

## Money Grab in China

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**Abstract:** Prior to recent reforms, it was easy for controlling shareholders in Chinese firms to siphon off funds. The popular press referred to a money grab (Quanqian) in which funds raised in the stock market were not used by the firms at all and instead were transferred directly to the controlling shareholder, usually a holding company. Investors in Chinese firms are counting on the effectiveness of the reforms in removing the money grab. We look at evidence of a money grab before reforms, and we describe the reforms and discuss the challenges investors should be aware of if they are contemplating investments in Chinese companies.

**Keywords:** money grab, controlling shareholder, rights issue

## **1. Introduction**

Ideally, firms raise money from the capital market when they want to launch positive-NPV projects. However, weak protection of minority shareholders has allowed controlling shareholders to deviate from the NPV principle and to do what the Chinese popular press refers to as a "money grab" (Quanqian). In a money grab, a firm raises capital for transfer to the controlling shareholders, usually a holding company, not for use within the firm. In effect, the listed firm becomes a conduit for capital and the minority shareholders' interests are seriously damaged. This agency problem was especially severe in China because corporate governance and security laws were not well established. In particular, a money grab is viewed as a major cause of the Chinese bear market from 2001 to 2005. This paper documents evidence of a money grab in Chinese market, outlines newly-enacted reforms intended to eliminate the problem, and some remaining challenges.

In a listed Chinese firm, it is common for the largest shareholder to be a holding company that is a state-owned enterprise (SOE) and has a controlling interest. At least in the past, Chinese law and institutions provided little protection of minority shareholders from transfer of the company's assets to the holding company. As a result, a money grab is available and often follows a three-step process. First, a listed firm manages earnings to qualify for raising money, typically as a rights issue by a subsidiary that looks attractive to the market. Second, money is raised in the secondary market, but controlling shareholders decline to exercise their own rights because they know it is a bad deal, for the funds will be siphoned off. Third, the money is siphoned off and the firm announces it is not undertaking the projects mentioned in the original application to regulators to make a rights issue.

Using the data from Chinese rights issues market; we find strong evidence of a money grab. As evidence of earnings management, we observe that the ROE distribution is concentrated around the regulatory threshold of seasoned equity offering, and the concentration changes as the regulatory threshold changes. As evidence that controlling shareholders do not believe they are raising money for good projects, we document that the more power controlling shareholders have, the more likely they are not to exercise their rights. As evidence that the funds are deflected, we found that highly concentrated ownership usually results in changing the use of proceeds after rights issues. These empirical results are all consistent with the three-step money grab we are

describing.

We also point out the mechanism behind these phenomena and the implicit rules that investors must be aware of when investing in Chinese market. Money grab has been and may still be a fundamental problem of Chinese stock market, even after the recent “successful” share-trading reform. Understanding the history and regulatory structure is essential for any investor reasonably expecting to make money in the Chinese market. The bull market in 2006 and 2007 indicates that investors believe that recently-enacted reforms will be effective in reducing the money grab and other agency problems. This is a bet that any investor in the Chinese market will share. We expect that the reforms are useful but not a silver bullet that will end all problems, and there remains an important role for understanding the ownership and governance structure of firms you are investing in.

## **2. The Chinese Stock Market: History and Recent Reforms**

Established in the early 1990s, the Chinese stock market has experienced fast growth. Initially, the stock market was created for SOEs to raise money from the capital market. By the end of 2005, the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE) had 1,381 listed companies, with a total market value of 762.95 billion US dollars.

### **2.1 Share Structure and Share-Trading Reforms**

Before share-trading reforms, the ownership structure was concentrated, representing a partial transition from an economy in which most enterprises were owned by the state. There are five types of mainland Chinese shares: state shares, legal-person shares, employee shares, A-shares and B-shares. (There are additional types of shares in Hong Kong and overseas stock markets: see Andrew and Wu, 2005.) Legal-person shares are the shares obtained by a state-owned legal person industrial enterprise or state-owned legal person non-industrial entity. They are similar to state shares in the sense that they are held by SOEs or government agencies. Neither legal-person nor state shares were tradable prior to share-trading reform, but legal-person shares were transferable between domestic institutions upon the approval of CSRC. A-shares and B-shares are tradable, but they are a very small part of market capitalization. For example, 63% of

the shares were not tradable in 2003. The largest shareholder controls more than 40% of the total shares in around 80% of listed firms, while the second largest shareholder typically owns less than 10%. As a result, large shareholders can select the board of directors and the supervisory board, ignoring the preferences of A and B shareholders.

This split-share structure (between tradable shares and non-tradable shares) and the concentrated ownership structure are the results from partial privatization of SOEs. At the beginning of the Chinese stock market, the government intended to privatize SOEs partially to raise capital and improve their operating performance. As a result, a large number of listed firms were created from the existing SOEs through carve-outs. In that process, part of a business group, usually the attractive and profitable part, was carved out to become a listed firm. The original business group remains as the parent firm, as well as the controlling shareholder.

In January of 2004, the state council called for comments on how to promote the share-trading reforms. This showed the Chinese government's determination to change the structure of the stock market. One year later, under the permission of state council, the CSRC issued "Notice on the Pilot Reform of the Share-Trading Business of Listed Companies" in April of 2005, which started the share-trading reform process with four listed firms. By November of 2006, 1200 firms accounting for 96% of listed companies had completed the restructuring. During the reform, many new regulatory policies were launched, such as new accounting standards which aimed to improve transparency and to protect the interest of minority shareholders.

The motivation of the share-trading reform is to reduce the inefficiency caused by the split-share ownership structure. It has been argued that prior to reform, managers focused too much on book value, since any trades of state shares or legal shares approved by the CSRC took place at book value. Since the stock price will become the unique measure of interests of both controlling shareholders and minority shareholders, it was hoped that interests of the two parties will become more consistent. However, a model in our paper illustrates that the money grab will be attractive to controlling shareholders even if they value shares at market. Also, our empirical evidence suggests that valuation at book is not the primary cause of firms' behavior.

Investors seem to believe that the Chinese stock market has improved a lot since the completion of the reform. In 2006, The Shanghai Composite Index increased from 1180 to 2675

and the total capitalization of the Shanghai Stock Exchange grew to 5.9 trillion RMB (737.5 billion US\$), nearly double that of 2005. Total market capitalization of both the Shanghai Stock Exchange and the Shenzhen Stock Exchange was over 7.5 trillion RMB (937.5 billion US\$), about 35% of GDP. The trading volume was about 2.6 times of 2005. Based on the survey by World Federation of Exchanges (WFE), the Shanghai Stock Exchange is ranked 19<sup>th</sup> in the world with trading volume ahead of India, Oslo and has a larger volume of IPOs than NASDAQ. The large price increase for existing shares and the success of new issues both suggest that investors have confidence in the success of the reforms.

## **2.2 Institutional Environment**

The institutional environment for minority shareholders in China has changed a lot with the introduction of the new Company Law. According to the old Company Law enacted on July 1<sup>st</sup> of 1994, corporate governance in China includes shareholders, a board of directors, a board of supervisors, and managers.

As specified by the old company law, the board of directors is responsible for hiring and supervising the managers who are responsible for day-to-day operations of the firm. In turn, the board of supervisors oversees the board of directors and has the right to call a shareholders' meeting to make the board face re-election. In practice, shareholders have the rights to vote in the shareholders' meeting, and they ratify many of the choices of the board. Both boards were elected without proxy voting in the shareholders' meeting. As a result, the old law made it easy for a controlling shareholder to have absolute control over board composition. This environment was ideal for a money grab.

According to the old laws and regulatory rules, minority shareholders could seek protection from the CSRC or the court system. They had "rights to know" and they could use legal system to sue for their rights. However, the scope of these rights was quite limited. Minority shareholders could only ask for the shareholders' meeting record and financial statements, and they could not choose the auditors. Meanwhile, it was prohibitively expensive for a single minority shareholder to file a law suit. There didn't exist class action suits or any similar mechanism. As a consequence, the enforcement of minority shareholders' rights was not effective. Of many possible violations of

securities laws, in practice only false statements and other disclosure failures were controlled by lawsuits. In these cases, settlement was rarely reached. Usually, the firm would be fined by the CSRC or the court, and there was no remedy for the minority shareholders.

The Chinese government had realized the above problems and started to make stricter legislations and rules on the protection of minority shareholders recently. On January<sup>1<sup>st</sup></sup> of 2006, a new Company Law was implemented.

The scope of “the rights to know” was expanded. Compared to the old law, minority shareholders have stronger rights to check company rules, shareholders’ meeting records, directors’ meeting records, supervisors’ meeting records, and financial records. The new Company Law also changed to a cumulative voting system, which allows shareholders to multiply his voting rights by the number of candidates and vote them all for one candidate of director or supervisor. This is not enough to give minority shareholders’ representatives enough votes to counter the controlling shareholders’ representatives directly, but it may be enough to get one representative who can report any misdeeds to the board of supervisors or the CSRC.

The new law also regulates voting when there is a conflict of interest. In particular, when some shareholders’ interests are affiliated with the terms discussed in the shareholder meeting, they and their representatives must recuse themselves and can’t vote on the transaction. This rule helps to prevent affiliated transactions which are in favor of the controlling shareholders’ interests.

Another potential improvement of the new Company Law is the new representative suit system. When firm’s interest is harmed and the controlling shareholders don’t execute their rights to sue, minority shareholders can file a suit on behalf of the company. This rule allows the minority shareholders to sue without reaching an agreement with the controlling shareholders, and it is especially useful when the controlling shareholders harm the interests of the firm or the board of supervisors is not effective. Despite being far from a full class action mechanism, the new Company Law is a start towards it.

After the implementation of the new Company Law, the institutional environment should be much better for minority shareholders. However, the governments in most developing and transitional economies fail to enforce their laws, rules, and regulations consistently and evenly. The protection of minority shareholders will take some time to be eventually realized. Also, it will

always be a 'work in progress', dealing with new challenges, as in developing countries. This point is illustrated by recent steps taken by the US SEC to deal with stock manipulation through tips spread via internet spam e-mails.

### **2.3 Dominance of rights issues**

Before reform, rights issues were the dominant method for making seasoned equity offerings (as SEOs) in the Chinese market. As stated in a report by Dow Jones Index,

“...84% of the market growth in the U.S. was the result of internal growth while only 16% was contributed by the issue of new stocks. China's market presents an entirely different scenario. While the total market value grew at an annual rate of 47.4% (from 1990 to 2002), three times faster than the U.S., only 16.9% was the result of internal growth... almost two thirds (64.4%) came from the issue of new stocks (23.8% from IPOs and 40.6% from SEOs)... ”

From 1991 to 2001, Chinese listed firms raised 193 billion RMB (24 billion US\$) from rights issues, accounting for 53.9% of all value from the stock market. While public offerings, which raised 48 billion RMB (6 billion US\$) from 2001 to 2004, started to play a bigger role, rights issues were still more than 70% by market value of seasoned equity offerings. Table 1 provides annual distribution of rights issues from 1994 to 2004.

**Table 1. Annual Distribution of non-financial A share rights issues**

Year	Total	SHSE	SZSE
1994	56	41	15
1995	78	38	40
1996	49	28	21
1997	102	60	42
1998	159	81	78
1999	113	61	52
2000	155	75	80
2001	127	73	54
2002	22	11	11
2003	25	14	11
2004	23	10	13
All	911	494	417

Of 911 rights issues in the Chinese stock market between 1994 and 2004, 494 were on the Shanghai Stock Exchange (SHSE) and 417 were on the Shenzhen Stock Exchange (SZSE). These issues took place before the share-trading reforms and the introduction of the new company law.

Data source: CSMAR

Normally, when a firm meets the requirements of the CSRC and plans a rights issue, it has to submit a proposal to the board of directors. Upon the approval from the board, the firm will inform the stock exchange within two days and hold a shareholder meeting within one week. After approval by shareholders, the firm will submit the application materials to the CSRC. Even after the CSRC authorizes the new equity issues, the firm has to wait in queue for the final issue. Timing of the offering depends on the market situation. When the market is booming, it is easier to issue new shares, but the delay can be large in a bear market. The CSRC has a great concern about the new issue's impact on the market. On average, the rights issue procedure lasts six months from the signing of the prospectus until receipt of the proceeds. The procedure for public offerings is almost the same as for rights issues except that the firm has to get a pre-approval from the CSRC and then hold the shareholders meeting to determine the specific details in the prospectus. This prior submission and approval by the CSRC may add a delay.

With regulatory changes issued by the CSRC from time to time, the behavior of listed firms changes accordingly. During the implementation of share-trading reforms, SEOs and IPOs were prohibited by the CSRC from 2005 until the re-opening of IPOs in June, 2006. Our data precedes that period; it will be interesting to see whether data in coming years reflect a continuation or elimination of the money grab.

### **3. Features of the Historical Money Grab**

Understanding the Chinese stock market and recent reforms requires some background. We have too little data after the reforms to have a clear picture of where the market is now, but we learn a lot from looking at the state of the market before the reforms. In this section, we look at the money grab from several perspectives. First, we show that dominant shareholders in firms with concentrated ownership tended not to exercise their rights, which is strong evidence they did not believe the money was going to be used profitably within the firm. Dominant shareholders who did exercise their rights tendered assets, which may have been a further money grab if valuations were inflated, or may have been an optimal response to a cash shortage. Also, we show evidence of earnings management, which is more pronounced when ownership is concentrated. Finally, concentrated management is more likely to deviate from the intended project announced when raising the money. Together, these results present a tapestry that helps us to understand the motivation for the recent reforms. Understanding the money grab allows investors to have an informed opinion of whether the reforms will be successful.

#### **3.1 Powerful controlling shareholders do not exercise their rights, and they tend not to take the new project.**

To understand why these empirical results are consistent with a money grab, let's consider the following simple example, leaving details to the appendix. Suppose there is a rights issue with a current stock price of \$45 per share<sup>1</sup>, and the new offering size available is 30 percent of the original shares. The strike price for the rights issue is \$40 and is paid in cash or in assets, the true worth of which is \$40. There is a positive-NPV project with a present value of \$1.5 per dollar investment. The share percent of controlling shareholder is 40%, and the controlling shareholder can grab a fixed amount \$25 from the liquidation of cash equivalents or other current assets from the firm. Moreover, the controlling shareholder can grab 40% from the new proceeds raised, and must leave 60% of the new proceeds in the firm. The fixed amount and marginal value that the controlling shareholder can grab is strongly affected by the regulatory enforcement and by the relative power of the other large shareholders. Based on the institutional environment in China, it

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<sup>1</sup> We suppose the firm value is the market value of the firm after share-trading reform

is the controlling shareholders who decide whether to implement the project or grab the proceeds and they have four possible choices (the formulas are in the appendix):

- I. Grab money but don't exercise the rights issue: the value of controlling shareholder will be the sum of the money grabbed and the shared benefit of the firm value after issue. In our example the total value for controlling shareholder is 36.12.
- II. Grab money and exercise using assets with a true value at \$40: the controlling shareholder gets from the money grab and the shared benefit of the firm value after issue, and extract the cost of tender which is \$4.8; the total value for controlling shareholder is 35.88.
- III. Implement the project but don't exercise the rights issue: the controlling shareholder gets the fixed amount \$25 from money grab and invests the whole proceeds to implement the new project. The firm value after the issue will be \$27.2; the value for controlling shareholder is 35.44.
- IV. Take the project and exercise the rights issue: the controlling shareholder gets \$25 from money grab and pays tender cost at \$4.8; the firm value after the issue is \$38 and the value for controlling shareholder is 35.40.

From the simple model above, we find the best choice of controlling shareholder will be not to tender during rights issue and grab money from the new proceeds. More powerful controlling shareholders, namely controlling shareholders with smaller fixed amount and variable amount of money grab in the model, will not tender during rights issue when the marginal value they grab is less than the fixed value of money grab. Moreover, only the net present value and the marginal amount of money grab will affect the firm's choice between implementing the project and grabbing money. In other words, only when the net present value of the new project is large enough or the limits on grabbing of proceeds is strict enough, will the controlling shareholder implement the project rather than grabbing money. In that sense, the share-trading reform that aimed to consolidate the firm value and market value can only reduce the no-exercise probability of controlling shareholder and won't help to reduce the money grab. Indeed our example always assumes a consolidation in value. What is needed is enforcement of restrictions on affiliate transactions to keep the proceeds in the firm; this will reduce the money grab.

If the controlling shareholder does choose to exercise rights, it is more attractive to tender assets than cash, provided it is possible to use assets whose valuation for the purpose of tendering is higher than their fair value.

To test the prediction of our model, we run logistic regressions with a dummy dependent variable indicating whether the controlling shareholder tenders during the rights issues. Our independent variables are inter-balance (a measure of dominance of the largest shareholder, as equal to the share percentage of 2<sup>nd</sup> and 3<sup>rd</sup> shareholders divided by the share percentage of 1<sup>st</sup> shareholder), firm size (total assets), market (traded in Shanghai Stock Exchange or Shenzhen Stock Exchange), and other control variables. Ownership structure and regression results are shown in Tables 2.a and 2.b.

From Table 2.a, among the 809 rights issues, there were 361 rights issues without exercise by controlling shareholders. The all-tender percentage was only 10.63% while there are 44.62% of the firms that partially tendered. It should be noticed that there was no tender at all after CSRC prohibited asset tenders in 2002.

Panel A of Table 2.b shows how ownership concentration affects the controlling shareholder's exercise choice, which is significantly positive for almost all the sample periods. It is a pity that we don't have details on the tender percentage of the partially exercising firms. Therefore, we divide the sample into two groups by two kinds of classifications. In panel A, we sort some tender firms as tender firm and there is significantly positive correlation between inter-balance and tender choice. In panel B, we include partially tendering firms in the no-tender group and the regression results are significant too. That means that higher concentrated ownership structure (reflected by low inter-balance indicator) will lead the controlling shareholder not to exercise their rights. The result remains when we control for other variables, e.g., firm size, market return, year, industry, cost of issue, strike price/book value per share, propose share change, etc. The result coincides with our expectation and supports the model: the more powerful the controlling shareholders, the smaller the probability they will exercise rights because they know the rights issue is a bad deal and the firm won't take the project.

**Table 2.a Summary statistics of controlling shareholders' exercise of rights**

Mainland Chinese stock market, 1994-2004	No-tender	Some Tender	All tender
Number of issues	361	362	86
Percentage (%)	44.62	44.75	10.63
Total Assets: million US\$	150.25	176.37	125.93
% of non-tradable share	63.26	63.72	59.37
% of the first shareholder	42.89	44.63	44.13
% of the first five shareholders	55.23	54.99	56.47
% of 2nd & 3rd/% of 1st shareholder	32.31	32.88	34.46
Issue cost, % of proceeds	3.99	3.03	3.40
Strike price, % of book value per share	237.55	225.31	153.43
Proposed share change, %	27.86	28.52	26.29

In our sample 10.63% of the controlling shareholders fully exercised in the rights issue, and 44.75% of them exercised partially. No controlling shareholders exercised rights after 2002 when the CSRC prohibited asset tenders. This is consistent with a money grab in which controlling shareholders understand that exercising the rights is a bad deal unless they can use artificially valued assets.

**Table 2.b Logistic regression on controlling shareholder's exercise of rights**

	Period 1994-2004	Period 1994-1999	Period 2000-2004
Panel A:			
Dependent variable: tender=1 when all tender or some tender, tender=0 when no-tender;			
Explanatory variable: Inter-balance=Log(% of 2 <sup>nd</sup> and 3 <sup>rd</sup> shareholders/% of 1 <sup>st</sup> shareholder)			
Estimate	0.17***	0.13**	0.23***
Number of Tender=0	361	144	217
Number of Tender=1	448	257	191
Panel B:			
Dependent variable: tender=1 when all tender, tender=0 when no-tender or some tender;			
Explanatory variable: Inter-balance= Log(% of 2 <sup>nd</sup> and 3 <sup>rd</sup> shareholders/% of 1 <sup>st</sup> shareholder)			
Estimate	0.13**	0.21***	-0.04
Number of Tender=0	723	332	391
Number of Tender=1	86	69	17

Consistent with money grab, controlling shareholders in highly concentrated firms usually refrained for exercising their rights. In panel A, the dependent variable is firms' tender choice, which equals 1 if the controlling shareholder fully tendered or partially tendered. In panel B, the dependent variable is firm's tender choice, which equals 1 only if the controlling shareholder fully tendered.

Independent variables in both regressions are inter-balance and the results are virtually unchanged when controlled by firm size, market, industry and year, cost of issue, strike price/book value per share, propose share change.

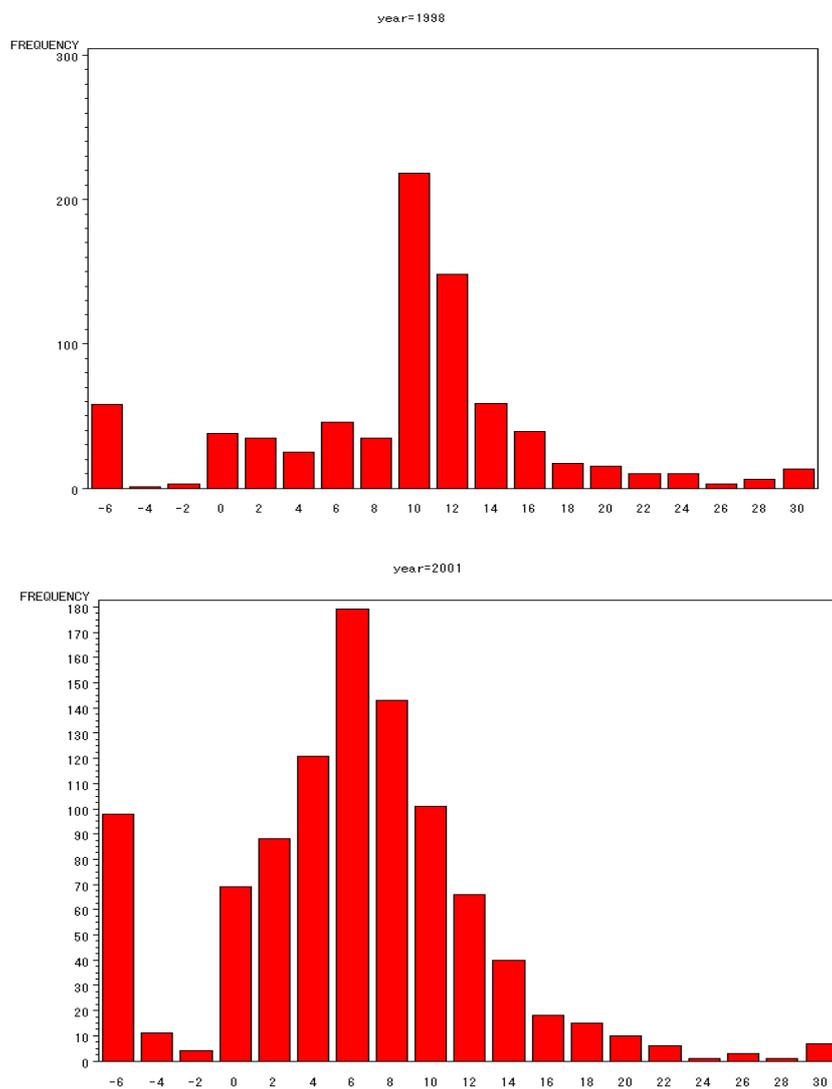
\* means significant at 10% level; \*\* means significant at 5% level; \*\*\* means significant at 1% level.

### **3.2 Earnings management: controlling shareholders in highly concentrated firms manage their earnings to reach the ROE threshold of rights issue for the motive of money grab.**

Interestingly, ROE performance of most Chinese listed firm's changes with the requirement of seasoned equities issues by CSRC. More specifically, the ROE performance is concentrated around the threshold for qualifying for rights issues, because ROE is the only "hard" requirements by CSRC to approve a new issue. This phenomenon can be regarded as the first step of a money grab, for listed firms have to reach the threshold in order to issue new equities. Our empirical results support this hypothesis.

The ROE requirements was 10% for past of 3 years before 1999 and 6% for past of 3 years from 2001, average 10% for past of 3 years during 1999 to 2001. We then define the critical ROE to be 10-11% before 1999, 6-7% and 10-11% from 1999 to 2001, and 6-7% after. Listed firms are classified as critical firms if their ROEs lie within the critical region; and as non-critical firms if their ROEs lie beyond the critical region. Moreover, critical firms are divided into high critical firm (H-critical) whose ROE is between 6-7% and low critical firm (L-critical) whose ROE is between 10-11%. Figure 1 shows the distribution of ROE for all the listed firms in our sample. There is an obvious shift of the distribution: concentrating around 10% before 1999; concentrating around 6% after 2001. This trend coincides with the regulatory changes on the rights issue. The simultaneous changes of ROE distribution and regulatory policies provide evidence that the ROEs are manipulated by listed firms. We also run the regressions with dependent variables as ROE, and dummy reflecting whether the firm is a critical firm and the results also supports our argument. (See Cao and Qiu, 2006).

**Figure 1. Distribution of ROE for Chinese listed firms**



The ROE distribution for all Chinese listed firms is centered on 10% in 1998, which is the same of ROE threshold of seasoned equity offerings by CSRC that year. In 2001, it switched to around 6% where the new rules on ROE required by CSRC that year.

### **3.3 Change the use of proceeds: controlling shareholders with highly concentrated ownership tend to change the use of proceeds after rights issue to finish a money grab.**

In the Chinese market, changing the use of proceeds often happens. In fact, after seasoned equity offerings, a large proportion of listed firms departs from the original projects and invests in other lines of business. Due to the data limits after 2000, we only collect 371 statements on rights issue from 1994 to 2000, in which about 30% were reported to fully change the use of proceeds; no matter how much more partial changes without announcement. This phenomenon makes people suspect that these listed firms “make up” the projects in order to please regulators and get approval for the new issue. We believe this consists for the final step of money grab: proceeds are first raised to listed firms, and then transferred to controlling shareholders.

We find that the firms who changed the use of proceeds were more concentrated in their ownership. It can be shown from the ownership comparison in table 3.a: the state shares, non-tradable shares and first-five shares are higher for changing firms, while the inter-balance indicator (percentage of 2<sup>nd</sup> & 3<sup>rd</sup> shareholders divided by percentage of 1<sup>st</sup> shareholder) appears in the opposite manner.

In order to explain this phenomenon further, we run a logistic regression on rights issues as shown in Table 3.b. The regression result shows that inter-balance indicator is significantly negative, which reflects ownership concentration has a positive effects on firms’ decision of whether to change the use of proceeds: the higher the firms are concentrated, which means that the more powerful the controlling shareholders, the higher the probability to change the use of proceeds after rights issue.

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**Table 3.a Ownership Characteristic of Changing Firms and Non-Changing Firms**

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	No-Change	Change
Rights Issue from 1994-2000		
Total asset: in million US\$	176.63	131.88
% of non-tradable shares	63.35	67.8
% of first shareholders	45.54	49.12
% of first five shareholders	57.19	61.1
% of 2nd & 3rd/1st shares	36	28
Number of issues	270	101

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From 1994 to 2000, there were 371 statements of rights issues available, among which 101 totally changed the use of proceeds after money was collected from the market. Firms that changed the use of proceeds generally had higher percentage of shares held by the first shareholder, as well as the first five shareholders, non-tradable shareholders and state shareholders.

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**Table 3.b Logistic Regression of Ownership Concentration on the Change of Proceeds**

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Rights Issue 94-00: Dependent Variable: change=1, no change=0

Variable	Inter-balance
Estimate	-0.48**
Number of issues	371
Number of changes	101

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Consistent with a money grab, controlling shareholders in highly concentrated firms tend not to use the proceeds for the originally stated purpose, and instead transfer some or all of the proceeds to the controlling shareholder transferred to controlling shareholders.

From 1994 to 2000, inter-balance significantly predicts the use of proceeds, which implies that relatively powerful 2<sup>nd</sup> and 3<sup>rd</sup> shareholders could reduce money grab.

\* means significant at 10% level; \*\* means significant at 5% level; \*\*\* means significant at 1% level.

#### **4. Conclusion and remaining challenges**

Investing in China's giant and largely untapped market represents tremendous potential for growth. Recent reforms have gone a long way towards protecting minority shareholders' rights, but the effectiveness of the reforms has not been tested yet. Also, as in developed countries, corporate regulation is a work in progress and will have to adapt to changing needs.

In this paper, we document the evidence of a money grab in the Chinese stock market before recent reforms. The money grab is the result of a particularly severe agency problem between controlling shareholders and minority shareholders. We investigate this problem from the perspective of corporate re-financing behavior, and find indirect evidence that controlling shareholders used listed subsidiaries to raise money that was transferred out of the subsidiary. This evidence points to a failure to protect the rights of minority shareholders.

This paper helps us to evaluate recent reforms of the Chinese stock market. These reforms aim to reduce the conflict of interest between non-tradable shareholders and tradable shareholders. It turns out our model gives only modest support to attempts to encourage managers to focus on market value. In particular, share-trading reform alone reduces but does not remove the incentive for a money grab: transferring assets from a subsidiary to the parent company looks beneficial to the parent whether valuation uses book or market value.

In developed economies, various mechanisms interact to protect minority shareholders. Important pieces include the legal system, regulation, enforcement, transparency, accounting, and mandatory disclosure. Without improvement of the institutional environment, the severe agency problem between controlling shareholders and minority shareholders will remain. Fortunately, the Chinese government has realized the severe problem and is making progress on all these fronts. In particular, the government issued a special regulatory rule in November 2006 to prohibit the money grab by controlling shareholders. Meanwhile, The Property Law of China was adopted by the National People's Congress in 2007 and will go into effect on October 1, 2007. The law covers the creation, transfer, and ownership of property and will start to protect property rights in law.

Aside from the ongoing challenges in corporate governance (which exist even in developed

economies), China also faces challenges in the security markets themselves. There are a lot of rumors of successful stock manipulation, and trading by holding companies in their own shares only increases this possibility. Another source of inefficiency in the market is that the press is still tightly controlled in China, and negative news may be suppressed or delayed. Other sources of inefficiency in the market are the inability to sell short, the suspension of trading after large price moves, and the share trading tax. Also, while having the share trading tax is bad enough, the recent increase in the share trading tax to cool the market suggests to investors that Chinese regulators have succumbed to the temptation to intervene too much in the market and cannot be trusted to maintain a stable regulatory environment. While the market and its supporting legal and regulatory institutions have come a long way in a short time, there remain many challenges ahead.

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## Appendix

### Money Grab Model

In our model, we assume the controlling shareholders' choice of exercise and money grab depends on the payoffs they get after rights issue, which can be divided into four parts: the fixed part of the money grab, the variable part of the money grab, the effect on the value of the controlling shareholders' shares, and the cost of exercise. Consistent with our empirical results, the model shows that controlling shareholders will always grab money and don't exercise their rights all the time. In particular, they do not exercise rights when the net present value of the new project is small and the marginal proceeds they can grab is small. Furthermore, our model shows that share trading reforms aimed at consolidation of market value and book value of the firm can't reduce the money grab directly.

#### 1. Shares and ownership:

$A$  : Fraction of shares owned initially by the largest shareholder, which is assumed to have control of the firm;  $1 - A$  is the fraction of shares owned by other shareholders.

$f$  : Fractional increase in the number of shares if all shareholders exercise their rights.

$a$  : Controlling shareholders' exercise indicator: equals 1 when controlling shareholder exercises and equals 0 otherwise; other shareholders are assumed to exercise their rights all the time.

Therefore, if controlling shareholders don't exercise their rights,  $a=0$ , then the fraction of controlling

shareholders after the rights issue will be  $S = \frac{A}{1 + f(1 - A)}$ ; otherwise, when  $a=1$ , the fraction of

controlling shareholders after the rights issue will remain the same at  $A$ .

#### 2. Money grab and valuation:

$P$  : Base firm value per share, absent any new issue, new investment or money grab;  $P - b$  is the strike price of the rights issue;  $V$  is value per share of cash or assets to tender by controlling shareholders,  $V \leq P - b$ . If the controlling shareholder can tender assets with a claimed value larger

than the true value,  $V < P - b$ , while if the controlling shareholder tenders cash,  $V = P - b$ .  $R$  is the proceeds raised from both controlling shareholders and other shareholders that  $R = (1 - A)(P - b)f + A \cdot V \cdot f \cdot a$  and the costs for controlling shareholders during the rights issue will be  $A \cdot f \cdot V \cdot a$

The money grab by controlling shareholders is  $F + mR$ , where  $F$  is the fixed part of the money grab out of existing assets, and  $mR$  is the variable part of the money grabbed out of proceeds  $R$  and  $(1 - m)R$  is the proceeds that must remain in the firm by controlling shareholders. In the model,  $F$  and  $m$  are exogenous constants. In practice, they will depend on the controlling shareholders' power. For example, if the second and third shareholders are large enough to constrain the controlling shareholder,  $F$  and  $m$  should be small.

In any case, the firm value after the rights issues will be  $P + NR - F$  when the firm takes the new project, or  $P + (1 - m)R - F$  when controlling shareholders money grab, where  $N$  is the present value of new project per dollar investment ( $N \geq 1$ ).

### 3. Payoffs of controlling shareholders:

Benefits	Exercise Rights	Not Exercise Rights
Money grab	$B_1 = F + mR + A(P + (1 - m)R - F) - AVf$	$B_2 = F + mR + S(P + (1 - m)R - F)$
Take project	$B_3 = F + A(P + NR - F) - AVf$	$B_4 = F + S(P + NR - F)$

This table shows the payoffs to the controlling shareholder as a function of the controlling shareholder's choices. For example, the upper left cell shows the payoff to the controlling shareholder of grabbing money and exercising the rights. The money grab yields  $F + mR$ ,  $A(P + (1 - m)R - F)$  is the value at the insiders' shares after the rights issue and money grab, and  $AVf$  is the cost of exercising.

#### 4. Economic comparisons:

(1): The choice of exercising by controlling shareholders

Simple algebra shows that:

$$B_2 - B_1 > 0 \Leftrightarrow m < 1 - \frac{P - F}{V - (P - b - V)(1 - A)f}$$

If the firm wants to grab money, controlling shareholder won't exercise their rights when the limit on grabbing of proceeds is strict enough.

(2) The choice of whether to take the project or grab money (exercise)

$$B_1 - B_3 > 0 \Leftrightarrow N < 1 - m + \frac{m}{A}$$

If the controlling shareholder doesn't exercise during rights issue, they will grab money instead of taking the project if the net present value of the new project is small. Also, if the regulation gets stricter and the marginal proceeds grabbed by controlling shareholder decreases, the probability of taking the project will increase.

(3) The choice of whether to take the project or grab money (no exercise):

$$B_2 - B_4 > 0 \Leftrightarrow N < \frac{1 + f - fA}{A} - \frac{(1 + f)(1 - A)(1 - m)}{A}$$

If the controlling shareholders tenders during the rights issue, they will grab money instead of take the project if net present value of the new project is small. Meanwhile, given a certain project, the attractiveness of taking project will increase when m decreases.

#### 5. Conclusions from the example

In all, when  $m < 1 - \frac{P - F}{V - (P - b - V)(1 - A)f}$  and  $N < 1 - m + \frac{m}{A}$ , B2 always dominates B1, B3

and B4. That means the controlling shareholder will always grab money and won't exercise their rights when the project is not profitable and the fraction of proceeds that can be grabbed is small. As showed in the numerical examples in the body of the paper (where  $A=40\%$ ,  $P=45$ ,  $P-b=40$ ,  $F=25$ ,  $m=60\%$ ,  $N=1.5$ ,  $f=30\%$ ), the controlling shareholder will grab money and don't exercise their rights during the rights issue, which coincides with practice in Chinese stock market.

Further, if we assume that the original firm value  $P$  is between the strike price  $P-b$  and the book value of the firm before share trading reforms, the condition for a money grab remains the same as  $N < 1 - m + \frac{m}{A}$ . This means that the share trading reforms aimed at consolidation of market value and book value only affect the choice of exercise by controlling shareholders and don't help in reducing money grab directly. Improved protection of minority shareholders, through new laws and better enforcement of existing laws, must be relied on to reduce the money grab and induce the firm to take positive NPV projects.