharmaceutical Group Corp. is solely owned by State-owned the Assets Supervision and Administration Commission (SASAC), on behalf of State Council.

SINOP therefore is a state-owned enterprise. Its core business is the nationwide distribution of medicinal products, including chemical reagent, medical instruments and professional laboratory glassware. Its scope of business also includes industrial investment, management and assets re-organisation of pharmaceutical enterprises; logistics supply and relevant consultant services, etc.

The share structure of SINOP is best illustrated by the following diagram.

**Figure 2.6.2.1a Shareholding Structure of SINOP**

- **State Council**
  - **SASAC**
    - 100%
    - **China National Pharm. Group Corp. (unlisted firm)**
      - 51%
      - **SINOP (unlisted firm)**
    - **Shanghai Fosun Hi-Tech Co. Ltd. (unlisted firm)**
      - 49%

**SIHC - Seller**

SIHC was established by SASAC's Shenzhen Office, on behalf of Shenzhen Municipal Government in February, 1988, as a solely state-owned corporation, with a registered capital of 2 billion RMB. It is one of Shenzhen's municipal development agencies, which provide management and supervision of municipal enterprises' state assets and property rights. Like many state development agencies, SIHC is holding
shares in a number of state-owned enterprises, including listed companies. It should be noted that most of these shares held by the development agencies are either the majority (over 50 percent, hence, largest shareholder) or a significant proportion.

SIHC was the largest shareholder of SAPC, as illustrated by the following diagram.

![Shareholding Structure of SAPC](image)

**SAPC – Underlined Firm**

SAPC was formed in February, 1993 and has been listed on Shenzhen Stock Exchange since August, 1998. SAPC's scope of main operations includes R&D and production of pharmaceuticals, wholesaling and retailing of Chinese and Western patent medicine, Chinese traditional medicine, biological products, bio-chemical medicine, health care products and medical apparatus and instruments. Most of its business activities have been carried out in Shenzhen, Guangzhou and the surrounding areas in southern China.

**2.6.2.2 SAPC: Ownership Structure and Control**

As a listed company, the share structure of SAPC was more sophisticated compared to the buying and selling corporations. By the end of 31st December 2003, SAPC had a
total of 288,149,400 shares, including 54,885,600 B-shares, and it had a total of 29,242 shareholders, including 10,282 shareholders of B-shares.100

According to SAPC's 2003 Annual Report, by the end of 31st December, 2003, the top ten shareholders were as follows:

<table>
<thead>
<tr>
<th>Name</th>
<th>No. of Shares</th>
<th>% Circulating</th>
<th>Nature of Shares</th>
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</thead>
<tbody>
<tr>
<td>1st SIHC</td>
<td>124,864,740</td>
<td>43.33</td>
<td>State-owned</td>
</tr>
<tr>
<td>2nd Shenzhen Baoan District Shiyan Town Economic and Development Corporation [BAOAN]</td>
<td>26,070,660</td>
<td>9.05</td>
<td>Legal-person</td>
</tr>
<tr>
<td>3rd Shenzhen Baoan Shangwu Economic and Development Co., Ltd.</td>
<td>13,942,800</td>
<td>4.84</td>
<td>Legal-person</td>
</tr>
<tr>
<td>4th Shenzhen Wangzong Industrial Co., Ltd.</td>
<td>5,303,200</td>
<td>1.84</td>
<td>Legal-person</td>
</tr>
<tr>
<td>5th Nanjing Junyue Investment and Consultation Co., Ltd.</td>
<td>5,000,000</td>
<td>1.74</td>
<td>Legal-person</td>
</tr>
<tr>
<td>6th CHAN PONG HUNG</td>
<td>1,567,571</td>
<td>0.54</td>
<td>B Share</td>
</tr>
<tr>
<td>7th Wuxi Huaxin Investment Management Co., Ltd.</td>
<td>1,396,800</td>
<td>0.48</td>
<td>Legal-person</td>
</tr>
<tr>
<td>8th Shanghai Shisheng Enterprise Development Co., Ltd.</td>
<td>1,000,000</td>
<td>0.35</td>
<td>Legal-person</td>
</tr>
<tr>
<td>9th SONG LI RONG</td>
<td>875,117</td>
<td>0.30</td>
<td>A Share</td>
</tr>
<tr>
<td>10th Tianjin Polytechnic University</td>
<td>825,345</td>
<td>0.29</td>
<td>A Share</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>180,846,133</strong></td>
<td><strong>62.76</strong></td>
<td></td>
</tr>
</tbody>
</table>

As can be seen from the above table, 43.33% of shares were controlled by the largest shareholder, and the top 10 shareholders owned 62.76% of the total shares. The rest of the shares, 37.24%, are shared by 29,232 shareholders, each with an average ownership of 0.00127%. Whereas this average figure must not be taken too literally, it suggests how the rest of the shares are widely spread. As reviewed earlier in Chapter

100 SAPC's 2003 Annual Report
101 SAPC 2003 Annual Report
2, this unique and extreme "pyramid shape" share structure was created to preserve a dominant position for state ownership and enhance the voting rights of the controlling shareholders.

The significance of controlling shareholders, as far as voting rights is concerned, is perhaps best illustrated by examining how the General Meetings of Shareholders have been held. Chapter 6 of SAPC's 2003 Annual Report documented the following (the clauses below are taken straight from the Annual Report):

"In the report period, the Company held the Shareholders' General Meeting once, namely the Shareholders' General Meeting of 2002.


2. ....... There were 5 shareholders and shareholders' proxies attended the meeting who represented 170,231,400 shares, taking 59.08% of total shares with voting right of the Company (including 4 shareholders and shareholders' proxies of A shares who represented 170,181,400 shares, taking 59.05% of total shares with voting right of the Company; 1 shareholder of B shares who represented 50,000 shares, taking 0.017% of total shares with voting right of the Company, as well as taking 0.029% of total shares with voting right of attending meeting).

The following resolutions were examined and approved by means of registered voting in the Shareholders' General Meeting:
(1) Approved Work Report 2002 of the Board of Directors;
(2) Approved Work Report 2002 of the Supervisory Committee;
(3) Approved 2002 Financial Settlement Report;
(4) Approved 2002 Profit Distribution Plan;
(5) Approved Annual Report 2002;
(6) Approved the Proposal on Additionally Electing Su Yanwei as Director of the Company;
(7) Approved the Proposal on Reengaging Certified Public Accountant.

Beijing Tong Shang Law Firm witnessed this meeting on the spot in terms of its convening, holding, voting and legitimacy and validity of resolutions and issued a Law Opinion.

3. The resolutions of the shareholders' general meeting 2002 were published in Securities Times and Ta Kung Pao dated May 20, 2003."

The above shows how the large/controlling shareholders can enjoy relatively higher voting rights during the Shareholders General Meeting – the highest authority. This is
very similar to certain ownership structures in Western companies. If there is a widely
dispersed ownership, holdings of 10% to 20% probably give effective control, and
ownership of more than 50% conveys certain control. By effectively controlling the
Shareholders General Meeting and approving key resolutions, including personnel
arrangement, larger shareholders control the company.

A detailed examination of the board of directors of SAPC further illustrates how large
shareholders control the company via personnel arrangement. According to SAPC's
2003 Annual Report, at the end of 31st December, 2003, all eight board members are
as follows:

<table>
<thead>
<tr>
<th>Name</th>
<th>Post</th>
<th>Previous Post and/or Other Current Post</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Mr. Guo Yuan</td>
<td>Chairman of the Board</td>
<td>Previously the Deputy Director of SASAC, Shenzhen Office</td>
</tr>
<tr>
<td>2 Mr. Zeng Yuxiang</td>
<td>Vice Chairman of the Board</td>
<td>Also the Chairman of the Supervisory Committee of BAOAN104 – 2nd largest shareholder (see Table above)</td>
</tr>
<tr>
<td>3 Mr. Su Yanwei</td>
<td>Director, General Manager</td>
<td>Previously one of the directors in SIHC – Largest shareholder</td>
</tr>
<tr>
<td>4 Mr. Qin Changsheng</td>
<td>Director, CFO</td>
<td>N/A</td>
</tr>
<tr>
<td>5 Ms. Yuan Xueping</td>
<td>Director</td>
<td>Previously one of the directors in SIHC</td>
</tr>
<tr>
<td>6 Mr. Liao Yuchun</td>
<td>Director</td>
<td>Also the General Manager of BAOAN105</td>
</tr>
<tr>
<td>7 Mr. Hao Zhujian</td>
<td>Independent Director</td>
<td>N/A</td>
</tr>
<tr>
<td>8 Mr. Guo Jinlong</td>
<td>Independent Director</td>
<td>N/A</td>
</tr>
</tbody>
</table>

The above table further showed that five out of six non-independent directors
remained "closely" associated with the largest or the second largest shareholder.
Controlling the board of directors and appointing key personnel in senior management

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102 SAPC 2003 Annual Reports
104 Shenzhen Baoan District Shiyan Town Economic and Development Corporation
105 See footnote above
give large legal-person shareholders an even higher degree of control of the company, compared to the proportion of shares they hold.

Other listed companies in China may not have identical ownership and management structures as those of SAPC shown above, but they tend to have very similar arrangements. When the largest shareholder sells or transfers its shares to another entity, the control of the underlined company is usually shifted with the transaction.

2.6.2.3 Initialising the Transaction
The party that initialises the transaction process in China can vary from sellers to buyers, motivated by different incentives. These motivations can be loosely grouped into three categories: 1) financial objectives; 2) corporate strategic objectives and 3) other non-economic objectives, such as political commitment, etc. Please note that the motivations discussed here are more specific in Chinese context.106

For instance, a controlling shareholder (government or its agency) may choose to actively look for a buyer,
1) when it intends to "harvest" from previous financial investments and gather capital for other purposes - these purposes can be of a financial nature, for example, direct investment elsewhere, or they can be in a form that is of non-financial nature, for example, to help prevent job loss in another factory, etc.; or

---

106 Other motivations include: economics of scale, diversification, monopoly power, asset stripping, increased market valuation, and managerial motives like growth, empire building, etc. These motivations have been addressed throughout the thesis.
2) when it fails to provide adequate management and supervision to the underlined company and therefore looks for a new owner with the right expertise to improve company performance, hence, achieving strategic objectives; or

3) when it is simply obeying administrative orders from its superior department and therefore fulfilling political tasks, etc.

Similarly, a firm (most likely unlisted) may choose to actively seek a potential seller because of different reasons:

1) when the buyer obtains control of a listed firm, it also obtains a stock market quotation – also known as "shell"\textsuperscript{107} – and therefore gains access to the secondary market to raise more funds. This financial motivation was "not uncommon behind many earlier transactions" – commented by Mr. Shi from Guosen Securities;

2) when the buyer wants to diversify into different lines of businesses or expand into different geographic regions, hence, from a strategic development angle, it may also be interested in acquiring a listed firm.

3) Other motivations may include political orders, etc.

Undoubtedly there are more specific incentives associated with any M&A transaction in China apart from the ones listed above. While some of these motivations are similar to those indicated by Western theory, some of them are unique in the Chinese socialist context. There are, however, no empirical surveys available to summarise these motivations in the Chinese context. Chapter 5 will attempt to examine the motivations and effects of M&As in China in greater depth via the empirical analysis.

\textsuperscript{107} "Shell" is a unique resource in China, as commented in Section 2.4.2.2.
Driven by different incentives, either a seller or a buyer may initiate the process of M&A transactions in China. In the SAPC’s case, for instance, it was the acquiring firm, SINOP, that initiated the process.

SINOP, backed by its major shareholder, China National Pharmaceutical Group Corp., the largest domestic medicine corporation in China, has operations nationwide. However, its performance in southern China has been restrained by its limited distribution networks, which have already been controlled by earlier market entrants such as SAPC. SINOP aimed to increase its market share in the region, and believed that expansion through acquiring an existing medical firm with well-established distribution channels would be a fast and cost-effective way to accomplish this goal.108 It was under this corporate strategy, SINOP approached SAPC’s controlling shareholder, SIHC, towards the end of 2003.109 Although how the initial contact had been established was not documented, interviews with professional individuals revealed many possible ways it might have happened: the contact could have been coordinated by their superior governmental departments, SASAC or even the Ministry of Health; or via their business partners or via assistance from investment bankers, lawyers and accountants, etc.

2.6.2.4 Negotiation
If there appears to be no strong objection from the involved parties, formal meetings between them will follow. In the SAPC’s case, the first formal negotiation was held on 7th January, 2004.110

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108 Internal memo from Guosen Securities.
109 There was no documentation regarding when and how this initial approach took place.
110 Meeting memo from Guosen Securities.
2.6.2.4.1 Parties Involved
Representatives from the acquiring firm and the seller are present in the meetings, along with their lawyers and financial consultants (if there are any), who will provide legal opinion and financial advice. Accountants are normally not required for the first rounds of negotiations, but they will work closely with the lawyers and the financial consultants at later stages. A legal representative of the listed firm may also choose to be present along with officials from the local authority. They are present to witness the process and ensure the legitimacy and validity of the talks.

In SAPC's case, officials from SASAC's Shenzhen Office and the State Development Planning Commission's Shenzhen Office were also present at the meetings. These government officials were involved for monitoring, supervising and supporting purposes.

2.6.2.4.2 Topics Covered
There might be a few rounds of negotiations before any "Framework Agreement" or official Transaction Agreement can be prepared and signed. In general, there are five topics discussed in negotiations.

1. Price per share – at what price will the shares be traded. This is the most important issue, yet how price is determined specifically remains non-transparent. In practise, net asset value (NAV) per share is used as a criterion, that is, a price lower
than NAV per share will generally be considered not acceptable and will most likely be rejected by the authority in the later approval stage.\textsuperscript{111}

SINOP, for example, during the first negotiation, offered a price per share no less than 20\% over the "criterion"\textsuperscript{112} – 1.185, and on 18\textsuperscript{th} February, 2004, agreed on a final price\textsuperscript{113} of 1.505 RMB/share, which is 27\% over the audited net asset value per share as of 31\textsuperscript{st} December, 2003.

2. Payment— including payment method, amount of deposit, how funds should be jointly administrated during the transitional period, and conditions and deadline for a full payment. Each different transaction will have a slightly different arrangement regarding payment. However the procedures detailed below provide an example of a common solution.

In SAPC's case, SINOP agreed that it would pay cash\textsuperscript{114} (full payment is calculated as 1.505\textsuperscript{115} X 124,864,740, which equals approx. 187.9 million RMB) for the involved shares, in four steps:

- Step 1: Within three working days of the "framework agreement"\textsuperscript{116}, SINOP will pay 25 million RMB as a deposit to SIHC;
- Step 2: Within five working days of the "final agreement", SINOP will pay 125 million RMB to a bank account jointly nominated by two parties and sign a "Jointly Managing Account Agreement" with the involved bank.

\textsuperscript{111} Interviews with professional individuals.
\textsuperscript{112} NAV/Share as of 31\textsuperscript{st} December, 2003 was 1.185 RMB – SAPC's 2003 Annual Report.
\textsuperscript{113} Subject to final approval from authority.
\textsuperscript{114} Virtually all M&A transactions in China are paid by cash.
\textsuperscript{115} Assuming that this price is the final price approved by the authority.
\textsuperscript{116} See section 2.6.4.3 below.
• Step 3: On the day when the transaction has been cleared and confirmed by China Securities Depository & Clearing Corporation Ltd. (SD&C), the bank will transfer the 125 million RMB to SIHC; and

• Step 4: SINOP will pay the rest of the payment to SIHC within 3 working days upon receiving confirmation from SD&C.

3. Management over transitional period – how the firm will be managed over the transitional period. The transitional period is defined as the time period between Step 2 and Step 3 (inclusive) as detailed above. Given that an agreement can be reached, the acquiring firm may nominate new executives for this period, subject to the approval of the original board, and take part in daily management of the firm. The involved parties normally promise not to carry out major business/investment activities during the transitional period. This solution was also adapted by SINOP.

As specified in the official Agreement on 18th February, 2004, SINOP nominated a General Manager and a Chief Financial Officer to replace the original ones. The new executive officers were approved by the original board of SAPC and they began to participate in the daily management of the SAPC during the transitional period.

4. Arrangements regarding current employees – whether their post/salary/welfare will be maintained, etc. If the acquiring firm cannot provide an adequate solution, the seller tends to increase the asking price so that it receives additional funds to settle current staff. SINOP agreed to provide a "satisfactory" arrangements, in complying with the local municipal government's regulations. For instance, it promised that the
majority of the staff would be offered a 3-year new contract with annual salary no less than 2003's level after the transaction.

5. Other topics – any other topics that are of specific local interest. For example, some local governments may ask the acquiring firm to promise not to relocate the firms, for local taxation considerations, i.e. to maintain local tax income. For instance, one of the conditions that SINOP had to agree to was a 3 year lock-up period, that is, it promised to hold the underlined shares for at least three years before disposing of any of them.

2.6.2.4.3 Agreements Reached
At least two agreements will be signed throughout the negotiations, a framework agreement and a final official agreement.

The framework agreement would not contain any specific solution to the issues mentioned above. Instead, it provides a summary of all the negotiations held so far and confirms the two parties' interests and intentions, hence, a "stepping stone" for further talks. The contents of this framework agreement are generally not revealed to the public.

The final agreement will contain all details regarding the transaction and specific arrangement for each topic mentioned above. If necessary, additional notes and/or supplementary agreements can be signed later.
Following their first official meeting on 7th January, 2004, SINOP and SIHC signed the "framework agreement" on the 2nd February, and managed to come to a final agreement on 18th February, 2004. This, however, should not lead to an impression that all negotiations in China can be conducted in a similar "speedy" fashion. Reaching agreement on all topics mentioned above can be very difficult and time-consuming. Lawyers and investment bankers interviewed believe that only one out of ten potential deals may eventually achieve an agreement. As far as time length is concerned, negotiations can take up to 18 months.

2.6.2.5 Approval Procedures
Once an agreement has been signed by all parties involved, the transaction application may be filed to the relevant authorities for approval. Three types of authorities are involved in the approval process: 1) China Securities Regulatory Commission (CSRC); 2) State-owned Assets Supervision and Administration Commission of the State Council (SASAC) and 3) Ministry of Commerce (MOC)\textsuperscript{117}.

Any agreement report will be filed to the CSRC first. In practice, it takes five working days for the CSRC to check if the application is legitimate and valid, i.e. whether the correct form(s) have been submitted, and whether a full set of documents has been provided, before the application is considered. If however the application fails to pass the validity check, a "Note of Requiring Additional Documents" (补证通知) will be issued and the application needs to be re-filed. According to The Measures on the Takeover of Listed Companies issued in 2002 (上市公司收购管理办法) (the

\textsuperscript{117} Ministry of Commerce's approval is unique and only required for transactions concerning foreign capitals or when special "industry admittance" issues are raised – it shall not be further described here.
Measures), as reviewed in Section 2.5, "If the CSRC does not object within 15 days from the date of receiving the report, the acquirer may make a public announcement of the report on the takeover of the target and perform the takeover agreement." (Article 12)

In general, CSRC may object to an application if 1) the application continues to fail its validity check after re-submission; 2) that information regarding this transaction has not been disclosed according to the relevant regulations; 3) when the buyer's or seller's financial status is in such a state that it may not be able to honour the agreement. In practice, the applicant would normally be given a chance to provide additional supporting or clarification documents.

SASAC's approval is required when state-shares or legal-person shares are involved in a M&A transaction. 1) SASAC checks if the buyer is "qualified" to hold such shares. In order to ensure the dominance of state ownership, state-owned shares can not be transferred or sold to private individuals or groups. SASAC examines the involved buyer to see if it is a state-owned entity. 2) SASAC also acts as a controller to ensure that the price is set at a satisfactory (high) level, to avoid potential loss on state assets. Objections from SASAC are normally made on these two grounds.

In the case where state-owned shares are involved, if either of the above two authorities objects to the application, or raises enquires about the transaction, the applicant must prepare additional documents/information and re-submit.

118 Interviews with the professional individuals.
If both the CSRC and the SASAC approve the application, however, a final application may need to be filed to the CSRC. This is detailed as follows. According to the Measures (see above),

"Where a listed company is taken over by agreement, if 1) the purchaser continues to increase shareholding or the control of the listed company after he comes to hold or control 30 percent of the shares issued by the listed company, (Article 13) or 2) if the shares the purchaser plans to hold or control in excess of 30 percent of the shares issued by the listed company, (Article 14) he shall issue a takeover offer to all shareholders of the listed company to be taken over, which indicates a proposal to buy all the shares held by all the shareholders; ...... the purchaser (however) may submit an application to the SCRC for exemption; upon exemption, the listed company may be taken over by agreement."

Article 49 further defines 5 circumstances, under which a purchaser may apply to the CSRC for such an exemption:

"1. if the transfer of shares issued by a listed company occurs among entities who are under control of a same practical controller who, upon the completion of the transfer of shares, continues to be the practical controller of the said listed company, and the transferee promises to perform the issuers' obligations;"
"2. if the listed company is confronted with severe financial difficulty, the purchaser buys up the shares in order to save the said company, and has offered reliable and feasible redistribution programs;"
"3. if the listed company, according to the decision of the shareholders' general meeting, issues new shares, which makes the shares held or controlled by the purchaser exceed 30 percent of the shares issued by the said company;"
"4. if based on the ruling of the court, an application for transfer of shares is effected, which makes the shares held or controlled by a purchaser exceed 30 percent of the shares issued by the said company; and"
"5. other circumstances determined by the CSRC to satisfy the needs to adapt to the development and change of the securities market and to protect the investors' lawful rights and interests."

If the transaction or the result of the transaction involves over 30% of total shares of a target, in order to avoid a costly secondary market share acquisition, it is routine for the acquiring firm to apply for such an exemption. In practice, this exemption application is often submitted along with the transaction application. If both the acquiring firm and the seller are solely state-owned or majority state-owned, then the
practical controller after the transaction remains the state. This fulfils circumstance 1 above. Therefore an exemption will almost always be granted, which concludes the approval procedures.

SINOP followed the above procedures in seeking for approval of its takeover by agreement, and their results are showed in the following timeline.

2.6.2.6 Timeline
Throughout the negotiations and approval seeking period, the underlined listed firm SPAC is required to disclose relevant information to the general public according to Measures for the Administration of Disclosure of Shareholder Equity Changes of Listed Companies (上市公司股东持股变动信息披露管理办法), issued in 2002. the events and information disclosed are perhaps best illustrated through a timeline and the information summarised in the table below are collected from Securities Daily, Guosen Securities and SAPC's annual reports:

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>Information Publicly Disclosed (summary)</th>
</tr>
</thead>
<tbody>
<tr>
<td>End of 2003</td>
<td>Initial approach</td>
<td>None</td>
</tr>
<tr>
<td>07/01/2004</td>
<td>First official meeting</td>
<td>None</td>
</tr>
<tr>
<td>30/01/2004</td>
<td>None</td>
<td>A clarification announcement: Largest shareholder is holding talks with third party regarding transferring its shares; No agreement is yet reached.</td>
</tr>
<tr>
<td>02/02/2004</td>
<td>Frame agreement signed</td>
<td>Announcement on 04/02/2004: Framework agreement signed and a brief summary of the agreement; No official agreement is yet signed.</td>
</tr>
<tr>
<td>18/02/2004</td>
<td>Official agreement signed</td>
<td>Announcement* made on 20/02/2004: Official agreement signed and a summary of the agreement provided; Currently waiting for approvals from CSRC and SASAC</td>
</tr>
<tr>
<td>02-03/2004</td>
<td>CSRC raised enquiries about SINOP's financial status</td>
<td>None</td>
</tr>
</tbody>
</table>

Table 2.6.2.6 A Timeline of SAPC's Transaction
05/07/2004 SASAC approved | Announcement on 15/07/2004: SASAC approved; Still preparing to re-submit to CSRC.

10/2004 Re-submitted to CSRC | None


*It is required that "Where a listed company is taken over by agreement, the acquirer needs to submit to the SCRC a report on the takeover of the listed company the next day after the conclusion of the agreement and at the same time make a suggestive announcement of the summary of the report." On 20<sup>th</sup> February, 2004, the following announcement was made in Securities Times:

"On Feb. 18, 2004, the principal shareholder of the Company, Shenzhen Investment Holding Corporation and Sinopharm Medicine Holding Co., Ltd. signed the Equity Transfer Agreement and SIHC agreed to transfer total 124,864,740 state-owned shares of the Company (43.33% of the total share capital of the Company) to SINOP. The transfer price is determined by reference to the Company's audited net assets value per share as of 31st December 2003 plus 27%. The final transfer price is subject to the approval from State-owned Assets Supervision and Administration Commission of the State Council. The Equity Transfer Agreement cannot be implemented till the relevant national institutions authorise. Relevant procedure of application for authorization is in process."

As summarised above, the first public announcement containing detailed contents of the official agreement was made on 20<sup>th</sup> February, 2004. However, two earlier announcements on 30/01/2004 and 04/02/2004 may have leaked the information to certain conscious market participants prior to the official announcement. This possible information leakage is further addressed in Chapter 4 and 5.

2.6.2.7 Outcome
Transfer of a targeted firm's control affects the firm's operation and business in many aspects. Some of these impacts are easy to observe whereas some are not so obvious.

119 Article 12, The Measures on the Takeover of Listed Companies
Board composition and senior management will almost certainly be altered as a result of an M&A transaction. As mentioned earlier, the acquiring firm will appoint key personnel to senior management positions in the targeted firm, from during the transitional period. Via these personnel arrangements, the new controlling shareholder has its interest represented and ensures that the targeted firm and its business are evolving towards the new controlling shareholder's desired direction. Hence, the way in which the acquired company undertakes its business will change.

Changes in control will also lead to the integration of certain activities of the acquired and acquiring companies, especially in a vertical or a horizontal merger. The depth of the integration largely depends on the similarity of the level of economic activity—exploration, production or manufacturing, wholesale distribution, retail distribution to the ultimate consumer, or in other words, the element of relatedness. SINOP and SAPC presented in this section are both medical firms. After SINOP's takeover, SAPC's operation is likely to be strengthened, given SINOP's powerful distribution network advantage in the north, along with many other potential improvements (more experienced management, stronger political connection, better capital support, etc.) that may have been brought in by the controlling shareholder. Similarly, SINOP's business will also benefit from gaining control of SAPC as this grants it access to the medicine market in southern China. The business activities of the above two are well integrated and mutually beneficial.

However, in a conglomerate merger, the degree and success of the integration remains difficult to evaluate, especially when the acquired and the acquiring firms are in totally unrelated industries. A new owners may choose to add new lines of business
to the original performing core business of the targeted firm, hence, diversification. Or in some cases, the new owner may choose to replace the original non-performing core business with new ones, hence, increased concentration.

The specific consequences of ownership change will vary from one transaction to another. Indeed, evaluating these outcomes and companies' post-event performance allows one to better understand the nature of the decision process, and gain more meaningful insights into the phenomenon of M&A.

### 2.7 Conclusion

Mergers and acquisitions in China emerged and developed along with the evolvement of the reform, the expansion of the securities markets and the improving regulatory framework.

Various SOE reform schemes have been introduced since the late 1970s. After years of experiments without an entirely satisfactory success, a shareholding system corporatisation scheme was gradually introduced, attempting to convert SOE governance into that of a modern corporate governance structure. By the end of 1991, a number of selected corporatised SOEs were allowed to be publicly listed on the stock markets: the Shanghai Stock Exchange and Shenzhen Stock Exchange. In order to preserve the state-ownership, firms that were permitted to go public had to issue shares to the government. This resulted in a complicated mixed share structure in the listed firms.
The size of the stock markets in China has been growing dramatically, despite the fact that only about one third of the total outstanding shares are tradable. Along with the fast expansion of the financial markets and the deepening of the reform, M&A, as an important means of corporate restructuring, has gained currency. Listed firms can be targeted and their control can be gained via an agreement between the buyer and the dominating shareholders – a commonly used form of acquisition in China.

Legislations and regulations have been constantly passed and amended to better regulate the Chinese economic development. Some of the key Laws and regulations reviewed in this chapter showed that legislators in China are improving the regulatory framework, especially concerning the securities market and the restructuring activities.

Overall, the growth of the M&As in China appears to be on the right track. However, compared with its fast expansion speed, the amount and the depth of research, both theoretical and empirical, has been limited in this field. As outlined in Chapter 1, this thesis will contribute further to knowledge by empirically testing the informational efficiency of the Chinese domestic stock markets and investigating whether the M&As create value to Chinese shareholders. The results and their implications should give insights into corporate restructuring activities in China and provide information useful to the shaping of the stock markets and to the improvement of the regulatory structure.

The future development and success of Chinese enterprise reform, as well as corporate restructuring, will depend on the maturity of the stock markets and an efficient legal framework that can quickly adjust to changing circumstances.
Privately-owned companies, for instance, if allowed to be listed on the stock exchanges, would surely bring new perspectives to the market. Foreign institutional investors, if allowed freely into the market, will also have strong impacts. China's entry to the World Trade Organisation indicates that the listed SOEs will one day no longer be isolated from the competitive pressures of world capital markets. The current protection (capital control policy and price limit) will have to be lifted. Perhaps that is when the vitality of the Chinese financial market will be truly tested.
Chapter 3  The Literature of EMH, Abnormal Returns and Corporate Governance

3.0 Introduction

During the last three decades, researchers in the fields of economics and finance have made great progress in comprehending the operations of capital markets and the ways in which the causes and effects of mergers and acquisitions might be modelled and measured. Evidence on the financial performance of mergers is derived from two major sources: 1) the effect on accounting profits and cash flows and 2) the impact on share prices.\textsuperscript{120}

It is possible to compare the level of accounting profits in the period immediately after a merger with those of the two involving companies immediately prior to it. However the difficulties of conducting such comparison should be noted.

Proper comparison would not be with pre-merger performance of the merging firms but rather with what post-merger performance would have been if the merger had not occurred.

\textsuperscript{120} In addition to these two sources, evidence is also derived from surveys of executives and case studies: Surveys of executives normally present a standardised questionnaire to a sample of managers, asking them whether a takeover created value. Their answers are then summarised to yield generalisation. Clinical studies are inductive research, concentrating on one or a small number of transactions in great depth. Such case studies normally provide comprehensive description of the factual background and detailed study of views from the involved managers and the (uninvolved) observers. However, it should be noted that while these two research approaches can offer certain insights regarding effects of M&A, they aim to describe rather than scientifically test a hypothesis. Bruner (2003) provides a good summary of advantages and disadvantages of different research approaches.
The period chosen for comparison can be short, for example over 90 days, which might give a false impression of the effects of the merger, especially since acquisition and reorganisation costs may occur early while benefits may take longer to accrue. The period can be much longer, for example 7 years, during which case factors other than the merger itself are likely to have significant influences on performance. Last but not least, accounting methodology can measure return on assets ratios before and after the merger, which should reflect actual changes in the profitability of assets. However, accounting rates of return are rarely equal to economic rates of return (see Solomon and Laya (1967), Kay (1976)). Accounting profits may be different from free cash flows, but more importantly, the initial and final book value of assets may be poor proxies for their economic values.

It is perhaps because of the above reasons, increasing attention has been given to assessments of the influence of mergers on share prices. Indeed, the effects of M&As on share prices have been extensively reviewed for many years in the West. This chapter will review some of the most relevant theoretical and methodological development in this field.

The structure of this chapter is as follows. Section 3.1 reviews the evolvement of the efficient market hypothesis (EMH) and related research. Section 3.2 discusses the methodological issues regarding measuring and analysing the effects of a takeover. Section 3.3 presents the empirical evidence in M&A studies from the US, UK and China. Section 3.4 reviews the relevant literature regarding corporate governance and Section 3.4 summaries the chapter.
3.1 Market Efficiency

An acquisition is expected to bring changes in future profit and dividend streams. Such changes should be reflected by changes in prices and returns of the company's shares. This is the basic assumption underlying the use of stock market data to estimate the effects of acquisitions. In terms of Fama's classification, there is semi-strong market efficiency (Fama, 1970).

3.1.1 Random "Walking" Information

Business cycle theorists believe that the progress of the economy through boom and bust periods can be clarified and predicted by tracing the evolution of several economic variables over time. A natural candidate for analysis was the behaviour of stock market prices over time. Assuming that stock prices reflect the prospects of the firm, recurrent patterns of peaks and troughs in economic performance ought to show up in those prices.

Kendall (1953) examined this proposition and he could not identify predictable patterns in stock prices. Prices seemed to evolve randomly and were as likely to go up as they were to go down on any particular day, regardless of past performance. This seemed to imply a stock market dominated by "animal spirits" that follows no logical rules. In short, the results appeared to suggest the irrationality of the market.
It however soon became apparent that the random price movements indicated a well-functioning or informationally efficient market, not an irrational one.

The security market is not only involved in allocating funds for the finance of company activities, but also provides a vital supply of information for this process to work by establishing appropriate prices given the risk of the company. Prices are a "fair" indicator of a company's worth. Competition among investors ensures that the market price reflects all that is known about a company and, moreover, that all new information will lead to a rapid adjustment in price. In this way the market establishes the "true" and "fair" value of the share. The market is therefore described as being "informationally efficient" because it produces prices which reflect all available information. Prices in the market will increase or decrease only in response to new information. This notion has been termed the Efficient Market Hypothesis (EMH)\textsuperscript{121}, which has attracted a great deal of attention and debate for many years.

New information, by definition, must be unpredictable; if it could be predicted, then it would be part of today's information. Thus, share prices that change in response to new information also must move unpredictably, hence they appear to be following a random walk, which would be the natural result of prices that always reflect all current knowledge.

3.1.2 Early Works

Early works dealing with security analysis, such as Graham and Dodd's (1934) put forward the idea that the fundamental value of any security equals the discounted

\textsuperscript{121} Fama (1970)
expected cash flow which that security gives title to, and that actual prices fluctuate around these fundamental values. Accordingly, investors were advised to buy (or sell) shares that were priced to below (or above) fundamental values and to realise profits when the gaps were eliminated.

Cowles (1933) showed that the recommendations of major brokerage houses, presumably based at least partially on fundamental analysis, did not outperform the market. Working (1934) argued that "random walks" characteristically develop patterns that look like those commonly ascribed by market analysts to stock prices. Studies by Kendall (1953) and Granger and Morgenstern (1964) supported the random walk hypothesis.

3.1.3 Efficient Market Hypothesis

The modern literature can be seen as starting with Samuelson's paper in 1965, and, in particular, Fama's survey article in 1970. This section continued to review the EMH's presumptions, its versions, and presents empirical evidence from the West and China.

3.1.3.1 Conditions

For a market to be informationally efficient, some pre-conditions must be met.\textsuperscript{122}

1. The presence of a large number of independent profit-seeking participants, who are able to assess the impact of relevant information on share prices. They may

\textsuperscript{122} Thomas (1989)
have different interpretation of new information, but on average the market will view it "correctly".

2. Information reaches the market in a random fashion and independently of each other so there can be no anticipated news.

3. Investors are presumed to respond quickly enough to the arrival of new information and affect security prices by trading. Professionals will react particularly promptly

Therefore, it is asserted that if these general conditions are met, an "efficient" market exists, one where share prices adjust rapidly to the arrival of new information, giving prices which reflect all that is known about a security.

Unlike the random walk approach, Samuelson's (1965) used a Martingale model and constituted an economic model of asset price determination that could be linked with traditional assumptions about preferences and returns. LeRoy (1989) suggests that it is best to view the Samuelson's model as a modified extreme version of the fundamental model. "Instead of assuming that price fluctuates around fundamental value, Samuelson assumed that price actually equals fundamental value."123

Fama's (1970) survey marks the start of the modern literature on efficient capital markets. Fama's paper was largely concerned with empirical work. However, he also provided some preliminary theoretical argument which determined the nature of his work. Fama utilised the Martingale model and it should be noted that he identified market efficiency by doing so. Market efficiency thus becomes a complex joint

123 LeRoy (1989)
hypothesis. That is, the null hypothesis of market efficiency can be rejected due to true market inefficiency, an incorrect model, an inappropriate market proxy, other research design errors, random sampling errors, or any combination of such imperfections.\textsuperscript{124}

3.1.3.2 Versions of EMH and Implications

It is common to distinguish three versions of the efficient market hypothesis: the weak, semi-strong, and strong forms of the hypothesis\textsuperscript{125}. These versions differ by their notions of what is meant by the term – "all available information."

3.1.3.2.1 Weak Form and Chartists

The first is the "weak form" which asserts that share prices fully reflect the information implied by all previous price movements. Nothing is to be gained by examining the stock price history since past and future price movements are unrelated. Prices there follow a random walk since there is no correlation with past movements. Neither is it possible to use trading rules or other similar strategies to produce above average returns. Such conclusions, however, have not stopped the technical analysts from studying how prices have behaved.

Although technical analysts recognise the value of information regarding future economic prospects of a firm, they believe that such information is not necessary for a successful trading strategy. This is because whatever the fundamental reason for a change in stock price, if the stock price responds slowly enough, the analyst will be

\textsuperscript{124} Zivney and Thompson (1985)
\textsuperscript{125} Fama (1970)
able to identify a trend that can be exploited during the adjustment period. The key to successful technical analysis is therefore a prompt response of stock prices to fundamental supply-and-demand factors. It is also argued that more sophisticated analysis is required, such as non-liner models.

The Dow theory is perhaps the "forebear" of most technical analysis. The objective of the Dow theory is to identify long-term trends in stock market prices. The two indicators used are the Dow Jones Industrial Average (DJIA) and the Dow Jones Transportation Average (DJTA) where the DJIA is the prime indicator of underlying trends, while the DJTA usually serves as a check to corroborate or reject the buy signal. The Dow theory posits three forces simultaneously affecting stock prices as summarised by Bodie et al. (1996):

1. A primary trend of long-term movement of prices, lasting from several months to several years.
2. A secondary (intermediate) trend caused by short-term deviations of prices from the underlying trend line. These deviations are eliminated via corrections when prices revert back to trend values.
3. A tertiary (minor) trend of daily fluctuations of little importance.

Later variations on the Dow theory are the Elliott wave theory and the theory of Kondratieff waves. Like the Dow theory, the idea behind Elliott wave theory is that stock prices can be described by a set of wave patterns. Kondratieff waves are similar to the primary trend of Dow theory, although of far longer duration (48-60 years), which are difficult to be empirically tested.

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126 Kondratieff (1935)
Above theories are based on a notion of predictably recovering price patterns. However, the EMH holds that if any pattern is exploitable, many investors would attempt to profit from such predictability, which would move stock prices and cause the pattern to change. In addition, the EMH implies that no matter which pattern is found by technical analysis, these theories are no help since historical data is publicly and freely available. Any information that was ever available has already been reflected in the prices. Therefore looking at past performance could not generate abnormal returns. Moreover, the patterns may be non-linear, whilst the statistical analysis could be largely linear.

3.1.3.2.2 Semi-strong Form and Fundamental Analysts

The second approach, the "semi-strong form", holds that security prices adjust quickly to the announcement of new public information. The market reacts to the information and the prices reflect it in the most efficient manner. An investor that acts according to new public information will not obtain above average profits since the information has already been discounted in the price. Intensive and expensive research will therefore not produce systematic and abnormal returns for investors. However, this assertion has not stopped a large number of fundamental analysts from studying corporate financial reports, evaluating the quality of management, assessing prospects for the industry and indeed exploring any available information to detect "mis-priced" shares, i.e. shares that are not priced according to its "real" value.

It is true that in practice information is sometimes available to just a few people, for example, in analysts' visits and briefings by companies. In addition, even when
information has been made public, it is possible that not all recipients can anticipate it correctly and act accordingly. It has also been observed that some analysts appear to have a greater talent in predicting share prices than others and consistently outperform the market.

This point has been stressed by Grossman and Stiglitz (1980). They argue that investors will have an incentive to spend time and resources to analyse and uncover new information only if such activity is likely to generate higher investment returns. Therefore, in market equilibrium, efficient information gathering activity should be "fruitful or profitable."127

3.1.3.2.3 **Strong Form**

Finally, the strong-form version of the efficient market hypothesis states that stock prices reflect all information relevant to the firm, whether public or private, including the information available only to insiders. Therefore no investors, whatever information they possess, can consistently generate above average profits. The implication of the strong form is that share prices always reflect their intrinsic worth and can be taken at face value. In this case even the insider with privileged access to information would not be able to profit from it.

This version of the hypothesis is extreme. If the managers, with access to all pertinent information long before public release, were allowed to trade the related shares, they would surely profit from such trading. Few would argue with this proposition. That is why Acts and Laws have been passed in most Western economies to set limits on

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127 Grossman (1980)
trading by corporate officers, directors, and substantial owners. Trading by these insiders, their relatives, and any associates who trade on the information supplied by insiders are considered in violation of the law. However, it should be noted that defining insider trading is not always easy. After all, stock analysts are in the business of uncovering information not already widely known to market participants. The distinction between private and inside information is sometimes vague.

### 3.1.4 Evidence from the West

Early tests of the efficient market hypothesis concentrated on the weak-form of the hypothesis, specifically that security prices perform a random walk. If the weak-form of the efficient market hypothesis is correct, then the correlation coefficient between the price changes of a security observed over two periods of time, the autocorrelation coefficient, should be zero. This can be stated more formally as:

\[
\rho_{\Delta P_t, \Delta P_{t-1}} = \frac{\text{Covariance}(\Delta P_t, \Delta P_{t-1})}{\sigma_{\Delta P_t} \cdot \sigma_{\Delta P_{t-1}}} = 0, \tag{1.1}
\]

where

- \(\Delta P_t\) is the price changes of the asset at time \(t\)
- \(\sigma_{\Delta P_t}\) is the standard deviation of \(\Delta P_t\).

Fama (1965) published daily autocorrelation coefficients for lags of up to 10 days for 30 stocks. Out of 300 coefficients computed, it was found that 42 of them were more than twice their estimated standard deviations. By normal standards, it is reasonable to accept the hypothesis that coefficients of this magnitude are different from zero. The
The relatively small size of the autocorrelation coefficients, however, supports the weak form of the EMH.

In order to measure abnormal returns, it is necessary to have an acceptable measure of "normal" or expected returns, and this, in turn, requires an acceptable measure of the risk of the security or some theory of how the concerned asset is priced. Most empirical studies of the EMH have used the Capital Asset Pricing Model (CAPM) to measure expected returns on security. This means that the expected return on an equity security will be defined as the beta ($\beta$) of that security times the expected return on a well-diversified portfolio of securities which represents the market as a whole. Abnormal return in any single period are then defined as the difference between the actual return on a security in a given period less the expected return:

$$\text{Abnormal Return} = \text{Actual Return} - (\beta \times \text{Expected Return on The Market})$$

Therefore, any test of the hypothesis of market efficiency is actually a joint test of two hypotheses. One hypothesis is that the market is efficient; the other is about how assets are priced. The CAPM is usually the basis for formulating measures of expected returns when tests of the efficiency of pricing equity securities are conducted. If this model is flawed in ways that produce biased tests, then evidence might seem to point to market inefficiency when that is not the case. Without developing better theories of the pricing of assets, it is very difficult or even impossible to determine whether the model is wrong or the market is inefficient.

\[12^8\] Further technical details on the Capital Asset Pricing Model, beta estimation and the value of actual return and expected market return will be presented in 3.2.2.
Since Fama initially published his finding in 1965, more and more tests of the EMH have emerged. Some of the later studies tried to determine whether there were some "trading rules" that could consistently earn excess returns and the results of these studies varied.

Meese and Rogoff (1983) found that no economic model was available which could outperform a random walk model.

Allen and Taylor (1990) examined the relative performance of a number of chartists on the London Foreign Exchange market and concluded that only one particular chartist was consistently able to outperform the random walk model. Although there were substantial differences between individual chartists, with the median return of the chartists failing to outperform random walk models. In a following study of short-term exchange rate behaviour, Allen and Taylor (1992) further concluded that at least 90% of their questionnaire respondents (chief foreign exchange dealers in London) placed some weight on technical analysis, indicating that foreign exchange dealers may be realising abnormal returns, via technical analysis.

Brock et al. (1992) employed data from the Dow Jones over a 100-year period to test two technical trading rules via bootstrapping, and concluded that these trading rules contain predictive ability. Hudson et al. (1996) replicated Brock et al.'s study by using 60 years of daily returns from the FT30 on the London International Stock Exchange and reported that although their results were similar to those of Brock et al., long-term "buy and hold" strategies cannot generate abnormal returns because of the higher transaction occurred. Hudson et al.'s conclusion was later supported by Mills
(1998), who employed the same data set with a more rigorous econometric analysis.
Raj (1998), using data from the Sydney Futures Exchange, concluded that the application of simple trading rules could not realise abnormal returns.

Coutts and Cheung (2000) investigated two trading rules using 13 years of daily returns from Hang Seng index on the Hong Kong Stock Exchange and found no positive abnormal returns, net of transaction costs and the associated opportunity costs of investing.

In short, whereas some trading rules may have predictive ability, they tend to be unexploitable and net of transaction costs. These academic results are, again, generally interpreted as evidence in favour of the EMH, in particular, its weak form.

3.1.5 Evidence from China

In recent years, evidence on the EMH from emerging markets, such as China, have also become more plentiful.

Much earlier empirical research on the Chinese stock market has focused on the correlation structure of the A shares versus the B shares and the puzzle that the A shares are traded at a high premium versus the B shares.

Bailey (1994) examined the securities returns of nine companies listed on the Shanghai and Shenzhen exchanges. He found that B share returns exhibited little or no correlation with international stock index returns or returns on China-related stocks traded in Hong Kong and the US. However, instruments for international risk
premiums had some power to forecast B share returns. Ma (1996) investigated 38 companies that had both A and B shares listed on the two exchanges during the period of 1992–1994. Ma found that cross-sectional differences between returns of A shares and B shares were correlated with investors' attitudes toward risk. He also argued that regulatory changes might explain part of the variability of B shares' discounts over time.

Chui and Kwok (1998) examined the cross-autocorrelation between A and B shares listed on the two exchanges during the period of 1993-1996. They found that prior price movements affect price changes in the A and B share markets and that the returns in the B share market lead the returns in the A share market. However, according to Sjoo and Zhang (2000), this relationship holds only for the Shanghai market. Fung, Lee, and Leung (2000) used a latent variable model to examine the pricing of the A and B shares in the period from May 1993 to June 1997 and demonstrated that the latent variables of the A and B share markets were different.¹²⁹ Their results suggest the A and B share markets on both the Shanghai and Shenzhen exchanges are segmented and although owners of the A and B shares share equal rights in the same companies, they react to different underlying forces. Fung et al. therefore conclude that the pricing in the two markets reflects more of the similar fundamentals in the respective markets. It has been further suggested by Chen et al. (2001), that A shares are over-priced and that the returns to B shares move more closely with market fundamentals than do those for A share prices. Using cointegration analysis, Chan, Cheng, and Fung (2001) concluded that the A and B share prices did not follow the same dynamics. Overall, these results suggest that

¹²⁹ Under a competitive financial market, the latent variables of the A and B shares for the same company are expected to be the same. The correlation for A and B shares of the same company is expected to be one (i.e., perfect correlation).
there is a difference in the price dynamics of the two markets, but there is also relevant information flowing between the two markets.

Mookerjee and Yu (1999) used share price index data for 1991–1993 released by the Shanghai and Shenzhen stock exchanges to test market efficiency. They found the existence of significant inefficiency including weekend and holiday effects in China's two stock markets. This result is supported by Ma's (2000) study of informational efficiency of China's stock market. He found evidence of the day-of-the-week and the month-of-the-year effects in the Chinese stock markets.

Xu (2000) analysed the time series return and volatility patterns of the Shanghai market and found no day-of-the-week effect in returns in the Shanghai stock market.

Chen et al. (2001) investigated the day-of-the-week effect in China's two stock markets. They found negative returns on Tuesdays during 1992–1997 and argued that this Tuesday anomaly may be due to the "spill-over" effect from the America. Their finding, however, contradicts those of Xu (2000).

The latest tests of the EMH in Chinese stock markets include Su (2003) and Gao and Tse (2004). Using 183 earnings announcements between 1997 and 1998 for firms that have issued both A and B shares prior to 1 January 1996, Su (2003) finds that domestic A share investors, on average, do not correctly anticipate the earnings per share (EPS) changes and do not adjust to the new earnings information very rapidly in the markets. As a result, abnormal returns can be obtained by trading A shares on the earnings information. Gao and Tse (2004) also conducted an event study on the
annual earnings announcements. They observed negative abnormal returns (though not statistically significant) on the event day of so-called "good-earnings surprises" on the A share market.

Overall, the studies of EMH in the Chinese context have produced varied but not conclusive results.

3.2 Event Study Methodology

Assuming semi-strong market efficiency, one can test for the effect of an acquisition on expected future profit and dividend streams by measuring the change in returns to acquiring company shareholders. The majority of studies on the impact of mergers on stock price movements have used "event study" methodology.

When Fama et al. (1969) introduced the event study methodology they started a methodological revolution in accounting, economics and finance. To showcase the CRSP monthly database, Fama et al. examined the effect of the announcement of a stock split on stock prices by using a sample of monthly return data from 1926 to 1960 and a "Market Model". Their classic paper is commonly viewed as the earliest and most influential event study.

Event study methodology has subsequently been widely used and has become the standard method of measuring share price behaviour around events (both controllable and non-controllable events) such as earnings announcements, accounting rule changes, etc. Put simply, a model of stock price returns is estimated excluding data
for a short period before, and after the event, and then the actual returns for the firms involved are compared with the counterfactual returns. The differences are called abnormal returns after adjusting for the market, and their cumulative sum is taken as the market's reaction to the "new information" contained in the event. The underling idea is to see whether the returns were "abnormal", or different from what would otherwise be expected in the absence of the event. When measuring effects of a merger, for instance, positive cumulative abnormal returns associated with merger are taken to show that the merger is expected to create value for the shareholders reflecting economic efficiency gains.

This section will look at the relevant methodological issues, in particular, the approaches that have been developed in M&A studies. Section 3.2.1 discusses the properties of an "event". Section 3.2.2 presents some selective models developed to measure normal returns. Section 3.2.3 reviews key statistical testing problems.

3.2.1 Event

To measure the effect of the takeover on shareholder returns, two questions must be answered first:

1. When is the effect to be measured?

2. How to separate the effect from other contemporaneous factors?
The first question could be easily answered, if 1) all of the relevant information becomes public on the day the takeover is announced and 2) the market can adjust fully in that day to the new information. But news of an acquisition is known to leak into the market prior to the announcement, and it is unrealistic to assume that the market is capable of predicting the full future consequences of an acquisition immediately upon learning of it.

Shiller (1981), in his controversial paper, has shown that in a bull market, prices rise by far more than subsequent increases in dividends will warrant; in a bear market, they fall too far. The market has historically continually shifted from being too optimistic in bull markets to being too pessimistic in bear markets.

Although not everyone agrees with Shiller's analysis, his interpretation is of particular relevance to the literature on M&As. It is well known that acquisition activity has been highly correlated with stock market activity (Crook, 1996). Takeovers have occurred most frequently at times when stock market prices are rising and the market in general is known to be overly optimistic about the future performance of companies, in particular, the market may be overly optimistic in evaluation of acquisitions when they are first announced (Geroski, 1984). Given the positive correlation between stock market activity and takeover activity, the above arguments suggest that the share price movement should be observed over a relatively long period of time so that the effects of takeover can be truly reflected and measured.
3.2.1.2 Contemporaneous Events

Share prices and returns are affected by many different factors, economical and political. Many of these factors are related, especially when they concern the same underlying assets. To correctly measure the effects of a specific "event" such as a takeover, it is desirable to separate the effects of acquisition from other contemporaneous events. By studying a large sample of companies and adjusting returns for influences that affect all or most companies, to a greater or lesser extent, it is possible to reduce the possibility of information extraneous to the subject under investigation obscuring the effects of the event (Draper, 1989).

In general, three approximations have been employed in the literature:

1. to assume the firm's returns post-event would have been the same as its returns pre-event in the absence of the acquisition;
2. to select a control group and assume that the firm's returns post-event would have been the same as those of the control group firm(s);
3. a combination of 1 and 2, i.e. to assume that the change in returns of the acquiring firm following the announcement of an acquisition would have been the same as the change in returns for the control group firm(s) for the same time period. The difference between this predicated change and the change actually observed is attributed to the acquisition.

The third method is perhaps the best. If one simply compares a firm's post-event performance to its pre-event performance (approximation 1), one ignores all of the other contemporaneous events that may affect its returns, along with the acquisition. But if one predicts a firm's returns in the post-event period entirely from the control
group (approximation 2) one ignores any possible systematic difference between the merging firms and the control group. This is particularly important because the differences between the performance of acquiring firms and the usually employed control groups can be substantial over the pre-event period.

3.2.1.3 Information in Announcement

It is worth pointing out that the announcement itself may convey information about the bidder, related or unrelated to the takeover event. Like any other public announcement, announcement of a bid will lead investors to revise their opinions about the value of the concerned parties.

The announcement of a takeover bid can disclose at least three pieces of information: 1) that the takeover will be attempted, 2) that the internal affairs of the bidding firm are in such a state that a bid is possible and 3) that the target might be in a state that it is being targeted.

3.2.2 Models for Measuring Normal Returns

This section will review the models commonly used in event study approach, in particular, the Market Model and the Capital Asset Pricing Model.

3.2.2.1 An Overview

A number of models have been used to calculate the normal return of a stock. These models can be generally divided into one of the two groups: statistical models or economic models.
Statistical models, such as the Mean-Adjusted Return Model, Market-Adjusted Return Model and the Market Model, rely on no economic arguments but follow statistical assumptions concerning the behaviour of asset returns, which are that the asset returns are jointly multi-variate normal and independently and identically distributed through time. Although the assumptions are strong, they tend not to lead to problems in practice because the assumption is empirically reasonable and the results obtained using such models are generally robust.\textsuperscript{130} Specific issues associated with statistical assumptions will also be reviewed further in section 3.2.3.

Economic models, such as the Capital Asset Pricing Model (CAPM), in contrast, rely on economic assumptions and are not based solely on statistical assumptions, although in practice, however, statistical assumptions are often added. Therefore, economic models can be best used as restrictions on the statistic models to calculate more precise measures of the normal return.

Actual returns may be set out as follows, where $P$ is the security price, $D$ represents dividends, $r_i$ is the return on security $i$ in time $t$, $\overline{r_{it:t+k}}$ is its average value over some period of time $k$, $r_m$ is the return on a market index, $r_f$ is the risk-free rate of return, and $\alpha$ and $\beta$ are coefficients of a regression equation used to estimate $\hat{R}_u$ (the counterfactual "normal" return) so that:

$$AR_{it} = r_{it} - \hat{R}_u$$

(3.1)

and

\textsuperscript{130} Brown and Warner (1980)
\[ r_{it} = \left( \frac{P_{it} - P_{it-1}}{P_{it-1}} \right) + D_{it}. \]  

(3.2)

\[ \tilde{R}_{it} \] and hence \( AR_{it} \) may be calculated using one of the models presented below:

<table>
<thead>
<tr>
<th>Model</th>
<th>Equation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Mean-Adjusted Return Model</td>
<td>( \tilde{R}<em>{it} = r</em>{it(t,t+k)} )</td>
</tr>
<tr>
<td></td>
<td>( AR_{it} = r_{it} - \bar{r}_t )</td>
</tr>
<tr>
<td>2. Market-Adjusted Return Model</td>
<td>( \tilde{R}<em>{it} = r</em>{mt} )</td>
</tr>
<tr>
<td></td>
<td>( AR_{it} = r_{it} - r_{mt} )</td>
</tr>
<tr>
<td>3. Market Model(^{131})</td>
<td>( \tilde{R}<em>{it} = \alpha_i + \beta_i r</em>{mt} )</td>
</tr>
<tr>
<td></td>
<td>( AR_{it} = r_{it} - (\alpha_i + \beta_i r_{mt}) )</td>
</tr>
<tr>
<td>4. Capital Asset Pricing Model</td>
<td>( \tilde{R}<em>{it} = r</em>{ft} + \beta_i (r_{mt} - r_{ff}) )</td>
</tr>
<tr>
<td></td>
<td>( AR_{it} = r_{it} - [r_{ft} + \beta_i (r_{mt} - r_{ff})] )</td>
</tr>
</tbody>
</table>

### 3.2.2.2 The Market Model

The market model divides the return on a stock into a number of separate components:

\[ R_{it} = \alpha_i + \beta_i R_{mt} + \epsilon_{it}, \]  

(3.13)

where

\( R_{it} \) is the return on the individual stock \( i \) in time period \( t \);

\( R_{mt} \) is the return on the market in time period \( t \);

\( \alpha_i \) is the component of a security’s return (alpha) which is independent of its market related element;

\(^{131}\) In some cases an industry-specific index may be added to the estimating equation:

\[ \tilde{R}_{it} = \alpha_i + \beta_i r_m + \gamma_i r_{z_i}. \]  

(3.9)

where \( r_{z_i} \) is the return on the industry-specific index in time period \( t \).

Hence, \( AR_{it} = r_{it} - (\alpha_i + \beta_i r_m + \gamma_i r_{z_i}) \).  

(3.10)
\( \beta_i \) is a constant (beta) that measures the expected change in the return on the stock given a change in the return on the market;

\( \varepsilon_i \) is an error term with an expected value of zero, i.e. \( E(\varepsilon_i) = 0 \).

Typically Equation 3.13 has been parameterised using Ordinary Least Squares (OLS) estimates, when it is assumed that the market return is unrelated to the unique return (\( \text{Cov}(\varepsilon_i, R_m) = 0 \)) and that securities are only related through their common response to the market (\( \text{E}(\varepsilon_i, \varepsilon_j) = 0 \) (\( i \neq j \))).

The market model is an adjustment procedure unsupported by any theory. It simply represents a convenient assumption about the return generating process. The reason why the model is popular is perhaps due to its simplicity and robustness. Investigations of its behaviour by Brown and Warner (1980) have revealed it to be as successful as other more theoretically based methods and Brown and Warner conclude that "beyond a simple one factor market model there is no evidence that more complicated methodologies convey any benefit."\(^{132}\)

The parameters of the market model are computed using past time series data. Prices and dividends on individual securities are observable and price indices of broad aggregates of securities readily available. Returns may be calculated in a variety of ways but a common method is to define the return on a security at period \( t \) as the sum of the change in prices and the dividends expressed as a proportion (see Equation 3.2).

\(^{132}\) Brown and Warner (1980)
Similarly, market return is also expressed as a proportion:

$$R_{mt} = \frac{P_{mt} - P_{mt-1}}{P_{mt-1}},$$

(3.15)

where

$$P_{mt}$$ is the value of $$R_{mt}$$, the market index at period $$t$$.

Market return is taken as a measure of the expected return on a well-diversified portfolio of securities which represents the market as a whole. The model assigns no particular significance to any market index. Market indices vary both in their coverage and their methods of construction, hence, the values of market return calculated from different indices will be different, even given the same period $$t$$.

The model specifies no particular time interval over which the parameters should be estimated. Earlier studies have used returns calculated on a calendar month basis. However, daily (and sometimes intraday) data has now been more frequently used to better measure abnormal returns and yield more informative studies of announcement effects.

Theoretically, the beta is defined by the covariance between the security and the market portfolio in the following way:

$$\beta_i = \frac{\sigma_{im}}{\sigma_m^2},$$

(3.16)

where

$$\sigma_{im}$$ is the covariance over time between returns on asset $$i$$ and returns on the market portfolio;
\( \sigma_n^2 \) is the variance of the latter.

However, it is inconvenient to calculate beta with the Equation 3.16. The Market Model relationship has therefore been used to estimate an individual security's beta over a certain period of time. The beta of a portfolio is then defined as weighted average of the betas of the individual component securities:

\[
\beta_p = \sum_{i=1}^{n} X_i \beta_i ,
\]  

(3.17)

where

- \( \beta_p \) is the beta of the portfolio;
- \( X_i \) is the weight for security \( i \) in the portfolio;
- \( \beta_i \) is the estimated beta for security \( i \).

The parameters of the Market Model are commonly estimated over an arbitrary period. Such estimation assumes that the \( \beta \) and intercept term, \( \alpha \), are constant over the time period during which the model is fitted to the data. A number of techniques have been suggested to detect possible changes in beta, in order to test whether this assumption is appropriate or not. However, Brown and Warner (1980, 1985) suggest that little is lost, in many situations, by assuming that \( \alpha \) and \( \beta \) are constant over the time period concerned.

The relationships between a security's "true" beta (its beta if the population of returns were known) and a security's observed beta have been analysed by a number of scholars, including Scholes and Williams (1976) and Cohen et al. (1986). Their...
studies suggest a number of procedures using time weighted averages of past and present betas on a security for adjusting estimates.

3.2.2.3 The Capital Asset Pricing Model

The Capital Asset Pricing Model (CAPM) demonstrates that the expected return of an asset is directly and linearly related to its risk. The higher the risk of an asset, the higher the return that the asset must offer investors to induce them to buy and hold it rather than some other security. Similarly, the lower the risk, the lower the return that the asset needs to offer to investors. In this way, all financial assets are priced in the capital market according to their risk. The risk that influences the expected return (and hence the price) of an asset is only the asset's market related risk and is measured by the statistic beta. Mathematically, the CAPM suggests that the expected return on an investment is equal to the risk-free rate of interest plus a premium for risk. The premium for risk is equal to beta multiplied by the equity market risk premium:

\[ E(R_i) = R_f + \beta_i [E(R_m) - R_f] \] (3.18)

where

- \( E(R_i) \) and \( E(R_m) \) are the expected returns for firm \( i \) and the market portfolio;
- \( R_f \) is the return on a risk-free (\( \beta = 0 \)) asset;
- \( \beta_i \) is the covariance of \( i \)'s returns with the market portfolio divided by the variance of the market portfolio.

The CAPM states that the expected return on any firm, \( i \)'s, shares, \( R_i \), varies directly with the return on the portfolio of all shares, \( R_m \), and thus that changes in \( R_i \) can be predicted from changes in \( R_m \) if \( \beta_i \) is unchanged. The \( \beta_i \) term can be estimated from
a time-series regression of $R_i$ on $R_{mt}$ or from a regression of $(R_i - R_f)$ on $(R_{mt} - R_f)$. From Equation (3.18), the intercept of this latter estimating equation should equal zero. But if the intercept is not constrained to equal zero, the following regression can be applied to estimate $\hat{\alpha}_i$:

$$(R_i - R_f) = \hat{\alpha}_i + \hat{\beta}_i (R_{mt} - R_f) + e_i$$  \hspace{1cm} (3.19)

Note that $\hat{\alpha}_i$ is the average residual from the Equation (3.18) for firm $i$ implied by the CAPM. As such, it is a measure of the performance of the company over the sample period used to estimate $\hat{\beta}_i$ (Jensen, 1969), and has been used in many acquisition studies. A company with $\hat{\alpha}_i > 0$ has on average earned higher returns than are predicted by the CAPM. If $\hat{\beta}_i$ were not affected by the acquisition, one way to estimate the effects of the acquisition would be to estimate $\hat{\alpha}_i$ from data from before the acquisition and again from data following its announcement. If all other effects are captured through the movement of $(R_{mt} - R_f)$ over the two periods, then the effect of the acquisition can be estimated by the change in $\hat{\alpha}_i$ between the two periods.

Alternatively, one can estimate Equation (3.19) by using pre-event data, and then use the $\hat{\alpha}_i$ and $\hat{\beta}_i$ estimated from the pre-event data to predict $R_i$ from the post-event $R_{mt}$ and $R_f$. The difference between the actual and predicted $R_i$ based in the pre-event $\hat{\alpha}_i$ and $\hat{\beta}_i$ is a second measure of the effects of the acquisition on shareholder returns.
Different estimation periods are likely to alter both $\hat{\alpha}_i$ and $\hat{\beta}_i$. Although in theory, if this alteration is random, measures of the effects of acquisition should not be biased, studies differ widely as to how they treat the pre-event period when estimating the $\hat{\alpha}_i$ and $\hat{\beta}_i$ used in predicting post-event performance.

As can be seen both from Equation 3.18 and 3.19, beta is at the centre of the CAPM. The total risk of a security (or a portfolio of securities) can be divided into two components: the systematic risk (market risk) and unsystematic risk (unique risk). The market risk of a security reflects the impact of changes in the economy as a whole on individual firms and the unique risk is the risk that arises from the individual characteristics of assets. Investors can get rid of the unique risk by simply holding a well-diversified portfolio, and can expect to be compensated only for bearing the market risk which can not be diversified away. A beta of zero indicates that the firm's return will not be affected no matter how the market as a whole fluctuates. An asset that, on average, moves exactly in step with the market will have a beta of one. In contrast, the returns on a security with a high beta will amplify fluctuations in the market. In summary, "the key insight of the CAPM is that high expected returns go with the greater risk of doing badly in bad times. Beta is a measure of that. Securities or asset classes with high betas tend to do worse in bad times than those with low betas."\textsuperscript{133}

\textsuperscript{133} Burton (1998)
Two significant differences between the market model and CAPM are noted as below:

1. The market model is a one-factor model, where the factor is a market index. Unlike the CAPM, however, it is not an equilibrium model that describes how prices are set for securities based on economic theory.

2. The market model utilises a market index, whereas the Capital Assets Pricing Model involves the market portfolio. Therefore, in theory the beta of a stock based on the market model, differs from the beta of the stock according to the CAPM. In practice, however, a market index is normally used as a proxy because the composition of the market portfolio is not precisely known.

3.2.2.4 Multifactor Models

A number of other statistical and economic models have also been proposed for modelling the normal return, most of which are multifactor models, aiming to reduce the variance of the abnormal return by explaining more of the variation in the normal return, hence, introducing extra factor(s) to the modelling. For example, index models with factors based on industry classification are discussed by Sharpe (1970) and Sharpe et al. (1995) in addition to the market index. The Asset Pricing Theory due to Ross (1976) calculates the expected return as a linear combination of multiple risk factors.\(^{134}\)

Another approach defines abnormal return as the difference between the return on an event firm or portfolio and the return on a non-event firm or portfolio that is similar on characteristics known to be related to average returns. This "matching" approach

\(^{134}\) However, it should be noted that the multifactor models motivated by the APT provide relatively little improvement over the market model (Brown and Weinstein, 1985). Because with the APT the most important factor behaves like a market factor and additional factors do not add significant explanatory power.
aims to control for cross-firm variation. For example, following Banz' (1980) evidence that small stocks have higher average returns than predicted by the CAPM, abnormal return is often estimated as the difference between the actual return and a portfolio of firms of similar size, where size is measured by market value of equity. Similarly, abnormal returns are also estimated by matching event firms with non-event firms in terms of size and book-to-market equity ($BE/ME$) (Fama and French, 1992, 1993). Carhart (1997) modifies the Fama-French three-factor model by incorporating the momentum factor. Recent evidence suggests that a liquidity factor might also explain expected returns. (Pastor and Stambaugh, 2003, and Sadka, 2006)

Generally, the marginal explanatory power of additional factors appears to be small, because the reduction in the variance of the abnormal return is relatively small. Multifactor models therefore provide limited gains over a one-factor model, such as the Market Model, especially concerning short-horizon returns.

### 3.2.3 Measuring Abnormal Returns

Regardless which models that have been used to calculate the normal returns of a stock, research is interested in testing hypothesis about the abnormal returns and estimating their magnitude.

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135 MacKinlay (1997)
3.2.3.1 Hypothesis Testing

Broadly speaking, there are two types of hypotheses: cross-sectional type and time-series type.

The cross-sectional approach examines if the cross-sectional distribution of returns at the time of an event is abnormal (i.e., systematically different from predicted) and the focus is almost always on the average abnormal returns. Typically the null hypothesis to be tested is whether the mean abnormal return at event time is equal to zero, in order to examine if the event is, on average, associated with a change in shareholders' wealth. For a sample of $N$ securities, the cross-sectional average abnormal return for period $t$ is:

$$ AAR_t = \frac{1}{N} \sum_{i=1}^{N} AR_i $$

(3.20)$^{136}$

The time-series approach examines if the cumulative average abnormal returns for periods around the event are equal to zero. For instance, some of the abnormal return behaviour should show up in the pre-event period when the event is partially anticipated. In examining market efficiency, the post-event returns would provide empirical evidence regarding the speed of the market's adjustment to the information revealed at the time of the event. One of the well-established methods for time-series aggregation is the Cumulative Average Abnormal Return (CAAR) method. The Buy-and-Hold method (BAHAR) is also becoming increasingly popular and will be

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$^{136}$This equation can also be written as $AR_t = \frac{1}{N} \sum_{i=1}^{N} e_{it}$, where $e_{it}$ is the component of returns which is abnormal or unexpected.
discussed further in section 3.2.4. Considering a sample of N securities, CAAR starting at time $t_1$ through $t_2$ (therefore horizon length $L = t_2 - t_1 + 1$) is:

\[ CAAR_{NL} = \frac{1}{N} \sum_{i=1}^{N} \sum_{t=t}^{L} AR_{it}. \]  \hspace{1cm} (3.21) \hspace{1cm} ^{137}

The null hypothesis to be tested is whether the cumulative abnormal performance is equal to zero.

Once a performance is estimated, such as CAAR above, a test statistic can be computed and compared to its assumed distribution under the null hypothesis. The null hypothesis is rejected if the test statistic exceeds a critical value. A traditional method defines the standard test statistic as the CAAR divided by an estimate of its standard deviation: $\frac{CAAR_{NL}}{\sqrt{L \sigma^2(AAR_i)}}$. It is assumed that security residuals are uncorrelated and that event-induced variance is insignificant.

Note that this method may not be appropriate if securities' residuals are cross-sectionally correlated, for instance, when the securities have a common event date. There are, indeed, important assumptions underlying the testing procedures that need to be addressed.

Among other statistical assumptions, returns are assumed to be jointly multi-variate normal and independently and identically distributed through time. However, there

\[ ^{137} \text{This equation can also be expressed as } CAR_{NL} = \frac{1}{N} \sum_{i=1}^{N} \sum_{t=t}^{L} e_{it}, \text{ where } e_{it} \text{ is defined in footnote 63.} \]
are several potential problems in hypothesis testing, due to the fact that frequently the abnormal return estimators are not independent or they do not have identical variance. We discuss these problems next.

3.2.3.2 Cross-Sectional Dependence

The dependence problem was first noted by Jaffe (1974) and Mandelker (1974), that the market model prediction errors may not be independent across firms: the covariance of prediction errors across firms is non-zero.

Jaffe (1974) and Mandelker (1974) has introduced a portfolio method to accommodate this issue. First, the \( AAR_t \) is calculated for all firms with an event during calendar month \( t \). Based on the average abnormal return estimates for the portfolio during the preceding months, a time series estimate of \( AAR_t \) is calculated for this portfolio, assuming that the \( AAR_t \)'s are independent over time. Then the estimated \( AAR_t \) is standardised by dividing by the estimated standard deviation. This procedure is repeated for every sample calendar month which contains at least one event, producing a series of standardised average abnormal return \( SAAR_t \) estimates. The \( SAAR_t \)'s are independent, if the \( AAR_t \)'s are independent across time. The statistical significance of the average (in event time) \( SAAR_t \) estimate is assessed using a standard \( t \) test.

Brown and Warner (1980)'s "crude dependence adjustment method" uses the variance of portfolio residuals from the estimation period. The \( t \)-statistic equals the portfolio abnormal return divided by the portfolio residual's standard deviation from the estimation period. Although the authors report that this portfolio approach is less powerful than the traditional test.
3.2.3.3 Time Series Dependence

A further possible problem is time series dependence. As Mikkleson and Partch (1988) discuss, it is a standard result in the econometric literature that regression residuals (and similarly prediction errors) are correlated since they are based on the same parameter estimates.

However, the time series dependence problem is relatively unimportant, as noted by Cowan (1991). The degree of bias depends on the length of the estimation period and the event period. When the event period is relatively small compared to the estimation period, the uncorrected (biased) test statistic is expected to be very close to the corrected (unbiased) one. For example, when the event period is 5 time periods and the estimation period is 100 periods, the test statistic exceeds the corrected result by only 1.6 per cent.\(^{138}\)

3.2.3.4 Heteroscedasticity

Fama (1976) provides evidence that market model residuals have unequal variances across firms.

One approach to address this issue is to aggregate abnormal returns into a portfolio dated using event time, hence, the portfolio method mentioned above.

\(^{138}\) When event period = 60 and estimation period = 100, the figure is 25.2 per cent (Cowan, 1991)!
Another approach (Schipper and Thompson, 1983, 1985) is to analyse individual security returns without aggregation, as Bhattacharya, Daouk, Jorgenson, and Kehr (2000) do. The advantage of the second approach is that, unlike the portfolio method, it can accommodate an alternative hypothesis where some of the firms have positive abnormal returns and some of the firms have negative abnormal returns. However, except in special cases, the test statistics of this approach have poor finite sample properties,\(^\text{139}\) thus the test provides limited empirical evidence compared to economically reasonable alternatives.

As Patell (1976) points out, it is well known in the econometrics literature that prediction errors variance tend to be greater than the regression disturbances, since prediction errors are a function of estimation error in the parameters as well as disturbance variance. There are three ways to solve this problem.

The first (and perhaps easiest) method is to use a sample of data before and after the event period to generate a separate series of prediction errors used solely to calculate the variance of the event period prediction error. The ratio of the variances during the event period and non-event periods might serve as an estimate of the degree of increase in the variability of returns during the event period, which can be used to adjust for the bias in the test statistic calculated ignoring the increased event-period uncertainty.\(^\text{140}\)

The second solution is the "standardised-residual test method" proposed by Patell (1976). His method assumes the security residuals are uncorrelated and that event-

\(^{139}\) MacKinlay (1997)
\(^{140}\) Binder (1998)
induced variance is insignificant. However, the residuals are standardised before forming portfolios. This standardisation adjusts for the fact that the event-period residual is an out-of-sample prediction and hence it will have a higher standard deviation than estimation-period residuals. Standardising the event-period residuals before forming portfolios also allows for heteroskedastic event-day residuals, and prevents securities with large variances from dominating the test. The standardised residual equals the event-period residual divided by the standard deviation of the estimation-period residuals, adjusted to reflect the prediction error. This standardised residual is approximately unit normal, hence, the standard t-statistic applies.

The third method is the "ordinary cross-sectional method" which conducts a t-test by dividing the average event-period residual by its contemporaneous cross-sectional standard error. This method also requires security residuals to be uncorrelated across firms but does not require event-induced variance to be insignificant. However, if the variance of security returns does not increase around the event period, the ordinary cross-sectional test will be mis-specified and the cross-sectional variances will not provide powerful tests because they ignore event period data.

3.2.3.5 Event-Induced Variance

Event-induced variance is also likely. Since the event period security return is a function of the information content in the announcement and other firm-specific characteristics, the abnormal return estimator will likely have a greater variance during the event period than in the surrounding periods. These events include, for instance, tax law changes, accounting method changes and government regulation changes, etc. Clustering in calendar time means that the number of securities whose
event periods are independent is reduced or eliminated, which increases the variance of the estimated return. As a result, there is lower power of the test to detect abnormal performance. A number of approaches have been developed to accommodate the event-induced variance.

Collins and Dent (1984) propose a generalized least squares (GLS) technique, assuming the variance of each firm’s abnormal return estimator increases proportionally during the event period. By taking into account the variance/covariance structure of the residual returns, they show that tests based on GLS produce unbiased and efficient estimates of mean abnormal returns and their standard deviation.

Froot (1989) suggests a "method-of-moments estimator", allowing residuals to be contemporaneously correlated and heteroskedastic. The procedures requires, however, that groups of firms are identified in a way that the residuals across groups are independent, though residuals within groups may be correlated. Samples are first classified according to industry type. The average residual for each industry are then computed. This residual is divided by its standard error to form a standardised industry residual. Since it is assumed that the standardised industry residuals are independent, the resulting test statistic is the sum of the standardised industry residuals divided by the square root of the number of groups/industries classified.

Boehmer et al. (1991) discuss a "standardised cross-sectional test" to solve the problem of event-induced heteroskedasticity. This method addresses the misspecification problem of the ordinary cross-sectional technique reviewed above. First, the residuals are standardised by the estimation-period standard deviation
(adjusted for forecast error) to eliminate the misspecification problem of the ordinary cross-sectional test. The ordinary cross-sectional technique is then applied to the standardised residuals; the test statistic is found by dividing the average event-period standardised residual by its contemporaneous cross-sectional standard error. This test also allows event-induced variance changes. Their test is unbiased and more powerful than other well specified alternatives.

To sum up, a number of potential statistical problems need to be considered when measuring and testing abnormal returns. These problems can be broadly divided into four groups: that estimated abnormal returns

1) are cross-sectionally (in event time) correlated,
2) are not independent across time for a given firm,
3) have different variances across firms, or
4) have greater variance during the event period than in the surrounding periods.

It should be stressed that they are all "solvable" to some extent, as reviewed above. Binder (1998) points out, that although these problems appear to be serious, many of them can simply be ignored, because they are quite minor in practice. For instance, cross-sectional dependence is not a problem when the event periods are randomly dispersed through calendar time, i.e., when there is no event-clustering. Cross-sectional dependence will only be a minor problem when there is event clustering but securities are randomly chosen (from different industries). Similarly, when the event period is short, relative to the estimation period, time series dependence issue will be unimportant.
3.2.3.6 Nonparametric Tests

All the testing methods reviewed so far are parametric in nature - specific assumptions have to be made regarding the distribution of abnormal returns in order to apply test statistics. But it is possible these assumptions are not valid. In these circumstances nonparametric approaches have been advocated.

The traditional sign test is based on the sign of the abnormal returns and it requires that the expected percentage of positive abnormal returns under the null hypothesis is 50%. The underlying idea is that the cumulative abnormal return, under the null hypothesis, has an equal probability to be either positive or negative. If for example, the null hypothesis is that there is a positive abnormal return associated with a given event, the null hypothesis is then \( H_0 : p \leq 0.5 \) where \( p = pr[CAAR_i \geq 0] \). Define the number of cases where the abnormal return is positive as \( N^+ \) and the total number as \( N \), the test statistic can then be defined as \( \lambda_i = \left[ \frac{N^+}{N} - 0.5 \right] \frac{\sqrt{N}}{0.5} \sim N^*(0,1) \). For a test of size \( (1 - \alpha) \), the null hypothesis is rejected if \( \lambda_i > \Phi^{-1}(\alpha) \).

The drawback of the traditional sign test is that it may not be well specified. For instance, the market model errors (especially when using daily data) are skewed slightly to the right, so the median is less than zero, meaning that the test statistics defined above will tend to be negative even when the mean error is zero. This causes under-rejection of the null hypothesis.

Corrodo and Zivney (1992) present a revised sign test to combat this skewness problem. The sign allocated to an abnormal return is relative to the median abnormal
return, rather than zero, i.e., an abnormal return is defined as positive if it is equal to or greater than the median abnormal return. This revision addresses the misspecification problem and represents an improvement over the traditional sign test.

Corrado (1989) proposes a nonparametric rank test, which is simple and does not assume that abnormal returns are distributed symmetrically around the mean. Considering a sample of N securities, with event period starting at time $t_1$ through $t_2$ (therefore horizon length $L = t_2 - t_1 + 1$). To implement the rank test, for each share abnormal returns are ranked from one to $L$ and the expected rank of the event day is $(L+1)/2$ under the null hypothesis. The test statistic for the null hypothesis of no abnormal return on event day for share $i$ is therefore defined as:

$$\lambda_2 = \frac{1}{N} \sum_{i=1}^{N} (K_{i0} - \frac{L+1}{2}) / s(K)$$

where

$$s(K) = \sqrt{\frac{1}{L} \sum_{i=t_1+1}^{t_2} \left( \frac{1}{N} \sum_{i=1}^{N} (K_{it} - \frac{L+1}{2}) \right)^2}.$$  

The null hypothesis can then be tested since the asymptotic null distribution of the test statistic calculated above is standard normal. Campbell and Wasley (1993) find that the rank test outperforms the sign test and standard parametric tests. However, it should be noted that nonparametric tests are generally used to confirm parametric results, as a robustness check, especially when the assumption of normally distributed security returns may not be correct.
3.2.3.7 Long-term Performance Measurement

Long-term performance studies are studies which examine abnormal returns over several months or years rather than over many days. They are different from short-term studies for several reasons, not the least of which is the greater chance of extraneous events. Additionally, short-horizon results tend to be more error-tolerant and model-misspecification-tolerant, while similar flaws can be fatal in long-term performance studies.

Two new methods for long-term post-event performance measurement have emerged since the late 1990s: buy-and-hold abnormal returns (BHAR) and the calendar-time portfolio approach and they will be briefly introduced here.

*BHAR* is described as "the average multi-year return from a strategy of investing in all firms that complete an event and selling at the end of a pre-specified holding period vs. a comparable strategy using otherwise similar non-event firms."\(^{141}\) Therefore a characteristic-based "matching" approach, as described in section 3.2.2.6, is applied to identify a matching firm or portfolio. A $T$-month BHAR for event firm $i$ is then defined as:

\[
BHAR_{i}(t,T) = \prod_{t=1}^{T} (1 + R_{it}) - \prod_{t=1}^{T} (1 + R_{Bt}), \quad (3.24)
\]

where

$R_{B}$ is the return on a matching firm (matched to firm $i$) or portfolio.

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\(^{141}\) Mitchell and Stafford (2000, p296)
The calendar-time portfolio approach (also known as the Jenson-alpha approach) calculates calendar-time portfolio returns for event firms and examines if they are abnormal in multifactor regression, using CAPM for instance. In each calendar month over the entire sample period, a portfolio is constructed comprising all firms experiencing the event within the previous T months, hence, the number of firms included in a portfolio is not constant through time. The portfolios are then rebalanced every month and an equal or value-weighted portfolio excess return is calculated to obtain a time series of monthly excess returns, which is regressed on the CAPM market factor, or the three Fama-French (1993) factors, or the four Carhart (1997) factors. One definition is given as follows:142

\[ R_{pt} - R_{ft} = a_p + b_p (R_{mt} - R_{ft}) + s_p SMB_{pt} + h_p HML_{pt} + m_p UMD_{pt} + e_{pt}, \tag{3.25} \]

where

- \( R_{pt} \) is the equal or value-weighted return for calendar month \( t \) for the portfolio of event firms that experienced the event within the previous T months,
- \( R_{ft} \) is the risk-free rate for calendar month \( t \),
- \( R_{mt} \) is the return on the CRSP value-weight market portfolio for calendar month \( t \),
- \( SMB_{pt} \) is the difference between the return on the portfolio of "small" and "big" stocks for calendar month \( t \),
- \( HML_{pt} \) is the difference between the return on the portfolio of "high" and "low" book-to-market stocks for calendar month \( t \),
- \( UMD_{pt} \) is the difference between the return on the portfolio of past one-year "winners" and "losers" for calendar month \( t \).

142 Kothari and Warner (2006)
\( a_{pt} \) is the average monthly abnormal return on the portfolio of event firms over the T-month post-event period for calendar month t.

\( b_{pt}, s_{pt}, h_{pt}, \) and \( m_{pt} \) are sensitivities of the event portfolio to the four factors for calendar month t.

Long-term performance measurement has gained its currency due to its underlying philosophy that stock prices may adjust slowly to information – so one must examine over long horizons. This challenges the assumption in studies that focus on short return window, that "any lag in the response of prices to an event is short-lived".\(^{143}\)

Advantages of the BHAR method and the calendar-time portfolio approach should be noted. BHAR constructs the abnormal returns in a specific way that attempts to "simulate" investors' actual long-term investing behaviour when measuring risk-adjusted performance by compounding short-term returns to obtain long-term buy-and-hold abnormal returns. And the calendar-time portfolio approach extends the application of a multi-factor model into a long-horizon event context.

However, both the BHAR and the calendar-time portfolio approach potentially suffer from econometric misspecification. For instance, some of the economic assumptions in BHAR include: 1) that the marched characteristics (e.g., size and book-to-market, etc.) would perfect proxy for the expected return on a security and 2) that experiencing the event or not is the only difference between event and non-event firms. When these assumptions are not valid, there is a danger that the event and non-event firms differ systematically in their expected returns despite the fact that they are

\(^{143}\) Fama (1998, p284)
matched on certain firm characteristics. Additionally, BHARs can give false impressions of the speed of price adjustment to an event (Mitchell and Stafford, 1997). The abnormal returns may be exaggerated even when there is no abnormal return after the initial period. As far as calendar-time portfolio approach is concerned, it hinges on the validity of the assumption that multi-factor models provide a complete description of average returns, whereas they may fail to do this.

In short, neither of these methods is immune to misspecification. While this problem is inevitable, it is often more serious in measuring long-term performance. Therefore interpreting the results from these two methods requires extra caution.

### 3.3 AR and M&A: Empirical Results

The available empirical results about the effects of takeover can be summarised as follows. Takeovers provide substantial economic benefits to target shareholders. However, there is more doubt as to whether takeovers, on average, provide gains to the shareholders of acquiring firms, and there is similar doubt that gains accrue in aggregate and on average to all shareholders.

This section first reviews empirical evidence on abnormal returns from mainly the US in section 3.3.1 and 3.3.2, evidence from the UK and China are presented in section 3.3.3 and 3.3.4. Recent research trends and evidence are summarised in section 3.3.5.

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144 For example, suppose returns for the first year after the event are 10% for event firms and zero for benchmark firms, so the first-year abnormal return is 10%. Suppose event and benchmark firms both have a 100% buy-and-hold return over the next four years. Although there is no abnormal return after the first year, the BHAR after five years grows to 20% [i.e., 1.1x2.0-1.0x2.0]. Fama (1998, p294)
3.3.1 Earlier US Evidence: Effects on Targets

Virtually every empirical study has found that acquired companies display statistically significant positive price responses to the announcement of a takeover attempt. Jensen and Ruback (1983) averaged the results of about twenty scholarly papers and found an increase (over the pre-announcement market price) of 20 percent for mergers and 30 per cent for tender offers around the takeover event.

Dennis and McConnell (1985) found that the average target firm's shares increased by 8.7 percent, adjusted for market movements, on the day of a bid announcement and the previous trading day. This is an annualised return of several thousand percent!

Firth (1979, 1980) reports mildly negative deviations from expected returns in the first 10 months of the year prior to the bid, with around 55 per cent of the acquired companies showing negative cumulative average abnormal returns (CARs). In the 2 months prior to the bid announcement, however, positive abnormal returns occur, becoming very large and statistically significant in the merger month itself, so that by the announcement date 99 per cent of acquired companies show positive CARs suggesting gains of around 22 to 28 per cent due to the merger event.

Similarly, Franks, Broyles, and Hecht (1977) report abnormal gains in share prices of target firms amounting to 26 per cent on average over the 5 months up to and including the offer date. Franks and Harris (1989) report bid premiums in the 25 to 30 per cent range over the interval from 4 months prior to 1 month after the first
approach or first bid date, and Meadowcroft and Thompson (1986) report similar gains over a slightly shorter period straddling the bid date.

A bid is generally considered as good economic news for the target, regardless what the motives of bidding firms are in takeovers. No matter what might happen to target firm shareholders after the announcement, the bid per se is beneficial. If the target firm's shareholders were concerned about subsequent damaging action by the bidder (say in a two-tiered offer), they could simply sell at the price just after the bid. In doing so, they would realise a total return considerably higher than what they would have obtained if there had not been a bid.

Even unsuccessful bid appears to be good news for target shareholders. Bradley et al. (1983) in a study of unsuccessful tender offers provided convincing evidence. They find that when an unsuccessful tender offer is followed by a successful offer within a few years, the original price increase around the first bid is maintained permanently. However, when the original (unsuccessful) offer is not followed by a successful offer within five years, the entire market price increase associated with the original bid is reversed.

Most studies have found sharp price increase in the days immediately surrounding the announcement date; and this announcement effect is much larger per unit of time than observed price movements either prior to or after the event. This result either suggests short-term information leakage, or that the market is "surprised" by the news.
Compared to these earlier studies, recent empirical studies have applied more complicated statistical models, such as French-Fama three factor model, and have used more complicated methods to measure the event effects, such as Buy And Hold Abnormal Return (BAHAR), however, they tend to reach similar results. More recent evidences are presented in section 3.3.5.

Overall, the picture here is fairly clear-cut: the acquired companies have a mildly below par performance in the year before merger, but as the bid date approaches they gain in performance, possibly due to information leakage, insider trading, or the build-up of pre-bid strategic shareholdings. The bid period itself then generates substantial positive premiums.

### 3.3.2 Earlier US Evidence: Effects on Acquiring Companies

The empirical results for acquiring firms vary. Different papers have found different results. Methods, estimation periods, event windows, and samples of firms vary across studies, making it difficult to draw conclusions.


The bidding firm share price' movements, in percentage terms, appear to be much smaller than target firms. For example, using market adjusted model, Dennis and McConnell (1985) report a small, non-significant -0.12% abnormal return for bidding
firms on the day of the announcement and the previous trading day (day-1 to day0), whereas targets firms show a much larger 8.74% for the same two day window. The authors also calculated returns for other periods, (including two pre-event windows, day-19 to day-2 and day-19 to day0; one event window centred by day0, day-6 to day+6). Overall, the cumulative abnormal return is positive. Therefore, the authors conclude that the effect on acquiring firms actually is positive. However, the results are not convincing enough since the positive abnormal returns are small, and only marginally significant.

Dennis and McConnell also investigate whether the total potential gains to bidding firms (therefore including, for example, bondholders' gain) may be larger than gains to shareholders. They report that 1) Convertible preferred stockholders gain (even more than equityholders) in a wide period around the merger announcement, but the announcement day return is virtually zero; 2) Convertible bondholders gain over a longer period but not by a statistically significant amount, and the announcement day return is negative (but insignificant); 3) Nonconvertible bondholders have negative returns in all periods, but the results are only marginally significant.

Compared to the target shareholders who often receive substantial abnormal returns prior to the announcement, acquiring firms' shareholders, however, do not gain much from such activities, if they gain at all. Indeed, researchers now are trying to look at the gains over a much longer period for both target and bidding firm shareholders, as will be shown in section 3.3.5.
3.3.3 UK Evidence

Empirical evidence from the UK also contributes to the variety of the results.

Cosh, Hughes, and Singh (1980) conduct a comparison of shareholder returns (capital gains plus reinvested dividends) in the 5 years before and after merger for 63 acquiring companies and 63 size- and industry-matched non-acquiring companies in the period 1967-9. They find that for the pre- and post-merger periods the acquiring companies had higher shareholder returns. For the pre-merger periods and one year after merger, these positive differences were statistically significant. Thereafter the performance of the acquirers deteriorated relative to the control group.

Sturgess and Wheale (1984) compare, for each year in the period 1961-70, shareholder returns for two groups of 26 companies which differ in that one experienced intensive merger activity in the period 1961-5 and the other did not. They find no significant differences between the groups in either period. Their results, however, show that in 3 of the years 1961-5 the merger-intensive group significantly outperformed, and in 2 of them significantly under-performed, relative to the non-merging group. In the 1966-70 period this is so in only one year. This pattern of performance between periods is consistent with the Cosh, Hughes, and Singh's results which suggest post merger declines for the acquirers. (Adjusting their returns for risk using the Sharpe measure reverses the periods, in the sense that the internal growers now outperform the acquirers in the merger-intensive period and vice versa.)
Barnes estimated the effects of making a bid on 39 acquiring companies in the period June 1974 to February 1976 using a simple index model (Barnes (1978)) and the market model plus an industry index (Barnes (1984)). He reports small positive abnormal returns in the year before merger and offsetting or more than offsetting cumulative negative returns lasting up to 5 years afterwards, although none of these effects are statistically significant. This is in keeping with the declining post-merger results of Cosh, Hughes, and Singh, using shareholder returns relative to a non-merging control group.

Franks, Broyles, and Hecht (1977) also use the market model plus a market index in a study of 70 mergers in the period 1955-72 in the UK brewing industry. Like Barnes, they find positive abnormal returns in the immediate run-up to the bid announcement that persist for a few months after. There then follow negative effects, chiefly in the period between 5 and 10 months after the bid, so that by the fourth year after merger the CARs are negative.

Similar post-bid results are reported by Dodds and Quek (1985). They analyse 70 acquisitions using the market model in the same period of low merger activity in the mid-1970s as the Barnes sample. They reported that after initially positive post-merger effects, the CARs are negative by the fifth year, with 58 per cent of the acquirers showing negative returns. However, as in Barnes (1978, 1984), none of this is statistically significant.

Franks and Harris (1989), again using the market model, also report positive abnormal returns over the immediate bid announcement period in a sample of 1,048 mergers in
the period of 1955-85, a similar result to that of Meadowcroft and Thompson (1986) for 67 mergers in the period 1982-84. In the Franks and Harris study, this is followed by cumulatively negative effects, so that by 2 years after the mergers the CARs are significantly negative and outweigh the pre-merger gains.

Firth (1979, 1980), from samples of 224 successful bids in the period of 1972-4 and 434 in the period 1969-75 respectively, reports positive abnormal residuals prior to merger for bidders using equity as the means of payment, substantial losses at the time of bid announcement, and cumulatively negative residuals after the bid, so that for his 1969-75 sample, for instance, by the end of the third year 64 per cent of the acquiring companies have negative CARs. (See also Firth, 1976)

Taken as a whole, these studies seem to suggest that the bid is associated with positive short-term effects. In the longer run, they are followed by cumulative negative effects. However, depending on the paper, the sample, the period of observation and the biases of the reader, widely differing conclusions can, indeed, be reached.

3.3.4 Evidence from China

Compared to the sheer amount of literature available in the west, there have been few empirical researches conducted using Chinese data.

Earlier studies in China are often limited by the small size of the sample used. Chen and Zhang (1999) examined the market responses to 28 announcements of restructurings of listed companies in 1997. They reported that the market responded to
the announcement but no significant abnormal returns are identified (day-10 to day+20). Tan (1998) studied 31 transactions of state-owned shares on the SHSE in 1997, and reported positive abnormal returns in 26 cases. Yang and Cai (2000) studied 29 transactions involving controlling shares in 1998. He found abnormal returns occur at as early as day-40 and concludes possible information leakage and insider trading.

Chen and Chen (2000) examined one specific merger between two listed companies. They claimed that the acquirer's shareholders gained between 2.5% to 5.88%, however, no significance test was provided.

Later studies used larger data sets compared to the earlier ones. Shi (2002), using 119 controlling share transactions between mid-1999 and 2000, observed significant abnormal returns in the immediate days prior to and around day 0 (as high as 9.39% on day+2). Zhang and Ji (2003) extended Shi (2002)'s research and included the announcements in 2001. Whilst they examined the abnormal returns for the targets, they however concluded that the acquirers' shareholders lose due to the restructurings. Their findings contradict their theoretical analysis.

More recently, Zhang (2003) studied some 1216 announcements of restructuring activities involving listed companies between 1993 and 2002. The author reported a staggering 29.05% average abnormal return in an event window day-60 to day+30 and concluded that the target shareholders gain from acquisition. Zhang (2003)'s research was important for he used the largest data sample. However, the author included some of the earliest events and these earlier "experimental" cases might lead
to less accurate interpretation. In addition, he did not differentiate between the announcements of 1) asset acquisition, 2) legal-person share transaction, 3) state share transaction, and 4) asset replacement and restructuring,\(^\text{145}\) which may convey different information contents. Zhang (2003) however was prudent regarding the results for he concluded that the overall impacts as to whether acquisitions of corporate control created value in China remained unclear.

In summary, the limited evidence from China seemed to indicate that the market generally anticipate acquisitions of control as "value-adding" to targets. However, these researches have their limitations, both methodological and analytical.

### 3.3.5 Recent Trends

Since the middle 1980s, there have been new developments in the investigation of the abnormal returns due to announced M&As.

#### 3.3.5.1 New Merger Waves

Merger waves since the mid-1980s have been distinct in terms of the increase of cross-border acquisitions and the increasing number of acquisitions of privately held companies compared to previous waves.

\(^{145}\) Please refer to section 2.4.2.2.
According to the United Nations Conference on Trade and Development (UNCTAD)\(^\text{146}\), the global value of cross-border acquisitions rose steadily from about 0.5% of world wide GDP in the mid-1980s to being over 2% in 2000. On a global scale, cross-border acquisitions worldwide during 1986-2000 accounted for 26% of the value of total acquisitions. These international deals bring more attention to the determinants of acquisition returns. In addition to factors such as method of payment and relative size, etc, newer issues such as target country characteristics, international law changes, currency exchange rate and so on are now being analysed to see if they have significant effects on abnormal returns in cross-border acquisitions.

Another important aspect of new acquisition activity, as noted by Conn and Cosh (2003), is the acquisition of privately held companies. "Over the period 1985-98, 94% of the number of cross-border acquisitions by UK companies was for privately held targets. In terms of total expenditure, 58% of the value of cross-border acquisitions was for privately held targets," and "for domestic acquisitions, 88% of their number and 25% of their value are accounted for by acquisitions of privately held targets\(^\text{147}\). Acquisitions of private targets therefore account for the vast majority of acquisitions made by UK companies in terms of number, and approximately half in terms of value." While previous acquisition studies were relatively limited to acquisitions of targets that are publicly quoted, there has been a growing need to examine the acquisition results of targets that are privately held.

\(^{146}\) UNCTAD (2000)

\(^{147}\) Based on figures from Acquisitions Monthly, representing all acquisitions made by all UK companies (public and private), in which the transaction value is disclosed. This source reports that the vast majority in terms of both number (85%) and value (87%) of domestic and cross-border acquisitions by UK companies are carried out by publicly held companies.
3.3.5.2 Methodology Development

Since Fama et al. (1969) first introduced event study techniques and the market model, a number of modifications have been made. Modifications relate to renewed opinions about the statistical assumptions used in the earlier work, more readily available data at a more frequent interval and design adjustments to test more specific hypotheses.

**Modelling normal returns:** Weaknesses of the market model was addressed\(^{148}\) and a number of other statistical models, including French-Fama three factor model\(^{149}\), have been proposed for modelling the normal return generating process, as reviewed in section 3.2.2.

**Measuring abnormal returns:** Apart from the models and issues discussed in section 3.2.3, there have been newer methods of measuring and testing abnormal returns. Some of the latest methods include cross-sectional averages of logarithmic returns (LCAR) (Eckbo and Thorburn, 2000) and bootstrapping skewness-adjusted t-statistic (Lyon et al., 1999), etc.\(^{150}\)

**Data availability:** More readily available data means that researchers can now use monthly data, daily data or data at even shorter intervals to determine the balance between simplicity and sophistication that is appropriate for their specific applications. Evaluation of the long run performance of acquisitions, especially the acquisition effect on bidding firms, is becoming the main theme of recent empirical studies.

Table 3.3 below summarises the results of 10 recent empirical studies.

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\(^{148}\) Market models suffer from parameter instability (Coutts, Mills and Roberts (1997)), are sometimes inferior to multi-index models (Fama and French (1992)), and are subject to statistical biases (Lyon, Barber and Tsai (1999)).

\(^{149}\) Fama and French (1992).

\(^{150}\) Due to the scope of this thesis, these developments will not be reviewed comprehensively here.
### Table 3.3 Recent Research in Measuring Abnormal Returns

<table>
<thead>
<tr>
<th>Study</th>
<th>Data Period</th>
<th>Data Interval</th>
<th>Data Size</th>
<th>Event Period</th>
<th>Methodology</th>
<th>Share Returns (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gregory (1997)</td>
<td>84-92</td>
<td>monthly</td>
<td>420 acquirers</td>
<td>+2 yrs</td>
<td>CAPM</td>
<td>-17.73*</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>French-Fama 3-factor model</td>
<td>-18.01*</td>
</tr>
<tr>
<td>Rau &amp; Vermaelen (1998)</td>
<td>80-91</td>
<td>monthly</td>
<td>2823 mergers; 316 tender offers</td>
<td>+3 yrs</td>
<td>Market Model CARs</td>
<td>-4.04*</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>8.85*</td>
</tr>
<tr>
<td>Draper &amp; Paudyal (1999)</td>
<td>88-96</td>
<td>daily</td>
<td>581 targets; 349 acquirers</td>
<td>short</td>
<td>Market Model CARs</td>
<td>-20:+20 16.80*; 0.60*</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>-1:+1 8.93*;-1.01*</td>
</tr>
<tr>
<td>Eckbo &amp; Thorburn (2000)</td>
<td>64-83</td>
<td>monthly</td>
<td>394 acquirers</td>
<td>+1 yr</td>
<td>Market Model CARs</td>
<td>-3.7</td>
</tr>
<tr>
<td>Ang &amp; Kohers (2001)</td>
<td>84-76</td>
<td>monthly</td>
<td>7070 acquirers</td>
<td>+3 yrs</td>
<td>French-Fama 3-factor model</td>
<td>0.8</td>
</tr>
<tr>
<td>Moeller et al. (2003)</td>
<td>80-01</td>
<td>monthly</td>
<td>5583 acquirers</td>
<td>+3 yrs</td>
<td>French-Fama 3-factor model Size and book-to-market control firm BHARs</td>
<td>-0.03</td>
</tr>
<tr>
<td>Sudarsanam &amp; Mahate (2003)</td>
<td>83-95</td>
<td>daily</td>
<td>519 acquirers</td>
<td>+3 yrs</td>
<td>Size portfolio BAHRs</td>
<td>-15</td>
</tr>
<tr>
<td>Conn &amp; Cosh (2003)</td>
<td>84-98</td>
<td>monthly</td>
<td>4000 acquirers</td>
<td>+3 yrs</td>
<td>BHARs</td>
<td>-9.02</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Calendar Time ARs</td>
<td>-0.21</td>
</tr>
<tr>
<td>Moeller et al. (2004)</td>
<td>80-01</td>
<td>daily</td>
<td>12023 acquirers</td>
<td>short</td>
<td>Market Model CARs</td>
<td>-1:+1 1.1*</td>
</tr>
</tbody>
</table>

* Significantly different from zero at 1% levels – two tailed test.

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102 For mergers and tender offers respectively.
103 CAR for target firms and bidding firms respectively.
3.4 Corporate Governance

As emphasised in Chapter 2, Chinese M&As are not entirely identical compared to M&As in the West. They primarily involve changes in the control of companies, as a result of transfers in the ownership of state shares. While such changes in the ownership and control of companies have features in common with the changes in ownership following M&As in market based economies, there are important differences. This section reviews the related literature in corporate governance that is relevant to this thesis.171

3.4.1 History

The corporate governance structure specifies the rules and procedures for making decisions on corporate affairs. It also provides the structure through which a company's objectives are set, as well as the means of monitoring the achievement of those objectives – whether outcomes are in accordance with plans, and in particular, whether individual's behaviours are aligned with all the related parites. Therefore, the term corporate governance can be translated into: 1) the processes by which companies are directed and controlled and 2) a field in economics, which studies the many issues arising from the separation of ownership and control.

Berle and Means (1932) first expressed concern about the separation of ownership and control in "The Modern Corporation and Private Property". The authors note that

171 This section draws heavily on Johnson, Siu and Weston (2003) for it has provided a good survey and comprehensively covered the related issues.
managers, largely free from shareholder control, have a natural tendency both to enrich themselves and to "fritter away the firm's assets in unproductive endeavours and inattentiveness," at the expense of the owners.\footnote{Berle and Means (1932)}

3.4.2 Principal – Agent Problem

The contractual theory views the firm as a network of contracts, actual and implicit, that specify the roles of multiple participants or stakeholders and defines their rights, obligations and payoffs under various conditions.\footnote{Fama and Jensen (1983a, 1983b)} Most important participants or stakeholders of a firm include the owners, managers, directors of the board, regulatory authorities and to a lesser extent employees and the community at large.

In order to achieve efficiency and value maximisation, the interests of these related parties must be harmonised. However, potential conflicts may occur as contracts may fail to properly capture all of the dynamic development in a firm's operation and participants may have "selfish" goals. Conflicts between the owners and managers are perhaps most noticeable. In general, the shareholders (principals) hire managers (agents) to conduct the operations of the firm on their behalf. These managers do not normally have major stock ownership. The principal’s key problem is that the agent retains control over his actions, and given the asymmetry of information between the principals and the agents, may fully or in part, work to his or her own advantage, hence, the principal-agent problem.
Jensen and Meckling (1976) describe how the agency problem results whenever a manager owns less than all of the common stocks of the firm. This fractional ownership can lead managers to work less than strenuously and to acquire more perquisites than if they had to bear all of the costs themselves. Jensen (1994) further argues that the principal-agent theory is useful not because individuals are invariably rational economic maximisers, but because typically they are not. Managers work under a variety of social obligations which make it impossible for them to maximise share price. Their family, personal and political ties and other social obligations make it impossible for them to be perfect agents for anyone else other than themselves.

It is because of the inevitable nature of the principal-agent relationship, various control mechanisms have been introduced, both internally and externally, attempting to deal with the agency problem.

### 3.4.3 Solution: Internal Control Mechanism

Internal control mechanisms can be loosely grouped into two types: monitoring systems and incentive schemes.

#### 3.4.3.1 Monitoring Systems
Expenditures associated with monitoring are also termed agency costs and they include 1) auditing systems to limit this kind of management behaviour, 2) various kinds of bonding assurances by the managers that such abuses will not be practised, and 3) changes in organisational systems to limit the ability of managers to engage in
the undesirable practices.\textsuperscript{174} It is hoped that through monitoring, the principal would be able to constrain and direct the agent’s actions so the agent realises the principal’s objectives. The effectiveness of this monitoring systems largely depends on the board of directors.

Under the Anglo-American model, a corporation is governed by a board of directors, which is nominally selected by and responsible to the shareholders. The board has the power to appoint executive officers, who have broad power to manage the corporation on a daily basis, but need to get board approval for certain major actions. These major actions include hiring senior managers, raising funds, acquiring another company, major capital expansions, or other expensive projects. Other duties of the board include policy setting, decision making and evaluating management's performance, etc.

Monitoring by boards of directors can, in theory, deal with at least some problems of corporate governance. In reality, however, the bylaws of many companies make it difficult for all but the largest shareholders to have any influence over the makeup of the board. Smaller individual shareholders are not offered a choice of board nominees, but are merely asked to rubberstamp and accept the nominees of the sitting board. The unbalanced composition of the board makes one doubt its effectiveness and fairness in monitoring management performance. Perhaps that is why independent directors are required by regulators.

\textsuperscript{174} Johnson, Siu and Weston (2003)
Independent directors are usually respected leaders from other businesses and/or academic communities. They tend to have incentives to protect and develop their reputation as experts in the field of decision control. Independent outside directors are believed to play a more important role in monitoring management than inside directors, since they are not officers of the firm and do not have a direct business relationship with the firm. Fama (1980) argues that the inclusion of these directors as professional referees enhances the viability of the board in achieving low-cost internal transfer of control. Top management selected by independent directors may have fewer conflicts of interest with shareholders in general.

It should be noted that independent outside directors may improve the effectiveness in monitoring the agents (managers), but they can not provide a cure-all solution either. This is because when they are selected as board members, they become agents of the principals as well, although in a different domain. New types of principal-agent problems thus occur.

3.4.3.2 Incentive Schemes
Hechter (1984) argues that monitoring alone is often not practical or efficient enough. Incentives such as linking performance to pay should also be introduced since they are economically more effective. Key incentives are promotions and performance enhancing compensation schemes. By linking an agent's financial interests to the benefit realised by a principal, the principal aligns the agent's interests with those of the principal's own.
Performance-based remuneration may be in the form of cash or non-cash payments such as shares, share options or other benefits. It is designed to relate some proportion of pay to the performance of the members of the board. For instance, Johnson, Siu and Weston (2003) noted that directors of top-performing companies hold more stock than do their counterparts at poor performers, suggesting a positive link between company performance and director stock ownership.

Similarly, a tightly pay-to-performance related executive compensation scheme is believed to be able to substantially reduce the conflict of interest between owners and managers because a significant impact on executive wealth could provide strong incentives. By studying 495 observations for 205 listed US firms from 1982 to 1984, Core, Holthausen and Larcker (1999) examined the association between the firm's corporate governance structure and the level of CEO compensation. They suggested that the board and ownership variables were proxies for the effectiveness of the firm's governance structure in controlling agency problems and firms with weaker governance structures had greater agency problems. It was also found that the firms with greater agency problems did not perform as well.

Such incentive schemes, however, are only reactive in the sense that they provide no mechanism for preventing mistakes or opportunistic behaviour before they happen. Well-structured director and executive compensation systems may therefore only provide part of the solution.
In summary, internal control mechanisms such as monitoring systems and incentive schemes are used to balance the interests of the multiple stakeholders and to attempt to reduce agency problem.

3.4.4 Solution: External Control Mechanism

There are many external forces to discipline a firm should internal mechanisms fail. These outside control mechanisms include shareholder activism and the M&A market for control.

3.4.4.1 Shareholder Activism
Shareholder activism is often associated with actions asserting shareholder power, by putting pressure on management to change major corporate decisions such as a takeover or a large investment. It can be in the form of hostile voting at annual general meetings, seeking representation on the board, or proxy contests and voting against plans proposed by the senior management. Typically, such actions are carried out by two main bodies: institutional investors, due to their large investment in the firm, and dissident groups of shareholders, due to their different interests.

Large institutional investors in the West have, in theory, the potential ability and size to become significant factors in corporate governance. However, earlier studies reveal that they choose not to interfere with the management operation too actively. For instance, Gillan and Starks (2000) analysed 2,042 shareholder proposals related to corporate governance at 452 companies between 1987 and 1994 and found that the influence of shareholders activism was only modest.
Several recent studies further reveal that not all institutional investors hold such a passive attitudes (Almazan et al., 2005 and Chen et al., 2005). It is proposed that some institutional investors such as insurance companies have either existing or potential business relations with the firm. They are therefore "pressure-sensitive" and might be less willing to challenge management decisions in order to protect those business relations. In contrast, the "pressure-insensitive" investors such as investment companies and independent investment advisors may be less constrained from such pressure and therefore become more significant factors in corporate governance. Almazan et al. (2005) show that greater share ownership by "pressure-insensitive" investors is associated with greater discipline on executive compensation. Chen et al. (2005) find that "pressure-insensitive" ownership is associated with better acquisition decisions.

Proxy contests (also known as proxy fights) are somewhat "extreme" attempts by dissident groups of shareholders to obtain board representation. By definition, a proxy fight is a hostile control activity. It represents another form of external corporate control mechanism, a form that can lead to takeovers and/or often accompany hostile takeovers. Since a proxy fight is a contest for control between management and dissident shareholder groups, several factors could determine whether a firm becomes a target in such a contest.

One such factor is managerial ownership. If management controls 50% or more of the firm’s voting power and directors are not elected through cumulative voting, dissidents are guaranteed to fail and no proxy contests would occur. Besides, higher
managerial ownership reduces the likelihood of severe agency problems that may be addressed via a proxy fight. Thus, firms with high managerial ownership should be less likely to become targets in proxy contests. But this does not mean that proxy contests will not take place when the firm becomes the target of an acquiring company. When shareholdings of (poor) management are high, they are more likely to be able to block a tender offer, hostile or not. The acquiring company may therefore convince shareholders to use their proxy votes to install new management that is open to the takeover. The technique allows the acquiring firm to avoid paying a premium for the target.

The other factor is corporate performance. Warner, Watts and Wruck (1988) found that poor stock price performance was likely to result in an increased rate of management turnover. A poor performance can indicate that management is not maximising shareholder wealth. Thus, the likelihood of a proxy contest should be increasing as the firm’s performance declines. Sridharan and Reiganum (1995) studied 79 hostile tender offers and 38 proxy contests. They found that a proxy fight is more likely to take place when a target firm's performance is relatively poor, measured by return on assets and stock market returns. Managerial inefficiency leads to a proxy contest and failure to pursue new and profitable investment opportunities leads to a tender offer. Gibson (2003) examines empirically the link between manager turnover and firm performance for emerging market firms. He finds that there are significant links between manager turnover and firm performance for over 1200 firms in eight emerging markets.175

175 His study does not include China.
It should be noted that not all shareholder activism activities are hostile contrary to the impression indicated as above. The outcome of institutional investors involvement and proxy contests can be constructive and helpful to the current management. For instance, shareholders may take an active interest in the running of the firm and demand to learn more about the business. That, does not necessarily mean the shareholders will choose to revolt against management. Instead, they may choose to co-operate with management to achieve improvements and to maximise shareholder value that way.

3.4.4.2 M&A Market for Control
The most widely recognised form of external corporate governance mechanism is the market for corporate control: mergers and acquisitions.

Generally speaking, poor management performance increases the likelihood of a firm becoming the target of a takeover attempt. Denis and Denis (1995) find that forced resignations of top executives are often due to takeover-related pressures. They also documented that the majority of the firms with a forced top executive change became the target of some form of takeover. They therefore concluded that internal control mechanisms were inadequate to do the job alone and required the pressure of external corporate control markets.

Denis and Denis (1995)'s conclusion is consistent with previous studies. For example, Morch, Shleifer and Vishny (1989) found that the probability of hostile takeovers is inversely related to firm performance, whilst Mitchell and Lehn (1990) found that firms making value-decreasing acquisitions are more likely to subsequently become
targets themselves. Martin and McConnell (1991) found an increased rate of management turnover following corporate takeovers and that pre-takeover performance is significantly worse among those takeover targets that have post-takeover turnover.

Mitchell and Mulherin (1996) tracked 1,064 firms at year-end 1981 and reported that by 1989, 57% of these firms had either been a takeover target or had engaged in substantial defensive asset restructuring. The M&A market is clearly a major source of external control mechanisms.

3.4.5 Solution: China's Approach

During the period of the "pure" planned economy in China, the legal regime for corporate governance was largely irrelevant. All production and distribution decisions were centrally planned and the state owned enterprises were effectively operated as "cost centres." SOE executives were appointed and removed at the government's will and usually treated as government officials. In the absence of market competition and a proper incentive system, the performance of most SOEs was poor. As the central plan became less involved in the allocation of labour and investment capital, the importance of constructing a productivity-optimising corporate governance structure increased. As we have reviewed in Chapter 2, China's SOE reforms since the late 1970s has attempted to improve company performance from many angles and many of these angles have been around corporate governance issues, from incentive contracts to independent directors, executive compensation to acquisition of control.
Incentive Contract: The SOE reform of the earlier stage (1978 - 1993), attempted to offer incentive contracts to enterprises among various other measures. While it boosted productivity, especially over private and collective sectors, the results of such incentive programmes are somewhat mixed for the state sector. Li (1997) showed that over 87% of the growth in productivity was partially due to improved incentive contracts, whereas Shirley and Xu (2001) found that such contracts had no effect on profitability and labour productivity. The government was not yet able to establish an effective monitoring, control, or incentive system to encourage managers to act in the State's best interests.176

Shareholding System: In order to further address the corporate governance issue, the shareholding system was introduced in the early 1990s to tackle the ownership of the SOEs. It was hoped that through partial privatisation, widely dispersed ownership and the introduction of boards of directors, better monitoring mechanisms could be established. However at the same time the government wanted to preserve predominant state ownership and it intentionally created a rigid state shareholding ratio. A De facto controlling state-owned shareholder therefore enjoys relatively high voting power and high representation on the boards.177 This limited the effectiveness of an internal monitoring mechanism.

Market for Corporate Control: China continued to implement reforms in pursuit of better corporate governance. Since the late 1990s the government has encouraged corporate restructuring and M&A or rather acquisitions of control. Because of the unique shareholding structure, the market for corporate control in China appears

176 For a detailed description, please refer to Section 2.1.1.
177 As have been documented in Section 2.2 and 2.6.
mainly in the form of transactions of majority/controlling state-owned shares. Once again, it should be stressed that the underlying idea of such transactions is the same as M&As traditionally defined in the West – the changing hands of these state-owned shares shifts control of a Chinese company. Whether such a market for corporate control can help deal with the principal-agency problem and improve the corporate governance structure remains to be fully evaluated.

To the best of my knowledge, there are no studies in China which specifically shows how effective the acquisition of corporate control market has been so far. Questions such as "are the agency costs reduced after the change of corporate control?" or "did the firms that are 'acquired' have a poorer pre-acquisition performance?" still need to be addressed. Indeed, one of the aims of this thesis is to examine the causes and consequences of such transactions and the following chapters provide some relevant empirical evidence.

**Independent Director:** In September 2001 a *Guiding Opinion for Listed Companies on the Establishment of an Independent Non-Executive Directors System* (关于在上市公司建立独立董事制度的指导意见) was issued by the China Securities Regulatory Commission (CSRC). In January 2002, the CSRC issued *Code of Corporate Governance for Listed Companies in China* (上市公司治理准则). In this new legislation, the regulator further addressed corporate governance issues. All domestically listed companies are now required to appoint qualified persons to be independent directors. At least one of them needs to be an accounting professional. It was required that by June 30th, 2002, at least two members of the board of directors
should be independent directors; and by June 30th, 2003, at least one third of the board should be independent directors.

**Executive Compensation:** More recently, central government revised the Corporate Law (公司法) (effective since January 1st, 2006). Chinese companies are now, permitted by the revised legislation, better able to structure managers' compensation to help align their interests more closely with those of investors by introducing equity incentive schemes. Executives can sell shares they own in the company for which they currently work, after the company is listed on a national exchange for 1 year.\(^{178}\)

In contrast, management's ability to divest its shares while in the service of the company was previously prohibited. This development is particularly significant in light of the incentive compensation legislation issued at the time. The State-owned Assets Supervision and Administration Commission (SASAC) and Ministry of Finance (MOF) issued the *Trial Measures on Implementation of Share Incentive Plans in (Domestic) State-Controlled Listed Companies* (国有控股上市公司(境内)实施股权激励试行办法), which became effective from January 6th, 2006. These measurements are the government's latest attempts at improving corporate governance. However, executive stock ownership or compensation cannot always sufficiently limit management self-dealing and profit-taking actions for a "true" compensation that would perfectly align the interests of managers and investors can be too expensive.

**Minority Shareholder Protection:** Last but not least, recent legislation embraced minority shareholder protection. As shown in Section 2.6, Chinese controlling shareholders typically hold sufficient voting rights to have a significant influence on

\(^{178}\) Article 142, the Corporate Law (revised).
shareholder resolutions and are able to appoint and remove board members freely. Minority shareholders are often precluded from attaining this power and therefore have little or no power over the self-interested actions of the controlling shareholders. To better protect minority shareholders, Article 21 in the (revised) Corporate Law for instance, render the "controlling shareholders" and "de facto controlling persons" liable to pay compensation for any loss the company suffers as a result of their taking advantage of any affiliation relationship. Therefore, if a shareholder abuses his or her rights and causes losses to any other (minority) shareholder, the latter can take legal actions against the former.\textsuperscript{179} Furthermore, shareholders may bring lawsuits against any person, including controlling shareholders, who encroache upon the lawful rights and interests of the company and causes losses to the company.\textsuperscript{180} However, the (revised) Corporate Law does not clearly define what acts would be regarded as abuses of a shareholder's rights.

As reviewed above, China has been dealing with the Principal – Agent problem and corporate governance structure along with its economic reform for the last 30 years or so. However, Chinese corporate performance is still relatively poor using accounting and stock market measures of success. (Chen et al., 1998, 2006) Three reasons have been put forward for firms' poor performances. They are 1) the government's continued interference in commercial decisions, 2) poor corporate governance, and 3) the lack of incentives for top managers (Chen et al., 1998, 2006). The related regulatory developments are indeed appropriate attempts to improve corporate governance structure for Chinese business practices. However, the impact of these regulations will ultimately depend on the government's approach to enforcement.

\textsuperscript{179} Article 20, \textit{ibid.}
\textsuperscript{180} Article 152, \textit{ibid.}
3.5 Conclusion

If share prices reflect expected future profit and dividend streams, and that any changes in future profit and dividend streams are reflected in changes in the prices and returns of a company's shares, then securities markets are at least semi-strong efficient, as defined by Fama (1969). This is the basic assumption that allows the use of stock market data to estimate the anticipated effects of acquisitions.

However, it is not easy to precisely measure the effects of acquisitions. Although event study methodology and abnormal returns calculated using market model have been used as the standard approach in empirical research and it is widely accepted that they deliver accurate results, they are not without their weakness. Other statistical models and measurement methods have been developed in the more recent studies.

Chapter 3 looked at the relevant conceptual and methodological issues for measuring abnormal returns in takeover activity and reviewed some primary empirical evidence. The available empirical results about takeover activity can be summarised as follows. Earlier studies show that takeovers provide substantial economic benefits to shareholders of target firms. However, there is more doubt as to whether takeovers, on average, provide gains to the shareholders of bidding firms, and there is similar doubt that gains accrue in aggregate and on average to all shareholders. This is perhaps why more recent studies have focused on acquirer gains and their long-run performance.

Chapter 3 finally reviewed the relevant literature regarding corporate governance. Development of corporate governance in China has been highlighted.