

Chapter 4 The theory of the market for corporate control and the current state of the market for corporate control in China

KEY IDEAS

1. The market for corporate control mainly refers to the market for acquisitions and mergers where there is competition for control rights. In the theory of the market for corporate control, the conduct of takeovers by companies in that market and the accompanying threat of takeover are external control mechanisms which can reduce agency costs. The opposing view considers that the market for corporate control cannot resolve principal-agent problems and that, on the contrary, mergers and acquisitions are manifestations of acts of agency that can exacerbate contradictions between management and shareholders.

2. In such countries as the U.K. and U.S.A., company stock rights are highly decentralised and shareholders have limited influence over companies' operations and management. The market for corporate control is quite dynamic and its functions can be effectively brought into play. In such countries as Japan and Germany and in countries of Southeast Asia where there are family holdings, the market for corporate control is by no means dynamic since stock rights are more concentrated.

3. In China, transactions in enterprise control rights began in 1984 in such cities as Baoding and Wuhan. Its development can be divided into five phases from an initial phase between 1984 and 1987, a first high tide in control transactions between 1987 and 1989, a low ebb between 1989 and 1992, a second high tide between 1992 and 1996 and a third high tide from 1997 until today. Since 1997, the scale of transactions in the control of listed companies in China has expanded year by year. The aim of such transactions has been mainly shell purchase and arbitrage, with the purchasing subject being mainly state-owned enterprises.

4. With China's state-owned assets gradually being withdrawn from competitive industry and the gradual process of opening up in the direction of privately-run capital and foreign investment, the functions of the market for corporate control are being identified. As China's legal system and standards regarding the merger and acquisition of listed and unlisted companies constantly improve, the market for corporate control of both listed and unlisted companies in China is moving progressively in the direction of standardisation and maturity.

Questions to answer

1. What disagreements are there among theorists concerning the definition of corporate control?
2. How does the form of a company's organisation gradually evolve from the proprietary system to the partnership and company systems? What is at the heart of this evolution?
3. What are the three kinds of mechanism for corporate control? What are their respective features?
4. What is meant by the internal and external control mechanisms of corporate control? How are they brought into play?
5. What are the basic theories of the market for corporate control? What theoretical disputes are there about it?
6. What is the basic situation of the market for corporate control in the U.S.A.?
7. What is the legal basis for corporate control in China? What was the course of development of the market for corporate control in China?
8. What is the current situation regarding the market for corporate control for listed and unlisted companies in China and what are the prospects for its development?

1 Corporate control

(1) The concept of corporate control

At present, there is no unanimous definition of corporate control. Where theory is concerned, scholars have provided a number of definitions from different perspectives. In practice, corporate control is often linked with policy management. In theory, control has been defined as follows.

(1) In their famous work *The Modern corporation and Private Property*, Berle and Means (1932) started from a pragmatic perspective, defining corporate control as “the actual right to choose the members of the board of directors of a company or the majority of the members whether through the exercise of legal powers or by bringing pressure to bear.”

(2) In his entry for “market for corporate control” in the *New Palgrave Dictionary of Money and Finance*, Michael Jensen (1992) wrote that the definition of corporate control was the authority to employ and dismiss managers at the highest level and to determine their remuneration.

(3) i.e. the “residual rights of control” of the incomplete contract theory¹.

There has been much investigation into residual rights of control. Grossmann and Hart define residual rights of control as enterprise ownership. Yang Ruilong and Zhou Ye’an (1997) define them as the power to make important decisions about the company. Residual rights of control are the power to make decisions regarding the distribution of the residue produced under the contract. This power, however, by no means represents the reversion of the residue to ownership. Liu Xiaoxuan’s (1997) perspective is similar. He considers that residual rights of control meant that the controllers possess the right to decide how residue is to be allocated and does not mean its reversion to their ownership. Yang Xiaowei (1992) considered that claim to residue refers to residual rights of control with the implication that those with claims regarding the ownership of residue are the contractual controllers in respect of actions concerning the assets and have the final decision and also that they bear operational profits and losses independently.

(4) Other definitions

Yin Zhaoliang (2001) defines powers of control as the power to control and manage all the resources which a company can allocate and use. Zhu Yikun (2001) succinctly defines corporate control as the power exercised over the company with varying degrees of influence by shareholders or those with related benefits.

In practice, control is linked to a company’s operational policies and management powers. As the U.S. Federal Securities Act provides, control means the power to exercise a controlling influence over a company’s operational management or general and specific policies or the activity of a natural person directly or indirectly whether by voting, through one or more intermediaries, a contract or other means. China’s Guidance on Enterprise Accounting

¹ The starting point for Hart (1995)、Williams (1996)、Grossmann and Hart (1996)、Hart and Moore (1996)、Hart (1998) and others is the deficiency of contracts. They consider that, since information is incomplete and of limited rationality, all contracts have omissions and oversights and all are therefore deficient. This inevitably gives rise to residual rights and interests. Of these, the residual control rights are the residual rights of control. Many scholars both at home and abroad use this idea in analysing the structure of enterprise property rights and consider that an enterprise is “an alliance formed by a series of peace treaties” and explain the phenomena of capital employing labour or labour employing capital as residual rights of control controlled by the owners of capital or workers.

Standards – Disclosure of Related Party Relationships and Transactions provides that control is “the entitlement to determine an enterprise’s financial and operational policies and to be able to obtain benefit based on the enterprise’s operational activities.” Yin Zhaoliang (2001) summarises the substance of control as “the possession of the power of decisive influence on a company’s operational management or general and specific policies. This power can determine the appointment of a company’s board of directors, determine its financial and operational management activities and even cause the company to become the means of achieving a specific aim”.

In countries or regions such as the United Kingdom or Hong Kong which have a system of compulsory tender offers, laws and regulations on the acquisition of listed companies have special provisions with regard to powers of control. For example, the Regulations of Hong Kong Regarding Acquisitions and Mergers gives a clear definition of control rights, namely that “unless provided otherwise in writing, control rights need ownership or joint ownership of 30% or more of the voting rights in a company, whether or not the amount owned constitutes (is equivalent to) the actual voting rights”. The City of London Regulations of the United Kingdom define control rights as “meaning the ownership or joint ownership of 30% or more of the voting shares in a company whether or not the amount owned constitutes (is equivalent to) the actual voting rights”.

On 1st December 2002, China implemented the Method of Managing Acquisitions of Listed Companies using the concept of actual powers of control. The Method had 61 provisions and, if one of the following conditions applied to the purchaser, it constituted actual control rights:

- (1) ownership of the majority of shares in the register of shareholders of a listed company unless there is evidence to the contrary;
- (2) the ability to exercise voting rights to control a listed company exceeding the maximum number of shares owned by shareholders on its register;
- (3) the ratio of possession and control of a listed company’s shares or voting rights reaches 30% or more unless there is evidence to the contrary;
- (4) half or more of the appointments of members of the board of directors of a listed company can be decided through the exercising of voting rights;
- (5) other situations identified by the China Securities Regulatory Commission.

(2) The organisational form of enterprises and the development of powers of control

Private wholly-owned enterprises, partnerships and enterprises with a corporate system are three legal forms of enterprise in Western countries. When seen from an historical perspective, the earliest to come into being were private wholly-owned enterprises (also known as proprietorial enterprises). After that partnerships appeared and finally companies. Enterprises in the corporate system are categorised as either limited liability companies or joint stock limited companies. At the heart of this evolution of company forms lies the evolution of control rights.

In proprietorial enterprises, the proprietor is both the owner and the manager of the enterprise, with ownership and control rights integrated to a high degree. The enterprise established a legal relationship with its customers and employees through contracts and the proprietor bears unlimited liability in respect of this with all his own property.

Partnerships are the result of the extension of proprietorial enterprises. If proprietors establish a partnership by means of a contract they become partners. In this way, before any decision is made regarding the enterprise, it has to be discussed and agreed internally by all the partners. The cost of such negotiations can sometimes be very high so that a superior economy of scale relative to enterprises in the proprietorial system brought about by forming a partnership is non-existent. It is therefore necessary to concentrate control rights in the hands of some of the partners, thereby reducing the costs of negotiations. This process is referred to by Demsetz as “the first legal

modification". As a result, control is transferred from all partners to some of them. The advantage of such a transfer is that benefits of economy of scale can be obtained on the basis of the reduction of the costs of negotiations. At the same time, transfer also brings new problems to the enterprise, namely the emergence of agency costs and externality of management and the expansion of the enterprise is affected as a result. Hence, limited liability appeared and this was "the second legal modification". As Demsetz stated, the combination of operations by managers in whose hands control is concentrated with limited liability means that, after expansion, enterprises return to running with the minimum operational costs. The emergence of limited liability led to the evolution of the form of enterprises into companies. When a shareholder is dissatisfied with the managers' policy decisions and it is impossible to change it, all he can do is to withdraw from the enterprise. Although the law does not prohibit the withdrawal of shareholders from limited liability companies, there are a considerable number of restrictions. As a result, "the third legal modification" appears, namely the free transfer of shares. As a result joint stock limited companies emerged bringing the prosperity of the stock market with them.

The establishment of a company requires that all internal organisations be set up in accordance with the law. Company legislation in all countries has adopted principles similar to the "separation of three powers", requiring that organisations with power should have mutual restrictions. Of these, the general meeting of shareholders is the highest, enjoying the power to decide some important matters and to elect and dismiss directors. The board of directors has the power to decide most matters and, at the same time, it engages managers to carry out day-to-day operations management. Where the setting up of supervisory organisations is concerned, the two major legal systems do not have much in common. In the Continental system, a board of supervisors is established outside the board of directors while in the U.S. and British legal systems, supervisory powers are exercised through the establishment of an audit committee consisting mainly of independent directors.

Thus it can be seen that, through the establishment of organisations of company power, the law performs a single, initial allocation of corporate control. Fama and Jensen divide enterprise decision-making into "decision management" and "decision control". "Decision management" includes the decision's initial proposal and its implementation after authorisation while "decision control" includes the examination and approval of the proposed decision and supervision of its implementation. According to this division, specific powers of control received by managers are "decision management powers" while the remaining powers owned by the board of directors are "decision control powers".

(3) Models of control mechanisms

Since the structure of stock rights differs, divergence has arisen with respect to the initial allocation of control in the administrative practice of each country. This is mainly represented by three models.

1. The U.K.-U.S. Model – a high degree of decentralisation and liquidity

This model has mainly emerged in countries with a U.K.-U.S. legal system such as the U.S.A. and the United Kingdom. The main features of such a system are the high degree of decentralisation of stock rights, the existence of a flourishing capital market and a high level of liquidity in stock rights. In the U.K.-U.S. Model, since the number of shares owned by shareholders in a company is quite small their influence on operational management is limited. Therefore, they pay more attention to the rise and fall of company share prices rather than the operational management of the company. The significance of this is that the internal administration of the company is of little importance and control of the company is in the hands of the managers. However, since there are efficient capital and management markets, incompetent managers can be quickly discovered and replaced, thus companies are actually controlled by their shareholders. As Professor Michael Useem of the U.S. Corporate Governance Authority

and the Wharton School stated, the American enterprise system has been transformed from “management capitalism” with de facto management control to “investor capitalism” where the investor exercise effective constraints on managers.

2. The Continental Model – stock rights relatively centralised and stable

The Continental Model has mainly emerged in such countries as Germany and Japan with the Continental legal system. The degree of centralisation of stock rights is between the U.K.-U.S. Model and the Family Model. In addition, the Continental Model differs from the U.K.-U.S. Model in two respects. The first is the interlocking shareholdings of commercial banks and industrial enterprises and the second is that boards of directors do not exercise any supervisory function. Actions at management level are supervised by a specialist board of supervisors. Hence, governance in the Continental Model is inclined towards mutual checks and balances by all empowered internal organisations. Companies are actually controlled by enterprises with large shareholdings or banks.

3. The Family Model – high concentration of stock rights

The Family Model has mainly emerged in Southeast Asia. Its outstanding feature is family holdings, for example family control in South Korea accounts for 48% of all enterprises, in Taiwan it is 61.6% and in Malaysia 67.2%. In enterprises with family control, family members are not only shareholders with control but also participate widely in the operational management of enterprises. As a result, benefits for shareholders and management tend to be the same. In addition, enterprises in the Family Model are more stable as a result of family blood ties and marital connections.

To sum up, control of modern companies is held by two sorts of people. The first is held by company management with little or no holdings of the company's shares while another is held by shareholders with controlling shares. Since management has no shares or just a few, its holding of control rights may be used in pursuit of aims maximising its self-interest while deviating from maximising company benefits and agency problems may arise. When shareholders with controlling shares control a company, the motivation for them to seek private benefits of control may also cause the company's operations to deviate from the goal of maximising company benefits. These problems need to be resolved through the company's internal and external control mechanisms.

(4) Mechanisms of restraint for control rights

Mechanisms of restraint in corporate control can be examined with regard to internal and external mechanisms.

1. Internal control mechanisms

Internal control mechanisms are also known as the company's internal governance structure. They mainly indicate what internal systems and measures a company has to prevent management from deviating from the aim of maximising company benefits. Management includes the board of directors and the high-level managers it appoints. The board of directors is the company's highest organ of power – the permanent organ of the general meeting of shareholders with responsibility for the day-to-day management of the company. In theory, directors are appointed by the general meeting of shareholders and should be answerable to it, supervising the activity of such high-level administrative staff as managers so that it coincides with the company's interests. In practice, however, since the directors' interests are not completely identical with those of shareholders, the phenomenon of the board's activities diverging from the company's interests may occur. Thus, a company's internal control mechanisms are at two levels. The first is the supervision of managers through the board of directors, which is mainly realised through the directors' duties. When the board cannot carry out its functions and even deviates seriously from its obligations, established institutional arrangements are needed as a guarantee for the final owners of the company, the shareholders, to safeguard their own interests. This is the second level, which is realised through all of the

shareholders' powers.

(1) Directors' duties

The main duties of the directors are duty of care and duty of loyalty.

Duty of care is an expression in the U.K.-U.S. legal system. It is expressed in a variety of ways such as duty of care, duty of diligence and duty of care and skill. In the Continental legal system, it is known as the duty of care of a good manager or, more briefly, the duty of good management. Specifically, this duty requires that directors should act within the scope of operations and scope of aims permitted by the law and the company's articles of association, act within the scope of the limits of their powers and should have the essential knowledge and conditions for fulfilling their responsibilities as required by company law and their articles of association. If unable to carry out this duty of good management, they should resign immediately.

The directors' duty of loyalty is also known as fiduciary duty. It is a concept of the U.K.-U.S. legal system. Currently it is also integrated into the Continental legal system. Duty of loyalty contains two items. One is the duty to be subjectively honest and have good intentions while the other is the duty to be objectively impartial, namely that there should be no conflict between one's duty and private interest. Company directors should be loyal to the company's interests with the goal of maximising its benefits and must not use their dominant position within the company to seek improper benefits for themselves or third parties with whom they have common interests.

(2) Shareholders' rights

① The right to inside information

Since shareholders hand the operational management of the company over to management, they have no inside information about its day-to-day running. Without this information, they cannot carry out supervision and therefore the right to inside information is a prerequisite for their supervisory control over management. As Article 10 of China's Company Law provides, shareholders are entitled to consult the company's articles of association, the minutes of general meetings of shareholders and financial accounts and make recommendations or inquiries regarding the company's operations.

② The right to make proposals

Since the board of directors is responsible for convening general meetings of shareholders and matters for discussion at the meeting are all chosen in advance by the board, the meeting ultimately only has two choices with regard to the proposals formulated by the board: agree or reject. Thus it can happen that no-one puts forward proposals which are in the interests of the shareholders and the subjects for discussion as determined by the board may also not meet the shareholders requirements. Hence, the question of the right of shareholders to make proposals has been raised.

This right may be divided into two categories according to the content, namely the right to raise matters at the general meeting of shareholders and the right to call interim general meetings of shareholders. The Company law of Taiwan provides that, "shareholders who for one year or more have holdings of 3% or more of the total shares issued must record in writing the reason for raising the matter and request the board to call an interim shareholders' meeting." "If the board of directors does not issue a notification regarding such a call within fifteen days of the request in the previous paragraph being made, shareholders can autonomously call a meeting with the permission of the concerned local authorities."

③ The right to institute proceedings

When the rights and interests of shareholders are infringed by the board of directors, the shareholders may protect them by instituting legal proceedings. Article 111 of China's Company Law provides that, where the resolutions of general meetings of shareholders and boards of directors violate the law, administrative regulations or

infringe the lawful rights and interests of shareholders, shareholders are entitled to submit a request to the People's Court to institute proceedings in order to halt such illegal and injurious acts.

④ The shareholder's right of dissent

The shareholder's right of dissent is the right of shareholders to maintain their dissent regarding the company's actions in some specific circumstances and to be able to sell their shares to the company on these grounds. The sale of shares in these circumstances is not the transfer of shares in the normal sense but is an important measure for protecting small shareholders. For example dissenting shareholders have the right to ask the company to buy back shares if the company is merged. The company laws of such places as the USA and Taiwan have provisions for this.

The internal control mechanisms of corporate governance are far from being omnipotent. Where they are ineffective, it is necessary to bring external control mechanisms into play to jointly realise the aim of corporate governance.

2. External control mechanisms – contention for control rights

Beginning from the perspective of control rights, the external control mechanisms of corporate governance are mainly reflected in the market for corporate control and especially in contention for control rights. There are two sides to contention for control rights: the first is company acquisition and mergers, in particular hostile takeovers, and the second is the gaining of proxy voting rights.

(1) Company acquisitions and mergers

The market for company acquisitions and mergers is mainly a source of external control power and problems of corporate governance can be resolved in part through this external pressure. Through an analysis of 1064 enterprises recorded in *Value Line Investment Research*, Mitchell and Mulherin (1996) confirmed the effect of acquisitions and mergers on companies. Even enterprises are not involved in acquisitions and mergers, they can be threatened by takeovers if their record is poor while those with a good record may increase the wealth of their shareholders through a takeover.

(2) The acquisition of proxy voting rights

In general, company law provides that shareholder voting rights can be exercised by authorising a proxy. This is the fundamental legal basis for the acquisition of property rights. It means that a minority of shareholders can publicly obtain such delegated proxy rights from others. Weston et al. point out that, even if the acquisition is not successful, this contention for proxy rights can have a significant effect on the wealth of the target company's shareholders. It can be seen from this that the acquisition of proxy voting rights does not merely provide small shareholders with an opportunity of voicing their opinions. More importantly, it forms a source of external pressure on management and major shareholders. To this end, in October 1992, the U.S. Securities Exchange Commission (SEC) relaxed the restrictions on shareholders gaining proxy voting rights.

In an analysis of the acquisition of proxy voting rights and public acquisitions, Loss (1988) demonstrates that the latter is superior as a method of obtaining corporate control for the following reasons. (A public acquisition is relatively easy with low costs. All expenditure becomes investment at the same time as corporate control is obtained. Expenditure for obtaining proxy voting rights, however, does not become investment even if corporate control is obtained and generally has to be borne by the proxy. (If a public acquisition is unsuccessful, those failing to make the acquisition can give their votes to the target company or its managers without any loss-making transaction. (Public acquisitions are limited to a fixed period of time and the entire transaction can take place rapidly. This is an important factor in preventing management from putting defensive measures into place and in economising on the cost of obtaining control rights.

The approach for resolving problems of corporate governance is mainly through the internal and external control measures given above. However, Grossmann and Hart consider that these measures are incapable of completely eliminating “problems of motivation” where the aims of the trustor and proxy are not identical. As a result, they propose “bankruptcy” as the third method. If management does not have the maximising of the shareholders’ wealth as their aim, the possibility of bankruptcy is increased. Once bankruptcy has occurred, the benefits received by management from the company will not exist again. Therefore, management will have maximising shareholders’ wealth as their aim under pressure from “bankruptcy” or an aim that is close to it.

2, The theory of the market for corporate control

(1) Definition of the market for corporate control

There are two definitions of the market for corporate control. The first is the realisation of a market for transactions in and transfer of control rights through mergers and contention for proxy rights as proposed by Henry G. Manne (1965). The other was proposed by Jensen and Ruback (1983) as a market in which different managerial teams contend for the control rights over company resources.

Since this Chapter is mainly a study of mergers and acquisitions, reference to the “market for corporate control” here is mainly to contention for control rights in the mergers and acquisitions market.

(2) The neoclassical hypothesis of the separation of ownership and control and the theory of market for corporate control

The theory of the market for corporate control was first put forward by Professor Henry G. Manne of the Washington University Law School in 1965. He mainly analysed the market for corporate control as having the role of mitigating problems of agency caused by the separation of ownership and control in modern companies. Some scholars consider that the market for corporate control can play a positive role and act as an external control mechanism, capable of bringing down agency costs and mitigating contradictions between shareholders and management. It can also optimise the allocation of resources. Other scholars call the role of the market for corporate control into question, considering that the market for corporate control cannot resolve principal-agent problems while acquisitions and mergers are, on the contrary, the manifestation of agency activity which can exacerbate contradictions between management and shareholders.

It is common knowledge that traditional neoclassical theory assumes that seeking the maximising of profits is the sole aim of companies. This is one of the key hypotheses of the general equilibrium theory. The separation of ownership and control in modern companies has challenged this hypothesis.

The separation of ownership and control refers to the phenomenon of the almost total lack of control rights or lack of direct control rights over company management policy by shareholders in publicly held corporations (the residual claimants) (Marks 1999).

Attention to the phenomenon of the separation of ownership and control can be traced back to Smith. In his famous *Wealth of Nations* (1776), he suggested that the separation of ownership and control means that the managers of companies cannot be as deeply committed as private owners and this affects the companies’ efficiency and competitiveness. An investigation into American companies by Berle and Means (1932) discovered that there were more and more modern companies characterised by the separation of ownership and control in the U.S.A. In view of this observation, Berle and Means raised doubts about the basic hypothesis of neoclassical theory that “the sole aim of companies is seeking to maximise profits”. If separation of ownership and control occurs in a company, why can managers not make the maximising of their own interests as their aim? After that, the separation of

ownership and control attracted the interest of more and more scholars. The principal-agent theory and information economics put forward theoretical grounds for the standpoint that “managers can pursue their own interests”. Serious principal-agent problems are evident in modern companies, information is not symmetrical and contracts are incomplete. It is difficult to restrict self-interested activity by managers through the company's internal control mechanisms (Shleifer and Vishny 1988). The phenomenon described above of having no concern for shareholder's interests while pursuing one's own is known as a moral hazard. It is a reason why managers cannot realise the maximisation of shareholder's benefits. There is also a problem known as adverse selection in which managers employed by the company are unable to realise the aim of maximising the shareholders' interests, that is to say, they lack ability. Problems of moral hazards and adverse selection bring costs to the separation of ownership and control (Marks 1999).

Neoclassicism uses the theory of competitive selection to reply to this theoretical challenge. Whatever may be the form of shareholder's rights or the internal organisational structure of the company, companies that have not realised the maximisation of profit may naturally be eliminated in the market¹. However, a serious theoretical consideration of competitive selection demonstrates that competitive selection only signifies maximisation of profit in some specific circumstances. Where competition is not total, this argument is untenable.

In these circumstances, some scholars represented by Manne (1965) have put forward the theory of the market for corporate control in defence of the neoclassical hypothesis. This theory considers that even if the competitive selection process is ineffective in the commodities market or some other markets, simply playing a role in the capital market by using the mechanism of the takeover is sufficient to ensure that only companies maximising their stock market value can survive.

Manne and his followers consider that a market for corporate control has emerged along with the development of merger and acquisition activities. In this market, different interest groups (i.e. perhaps the company shareholders or some power outside of the company) obtain control rights to a company through contention for stock rights or the acquisition of proxy voting rights. As a result, there are changes in the disposition of the company's management or in the company's operational aims.

The theory of the market for corporate control advocated by Manne et al. accepts the basic hypothesis of the neoclassical capital market theory, that is to say it considers that enterprises should adhere to the aim of maximising value. On the basis of this theory, if management deviates from this single aim, causing the enterprise to be badly run, with reduced profits, the share price is bound to fall. When it falls to a certain degree, the enterprise will be undervalued. It is likely then that enterprise will become the target for acquisitions and mergers and after the parties involved have obtained controlling shares, there are frequently changes to the board of directors and managers. Such external pressure causes the enterprise to return to a maximised value. Even if the bid is unsuccessful, the latent threat is a source of external pressure forcing management not to deviate too much from the aim of maximised value. An unsuccessful takeover is like a salutary kick for the managers in office (Keasy 1997). In this way, the market for corporate control can bring down the costs incurred by the separation of ownership and control to some extent.

Two conditions are required to make the above point of view tenable. (1) A company's stock market price has to reflect the actions and operational efficiency of the managers. A higher price is an indication that the managers' operational efficiency is higher, that is to say there is genuine dependency between share price and the actions and operational efficiency of the managers. (2) Takeovers have to occur because managers lack ability or their actions

For details see: Friedman, M. 1953, *Essays in Positive Economics*, Chicago: University of Chicago Press.

deviate from the interests of the shareholders, that is to say there is genuine dependency between takeovers and the ability and actions of managers. However, some scholars have called these two conditions into question. In the first place, of the factors that determine a company's value, apart from the conduct of the managers, there are many random elements which are not related to the managers. Sometimes, it is these very random elements which determine a company's basic value. On second thoughts, even if we suppose that managers are the main or even the only factor determining the value of a company, it is difficult for the market to fully observe the managers' actions and evaluate them correctly, since there is a lack of symmetry of information between managers and the market. In this, the dependency between the conduct of managers and share price is much reduced. Next, there are numerous reasons why takeovers occur, such as the pursuit of synergy and economy of scale, the accumulation of market strength and the building of enterprise empires. Therefore, inappropriate actions and incompetence on the part of managers is by no means the only cause of company takeovers. Some may well happen for reasons absolutely unconnected with managers' actions and this weakens the dependency of takeover activity on managers' actions.

Critics of the theory of the market for corporate control also consider that it is liable to lead to short-sighted actions on the part of management. The market for corporate control cannot resolve principal-agent problems while, on the other hand, acquisitions and mergers are the manifestation of agency action. Hence, the market for corporate control can exacerbate contradictions between management and shareholders: acquisitions and mergers cannot create value but, on the contrary, may destroy it. The market for corporate control is a "competitive, violent and avaricious world" (Sommer 1991). At the same time, the operational efficiency of the market for corporate control is impeded by certain factors such as thumbing rides and management defence.

1. Thumbing rides

The phenomenon of "thumbing rides" can influence the efficiency of acquisitions. Many small shareholders pay close attention to fluctuations in the price of company shares and take absolutely no notice of the ownership of corporate control. If they consider that an acquisition can make the company share price go up they will continue to hold their shares and this may increase the cost of the acquisition. At such times, even if the action of the company's management does not have the maximisation of the shareholders' wealth as its aim, the acquisition will not be successful and, as a result, the efficiency of the market for corporate control will be affected (Grossman, Sanford and Hart, Oliver 1980).

2. Management defence

In hostile takeovers, the party making the acquisition may encounter fierce resistance from management and this will influence the operational efficiency of the market for corporate control. Since the 1980s, anti-takeover measures of all types have appeared for example poison pills, green-mail, golden parachutes and white knights.

(3) Private income from control rights

The U.S. corporate governance experts, Shleifer and Vishny (1997), pointed out that "When ownership goes past a certain point and large shareholders have almost taken over all control rights, it is sufficient to use the enterprise to create the private benefits of control which small shareholders cannot enjoy." Private benefits of control and shared benefits of control are reciprocal concepts (Holderness 2002). From Holderness's point of view, the reason major shareholders are willing to forgo the benefits brought by diversification of investment and to concentrate their funds to obtain the control rights of a company is that they are motivated by these two factors namely shared benefits of control and private benefits of control. Where other conditions are equal, the higher the proportion of shares held by major shareholders, the greater the motivation and capability for increasing the value of the company. Increased company value may happen as a result of the major shareholders' supervisory functions

being brought fully into play (Shleifer and Vishny 1986), or it may happen as a result of the proper influence of major shareholders on the company's operational policies. Since all shareholders can obtain benefit from increased company value and the part of the benefits for major shareholders is restricted by cash flow, this part is known as shared benefits of control. On the other hand, major shareholders are not only motivated to increase a company's value, they are even more motivated to make use of the company's resources to seek personal gains (Barcaly and Holderness 1992). Only through the possession of corporate control by major shareholders is it possible for this part of the gains to be termed private benefits of control.

The earliest metrological research into private benefits of control was by Barcaly and Holderness (1989). In their research into bulk share transactions, they discovered that the transaction price of these shares was normally higher than the market price. The difference between the two represents private benefits of control. The approach taken in Barcaly and Holderness's argument was as follows. If all shareholders obtain benefits in proportion to their holdings, there are no private benefits of control. Bulk share transactions should then be in accordance with market prices. If purchasers of bulk shares anticipate that, as a result of the voting rights they have obtained, it will become impossible for other small shareholders to profit, then there are true private benefits of control. The price they pay may be higher than the market price and the excess is approximately equivalent to the discounted value of the private benefits of control. If purchasers of bulk shares anticipate that, after buying the shares, the costs will exceed the benefits, that is to say the private benefits of control have a negative value, dealings in the shares may then be at a discounted price, which is less than the market price. In their investigation into 63 samples, they discovered that the price of 80% of bulk share transactions was higher than the subsequent market price for that share, i.e. 80% of bulk shares were sold at a premium with the average premium being 20.4%. Premiums accounted for 4% of the market price of sample shares, i.e. private benefits of control accounted for 4% of the market price of sample shares. Another hypothesis concerning transactions at premium prices is that the purchasers have more information concerning the value of the target company. Barcaly and Holderness discovered that, whether or not bulk share transactions are at a premium or discounted, the cumulative excess earnings ratio from the target shares is always positive. If the above hypothesis concerning superior information is tenable, it follows that sales of shares at a discount should have a negative and not a positive cumulative excess earnings ratio. Hence, Barcaly and Holderness consider that the hypothesis concerning superior information is incorrect and that bulk transactions at a premium are a reflection of private benefits of control. A sectional regression analysis of transactions at a premium also supported the private benefits hypothesis. They discovered that transactions at a premium became larger as the ratio of shares traded in such transactions to the total shares increased. In addition, the share premium level of companies with a good record was also high. This fits in with the private benefits hypothesis: the larger the proportion of shares held, the stronger the control rights over the company and the greater the possibility of obtaining private benefits. The better a company's record, the greater the possibility of obtaining private benefits.

Private benefits of control may be monetary such as expenditure on remuneration that is too high or more investment on the major shareholders' pet projects. They may also be non-monetary such as psychological satisfaction. Private benefits of control are not necessarily always scrupulous. If supervision by major shareholders brings about costs or leads to legal action because of harm done to the interests of small shareholders, private benefits of control may be negative. Holderness and Sheehan (1988) investigated whether or not when major shareholders took up posts as the company's top managers they formulated excessively high remunerations and rewards for themselves. They compared two sets of samples: in the first the company's top management owned the majority of shares in the company while in the other they had no shares in the company and the company had no major shareholders. From the results, they discovered that the annual salaries and rewards for the first group were

indeed higher than for the second, however the difference was only US \$20,000 - \$30,000. Holderness and Sheehan consider that it is very hard to imagine that this slight gain could encourage investors to pay out more than US \$60,000,000 (average) to obtain the controlling shares. Chong-en Bai Etal (2002) points out that, in countries with a thriving market, the value of control rights comes mainly from profit transferred by the "tunnelling" activity of shareholders with controlling shares.

(4) The evidence of the experience of the market for control

1. The selection of targets for takeover in market for corporate control

Singh (1971, 1975) applied a multivariate analysis. The first formal attempt described the main characteristics of the mechanisms of stock market mergers from experience, i.e. through the operations of the market for corporate control, which companies were eliminated and which survived. He compared the economic and financial characteristics of the following three categories of company: (1) surviving and merged companies; (2) companies launching acquisitions and victims (companies taken over); (3) companies launching acquisitions and those which did not / companies which were not acquired. The samples in the first study were five cases of businesses listed on the U.K. stock market fully taken over between 1954 and 1960. The second study targeted a large number of mergers during the high tide of mergers between 1967 and 1970. His conclusions were as follows.

First, there is much overlapping in the characteristics of companies taken over and surviving companies and, as a result, it is difficult to distinguish between them. Second, the extent of overlapping during the period of the high tide of mergers can be increased. Third, although variables (such as profit margin) in their records are statistically significant, the extent to which distinctions can be made through them is relatively small. Fourth, although a company's size is not too closely connected to its profit margin, it was proven by the samples studied that it was another distinguishing variable of great statistical significance. Fifth, a multivariate analysis shows that the addition of variables other than profit margin and company size can only make a distinction increase slightly.

Although scale and profit margin are not particularly good distinguishing variables, of all the economic and financial variables considered, they were the most important. Since these two variables are almost unrelated, the author examines their respective relationships with the possibility of acquisition. The results of the study show that they have a nonlinear relationship with the possibility of acquisition. The possibility of companies with a very low profit margin being taken over is significantly higher than the average. As profit margin rises, the possibility of being taken over falls along with it but, after the profit margin reaches a certain level, or even if it continues to rise, the possibility of the company being taken over stops falling. From the perspective of company size, the possibility of a small company being taken over is relatively small and this is perhaps because small companies are more often than not under family control. Where medium-sized companies are concerned, the possibility of their being taken over is larger but by no means increases in accordance with an increase in company size. The possibility of the 100 or so largest companies being taken over is very small and this has a negative correlation with their scale.

Singh's later research largely verified the above conclusions. In general, practical evidence demonstrates that, in the market for corporate control, the choice of surviving companies is established on a basis of two indices namely profit margin and scale. Contrary to the predictions of neoclassical theory, efficiency (shown by indices in the narrow sense of the word such as profit margin and stock market valuation) is by no means the only factor to determine a company's survival in takeovers. It has been proven in practice that the possibility of large companies with relatively low efficiency being taken over is smaller than that of small companies which are relatively efficient. Hence, the threat of takeover does not constitute pressure to raise profit margins. In reality, it may be a factor encouraging companies to expand their scale.

Therefore, some scholars have begun to consider the reasons why the market for corporate control does not work properly. The phenomena they put forward below may partially explain this. (1) During takeovers, companies (especially where the takeover of large companies is concerned) generally get involved in huge transaction costs. (2) The information received by potential purchasers may be insufficient to the extent that they cannot mount a binding takeover. (3) The market share price is of no avail and cannot correctly reflect the market's expectations of company profits. (4) The purchaser itself may also be controlled by managers seeking to maximise scale rather than value.

2. The function of takeovers

Studies based on experience of the function of takeovers can be divided into two categories based on method. Under the first method, accounting data on profit margin is used and the weighted mean of the record of the purchasing company and target company before the takeover are compared with the conglomerate after the merger. Under the second method, "event study methods" are used to study the share price reaction of the target and purchasing companies around the time news of acquisitions and mergers is made public.

These two types of study produced results which were quite different. In the study of most accounting data it was discovered that, in the U.K. at least, the economic benefits of mergers are barely satisfactory. The performance of an amalgamated company after a merger is frequently worse than that of the two independent companies before the merger. In their studies using American data, the researchers came to different conclusions. Healy, Palepu and Ruback (1992) studied the record of the 50 largest mergers in the U.S.A. after the acquisition between 1979 and 1984. Their analysis of the results showed that the performance of merged enterprises improves after their operations have been reorganised. This improvement results from improvement in asset management and there is no significant change in investment in capital equipment and investment in research and development. Agrawal, Jaffe and Mandelker (1992) established an even larger sample including 937 merger transactions and 227 tender offers. They discovered that shareholders of purchased enterprises lost 10% of their wealth in the five years following the takeover. Contrary to this, it was discovered through research into share prices that around the time news of acquisitions and mergers is made public, the shareholders of the target company may receive considerable earnings. Shareholders of the purchaser generally do not suffer any loss and sometimes receive excellent earnings. Hence, the overall benefits of acquisitions and mergers are positive. There are several explanations of the sources of these benefits: (1) undervalued share price; (2) market strength produced by increased industrial concentration; (3) excessively high bid by the purchasing company; (4) the effect of coordination after the merger; (5) post-merger tax advantages.

3. A survey of foreign markets for corporate control

Although the theory of the market for corporate control is hotly disputed, this does not hinder the development of the market for corporate control in practice. Beginning in the mid 1970s, the U.S. market for corporate control began to surge forward and the whole of the 1980s was a flourishing time. Between 1976 and 1990, there were over 35,000 cases of control rights transactions being accomplished, with a total volume of US \$2,400,000,000,000. Over the last few decades, takeovers have been the main cause for the demise of numerous listed companies in the U.K. and U.S.A. They can account for $\frac{3}{4}$ or more of listed companies which have disappeared (Hughes and Singh 1987). In such economically developed industrialised countries as continental Europe and Japan, the rate of occurrence of mergers and acquisitions is much lower than in the U.K. and U.S.A. and hostile takeovers are almost non-existent. These differences have their origin in differences in the framework of company law, methods of share ownership and other systems. On the other hand, the capital market of these countries is much less developed than in the U.K. and U.S.A. and this, too, limits the scale of the market for corporate control. There follows a simple

introduction to the U.S. market for corporate control.

(1) Control rights transaction methods

In the U.S. market, purchasers can acquire control rights of a listed company through the following methods (Bittlingmayer 1998).

(1) Open market purchase, i.e. through the direct purchase of the target company's shares through a secondary market. Generally speaking, purchasers may conceal their intentions and endeavour to buy as many shares as possible before news leaks out. However, when their shareholding ratio reaches a certain level, they should disclose information about their holdings in accordance with the requirements of regulations concerning the supervision of securities. The requirement of the 1934 Securities Exchange Act in respect of this ratio is 10%, while the amendment to the 1970 Williams Act reduced it to 5%.

(2) Block purchase, i.e. the purchase of block shares by means of agreement.

(3) Tender offer, i.e. the purchaser makes a tender offer to the shareholders to buy their shares at a fixed price.

(4) Negotiated purchase, i.e. the purchaser negotiates conditions for making an acquisition directly with the management and board of directors of the target company. This method is normally used to purchase all outstanding stock issued by the target company. The details of the negotiations are by no means restricted to control rights transactions and include a series of other conditions such as contracts for employment with current management and compensation. This type of transaction method is actually the one commonly known as a merger.

(5) Proxy contest, i.e. the acquisition of proxy voting rights described above.

In the practice of mergers and acquisitions in the U.S.A., the purchaser is also a listed company and control rights transactions resulting in the merger of two listed companies are quite common. In recent years, the phenomenon has appeared similar to Europe where the purchaser does not immediately perform the acquisition and mergers after obtaining control rights. In addition leveraged buyouts (LBO) and management buyouts (MBO) are a rising trend.

(2) The role of management in acquisitions

In the process of a company acquisition, the management of the target company are faced with two predicaments. On the one hand, an acquisition always implies a repudiation of the abilities of the target company's management and its punishment by the market. After the acquisition has succeeded, the current managers are frequently replaced and lose their control rights over the company. Thus, the management of the target company will attempt to adopt all types of anti-acquisition tactics to maintain these control rights. On the other hand, the management of the target company should act in accordance with the principle of maximising the shareholders' benefits. If the acquisition of the company is advantageous to the maximisation of the shareholders' benefits, the management of the target company should give its support.

Based on the principle of the target company's management's duty of trust, U.K. and U.S. law require that it should not be actuated by the aim of maintaining its own controlling position and resist the tender offer. Naturally, no managers of a target company would be so stupid as to unequivocally inform everybody that reverse takeover measures are to maintain their control rights over the company. Some legitimate reasons may be given such as the price of the tender being too low and not reflecting the true value of the company's assets or the purchaser's financial status is bad. How can the legitimacy of reverse takeover activity be judged? The main basis in the U.S.A. is the Business Judgment Rule. This supposes that, in their commercial policy decisions, company directors are fully informed, have good intentions and sincerely believe that the measures they adopt are in accordance with the maximum benefits of the company. Based on this rule, directors can only be responsible for damage done to the

company as a result of their breaches of the duty of care and the duty of trust and are not responsible for damage done to the company because of their errors of judgement. So long as the management of the target company puts forward reasonable resolutions based on reasonable information, has good intentions and is honest, even if afterward they are seen to be incorrect and/ or harmful, it need not assume any responsibility. The Business Judgment Rule means that directors are quite free to take reverse takeover measures.

There are many types of reverse takeover measures. One is a reverse takeover clause in the company's articles of association. Such clauses can be summarised as shark repellent and porcupine clauses. The former refers to alterations to the company's established articles of association before the offer is tendered or other defensive preparations to make the offer more difficult. The latter refers to the design of defensive clauses in the company's articles of association or internal rules so that attempted takeovers which have not been agreed by the board of directors of the target company cannot be implemented or are infeasible. These reverse takeover measures include super-majority, fair-price, cumulative voting and super voting right clauses. Another countermeasure is to arrange for the goal of reversing or delaying the takeover through some special agreements such as golden parachutes, poison pills and white knights. No further details of these will be given here.

(3) Regulations of the market for corporate control

The U.S. market for corporate control is subject to a series of legal system constraints such as company law, anti-trust policies and securities law. Each state has its own company law and, in order to attract more companies to register and undertake some subsequent legal matters there, the state legislation always emphasises protection of management with little protection for shareholders' interests. Approximately half of the major listed companies in the U.S.A. are registered in Delaware, a small state on the eastern seaboard. Others are distributed over New York, California, Pennsylvania and Illinois. The effect of company law on the market for corporate control is large. For example, its provisions on the shareholders' voting rights, the duties of company directors and reverse takeover measures by the management of target companies can influence the mechanisms of control rights and therefore ultimately influence their value.

The effect of federal legislation on the market for corporate control is not as direct as that of state legislation. Previous federal legislation established a foothold with anti-trust measures and limitations on mergers, acquisitions and overlapping share holdings. The 1934 Securities Exchange Act greatly increased the use of federal law. Subsequent legislation, especially the 1968 Williams Act, provided for the disclosure of information about acquisitions and the conditions of tender offers. Proxy contests also come within the limits of supervision of federal securities legislation. Federal legislation on limits on shareholdings in listed companies by banks, common funds and other financial organizations also has some influence on the market for corporate control. During the late 1980s, the initiative for regulating the market for corporate control returned to each state and, faced with the tide of mergers at the time, each state undertook more anti-merger legislation.

1. The effect of anti-trust policies on the market for corporate control

Early intervention by the federal government in the market for corporate control was through anti-trust policies. According to an explanation given at the time by the Supreme Court, the object of regulation by the 1890 Sherman Anti-Trust Act was cartels blocking interstate trade through agreements but dealings in company shares and mergers and acquisitions of companies with no restrictive trade agreements were not included. During the upsurge of merges between 1898 and 1902, the industrial tycoons of American Steel, Du Pont and American Tobacco came into being. At the time there occurred a series of fierce battles for control rights. The most famous was the battle for the control of Northern Pacific between the railway tycoons Hill and Harriman. In 1904, President Theodore

Roosevelt signed Northern Securities. There was reversal in the attitude towards mergers which were brought within the direct control of the federal government and the Bureau of Corporations (the predecessor of the Federal Trade Commission) and the Anti-Trust Department of the Ministry of Justice were established. Between 1906 and 1907, the Roosevelt government broke up Standard Oil, Du Pont and American Tobacco. This resulted in a large fall in share prices and output and caused public outcry. Finally, the government abandoned its goal of breaking up large companies which came into being during the merger upsurge between 1898 and 1902. Apart from short-lived anti-trust enthusiasm after the First World War, the government provided a relaxed environment for mergers during the whole of the 1920s and some large companies such as General Electric came into being. The prosperity of companies and the stock market encouraged the emergence of a large number of modern companies characterised by the separation of ownership and control rights. The tide of mergers during the 1920s came to an end with the collapse of the stock market in 1929. Changes in legislation and supervision brought about by President Roosevelt's "New Deal" (disclosure of share holdings and restrictions on proxy fighting) had an indirect effect on control rights. After the Second World War, problems of the relationship between corporate control and monopoly surfaced again. In 1950, Congress passed the Celler-Kefauver amendment to the Clayton Act which forbade the anti-competitive purchase of shares but did not relate to the purchase of assets. The amendment forbade the anti-competitive purchase of assets. This Act and the interpretations by the Supreme Court caused the strict limitations upon horizontal mergers during the 1950s and 1960s. Vertical mergers were also affected to some extent resulting in mixed mergers prevailing during the 1960s. In 1982, the Supreme Court proclaimed anti-takeover laws drawn up by states to be unconstitutional. The Reagan government adopted an attitude of approval towards mergers. Together with the appearance of such new funding methods as "junk bonds", this produced the upsurge in mergers and acquisitions of the 1980s and 1990s.

2. The regulation of takeovers

During the 1950s, the appearance and development of hostile takeovers caused the regulation of takeovers to be placed on the agenda. At the time, the New York and U.S. exchanges had provisions concerning tender offers and information disclosure. In July 1968, the Williams Act was passed which combined comprehensive disclosure and a set of regulations on fair trading with tender offers. It provided that tender offers should be maintained for at least twenty days. With regard to the excessive collection of shares in advance by shareholders, the purchaser must buy at a ratio and cannot buy in accordance with the principle of "who collects first, buys first". This act also required that purchasers buying 10% of the target company on the open market should disclose this to the Securities Exchange Commission. This proportion was reduced to 5% in the 1970 amendment. It was discovered through the study of much concrete evidence that, after the Williams Act was passed, the benefits of target company shareholders increased while the benefits of shareholders in the purchasing company decreased. Hence, it is considered by some that the increase in the benefits of target company shareholders is at the cost of gains by the purchasing company's shareholders. This statute has limited the development of mergers and acquisitions. However, this standpoint has not been corroborated. It has been discovered through research that similar changes occurred at the same time in the U.K. where there is no similar legislation.

At the state legislation level, each state completed the first generation of takeover legislation between 1968 and 1979. By 1979, all states with a large number of companies had passed anti-takeover laws. However, in 1982, these laws were declared illegal in the majority of states by the Supreme Court on the grounds that they affected interstate commercial activity. This led to the second generation of takeover legislation after 1982 which was mainly implemented through amendments to company law. For example, Indiana's "purchase of controlling shares" clause provided voting rights could not be exercised with a purchaser's shares unless the authorisation and approval of the

target company's board of directors or of shareholders unconnected with the purchaser are obtained. Maryland's "fair price" clause provides for the lowest price in double offers. Some states have passed a "freeze out" clause. If the purchase does not have the agreement of the board of the target company, the purchaser's ability to integrate (takeover) the target company is greatly limited. The second generation of takeover legislation received broad support. It has been discovered through the study of much evidence that the negative effect of such legislation on mergers and acquisitions is not great (George Bittlingmayer 1998).

4. A survey of the Chinese market for corporate control

In this section, the process of the emergence of corporate control, its transactions and its demise are first introduced followed by a review of the course of development of the Chinese market for corporate control. The specific operations of the market for corporate control for listed and unlisted companies are each introduced and, finally, the prospects for the development of the Chinese market for corporate control are surveyed.

(1) The emergence of, transactions in and loss of control rights

1. The formation of control rights – the establishment and listing of a company

When a company is established, its organisational structure is set up in accordance with the requirements of Company Law and an initial allocation of control rights is made. China's Company Law provides that companies can take two forms, namely limited liability companies, or joint stock limited companies. Limited liability companies are established when between two and fifty shareholders jointly contribute. The lowest limit for registered capital is Renminbi 150,000 Yuan. State-authorized investment organisations or departments can exclusively invest in the establishment of an exclusively state-owned company. There should be more than five promoters to establish a joint stock limited company, over half of whom must be domiciled in China. The lowest limit for registered capital is Renminbi 10,000,000 Yuan. When state-owned enterprises are restructured as joint stock limited companies, there can be fewer than five promoters but fund raising should be adopted as the method of establishment.

① Organisational structure of joint stock limited companies

The organisational structure of joint stock limited companies includes the general meeting of shareholders, the board of directors, managers and board of supervisors.

The general meeting of shareholders is the company's organ of authority, exercising the following powers.

- Determining the company's operational policies and investment plan.
- Electing and replacing directors and deciding matters relating to their remuneration.
- Electing and replacing shareholder representative members of the supervisory board and determining matters relating to their remuneration.
- Considering and authorising the board's reports.
- Considering and authorising the supervisors' reports.
- Considering and authorising the company's proposed annual financial budgets and final accounts.
- Considering and authorising the company's proposals for distribution of profits and making up deficits.
- Passing resolutions on increases or reductions in the company's registered capital.
- Passing resolutions on the issue of company bonds.
- Passing resolutions on such matters as amalgamating, splitting, dissolving or liquidating the company.
- Altering the company's articles of association.

Joint stock limited liability companies set up a board of directors with between five and nineteen members. The board is responsible to the general meeting of shareholders and exercises the following powers:

- Responsibility for calling general meetings of shareholders and reporting their work to it.

- Implementing the resolutions of general meetings of shareholders.
- Determining the company's operational plan and investment proposal.
- Formulating the company's proposed annual financial budgets and final accounts.
- Formulating proposals for the distribution of the company's profits and making up deficits.
- Formulating proposals for increasing or reducing the company's registered capital.
- Formulating proposals for amalgamating, splitting or dissolving the company.
- Determining the setting up of the company's internal management structure.
- Appointing or dismissing the company's manager, appointing or dismissing the company's deputy manager and head of finance as nominated by the manager and determining their remuneration.
- Formulating the company's basic management system.

The board of directors of a joint-stock limited company appoints and dismisses the manager. The board may decide that one of its members should assume the role of manager. The manager is responsible to the board of directors and exercises the following powers:

- Taking charge of the company's production, operations, and management work, organising the implementation of the board's resolutions.
- Organising the implementation of the company's annual operations plans and investment proposal.
- Drafting a proposal for setting up the company's internal management structure.
- Drafting the company's basic management system.
- Formulating specific company rules.
- Submitting the appointment or dismissal of the company's deputy manager or head of finance.
- Appointing or dismissing responsible managers unless this should be carried out by the board of directors.
- Other duties as determined by the company's articles of association or the board of directors.

The supervisory committee established by a joint-stock company should have at least three members. It comprises shareholder representatives and a suitable ratio of company staff representatives with the specific ratio determined by the articles of association. The supervisory committee exercises the following powers:

- Inspection of the company's finances.
- Supervision of the directors and manager for any actions in breach of the law, regulations or the company's articles of association when performing their duties for the company.
- Requiring the directors or manager to mend their ways if their actions are harmful to the company's interests.
- Proposing the calling of a provisional general meeting of shareholders.
- Other duties as provided by the company's articles of association.
- The organisational structure of limited liability companies

The organisational structure of limited liability companies of limited liability companies is similar to that of joint-stock limited companies, including shareholder's meetings, a board of directors, a manager and supervisory committee.

Apart from exercising similar powers to those of the general meeting of shareholders of a joint-stock company, the shareholder's meeting of a limited liability company also puts forward resolutions on the transferring by the shareholders of capital to persons other than the shareholders.

A limited liability company's board of directors¹ has between three and thirteen members. Their powers are identical to those of the board of directors of a joint stock company.

¹ If the number of shareholders and the scale of a limited liability company are small, an executive director can be appointed rather than a board. The executive director can be the company manager at the same time.

The appointment, dismissal and powers of the manager of a limited liability company are also identical to those of a joint-stock limited company.

Where the scale of operations of a limited liability company is larger, a supervisory committee with no fewer than three members is established. Where there are fewer shareholders and the scale is smaller, one or two supervisors may be appointed. The powers of the supervisory committee or directors are identical to those in a joint-stock limited company.

③ The organisational structure of an exclusively state-owned company

An exclusively state-owned company means a limited liability company established by a state-authorized investment organisation or state-authorized department. Its organisational structure is not like that of an ordinary limited liability company.

An exclusively state-owned company does not organise any shareholder's meetings. The state-authorized investment organisation or state-authorized department authorises the company's board of directors to exercise some of the powers of the shareholder's meeting and decide important company matters. However, amalgamating, splitting or dissolving the company, increasing or reducing capital and the issuing of company stock must be decided by the state-authorized investment organisation or state-authorized department.

There are between three and nine members of the company's board of directors. They are appointed or replaced by the state-authorized investment organisation or state-authorized department according to the term of office of the board of directors. Members of the board of directors include staff representatives who are chosen democratically by the staff.

The supervisory committee of an exclusively state-owned company consists of persons appointed by the State Council or organisations or departments authorised by it and company staff representatives participate. There are not fewer than three members in a supervisory committee.

(2) Listed companies

Chapters 4, 5, 6 and 7 of the *Guidance on the Articles of Association of Listed Companies* each have specific provisions concerning the interests, duties and their execution with respect to the general meeting of shareholders, the board of directors, the manager and supervisory committee of listed companies.

The Rules for Share Listings of the Shenzhen and Shanghai stock exchanges have specific provisions concerning the qualifications for office and duties for the secretary to the board of directors.

Since many listed companies are restructured and reorganised from state enterprises, the restructuring process may involve changes to control rights. Therefore, we shall give a brief introduction here to the requirements for restructuring and reorganising companies which it is planned to list (joint-stock companies organized in accordance with the Company Law and planning to publicly issue shares for the first time within the borders of the People's Republic of China).

On the basis of the *Guidance on the Restructuring and Reorganisation of Companies Planning to be Listed (Public Opinion Survey)* of 5th April 2004, such reorganisation should abide by the relevant provisions of the Company Law and be organized as a joint-stock limited company in accordance with its requirements for standardised restructuring and complete reorganisation. Otherwise a joint-stock limited company should be established by comprehensive changes.

If significant replacement, purchase (including mergers) or sales of assets (including stock rights) or increases or reductions in capital have occurred over the past three years in companies intending to be listed (if less than

three years, data for the original enterprise should be included)¹, especially if these actions result in changes to the controlling shareholders of the companies which it is planned to list or else there are changes to 1/3 or more of the management, they should operate independently for at least one complete financial year from the date of change before an application to be listed is made.

If the assets (stock rights) of companies which it is planned to list are replaced, acquired or sold or the extent of increases or reductions in their capital exceed 70% (in accordance with the above specification) and the main field of business is changed, such companies should operate for at least three complete financial years from the date of the changes before an application to be listed is made.

During the process of restructuring and reorganisation and continuing operations, companies which it is planned to list should guarantee their standard operation in such matters as organizational form, corporate governance structure, company policy and operations. They should achieve complete independence in their assets and independence in staffing, structure and finance.

Where staff independence is concerned, if the company which it is planned to list is competing in trade or there is significant joint business, the chairman of the board must not concurrently hold the post of legal representative of the shareholding unit. The latter's legal representative refers to the legal representative of a shareholding unit owning 5% or more of stock rights in the company to be listed. Such high ranking management of the company to be listed such as its general manager (including other equivalent titles such as C.E.O.), the deputy general manager, head of finance, head of marketing and the secretary to the board of directors should work full-time for the company and draw their remuneration from it. They must not hold any position with the shareholding unit holding 5% or more of the stock rights in the company to be listed or with the unit's subsidiaries apart from being a director or supervisor. Nor must they hold a post with any other enterprise in the same or similar business to that of the company to be listed.

Where organisational independence is concerned, the production operations and office organisation of companies planning to be listed should be completely separate from the controlling shareholder. There must be no combined operations or joint offices. Neither the controlling shareholder or any other unit or individual may interfere in the setting up of the organisation of a company it is planned to list. There should be no higher and lower ranking between the controlling shareholder and its functional departments and the company to be listed and its functional departments and no enterprise may interfere in any way with the production operations of a company to be listed.

2. Control rights transactions

There can be trading in and transfers of corporate control (including both listed and unlisted companies) in

¹ "Replacement, purchase (including mergers) or sales of assets (including stock rights) and increases or reductions in capital" indicates that one of the following situations has occurred. (1) The total amount of assets replaced, purchased or sold accounts for more than 30% but not more than 70% of the total assets of the company to be listed after the most recent audit. (2) Payment for or earnings from replacement, the payment for the purchase or sale of assets accounts for more than 30% but not more than 70% of the total assets of the company to be listed after the most recent audit. (3) The profit from the replacement, purchase or sale of assets accounts for more than 30% but not more than 70% of the profits of the company to be listed after the most recent audit. (4) Increases to or reductions in the company's registered capital exceed 30% but not more than 70%. Exceptions are increased capital stock by the transfer as provided of accumulation funds or bonus issues without distributed profits or else reduced stock in an equivalent ratio.

designated places and by certain methods. The specific places, methods, main participants and supervisory laws and regulations are introduced below in the introduction to the market for corporate control.

3、 Loss of control rights

(1) Suspension or termination of a company's listing

The Company Law and Securities Law provide as follows.

Article 49 of the Securities Law provides that, where listed companies no longer meet the conditions for listing as provided by the Company Law, the listing of its shares will be suspended or terminated in accordance with the law.

Article 157 of the Company law provides that, in any of the following circumstances, the Securities Administration Department of the State Council will suspend the listing of a listed company's shares.

(1) Changes in the total amount of the company's capital stock or the distribution of stock rights no longer meet the conditions for listing.

(2) Companies do not make public the financial status as provided or falsify the recording of their financial accounts.

(3) Companies commit serious breaches of the law.

(4) Companies run at a loss for three years in succession.

Article 158 provides that, if listed companies are in one of the situations described in Paragraphs 2 and 3 of the preceding Article and it is found through investigation to be serious or else they are in one of the situations described in Paragraphs 1 and 4 and cannot eliminate it within the time limit, they no longer meet the conditions for listing and the listing of its shares will be terminated by the Securities Administration Department of the State Council.

If a company resolves to dissolve itself, or it is legally ordered to close down by a responsible administrative department, or it is declared bankrupt, the company shall have its listing terminated by the Securities Administration Department of the State Council.

Implementation method

(Rules for dealing with matters relating to the suspension of share listings)

In July 1997, on the basis of Articles 157 and 158 of the Company Law, the Shanghai and Shenzhen stock exchanges drew up and promulgated the Regulations for Dealing with Matters Concerning the Suspension of Listed Shares (referred to below as the Regulations) which provided that, "When a listed company runs at loss for three years in succession, the listing of its shares should be suspended." "During the period of suspension, the company's shares are designated with the prefix PT (i.e. particular transfer) and, every Friday, investors holding or wishing to purchase the company's share which previously circulated on the market are provided with a 'particular transfer' service. On that day, when the market is open for trading, investors can transfer or authorise a request to purchase which to be valid has to have a price within a range is 5% less or more than the previous transfer price. When the market closes for that day, valid requests are matched and deals agreed in accordance with the aggregate competitive price method. The company's medium-term reports must be audited and the share's market price should be especially indicated." On 16th June 2000, the exchanges amended these Regulations to cut out the 5% decrease limit. On 18th April 2001, the exchanges amended then again, changing the name to the Regulations for Dealing with Special Transfers of Listed Shares.

Implementation Method for the Suspension and Termination of Shares of Loss-making, Listed Companies

On 22nd February 2001, The China Securities Regulatory Commission issued its Implementation Method for the Suspension and Termination of Shares of Loss-making, Listed Companies stipulating the conditions, procedure and

disclosure for the suspension or termination of listed companies.

Suspension

Article 5 provides that when a listed company runs at a loss for three years in succession, from the date of publication of its annual report for the third year (if the company has not published annual reports, from the date of the end of the time limit provided by the Securities Law for the publication of annual reports), the stock exchange should suspend trading in its shares and should determine within five working days of this suspension whether to suspend the listing of the company's shares.

Article 8 provides that, after a company's listing has been suspended, it can apply to the stock exchange within 45 days for a period of grace in order to defer the period of the suspension of its listing. The period of grace shall be twelve months from the date of suspension.

During the period of suspension of a company's listing, the stock exchange may provide investors with a particular transfer service for its shares. The method of transfer will be determined by the stock exchange.

Article 12 provides that, if a suspended company makes a profit for the first accounting year in the period of grace, it may apply to the China Securities Regulatory Commission following publication of its annual report for restoration of its listing.

Termination of listing

Article 17: If the first annual report of a suspended company continues to show a loss during the period of grace, or a chartered accountant contradicts its financial report or refuses to give an opinion when auditing it, the stock exchange shall suspend its share transfer service from the date the company publishes its report.

Article 18: In any of the following circumstances, the China Securities Regulatory Commission shall determine to terminate the listing of its shares:

- (1) the company decides not to apply for a period of grace;
- (2) there has been no application for a period of grace within 45 days of the date of suspension of its listing or the application for a period of grace has not been approved by the stock exchange;
- (3) the company has not published an annual report by the close of the period of grace as described in Article 17;
- (4) an application for restoration of listing has not been approved by the China Securities Regulatory Commission.

After this Implementation Method took effect, three listed companies, namely PT Narcissus, PT Guangdong Kingman and PT Zhonghao were delisted.

When implemented, this Implementation Method had some shortcomings. For example, it provided that restoration of a listing and termination were both subject to the authorisation of the China Securities Regulatory Commission and the front-line monitoring function of the stock exchange could not be fully brought into play. The Method did not clearly stipulate the standards which should be applied by a stock exchange in authorising a period of grace. When implemented there were a good number of artificial factors and much scope for subjective lack of restraint. Although a company's shares were prefixed "PT" during the period of delisting, they could still be traded. Problems of reorganisation and of turning around a loss by speculating in PT shares arose. This increased market risks.

Implementation Method for the Suspension and Termination of Shares of Loss-making, Listed Companies (revised)

In January 2002, the Securities Commission published a new method for withdrawing from the market. It issued an Implementation Method for the Suspension and Termination of Shares of Loss-making, Listed Companies

(revised). The new method of withdrawing from the market made important revisions concerning such matters as authorisation powers and procedure and share transactions when a listing is suspended or terminated.

In the first place, according to the relevant provisions of the Company Law and Securities Law, the China Securities Regulatory Commission authorises stock exchanges to issue rulings in accordance with the law suspending, restoring or terminating listings. From the perspective of international practice, a company's listing is an arrangement between a stock exchange and a company to reach a market-oriented agreement. When a company fulfils the conditions stipulated by the stock exchange, it signs a listing agreement with it and its shares can then be listed at the stock exchange. Conversely, if a listed company no longer fulfils the conditions for listing, the stock exchange is entitled to terminate its listing agreement with the company in accordance with the law and rule that the listing be terminated. This provision in the new method is close to international practice and embodies the market-oriented principle of withdrawal from the market.

Next, the relevant procedure for applying for a period of grace has been abolished. If a company makes a loss for three successive years, its shares are suspended. If a company has still turned around this loss in the first six months after suspension, the stock exchange will directly issue a ruling terminating its listing. Conversely, if the company realises a profit, it can apply for its listing to be restored in accordance with the procedure provided in the Method. This has increased objectivity and reduced subjective factors while simplifying the procedure.

Finally, the PT (particular transfer) system has been abolished. After a company's listing has been suspended, trading in its shares ceases and the stock exchange no longer provides a transfer service. The aim of the PT system was to facilitate the transfer of the shareholders' shares. Since it was implemented, it has played an active role in such matters as removing market risk. However, the phenomenon of stopping the slump in PT shares has increased market risk. The new method has abolished the PT system. When a company has had its listing terminated, it can authorise a share dealer approved by the China Securities Regulatory Commission to act for it in a share transfer service in order to safeguard the interests of shareholders in lawful share transfers.

(2) Bankruptcy, dissolution and liquidation

Chapter 8 of the Company Law has provisions concerning company bankruptcy, dissolution and liquidation.

Article 189: If a company is legally declared bankrupt because it cannot pay debts that are due, the People's Court shall, in accordance with the provisions of relevant laws, organise the shareholders, relevant organisations and professional persons in establishing a liquidation group to carry out bankruptcy liquidation with regard to the company.

Article 190: A company may be dissolved in any of the following situations:

(1) the company's term of operations as provided by its articles of association has expired or another reason for dissolution as provided by the articles of association has occurred;

(2) a shareholder's meeting resolves that it should be dissolved;

(3) dissolution is required because of the company's merger or division.

Article 192: When a company is ordered by law to close for violation of laws and administrative regulations, it should be dissolved and the relevant authority in charge shall organise the shareholders, relevant organisations and professional persons in establishing a liquidation group to carry out bankruptcy liquidation with regard to the company.

Article 196: When a company is liquidated following dissolution, if after putting the company's assets in order and compiling a balance sheet of the property and inventory of the assets the liquidation group discovers that the company's assets are insufficient to pay its debts, it should immediately apply to the People's Court for a declaration of bankruptcy.

After a company has been declared bankrupt by the People's Court, the liquidation groups should hand over its bankruptcy work to the People's Court.

(2) The course of development of the Chinese market for corporate control

Transactions in enterprise control rights began in such cities as Baoding and Wuhan in 1984. Its development can be divided into three phases¹.

1. Initial phase (1984-1987)

In July 1984, the Hebei Baoding Textiles Factory and the Baoding City Boiler Factory, with each assuming full liability for their creditor's rights and obligations, merged with the Baoding City Knitting Equipment Factory and Baoding City Bellows Factory and founded the forerunner of state-owned enterprise acquisitions and mergers. In September 1984, the Baoding City Steel Sash Factory purchased the Baoding City Coal Ash Brick Factory with 110,000 Yuan. This was the earliest recorded merger of a Chinese collective enterprise with a state-owned enterprise. By 1987, there were over twenty enterprises in both Wuhan and Baoding where there were paid property rights transfers in different forms. In nine other cities including Beijing and Wuhan, mergers and acquisitions of state-owned enterprises were also seen.

2. The first high tide of control rights transaction activity (1987- 1989)

After 1987, the government published a series of policy laws and regulations to encourage enterprise acquisitions and mergers such as the report at the 13th National Congress of the CCP making clear that the paid transfer of the property rights of state-owned enterprises to collectives or individuals was permitted. In February 1989, the State Economic System Reform Commission, the State Planning Commission, the Ministry of Finance and the Administrative Bureau of State-owned Assets jointly promulgated the Provisional Method for Merging Enterprises amongst others. These helped to bring about the first high tide of mergers. According to statistics, during the 1980s 6,226 enterprises in 25 provinces, cities, autonomous regions and 13 cities specifically designated in the State Plan merged with 6,966 others with a total of 8,225,000,000 Yuan in assets transferred, a reduction of 4,095 loss-making enterprises and a reduction of an amount of 522,000,000 Yuan in losses.

3. The low ebb in enterprise control rights transaction activity (1989-1992)

During the second half of 1989, there was a shortage in funds for enterprises as a result of macroeconomic retrenchment and the economy entered a phase of comprehensive improvement and rectification. As this phase developed, there was an increase in the number of loss-making enterprises. The government expanded its role in the transfer of property rights and, in some areas, the amalgamation of enterprises by administrative coercion emerged. There was also some increase in free transfer mergers within the same area or department.

4. The second high tide of control rights transaction activity (1992-1996)

During 1992, the direction of the reform of the Chinese economy towards the market economy was established firmly and acquisitions and mergers became an important part of the reform of state-owned enterprises. During this phase, the acquisition and merger of Chinese enterprises followed the growth of the property rights and stock markets and the forms of acquisitions and mergers became more plentiful. There emerged the phenomena of listed companies and foreign firms merging with and acquiring state-owned enterprises and of transnational acquisitions and mergers by Chinese enterprises

¹ Research results from the Scientific Research Centre of the Administrative Bureau of State-owned Assets quoted from Zhang Qiusheng and Wang Dong, *Enterprise Mergers and Acquisitions*, Northern Communications University Press, 2001.

5. The third high tide of control rights transaction activity (1997 until the present)

Beginning in 1997, along with the reform of the Chinese investment system, the structure of enterprise financing gradually shifted from dependence on a single bank for borrowing to a structure with simultaneous indirect and direct financing. Stock markets had become an important place for enterprises to obtain long-term capital support. There was a rapid increase in the impetus for the merging of listed enterprises and the reorganisation of assets. The quantity of control rights transactions and the number of transactions also tended to rise over the years.

Since the establishment of stock markets and the emergence of listed companies during the 1990s, transactions in the control rights of listed and unlisted companies have become a market in their own right. Together they constitute the Chinese market for corporate control. Below, we introduce the specific operations and current status of the market for corporate control for both listed and unlisted companies.

(3) Overview of the market for corporate control for listed companies

1. Location of trading

Transactions in the control rights of listed companies are realised mainly through the transfer of shares at a stock exchange. In recent years, there has been an increase in cases of the transfer of corporate control rights through judicial channels (auctions and adjudications).

2. Main participants

Apart from mutual control rights transactions and those through intermediaries, there are also the following participants in the market for corporate control of listed companies.

(1) SASAC

With the current stock right structures of listed companies, most transfers of the control rights of listed companies involve the transfer of state-owned stock rights. Since such transfers require examination and approval, the Department for the Administration of State-owned Assets is an important participant in the market for corporate control.

In August 1988, the State Council established the State-owned Assets Administration Bureau which centralised the administration of all state-owned assets at home and abroad. In 1998, the Bureau was abolished and incorporated into the Ministry of Finance. In 2003, the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) was established to carry out the duties of an investor of state-owned assets with the responsibility for supervising and administering the state-owned assets of enterprises. The following are the main functions of SASAC.

① With the authorisation of the State Council and in accordance with such laws and administrative regulations as the Company Law of the People's Republic of China, it carries out the duties of an investor, directing and promoting the reform and reorganisation of state-owned enterprises, checking that the value of state-owned assets in the enterprises it is supervising is retained or increased and enhancing state-owned asset administration work. It promotes the establishment of a modern enterprise system for state-owned enterprises, perfects the structure of corporate governance and gives impetus to the strategic adjustment of the structure and distribution of the state-owned economy.

② It represents the state in sending supervisory committees to some large-scale enterprises with responsibility for the day-to-day work of the supervisory committee.

③ It appoints, dismisses and appraises persons responsible for enterprises through statutory procedures, rewarding or penalising them on the basis of their management record. It establishes mechanisms for selecting and employing staff which are in keeping with the socialist market economy and modern enterprise systems and

perfects systems for encouraging and restricting managers.

④ It supervises the retained and increased value of state-owned assets which are under its supervision through statistics and audits. It establishes and perfects systems of indices for the retained and increased value of state-owned assets and draws up assessment criteria. It safeguards the rights and interests of investors of state-owned assets.

⑤ It drafts laws and administrative regulations for the management of state-owned assets and formulates a system of relevant rules. In accordance with the law, it provides guidance for and monitoring of the management of local state-owned assets.

⑥ It undertakes any other matters with which it is entrusted by the State Council.

(2) Ministry of Commerce

The Ministry of Commerce is a constituent part of the State Council in charge of domestic and international trade and international economic cooperation. Its main duties are as follows.

① The drawing up of a development strategy, principles and policies for domestic and foreign trade and international economic development and drafting laws, regulations and implementation rules and regulations for domestic and foreign trade, international economic development and foreign investment.

② Research into and putting forward ideas on linkage between Chinese economic and trade laws and regulations and international multilateral and bilateral economic and trade treaties and agreements.

③ The drawing up a domestic trade development programme, researching into and putting forward ideas on the reform of the system of circulation, fostering the development of urban and rural markets and advancing such modern modes of circulation with an adjusted circulation industrial structure as chained operations, coordinated materials flow and electronic trade.

④ Research into and the drawing up of policies for standard market operations, sequence of flow and breaking market monopolies and for regional blockades and the establishment of a sound, healthy, open, competitive, orderly market system.

⑤ Monitoring and analysing market operations and commodity supply and demand and organising and implementing the regulation and control of the market for important consumer goods and the management of the flow of important means of production.

Laws and regulations involving foreign investment and anti-monopoly policies and measures have an important effect on the market for corporate control.

(3) The State Development and Reform Commission

In 2003 The State Planning Commission was reorganized as the State Development and Reform Commission. Its main duties are as follows.

① The drawing up and implementation of a national economic and social development strategy, with long and medium term programmes and annual plans; the submission of aims and policies for national economic development and the optimisation of important economic structures; the submission of proposals for applying all types of economic methods and policies and reporting on the national economic and development plan to the National People's Congress with the authorisation of the State Council.

② Research into and analysis of the developmental trends of the domestic and foreign economies, making macroeconomic forecasts and early warnings; research into important matters involving state economic security, with proposals for policies for macroeconomic regulation and control and synthesising and coordinating economic and social development; responsibility for the regulation of day-to-day economic operations and the resolution of major problems with regard to economic operations.

③ Responsibility for gathering and analysing information about the public economy and about finance, participating in the formulation of public financial and currency policies and drawing up and implementing industrial and pricing policies; performing synthetical analysis of the results of implementing policies pertaining to the public economy, finance, industry and pricing; the formulation and adjustment of a minority of standards for important state-managed commodity prices and charges; responsibility for controlling the aggregate of foreign debt, for structural optimisation and monitoring and for maintaining the balance of international trade.

④ Research into important matters concerning the reform of the economic system and opening up to the outside world, organizing the drawing up of proposals for comprehensive reform of the economic system and coordinating proposals concerning earmarked economic system reforms; the submission of proposals for perfecting the socialist market economy system to encourage its development through reform and liberalisation, giving guidance to and promoting overall economic system reform.

⑤ Putting forward the scale of fixed asset investment for the whole of society, planning the distribution of major projects and productive forces; arranging funds set up by state finance and guiding and monitoring the use of construction funds from foreign loans and guiding and monitoring the orientation of the use of policy loans; giving guidance to the orientation of popular funds used in fixed asset investments; researching and putting forward aims and policies for strategy, overall balance and structural optimisation when using foreign capital and external investment; arranging construction projects with funds allocated by the state together with important foreign-funded projects, external resource development and high-volume foreign exchange investment projects; the organisation and management of major projects to check the work of special delegates.

⑥ The promotion of strategic adjustments and upgrading with regard to industry structure, submitting a strategy and plan for the development of industries of national economic importance; research and coordination of some important relevant matters regarding agriculture and rural economic and social development, linked with special planning and policies regarding agriculture; the provision of guidance in industrial development, promoting industrialisation and computerisation; the formulation of professional industrial programmes, giving guidance in the drawing up of professional and technical laws and regulations and professional standards; the drawing up of development programmes for such resources as oil, natural gas, coal and electricity; the promotion of the development of high-technology industry with the implementation of macroscopic guidance for technological progress and industrial modernization and guidance in the assimilation and innovation of significant, imported technologies and equipment.

⑦ Research into and analysis of regional economies and the development of urbanisation; the submission of plans for the coordinated development of regional economies and the implementation of a strategy for the large-scale development of the west of China and submitting measures and major policies for an urbanisation strategy; responsibility for overall harmonisation of regional economic coordination and giving guidance in the work of regional economic coordination.

⑧ Research into and analysis of domestic and foreign markets, with responsibility for the overall balance and macroscopic regulation and control of important commodities; the compilation of an overall plan for the import and export of important agricultural and industrial products and of raw materials, monitoring the implementation of this plan and making adjustments to it on the basis of the actual workings of the economy; the management of state reserves of such important materials and commodities as grain, cotton, sugar, oil and medicines; the submission of a strategy and plan for the development of a modern materials circulation industry.

⑨ Ensuring a balance between social undertakings such as population and family planning, science and technology, education, culture and health, national defence construction and national economic development,

putting forward policies for harmonised economic and social development and their mutual promotion while harmonising major problems in the development of social undertakings.

⑩ The promotion of a strategy for sustainable development, researching and drawing up plans for resource conservation and comprehensive utilisation, participation in the compilation of an ecological construction plan, putting forward policies for resource conservation and comprehensive utilisation and harmonising major problems of ecological construction and resource conservation and comprehensive utilisation; organising the harmonisation of the work of the environmental protection industry.

Research into the economic state of a wide variety of ownership systems, putting forward proposals for optimising ownership structures and enterprise organisational structures, encouraging fair competition between and the joint development of enterprises with all types of ownership systems; researching and putting forward policy measures for the encouragement of the development of small and medium enterprises and the non-state economy, increasing macroscopic guidance and harmonising major problems in the course of development.

Researching and putting forward policies for encouraging employment, the adjustment of the distribution of income and improving the harmonised development of social security and the economy, harmonising major problems of employment, the distribution of income and social security.

The drawing up and formulation of laws, rules and regulations concerned with the national economic and social development, reform of the structure of the economy and opening up to the world, while participating in the drafting and implementation of these laws, rules and regulations.

Undertaking other matters given to it by the State Council and the management of the State Grain Bureau and State Tobacco Monopoly Bureau, as provided by the State Council.

The aims and policies for the optimisation of the structure of the economy formulated by the State Development and Reform Commission and its industrial and pricing policies are an important influence on the market for corporate control.

(4) Securities Regulatory Commission

The Securities Regulatory Commission acts as a monitor over stock markets with responsibility for formulating specific regulations for transactions in the market for corporate control and for examining, approving and supervising their implementation with regard to transactions.

(5) The judicial system

Since 2000, many incidents have occurred of the transfer of the control rights in listed companies through judicial auctions and adjudications. The execution on 30th September 2001 of the “Decision of the Supreme People’s Court on Some Questions Concerning the Freezing and Auctioning of State-owned Shares and Legal Person Shares in Listed Companies” made the legal system an important participant in the market for corporate control.

3. Transaction methods

The Method for Administering Purchases of Listed Companies provides that a purchaser may purchase a listed company through a transaction by agreement, tender offer, or a centralised auction at a stock exchange and obtain the actual control rights. In practice, apart from this, there are also such methods as judicial auctions and adjudications, the free assignment of state stock and the direct purchase of stock rights in the listed company’s parent company.

4. Standard laws and regulations regarding trading in the control rights of listed companies

(1) General provisions concerning the transfer and purchase of stock rights in listed companies

The Company Law has the following provisions concerning the transfer of shares in joint stock limited

companies.

Article 143: A shareholder may transfer his shares in accordance with the law.

Article 144: A transfer of shares by a shareholder must be done through a legally established stock exchange.

Article 145: Registered share certificates are transferred by the endorsement of the shareholder or by other means as provided by the law or administrative regulations.

When the registered share certificates are transferred, the company records the name or designation and address of the assignee in the register of shareholders.

Changes to the register of shareholders as provided in the previous paragraph must not be made within thirty days before a general meeting of shareholders is called or within five days before the record date for the distribution of dividends.

Article 146: The transfer of bearer share certificates shall take effect upon the delivery of the share certificates to the recipient through a legally established stock exchange.

Article 147: Shares in a company held by its sponsor may not be transferred within three years of the date of its establishment.

Directors, supervisors and the manager of the company should report to the company all shares they hold in a company and must not transfer them during their term of office.

Article 148: A state-authorized investment organisation may transfer shares it holds in accordance with the law and may also purchase shares held by other shareholders. The limits of powers for examination and approval and methods of administration for such transfers or purchases are provided elsewhere by law and by administrative regulations.

Article 149: A company must not purchase its own share certificates except to cancel shares in order to reduce its capital or when merging with another company which holds its shares.

After a company has purchased its own share certificates in accordance with the provisions of the previous paragraph, it must cancel that part of its shares within ten days, change its registration in accordance with the law and administrative regulations and issue a public notice.

A company must not accept its own share certificates as collateral for a mortgage.

The Company Law provides as follows in respect of company mergers.

Article 182: The merger or division of a company should be passed as a resolution at a company shareholder's meeting.

Article 183: The merger or division of a joint stock limited company must be approved by the authorised department of the State Council or a People's Government at provincial level.

Article 184: The merger of a company may take the form of a merger by absorption or merger by the establishment of a new company.

When a company absorbs another in a merger by absorption, the absorbed company is dissolved. When two or more companies establish a new company in a merger by establishment, all parties to the merger are dissolved. When companies merge, each party to the merger should sign a merger agreement and prepare a balance sheet and property inventory. A company should notify its creditors within ten days of the date of the merger resolution and should issue public notices in newspapers at least three times within thirty days. Within thirty days of the date of receiving notice, or within ninety days of the date of the first public notice in the case of creditors who do not receive a notice, a creditor is entitled to demand that the company clears its debts or provides a corresponding guarantee. If a company does not clear its debts or provide corresponding guarantees it must not be merged.

When companies merge, the creditors' rights and liabilities of each party to the merger should be inherited by the company which continues to exist after the merger or by the newly-established company

Provisions concerning the purchase of listed companies

The provisions of Chapter 4 of the Securities Law concerning the purchase of listed companies, the methods and procedures of the Administration Method for the Purchase of Listed Companies and the information disclosure in the purchase of listed companies in the Administration Method for the Disclosure of Information concerning Changes in Share Holdings in Listed Companies provide specific provisions. See other chapters of this book for details.

(2) Provisions concerning the transfer of state-owned stock rights

On 3rd November 1994, the implementation of the provisions of Article 29 of the Provisional Administration Method for State-Owned Stock Rights in Joint-Stock Companies was announced. The transfer of state-owned stock rights should be in accordance with the following provisions.

① The chief aim of the transfer of state-owned stock rights should be readjustment of investment structure.

② The transfer of state stock rights must abide by the provisions of the state with respect to the transfer of state-owned shares. Units holding state-owned shares submit an application stating the aim of the transfer, the investment orientation of the proceeds from the transfer, the amount of the transfer, the object of the transfer, the means and conditions of the transfer, its fixed price, time and other specific arrangements.

③ Applications for the transfer of state-owned stock rights are submitted to the State Bureau for State Property Administration and to the State Property Administrative Department of the provincial People's Government for approval. Those for the transfer of state-owned stock rights abroad are submitted to the State Bureau for State Property Administration for approval. If the amount of state share transfers is quite large and involves controlling interests and changes in controlling interests, it must be jointly approved by the State Bureau for State Property Administration, the State Economic System Reform Commission and relevant departments.

④ After shareholding units other than a State Property Administrative Department have transferred state shares, they must report the amount of income from the transfer to the Department, together with the plan for its use and the results of its implementation.

On 1st July 2000, the Ministry of Finance issued its Notice on Some Questions Concerning the Management of the State-owned Stock Rights by Joint-stock Companies. According to this document, the transfer of the state-owned stock by listed companies must be authorised by central financial authorities.

On 27th May 2003, the Provisional Regulations for the Supervision and Management of Enterprise State-owned Assets was promulgated and executed. Article 23 of these Regulations provide that the organisation supervising and managing state-owned assets (i.e. SASAC) should decide the transfer of state-owned stock rights by companies it financed. Of these, where all state stock rights are transferred or part of them are transferred to the extent that the state was no longer in control, it must be reported to the People's Government at the same level for authorisation. It is reported that the Provisional Method for the Transfer of Listed Companies State-owned Stock Rights which is at the heart of Article 23 is currently in its first draft and, following internal discussions, the opinions and proposals of the Ministry of Finance, the Securities Regulatory Commission and other concerned ministries and commissions will be sought. The formulation of this Method will fill a gap in the complete provision of authorisation procedures and time limits for the transfer of listed companies' state-owned shares, which is currently lacking in China.

The execution on 30th September 2001 of the "Provisions of the Supreme People's Court on Some Questions Concerning the Freezing and Auctioning of State-owned Shares and Social Legal Person Shares in Listed

Companies" standardised the freezing and auctioning of state-owned shares in listed companies.

(3) Provisions relating to mergers with foreign capital

On 8th October 2001, the former Ministry of Foreign Trade and the Securities Regulatory Commission jointly issued Some Opinions Concerning Questions Related to the Involvement of Listed Companies in Foreign Investment, which standardised the issuing of share certificates by joint-stock companies with foreign investment and the actions of foreign-investment enterprises in stock markets. The second article made the following provisions with regard to the issuing of share certificates by joint-stock companies with foreign investment.

① When joint-stock companies with foreign investment issue share certificates within China (A and B shares), they must be in accordance with industrial policies pertaining to the foreign investment and requirements regarding the issuing of listed shares.

② The first time a joint-stock company with foreign investment publicly issues shares and is listed, as well as adhering to such laws and regulations as the Company Law and the relevant provisions of the China Securities Regulatory Commission, it should abide by the following conditions.

- It should have passed the combined annual examination of joint-stock companies with foreign investment for three years before applying to be listed.

- Its scope of operations should meet the requirements of the Interim Provisions for Guiding the Orientation of Foreign Investment and the Foreign Investment Industrial Guidance Catalogue.

- After being listed and issuing share certificates, the ratio of its foreign investment shares should not be less than 10% of its total capital stock.

- A joint-stock company with foreign investment, where the Chinese party has a controlling interest as required by provisions (including relative control) or where there are special provisions regarding the ratio of the Chinese party's holding, should, following listing, continue to maintain the Chinese party's controlling position or the ratio of its holding as required by relevant provisions.

- It should conform to the requirements of laws and regulations regarding the issue of listed shares and other conditions.

③ The first time a joint-stock company with foreign investment publicly issues shares and is listed, apart from the submission of stipulated materials to the China Securities Regulatory Commission, it should also provide an authorisation certificate for passing the combined annual examination of joint-stock companies with foreign investment and its business licence.

④ After issuing share certificates for the first time, the additional issue of shares and stock dividends by a joint-stock company with foreign investment should be in accordance with the conditions provided by Section 2 above of this Article and the relevant provisions concerning the additional issue of shares and stock dividends.

⑤ After the completion of the first issue of shares, and additional issue of shares or stock dividends and the delivery of share certificates, it should undertake procedures for changing its legal documentation with the Ministry of Foreign Trade and Economic Development.

Article 3 provides that a joint-stock company with foreign investment with B shares, when applying for its non-listed foreign capital shares to be circulated on B stock markets, should obtain the agreement of the Ministry of Foreign Trade and Economic Development and then submit its application for circulating these non-listed shares as listed shares to the China Securities Regulatory Commission.

Applications for the circulation of unlisted foreign capital shares on the listed share market should meet the following conditions.

① The holder of unlisted foreign capital shares, which it is planned to circulate on the listed share market,

should have owned these unlisted shares for a period of more than one year.

② After these unlisted foreign capital shares have been converted into circulating shares, the original owner must continue to hold them for a period exceeding one year.

③ The original owner of unlisted foreign capital shares should fulfil undertakings and duties in the light of particular undertakings to the company in the company's articles of association, shareholder agreements and other legal documents and particular duties and responsibilities required by laws and regulations.

④ Other conditions required by relevant laws and regulations on the issuing of share certificates on the market should be met.

Article 4 provides that the assignment by foreign investment enterprises (including joint-stock companies with foreign investment) of uncirculated shares to listed companies within China should be conducted in accordance with the relevant procedures and requirements as provided by the Interim Provisions for Investment within China by Foreign-investment Enterprises.

Currently, foreign-investment enterprises are not permitted to assign non-circulating shares to listed companies.

Article 6 provides that foreign-investment enterprises which meet the conditions can issue shares outside China.

On 1st November 2002, the Securities Regulatory Commission issued the Notice Concerning the Transfer of State-Owned Shares and Legal Person Shares of Listed Companies To Foreign Investors (SRC 2002, no. 83) which made the following provisions in respect of related problems.

① The transfer of state-owned shares and legal person shares of listed companies to a foreign investor should be in accordance with the requirements of the Foreign Investment Industrial Guidance Catalogue. No state-owned shares and legal person shares in any industries prohibited to foreign investors may be transferred to foreign investors. If the Chinese party must have controlling status or comparative controlling status, this status should be retained after the transfer.

② In principle, the transfer of state-owned shares and legal person shares of listed companies to foreign investors is to be conducted through open bidding.

③ The State Economic and Trade Commission is responsible for examining and approving any transfer of state-owned shares and legal person shares of listed companies to foreign investors which involves industrial policy or enterprise reorganisation. Where the administration of state-owned stock rights is involved, the Ministry of Finance is responsible for examination and approval. Important matters are reported to the State Council for approval. The transfer of the state-owned shares and legal person shares to foreign investors must be in accordance with the provisions of the China Securities Regulatory Commission on the purchase of listed companies and information disclosure.

④ After the transfer of state-owned shares and legal person shares of listed companies to a foreign investor, the net profits distributed by the listed company, income obtained from the reassignment of stock rights and funds distributed after the termination and liquidation of the listed company may be legally exchanged and remitted abroad after examination and approval by the Foreign Exchange Administration.

⑤ After the transfer of state-owned shares and legal person shares of listed companies to a foreign investor, the listed company shall still continue to implement its original policies and will not enjoy special treatment by the foreign investment company. On 7th March 2003, the former Ministry of Foreign Trade and Economic Development, the State Taxation Administration, the State Administration of Industry and Commerce and the State Administration of Foreign Exchange jointly promulgated the Provisional Rules on the Merger and Acquisition of Domestic Enterprises by Foreign Investors, which were implemented on 12th April 2003. They permit foreign investors to merge with and acquire domestic companies with no foreign investment by stock rights or assets. "Merger and

acquisition by stock rights” refers to the foreign investor agreeing to purchase the stock rights to a domestic company from shareholders or by subscribing to the increased capitalisation of a domestic company so that the domestic company changes its establishment to a foreign investment company. “Merger and acquisition by assets” refers to the foreign investor agreeing to purchase the assets of a domestic company and using them to invest in the establishment of foreign investment company to put these assets into use.

5. The current status of the market for corporate control for listed companies

(1) The structure of control rights in listed companies.

Just as the status of its shareholders differs, the A shares issued by Chinese stock exchanges can be divided into three types, namely state shares, state-owned legal person shares and public shares. State shares and state-owned legal person shares are generally known as state-owned shares and cannot be freely bought and sold in secondary markets. State shares are those where organisations or departments authorised to represent state investment obtain shares from joint-stock companies by subscription or by legal procedures. The registration of stock rights in joint-stock companies is under the name of the organisation or department holding the shares. State-owned legal person shares refers to state-owned enterprises, undertakings and other units qualified as legal persons and their legal use of legal person assets to obtain shares from joint-stock companies other than themselves by capital subscription or by statutory procedures. The registration of stock rights in joint-stock companies is under the name of the state-owned enterprise, undertaking or other unit holding the shares.

State stock rights should be held by investment organisations authorised by the state. Before such organisations have been made definite, they can be held by the State Property Administrative Department or by another organisation authorised to do so by the State Property Administrative Department on behalf of the government. When the holding of state stock rights is authorised, the State Property Administrative Department should go through authorisation procedures with the authorised unit and conclude an authorisation agreement which makes clear the rights and duties of both parties in such matters as the execution of stock rights, the collection of dividends and the assignment of stock rights. When organisations authorised to invest by the state hold state stock rights, the State Property Administrative Department acts for the authorised party in drawing up the relevant agreement.

State-owned legal person shares should be held by the state-owned legal person unit acting as the subject of investment and exercising stock rights.

On the basis of the Provisional Administration Method for State-Owned Stock Rights in Joint-Stock Companies, a state-owned enterprise changing its stock system should guarantee the controlling status of its state shares or state-owned legal person shares in accordance with the Interim Provisions on Some Questions on the Implementation of State Industrial Policies in Share System Experiments (the state-owned legal person unit should be a wholly-financed state-owned enterprise or company).

The controlling shares in state-owned stock rights are divided into absolute controlling shares and comparative controlling shares. By “absolute controlling shares” is meant where the ratio of the holding of state owned stock rights is greater than 50%; “comparative controlling shares” means that the ratio is greater than 30% and less than 50% but, because stock rights are dispersed, the state has a controlling influence over the joint-stock company. Calculations of the ratio of the holding should generally take the shares of one and the same unit and the holdings of two or more units with state-owned stock rights should not be summed.

Of the above requirements, the stock rights structure of listed companies shows a situation of highly concentrated stock rights and “one major shareholder” of state-owned shares. Until the end of April 2002, of the 1102 listed “A” share companies, the share holding ratio of the largest shareholder was as high as 44.86% on average, of which

890 exceeded 50%. The average ratio for the second largest shareholder was only 8.22%, less than 1/5 of the largest shareholder. On the basis of statistic for the type of ownership of the actual controller of listed companies, the control rights structure of listed companies is as shown in the following table.

Table 4-1 Control rights structure of listed companies

Actual controller	June 2003	2002	2001	2000	1999	1998	1997
State-owned enterprise	77.60%	78.92%	77.84%	76.47%	74.71%	74.62%	73.83%
Collective enterprise	4.48%	3.76%	4.05%	4.23%	4.85%	5.17%	5.50%
Privately run enterprise	8.80%	7.03%	7.07%	6.34%	6.95%	6.35%	6.31%
Foreign business	0.72%	0.90%	0.95%	1.01%	1.16%	1.18%	1.34%
Limited company etc.	8.40%	9.40%	10.09%	11.95%	12.33%	12.69%	13.02%
Total	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%

Of these, the control rights of state-owned enterprises include three sets of circumstances: ① absolute controlling shares where the largest shareholder holds more than 50% of the shares; ② comparative controlling shares where the largest shareholder holds more than 30% of the shares; ③ the holding of the largest shareholder is less than 30% but other types of large holding are dispersed and the state-owned enterprise remains the actual controlling shareholder.

Collective, privately-run and foreign business control means that the largest shareholder of a listed company is a collective, privately-run or foreign capital holdings enterprise. If the actual controller is a limited company, it means the largest shareholder is a joint-stock company. If the prospectus or other public notice does not define the actual controller of a holdings company clearly, it is always given under this heading.

(2) The scale of control rights transactions is getting larger year by year. The aim of these transactions is mainly shell purchases and arbitrage and the subjects of purchases are mainly state-owned enterprises.

Since 1997, the number of control rights transactions for listed companies and their volume has tended to rise year by year (See Table 4-2).

Table 4-2 The number a volume of control rights transactions for listed companies

Item	1997	1998	1999	2000	2001	2002
Number of listed companies with public control rights transactions	33	70	84	103	119	168
Average annual volume (100,000,000 Yuan)	0.64	0.91	0.91	0.95	1.41	2.02

Source: Lü Aibing, 2003

When viewed from the perspective of the aim of transactions, mergers and acquisitions by listed companies are mainly shell purchases and arbitrage and actual industrial mergers and acquisitions are few. "Industrial mergers and acquisitions" refers to the party being merged or acquired having a main field of business which is identical or

related to the listed company's. The value orientation of industrial mergers and acquisitions is the effect of coordination following a merger or acquisition, i.e. the benefits from an enterprise are raised by industrial integration following a merger or acquisition. Arbitrage mergers and acquisitions are also known as financial mergers and acquisitions. Their value orientation is towards the financial effects for a merger or acquisition, i.e. changes to the enterprise's financial indices by all means after a merger or acquisition and the use of all means to obtain profits from listed company arbitrage. Based on Lü Aibing's (2003) statistics, the ratio of industrial mergers and acquisitions of listed companies was only 25% and, prior to this, it was even less than 20%. When the cause was investigated, apart from the operation of arbitrage mergers and acquisitions being characterised by being rather simple with quick results, there were also system and structural factors. The listing of an enterprise is quite difficult for system reasons, the value orientation of mergers and acquisitions of listed companies is towards obtaining a "shell" and the business and value of the assets or the listed company are not valued at all. Where the merging or acquiring party is concerned, the aim of the merger or acquisition is funding or to obtain cash while the party being sold is mainly passive by nature. When control rights are granted, high premium arbitrage occurs. This idea of using a "shell" for the value orientation of mergers and acquisitions has resulted in a large number of arbitrage mergers and acquisitions.

From the perspective of the purchasing subject, mostly of state-owned enterprises, there is a rising trend in the purchase of the control rights of listed companies by privately run enterprises. According to statistics, of the cases of the transfer of the control rights of listed companies over the years, almost 60% of the purchasers are state-owned enterprises, much more than privately run enterprises. However, against the background of less state and more private involvement, there is also a rising trend in the purchase of the control rights of listed companies by privately run enterprises. The ratio of the total purchases of listed companies by privately run enterprises over the year rose from 21% in 1997 to 34% in 2002 (Lü Aibing, 2003).

(3) The method of transaction is mainly by agreed transfer with a rising trend of realising transfers through judicial channels but many problems remain.

When China began to experiment with the shareholding system during the mid 1980s, it was actuated by the principle of maintaining socialist public ownership and concern for the erosion of state-owned assets. Such practices as the requirement as a matter of principle that state-owned stock rights should occupy a controlling position and strict control over the circulation on the market of state and legal person shares continue today. Therefore, the vast majority of listed companies quoted on the Shenzhen and Shanghai stock exchanges have state and legal person shares. These shares normally account for a fairly high proportion of a company's overall capital stock and, for the time being, are not circulated on the market while publicly owned shares circulating on the market account for a correspondingly low proportion. Hence, it is difficult to achieve the aim of control two-level market acquisition commonly adopted by foreign stock markets. In these circumstances, the method of assigning state and legal person shares not circulated at exchanges through transfer by agreement and obtaining control rights of listed companies as a result has become the most operable method of obtaining such control rights in Chinese stock markets at present (See Table 4-3).

Table 4-3 Summary of the means of transferring corporate control by listed companies

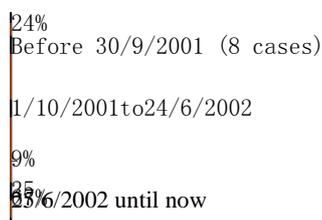
Acquisition method		1997	1998	19999	2000	2001	2002
Free transfer	Number (firms)	7	18	30	27	25	29
	Proportion	21.2	25.7	35.7	26.3	21	17.3
Judicial auction/ court ruling	Number (firms)	0	0	1	3	14	10
	Proportion	0	0	1.2	2.9	11.8	6
Purchase of listed company control rights by agreement	Number (firms)	26	47	46	68	70	104
	Proportion	78.8	67.1	54.7	66	58.8	61.9
Purchase of parent company's stock rights	Number (firms)	0	4	5	2	4	11
	Proportion	0	5.7	6	1.9	3.4	6.5
Reconstruction of parent company	Number (firms)	0	1	2	2	6	14
	Proportion	0	1.4	2.4	1.9	5	8.3

Source: Lü Aibing, 2003

In recent years, the method of transferring the state-owned stock rights of listed companies realised with the help of judicial channels has been an increasing trend and many problems remain in practice. We shall introduce them here.

Since November 2000, there have been 33 cases of the transfer of the state-owned stock rights of listed companies through judicial channels, involving 31 listed companies (of which two have had stock rights transferred twice). After the transfer of the above companies' state-owned stock rights through judicial channels, there was a change to the largest shareholder in ten of them while corporate control remained unchanged in 21. Of these, 18 were realised through judicial auctions.

Figure 4-1 Cases of the transfer of corporate control realised through judicial channels



As the Figure shows, there was a peak in transfers of this kind in September 2001 with six in one month. This was because, on 28th August 2001, the Supreme People's Court passed the Provisions on Some Questions Concerning the Freezing and Auctioning of State-Owned Shares and Social Legal Person Shares in Listed Companies. This was implemented on 30th September, and therefore, during the period after its promulgation and before its implementation, there were a number of cases of rushed transfers in order to avoid such procedures as

auctions required after implementation.

Following the publication and implementation of the Method of Managing Acquisitions of Listed Companies and the Method of Managing the Disclosure of Information Concerning Changes to the Share holdings of Listed Companies, the procedure for the assignment of the share rights of listed companies became more standardised. There was also some increase in the difficulty of transferring the corporate control of listed companies through normal transactions. For this reason, there was a rapid increase in cases of the transfer of the stock rights of listed companies through judicial channels. There have been more than twenty cases alone since the second half of 2002. An analysis of the cases has revealed that there are the following kinds of models of transfers of the state-owned stock rights of listed companies through judicial judgements and executive procedures.

① When holders of state-owned shares in listed companies sign stock rights transfer agreements with the assignees, before authorisation has been obtained or if there is any obstacle to the authorisation, the assignee brings a claim to a court on the grounds that the assignor has not executed his duties in respect of the transfer and the court makes a judicial judgement to carry out the transfer of ownership such as Shenzhen Electronics Group shares.

② Before judicial procedures begin, a loan contract between the holder of the state-owned shares and the assignee or a third party is fabricated and an agreement is signed illegally which is then used to bring a claim to court or to carry out notarisation and obtain execution. The court upholds an auction, determines the amount of compensation or else makes an assignment to a third party, for example ST Jinpan.

③ Before judicial procedures begin, a transaction, matter for cooperation or collateral relationship is fabricated and an agreement is signed illegally which is then used to bring a claim to court or to carry out notarisation and obtain execution. The court upholds an auction, determines the amount of compensation or else makes an assignment to a third party, for example Sino-Microelectronics.

These non-standard practices cause the following harm.

① Nobody checks to see if the assignee possesses a principal's qualifications

When state-owned stock rights are assigned without supervision, the phenomenon may arise of the assignment of listed company stock rights where the assignee lacks intellectual, financial or operational ability or even lacks a principal's qualifications so that state assets cannot retain or increase their value and the ability of listed companies to sustain their operations is seriously affected. For example, numerous investment companies are assigned state stock rights such as Meida Nylon, Longyuan Shuangdeng and Qingqi Haiyao. It is very difficult to ensure that they have the right qualities and operational and managerial abilities.

② Unsupervised transfers at a set price

It is easy for state-owned stock rights to be transferred at a comparatively low price and for state-owned assets to be improperly eroded. The transfer price in some cases was even lower than the short-term net assets at the time including Daye Steel, ST Refrigeration and Hebei Huayu. Of these, the transfer price of Daye Steel was not even one third of the short-term net assets at the time while, in the case of ST Refrigeration, the single transfer of two parts of the stock rights involved two creditor's rights with evaluations of 1.04 Yuan and 0.79 Yuan respectively. This was very difficult to understand.

③ Necessary information disclosure is lacking

In some cases, the announcement is very simple and does not make necessary information public. For example, in the announcement by Chongqing Dayuan the transfer price was not disclosed. In the announcement for ST Hongye and ST Northeast Electrical Power, neither the stock rights transfer price nor the creditor were disclosed. ST Northeast Electrical Power failed even to publish a report on changes to the shareholders' holdings as required

by the Administration Method for the Disclosure of Information concerning Changes in Share Holdings in Listed Companies. This inevitably harmed the interests of small and medium shareholders while causing more speculation about what was really going on behind the scenes. Even if a “report on changes in share holdings in a listed company” is made public as provided, this is not sufficient to enable the public to understand the ins and outs of relevant transactions before the transfer of state-owned stock rights, including the reasons for and changes to the details of the case and the resolution of the negotiations for the plan and choices made. Since there is no requirement in the Administration Method for the Disclosure of Information concerning Changes in Share Holdings in Listed Companies that persons disclosing information should provide more details about such matters, this also provides a loophole for false transactions and *camera obscura* operations.

④ The challenge to the system of acquiring listed companies

The Method of Managing the Acquisition of Listed Companies provides that, when transfer of ownership of stock rights as a result of judicial judgement exceeds 30%, the purchaser may apply to the Securities Regulatory Commission for exemption from the duty of a tender offer. Such a provision which originates in the deference of executive power towards judicial power can, in certain circumstances, be reduced to an effective measure by which the purchasers of the corporate control of a listed company manipulate the administration of justice, using judicial channels to evade execution of their duty to tender an offer to purchase.

(4) Overview of the market for corporate control for non-listed companies

1. Stock exchanges

Trading in the control rights of non-listed companies is mainly carried out in the property rights exchanges (property rights trading centres). The experience of the development of property rights exchanges in China has been tortuous. It may be regarded as a special product of the course of reform in China and is intimately linked to the reform of Chinese property rights.¹

(1) The preliminary exploratory stage of getting practical experience

The Third Plenary Session of the 12th CCP Central Committee during October 1984 passed a Resolution of the Central Committee of the CCP on Reform of the Economic System. The resolution pointed out that, “the establishment of a lively, vigorous socialist economic system with Chinese characteristics and the stimulation of the development of social productive forces are our basic tasks in this reform”. The reform of state-owned enterprises was classified as a central link in the reform of the Chinese economic system. Mergers and acquisitions of Chinese State-owned enterprises began to appear. The number of mergers at the time was quite few with spontaneous transactions existing alongside government interference, the majority of them occurring in the same area, the same industry or the same department. The initial motive was to eliminate loss-making enterprises through mergers.

(2) The developmental stage of high and low tides

During the early 1980s, property rights transactions appeared. Policy regarding them was formulated during the late 1980s. In October 1987, the report of the 13th CCP Central Committee pointed out that “the property rights of some small and medium-sized enterprises owned by the whole people may be transferred to collectives or individuals for payment”. In March 1988, the First Meeting of the Seventh National People’s Congress also made the “implementation of the conditional transfer of enterprises for payment” an important measure in intensifying the

¹ Property rights and control rights are not completely identical but the latter is dependent on the former and they are closely linked.

reform of state enterprises. In February 1989, the State Economic System Reform Commission, the State Planning Commission, the Ministry of Finance and the State Administrative Bureau of State-owned Assets printed and distributed the Provisional Method for Merging Enterprises and the State Economic System Reform Commission while the Ministry of Finance and Administrative Bureau of State-owned Assets jointly issued the Temporary Provisions on the sale of small state-owned enterprises. They pointed out that, "Where the conditions are right, it is also possible to organise enterprise auction markets and property rights exchange markets". This was the time of the first high tide of share reform in China. Chinese property right exchanges came into being against this background. In May 1988, Wuhan City took the lead in establishing the first enterprise property rights market – the Wuhan City Enterprise Merger Market Agency - and formulated corresponding operating rules. In the same year, such places as Baoding, Nanjing, Fuzhou, Chengdu and Shenzhen founded enterprise property rights transfer markets or property rights exchanges one after the other. This phase of enterprise mergers and the transfer of property rights expanded from a small number of cities over the whole country and the scale of mergers also began to develop across local and industrial boundaries. The aim of mergers developed from the simple elimination of loss-making companies towards self-conscious structural optimisation while the methods of merging began to be diversified. As a result of macroeconomic retrenchment during the second half of 1989, there appeared to be a shortage of enterprise funds and the entire national economy entered a phase of improvement and rectification. The impetus towards mergers and transfer of property rights grew somewhat weaker. As far as methods of transfer were concerned, there was some increase in free transfers within the same area or department.

(3) The development phase of "services handling state-owned assets in a flexible way"

Between 1992 and 1996, the second high tide of mergers appeared in China. During the spring of 1992, Deng Xiaoping delivered his southern tour speech and, in October of the same year, the Chinese Communist Party held its 14th National Congress. The aim of the proposed reform of the economic system was the establishment of a socialist market economy enabling the market to play a fundamental role in the allocation of resources subject to socialist macroscopic adjustment so that they are allocated in key areas where greater benefits may be obtained. The specific requirement of "industrial structural adjustment and product structural adjustment" was also put forward. With the orientation of the reform of the Chinese economy firmly set towards the market economy, the reform of the property rights system also became an important component of enterprise reform. The cultivation and development of property rights transactions and the property rights market, with the aim of two structural adjustments, was increasingly subject to government attention and was followed with interest by all sections of society. There were breakthroughs both in scale and operation with respect to the acquisition of enterprises. "Services handling state-owned assets in a flexible way" became a powerful motive force in stimulating the development of the property rights market.

After 1992, property rights exchanges entered the first high tide of their development. The Shanghai Property Rights Exchange (known at the time as the Shanghai Urban and Rural Property Rights Exchange) was founded in April 1994 as an experiment in transactions in the property rights of suburban (county) collective enterprises. At the same time there was also considerable development in the markets for property rights transactions in Shenyang, Guangzhou, Shenzhen, Hangzhou, Nanjing, Wuxi, Nantong and Huzhou. Local organisations for property rights transactions played an important role in fostering market configuration as part of the services handling state-owned assets in a flexible way. According to statistics, during early 1993 the number of regional property rights transaction

centres and markets nationwide was almost 20¹. This phase can be seen as the initiation phase of property rights exchanges. Its basic features were that the market in property rights was mainly an invisible one with evident autonomous characteristics, the numbers of property rights transactions was small and the transaction methods were almost always in the form of the assumption of debts, the replacement and sale of assets and putting up capital to purchase an enterprise as a whole.

After 1994, although the state published relevant policy restrictions on property rights transactions², this by no means impeded their growth. By 1997 the market had heated up to its peak and more than 200 “property rights exchanges”, “property rights transaction centres” and “property rights markets” emerged in various places throughout the country. However, the development of property rights exchanges during this phase was rather reckless and disorderly and there were many problems. This was the phase of the rapid development of property rights exchanges.

(4) The developmental phase of reorganisation and rectification

In 1998, in view of serious infringements of regulations by some property rights exchanges, the General office of the State Council issued its Document No. 10 of 1998 to bring order to finance and to prevent financial risks. The document gave specific orders prohibiting split transactions and transactions in non-listed companies which it considered to be “illegal over-the-counter transactions in share certificates “. Property rights markets in Chengdu, Leshan, Wuhan and Zibo were closed as a result. Although as many such markets did not close, in fact they were in a half-closed or half-suspended state, only operating normally in Shanghai and Shenzhen. This phase was the phase of reorganisation, rectification and adjustment.

Naturally, the property rights market by no means came to a standstill during this period. In September 1999, when the 15th National Congress of the Chinese Communist Party was held, its report emphasised the task of adjusting and perfecting structures of ownership. It pointed out that, “It is possible to strengthen key sectors through the reorganisation of assets and structural adjustment and to increase the overall quality of state assets. It is necessary to have the enhancement of the whole national economy in mind. A strategic reform of state-owned enterprises will be realised by focussing on the restructuring of large enterprises and being flexible in respect of minor ones.” In order to develop the use of the property rights market in a standardised way, the direction for obtaining better standards in development was clearly indicated.

(5) The phase of redeveloping the “mechanisms for fostering market configuration”.

In September 1999, the Fourth Plenum of the 15th National Congress reiterated that the direction of the reform of state-owned enterprises was towards the establishment of a modern enterprise system with “distinct property rights, clear rights and duties, the separation of government and business and management science.” The Party’s 16th National Congress clearly pointed out that the property rights market should be developed, creating an

¹ See Industrial and Commercial Times, 7th July 1994.

² On 25th April 1994, the State Administrative Bureau of State-owned Assets transmitted Document GZZF [1994] No. 20, Notice of the General Office of the State Council on Strengthening the Management of the Property Rights Transactions of State-Owned Enterprises, as an open telegram. The Notice provided that, “The activities of property rights markets and organisations are suspended”. This is the 1994 open telegram, which is famous in the industry. Subsequently, formal state documents almost all adopted a restrictive attitude towards the development of property rights exchanges.

environment where a variety of market types make use of key production factors on an equal basis and stimulating the free flow of key commodity and production factors in the national market. Guided by this spirit, China's property rights market has entered a phase of standardised, healthy development and of new developments. Transaction organisations everywhere are thriving and play an important role of market configuration in respect of the strategic adjustment of the state-owned economy and state-owned enterprises.

During this time, a large number of property rights transactions organisations were formed, represented by the Shanghai property rights exchange, which obtained the approval of local governments and expanded without interruption. A large-scale transactions network system with the Shanghai Property Rights Exchange at its centre and orientated towards the whole country and even the world had begun to take shape. Property rights exchanges were established in all provinces, cities and autonomous regions to the extent that many have even appeared at county level.

2. Principal participants

Apart from mutual and intermediary control rights trading organisations, SASAC, the Ministry of Commerce and the State Development and Reform Commission, which were all mentioned above as participants in the market for the corporate control of listed companies, are similarly the principal participants in the market for corporate control of unlisted companies.

3. Transaction methods

At present, property right transactions by property rights exchanges mainly take the following forms.

(1) Transfer by agreement: this refers to a method of transaction in which the assignment of property rights is by an agreement discussed by both parties to the transfer.

(2) Competitive price auctions: this refers to a method of transaction where there are several intended assignees for the assignment of property rights, the subject matter is quite simple, the form is open competition and the deal is struck by the one offering the highest price.

(3) Transfer by invitation to tender: this refers to a method of transaction where there are several intended assignees for the assignment of property rights, the subject matter is quite complex, the form is open competition and the deal is struck by a tender evaluating committee deciding which is the best tender.

4. Laws and regulations standardising transactions in the corporate control of non-listed companies

The provisions of the Company Law on share transfers and company mergers introduced above, the provisions with respect to the management and transfer of state-owned stock rights of the Provisional Administration Method for State-Owned Stock Rights in Joint-Stock Companies, the Notice on Some Questions Concerning the Management of State-owned Stock Rights by Joint-stock Companies and the Provisional Regulations for the Supervision and Management of Enterprise State-owned Assets and the provisions on mergers and acquisitions by foreign investors in the Provisional Rules on the Merger and Acquisition of Domestic Enterprises by Foreign Investors are all applicable to transaction activities in the control rights of unlisted companies.

Where the property rights transactions markets are concerned, currently there are only local government rules and no unified, national laws and regulations. In 1996, the State Administrative Bureau of State-owned Assets printed and distributed the Opinion Giving Guidance on the Establishment of a System for Supervising the Enterprise Property Rights Market (GZCF 1996, No. 25). This put forward several opinions concerning the active fostering and development of an enterprise property rights market system, the strengthening of the management of

intermediary organisations transferring enterprise state-owned assets, the establishment of a supervisory system for the enterprise property rights market, emphasis on experimentation and good training of personnel.

5. The current status of the market for corporate control for non-listed companies

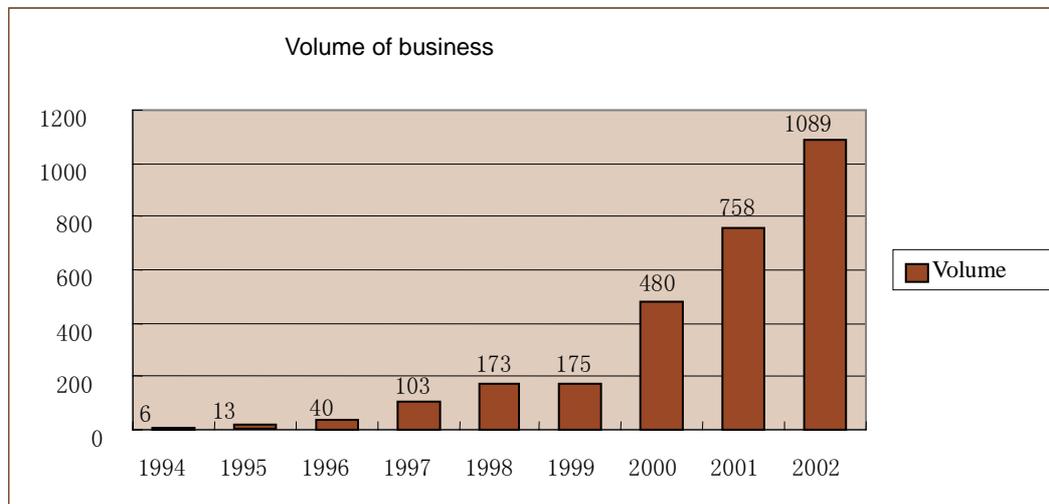
According to statistics, the property rights transactions centres, markets, exchanges and the property rights transactions departments of the State Property Administrative Department in various places currently number more than 2,000 above county level in China. At a rough estimate, the funds circulating at these markets may be approximately 100,000,000,000 Yuan. At present, some property rights exchanges have emerged that are influential on a national scale. The Shanghai and Shenzhen Property Rights Exchanges are the two most important

(1) The Shanghai Property Rights Exchange

The precursor of the Shanghai Property Rights Exchange was authorised by Document No. 1 (1994) of the Shanghai People's Government and was jointly established by the Shanghai Agricultural Commission, Economic System Reform Commission, Industry and Commerce Administration and Management Bureau, the Suburban Industrial Management Bureau and the Land Management Bureau. On 20th April, the Shanghai Urban and Rural Property Rights Exchange began pilot running. In March 1996, the Shanghai City Committee and City Government resolved to reorganise it and to call it the Shanghai Property Rights Exchange. This exchange was not much affected during the rectification around 1998 and continued to function normally.

As the property rights transactions centre for the whole country, up to the end of 2002, the Shanghai Property Rights Exchange had ranked first in the whole country for its volume of transactions for six successive years.

Figure 4-2 the volume of business of the Shanghai Property Rights Exchange over the Years



Source: Liberation Daily and the Shanghai Property Rights Exchange website

We can see from the Figure the rapid growth of the volume of transactions of the Shanghai Property Rights Exchange. From 1994 to 2002, the cumulative volume of its transactions was 13,031 cases for a total of 286,360,000,000 Yuan. Of its transactions during 2002, those for state-owned property rights alone accounted for ¼, while mixed economy property rights transactions, including state funded equity participation and controlling shares, accounted for ½. Today, the development of Shanghai Property Rights Exchange is even more rapid, with a total of

2,386 cases completed over the past eight months and a volume of transactions of 100,198,000,000 Yuan, breaching the 100,000,000,000 Yuan barrier at a stroke with the number of transactions double that for the same period in the previous year and close to the total volume of transactions of 108,940,000,000 for the whole of 2002. It is sure to remain first among the property rights exchanges throughout China.

(2) The Shenzhen Property Rights Transactions Centre

In 1993, the Shenzhen Structural Reform Office and the Shenzhen Investment Management Company jointly took the lead in setting up the Shenzhen Property Rights Exchange. In August 2000, the city changed the Shenzhen Property Rights Exchange to a city institution and changed its name to the Shenzhen Property Rights Transactions Centre, under the direct leadership of the Shenzhen State-owned Assets Management Office. Up to now, enterprises participating in transactions at the Shenzhen Property Rights Exchange extend throughout China (see Figure 4-3).

Figure 4-3 Distribution of enterprises participating in transactions at the Shenzhen Property Rights Transactions Centre



Apart from these two comparatively large property rights exchanges, some are tending to combine and set up a regional property rights transactions organisation. In 2000, Qingdao initiated the establishment of the Yellow River Basin Property Rights Transactions Common Market. In 2002, the establishment of the Northern Property Rights Transactions Common Market was initiated with Tianjin at the forefront. Together with the Yangtze Basin Property Rights Transactions Common Market founded in 1997 with Shanghai at its centre, there is a basic structure of three large regional property rights transactions markets running from north to south. Of these three common markets, only the Yangtze Basin Property Rights Transactions Common Market is quite mature while the other two are still developing.

There has been considerable development, too, in the technological means of property rights transactions. In 2001, the Shenzhen Property Rights Transactions Centre developed the Shenzhen Property Rights Transactions Management Software System using modern networked information technology, reinforcing management, reducing costs and increasing efficiency. Throughout the country at present, some of the main property rights exchanges are also using fairly advanced transactions systems.

Currently, there are some problems in the development of property rights exchanges which are worthy of

attention.

① Symptoms of precipitate action have appeared. As many as three or four exchanges of an identical nature may exist in a single city. In a situation where technical and capital resources are limited, it is difficult for property rights exchanges to attain the scale of transactions needed to maintain their existence. In fact the business of many exchanges is slack and in some cases there is an exchange but no market. An even more serious problem brought about by precipitate action is that they are a mixed lot. In particular, with the lack of standards, it is easy for excessive competition to obtain resources to emerge between exchanges out of the need to survive. Some exchanges may also be forced to take part in some transactions which go against regulations and which result in the healthy development of the market being affected and latent danger from hidden risks.

② There is a lack of standards in the operations of exchanges. Currently, property rights exchanges everywhere are basically in an exploratory phase of feeling their way forward one step at a time. Some exchanges limit the scope of their business to acting as an intermediary, only acting as a go-between for transactions between members and providing information. Some exchanges both set up trading platforms and take part in relevant operational services such as project introductions and consultancy. Some exchanges are located in investment banks and directly represent investors or else seek investors for the party being sold and provide global packages for technological projects or enterprises. There are also some exchanges which, because of a lack of income resources, take part in economic activity which has nothing to do with property rights transactions. In addition, where trading rules are concerned, each exchange has its own set and there is no unity whatsoever.

③ There is a lack of effective supervision. Property rights exchanges are like stock exchanges in that there are problems of information disclosure and fair trading. In order to encourage the healthy development of property rights transactions markets, standardise the actions of property rights exchanges and protect the rights and interests of both parties to a transaction, strict supervision is necessary. During the early 1990s, the State Administrative Bureau of State-owned Assets at the time had promulgated the Opinion Giving Guidance on the Establishment of a System for Supervising the Enterprise Property Rights Market (GZCF 1996, No. 25). Apart from Shanghai however, the overwhelming majority of provinces and cities failed to establish a supervisory body. Nor did central government establish a national supervisory body for property rights exchanges as it had done for the stock market. This was unfavourable for the development of the property rights transactions market.

(5) Prospects for the market for corporate control

As an emerging market economy en route to globalisation, the Chinese economy needs mergers and acquisitions in order to complete its change of course towards the market economy (a change to property rights completed through the purchase of stock rights). It needs the help of mergers and acquisitions to progress from emergence to maturity (adjustment and maturity of industry completed through reorganisation). It also needs the help of mergers and acquisitions to meet the challenges and opportunities brought by the WTO. In an environment where state-owned assets are gradually being withdrawn from competitive activity and are in a process of gradual opening up to private capital and foreign funding, the market for corporate control is being acknowledged.

On 1st December 2002, the Method of Managing Acquisitions of Listed Companies and the supporting Administration Method for the Disclosure of Information concerning Changes in Share Holdings in Listed Companies formally took effect. Based on full disclosure of information, the implementation of these two methods symbolised the basic formation of a legal framework for acquisitions, which encourages the acquisition, and merger of listed companies and safeguards the rights and interests of investors. In accordance with the active encouragement of basic legislative principles, the Acquisitions Method has many innovative features. For example, there is no limit on

the purchasing subject, whether it is a natural or legal person, state-owned, private or foreign-financed, it can participate equally in the activity of purchasing listed companies. A further example is the diversification of payment methods. It is permissible to use cash and it is also legal to use other methods of payment as provided by the law when transferring securities. Payment methods for mergers and acquisitions such as oriented additional shares issues, conversions and share exchanges are supported. Every effort is made to make the procedure crystal clear to reduce uncertainty and to reduce purchasing capital while, at the same time, safeguarding the lawful rights and interests of shareholders. Against such a background, it is possible to predict that the future of the market for corporate control for listed companies will be even more dynamic. Also, where methods of purchase, the purchasing subject and the target of the purchase are concerned there will also be changes. In the short term, purchase by agreement will remain the main method by which the purchaser obtains control rights to listed companies. In the long term, however, in the wake of the standardisation and further development of the capital market, the main stream of purchases of listed companies will be through such marketised methods as public price competition. Where the purchasing subject is concerned, a diversified situation will emerge in which state-owned, private and foreign capital enterprises coexist. The absolute dominance of state-owned enterprises in the acquisitions market will be broken. As far as the targets of acquisition are concerned, the perfection and implementation of laws and regulations pertaining to acquisitions will gradually reduce the profit gap of mergers and acquisitions purely by arbitrage while industrial mergers and acquisitions will gradually move over to become the main stream.

As far as the market for corporate control for unlisted companies is concerned, there is an urgent need for the legislative standardisation of the transactions market with clear definition of such matters as examination and approval organisations for the subjects of property rights transactions, also supervision and management, the main regulations for property rights transactions, transaction procedures, the use of income from transactions and the sale of state-owned property rights to foreign businesses. With regard to the question of establishing a national united property rights transactions market, opinions are currently divided. It has been announced in the media that relevant departments are actively studying the integration of the property rights exchanges present throughout China and will finally create a single, comprehensive, national, unified property rights exchange combining such related activity as property rights transactions, mergers and reorganisations, and setting up a national exchange platform for the transfer of the property rights of state-owned companies. However, this news has yet to be verified. It can be anticipated that, in the wake of the intensification of the reform of the state-owned asset management system, the market for corporate control for unlisted companies will also gradually tend towards standardisation and maturity.

5. Conclusions

The market for corporate control mainly refers to the market for acquisitions and mergers where there is competition for control rights. In the theory of the market for corporate control, the conduct of takeovers by companies in that market and the accompanying threat of takeover are external control mechanisms, which can reduce agency costs. The opposing view considers that the market for corporate control cannot resolve principal-agent problems and that, on the contrary, mergers and acquisitions are manifestations of acts of agency that can exacerbate contradictions between management and shareholders.

In such countries as the U.K. and U.S.A., company stock rights are highly decentralised and shareholders have limited influence over companies' operations and management. The market for corporate control is quite dynamic and its functions can be effectively brought into play. In such countries as Japan and Germany and in countries of Southeast Asia where there are family holdings, the market for corporate control is by no means dynamic since

stock rights are more concentrated.

In China, transactions in enterprise control rights began in 1984 in such cities as Baoding and Wuhan. Its development can be divided into five phases from an initial phase between 1984 and 1987, a first high tide in control transactions between 1987 and 1989, a low ebb between 1989 and 1992, a second high tide between 1992 and 1996 and a third high tide from 1997 until today. Since 1997, the scale of transactions in the control of listed companies in China has expanded year by year. The aim of such transactions has been mainly shell purchase and arbitrage, with the purchasing subject being mainly state-owned enterprises

With China's state-owned assets gradually being withdrawn from competitive industry and the gradual process of opening up in the direction of privately run capital and foreign investment, the functions of the market for corporate control are being recognised. As China's legal system and standards regarding the merger and acquisition of listed and unlisted companies constantly improve, the market for corporate control of both listed and unlisted companies in China is moving progressively in the direction of standardisation and maturity.

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